ESG Asset Class Report

31 March 2025

By:
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Executive Summary

The COP29 conference in Azerbaijan was disappointing overall, as the few agreements reached do not match the scale of progress needed to achieve the objectives of the Paris Accord. Leaders expressed a greater sense of urgency, stressing that ambition must be paired with action; yet, the gap likely will widen following the US withdrawal and review of the new NDCs due in advance of the COP30 conference in Brazil.

While changes to our Engagement Level and ESG Outlook assessments typically evolve over time for any particular asset class, we did revise the ESG Outlook across certain of the sovereigns, equities, and fixed income sub-asset classes we assess. Some updates from our last review include:

Sovereigns

We upgraded our ESG Outlook for Spain Sovereign from Stable to Improving, driven by efforts in renewable energy, social welfare programs, and anti-corruption measures. Elsewhere, we are mindful of potential for developments in both the US and the UK, which remain on watch for change. In the US, legislative action taken under the Biden Administration is funding a number of programs, more in Republican than Democratic districts, and is thus more likely to sustain its positive momentum than meets the eye. However, climate setbacks expected under the Trump administration have led us to put the sovereign ESG Outlook on negative watch. We placed the UK ESG Outlook on positive watch, reflecting a major shift with the restoration of previously diluted climate policies. Yet concerns persist around effective implementation and fiscal capacity.

Equities

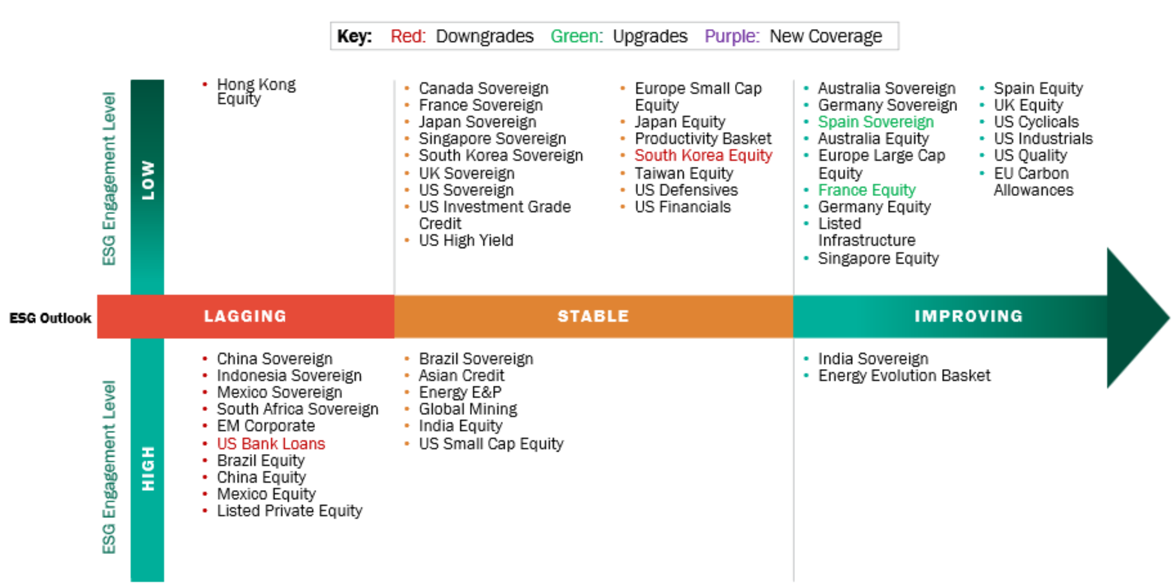
We upgraded our ESG Outlook for France equities from Stable to Improving, driven by efforts to increase the share of renewable energy and commitment to strong governance. In South Korean equities, we revised the ESG Outlook from Improving to Stable. While there is progress on the environmental front, particularly with the government providing funding to small businesses to aid them in achieving carbon neutrality, there are issues related to gender inequality, and uncertainty related to the stalled tax incentive critical to the success of the "Value-Up" program.

Fixed Income

With most of the key ESG metrics for US Bank Loans lagging those for Global Corporate Bonds, we revised our ESG Outlook for US Bank Loans from Stable to Lagging. While US Bank Loan issuers have been improving their ESG disclosure, such improvement has been much more limited than in 2020 and 2021. Meanwhile, issuance of sustainability-linked loans has been flatlining, carbon intensity is higher, and there is less board diversity.

