MERRILL
A BANK OF AMERICA COMPANY

CHIEF INVESTMENT OFFICE

Impactonomics®

Sustainable Investing: A focus on the "S" in ESG

March 2022

All data, projections and opinions are as of the date of this report and subject to change.

Momentum in sustainable investing continues to accelerate. A key factor in this growth stems from social progress at the policy level, coupled with an increased emphasis on the importance of an engaged and healthy workforce, elevating the once overlooked "S" in environmental, social governance (ESG). Social factors will likely become imperative for corporations if they are to create long-term value for shareholders and stakeholders. Government and private sector alignment on how to shift to a stakeholder-first approach is critical, and the apparent coalescing would serve as a tailwind to sustainable investing and potential attendant inflows. With this in mind, we look at the macro and micro pushes toward social progress with key takeaways for investors.

THE MACRO CASE

A key question and starting point is to ask whether or not social issues like economic freedom, structural inequalities, a healthy workforce, and diversity of thought from gender, race, and immigration can drive positive macroeconomic outcomes. In our view, the answer is yes. And others concur: A growing body of academic literature is reinforcing the long-established view that key social factors underpin the key inputs to economic growth.

More to the point, economic output is a function of the labor force, utilizing existing capital or resources, and innovation. Social progress (or a lack thereof) plays a pivotal role in all of these areas. Labor force strength is anchored by a healthy, well-educated, racial and gender diverse workforce. Diversity of thought, an anchor of U.S. dynamism, helps drive team performance, research and development intensity and innovation. The social indicators that are useful in evaluating sovereign bond ESG risk from a macro lens include, among others, data related to innovation, health, and people (including income inequality, female labor force participation and education, for example).

Measuring and monitoring Social indicators has never been as important as today, and hence the proliferation of ESG data analytics over the past few years. To wit, in October 2019, the World Bank launched a sovereign-level ESG data portal in response to demand for data from investors looking to "manage and assess ESG risk" related to these factors. Meanwhile, the Social Progress Index (SPI), published by the Social Progress Imperative, provides data on "quality of life factors" in over 148 nations, including data on access to basic education, healthcare and internet access. The list goes on: There's the Global Innovation Index (GII), the World Economic Forum's "Innovation Ecosystem" benchmark, the Sustainability Accounting Standards Board, and various metrics and studies from numerous consultancies

AUTHORED BY:

Chief Investment Office

Information as of February 25, 2022 and subject to change.

TWO OF THE FOUR CIO PILLARS OF SUSTAINABLE INVESTING

People

Commitment to engaged and healthy workers.

Prosperity

Contributions to equitable, innovative economic growth and sustainable communities.

The key macro point is this: There's more to life than "gross domestic product (GDP)"—or traditional measures of output. The investment community—along with corporations, governments and households—is finally coming around to realize this fundamental fact. A nation's output, to be sure, matters. But what also matters is how this output is derived and how it is distributed—equitably or inequitably? Sustainably or unsustainably? For the sake of shareholders or stakeholders? The same questions pertain to corporations, since the earnings outlook for many firms rests on the shoulders of potential GDP output. Over the long run, you can't have one (earnings) without the other (output).

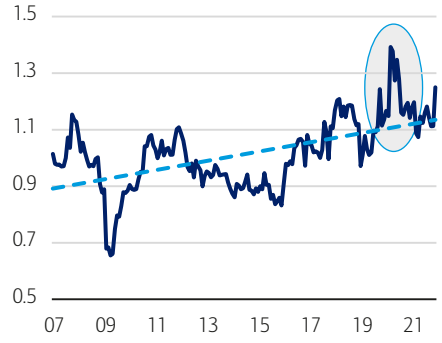
And broadening the lens, the total output of any nation is increasingly linked to female participation rates, family leave and child care initiatives, all non-traditional metrics of growth but growth metrics nonetheless. In the two years since the pandemic begun, many women have been forced to exit the labor force, pulling down the U.S.'s female labor force participation rate from an average of 58.9% in 2019 down to a low of 56.3% in April 2020, and rebounding gradually to 58.1% by January 2022.[1] Around the world, many women have left the labor force—global labor force participation for women dropped to 45.92% in 2020 from 47.76% 2019,[2] as unpaid care work (unpaid household services) has surged during the pandemic. With more than three-quarters of that burden falling on women, the cost is enormous: Globally, according to the United Nations, a two-hour increase in women's unpaid care work is correlated with a 10-percentage-point decrease in women's labor force participation.

