CIO Office

Sustainability Insights

Adding value to your investments with ESG and climate metrics

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- As the world is changing at a swift pace because of emerging opportunities, thanks to technological innovation, and due to pressing challenges linked to the changing climate patterns, rapid loss of biodiversity and rising global population, sustainable and ESG investing has evolved from a niche investment topic to a mainstream approach. Over one-third of global assets under management, equivalent to $35 trillion, are now sustainable.

- Despite the rising adoption, sustainable investing remains a wide topic, including various investment strategies. The underlying common principle, however, is to encompass environmental, social and governance (ESG) considerations into the investment analysis, alongside the more conventional financial metrics, in order to enrich the decision-making process and evaluate risks and opportunities beyond the traditional financial analysis.

- While ESG scores are increasingly informing portfolio flow decisions, there remain challenges in the data quality and transparency of corporate reporting. Amid emerging sustainability-related corporate disclosure standards, ESG-related information should improve and potentially even become standardised.

- While we caution that ESG and sustainability cannot be minimised into one quantitative score, we believe that using ESG scores and other metrics, such as the carbon intensity of a portfolio, can help to assess the risk and opportunity exposure to the sustainability revolution that will unfold over the coming decades, and thus may impact the financial performance of an investment.

- Our Sustainable Investment Framework ranges across asset classes and investment solutions in order to help investors build diversified portfolios, which is the core of our investment strategy. We believe that the first step in an ESG-enriched investment journey is to define the personal preferences to sustainable investing: Understanding whether and what ESG and sustainability considerations are of importance will then inform the decisions of the most appropriate investment strategy and ESG metrics to be used.

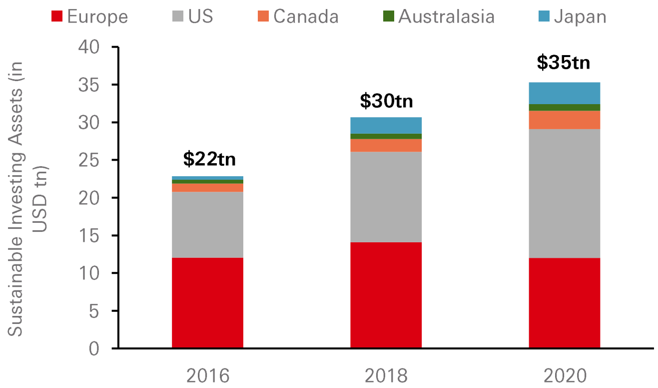
- Beyond incorporating ESG into the wider investment process, we see thematic high conviction investment opportunities around the energy transition to a low-carbon world, the upgrading of the healthcare sector to address social challenges and the preservation of biodiversity, which we outline in our top trend, "Investing in a Sustainable Future".

The rise of ESG to a mainstream approach

Sustainable investing is no longer a niche, gathering broad-based awareness in the financial industry. Evolving regulatory frameworks, shifting investor needs and changing priorities among institutions have driven the pick-up in momentum in the sustainable investment space. Indeed, the latest available data by the Global Sustainable Investment Alliance shows that sustainable investments now account for over one-third of all global assets under management, equivalent to $35 trillion. With expectations that this will rise beyond $50 trillion by 2025, according to Bloomberg Intelligence, it becomes evident that sustainability is a significant yet still rising force shaping global investment flows and portfolios.

Despite the rising adoption and awareness, sustainable investing remains a wide topic, including various investment strategies, such as ESG integration, exclusion, best-in-class, thematic and impact, to name a few. The underlying common principle is that sustainable investing encompasses environmental, social and governance (ESG) considerations in the investment analysis alongside more conventional financial metrics. The aim is to evaluate risks and opportunities beyond the traditional financial analysis, which might inform investors about a company's vulnerability to potential negative impacts stemming from extreme weather, poor product quality or lack of labour safety standards, as well as to the opportunities arising from efficient resource use, strong supply chain connections or diverse workforce.

Despite the rapid rise of sustainable investing, the ESG investment space still remains in transition



Source: Global Sustainable Investment Alliance, HSBC Global Private Banking and Wealth, 19 September 2023

With ESG being increasingly incorporated into the investment decision process, the corporate world has also advanced in integrating ESG considerations into their business strategies and disclosures. Over the past decade, a growing number of companies in the S&P 500 have started to regularly publish information regarding sustainability and ESG initiatives pertaining to their business. For businesses, venturing into the sustainability trend can have various meanings: integrating sustainability could mean to enhance corporate governance standards, implement diversity requirements, assess dependencies on "brown" resources but also explore new services and products to increase revenue streams by catering to underserved communities and by accessing untapped markets. In short, the overall objective is to increase value for the key stakeholders, including the environment and society as a whole.

