ESG Asset Class Report

(Abridged)

30 June 2022

By:
Global Multi-Asset Team (GMAT)
PineBridge Investments

Executive Summary

The brightening recovery outlook that bookended 2021 darkened considerably after Putin's invasion of Ukraine barely two months into 2022. At the asset-class level, the impact of the war was promptly seen in rising valuations in the energy and commodities sectors as sanctions pushed up prices in the global market. Asset classes more reliant on external energy and commodities sources faced supply constraints. Inflation soared and, alongside it, recession fears. It remains to be seen what the longer-term consequences will be for Sovereigns, where policy priorities may have been reordered as a result. At the forefront is the European Union (EU), where the war has forced members to address energy security and existing shortfalls in defense. The EU's actions are expected to have significant implications on the course of global sustainability efforts given its leadership in ESG.

Against this backdrop, our latest global asset class ESG review shows largely stable ESG Outlook and Engagement Level outcomes since our last review in December 2021. The main conclusions and changes to our ESG review follow:

Sovereigns

We initiated coverage of key Asian countries, including China, India, and Indonesia, as well as Latin America, South Africa, and Turkey. While China, Indonesia, and South Africa are lagging, we see improvement in India.

Equities

We initiated coverage of German Equity. Given the country's leadership on ESG, it is no surprise that consistent with the Germany Sovereign ESG Outlook, the equity market is also improving on the ESG front.

Fixed Income

Sub-asset classes have remained steady in the first half of 2022.

Alternatives

We initiated coverage of EU Carbon Allowances, an asset class directly related to the EU's path to decarbonization. Sub-asset classes have remained steady in the first half of 2022.

The chart below summarizes our current views:

Mapping of Current Views

ESG Outlook and ESG Engagement Level are considered in the team's allocation and implementation decisions.

ESG Engagement Level \ ESG Outlook	LAGGING	STABLE	IMPROVING
LOW	• Hong Kong Equity	• Australia Sovereign • Canada Sovereign • France Sovereign • Japan Sovereign • Spain Sovereign • US Sovereign • US Investment Grade Credit • US High Yield • US Bank Loans & CLOs • US Large Cap Value • US Defensives • US Industrials • US Financials • Europe Small Cap • Australian Equity • Japanese Equity • Taiwanese Equity • French Equity • Reopening Basket	• Germany Sovereign • UK Sovereign • US Large Cap Growth • US Quality • US Cyclicals • UK Equity • German Equity • Productivity Basket • New Energy • Listed Infrastructure • Europe Large Cap • Spanish Equity • South Korean Equity • EU Carbon Allowances
HIGH	• China Sovereign • Indonesia Sovereign • South Africa Sovereign • Mexico Sovereign • EM Corporate • Chinese Equity • Indonesian Equity • South African Equity • Turkish Equity • Brazilian Equity • Mexican Equity • Listed PE	• Asia Credit • Indian Equity • Turkey Sovereign • LatAm Bonds • Global Mining • US Small Cap • Brazil Sovereign	• Energy-E&P • India Sovereign

Global Developments and Trends

Is the war in Ukraine shifting the ESG paradigm?

From energy security to defense, the war in Ukraine and its consequences have put the spotlight on ESG considerations across various domains. At the Sovereign level, we see a tug of war between the imperative of meeting climate goals and the urgency of fulfilling current energy needs. At the securities level, the push for greater corporate social responsibility has driven hard business decisions.

Environmental

Among the most immediate consequences of the war in Ukraine is the notable **acceleration of the European Union's (EU) green energy transition**, which is already the most advanced in the world. The EU swiftly announced a plan to end its reliance on Russian fossil fuels by 2030 and reduce demand for Russian gas by two-thirds before the end of the year.[1] The REPowerEU Plan proposes to scale up previous climate pledges, such as increasing the target for renewables to 45% from 40% by 2030 under the "Fit for 55" targets of the Green Deal.[2] In essence, the Green Deal has become as much a geopolitical strategy as a climate change strategy for the EU. Separately, Germany announced several initiatives to diversify its energy sources away from Russia, including plans to bring forward its goal of 100% renewable power generation by 15 years to 2035.[3] Yet, in the interim, Europe will likely see elevated use of carbon-intensive fossil fuels from the transition before renewables or cleaner sources could make up for the supply. The pivot to clean or renewable energy will take time and requires significant investments in critical infrastructure.