With the U.S. workforce remaining in the spotlight, the Great Resignation—or Great Reshuffle—cannot be ignored. The department of labor reported record job openings last year, with 10.9 million jobs open as of December 2021.[3] Resignations propelled by care responsibilities or early retirement are coupled with those by workers reconfiguring their careers; seeking employers aligned to their values and roles that better suit and support their work-life needs. In the search for talent amid acute labor shortages the importance of a company's relationship with workers—think wages, benefits and flexibility, training and development—becomes ever more critical as the contract between employer and employee is being rewritten.

All of the above is another way of saying that investing increasingly pivots on the "S". We believe the potential for above-average returns lie with countries and companies that are actively working to improve access to quality healthcare and services, emphasizing greater diversity and inclusion, and that are abundantly aware of their social footprint in their communities. On a macro level, we believe the data is becoming clearer and more transparent.

Exhibit 1: The Pandemic saw S-Factors Rerate.

Relative forward price-to-earnings ratio of companies in top vs. bottom quintile by MSCI ESG score, 1/2007-12/2021



Source: MSCI, FactSet, BofA US Global Research as of December 2021.

The Micro Case: Private sector meets Public sector

Just as we need to leverage Social indicators to gauge macroeconomic activity, we also need to measure the success of execution at the company level. Companies that look to treat people as assets to invest in represent long-term investment opportunities—and the last two years highlighted how social aspects could materialize in financial performance.

One critical example of where this plays out is the health of a workforce (paid sick leave policies, etc.). How companies treat their workers and how that, in turn, benefits society matters—and investors are paying attention. BofA Global Research noted that companies in the S&P 500 that score in the top quintile of "S" factors re-rated on a relative forward price-to-earnings basis as the pandemic took hold (see Exhibit). While, JUST Capital observed significant alpha correlated to superior workforce treatment—the

[1] U.S. Bureau of Labor Statistics, women 20 years and older, monthly data as of January 2022.

[2] The World Bank. Labor force participation rate, female (% of female population ages 15+). Latest available data as of year-end 2020. Sourced February 22, 2022.

[3] U.S. Bureau of Labor Statistics, the Job Openings and Labor Turnover Survey (JOLTS) monthly data as of January 2022.

top quintile of companies with the highest workers' score outperformed the Russell 1000 by 5% for a period of one trailing year.[4]

The pandemic prompted companies and investors to put greater emphasis on how absenteeism, and poor access to paid leave and healthcare, may negatively affect the health and productivity of a workforce. A number of global brands are taking action towards ensuring living wages for workers throughout their supply chains—and calling on others to do the same.[5] Others offered many employees payment incentives to get the coronavirus vaccination. These plans hinge on the belief that a reliable and healthy workforce helps productivity and profits, and ultimately has the potential to decrease volatility.

The pandemic has helped to demonstrate the urgency of transforming the workplace to be more diverse, equitable and inclusive, and those that lean away from workplace inclusion may be disadvantaging themselves for the future. Diverse teams have the potential to generate a competitive edge through increased consumer insight such as anticipating customer needs and consumption patterns, generating new products and services, and positioning for future growth and talent acquisition.[6] In 2021, the Security and Exchange Commission (SEC) approved the Nasdaq Board Diversity rules requiring Nasdaq-listed companies to disclose board composition demographics and for most to have a minimum of two self-identified diverse directors by 2023.[7] Other organizations are following suit as the path to achieving diversity goals, and the recognition of the value creation and operational risk mitigation a diverse workforce can bring, are increasingly being recognized.[8]

The hallmark for a more inclusive capitalism is transparency, and when it comes to supply chains and product safety, it's no longer a choice. ESG disclosures increasingly tend to require companies to disclose their supply chain practices; these include environmental responsibility, human rights, labor practices, and ethics and corruption. The pandemic has helped to amplify the importance of resilient, sustainable and ethical supply chains, and companies that fail to provide adequate oversight and management could face regulatory scrutiny, not to mention economic losses and reputational risk.

