ClearBridge Investments

2022 ESG outlook

THE VALUE OF KNOWING WHAT YOU OWN

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KEY TAKEAWAYS

- The vast majority of ESG assets under management continues to be actively managed; we believe this speaks to the value added by those integrating financial and sustainability analysis and pursuing impact through engagement and proxy voting.
- We expect a continued push for diversity disclosures, and, related, a heightened awareness of the increasing importance of talent as an asset in the workforce.
- ESG investors must appreciate the increasing complexity of ownership of large tech platforms, balancing benchmark awareness with fidelity to sustainability criteria.

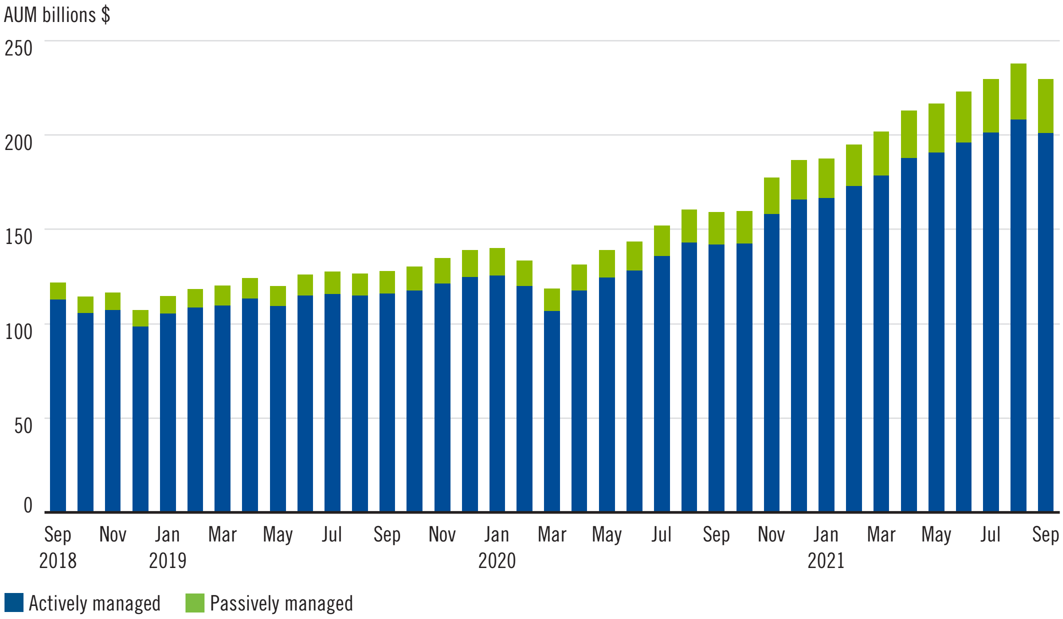
If 2020 was a year of reaction, ushering some of the biggest changes to daily life in recent memory, 2021 brought what could be called a year of reflection and reassessment. Many questions were social: vaccines were distributed, but where would they be hard to get? Would wages keep up with inflation? Where were companies on their progress toward more diverse workforces? There were environmental questions as well, as extreme weather events, the IPCC's sixth assessment report delivered in August and the United Nations Climate Change Conference in November (COP26) highlighted the urgency of acting on climate. Companies and governments were ratcheting up net-zero emissions commitments, but would they be enough and how would they meet them?

CONTINUED GROWTH FOR ESG PORTFOLIOS

Amid such reflection and reassessment, investors continued to seek out sustainability-focused investment strategies in 2021. While flows softened somewhat from peak inflows in early 2021, inflows into ESG funds in the third quarter of 2021 were 63% higher than in the third quarter of 2020 with total monthly inflows near US$40 billion for most of the year. The vast majority of ESG assets under management continues to be actively managed; we believe this speaks to the value added by those integrating financial and sustainability analysis and pursuing impact through engagement and proxy voting (Exhibit 1).

EXHIBIT 1: US ESG ACTIVE AND PASSIVE ASSETS UNDER MANAGEMENT (MONTHLY)

As of September 30, 2021



Source: Morningstar.

With the accelerated global investment allocations to sustainability strategies, regulatory bodies have stepped in to clarify the process, objectives and risks of credible sustainability funds, versus concerns around "greenwashing." This has been a particularly active discussion for European regulators and investors, with one result being the EU's recent Sustainable Finance Disclosure Regulation (SFDR), through which ClearBridge has a number of funds classified under Article 8.