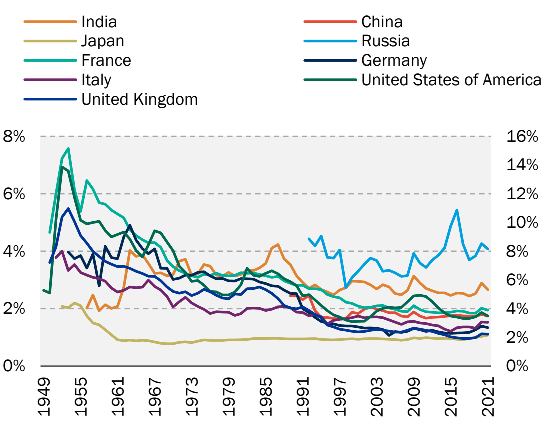
For the rest of the world, the choices are far from clear cut as the war triggered higher fuel prices. While President Biden stressed the importance of clean energy as a means to achieve energy security, the US lags its EU counterparts in the green energy transition. In the meantime, as gas prices soar, the US is seeking to boost fossil fuel supply.

A similar **dilemma between their decarbonization goals and energy needs** is faced by energy-importing Asia. Some countries have turned to cheaper sources, such as coal and LNG, to the benefit of producers like Australia. China is increasing domestic coal production by 300 million tons this year as well as buying Russian coal to avoid an energy crunch.[4]

Social

Another area that saw a tectonic shift is **the EU's acceleration of investments in its defense capabilities**, which has lagged the US, Russia, and China in recent years. Various EU member states have added approximately €200 billion to their defense budgets in the coming years, while the bloc sought coordinated investments to address urgent shortfalls, such as in research and development.[5] Separately, Germany has taken the unprecedented step of amending its constitution to increase its defense budget over the next several years.[6] In general, the required defense investment will let some of the air out of today's global savings glut, which is shrinking today's negative real interest rates. But we also expect higher defense spending to keep commodities prices higher for longer. Moreover, history has shown that such increases may come at the expense of social services. Globally, military spending fell by half from 3.6% of GDP during the Cold War period (1970-1990) to 1.9% in the years after the global financial crisis. The decline since the early 2000s coincided with larger budgets for education, health, and infrastructure.[7] We are watchful of the **potential negative impact this new focus on defense may have on the EU's Social priorities.**

Military Spending as Share of GDP[8]



Governance

Political risk became more material than ever after the war. The unprecedented scope of economic sanctions on Russia has forced several multinational companies to withdraw from the country. Others also aligned their decisions with their corporate "values".[9] This suggests a **new facet in Governance considerations,** where companies have to consider whether their operations in certain markets reflect what they stand for, forcing greater scrutiny over potential exposures across their value chains. As geopolitical tensions continue to simmer outside Europe, what was once a marginal risk has now risen higher on the governance checklist.

The war in Ukraine continues to present opportunities and challenges for assessing ESG. One thing that's clear is that ESG is an important journey that will continue to evolve given the various rising economic and geopolitical challenges.

Source: [1] European Commission, March 8, 2022, https://bit.ly/3HP4yDR; [2] European Commission, May 18, 2022, https://bit.ly/3HJ5Sbo; [3] Bloomberg, February 28, 2022, https://bloom.bg/3tYk36W; [4] National Energy Administration, April 4, 2022, http://www.nea.gov.cn/2022-04/22/c_1310569203.htm; Reuters, May 11, 2022, https://reut.rs/3HMTA1N; [5] European Commission press release, May 18, 2022, https://ec.europa.eu/commission/presscorner/detail/en/IP_22_3143; [6] Deutsche Welle, May 29, 2022, https://bit.ly/3tWB3Kz; [7] IMF, Summer 2021, https://bit.ly/3xQPktq; [8] SIPRI Military Expenditure Database, accessed June 16, 2022, https://milex.sipri.org/sipri; [9] McDonald's press release, May 16, 2022, https://bit.ly/3ydDpHB

Global Developments and Trends

A snapshot of notable developments around the world

Europe: Pace-Setting the Global ESG Agenda

Widely considered an ESG pioneer, the European Commission (EC) spearheaded sweeping initiatives across the eurozone for several years with the goal of greater sustainability. Most notably, the recent European Green Deal provides a roadmap toward carbon neutrality by 2050 – and, in turn, leads the globe. The pact includes the European Green Deal Investment Plan, as well as other sustainable finance disclosure measures, such as sustainable finance regulations for properly classifying green investments.

