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THE SUSTAINABILITY DOMINO EFFECT: FOUR FACTORS RESHAPING MARKETS

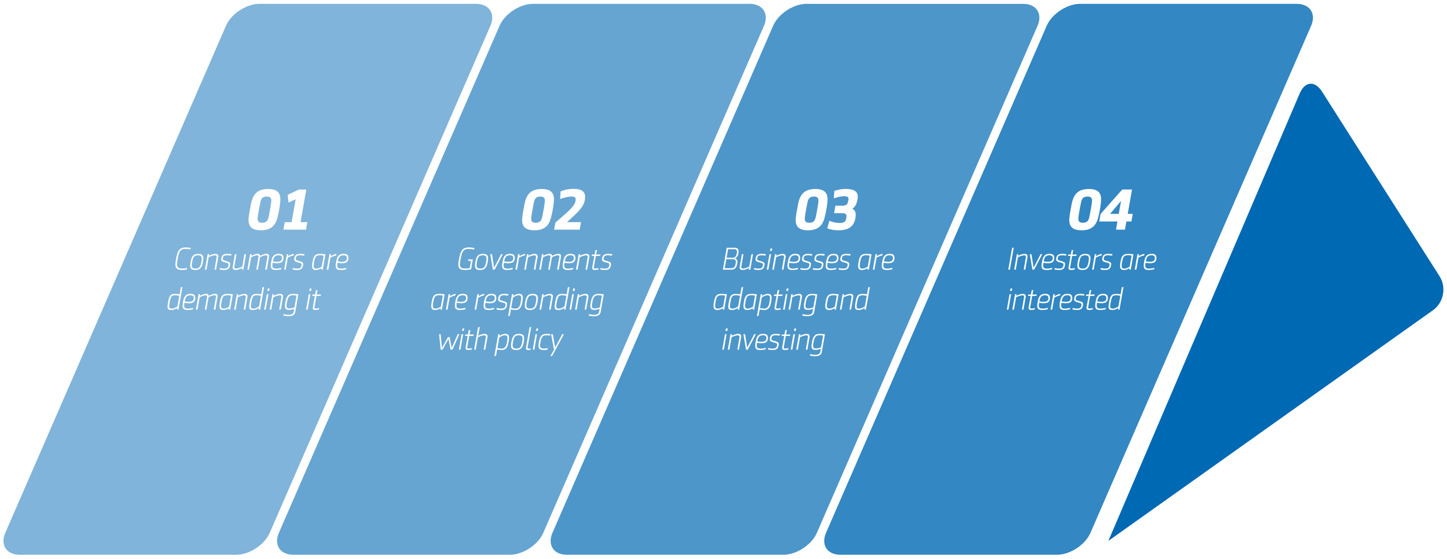
By James Rich, Senior Portfolio Manager

The secular shift towards sustainability is all around us—from the United Nations' Sustainable Development Goals and the B Corporation movement to politicians proposing extinguishment of student loans and Greta Thurnberg advocating for climate action. Environmental and social issues are now top-of-mind for consumers, policymakers and corporations.

Why is the secular shift towards sustainability taking place? One catalyst, as it relates to environmental issues, may be the growing consensus among scientists that the earth's climate is at an inflection point. Some scientists predict that if people do not alter the trajectory of climate change and reduce our negative impact on the environment, we may inevitably cost the economy trillions of dollars. Another catalyst, with respect to social issues, is the fact that global income inequality is at all-time highs.

As a result, consumers are demanding change, governments are responding with new policies, businesses are adapting and investors are adjusting their portfolios. We call this process the "sustainability domino effect," and we believe it presents one of the largest and most exciting investment opportunities in recent history. To meet the world's sustainability ambitions, we believe the entire global economy will go through major systemic changes over the next decade. Companies and governments that can evolve with shifting consumer preferences and pivot toward more sustainable business models could be more likely to achieve a competitive advantage in the future. Therefore, we believe investors that back them will have more opportunities to realize returns on their capital.

