Insights into responsible investing

Wealth Management

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Water: A key investable theme of 2024

Global warming and population growth continue to threaten the world's increasingly limited freshwater supply. Water scarcity is one of the most complex and costly issues, but there is no shortage of solutions as firms within the water industry have seen momentum.

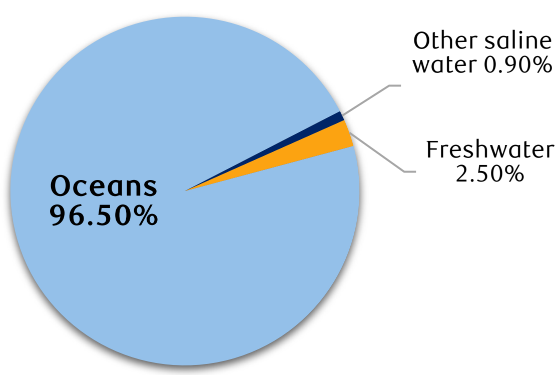
"Water, water, everywhere, nor any drop to drink." The words of the titular character from Samuel Taylor Coleridge's 18th-century poem "The Rime of the Ancient Mariner," expressed in frustration, certainly have relevance today. Variations of that adage illustrate the dangerous paradox of water. Water is everywhere, yet most of it is inaccessible.

Water covers roughly 70% of the Earth's surface, but only 3% is freshwater. Of that 3%, approximately 1% is drinkable.[1]

Water scarcity currently impacts more than 40% of the global population. By 2050, the World Resources Institute expects an additional one billion people to live with extremely high water stress, and some regions could see GDP growth rates decline by 6%. Water is vital to economic growth, impacting various essential functions of society, including growing crops and raising livestock, producing electricity, and maintaining human health. Population growth, economic development, and climate change will continue worsening water scarcity without improving water management.[2]

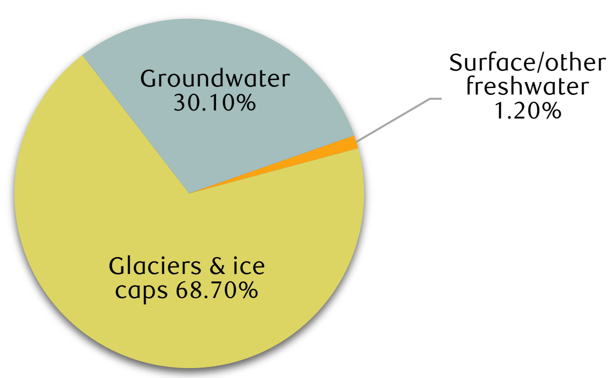
Although the outlook for water scarcity may seem bleak, it does not necessarily lead to a water crisis. The water theme continues to broaden with new innovations, seen in places such as Singapore and Las Vegas, proving that societies can thrive even in water-scarce conditions, with technology such as desalination (removing salt and other impurities from seawater to produce fresh water) and wastewater treatments.[3]

Total global water



Source - U.S. Geological Survey

Freshwater



Source - U.S. Geological Survey

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Water, continued from page 1

Panelists at the RBC Capital Markets Future of Water Conference 2024 discussed the water theme as a vast and fragmented landscape, rather than a single sector, which varies across numerous sub-sectors and has an approximate market size of more than $655 billion. Constituents in this theme include companies whose products and services provide access to water, increase water efficiency, and contribute to the sustainable management of water resources.[4]

The water theme has three main sector players: Industrials, Information Technology, and Utilities.