Environment

Putin's invasion of Ukraine changed the energy security calculus in Europe. The REPowerEU Plan announced in May aims to strengthen the EU's energy security, specifically by weaning itself off its dependence on Russian fossil fuels. The plan builds on the Fit for 55 package under the Green Deal, linchpin of the EU's climate policy, which mobilizes at least €1 trillion of sustainable investments by 2030.[2]

Social

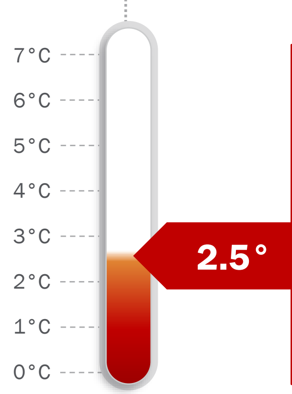
The EC's European Pillar of Social Rights (EPSR) targets improvements in 20 key principles across employment, skills, and social protections. In terms of board diversity, Spain and France have mandated a quota of 40% women on the boards of larger companies and required companies with at least 50 employees to publish information on gender pay gaps and how to address them.

Governance

The first set of standards under the Corporate Sustainability Reporting Directive is set to be adopted by October 2022. The standards will apply to all large companies and listed entities. These organizations will need to report according to mandatory sustainability standards on top of the double materiality principle of reporting. It will also require a general EU-wide audit for sustainability information.

Implied Temperature Rise in 2100[3]

An implied temperature rise (ITR) at or below 2.0°C shows that the relevant MSCI index is aligned with the maximum 2.0°C warming scenario under the Paris Agreement, while an ITR above 2.0°C indicates that the given index is lagging.



At 2.5°C, European Equities are still slightly behind the maximum global warming target despite significant achievements and measures in recent years.

Source: [1] "COP26: EU helps deliver outcome to keep the Paris Agreement targets alive," November 13, 2021, European Commission, https://ec.europa.eu/commission/presscorner/detail/en/IP_21_6021; [2] "The European Green Deal Investment Plan and Just Transition Mechanism explained," January 14, 2020, European Commission, https://ec.europa.eu/commission/presscorner/detail/en/qanda_20_24; [3] MSCI ESG Research, based on MSCI Europe Index as of December 31, 2021

Global Developments and Trends

A snapshot of notable developments around the world

UK: An Improving ESG Outlook

Like other developed markets, the UK's main environmental focus is on reducing carbon emissions. A corporate governance and audit regime revamp, and new climate-related financial disclosure reporting rules likely will improve the Governance score. Gender parity issues, which have seen some improvements, drive the UK's Social score.

Environment

The UK became the first major economy to embrace a legal obligation to achieve net-zero carbon emissions by 2050. In response to the war in Ukraine, the government released the Energy Security Strategy, which put renewed focus on domestic energy generation, including investments in nuclear, wind, hydrogen, and solar.

Social

A recent report showed that 34.3% of board positions in FTSE 350 Index constituents are now held by women, up 50% from five years ago.[1] The gender pay gap declined for employees in both larger and smaller companies in 2020. In addition, the gender pay gap among full-time employees under age 40 has fallen to almost zero.[2] However, the Human Capital Index and Ease of Doing Business have declined recently.

Governance

Corporate governance is poised for transformation, with mandated reporting aligned with the Task Force on Climate-related Financial Disclosure (TCFD); a potential change in the role, responsibility, and liability of company directors, along with improved reporting around how stakeholder engagement is impacting company decision-making, strategy, and remuneration policy; revamp of the UK corporate reporting and auditing regime through a new regulator (ARGA) to address greater accountability for big business and the dominance of the Big Four audit firms.

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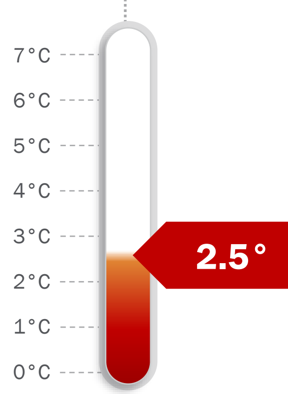
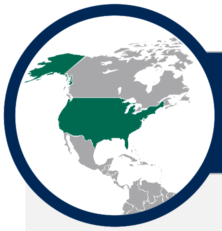


At 2.5°C, UK Equities are slightly behind the maximum global warming target. The impact of recent measures toward decarbonization may become evident in the next few years.

Source: [1] "Hampton-Alexander Review: FTSE Women Leaders," February 2021, https://ftsewomenleaders.com; [2] Office for National Statistics– Annual Survey of Hours and Earnings, April 2020, https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/bulletins/genderpaygapintheuk/2020#gender-pay-gap-data; [3] MSCI ESG Research, based on MSCI UK Index as of December 31, 2021.

