Responsible Investment in Practice: ESG Integration in Equities

HSBC Asset Management

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HSBC
Asset Management

Responsible investment – Our commitment

Responsible investment is integral to our investment philosophy and approach

With a strong heritage of successfully connecting our clients to global investment opportunities, and proven expertise in connecting the developed and developing world, we have a unique perspective on ESG factors

Long-term commitment to RI
20+ years of RI experience

A+

Recognised leader in ESG integration
Our Strategy and Governance score from the PRI

ESG Advanced

Awarded "ESG Advanced" by Morningstar[1]
"Among the industry's strongest ESG proponents"

Innovative sustainable investment solutions
Responding to sustainability challenges

Extensive resources and global expertise
Unique global perspective with expert insight

Well positioned to influence the future of RI
Working with stakeholders to shape the future

As at 31 March 2021.
Sources: Morningstar, HSBC Asset Management. For illustrative purposes only.
1. Out of 140 strategies and 34 asset managers assessed by Morningstar only five asset managers earned a Morningstar ESG Commitment Level of Advanced.

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Source: HSBC Asset Management. For illustrative purpose only

Our responsible investment beliefs underpin everything we do

There are two kinds of responsible investment	- Incorporating sustainability into decision making in order to generate superior risk-adjusted returns - Investing sustainably in order to achieve positive real word outcomes, however the latter is defined
Asset managers have a key role to play in both	- Our industry is fiduciary bound, which means understanding how sustainability affects valuation, risk and returns - As asset allocators, stewards of capital, and influencers of policy, we can help mobilise positive real world change
ESG integration improves risk-adjusted returns	- Our rigorous and proprietorial quant-based historical analysis shows that ESG integration has produced excess returns - This is consistent for each of E, S, and G, as well as across regions. It is also true for so-called ESG 'improvers'
Real world change is an opportunity more than a risk	- Transitions are positive for investment performance; trillion dollar technologies, business models and asset classes will emerge - Even climate change will spur nature based solutions, sustainable infrastructure spending and new green technologies
Engagement is central to both performance and outcomes	- Engagement is key to RI because of the role it plays in delivering investment returns as well as sustainable objectives - This is especially so for businesses funded with long-term or permeant capital, or which generate surplus cashflows
Responsible investing must be inclusive	- We believe that our commitment to diversity, equity, and inclusion leads to better investment outcomes for clients - Likewise, the transition to a sustainable future also means promoting prosperity and access to opportunity for all

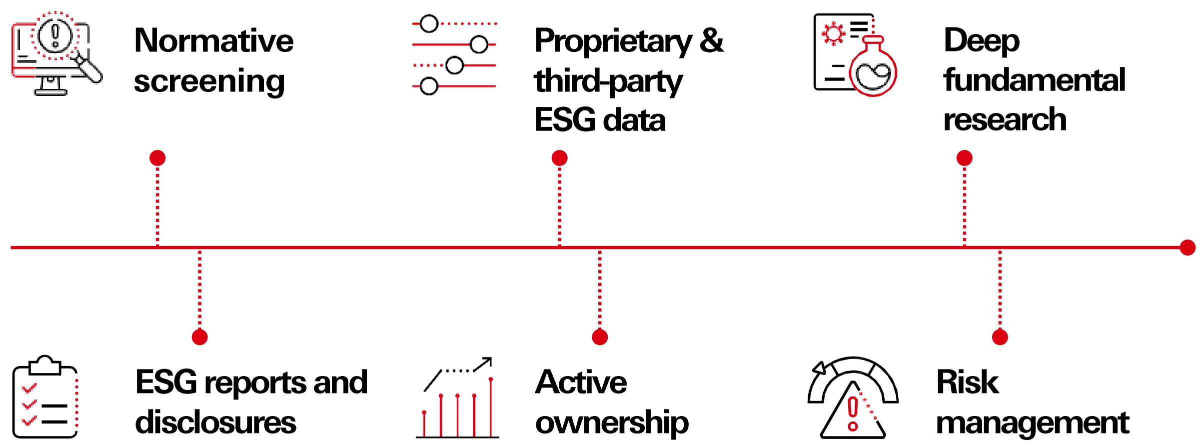
Source: HSBC Asset Management. For illustrative purpose only

What do we mean by ESG integration?