It's worth noting that the way a company manages ESG factors of a material nature is likely to have a greater influence over its performance than how it addresses non-material ones, and may be more important to investors.[9] Companies that embrace sustainable business practices on material issues had demonstrated the ability to increase revenue and decrease costs, including the cost of capital relative to peers.[10] As ESG analysis becomes entrenched in the investment world, this may affect both capital allocation decisions and financial performance.

As discussed, the pandemic has both intensified and highlighted a range of issues associated with Social factors affecting economic growth and corporate earnings. The pandemic has also brought forward public sector initiatives that could ultimately affect growth and returns over the long run.

Prioritization of policy relating to ESG initiatives is critical, but equally as important is support from corporations and standard-setting institutions, which we expect to only gather more momentum in the future.

[4] JUST Capital: Companies that Prioritize Workforce Investment and Training Outperform. March 3, 2021.

[5] Sustainablebrands.com, 10 Global Companies Take Action Towards Living Wages. April 2021.

[6] McKinsey: *Diversity Wins: How Inclusion Matters*, May 19, 2020 / Hewlett, Marshall, Sherbin: "*How diversity can drive innovation.*" Harvard Business Review, December 2013. Grant, Rock: "*Why diverse teams are smarter.*" Harvard Business Review, November 4, 2016.

[7] Nasdaq Listing Center, February, 2022.

[8] V-Squared Asset Management, ESG Trends to Watch 2022 – SI Reimagined, February 2022.

[9] Khan, Serafeim, Yoon: Harvard University: *Corporate Sustainability: First Evidence of Materiality*, February 1, 2017.

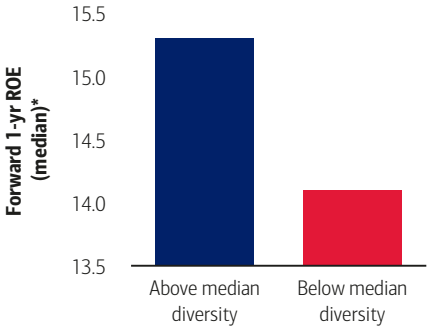
[10] Khan, Serafeim, Yoon: Harvard University: *Corporate Sustainability: First Evidence of Materiality*, February 1, 2017.

"There's **no business without employees**. But the power that those employees wield has never been greater—when asked to rank which group was more important to a company's long-term success, **employees topped the list** over customers, communities a business serves, and its shareholders."

Source: IBM Institute for Business Value, "*Sustainability at a turning point*", as of May 2021.

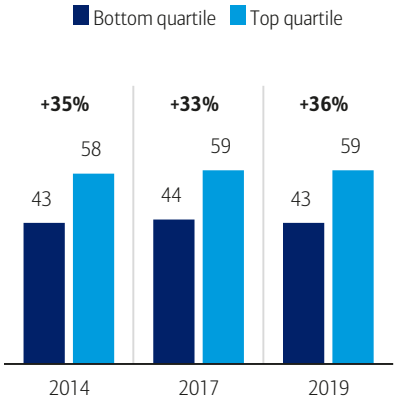
Exhibit 2: Diversity of all Kinds Contributes to Corporate Success.

Higher ethnic & racial diversity correlates with higher return on equity[11]



* Median forward one-year return on equity (ROE) based on the percentage of people of color in the workforce for S&P 500 companies (2008-2020).

And the outperformance is consistent[12]



Past performance is no guarantee of future results.

[11] BofA Global Research, Everybody Counts! Diversity & inclusion Primer, March 2021.

[12] McKinsey, Diversity Wins: How Inclusion Matters, May 2020.