Global Developments and Trends

A snapshot of notable developments around the world



US: At Risk of Setbacks

The Biden administration put the US back on the sustainability course when it rejoined the Paris Agreement and worked with allies on key climate change pledges at COP26 in 2021. However, progress on its domestic social and environmental agenda has slowed down largely due to legislative gridlock. The US ESG Outlook is beginning to show signs of lagging, and the global backdrop of the war in Europe and rising oil and commodity prices may detract it further.

Environment

After some positive steps on climate change, inflation and rising commodity prices triggered by the war in Ukraine threaten the Biden administration's environmental agenda. The US$2 trillion Build Back Better Act, which proposes clean energy tax credits, climate change mitigation investments and investment in renewable technologies, has been stalled in the Senate since November.[1] Pain at the pump in an election year builds pressure to tap more affordable domestic fossil fuel sources.

Social

The US has shown a deterioration in income inequality and has not ratified the UN international human rights treaties and the Human Capital Index for women. The American Rescue Plan provided relief to families in response to Covid. However, the Senate has yet to pass the larger Build Back Better Act, which provides funding for social and education programs, including universal free prekindergarten, up to four weeks paid family leave, and limits to childcare costs for low-income families, among others.[1]

Governance

Measures of governance have deteriorated in the US as illustrated by a declining Corruption Perceptions Index and a low Rule of Law Index relative to peers. Despite this, greater funding has been pledged to the Internal Revenue Service to crack down on tax avoidance, and the US is moving to strengthen the role of ESG in financial investments.

Implied Temperature Rise in 2100[2]

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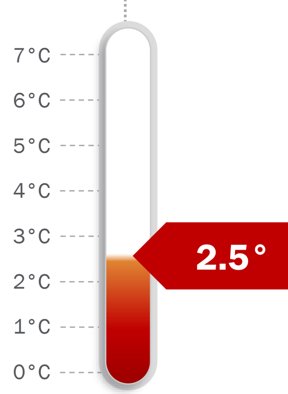

At 2.5°C, US Equities are slightly behind the maximum global warming target. The Biden administration's environmental policies are generally viewed positively, but politics may get in the way as elections loom once more.

Source: [1] US Congress, https://www.congress.gov/bill/117th-congress/house-bill/5376; [2] MSCI ESG Research, based on MSCI USA Index as of December 31, 2021

Global Developments and Trends

A snapshot of notable developments around the world

APAC: Advancing at an Uneven Pace

Increasing ESG awareness in Asia, driven by global trends and the visible impact of climate change across the region, has resulted in significant changes in governmental and corporate priorities. Yet short-term energy pressures threaten to slow progress on decarbonization.

Environment

Despite their net-zero commitments, Asian economies, including China, have increased their use of coal-generated electricity to meet energy demand. The International Energy Agency estimated coal demand in China in 2021 to be well above the 2014 peak. Paradoxically, the country is also estimated to see its largest-ever increase in renewable power output in the same period.[1]

Regulations continue to be the preferred route towards carbon neutrality or a low-carbon future in Asia, with governments implementing rules on renewable energy and single-use plastics, proposing carbon taxes, and offering green subsidies.

Social

The social aspects of ESG in the region have broadened from labor-related issues in factories to an enterprise's impact on the wider community, workers' well-being, human trafficking, and compelled labor. Notable examples include Australia's Modern Slavery Act in 2018; India's mandatory corporate social responsibility spending for companies above a certain size; and Taiwan's increase in childcare subsidies and child rearing allowances. South Korea's efforts to improve gender equality are uncertain under new President Yoon Seok-youl, who vowed to eliminate the Ministry of Gender Equality during his campaign.

Governance

Aligning with global regulations on ESG disclosures, the Monetary Authority of Singapore and Hong Kong's Securities and Futures Commission have released new disclosure requirements for environmental risk management/climate-related risks, respectively, for asset managers. Meanwhile, the China Enterprise Reform and Development Society – a think-tank under the foreign exchange regulator, State-owned Assets Supervision and Administration Commission – has released China's first ESG disclosure standards. Developed with input from private enterprises, the guidance is not mandatory, but it is seen as a positive development for ESG in China.

Implied Temperature Rise in 2100[2]

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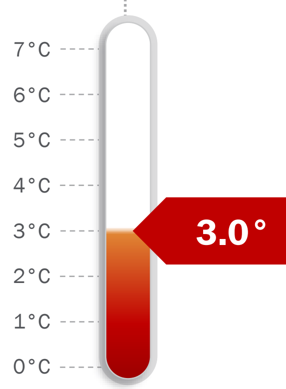

At 3.0°C, APAC Equities are a degree behind the maximum global warming target, suggesting more significant alignment efforts would be needed in the next several years.