"ESG integration means incorporating environmental, social and governance factors into investment analysis. Understanding related risks and opportunities not only enhances decision-making and risk-adjusted returns, it helps address the most urgent challenges facing our planet today.

Source: HSBC Asset Management. For illustrative purpose only

Components to incorporate ESG factors into the investment process



Source: HSBC Asset Management. For illustrative purpose only

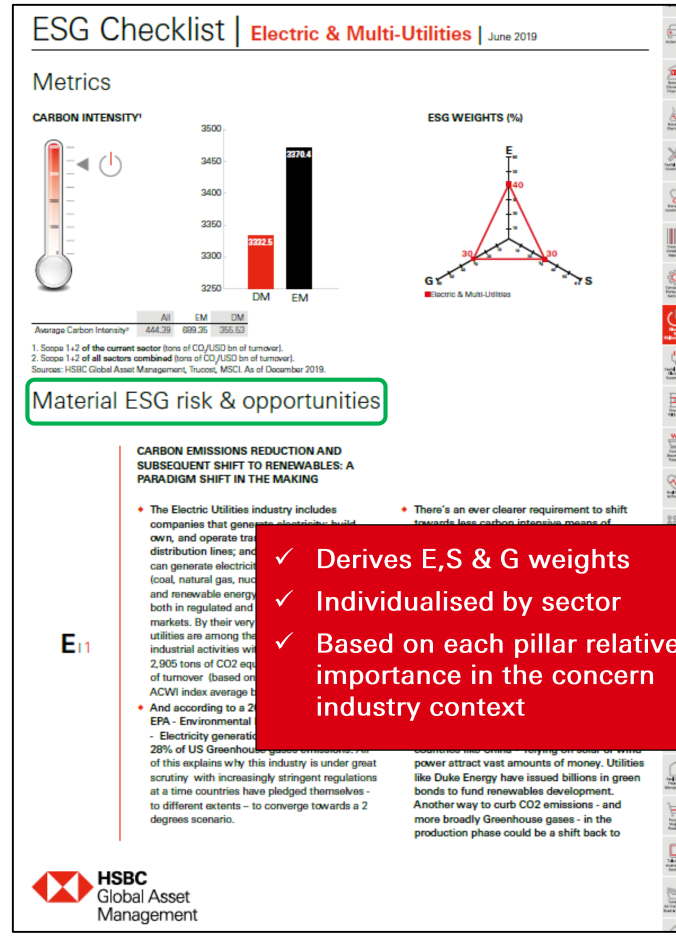
Defining ESG financial materiality

Focusing on financially-material ESG risks and opportunities for each sector / industry

- We identify key ESG **risks and opportunities** for each sector / industry
- This leverages **investment teams sector expertise** (credit, equity and RI teams)
- This gives us our proprietary **ESG materiality framework** for 24 sectors

Electric Utilities

Environmental	Social	Governance
GHG emissions reduction	Workplace H&S	Ownership structure
Shift to renewables; land use, biodiversity	Energy security and affordability	Board accountability and independence
Air quality, pollution and coal ash management	Grid resiliency & cyber security	Minority shareholder protection
Energy efficiency and end-user demand	Community impact	Audit & control
Water management		

