Insights into responsible investing

CREATE A POSITIVE IMPACT

Wealth Management

Issue 2 | Q1 2021

ESG trends for 2021

Recent U.S. leadership changes, ongoing demands for social justice and a global push for environmental reform are creating important themes we believe may spark investment conversations. This newsletter outlines a few key topics with potential investment ideas for 2021. Furthermore, RBC teams across Wealth Management, Global Asset Management and Capital Markets continue to release thought leadership, providing timely pieces we hope may provide further insights.

Should any of these topics be of interest, make sure to connect with your financial advisor about incorporating them into your portfolio.

1. A changed political climate for environmental investing

The new presidential administration's ensuing policies, RBC Wealth Management believes, may be a tailwind for responsible investing. Addressing climate change is a key priority for President Joe Biden; as one of his first acts, Biden signed a flurry of executive orders meant to confront the "profound climate crisis," including rejoining the Paris Climate Agreement.[1] In the U.S.'s new leadership comes a deliberate focus to integrate environmental policy across every federal agency.[2]

RBC Wealth Management's Vice President of Responsible Investing Kent McClanahan highlights several investment opportunities that may arise as a result of the Biden Administration's climate change policies in his piece, "A climate of opportunity." Kent details anticipated themes of infrastructure, renewable energy, carbon emission reduction, and new technologies that may be expressed via portfolio investments.

2. Stakeholder-capitalism and accountability

As 2020 made clear, investors can and continue to have impact on the ways companies are held accountable. Whereas 2020 was coined the "Year of S", we believe 2021 will continue to amplify the S. Stakeholders remain focused on social factors. Addressing systemic racism, transparency around employee diversity and inclusion initiatives, and political donation ties may be especially relevant. Meanwhile, inconsistent data reporting, disclosures and much less formalized metrics make tracking who is doing what extremely daunting. While global regulators are prioritizing disclosure transparency and standardization, we want to acknowledge the current landscape's confusing, difficult navigation for advisors and clients alike.

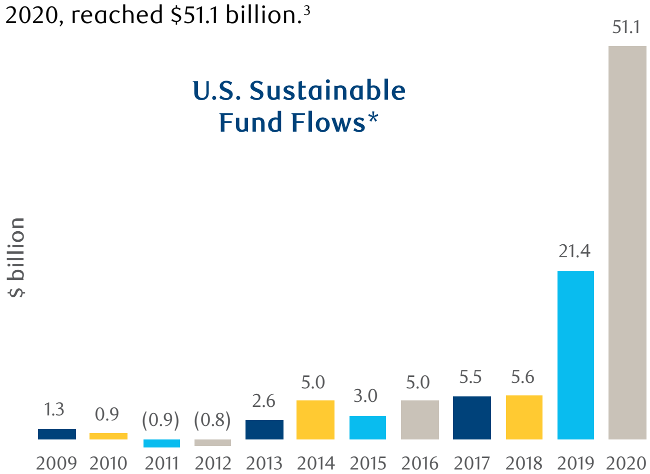
For clients, the key question may be, "How do we best align distinctive investor portfolio goals with equally unique values around responsible investing?" We believe increased demand for company-level accountability is rising alongside increased supply of resources to meet this ongoing question.

Continued on page 2

These resources include investment overlay screens that allow clients to screen sectors deemed material from environmental, social and/or governance aspects. RBC Wealth Management has a dedicated in-house due diligence team, as well as third-party rating resources, to provide advisors with up-to-date insights and reporting metrics. For clients, having conversations with your advisor to define together what responsible investing means to you—along with discussing together different terms and definitions (the jargon of responsible investing)—may open the door.