The chart below summarizes our most recent asset class review for the 50+ sub-asset classes we cover in this report.

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



As of December 2024. For illustrative purposes only. We are not soliciting or recommending any action based on this material.

Global Developments and Trends

A snapshot of notable developments around the world

Europe: Aims to be the first climate-neutral continent

The EU remains a climate leader, pledging to cut emissions by at least 55% by 2030 compared to 1990 levels and to become climate-neutral by 2050. A slew of EU measures and individual sovereign actions are bringing major changes to the environmental, social, and governance practices of European listed companies.

Environment

The EU proposed its Directive on Green Claims in March 2023. The general approach was approved in mid-2024 and negotiations are underway before countries can implement requirements in national laws. The Directive aims to increase environmental protection and help accelerate the transition to a clean and climate-neutral economy in the EU while protecting consumers and preventing companies from greenwashing. It would also improve legal certainty regarding environmental claims.

The EU has a strong Renewable Energy Directive compared with other regions across the globe, with Renewables targeted to comprise 42.5% share of EU energy consumption by 2030. In response to the US Inflation Reduction Act, the EU Commission launched the Green Deal Industrial Plan, which aims to make Europe's net-zero industry more competitive and accelerate the transition to climate neutrality by supporting the conditions needed to scale up the EU's manufacturing capacity for the net-zero technologies and products required to meet Europe's ambitious climate targets.

Germany is a global leader in the transition to renewables, pulling forward its coal phase-out from 2038 to 2030. Spain also is at the forefront of the renewables transition, investing heavily in renewables, and aiming for 81% renewable electricity by 2030. In contrast, France continues to lag on renewables and is deteriorating due to resource depletion and emissions per capita.

Social

Germany is taking a leading role in supply chain management, passing the German Supply Chain Act. The Act, which became effective in 2023 for companies with at least 3,000 employees and was expanded in 2024 to include companies with at least 1,000 employees, requires companies to take measures to prevent human rights violations and environmental damage in their global supply chains.

France has made significant strides in closing the gender gap, improving its rank by 18 positions to 22nd, and has committed to a new campaign to combat violence against women. France also has taken action to improve its asylum procedures, while the new immigration law passed in 2024, which aims to tighten immigration controls, has sparked significant controversy.

Governance

The EU maintains a strong corporate disclosure framework, with directives including, but not limited to:

- Corporate Sustainability Reporting Directive (CSRD)
- Sustainable Finance Disclosure Regulation (SFDR)
- Sustainable Corporate Governance Framework

Each country must implement the directives in its own legal framework.

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APAC: Social concerns offset climate action gains

In Asia, the drive toward decarbonization and the adoption of renewable energy sources is ongoing. However, human rights concerns remain an issue in some countries, and forced labor controversies continue to garner attention in the international community. Furthermore, there is a notable lag in terms of board diversity and structural advancements compared to Asia's Western counterparts. However, India leads the way in Social improvement as it transforms education and implements favorable labor codes.

Environment

China has progressed well with renewable energy, yet its growing use of coal fire power tops the world by a large margin, driven by national energy security concerns. While carbon emissions reduction is on target to peak before China's 2030 target, perhaps as early as 2025, continued reliance on coal power could impact China's commitment to achieve net zero by 2060. China has been protesting the EU Carbon Border Adjustment for several years, most recently at COP29, in conjunction with other developing nations, and reasserted its stance that the developed countries are responsible for funding to meet the climate finance goals.

India aims to achieve net zero by 2070 and plans to enhance its renewable energy capacity, which currently accounts for more than 46.3% of the country's total installed capacity. Key actions at COP29 reflect its ongoing commitment to climate action, as India joined China and other countries to protest the EU Carbon Adjustment and also advocated for fair and adequate financial support for developing countries.

In Australia, while the 2022 Climate Change Act included ambitious goals to achieve 43% emissions reduction from 2005 levels by 2030 and net zero by 2050, plans and policies to achieve these goals have not been published. Australia is bidding to host COP31 in 2026.

Social

While human rights issues in Hong Kong and Xinjiang, in addition to the Covid-related lockdowns, remain controversial in China, we are seeing improvement in the Human Development Index, including life expectancy, education, and gross national income, surpassing most emerging countries. Meanwhile, in Taiwan, we are seeing poor gender diversity in tech companies, and the Ministry of Labor is taking steps to address workplace bullying. In South Korea, the gender pay gap continues to hold the high spot among OECD countries.