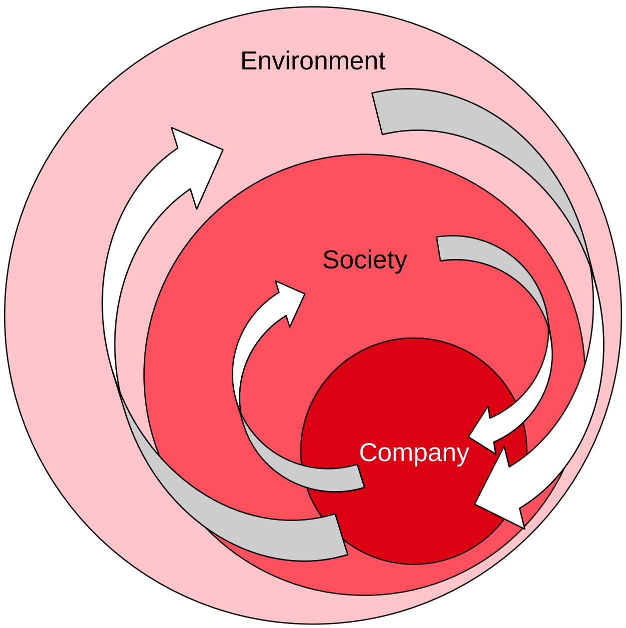


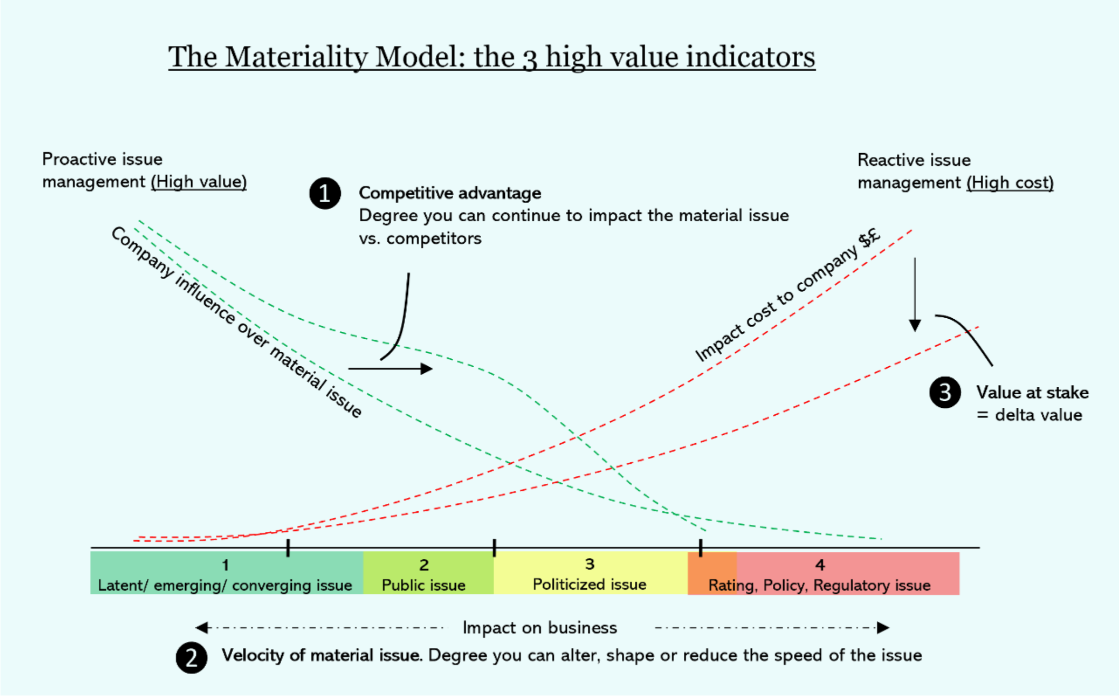
- ✓ Derives E,S & G weights
- ✓ Individualised by sector
- ✓ Based on each pillar relative importance in the concern industry context

Source: HSBC Asset Management. This is an example output only. For illustration purposes only and does not constitute investment advice.

Double and Dynamic

- **Double materiality**: not only the impact of ESG issues on companies, but also the company's impact on E and S
- **Dynamic materiality**: company's exposure, ability to manage and impact the issue, and the costs are constantly evolving





Source: HSBC Asset Management. For illustration purposes only and does not constitute investment advice.

Virtual Sector Teams

- Capture ESG sector specific knowledge across asset classes and geographies
- Build investment-relevant scores suiting our needs and convictions
- Share and disseminate this knowledge with broader investment platform and beyond

Virtual Sector Teams

ESG analysts / PMs (appointed by CIOs) representing all asset classes, multiple regions

- Conduct sector reviews
- Oversee sector checklist developments
- Pinpoint material issues: upside and downside
- Derive proprietary scores combining vendors data and 'on the field experience'

- Sector reviews and materiality checklists,
- Geographical specifics to be factored in
- Engagement objectives
- ESG overrides: proprietary and vendors' scores

On-going (virtual meetings and/or email)

The goal is to derive enhanced risk-adjusted investment value.