3. Investment growth

Dedicated investment resources and tools are especially important, we believe, as growth continues with responsible investing product launches and flows. Updated from last quarter's Insights into responsible investing issue, inflows into U.S. Sustainable Fund Flows (as defined by Morningstar) through December 31, 2020, reached $51.1 billion.[3]

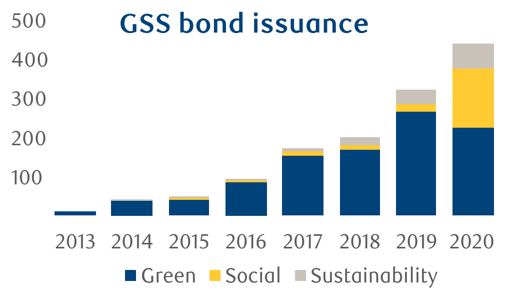


*Source: Morningstar Direct. Data as of 12/31/2020. Includes ESG Integration, Impact, and Sustainable Sector funds as defined in Sustainable Funds U.S. Landscape Report, 2018. Includes funds that have been liquidated; does not include fund of funds.

While flows across asset classes continue to reach new highs, we have observed that fixed income products in the responsible investing universe are evolving rapidly. Green, social and sustainability bonds are trending. Before going into the numbers and as means of cutting through the jargon, we want to define green bonds, social bonds and sustainability bonds. These three bond categories are virtually identical to traditional bonds in terms of their structure, risk and returns. The main difference of green, social and sustainability bonds from traditional bonds lie in their use of proceeds.

- **Green bonds:** Proceeds are typically used to partially/fully (re)finance new and/or existing climate- or environment-related projects. This includes, for example, investments in renewable energy or low carbon buildings. This bond category is expected to reach $500 billion worldwide in 2021.[4]
- **Social bonds:** Proceeds are typically used to partially/fully (re)finance new and/or existing social welfare investments for an identified target population, with a neutral or positive impact on the environment. Examples include affordable housing and community development projects.
- **Sustainability bonds:** Consider these a hybrid of green and social bonds. They are expected to provide environmental and social benefits for the identified target population. Sustainability bonds can be used to partially or fully (re)finance new and/or existing projects. Examples include education and sustainability research, modernization of education and public health facilities.

As the chart below shows, issuance in under a decade has grown exponentially. We believe the growth of supply and issuance provides a promising opportunity set for investors seeking fixed income exposures globally.[5]



(as of 12/24/20)
Climate Bonds Initiative (Green Bond Data) and Bloomberg (Social and Sustainability Bond Data)

4. Sustainability and biodiversity

Having touched upon current and ongoing trends, we believe that looking forward, this year will bring to light biodiversity as a topic of global concern. Biodiversity refers to the variety of living species on Earth. This includes plants, animals, humans, bacteria and fungi. Biodiversity is attributable to the planet's ecosystem survival. The Earth's biodiversity is being threatened, it is believed, with species extinction due to human activities. The United Nations Convention on Biological Diversity (CBD COP15) in May 2021 intends to focus on biodiversity and how to finance it.[7]

Biodiversity has been the focus of private companies as well, with financial institutions signing up for the Finance for Biodiversity Pledge.[8] This pledge commits those that sign it to share knowledge on assessment methodologies and biodiversity-related metrics, engage with portfolio companies on their impacts on biodiversity, assess the impact of their own activities, set and disclose targets for negative reduction in biodiversity and report on them annually. These financial institutions have until 2024 to complete these initial steps. We believe that this theme will be a key topic for additional discussions with your financial advisors; potentially generating new investment opportunities in 2021.

A climate of opportunity

After years of signaling its intent to withdraw from the Paris Agreement to fight climate change, the United States made the decision official on Nov. 4, 2020.

It was a move well noted by climate activists and savvy investors. That's because the decision to withdraw from the agreement could have significant economic impacts for the U.S., and as such, real ramifications for investors. In fact, it is because of these impacts that savvy investors are eyeing President Joe Biden's intentions related to the Paris Agreement with great interest and see potential opportunities in 2021 and beyond.

What is the Paris Agreement and what did withdrawal mean?

Announced at the UN Framework Convention on Climate Change in 2015, the Paris Agreement is essentially a pledge by participating member countries to do their best to prevent the global temperature from rising 2 degrees Celsius above pre-industrial levels by assessing their carbon emissions profiles and committing to reducing these emissions.

