12 December 2022, 9:11PM UTC
Chief Investment Office GWM
Investment Research

Sustainable Investing Perspectives: The Year Ahead

Sustainable investing

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- In the "year of inflections" we expect turning points for key macroeconomic variables, which should provide a more supportive backdrop for risk assets in the later part of the year.
- We ask three key topics for sustainable investing in 2023: central bank action, regulatory trends, and two short term risks to sustainable objectives.
- In this report we look at how sustainability-focused investors can take advantage of our investment ideas for 2023, while staying invested for the decade ahead.

Key questions for 2023 in sustainable investing

- Will central bank action on rates influence investment in sustainability solutions?
- (Geo)politics and regulation: How might regulatory action evolve?
- What might derail investor and corporate focus on sustainability?

Investing sustainably in 2023

- Add defensives and value
- Seek income opportunities
- Shelter in safe-have currencies
- Seek uncorrelated alternative investment strategies

Investing in the decade ahead

- Sustainability over the longer term
- Thematic and private market exposures

Contributing author: Sebastian van Winkel

Following the year of infections, the year of injections (monetary, fiscal, and medical), and the year of inflation, the 2020–2022 period will now be followed by what we're calling the "year of inflections". We expect turning points for key macroeconomic variables—inflation, interest rates, and GDP growth—which will eventually provide a more supportive backdrop for risk assets as the year evolves.

What does this mean for sustainable investing? And how can investors position in 2023 to address opportunities stemming from secular trends such as the transition to a low-carbon economy and a more equitable future?

In 2023, we see pockets of opportunities for sustainable investing strategies. Investors should identify sustainability exposures alongside our global investment views for 2023, being mindful of portfolio diversification to advance investment and sustainability objectives. We believe that investing sustainably will provide compelling opportunities for the decade ahead, offering strong performance on an absolute and relative basis.

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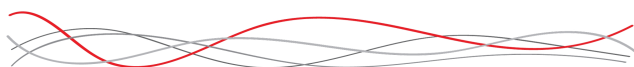


Key sustainable investing questions for 2023

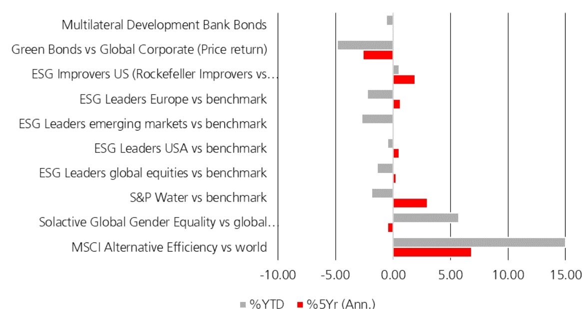
Will central bank action on rates influence investment in sustainability solutions?

Higher interest rate expectations as central banks around the world entered rate hike cycles were a key contributor to weak market performance in 2022. Sustainable investing strategies followed 'conventional' strategies with relatively weak performance over the year, with some sustainable themes and more growth-oriented ESG leader strategies in particular underperforming broad equity benchmarks. The picture was not uniform, however. We saw differentiation with some thematic strategies and the ESG improver strategy outperforming their benchmarks (Fig. 1).

At the time of writing, we think that year-over-year rates of inflation have topped out in the US and are likely to top out in the EU soon. In our base case, we expect that by the end of 2023 y-o-y rate of inflation will be close enough to central bank targets for policymakers to refocus their attention on economic growth. There is a downside risk that inflation fails to fall back to target, and an upside scenario that easing supply chains and a balanced US labor market allows central banks to cut rates sooner.

Fig. 1: A diversified sustainable investment approach has supported long-term returns

Annualized returns of select SI vs conventional indexes



Bloomberg, ICE, UBS, as of December 2022.

Green bonds refer to BofA Green Bonds index. All other indices are to MSCI unless otherwise specified.