Source: HSBC Asset Management. For illustrative purpose only

Selection of providers give us a variety of views

- We use 3rd party ESG data to support our analysis
- New providers can be added on ongoing basis to cater for new clients needs or further strengthening the accuracy of our ESG Scoring and analysis
- Data is used systematically to rank issuers by ESG scores rather than as an absolute performance measure and the scores feed our investment decision making tools
- Frequent dialogue with data providers and appropriate systematic checks ensure quality of data

	MSCI	SUSTAINALYTICS		ISS ESG		Trucost ESG Analysis S&P Global	carbon4finance	RepRisk
Issues under review	Overall E,S,G assessment	Revenues from sustainable or controversial products	UN Global Compact Principles assessment	Controversial weapons	E&S assessment for countries / governments	Data and analysis on Carbon, Water, Waste Pollutant and Natural Resources for countries & companies	Climate data solutions (Transition and Physical Risk)	Dynamic reputational risk assessment
Output	E, S and G numeric ratings (0-10 scale) + Sector reports + Company reports (focus on E&S)	Revenues percentage derived from products and services	Red / Amber / Green light	Company reports	E&S/G letter ratings + Country reports	GHG Emissions expressed in volumes + efficiency assessment	GHG Induced and Saved Emissions (Scope 1,2,3), Qualitative Analysis, Alignment with a 2° trajectory, Physical risk scoring	RepRisk Index (0-100) and Change

Source: HSBC Asset Management. For illustrative purposes only.

Integrating ESG factors

- We strive to identify ESG criteria which have a material financial impact, in affecting the business model and risk profile of companies on the upside or the downside
- We develop our own in-house ESG ratings for issuers and create sector-specific weightings that reflect the materiality of ESG factors
- They are incorporated into our ESG research platform and equity and fixed income portfolio analytic tools

HSBC in house research

- ESG pillar weights
- ESG materiality mapping
- In house ESG thematic research

ESG research providers

- MSCI ESG Research
- Sustainalytics
- S&P Trucost
- Carbon4 Finance
- ISS-Oekom
- ISS-Ethix
- RepRisk
- FTSE

Enhanced Due Diligence

Relative approach
Level of risk based on relative ESG scores calculated in each of the sectors
Low Risk
Medium Risk
High Risk

Absolute approach
10 Principles of the United Nations Global Compact (UNGC)
Low Risk: No violation
Medium Risk: Suspicion of violation
High Risk: Proven violation

Fundamental analysis

- Opportunities and risk assessment
- Impact on company valuation

Portfolio Analytics

- ESG rating
- Carbon footprint
  > Funds and benchmarks

Source: HSBC Asset Management. For illustrative purposes only. Representative overview of the investment process, which may differ by product, client mandate or market conditions.

Example: Indian property developer

One of the largest residential developers and office landlords in India – an ESG improver story…

What was the issue?

- There was a perception that the real estate sector in India has **lower governance**
- The company had governance standards that were perceived to be low due to **higher ownership of the founders**
- **Legacy litigations** with government related to tax and customer complaints

What did we do?

- We identified **improvement in governance** standards for the sector as a **key ESG catalyst**
- We analyzed governance related **concerns in detail** and tracked the company's **actions vs its commitments** in areas related to capital allocation, minority shareholder interest and customer related litigations
- We **engaged with the management** team and nudged them to progressively adopt best governance practices, increased disclosures and investor communication
- We analyzed and discussed with the management team on their commitments and actions in areas of **environment and operational safety** – use of renewable energy, recycling of water, treatment of waste, climate related risk
- **We incorporated the risk of financial penalties and loss of customers due to climate risk into our profitability projections and in our valuations**
- From a S perspective, the company does well to ensure adequate working conditions for its employees

Source: HSBC Asset Management as of June 2022. For illustration purposes only and does not constitute investment advice.

Example: Indian property developer

One of the largest residential developers and office landlords in India – an ESG improver story…

What was the outcome?

- The Indian property developer **has articulated its intentions publicly** to improve its governance practices and disclosures to best in class
- It is one of 5 Indian companies to be added to Dow Jones Sustainability Index
- It has 93rd percentile overall score on ESG dimensions
- It ranks 18th out of 250 global real estate companies across US, UK, Japan, Singapore, Hong Kong, etc.
- Its governance score in MSCI rating saw an improvement in 2020/2021