Source: [1]"Global Energy Review: C02 emissions in 2021, International Energy Agency, March 2022, https://www.iea.org/reports/global-energy-review-co2-emissions-in-2021-2; [2] MSCI ESG Research, based on MSCI AC Asia Pacific Index as of December 31, 2021

Global Developments and Trends

A snapshot of notable developments around the world

Latin America: Bright Spots Tempered by Local Realities

Latin America has seen laudable high-level pledges to meet key global climate change targets and advances on some social and governance issues. However, improvements have sometimes reversed as some countries face idiosyncratic challenges.

Environment

Steady but slow describes environmental progress broadly across the region. Mexico, for example, suffered a setback after it increased coal-fired power generation. On a positive note, Mexico committed to methane emission cuts at COP26. Brazil, meanwhile, has brought forward its carbon neutrality deadline by 10 years to 2050 and vowed to end illegal deforestation in the Amazon by 2030. A bright spot in Latin America has been green bond issuances.

Social

While board diversity has improved globally, Latin America still lags developed and other emerging markets. For example, while countries including Malaysia, India, Turkey, and South Africa have set requirements for female representation, progress on board diversity in Brazil and Mexico has stalled. Inconsistent Covid responses have led to a significant death toll among the poor and indigenous communities.

Governance

Governance improvements are seen across the region. In Brazil, proposals include requiring companies to report on key performance indicators for environmental and social matters, diversity in the workforce, and pay gaps and whether environmental and social indicators affect executive compensation. By 2022, Mexico's Retirement Funds Administrators (Afores) will be required to publicly disclose whether they integrate ESG factors into their investment process, their ESG risk management and exposure policies, and performance measurement. Afores now demand ESG reporting from investee companies.

Implied Temperature Rise in 2100[1]

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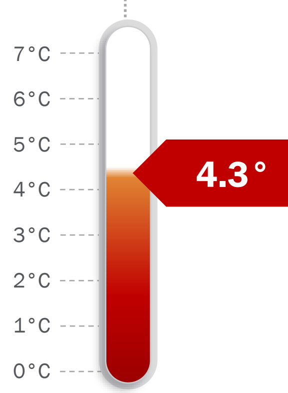

At 4.3°C, Latin America Equities lag significantly behind the global warming target, suggesting more ambitious action would be required in the next several years to narrow the gap.

Source: [1] MSCI ESG Research, based on MSCI EM Latin America Index as of December 31, 2021

Our ESG Review Process & Philosophy

The foundation of the Global Multi-Asset Team's investment philosophy is that forward-looking fundamentals ultimately drive markets. ESG complements our Multi-Asset approach, which centers on the belief that market prices converge toward fundamentals over the intermediate term.

Our ESG semiannual review of 50 sub-asset classes aims to produce two important indicators for each sub-asset class:

- The ESG Outlook (Improving, Stable, or Lagging) focused on forward-looking improvements, and
- The ESG Engagement Level (High or Low), which offers a view of the ESG risk at the asset class level, indicative of the engagement effort needed to drive ESG improvement.

We use the insights from this process to evaluate the ESG impact on cash flows and capitalization rates of various asset classes as part of our Capital Market Line (CML) modeling, and ultimately on how we choose to implement our asset class convictions to maximize ESG impact and alpha.

Determining Our ESG Outlook and Engagement Level

We believe forward-looking improvements in ESG will support cash flows and result in a more generous discount rate, driving investor value. We develop our ESG Outlook and Engagement level by:

Spotlighting the E, S, and G trends for both the current state and the areas of ESG improvement for each asset class using tools, including, but not limited to, MSCI data rolled up at the asset class level, the SASB Materiality Map, Sustainalytics, carbon emissions, board gender diversity, and social norms metrics, as well as wealth gap and publicly sourced metrics for each sovereign.

Engaging with asset class specialists and ESG experts to **understand the recent improvement trends (or lack thereof) and current state for each of the E, S, and G pillars.**

Evaluating the forward-looking ESG Outlook for improvement (Improving, Stable, or Lagging) and potential impact on each asset class's cash flows and capitalization rates through discussion and debate.

Evaluating the required ESG Engagement Level (High or Low) through discussion and debate. The associated level of engagement refers to what is required of investors, in our view, to drive enough ESG improvement given the asset class's current state, historical ESG trends, and degree of potential improvement in the asset class.

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