The three pillars of ESG

Environmental

Climate change & energy transition
Pollution & waste management
Biodiversity & natural resources
Water scarcity

Social

Workplace health & safety
Diversity & employee engagement
Relations to supply chain partners and society
Labor standards, human rights & data protection

Governance

Corporate leadership & risk management
Board composition & executive compensation
Addressing conflict of interests, bribery, corruption

Yet challenges with regard to ESG reporting divide the views on its usefulness, as it remains a backward-looking exercise and the quality of reported data varies across organisations, which is being disputed to entice a self-serving reporting bias. Moreover, in contrast to credit ratings that show a close correlation between ratings provided by the major credit rating agencies, ESG ratings exhibit a relatively low correlation due to differing measurements and scopes used in the assessment by the 600+ agencies that offer ESG rating services. While ESG ratings also vary in form, i.e., some agencies adopt numeric scores, while others follow the credit scoring pattern from AAA to D, nuances in ESG scores can also be linked to the varying ESG assessment of materiality in each sector, making cross-industry comparison more challenging. This also underpins the recent rating decisions that saw a leading US electric vehicle maker receive a lower ESG rating compared to one of the world's largest tobacco companies.

Adopting an ESG lens can help performance

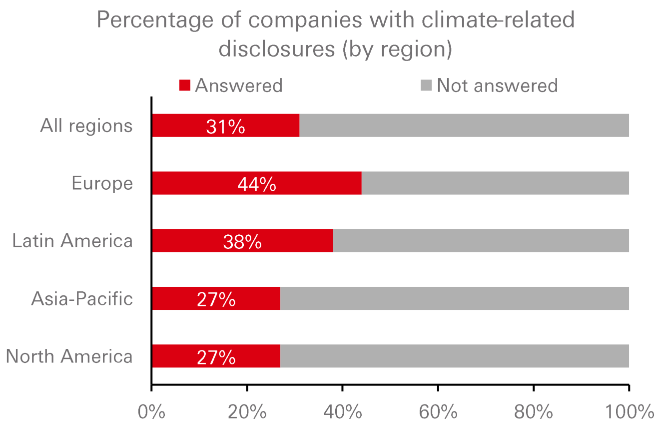
Source: Bloomberg, HSBC Global Private Banking and Wealth, 19 September 2023

Even though there still are discrepancies in reporting standards, ESG disclosures will be a continuation of the long journey in enhancing corporate disclosure requirements, in our view. We think this trend will be further driven by the emerging corporate reporting standards, such as the European Sustainability Reporting Standards (ESRS) or the ISSB's sustainability disclosure standards that were issued this summer.

ESG scores are an important tool for investment decisions but do not tell the whole story

While ESG reporting remains in a transition phase, the transparency on sustainability-related commitments and initiatives is rising. For investors, ESG scores and other metrics, such as the carbon intensity of a portfolio can help to benefit from the rising transparency in order to align investments with a more holistic cause, such as outlined in the UN Sustainability Goals or the Paris Agreement. Yet we would caution that ESG and sustainable investing, more broadly, cannot be reduced to one quantitative score. Similar to the various sustainable investing approaches, there is no "one-size-fits-all" implementation approach with regard to sustainability and ESG in the corporate world. As such, ESG scores and the likes can serve as a starting point to better understand ESG-related risks and opportunities from a company-specific viewpoint and in comparison, to its industry peers. Assessing the underlying momentum in the ESG performance of a corporate can also help to enhance the return profile of an investment.

European companies look better prepared for upcoming sustainability reporting standards



Source: S&P Global Sustainable, HSBC Global Private Banking and Wealth, 19 September 2023

ESG ratings have become an important tool in the investment management industry, supporting the evaluation and decision to allocate capital in portfolios. The main purpose is to measure a company's exposure to financially material ESG-related risks and opportunities. And while we addressed the rating divergences earlier, investors will also need to consider that there are various types of ESG rating agencies, which will provide different information to the investment evaluation, and thus using several data sources can enrich the ESG analysis, also depending on the investor's sustainability goals. Overall, we believe that integrating ESG considerations in investment portfolios can help to align sustainability preferences with the wider investment objectives of a portfolio and provide another element of risk monitoring (linked to ESG factors) from either a single-line investment perspective or at an aggregate portfolio level.