AREAS OF FOCUS: ENERGY TRANSITION, ROLE OF PROXY AND HUMAN CAPITAL MANAGEMENT

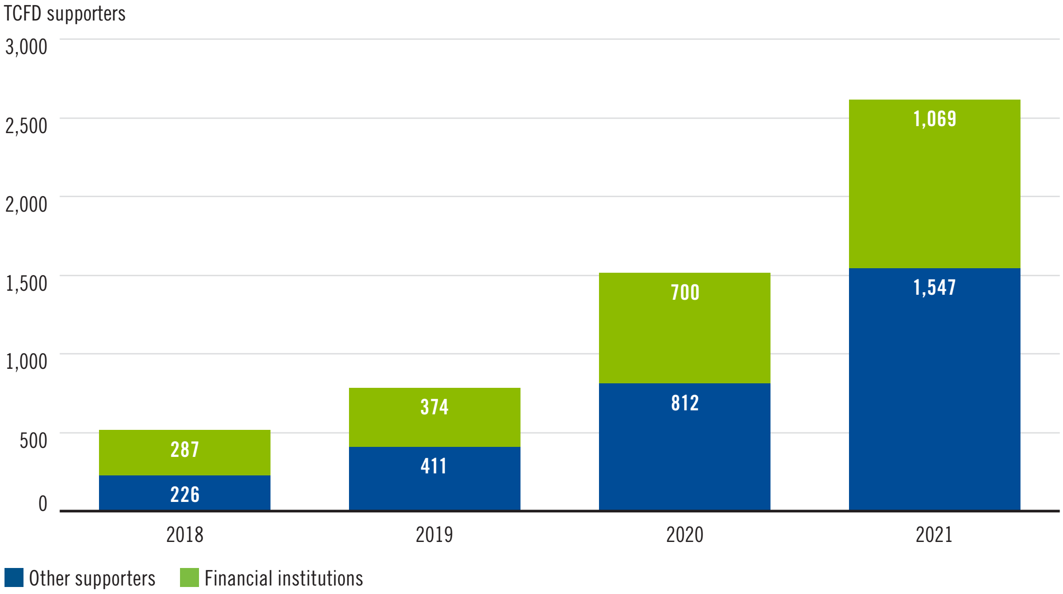
With the potential for public equities in mitigating climate change and making progress on social goals such as diversity top of mind, portfolios focused on delivering strong returns while having a credible impact on pressing ESG issues should continue to attract assets in 2022. Companies and investors have a role in such areas as fostering global biodiversity and helping to expand access to medicines as COVID-19 propagates in developing economies.

ESG portfolios will not be without their challenges in the next year. From the investment perspective, 2020 was a strong year for ESG performance driven by sustainable companies with strong earnings, and a fervour for renewable energy plays amid pandemic-related declines in oil demand. In 2021 this gave way to a bull market for oil and gas producers as industry and travel returned. In 2022 we expect continued economic recovery and rising interest rates may weigh on longer-duration tech companies in the renewables space to extend this back-and-forth, though relief from supply chain constraints and shipping delays should help in 2022. With many factors at play in energy markets—political, capacity-related, pricing, reserves—ESG investors could expect continued volatility between traditional and renewable energy in the short term.

The energy transition is real, however, and should continue to unlock tremendous value in renewable energy. We expect there to be a more acute awareness of climate risk and a move from companies setting targets, as many did in 2021, to investors holding them accountable for making progress on those targets in the first half of the decade. One example is the recent Net Zero Asset Management Initiative (NZAM), to which ClearBridge became a signatory in 2021. The Task Force on Climate-related Financial Disclosures (TCFD) has also been seeing increases in support (Exhibit 2).

EXHIBIT 2: NUMBER OF TCFD SUPPORTERS IS GROWING

As of October 2021



Source: Task Force on Climate-related Financial Disclosures 2021 Status Report.

We expect the role of proxy voting to be more visible in 2022 as well. Proxy voting used to be an underutilized engagement signal, but has become much more visible in recent years, partly because of the increased receptivity to ESG proposals by institutional investors, as well as reporting requirements such as those through SFDR and NZAM. Such regulations and initiatives are encouraging the use of proxy voting as a tool, and it appears to be having an effect. Shareholder proposals in 2021 saw higher pass rates (25%) than in 2020 (13%) amid heightened awareness of the need for diversity disclosures and emission reduction targets. Three major oil companies saw votes calling for greenhouse gas reduction targets pass, a sign of increasingly effective corporate engagement with fossil fuel companies.

Very large asset managers, particularly passive, are putting robust ESG-focused language in their proxy policies, such as stating they will vote in support of management teams that consider climate risk. That's a meaningful force for companies where large passive managers are top owners. These new passive votes help supplement the multi-decade larger active manager votes on ESG-focused shareholder proposals.

In terms of human capital management, we expect a continued push for diversity disclosures, and, related, a heightened awareness of the increasing importance of talent as an asset in the workforce. Many companies set diversity targets in 2020 and 2021 as more dimensions of diversity and inclusion gained mindshare. On one hand progress has been difficult, though increased diversity disclosures are a step in the right direction, as are improvements to human capital management practices that look to build an inclusive workplace. Diversity and inclusion was a firm-wide priority for ClearBridge in 2021 and continues to be, featuring as a central part of our company engagements. Large shareowners who are active in growing these conversations such as ClearBridge are helping develop solutions through keeping this topic high in the agenda and seeking and sharing best practices. There is still much work to be done to improve the inclusiveness and diversity of talent, as shown by the recent EEO-1 disclosures from among the 75 largest US companies (Exhibit 3).