Company Name	Market Cap (USD Mio)	Country	Sustainalytics ESG Risk Score	ESG Risk Category	MSCI ESG Rating
[redacted]	5,289	Singapore	8.8	Negligible	AAA
[redacted]	14,700	Singapore	11.2	Low	A
[redacted]	13,849	Hong Kong/China	14.2	Low	BBB
[redacted]	11,674	Philippines	17.1	Low	BB
Indian property developer	**10,100**	**India**	**18.6**	**Low**	**BB**
[redacted]	3,192	India	19.1	Low	
[redacted]	22,643	Philippines	20.0	Low	BBB
[redacted]	33,589	China	20.5	Medium	BB
[redacted]	36,269	China	22.3	Medium	BB
[redacted]	27,363	China	22.4	Medium	B
[redacted]	5,344	India	22.5	Medium	
[redacted]	648	India	24.3	Medium	
[redacted]	2,118	Philippines	24.7	Medium	
[redacted]	10,304	Hong Kong/China	24.7	Medium	BB
[redacted]	1,582	India	27.8	Medium	
[redacted]	896	Indonesia	32.3	High Risk	

Source: HSBC Asset Management as of June 2022. For illustration purposes only and does not constitute investment advice.

Example: Global cosmetics company

A multi-thematic fund focusing on social megatrends

Mega Trend & sub-theme

Societal Change

Aspirational consumption

Leisure, Entertainment, Lifestyle

SDG Mapping

8. Decent work and Economic Growth (8.4, 8.5)

12. Responsible Consumption and Production (12.2, 12.5)

Engagement - since 2020

Circular economy

- 100% owned-stores offering recycling programs by 2025
- 40-50% of packaging from recycled plastic by 2030; reduce total plastic consumption by 10%
- Lifecycle Assessment and impact measurement

Net Zero

- Group to achieve carbon net zero (scopes 1,2,3) by 2030
- 100% renewable electricity in French factories by 2025

Biodiversity

- 90% of raw materials with plants trace back to country of origin by 2025

B-Corp certification

- Expect to be certified by Mar 2023 (process since 2019/20)
- High E & S performance; embed *stakeholder* governance in legal docs (e.g. Articles of Incorporation)

Monitor

% of recycled material in plastic packaging

Plastic consumption

Raw materials traceability

Carbon intensity & energy efficiency

Board gender diversity

Other ESG considerations

- Exclude categories with negative social impacts using revenue thresholds
- UNGC compliance
- DNSH indicators
- Good governance is a must

Source: HSBC Asset Management, as of November 2021. For illustrative purpose only.

Passive strategies

Our Sustainable Equity ETF offering

FTSE ESG Low Carbon Select and MSCI Climate Paris Aligned

FTSE ESG Low Carbon Select Indices

- Indices designed to achieve an ESG score uplift, carbon emission reduction and fossil fuel reserves reduction relative to the parent index:
  - 20% ESG rating improvement tilt
  - 50% Carbon Intensity reduction tilt
  - 50% Fossil Fuel Reserve intensity reduction tilt

MSCI Climate Paris Aligned Indices

- Aligned with the Paris Agreement to take action on climate change
  - Aiming to reduce greenhouse gas emissions to ultimately cap global temperature rises in this century at 1.5˚C
- Designed to reduce investor exposure to transition and physical climate risks, and, those looking for opportunities arising from the transition to lower carbon economy while aligning with the Paris Agreement requirements

Source: HSBC Asset Management, as at 31st March 2022.
1. These funds were launched on the 12th of April 2022, and the AUMs are reflective of this date.

The MSCI Climate Paris Aligned Indices

The index architecture ensures it is designed and optimised to far exceed EU minimum standards

- Paris-Aligned benchmark (PAB) criteria offers a means of investing in an index which follows agreed European Paris-aligned climate principles aimed at creating a minimum emission reduction standard
- The MSCI Climate Paris-Aligned Index is designed to go beyond EU minimum standards to address climate change risks and opportunities

PAB criteria (EU Technical Expert Group on Sustainable Criteria)	MSCI Climate Paris-Aligned Index Series
Climate Scenario	**Climate Value-at-Risk (VaR)[1] under 1.5°C Scenario: VaR ≥ 0** **10% increase in weighted average Low Carbon Transition (LCT) Score relative to Parent Index**
Allocation Constraint	**Incentivise companies setting targets – 20% overweight** **Underweight companies facing transition risk** Neutral exposure to high impact sector Lower fossil fuel exposure
Self decarbonisation	Self-decarbonisation at 10%
Relative Decarbonisation	Minimum 50% reduction in GHG intensity (Scope 1, 2 and 3) relative to parent **Minimum 50% reduction in Weighted Average Potential Emissions intensity relative to parent** **Physical Risk Climate VaR is at least 50% lower**
Green to Brown[3]	**Weighted average green revenue at least 100% higher than parent** **Green/brown revenue ratio – at least 4 times higher than parent** **Companies providing solutions – overweight**