The U.S.'s short-term commitment was to reduce greenhouse gas (GHG) emissions by 26–28% from 2005 levels by 2025, largely through the adoption of renewable energy. The long-term commitment—called the "United States Mid-Century Strategy for Deep Decarbonization"—called for at least an 80% reduction of emissions from 2005 levels, but lacked a concrete strategy.

The World Bank estimated that the Paris Agreement created a $23 trillion global investment opportunity in emerging industries such as solar and wind as participating countries sought to shift energy sources in order to comply.

With the United States signaling in 2017 that it would pull back from these opportunities, China stepped in. Today, China is the world's largest producer of wind and solar energy and the largest investor in green energy projects around the world. Additionally, five of the six largest solar manufacturing companies, as well as the world's largest wind turbine manufacturer, can be found in China.

From a purely financial perspective, China and Europe have invested significantly in their renewable power infrastructure over the last 10 years. In fact, China's investment has accelerated since the Paris Agreement. Beyond simple investment in actual power generation, China also stepped up its investment in green and sustainable research. And finally, in October 2020, China made a commitment to reach net-zero carbon emissions by 2060. China remains the largest emitter of greenhouse gasses in the world, so this is a significant development.

Studies on the Paris Agreement conducted by the National Bureau of Economic Research identified significant global economic risks should global temperatures continue to increase. For the U.S., which is behind on the commitments it set forth when it joined the Paris Agreement in 2015, those risks range from a 10.5% decrease in GDP per capita if no action is taken worldwide to a nearly 2% decline even if the commitments in the agreement are met.

Rejoining the Paris Agreement

What happens to these economic risks now that the U.S. has rejoined the Paris Agreement? Agreement members are currently making plans for 2030. The U.S. is months, if not years, behind other nations on the planning and implementation of climate action.

During his campaign, Biden released a $2 trillion, multiyear plan[9] with the ultimate goal of moving the U.S. to 100% clean energy and net-zero emissions by 2050, which would quickly move the U.S. back in line with the Paris Agreement. However, it remains to be seen how much of this plan can be implemented, the level of congressional support these measures would receive, and how quickly it could be put in place. Despite these possible headwinds, it seems evident that climate change will be a priority during a Biden presidency.

A tailwind for responsible investing

RBC Wealth Management believes the new administration's focus on climate risks and opportunities could be a strong tailwind to responsible investing, which looks at factors beyond simple financial considerations when assessing the risks and return potential of an investment. These factors generally include environmental, social and governance (ESG) information and can be applied to investment portfolios in a number of ways.

Continued on page 4

Socially responsible investing

One of Biden's proposals calls for the removal of all fossil fuel subsidies for U.S. oil and gas companies, which amount to $17 billion, and without them, 45% of U.S. oil production would be unprofitable. A growing number of investors have already removed most, if not all, of these companies from their portfolios through a practice called fossil fuel free investing, and by doing so, have already removed this risk from their portfolios. This is an example of socially responsible investing (SRI), which seeks to align portfolio holdings with an investor's values by either removing or targeting companies that either violate or align with their values. Fossil fuel free investing may see increased interest under Biden's proposal.

In portfolios targeting companies that align with an investor's values, one area where we have seen some interest is renewable energy. As we highlighted earlier, the U.S. has invested less in this space than China and the EU. According to the Yale School of the Environment, the estimated cost to transition the U.S. to 100% renewable energy by 2050 is approximately $7.8 trillion. However, it is estimated that this investment could create 3.1 million jobs and reduce U.S. energy costs by $1.3 trillion. If the Biden plan is implemented, we will likely see further demand for products focused on renewable energy.

ESG

When the U.S. announced the withdrawal from the Paris Agreement, several companies announced that they were "Still In."[10] These companies have still operated as if the U.S. had not pulled out of the original agreement.

Biden's plan will impact public companies operating in the U.S. by requiring them to disclose climate risks and GHG emissions. The plan also calls for a 50% reduction in GHG emissions of all existing U.S. buildings by 2050. If a company has not been planning for either of these developments, it likely will have to invest time and money into meeting these requirements. ESG investors look at these as risks to future cash flows for companies. On the other hand, companies that have continued to monitor climate risks will likely have a plan for how to address them.