The four dominos of sustainability



Source: Aegon Asset Management US

01 Consumers are demanding it

Consumers are demanding sustainable products. In fact, 66% of consumers are willing to pay more for sustainable brands, while 73% say they would definitely change their consumption habits to reduce their environmental impact according to the Nielsen Global Corporate Sustainability Report. Millennials, who make up the largest generation of humans ever and are quickly approaching their prime spending years, list climate change as one of their top five concerns, tied with personal finances and health. For consumer-driven economies like the US where almost 70% of GDP is tied to consumer spending, this shift in preferences and consumption habits presents opportunities for companies to fulfill demand with more sustainable products and services; take global food manufacturer Group Danone, for example. Danone is one of the largest B Corporations, a certified business that balances purpose and profits, and, unlike many of its global food competitors, has chosen to emphasize healthful food products made from responsibly-sourced ingredients.

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02 Governments are responding with policy

Policymakers around the world are also rallying around sustainability matters because their citizens are demanding it and the immense potential costs of ignoring it. Climate change presents a risk that governments shouldn't overlook. It's been estimated that the economic ramifications from climate change could reach hundreds of billions of dollars by the end of the century.

The state of California, the world's sixth largest economy, is leading the way by mandating wide-spread adoption of renewable energy. Starting in 2020, California is requiring solar panels be installed on all new residential homes. By 2045, the state expects to receive 100% of its power from renewable sources. What's more, 30 states are requiring renewable energy investment, even if it's uneconomic without tax credits. These aggressive goals are likely to support product innovation as renewable energy companies work to develop large-scale renewable energy systems that are economically viable.

Globally, countries are joining forces to combat climate change and address the world's most pressing environmental and social issues. In 2015, all 193 members of the United Nations committed to solving the world's most pressing problems as represented by the 17 Sustainable Development Goals. In China, the central government has made bold commitments to reduce emissions to combat climate change. For example, by 2023, China's 6b emissions standards aim to reduce auto emissions by 50% from today's levels.

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In the United States, policy has gone in a decidedly different direction in recent years as the United States has withdrawn from the Paris Climate Agreement. Nevertheless, the response by many US consumers, companies and individual states has continued to accelerate the shift toward sustainability.

03 Businesses are adapting and investing

These actions from consumers and policymakers are creating a profound shift in the way companies do business. The shift toward environmental and social sustainability is evolving business models and reinventing supply chains. Sustainability is no longer viewed as merely a philanthropy effort, but rather, one of the most significant sources of real business opportunities and risks.

Businesses are generating new revenue streams by developing products and services that are aligned with this trend toward a sustainable global economy. For example, in response to both changing consumer tastes and increasingly stringent global emissions standards, automobile manufacturers—from Tesla to Toyota to Ford—are investing tens of billions of dollars over the next several years to develop better, hybrid-electric and fully electric cars and light trucks. Industry experts expect to see a staggering 46 million hybrid and electric cars on the road globally by 2030.

A focus on sustainability is also helping entire industries lower costs and reduce risk. Companies that prioritize sustainability are identifying new ways promote resource efficiency and improve energy efficiency, thus combating rising operating costs. The commercial real estate sector, for example, has, in recent years, embraced the international LEED and US Energy Star certification programs. In 2019, the US Green Building Council announced that commercial projects surpassed a new milestone of 100,000 registered and certified LEED buildings in the US, up from about 60,000 in 2013. With buildings accounting for about 40 percent of global energy-related carbon, the sustained momentum of LEED certifications is vital to help pivot toward a low-carbon economy. Energy Star buildings, which use 35% less energy than typical buildings across the US, accumulated an impressive energy savings of over $150 billion from 1992 through 2016. Energy efficiency programs and certifications not only help to attract tenants that are interested in promoting sustainability themselves, but may also reduce building operating costs by encouraging landlords to find ways to improve energy efficiency.