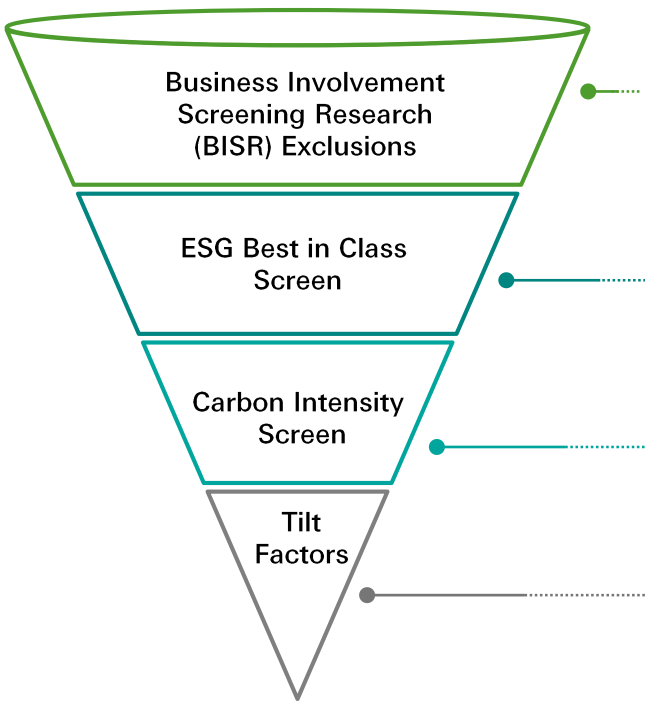
Sources: MSCI, HSBC Asset Management, as at 2021

1. Climate Value-at-Risk (Climate VaR) is designed to provide a forward-looking and return-based valuation assessment to measure climate related risks and opportunities in an investment portfolio. The fully quantitative model offers deep insights into how climate change could affect company valuations.
2. GHG stands for Greenhouse Gas.
3. MSCI notes that although historically there has been no industry standard definition of 'green' and 'brown' activities, the emerging EU taxonomy of sustainable economic activities provides guidance. In an analysis of the Green-to-Brown Premium (August, 2020), MSCI refer to the core principles presented by the EU Technical Expert Group on Sustainable Finance's Taxonomy Report: Technical Annex, March 2020.

Our Sustainable Fixed Income ETF offering

In collaboration with Bloomberg Barclays

We have been ambitious in our goals for our Sustainable ETFs. We have collaborated with Bloomberg Barclays to design indices that achieve an **ESG score uplift** and a **carbon emissions reduction** relative to the parent index through a clear and robust methodology whilst maintaining sector neutrality of the benchmark index.



Applied on annual basis (weapons, tobacco, thermal coal, nuclear energy, UN Global Compact (UNGC) principles, gambling and adult entertainment)

Best-in-class ESG screen rules applied:
- Exclude if ESG Rating < BB
- Exclude if E Score < 2
- Exclude if S Score < 2
- Exclude if G Score < 2
- Exclude Non-Rated Issuers

Exclude Issuers with MSCI carbon intensity score beyond the threshold of (750 t/USD million sales)

