December 2020

AEGON Asset Management

2021 OUTLOOK: RESPONSIBLE INVESTING

Four responsible investing themes to watch in 2021

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Key Takeaways

- Social issues, such as access to medicines and income inequality, were brought to the forefront during the pandemic and are expected to remain a top priority for investor engagement in 2021.
- Climate change continues to present a systemic risk to investment portfolios, yet the transition to a net-zero carbon economy also opens up opportunities for investors to benefit from growth trends.
- Regulation will likely continue to tighten, providing necessary standardization within the industry, which will likely help improve investor confidence and support continued growth.
- Impact investing is expected to accelerate, but greenwashing concerns and impact measurement challenges remain, warranting a pragmatic approach within the context of available data and industry standards.

2020 was an unprecedented year as the coronavirus crisis rattled markets and upended industries. Despite the volatility and economic weakness, investor demand for ESG-focused products continued to accelerate. Further, the downturn served as an opportunity for many investors to put ESG to the test, demonstrating that some ESG factors have direct financial impact. In a sense, the pandemic accelerated many of the existing responsible investing trends already in place as the industry appears to have reached a tipping point. As we embark on 2021, we anticipate four key themes will continue to dominate the responsible investment space in the year ahead.

1. Social Factors: Continued Spotlight on the 'S' in ESG

Covid-19 put the spotlight on social risks in 2020. From access to healthcare and the urgent need for vaccines to workplace safety and systemic inequalities, the 'S' in ESG became top-of-mind for many investors as they scrutinized companies' responses to the pandemic. We expect the social dimension will continue to demand increased attention in 2021. Although social risks are always important considerations in a comprehensive ESG assessment, we expect two key social topics will be top-of-mind for investors in 2021: access to medicines and income inequalities.

First, access to medicines, takes on paramount importance in the new year. The Covid-19 pandemic has sparked global attention to the pivotal role pharmaceutical companies play in providing effective solutions for health crises. In 2021, we will continue our efforts in engaging with the pharmaceutical sector and we will monitor sector developments closely. Through our engagement efforts, we play a part in assuring that vaccines and medicines, including those for the coronavirus, are available globally for people of all backgrounds and of all income levels, both in developed and developing countries. We believe transparency is key as knowledge and research sharing among pharmaceutical companies and other stakeholders will play a key role in such global accessibility.

Second, the economic disruption caused by the pandemic exposed systemic income inequalities and the ongoing importance of ensuring living wages around the globe. Research shows that many workers do not earn enough to provide for their basic needs such as food and housing. We engage with companies in order to stimulate a focus on sustainable systems of social protection and stable living wages. The potential benefit is twofold; in the future, workers may not experience the unexpected hardships like they did this year, contributing to social stability; and such sustainable systems ensure the resilience of global supply chains of all sectors, including garment, retail and agricultural and food sectors.

2. Climate Change: An Accelerating Transition to Net-Zero

Climate change is an inescapable global challenge, representing one of the greatest systemic risks for society. As greenhouse gas emissions continue to rise, the negative effects of global warming are increasingly clear: shifting weather patterns, rising sea levels, frequent and prolonged extreme weather events. With human activities resulting in about 1°C of warming to date and 2020 set to be the warmest year on record, achieving the objectives of the Paris Climate Agreement to pursue efforts to limit the increase in temperature to 1.5°C—along with the associated goal of achieving a 50% reduction in emissions by 2030 on the way to

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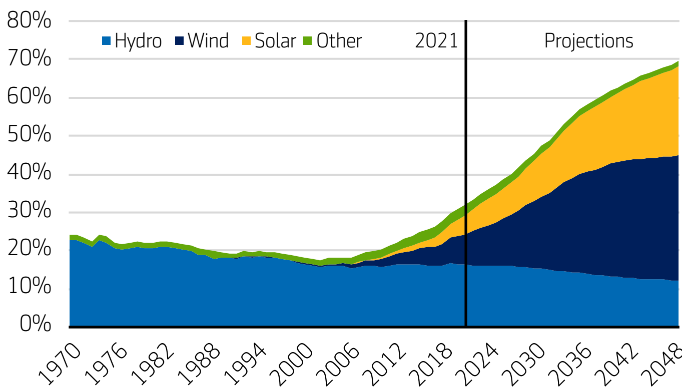
net zero around 2050—will require focus and dedication.