Impact investing

Impact investing is a form of investing that seeks to create a measurable environmental or social impact. The Biden plan may present investment opportunities for individuals who are looking for environmental impact. As mentioned above, China has made investment in new technology a priority. Biden's plan calls for the investment of $400 billion over 10 years in new clean technology such as new battery technology, carbon sequestration, carbon-free hydrogen, zero net energy buildings and decarbonizing industrial production of steel, concrete and chemicals. Any of these new technologies would present attractive investment opportunities as well as the positive, measurable effect that impact investors seek.

The opportunity

We believe there is an opportunity to increase responsible investing in the U.S. market. As Biden starts his presidential term, it is difficult to know which of his proposals will actually make it into law. However, we can assume that there will be an additional focus on environmental issues for at least the next four years. This creates a potential opportunity for a rise in responsible investing in the U.S. market and a chance for savvy investors to consider adding responsible investing solutions to their investment portfolios.

Key elements of the Biden climate plan

- Change U.S. government procurement to 100 percent clean energy and zero-emission vehicles
- Reinstate the Clean Air Act fuel economy standards
- Invest $400 billion over 10 years seeking innovative, clean technology
- Seek to reduce the carbon footprint of U.S. building stock by 50% by 2035
- Incentivize electric vehicles by building out charging infrastructure
- Remove subsidies for fossil fuel companies and encourage ending the practice around the world
- Require public companies to disclose climate risks and greenhouse gas emissions in their operations and supply chain

Additional responsible investing information

The Global Insight February issue provides background information on looking beyond financial statements to uncover added investment values in companies. Click here for more information.

Learn why going beyond financial statements to develop an understanding of how a company's unreported, "contingent" assets and liabilities can be the most important source of added investment value. Click here for more information.

[1] Biden, J. (2021, January 27). Executive order on tackling the climate crisis at home and abroad. Retrieved February 03, 2021, from https://www.whitehouse.gov/briefing-room/presidential-actions/2021/01/27/executive-order-on-tackling-the-climate-crisis-at-home-and-abroad/.

[2] Davenport, Coral, and Lisa Friedman. "Here's How Biden Plans to Move Fast With a 'Climate Administration' – The New York Times." The New York Times, 17 Nov. 2020, https://www.nytimes.com/2020/11/17/climate/biden-climate-change.html. Accessed 21 Dec. 2020.

[3] Hale, J. (2021, January 28). A Broken Record: Flows for U.S. Sustainable Funds Again Reach New Heights. Retrieved January 29, 2021, from https://www.morningstar.com/articles/1019195/a-broken-record-flows-for-us-sustainable-funds-again-reach-new-heights.

[4] Chestney, Nina. "Green Bond Issuance Expected to Reach Nearly $500 Bln in 2021-SEB." Nasdaq.com, 10 Dec. 2020, www.nasdaq.com/articles/green-bond-issuance-expected-to-reach-nearly-%24500-bln-in-2021-seb-2020-12-10. Accessed 20 Dec. 2020.

[5] Sustainable Debt Market Update [PDF]. (2021, January 4). RBC Capital Markets Government Finance.

[6] National Geographic Society. (2019, June 05). Biodiversity. Retrieved January 15, 2021, from https://www.nationalgeographic.org/encyclopedia/biodiversity.

[7] UN Biodiversity Conference. (n.d.). Retrieved January 21, 2021, from https://www.un.org/en/food-systems-summit-2021-en/un-biodiversity-conference.

[8] Marsh, Alastair. "Fund Managers Answer the Call to Save Earth's Biodiversity." Bloomberg.com, 2 Dec. 2020, www.bloomberg.com/news/articles/2020-12-02/wall-street-european-asset-managers-join-bid-to-preserve-biodiversity. Accessed 21 Dec. 2020.

[9] Joe Biden Climate Plan (joebiden.com/climate-plan).

[10] We Are Still In (www.wearestillin.com).

Author Kent McClanahan, CFA, Vice President of Responsible Investing, RBC Wealth Management