INVESTMENT IMPLICATIONS

In the end, ESG factors provide investors with an additional dimension to help identify market risks and potential opportunities, and we believe portfolio strategies in the coming years would allocate more capital to assets backed or underpinned by high-sustainability initiatives. Structural dynamics like rising political pressure and regulatory change are additional planks to sustainable investing and capital reallocation. Doing well and doing good have become strategic priorities of many firms and the asset managers that invest in them. Companies that are most transparent about their goals, and are better at execution, may reward investors. For example, full-year 2021 returns for the MSCI World ESG Leaders Index gained 25.3%, while the MSCI All Country World Index (ACWI) returned 19.0%, and we also saw the index outperform during a volatile 2020—performance that suggests an ESG leader aggregate is positioned defensively relative to its conventional peer.[13]

Investor demographics is also supportive of ESG flows, with Millennial and Gen Z investors more meaningfully aware and attuned to stakeholder capitalism versus shareholder. Per this generational cohort, a BlackRock[14] survey found that investors planned to almost double their sustainable assets under management from 18% to an average of 35% by 2025. As a result of the accelerated adoption of ESG factors into the investment process seen in 2021 ($69.2 billion poured into U.S. sustainable investment funds),[15] we expect growing demand for sustainable solutions and strategies, which in our view, may offer a competitive risk-adjusted return profile within a traditional asset allocation framework.

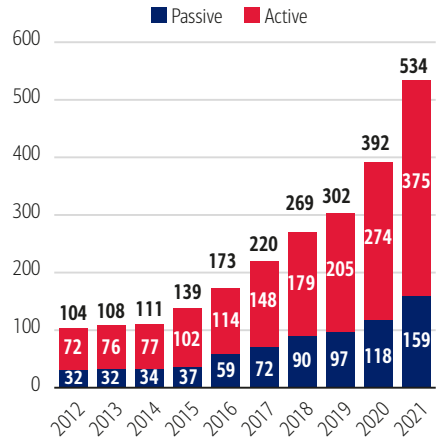
With the help of governments, corporations and other groups, a combined $859 billion was raised last year selling green, social and sustainability bonds according to Reuters. April 2020 marked the first month social and sustainability bond issuance surpassed green bond issuance showing a shift in attention to the social bond market. Moody's expects sustainable-debt issuance to reach $1.35 billion this year—a more-than-60% increase from 2021. The U.S. market is easily dwarfed by the funds, flows and initiatives of the European market, reflective of the unrelenting regulatory and political forces in Europe. But we expect U.S. flows to gather momentum in the future.[16]

The European Union (EU) continues to lead from the front. Notable updates include the EU Platform of Sustainable Finance's plans to release a Social Taxonomy, to be compatible with its existing green taxonomy. It will focus on areas such as the quality of work, adequate living standards and wellbeing for end users, and inclusive and sustainable communities and societies, demonstrating the intent to have a social plan that will work in partnership with its environmentally focused counterpart.

In a post-coronavirus world, ESG considerations, with social issues chief among them, will likely remain a top priority for many companies and countries, with employee health (safety precautions, medical benefits, paid leave), along with diversity and inclusivity commitments commanding investor focus. The flows associated with capital oriented toward the United Nations Division for Sustainable Development Goals (SDG) should create challenges for lagging companies and countries, but possible opportunities for leaders.

We expect the societal trends and imperatives for corporations that have served as tailwinds in the last two years to sustainable investments to further the momentum for quality ESG disclosure more broadly. Data challenges do persist—with analytics a key hurdle when considering broader implementation of sustainable investing. Help from the

Exhibit 3: U.S. Sustainable Fund Universe: A Fivefold Increase in the Past Decade.[14]



Passive Management is an investing strategy that tracks a market-weighted index or portfolio.
Active Managementseeks to outperform benchmarks through active investment decisions such as asset allocation and investment selection.
Source: Morningstar Direct as of 2021. **Past performance is no guarantee of future results.**

[13] Bloomberg. Data as of Jan. 3, 2022.

[14] BlackRock, Sustainability goes mainstream, September 2020.

[15] Morningstar Sustainable Funds U.S. Landscape Report. Funds. Jan 31, 2022.

[16] Responsible Investor: EU Advisors shake up social taxonomy proposal to better align with green counterpart. Feb 21, 2022.

recent consolidation of ESG standards including financial accounting and sustainability disclosure is a strong signal of meaningful change in reporting.