A risk of a high-rate environment is that it might stifle additional corporate investment in areas that advance sustainability objectives. **Despite market headwinds to further corporate investment, we believe that capital expenditure will continue in key areas** such as energy efficiency and green infrastructure, thus benefiting pockets of the market that are exposed to this longer-term resilient spending. The Inflation Reduction Act in the US and the RePowerEU program in the EU further support this thesis, with USD 369bn and EUR 300bn investment respectively keeping momentum up on scaling solutions to climate challenges and energy independence. In the meantime, key investments continue to be made in more socially focused areas such as healthcare and food security.

(Geo)politics and regulation: How might regulatory action evolve?

We are monitoring how geopolitical developments may impact markets. The broad issues like the development of the Russia-Ukraine war, tensions between China and the US, economic policy in China, etc., have implications on sustainable investing portfolios just like they do for conventional portfolios. However, specific to sustainability, we are watching two additional sets of developments around the world: ESG-related regulation and policy commitment to sustainability.

2022 was eventful on ESG regulation, **and 2023 is likely to see further attention from regulators on both corporate and investment advisor transparency on sustainability**. Notably, the EU Sustainable Finance Disclosure Regulation reporting requirements kicked in fully, the US SEC published draft rules on corporate climate disclosure and fund labeling, the UK published its own sustainable disclosure proposal, Switzerland introduced more climate-related transparency requirements for investments, China's financial regulator introduced guidelines specifying green finance and ESG related requirements for the financial sector, and the Monetary Authority of Singapore strengthened its requirements on considering environmental risks across investment decisions.

We expect the regulatory momentum globally to continue into 2023. Some jurisdictions will likely provide more clarity on existing guidance, move toward approval of proposals, and likely develop more granular requirements which impact companies and investors alike. A focus on corporate disclosure requirements is likely to continue as well into next year, as more stock exchanges make ESG disclosures compulsory.

Recommendations such as those by the Task Force on Climate-related Financial Disclosures (TCFD) are moving toward mandatory transparency requirements. Over the longer-term guidance from regulators on both the investment and the corporate disclosure should be positive. In the near term, however, we expect continued differences in what is considered "sustainable" by various stakeholders across different regions. Therefore, investors should continue to be diligent in their selection of investments; we recommend moving beyond labels and assessing whether an investment strategy's process and

objectives match asset owners' own expectations with regard to sustainability.

Beyond explicit "ESG" regulation, we expect that **governments will continue support of sustainability objectives ranging from social issues to climate and biodiversity**. The COP27 climate meeting this year resulted in few breakthroughs but did open up the door to a thawing of US-China relations on climate, which may be positive in the year ahead as the world's two largest economies—and largest emitters of CO_2 emissions—further focus on the energy transition and climate mitigation.

In the near term, it is likely that policymakers will take a 'portfolio approach' by diversifying across sources like natural gas and nuclear power, and continuing to invest to expand renewable energy capacity. The COVID-19 pandemic also put a spotlight on issues such as access to health services and quality healthcare more broadly, while the Russia-Ukraine war put a strain on food supply chains, including in Europe and the Middle East. Policy support, as well as private capital will continue to focus on tackling these challenges, in our view.

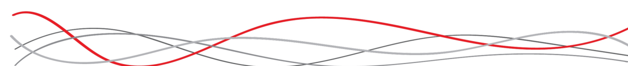
What might derail investor and corporate focus on sustainability?

We believe that social and environmental topics will continue to stay in focus for investors and companies, driven largely by consumer/voter behavior and regulatory action. We expect to see continued investment in opportunities tied to people and planet driven by a financial profitability thesis, independent of interest in advancing sustainability objectives.

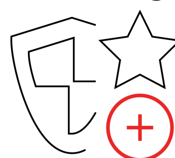
In 2023, we will monitor the following short-term risks to the acceleration of sustainability objectives:

Focus on energy reliability slowing down the Net Zero transition. As discussed above, in our view corporate and government spending will continue in areas like energy source diversification, energy efficiency, and electrification. In addition, we see new opportunities emerge in tangential areas, like investment in the circular economy - for example plastics alternatives, resale models or waste management. In a downside risk scenario where growth fails to re-accelerate and energy shortages continue, focus could turn to meeting short term energy needs including further use of fossil fuels, including coal.