Fortunately, 2020 saw a number of notable positive developments in support of climate action. A growing number of countries, from China to the UK, are making commitments to achieve net-zero emissions by mid-century while the number of global companies committed to the same has more than tripled. The International Energy Agency (IEA) has noted that, in addition to being the cheapest source of electricity in history, renewable power is continuing to grow even in the face of the on-going global pandemic. As electrification accelerates, the percentage of electricity generated from renewables is expected to more than double to over 60% in 30 years (Exhibit 1). At the same time, analysis from the International Monetary Fund (IMF) suggests that the emission reductions required to limit global warming could be delivered with a net economic benefit.

Exhibit 1: Renewable energy as a percentage of global electricity generation 1970-2050



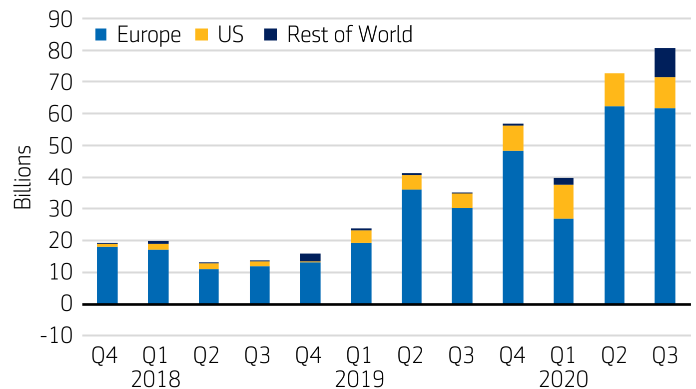
Source: Bloomberg New Energy Finance. As of November 4, 2020.

Looking toward 2021, we expect those trends to intensify. As governments introduce policies to "build back better" following the pandemic, the low carbon transition is set to accelerate. Whether it's continued deployment of renewables, increasing consumer demand for electric vehicles, or emerging plans for hydrogen to replace natural gas, we expect that many companies will embark on a radical transformation over the coming decades as the public and private sectors come together to mitigate climate change. For investors, this shift toward a net-zero carbon economy highlights the need to insulate their portfolios from transition risk and align with the energy transition. However, the climate change crisis also presents opportunities to pursue alpha by capturing growth trends.

3. Tighter Regulation: A Key Piece to Standardization and Growth

Responsible investing has matured in recent years. Like most asset managers, we believe the industry reached a tipping point, either in 2019 or 2020, with respect to the broad adoption of responsible investing practices. From ESG integration across asset classes to the development of focused responsible investment products such as best-in-class ESG, sustainability-themed or impact investments, the industry has witnessed tremendous growth. Underpinning this momentum is increasing evidence on the value of responsible investing coupled with improving data and disclosures as well as persistent and increasing investor demand for ESG-focused solutions. Asset flows into funds that apply some form of explicit ESG, sustainability or impact criteria have proved resilient in their growth even during the pandemic, notching record inflows during 2020 (Exhibit 2). The demand for RI is now commonplace among all investor segments from individual retail investors to the largest institutions.

Exhibit 2: Global sustainable fund flows accelerated in 2020



Source: Morningstar Direct. Data as of September 30, 2020. Includes ESG Integration, Impact and Sustainable Sector funds as defined by Morningstar. Includes funds that have been liquidated; does not include fund of funds.

With this stellar growth, however, comes a greater responsibility and regulatory scrutiny to ensure clients are getting what they are promised. Regulators are also interested in nurturing the RI industry for its potential impact on the cost of financing for initiatives, projects and companies actively addressing key sustainability challenges. Many regulators also recognize the importance of ensuring systemic ESG risks like the transition risks posed by climate change are sufficiently measured, analyzed and mitigated by market players.