As more investors incorporate ESG into their investment decision, it is key to understand the data source and value of the additional input

Basic Data

Wide-ranging source of publicly available, unprocessed data, usually derived from company reports or websites
Examples: Bloomberg, Refinitive

Comprehensive Data

Combination of publicly available data, own research and data analysis, incorporating all aspects of ESG
Examples: Sustainalytics, MSCI

Specialised Data

In-depth analysis and contextual data, with focus on a specific ESG area
Examples: TruCost, CDP

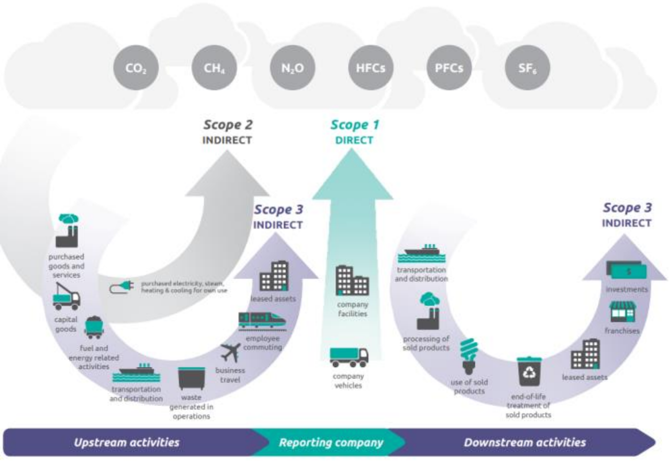
Source: HSBC Global Private Banking and Wealth, Deloitte, 19 September 2023

Enhancing the investment decision with ESG considerations by focusing on strategies such as ESG tilting or positive screening can also be another alternative to align the core portfolio with the sustainability trend without needing to drift into a more niche thematic investment idea that might expose the portfolio more towards growth-oriented areas such as renewable energies or innovative med-tech. While both approaches—ESG enhanced or thematic—are equally valid investment strategies, the sustainability trend requires investors to review their individual approach to sustainable investing and ESG objectives, if any, they would like to incorporate into their investment portfolios.

Assessing your investments' carbon exposure

While ESG scores incorporate all three areas of ESG, with a varying degree depending on the sector and the rating agencies' methodology, carbon intensity allows investors to take stock of their investment portfolios' contribution to the climate challenge predominantly. From a technical perspective, the carbon intensity of an investment portfolio assesses the carbon emissions of the invested companies, which can be attributed either directly through its operations (scope 1 emissions) or indirectly through its electricity consumption (scope 2 emission). Due to complexities in assessing the emissions alongside the value chain, scope 3 emissions are excluded from the calculation, as they can only be influenced to a limited degree by the company itself.

Corporations are increasingly being scrutinized for their carbon emissions, but the current reporting infrastructure limits the scope of transparency



Source: US Environmental Protection Agency, HSBC Global Private Banking and Wealth, 19 September 2023

To reduce a portfolio's carbon exposure and to align with a low-carbon future, the first thought would be to divest completely from highly polluting industries such as fossil fuel businesses. This would, however, also impact the wider portfolio's risk, return and diversification characteristics, and thus, a more targeted approach might be more suitable. To do this, investors can assess the carbon exposure of each invested company in the portfolio by utilising one of the main approaches to calculate the carbon intensity of a portfolio, for example:

1. **Weighted Average Carbon Intensity** evaluates a company's total emissions* per million USD in revenue sales from a portfolio perspective by allocating emissions based on the investment, relative to the entire portfolio value. It thus allows a metric that can be applied across asset classes, comparing size-adjusted emissions.

2. **Carbon Footprint** calculates the total emissions* of a company multiplied by the investment value as a ratio of the company's market cap. It thus provides the emissions "owned" by an investor through his/her investment, based on an equity ownership approach. Market cap changes can however misguide this calculation.

While both approaches have their reasoning and other methodologies also exist, the Task Force on Climate-related Financial Disclosures recommends the first approach, which we believe does provide a better analysis tool for our multi-asset investment approach. The size-agnostic metric also enables to discount any market cap biases in an investment portfolio, putting the carbon emission at the centre of the analysis.

Taking a holistic investment approach to sustainability and ESG investing

The first step in an ESG-enriched investment journey is to define your own approach to sustainable investing. Understanding whether and what ESG and sustainability considerations are of importance will inform the decisions of the most appropriate investment strategy. This can range from enhancing the traditional analysis with ESG scores, excluding certain sectors based on personal values or unlocking niche thematic opportunities. Our current top trend of "Investing in a Sustainable Future" outlines our high conviction thematic investment ideas around the energy transition to a low carbon world, the upgrading of the healthcare sector to address social challenges and the preservation of biodiversity.