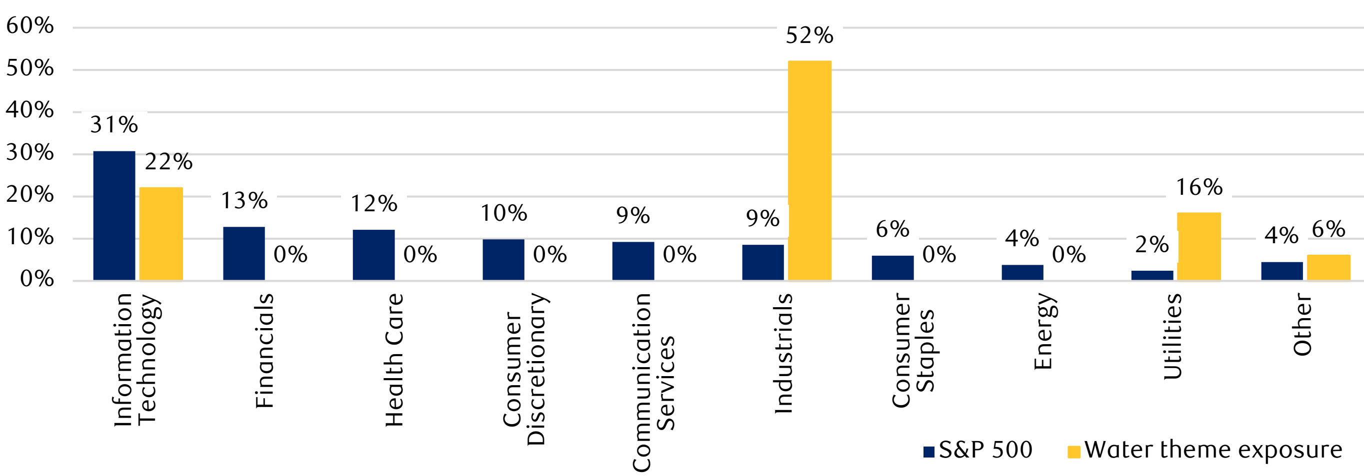
Industrials and Utilities

There is an abundance of Industrials and Utilities names within the water theme. A wide array of water management firms within industrials provides solutions and water utilities in areas such as wastewater, electric energy, irrigation, drainage, water filtration, and desalination. Within Industrials, you will find firms that operate within industries such as machinery, construction & engineering, building products, trading & distribution, and commercial services. In our view, these sectors will have imporptant roles in improving the quality and availability of water.

Technology

Technology is a growing space within the water theme as a solution to resilient infrastructure and water efficiency. Water metering technology has been around for some time but has seen significant advancements in recent years with the expansion of meter capabilities seen in 'smart water meters.' This technology has increased the precision and efficiency of water usage, reducing water overconsumption.[5]

Water theme exposure versus the S&P 500



Source - RBC Capital Markets, FactSet

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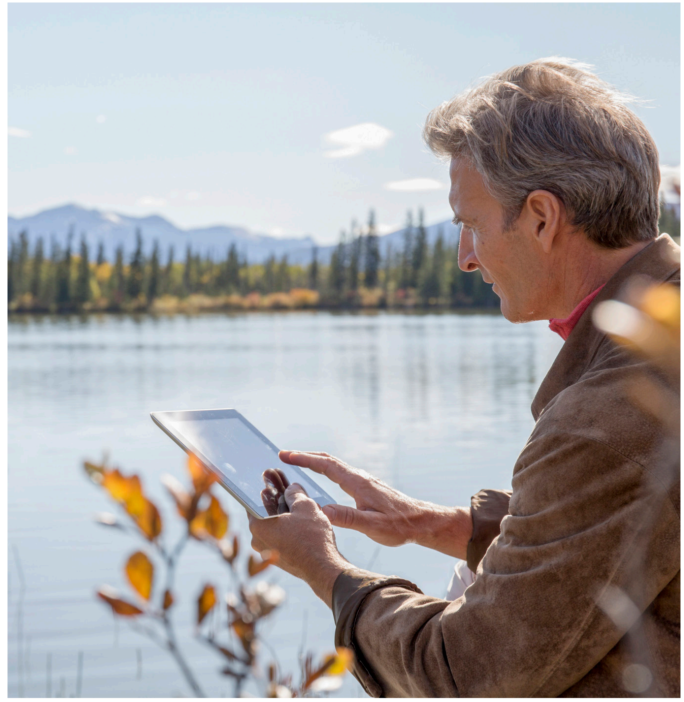
Water, continued from page 2



As an investment opportunity, according to the Sustainable Development Solutions Network, $735 billion will need to be invested by 2030 to meet the UN's goals for water and sanitation. However, the United Nations estimates some countries face a funding gap of over 60% to do so.[6] This major gap provides an economic opportunity for investment for both private and public sectors.

Water scarcity also poses a risk from an investment standpoint, in our view, as it may lead to revenue and supply chain disruptions and additional costs for firms that have a high intensity of water usage. According to RBC Capital Markets indicators, the water theme is well-positioned and has experienced resilient earnings revisions momentum and long-term growth.

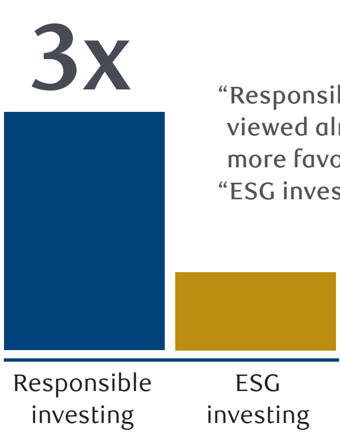
Incorporating the water theme into an investment portfolio falls under the umbrella of responsible investing or intentionally incorporating environmental, social, and governance (ESG) data into an investment portfolio. Investors can reach out to their advisors to discover the risks and opportunities related to the water theme and how to incorporate these factors into their investments.