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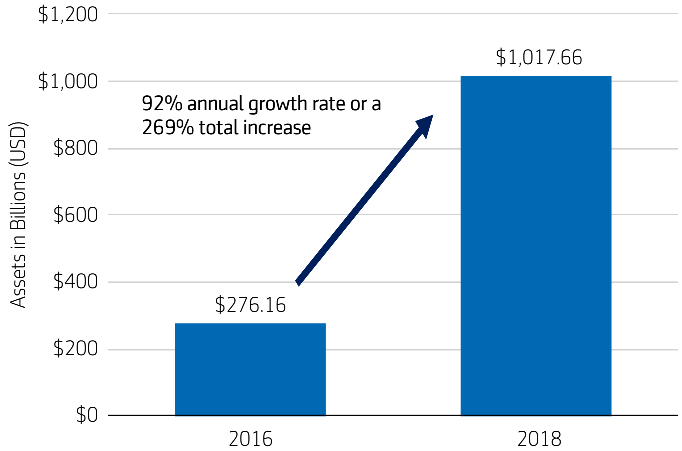
In our view, companies that can adapt and evolve with environmental and societal considerations in mind are more likely to attract new customers, drive revenue growth, and generate lower operating costs, thus producing sustainable cash flows and more resilient business models over the long term.

04 Investors are interested

Investors are also taking notice of issuers that are, or are not, embracing sustainability. Many investors are increasingly interested in aligning their portfolios with sustainability. According to a study conducted by Morgan Stanely, 85% of retail investors are interested in sustainable investing, up 10% from 2017. The potential size of the market is astounding; one study by Bank of America Merrill Lynch estimates that over $20 trillion of assets could flow into various responsible investing strategies over the next two decades.

Specific to sustainability-themed strategies, according to the Global Sustainable Investment Alliance flows into these strategies passed the $1 trillion mark in 2018 and are expected to continue to gain momentum (Exhibit 1).

Exhibit 1: Sustainability-themed investing gains momentum
Global assets under management 2016-2018*



Source: Global Sustainable Investment Alliance. 2018 Global Sustainable Investment Review report: http://www.gsi-alliance.org/trends-report-2018/ *Reflects assets under management in sustainability-themed investment strategies across five major markets—Europe, US, Japan, Canada and Australia and New Zealand.

The sustainability shift presents compelling opportunities for investors to pursue sustainable alpha and contribute to a more sustainable global economy. Further, the anticipated need for capital is astounding. The UN estimates that $5-7 trillion dollars are needed annually to achieve the Sustainable Development Goals (SDGs) by 2030.

The private sector financing arm of the World Bank, the International Finance Corporation, found that between now and 2030, there is a $23 trillion investment opportunity in climate smart investments in emerging markets. In China alone, the imperative to combat air pollution is forecasted to create more than $3 trillion in investment opportunities through 2030, ranging across industries from air-quality monitoring to indoor air purification and even cement mixing.

85% of retail investors are interested in sustainable investing

With expectations for continued growth in demand for responsible investment solutions, we believe investors will increasingly aspire to solve some of the world's most pressing problems by allocating capital to a sustainability-themed strategy.

Most importantly for investors, research suggests that aligning investment portfolios with sustainability can help enhance performance. According to a Morningstar study, 63% of US open-end and exchange-traded funds defined as 'sustainable' finished 2018 in the top half of their peer group.

Within fixed income, studies are now linking poor environmental and social credentials to higher rates of defaults. A recent study by Bank of America cited that 90% of companies that declared bankruptcy in the S&P 500 between 2005 and 2015 had below-average environmental and social scores from five years prior.

63% of US strategies marketed as 'sustainable' finished 2018 in the top half of their peer group according to Morningstar

Corporations are also witnessing the benefits as effective ESG profiles can lower their cost of capital and improve operating performance. A report published by the University of Oxford in 2015 that aggregated results from more than 200 research studies found that 90% of studies point to a lower cost of capital due to better ESG practices and 88% indicated that solid sustainability practices improved operational performance.

As the sustainability-related research expands, we expect the connection between sustainability factors and financial results to strengthen, further supporting the secular sustainability shift and the case for sustainable investing.

Summary

Looking ahead, we believe these four factors will continue to support the shift toward sustainability while presenting attractive opportunities for long-term investors. Within fixed income, we are finding numerous opportunities to effect positive change and pursue sustainable alpha. From products and services tied to ecological solutions, resource efficiency and climate change mitigation to supporting health and well-being and encouraging sustainable growth, ample opportunities exist to align with sustainability megatrends.

As the sustainability shift unfolds and the domino effect multiplies, we believe a sustainability-themed investment strategy may provide opportunities to pursue better long-term outcomes and contribute to a more sustainable global economy.

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