At HSBC, we understand that sustainability has many facets and that each client has a unique view on the "why" to invest sustainably. Our sustainable investing framework thus starts by assessing the six basic principles outlined in our previous Sustainability Insights edition, which aims to combine investment objectives with sustainability preferences. Our sustainable investment offering ranges across asset classes and investment solutions in order to help investors build diversified portfolios, which is the core of our investment strategy. Beyond seeking out to achieve an attractive financial return, the sustainable investment solutions can help to benefit others too, aiming to make a positive contribution to the environment and society.

Adopting ESG scores and other metrics, such as carbon footprints, can enrich the investment selection process to make better-informed decisions. ESG metrics may help to better assess the risk and opportunity exposure to the sustainability revolution that will unfold over the coming decades and thus may impact the financial performance of an investment. And the carbon emission analysis enables investors to take proactive investment decisions in line with a world envisioned under the Paris Agreement. These metrics will also enable investors to have ongoing visibility of the evolution of sustainability in their investment portfolio, because in the end, measuring the exposure and progress pertaining to ESG remain fundamental to take action.

*Total emissions refers to scope 1 and 2 greenhouse gas emissions

Risk Disclosures

Risks of investment in fixed income

There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

Credit risk

Investor is subject to the credit risk of the issuer. Investor is also subject to the credit risk of the government and/or the appointed trustee for debts that are guaranteed by the government.

Risks associated with high yield fixed income instruments

High yield fixed income instruments are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default. The net asset value of a high-yield bond fund may decline or be negatively affected if there is a default of any of the high yield bonds that it invests in or if interest rates change. The special features and risks of high-yield bond funds may also include the following:

- Capital growth risk - some high-yield bond funds may have fees and/ or dividends paid out of capital. As a result, the capital that the fund has available for investment in the future and capital growth may be reduced; and
- Dividend distributions - some high-yield bond funds may not distribute dividends, but instead reinvest the dividends into the fund or alternatively, the investment manager may have discretion on whether or not to make any distribution out of income and/ or capital of the fund. Also, a high distribution yield does not imply a positive or high return on the total investment.
- Vulnerability to economic cycles - during economic downturns such instruments may typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises.

Risks associated with subordinated debentures, perpetual debentures, and contingent convertible or bail-in debentures

- Subordinated debentures - subordinated debentures will bear higher risks than holders of senior debentures of the issuer due to a lower priority of claim in the event of the issuer's liquidation.
- Perpetual debentures - perpetual debentures often are callable, do not have maturity dates and are subordinated. Investors may incur reinvestment and subordination risks. Investors may lose all their invested principal in certain circumstances. Interest payments may be variable, deferred or cancelled. Investors may face uncertainties over when and how much they can receive such payments.
- Contingent convertible or bail-in debentures - Contingent convertible and bail-in debentures are hybrid debt-equity instruments that may be written off or converted to common stock on the occurrence of a trigger event. Contingent convertible debentures refer to debentures that contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event. These debentures generally absorb losses while the issuer remains a going concern (i.e. in advance of the point of non-viability). "Bail-in" generally refers to (a) contractual mechanisms (i.e. contractual bail-in) under which debentures contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event, or (b) statutory mechanisms (i.e. statutory bail-in) whereby a national resolution authority writes down or converts debentures under specified conditions to common stock. Bail-in debentures generally absorb losses at the point of non viability. These features can introduce notable risks to investors who may lose all their invested principal.

Contingent convertible securities (CoCos) or bail-in debentures are highly complex, high risk hybrid capital instruments with unusual loss-absorbency features written into their contractual terms.

Investors should note that their capital is at risk and they may lose some or all of their capital.

Changes in legislation and/or regulation

Changes in legislation and/or regulation could affect the performance, prices and mark-to-market valuation on the investment.

Nationalisation risk

The uncertainty as to the coupons and principal will be paid on schedule and/or that the risk on the ranking of the bond seniority would be compromised following nationalisation.

Reinvestment risk

A decline in interest rate would affect investors as coupons received and any return of principal may be reinvested at a lower rate. Changes in interest rate, volatility, credit spread, rating agencies actions, liquidity and market conditions may have a negative effect on the prices, mark-to-market valuations and your overall investment.

Risk disclosure on Dim Sum Bonds

Although sovereign bonds may be guaranteed by the China Central Government, investors should note that unless otherwise specified, other renminbi bonds will not be guaranteed by the China Central Government.

Renminbi bonds are settled in renminbi, changes in exchange rates may have an adverse effect on the value of that investment. You may not get back the same amount of Hong Kong Dollars upon maturity of the bond.