Client interest in responsible investing continues to grow

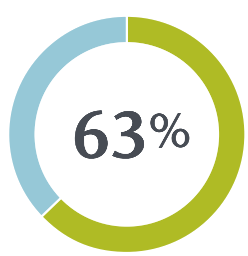
A recent survey conducted by RBC Wealth Management reveals positive investor sentiment around responsible investing and evolving preferences toward impact investing.

One of the most significant takeaways from this year's survey is the importance of positioning and using plain language for investment choices. Respondents favor "responsible investing" far more than other terms (sustainable investing, impact investing, and ESG investing), and the phrase has grown in popularity from the 2023 survey. "ESG investing" has rebounded somewhat from its nadir of 11% last year, but it still has a 22% positive impression compared to 59% for "responsible investing."

When asked about responsible investing strategies, impact investing—defined as investing in assets to create a measurable positive social or environmental impact—is more attractive to respondents, with 63% being interested in applying impact investing to their current portfolios versus 49% in 2023.



"Responsible investing" was viewed almost three times more favorably than "ESG investing."



Impact investing rose to the top

63% of respondents expressed interest in impact investing as an investment strategy.

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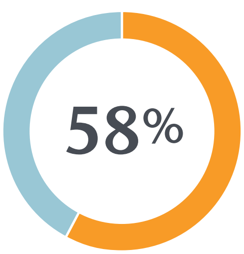
Growing interest in Responsible Investing, continued from page 3

“This year’s survey reflects what we’re seeing and hearing from our clients—words matter and have tremendous power. Investors want clear language, not jargon when constructing their portfolios,” said Kent McClanahan, head of responsible investing at RBC Wealth Management. “More than half of our clients are interested in responsible investing, so it’s important for advisors to be ready to talk about it to help clients make more informed investment decisions.”

Seventy-five percent of respondents fall between the ages of 50–77. While they skew slightly male (56%), the survey results point to four areas of consensus among men and women:

1. Both equally agree achieving financial goals is the most important factor when choosing investments.
2. The vast majority (87%) agree investors should be able to consider ESG criteria without government limitations or restraints.
3. Investment performance and transparency issues are their top two concerns as potential barriers to responsible investing.
4. Nearly all are philanthropically active, with 86% overall taking part in direct giving and 57% volunteering their time.

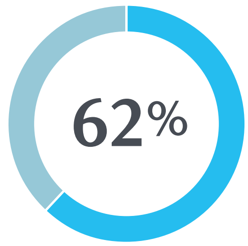


Achieving financial goals is #1

58% of men and women equally agree achieving financial goals is the most important factor when choosing investments – more than the professional recommendation of the investment, fees, risk profile, and past performance combined.

However, there are three areas in which men and women differ:

1. Sixty-two percent of women surveyed are likely to discuss responsible investing with advisors within the next year, as opposed to 47% of men.
2. Women are more likely to say they will only invest in traditional energy companies with plans to reduce greenhouse emissions and address climate concerns (59% women versus 41% men).
3. Water, health, education, and affordable/clean energy are the most popular themes that clients are interested in, driven by female respondents. Male respondents were more interested in investing in “industry, innovation and infrastructure,” which is fifth on this list.



Women have a strong interest in responsible investing

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An international survey found similar results

Similarly, a recent RBC Wealth Management International survey reveals high interest among clients in the United Kingdom. The results indicate that 55% of respondents stated they are already in sustainable solutions, and 45% are looking for further education in this space.

The two barriers that clients say they have towards investing sustainably are misleading marketing of products (greenwashing) and difficult-to-understand impact. Clients are intrigued to know the real-world implications of their investments, with a substantial minority of 30% saying that the real-world impact is equally as important as the financial return of their investment.

“Clients want to know what their money is doing on topics that are important to them. They want to understand what their impact is and how that affects their returns,” McClanahan said. “And they want access to all information—including ESG data—to construct investment portfolios that reflect their values and financial objectives.”

About the U.S. survey

Results are based on responses from 1,086 RBC Wealth Management – U.S. clients to an online survey in March and April 2024. Of the respondents, 51% are high net worth (HNW) clients with investable assets of $1 million or more.

The construction sector's low-carbon opportunity

There is an economic opportunity for creating environmentally sustainable buildings as countries around the globe look to reduce their carbon footprints. The construction sector may be entering a lower-carbon era. We discuss how lower-carbon timber and heat pumps can be key components in the decarbonization of this sector.

The heat pump's recent momentum

Heat pumps are playing a more important role in the drive toward heat decarbonization, with the technology receiving more policy support in several countries over the last several years. The key benefit of heat pumps is their efficiency, using 28% to 50% less electricity than a standard furnace.[7]

Overview: What is a heat pump?