Continued focus on climate limits investor attention and capital on other environmental, social and governance topics. Climate and associated investments have dominated headlines and capital commitments this year, and emissions reduction and climate resilience are likely to remain a priority next year, continuing to attract investment and spur innovation. Yet, even as attention on decarbonization opportunities continues, opportunities will emerge in other areas as well. Social issues, from a focus on diversity and inclusion policies to continued investment in healthcare-related areas are likely to benefit, in particular to the extent that they bring diversification benefits to portfolios. Further attention to food security is likely to also continue, and we expect conversation to accelerate on topics such as biodiversity conservation (although we don't see it as an area that is directly investable for private investors).



Investing sustainably in 2023



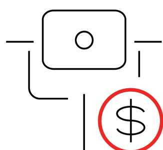
Add defensives and value

CIO expects the healthcare and consumer staples sectors to continue to outperform in the months ahead as economic growth decelerates. Sustainable investments tend to have a high structural allocation to both health and food-related investments, which will continue to support risk-adjusted financial performance in 2023. In our view, these allocations also help diversify broader sustainable investing exposures to balance out potential overallocation to themes such as climate-related technologies.

We also think that value stocks will continue to outperform growth. Inflation above 3% in the US has historically favored value stocks relative to growth, and we only expect inflation to fall below 3% toward the end of 2023. CIO continues to like the energy sector, which has been the best performing global equity sector year to date through October. Its valuation is at a meaningful discount to the MSCI ACWI and if oil prices trend higher for longer, as we expect, energy stocks still look like an attractive investment. However, we continue to see outright exposure to traditional energy without a transition lens being challenging for those investors focused on sustainability A structural underweight to any energy exposure could affect relative financial performance in the near term.

We do believe that investing in energy is not necessarily inconsistent with sustainability objectives as long as there is a clear rationale and approach to support the thesis, for example focusing on investments that have been assessed as advancing the just and timely transition to a low-carbon economy. In particular, investors can get exposure to traditional energy through ESG improvers and

ESG engagement strategies, as well as select ESG leaders within the sector. In our view, the focus should continue to be on companies' commitment and delivery against decarbonization targets.

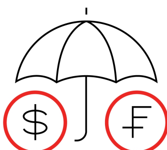


Seek income opportunities
Yields have risen significantly over the past year, broadening the opportunity set for investors focused on income.

Within fixed income, CIO likes investment grade bonds, and given slowing growth, we focus on more "resilient" issuers. Green, social, sustainable and sustainability-linked bonds can help build resilience in portfolios, particularly across high- and investment-grade issuers. Within this category, we see opportunity particularly in sustainable bonds with shorter tenors and somewhat higher credit risk than benchmark indexes.

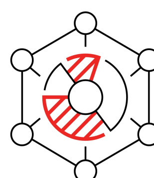
Within riskier credits, CIO finds that for now the immediate outlook for high yield credit is unattractive, which applies to sustainability-focused high yield strategies as well. However, for more risk-tolerant investors with an interest in sustainability we see targeted bondholder engagement in high-yield bonds as still instrumental in supporting material environmental and social improvements within issuers in this part of the credit spectrum.

In equities, we like "quality income," i.e. companies with a high return-on-equity, low earnings variability, and a low debt-to-equity, alongside attractive income metrics. These companies can often be found in ESG leader equities strategies, in particular, as good governance and superior diversity metrics tend to correlate with quality. While exposure to quality income through the ESG leader strategy is possible, being selective with implementation is important as ESG leader strategies also correlate with the growth factor.