2021 will likely see continued tightening of regulations on responsible investment. Leading the charge will be the EU's Sustainable Finance platform with a critical piece of

the legislative puzzle becoming effective in March: the Sustainable Finance Disclosure Regulation (SFDR). SFDR will require asset managers to disclose whether and how they consider sustainability risks in investment decision-making: how consideration of sustainability risks is factored into remuneration policies; as well as how they identify, monitor and mitigate actual or potential adverse impacts of their investments on 'sustainability factors.' The latter is already proving to be the most challenging requirement with technical reporting standards postponed for at least year, meaning asset managers will be flying blind at least in the first year.

Regulation is moving in the same direction in the UK with the revised Stewardship Code coming into force in January which requires significantly more detailed transparency on a whole host of RI practices and topics. While US regulators seemed to be swimming in the opposite direction, the Biden-Harris administration is likely to seek to catch up with Europe on sustainable finance guidance and regulation going forward. We are already witnessing interest in climate risk from the Federal Reserve and Securities Exchange Commission in relation to ESG funds. We expect a lot more scrutiny and a significantly increasing regulatory burden in 2021 and the years to come—hopefully helping the RI industry to standardize and reach its next level of growth.

4. Impact Investing: The Next Frontier of Responsible Investing

As the responsible investing industry continues to mature, we expect impact investing to continue to gain momentum as investors increasingly aspire to use their capital to effect measurable positive change. Impact investing is the most comprehensive approach to pursuing positive social and/or environmental outcomes alongside financial returns by assessing impacts ex-ante and monitoring, measuring and reporting the actual impact throughout the life of an investment. As investors seek to contribute meaningfully to the UN Sustainable Development Goals—a set of objectives for the world to achieve by 2030—impact investing can be a powerful tool. Accordingly, investments described as 'impact investing' have grown steadily to USD 715 billion in 2020 according to the Global Impact Investing Network. The fallout from the pandemic and the sums needed to rebuild parts of the economy will likely accelerate this trend in 2021.

Traditionally a project-finance tool, the widespread use of impact management has been complicated by three factors. First, general confusion around the goals to target, methodologies and approaches, give rise to fears of 'greenwashing'—providing misleading or deceptive impact claims. Second, the lack of appropriate data and difficulty to scale up some of this data has hampered ex-post measurement and management. Finally, the false conception that impact investing means sacrificing returns has reined in capital allocation.

Many initiatives have sought to address these issues in 2020, and we expect those to speed up and grow in 2021. The key to impact investing, in our view, is reasonable expectations. Impact investing is an exciting field, and investors can indeed have a significant positive impact on the key global sustainability challenges. But don't expect silver bullets and be wary of overly positive reporting. The key is to develop realistic expectations within the context of available data and industry standards.

In certain regions, greenwashing will partly be addressed by the entry into force of EU regulation and the development of harmonized market standards. We expect data will remain a challenge for years, although enhanced reporting by companies and pressure from regulators and markets to improve data quality will likely help. The perceived trade-off between impact and returns may also linger, though similar to ESG integration years ago, maturation of the impact investing market should help make the case that targeted investments can create value for investors, society and the environment.

Summary

Many of the greatest lessons are learned in a crisis. From surfacing social risks and systemic inequalities to reinforcing the urgent need to mitigate climate change risk, the pandemic has solidified the importance of ESG integration and reinforced the value of responsible investing. We expect the emphasis on social factors and climate change will continue into 2021.

As the global economy recovers, we expect responsible investing to continue to accelerate as the industry reaches a new level of maturity. More stringent regulation should help bring about standardization and support continued market growth. Further, investor demand is very likely to continue on an upward trajectory. Specifically, we expect impact investing will continue to gain momentum with an increasing focus on avoiding greenwashing and reinforcing the need for reasonable standards around measurement and reporting.

As the industry matures, we strive to continuously evolve our ESG integration approach, enhance our active ownership activities and develop progressive responsible investment solutions as we aim to mitigate risk, uncover opportunities and pursue better long-term outcomes.

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AdTrax: 3366600.2GBL
Exp Date: September 30, 2024