In essence, a heat pump does not produce heat; it just moves it. In the summer, heat pumps take the heat from the inside and transfer it outside, cooling the space. In the winter, the heat pump warms the inside by taking heat from the air outside (and sometimes the ground) and bringing it in. Even if it is below freezing outside, there is still some thermal energy in the air that the heat pump extracts. In contrast, a gas furnace generates heat by burning combustible fuel, such as gas or propane.

More than 100 million households globally use heat pumps to cover heating needs, according to the International Energy Agency, which means that one in 10 homes that require substantial heating are served by heat pumps today.[8] Installations of heat pumps remain concentrated in new buildings and existing single-family homes—so if solid growth is to continue, expansion into apartments and commercial spaces is necessary, in our view.

A solid growth runway for lower-carbon timber

Timber, specifically sustainable timber, is increasingly seen as an economically viable solution to curb emissions in the construction sector. In 2023, global demand softened largely due to low economic activity in China and as many U.S. citizens have locked in low mortgages, deterring new builds in this higher interest rate environment. Despite this, the Forest Business Network's International Mass Timber Report foresees growth ahead for the timber sector, projecting that the number of timber buildings could double every two years through 2034, at which point the construction industry would store more carbon than it emits.[9]

Continued on page 7

2024 is shaping up to be a pivotal year for carbon markets

Carbon credits are a component of compliance carbon markets (CCMs), also known as emissions trading systems or cap-and-trade programs.

A decade ago, only 7% of global emissions were covered by carbon taxes or CCMs; they now cover approximately a quarter of greenhouse gas emissions. In 2023, revenues from carbon taxes and CCMs reached a record high of around $95 billion.[13]

During RBC Capital Markets' 2023 Carbon Markets Conference, participants noted that CCMs represent more than 99% of the total traded value of the carbon markets and RBC Capital Markets projects CCMs to top $1 trillion this year. These markets continue to grow, drive positive climate impacts, and are viewed as one of the most effective tools for reducing carbon emissions. A recent example of a jurisdiction to explore CCMs is in the state of New York, which is looking to launch its own scheme, New York Cap-and-Invest.[14]

Within global carbon markets, there are also voluntary carbon markets (VCMs), where carbon offsets (also known as carbon credits) live. Carbon offsets are generated by projects that avoid, reduce, or remove carbon dioxide (CO_2) from the atmosphere. Carbon offsets include direct air capture, reforestation, regenerative agriculture, renewable energy, and methane capture.[15]

VCMs had a bumpy year in 2023 and were met with increased scrutiny on their credibility alongside concerns of greenwashing.[16]

2024 could be a turning point

While CCMs continue their steady growth, 2024 may be a pivotal year for VCMs and we believe their future success depends on the uptake and outcome of various initiatives focused on enhancing credibility and regulation.[17] Governing bodies such as the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) continue to grow their oversight capabilities to support the integrity of CCMs and to bolster initiatives in VCMs including the new Voluntary Carbon Markets Integrity Initiative (VCMI). The VCMI is piloting a framework that would allow companies to utilize carbon credits to reach up to 50% of their Scope 3 targets and, if successful, could unlock $19 billion in additional financing for carbon reduction and removal projects.[18]

Despite challenges within the VCMs, we think they are still poised for rapid growth, as evidenced by the billions invested in technology-based carbon removals in 2023. Between December 2023 and February 2024, VCMs experienced record levels of market activity.[19]

Continued on page 7

Sustainable buildings, continued from page 5

Timber as a substitute or complement to concrete and steel could cut emissions in buildings by as much as 25%, according to the RBC Climate Action Institute.[10] Timber also stores vast amounts of carbon, absorbing it from the atmosphere. A traditional building made from concrete and steel produces approximately 2,000 metric tons of carbon dioxide (CO_2) emissions, and an equivalent timber building can match this in terms of carbon storage.[11]

Approximately 70% of U.S. lumber demand comes from the construction, repair, and remodelling of homes. Pent-up U.S. housing demand among younger homebuyers, combined with anticipated interest rate cuts, should continue to create steady demand through 2025 and beyond, with increased demand in the following years as home prices and mortgage rates continue to decline.[12]

Carbon markets, continued from page 6

Role in net zero

According to an analysis in the scientific journal Nature Climate Change, even in a net-zero society, there will still be at least seven billion tons of residual emissions from sectors with limited options for decarbonization.[20] This decarbonization will require vast amounts of carbon dioxide removal, which can come from nature-based climate solutions (e.g., reforestation) and engineered or technology-based solutions (e.g., direct air capture). Meeting this demand represents an enormous economic challenge and opportunity, requiring $130 billion in investment annually from now until 2050, according to McKinsey & Company.[21] In our opinion, carbon markets can come in as a potentially scalable way to efficiently unlock private capital and create a business case for investment in carbon dioxide removal, meaning that carbon markets could be a crucial tool if the world is to reach net zero.[22]

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