There may not be active secondary market available even if a renminbi bond is listed. Therefore, you need to face a certain degree of liquidity risk.

Renminbi is subject to foreign exchange control. Renminbi is not freely convertible in Hong Kong. Should the China Central Government tighten the control, the liquidity of renminbi or even renminbi bonds in Hong Kong will be affected and you may be exposed to higher liquidity risks. Investors should be prepared that you may need to hold a renminbi bond until maturity.

Alternative Investments

Hedge Fund - Please note Hedge Funds often engage in leveraging and other speculative investment practices that may increase the risk of investment loss. They can also be highly illiquid, are not required to provide periodic pricing or valuation information to investors, and may involve complex tax structures and delays in distributing important information. Alternative investments are often not subject to the same regulatory requirements as, say, mutual funds, and often charge high fees that may potentially offset trading profits when they occur.

Private Equity - Please note Private Equity is generally illiquid, involving long term investments that do not display the liquid or transparency characteristics often found in other investments (e.g. Listed securities). It can take time for money to be invested (cash drag) and for investments to produce returns after initial losses.

Risk disclosure on Emerging Markets
Investment in emerging markets may involve certain, additional risks which may not be typically associated with investing in more established economies and/or securities markets. Such risks include (a) the risk of nationalisation or expropriation of assets;
(b) economic and political uncertainty; (c) less liquidity in so far of securities markets; (d) fluctuations in currency exchange rate; (c) higher rates of inflation; (f) less oversight by a regulator of local securities market; (g) longer settlement periods in so far as securities transactions and (h) less stringent laws in so far the duties of company officers and protection of Investors.

Risk disclosure on FX Margin
The price fluctuation of FX could be substantial under certain market conditions and/or occurrence of certain events, news or developments and this could pose significant risk to the Customer. Leveraged FX trading carry a high degree of risk and the Customer may suffer losses exceeding their initial margin funds. Market conditions may make it impossible to square/close-out FX contracts/options. Customers could face substantial margin calls and therefore liquidity problems if the relevant price of the currency goes against them.
The leverage of a product can work against you and losses can exceed those of a direct investment. If the market value of a portfolio falls by a certain amount, this could result in a situation where the value of collateral no longer covers all outstanding loan amounts. This means that investors might have to respond promptly to margin calls. If a portfolio's return is lower than its financing cost then leverage would reduce a portfolio's overall performance and even generate a negative return.

Currency risk – where product relates to other currencies
When an investment is denominated in a currency other than your local or reporting currency, changes in exchange rates may have a negative effect on your investment.
Chinese Yuan ("CNY") risks
There is a liquidity risk associated with CNY products, especially if such investments do not have an active secondary market and their prices have large bid/offer spreads.
CNY is currently not freely convertible and conversion of CNY through banks in Hong Kong and Singapore is subject to certain restrictions. CNY products are denominated and settled in CNY deliverable in Hong Kong and Singapore, which represents a market which is different from that of CNY deliverable in Mainland China.
There is a possibility of not receiving the full amount in CNY upon settlement, if the Bank is not able to obtain sufficient amount of CNY in a timely manner due to the exchange controls and restrictions applicable to the currency.

Illiquid markets/products
In the case of investments for which there is no recognised market,
it may be difficult for investors to sell their investments or to obtain reliable information about their value or the extent of the risk to which they are exposed.

Environmental, Social and Governance ("ESG") Customer Disclosure
In broad terms "sustainable investments" include investment approaches or instruments which consider environmental, social, governance and/or other sustainability factors to varying degrees. Certain instruments we classify as sustainable may be in the process of changing to deliver improved sustainability outcomes.
There is no guarantee that sustainable investments will produce returns similar to those which don't consider these factors. Sustainable investments may diverge from traditional market benchmarks.
In addition, there is no standard definition of, or measurement criteria for, sustainable investments or the impact of sustainable investments. Sustainable investment and sustainability impact measurement criteria are (a) highly subjective and (b) may vary significantly across and within sectors.
HSBC may rely on measurement criteria devised and reported by third party providers or issuers. HSBC does not always conduct its own specific due diligence in relation to measurement criteria.
There is no guarantee: (a) that the nature of the sustainability impact or measurement criteria of an investment will be aligned with any particular investor's sustainability goals; or (b) that the stated level or target level of sustainability impact will be achieved.
Sustainable investing is an evolving area and new regulatory frameworks are being developed which will affect how sustainable investments can be categorised or labelled. An investment which is considered to fulfil sustainable criteria today may not meet those criteria at some point in the future.

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