India continues to transform its education policy, expanding formal school education to include early childhood, aiming for equitable access to the highest-quality education regardless of social and economic background. Also, India implemented four labor codes aimed to enhance the ease of doing business, employment, and productivity.

Governance

While female board representation trails global peers, we are seeing board diversity rising in China and South Korea after a decade of stagnation, along with steady improvement in India and Indonesia, while Taiwan continues to lag.

Indonesia is leading the region in improvement, driven by political and operational stability and Sustainable Development Goals, yet continues to struggle with corruption. Other issues of note include freedom of speech concerns in Hong Kong, allegations of corruption in India, and tightened regulations on board independence and transparency in Taiwan.

[1]The Economic Times, 30 June 2023. "National Education Policy: What does NEP truly mean for students in India." https://economictimes.indiatimes.com/news/how-to/national-education-policy-what-does-nep-truly-mean-for-students-in-india/articleshow/101402955.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst

Global Developments and Trends

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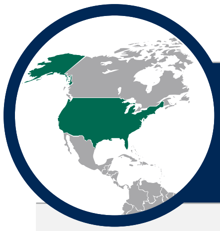

US: Climate Momentum May Pause

The US has begun the process to withdraw from the Paris Agreement, and it remains to be seen whether the climate momentum achieved under the Biden Administration with the passage of the Bipartisan Infrastructure Law and the Inflation Reduction Act, will continue.

Environment

While the US has made progress, its CO_2 emissions per capita remain elevated relative to peers, and its carbon footprint likely will increase with the anticipated increase in oil production.

At COP29, the Biden Administration committed to advancing energy infrastructure, clean hydrogen, space-based climate solutions, transparency, and methane emissions reduction, reflecting its dedication to global climate policy and international cooperation. The US also collaborated with state, territorial, Tribal, and local governments to develop the 2035 NDC, which was submitted in December 2024.

However, the 2035 NDC is not 1.5˚C aligned, and it will be effectively annulled under the Trump Administration, which has begun the process to withdraw from the Paris Agreement. The Trump Administration also seeks to limit financial commitments to other countries in climate change mitigation and adaptation efforts made by the US under the UN Framework Convention on Climate Change.

We anticipate continued positive momentum from the implementation of the Inflation Reduction Act (IRA) and the Bipartisan Infrastructure Law (BIL), given that programs are being funded in both Democratic and Republican states. The nonpartisan business organization E2 reported that over 60% of all IRA-related clean energy projects went to Republican congressional districts in the two years following its passage. In addition, the US Department of Transportation reports that the BIL has benefited all 50 US states, the District of Columbia, and US territories. We are monitoring activity closely for further developments.

In addition to legislative action, we note that green initiatives in the US also have been driven by active investor engagement, and we expect this to continue. However, the significant shift in climate policy under the Trump Administration has set the US on a trajectory toward a substantial overshoot of the 1.5˚C temperature limit, which will be difficult to reverse even with constructive actions by future administrations.

Social

The US Social score has deteriorated over the past three years. This trend may continue with the deportation of illegal immigrants, education spending cuts, and other policies that exacerbate inequalities. Income inequality, measured by the GINI Index, is greatest for the US relative to its peers.

Governance

The US Governance improvement score has increased over the past three years and now ranks second, behind France. Improvement relative to peers is driven by the World Justice Project's WJP Rule of Law Index and the Sustainable Development Goals Index. However, the improvement is offset by some deterioration in Corruption Perceptions Index and Political and Operational Stability Index.

Global Developments and Trends

A snapshot of notable developments around the world

Latin America and EMEA (Emerging):
Environmental progress while social and governance lag

Many emerging markets in Latin America and EMEA have committed to progress on environmental goals and have plans in place to pursue them. However, social issues – most notably human rights concerns – are an ongoing problem in many areas, as are governance concerns related to persistent corruption.

Environment

Brazil will host COP30 and was one of the first nations to submit its 2035 NDC, pledging to cut GHG emissions by as much as two-thirds by 2035 compared to 2005 levels. Brazil National Development Bank approved record finance of BRL882 million in efforts to restore the Amazon rainforest, increasing from BRL553 million in 2023.

Brazil has recommitted to its climate pledges, with President Lula vowing to crack down on illegal deforestation in the Amazon rainforest and to make Brazil a leader in the global fight against climate change.

Mexico announced at COP29 that it is working to have a net-zero economy by 2050, hailed as a crucial step forward by the world's 13th-largest emitter under its new president, Claudia Sheinbaum.