The bottom line: Output and profits matter to investors. That's neither new nor about to change. What is new and changing is that other metrics have been gaining in importance in determining returns, flows, asset allocation decisions and the like. Now and in the future, many countries and companies may be increasingly judged on a series of ESG metrics.

Reflecting this point, money flows into U.S. sustainable funds and accounts totaled $357 billion at the end of 2021.[17] That's a big number and more than 4 times the total three years ago. However, that represents only a small portion of the ~$51 trillion in U.S. assets under management, which portends more upside in the future.[18] Globally, meanwhile, sustainable fund assets under management topped $2.74 trillion in 2021[19] and are expected to continue expanding in Europe, Japan and many emerging markets over the course of this decade.

In terms of asset allocation, sustainable investing crosses various asset classes, with the expansion of strategies that integrate ESG metrics into core operations and activities. The goal is to support positive financial returns and positive effects for the environment and the community at large. The use of ESG metrics is just one component of the overarching investment process of elevating and managing risk portfolios, and positioning investments for future potential above-average returns.

Sustainable investing has arrived and has ample room to grow at home and abroad.

[17] Morningstar Sustainable Funds U.S. Landscape Report. Jan 31, 2022.

[18] "The 100 Most Sustainable Companies", *Barron's*, February 15, 2021.

[19] Morningstar Global Sustainable Fun Flows: Q4 2021 in Review. Jan 31, 2022.

Index definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in dollars.

MSCI World ESG Leaders Index are free float-adjusted market capitalization weighted indexes designed to represent the performance of companies that have high Environmental, Social and Governance (ESG) ratings relative to their sector peers, to ensure the inclusion of the best-in-class companies from an ESG perspective.

MSCI All Country World Index (ACWI) is a stock index designed to track broad global equity-market performance. Maintained by Morgan Stanley Capital International (MSCI), the index is comprised of the stocks of about 3,000 companies from 23 developed countries and 26 emerging markets.

Social Progress Index (SPI) is a framework for measuring the various dimensions of human well-being, from basic human needs to advanced education.

Global Innovation Index (GII) is an annual ranking of countries by their capacity for, and success in, innovation.

Important Disclosures

Investing involves risk, including the possible loss of principal. Past performance is no guarantee of future results.

This material does not take into account a client's particular investment objectives, financial situations, or needs and is not intended as a recommendation, offer, or solicitation for the purchase or sale of any security or investment strategy. Merrill offers a broad range of brokerage, investment advisory (including financial planning) and other services. There are important differences between brokerage and investment advisory services, including the type of advice and assistance provided, the fees charged, and the rights and obligations of the parties. It is important to understand the differences, particularly when determining which service or services to select. For more information about these services and their differences, speak with your Merrill financial advisor.

Bank of America, Merrill, their affiliates, and advisors do not provide legal, tax, or accounting advice. Clients should consult their legal and/or tax advisors before making any financial decisions.

The Chief Investment Office (CIO) provides thought leadership on wealth management, investment strategy and global markets; portfolio management solutions; due diligence; and solutions oversight and data analytics. CIO viewpoints are developed for Bank of America Private Bank, a division of Bank of America, N.A., ("Bank of America") and Merrill Lynch, Pierce, Fenner & Smith Incorporated ("MLPF&S" or "Merrill"), a registered broker-dealer, registered investment adviser and a wholly owned subsidiary of Bank of America Corporation ("BofA Corp."). This information should not be construed as investment advice and is subject to change. It is provided for informational purposes only and is not intended to be either a specific offer by Bank of America, Merrill or any affiliate to sell or provide, or a specific invitation for a consumer to apply for, any particular retail financial product or service that may be available.

All recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors.

Asset allocation does not ensure a profit or protect against loss in declining markets.

Sustainable and Impact Investing and/or Environmental, Social and Governance (ESG) managers may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviating.

Investments have varying degrees of risk. Some of the risks involved with equity securities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. Investing directly in Master Limited Partnerships, foreign equities, commodities or other investment strategies discussed in this document, may not be available to, or appropriate for, clients who receive this document. However, these investments may exist as part of an underlying investment strategy within exchange-traded funds and mutual funds.