EXHIBIT 3: MORE LARGE US COMPANIES DISCLOSING EEO-1 DATA

As of July 1, 2020

Source: Bloomberg. The nine job categories in the EEOC form were combined into three categories. Management includes executive and senior level workers as well as first/mid-level officers. Professionals category includes professionals and technicians. Sales workers, administrative staff, operatives, laborers, and service workers are combined into an 'other' worker category. Demographic information is from the U.S. Census population estimates as of July 1, 2020. Please visit https://www.bloomberg.com/graphics/diversity-equality-in-american-business/ to see each company disclosure as shown in the shaded cells of the exhibit.

Companies building more inclusive workforces will also likely have a strong competitive advantage amid what some have called the "great resignation"—employees quitting their jobs at higher rates in 2021. The labor market, made hot by pandemic displacements and increasingly by supply/demand dynamics in a strong recovery, reminds us that talent has always been key in competitive industries: if you don't have it, you need to get it, and if you have it, you don't want to lose it. The next year should see a continuation of this dynamic, with companies with strong human capital management practices having an edge in building resilient and innovative workforces. And while advocating for better workforce disclosures is the first step, it will be a must-have for asset managers to understand these practices at a level beyond just what the numbers say.

BALANCING BENCHMARK AWARENESS WITH SUSTAINABILITY CRITERIA

Equity markets allow for periods of rapid growth and dominance by a few companies, and increasingly large players are dominating benchmarks today. The trend is not new: General Electric, Exxon Mobil, Microsoft and Apple have had their turns on top in the past 25 years. Today challenges include staying diversified in a narrowing market, especially where some widely owned stocks present complex sustainability stories. The largest companies can have outsize effects, and this is both a challenge and an opportunity consistent with ClearBridge's philosophy of investing in public equities for investment returns while seeking to have an impact. Broad ownership of the largest tech companies, recently known as the FAANG stocks—Facebook (now Meta), Amazon, Apple, Netflix, Google (now Alphabet)—and which might also include Microsoft and Tesla, present challenges for investors to both keep up with benchmarks and stay diversified. There is inevitable concentration risk to manage here, but also complex ESG factors to sort out, which include headline, operational and regulatory risk. We believe one way to manage this is to build diversified information technology exposure, such as in small and mid-size companies that are enablers of the electric vehicle and renewable power transformations, for example.

At the same time, some of these companies are best-in-class sustainability leaders and are powerful tools to set standards for climate change commitments and social goals. This highlights the importance of active company engagement as we seek to influence companies to improve their sustainability potential and learn from those setting positive examples. ESG investors must appreciate the increasing complexity of ownership of large tech platforms, balancing benchmark awareness with fidelity to sustainability criteria. This must be done on a case-by-case basis; knowing what you own is key.

WHAT REALLY IS AN IMPROVER? THE IMPORTANCE OF KNOWING YOUR COMPANY

The complexity of ownership highlights how greenwashing—inaccurately branding or overstating a company, practice or investment strategy as eco-friendly—is still a challenge for both investors and regulators. This challenge will increase in 2022 as a value rotation in 2021 also meant certain ESG investors seeking performance were looking harder at value companies often found in higher-emitting sectors of the market. Sometimes these companies are considered "improvers." We are encouraged that there are cases of meaningful improvement among more challenging companies, but the risk is that managers really have to be dedicated to improving them and be transparent in their process. Like flipping a house, it can require a lot of work, and not all managers are willing or able to put that work in. Also, not all houses intended to be flipped do so: some flop. At the same time, increasing company disclosure, helped by continued investor advocacy as well as by recent regulation, will be an opportunity for better discussions with management and helpful in seeing risk/reward cases for companies.

Here again, knowing what you own is important, as is actively engaging with companies on a case-by-case basis, rather than simply seeking best-in-class sustainability stories. As regulatory scrutiny increases on how ESG is marketed and implemented, managers who are able to have discussions with companies on material ESG factors and who prioritize these as an essential part of ownership will stand out.

We continue to see an exponential increase in ESG data, from data providers and that required by increasing regulations. New regulations entail new reporting requirements, which means a heightened awareness from investors and company managements. As always, however, there is risk in acting simply on data and not understanding company-specific issues from an investment perspective.

PERFORMANCE CENTRAL TO GROWTH OF SUSTAINABILITY IN THE US

When ClearBridge started investing with ESG-integrated portfolios over 30 years ago, our focus was on the holistic nature of our investments—on both performance, as well as sustainability and societal values. The importance of performance is central to the debate over the Department of Labor's recent proposal, which seeks to emphasize that climate change and other ESG factors can be financially material and that considering these elements in investment analysis can lead to better long-term risk-adjusted returns. While the winds in Washington regularly change direction, we are optimistic that the better the performance case and the credibility of the manager's efforts for ESG portfolios, the fewer impediments there will be to participation in them.

CONCLUSION

Sorting out substance from noise in 2022 will challenge ESG investors to know the companies they invest in, both as a means to finding securities that will help support long-term returns and as a way to have a tangible impact on urgent sustainability matters. But while ESG investors will have plenty to accomplish in 2022, we are encouraged by the increasing number of tools at their disposal and the ongoing shift in perspective in company managements toward making sustainability a core part of the business.

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