South Africa's Climate Change Act mandates carbon budgets for companies, sets out national climate change response strategies, and aligns with the Paris Agreement goals. However, progress is slow, and timing is uncertain regarding the funding ($8.5 billion announced) and implementation of projects to reduce coal consumption.

Social

Human rights and other social issues continue to weigh on Latin American and EMEA sovereigns. Income inequality remains stubbornly high in Brazil. However, Brazil has enacted a law to combat political violence against women, a favorable development.

In Mexico, social safety nets have weakened and crime is rising, dampening our outlook for overall social stability.

South Africa continues to have the highest rate of income inequality in the world, with 10% of the population owning more than 80% of its wealth. However, the Black Economic Empowerment program is progressing, albeit slowly, and has the potential to improve employment prospects for underrepresented groups.

Governance

Corruption remains an impediment to economic development in parts of Latin America and emerging EMEA.

Brazil is showing signs of governance improvement, driven by the World Justice Project's WJP Rule of Law Index and the Sustainable Development Goals Index. In addition, female board representation has resumed an upward trend.

Mexico has introduced significant judicial reform aimed at enhancing the transparency and accountability of the judiciary. However, female board representation has plateaued, lagging global peers.

South Africa governance is deteriorating, and the country ranks lowest among the emerging market sovereigns we cover, driven by corruption, which remains rampant across the country.

Our ESG Review Process

Our ESG semiannual review of 50+ sub-asset classes aims to produce two important indicators for each asset class: (1) the ESG Outlook focused on forward-looking improvements, and (2) the ESG Engagement Level, which informs the level of ESG risk present and the expected engagement needed to drive improvement. We use the insights from this process to evaluate their likely impact on cash flows and capitalization rates as part of our Capital Market Line (CML) modeling and global asset allocation. Our ultimate goal is to seek and foster sustainable business practices through our investments, thus providing better outcomes for our clients.

1 ESG Outlook

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 by:

- **Spotlighting the E, S, and G trends for both the current state and the areas of ESG improvement for each asset class.**

  We built a series of individual E, S, and G factors and combined ESG historical trend lines to assist our research. We use proprietary tools and third-party data from MSCI, Bloomberg, and the Sustainability Accounting Standards Board (SASB), which provide the current status and recent trends for E, S, and G, as well as ESG overall for each asset class. For sovereigns, we have developed a proprietary framework incorporating publicly sourced ESG factors to assess countries' exposures to, and management of, ESG risks.

- **Understanding the recent improvement trends and current state for each of the E, S, and G pillars.**

  This provides a baseline to frame the ESG Outlook and ESG Engagement Level. We then drill down to understand each asset class's history and its current E, S, and G status. When a security skews these results, it becomes a useful guide for the team to identify which companies need to be engaged with, and which issues need to be addressed.

  The art is in identifying the potential catalysts of forward-looking improvement to move us above or below the existing trajectory. To complement our ESG research, we discuss and debate ESG-related changes underway at the asset class level with our bottom-up specialists, and then independently decide whether the forward-looking ESG Outlook is "Improving," "Stable," or "Lagging." We also place a special focus on certain E and S characteristics of global importance for each sub-asset class, specifically carbon emissions and board gender diversity, as well as the wealth gap for sovereigns (i.e., the Gini coefficient).

2 ESG Engagement Level

Engagement is a key component of our ESG improvement philosophy, particularly when we see potential in investments that are lagging on ESG.

The ESG Engagement Level reflects our assessment of the ESG risk if we were to invest passively in the asset class. The associated level of engagement we prescribe (Low or High) 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.

For instance, a "High" Engagement Level indicates the asset class's current ESG state is not favorable, the existing trends are not encouraging, and triggers for improvement are not apparent. In our view, traditional passive investing is not acceptable or appropriate for such an asset class, even if investing in the asset class is financially attractive after taking the drag from ESG into account as part of our Capital Market Line modeling.

Too few constituents in the index are likely to improve or appear receptive to engagement for improvement. In such circumstances, we will consider exposure to the asset class if we can source an active manager that we deem is very likely to add alpha in the right way – via vigorous ESG integration and engagement. We also may create an ESG-optimized allocation using third-party data for current and momentum carbon emissions and board gender diversity factors.

We seek to identify the potential good actors in segments that may be lagging on ESG, looking to incentivize others by producing clear improvements in performance. This is essential in a world where the largest potential improvements in areas like carbon emissions are in the lagging asset classes.

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