Shelter in safe havens
In fixed income, CIO likes high quality bonds, particularly with the move higher in rates creating a more attractive entry point. These bonds can rally in times of slowing economic growth. As mentioned above, within sustainable investments, we recommend tilting toward better sustainability characteristics, or focusing on thematic sustainable investments benefiting from long-term secular trends.

While outright currency strategies do not carry explicit sustainability purpose, in our view, we note that currency exposures are essential to achieving risk and return objectives. Therefore, even for investors who seek to allocate most of their portfolios in sustainable investing strategies, traditional currency strategies have an important role in the portfolio, as we discuss in the *Year Ahead 2023* report. This is particularly relevant when investing in or lending to companies that operate in emerging and frontier markets.



Uncorrelated alternative investment strategies.
Putting capital to work in private markets in the years after a market downturn has historically proven to be a rewarding strategy over the long term. Within private equity, investments in climate technologies and breakthrough healthcare solutions, such as medical devices and genetic therapies, could offer opportunities to investors to drive incremental and measurable positive impact – or what we refer to as "impact investing".

In addition, sustainable infrastructure, such renewables, energy storage and smart mobility, will continue to be instrumental in advancing sustainability objectives. In our view, select impact private market investments in 2023 and beyond can help drive sustainability objectives while offering the opportunity for competitive financial returns in the long-term.

As inflation and monetary policy concerns persist, hedge fund strategies relatively uncorrelated to those drivers look well placed for 2023. The extent to which sustainability risks or opportunities have been incorporated by most hedge funds remains relatively limited, but we believe this is changing as managers see the potential to capture alpha opportunities related to sustainability themes or risks that are not yet priced in for specific sectors or companies. The chance to play these situations from a long and short perspective adds potential sources of return and the expression of a sustainability thesis in both directions. Sustainability-focused hedge funds also offer the opportunity for exposure to niche areas like carbon credits which are more difficult to access through long only investments.

Investing in the future: Decade ahead

We continue to see the 2020s as the "Decade of Transformation", As we discuss in our CIO *Year Ahead 2023* publication, the decade has already brought significant changes in the global economic, political, societal, and environmental landscape. Having said that, we think a more positive secular backdrop remains possible.

Invest sustainably

In particular, investing sustainably will continue to be a key opportunity for the remainder of the decade, in our view. Companies that manage their business, stakeholders, and environmental impact sustainably should also be in a position to deliver sustainable financial results. The need for solutions to pressing environmental and social challenges, as well as the need to address sustainability-related risks and opportunities across companies and sectors, will benefit key themes such as green, health and education technologies, the establishment of a circular economy, and development of vital sustainable infrastructure.

Given that sustainable investing is not a single asset class, but an investment strategy across a variety of exposures, we continue to advocate for a diversified approach to sustainable investments across sectors, styles, and asset classes. In our view, this approach would benefit investments across the market cycle.

Position for the era of security, and seek value and growth in private markets

Naturally, our other decade-long investment recommendations are inherently linked to sustainability drivers.
CIO notes that an era of security, in which energy security, food security, and technological security will be increasingly prioritized by governments and businesses, even if they come at the cost of efficiency.

We discuss that Russia's invasion of Ukraine, and subsequent disruptions to European energy supplies is likely to accelerate those plans—as much on security grounds as on environmental ones. In addition, the food price shocks stemming from supply disruptions related to COVID-19, climate change, and the war are driving food security considerations. These drivers will benefit investments across the spectrum of greentech—such as renewables, clean air and carbon reduction solutions, smart mobility—as well as food- and agtech—including improving digitization, agricultural yield and supply chains. The circular economy, which encompasses a variety of environmental and social solutions will also see an acceleration in this decade, in our view.

As discussed above, we see opportunity in private markets for investors who can accept illiquidity and/or want to drive intentional positive change with their capital. We see opportunity both in the short term, and in the decade ahead. Thematic impact investing opportunities may provide a way for investors to diversify portfolios, enhance risk-adjusted returns, and drive measurable positive change.

Appendix

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