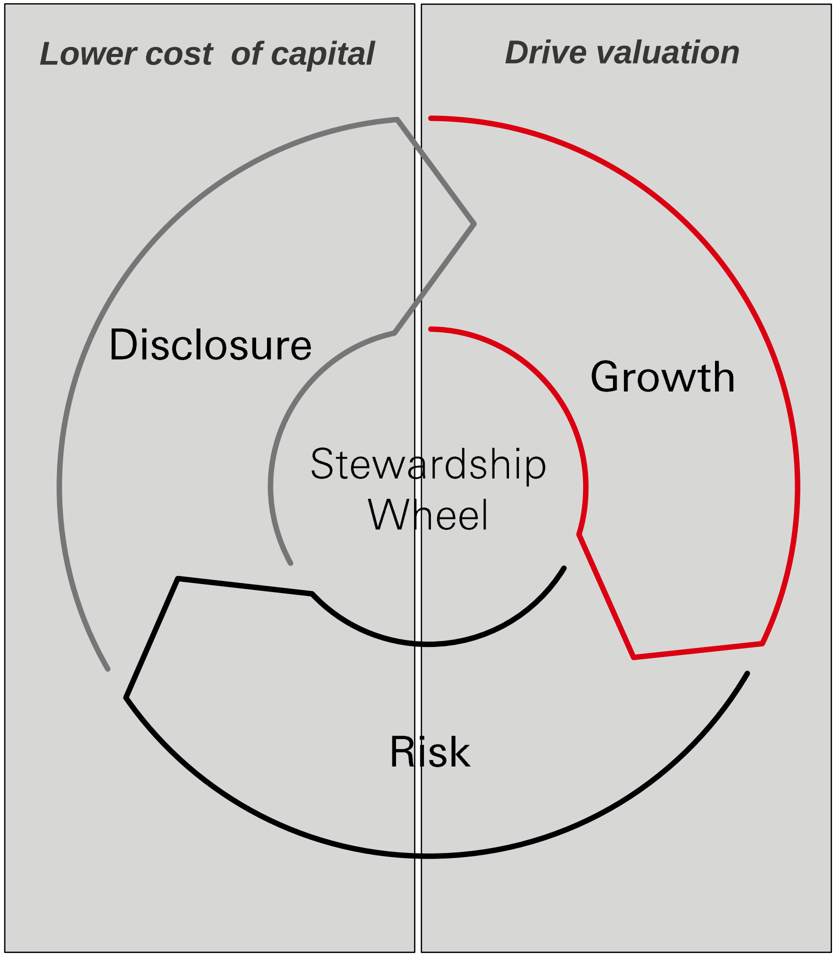
Apply tilt factors to increase/decrease weights of the highest/ lowest ESG-rated issuer

Source: HSBC Asset Management.
The UNGC exclusion is also captured in the pre-tilt exclusions, but in order to capture it at higher frequencies, we apply it on both a pre-tilt (annual process) and post-tilt basis (quarterly process).
MSCI carbon intensity is the amount of greenhouse emissions normalised by sales in USD. MSCI ESG Research collects company-specific direct (Scope 1) and indirect (Scope 2) greenhouse gas emissions data from company public documents and the Carbon Disclosure Project (CDP).

Stewardship and Engagement

Stewardship: Driving Positive Outcomes

Our purposeful engagement tracks and accelerates change towards sustainable future



1. **Value creation partner and inform emerging trends**
2. **Manage dynamic materiality of risks**
3. **Improve transparency and market efficiency**

Source: HSBC Asset Management, December 2021
For illustrative purposes only. Representative overview of the investment process, which may differ by product, client mandate or market conditions.
**Note:* The concept of "dynamic materiality" was first introduced by the World Economic Forum (WEF) in early 2020

As **responsible stewards**, we **constructively engage** with companies to enhance their **long term value creation** capabilities

We **intelligently leverage voting rights** to promote good environment, social and governance practices that meet stakeholders expectations

We ensure **additionality** and **intentionality** of engagements are documented with feedback loop that **informs investment decision-making**

How do we engage?

- **Research and analysis:** we critically analyse companies through three key lenses (growth, risk and disclosure) that cover material environmental, social and governance issues
- **Company engagement:** we engage with board members, executive management and subject experts to ensure companies are future-fit with long term financial sustainability. Our engagements are objectives-led with a six milestones tracking process
- **Voting:** we leverage voting rights to reward positive corporate development, drive behaviour changes, and hold directors of companies accountable when they fail to meet our expectations
- **Clear escalation approach:** we are explicit about our engagement escalation approach guided by industry best practices[1]
- **Public policy engagements:** we engage with policy makers and standard setters to support the integrity of the market and share industry best practices

Environmental
- Climate change
- Water stewardship
- Biodiversity – sustainable food, circularity by design

Social
- Inclusive growth: Just transition and Access to healthcare
- Human rights in supply chain
- Diversity, equity & inclusion

Governance
- Board effectiveness
- Business Purpose
- Ethics and Culture
- Responsible tax
- Access to trusted information

1: Professor Robert Eccles et al (2021) Value Creation of Active Engagement (English and Chinese versions available, City of London UK-China Green Finance ELF Forum. HSBC is a co-author.

Setting S.M.A.R.T. objectives

Creating Value through Purposeful Dialogue

SPECIFIC – Why are we engaging

- Regulatory change (new standards or procedures)
- Event-Driven (Shareholder meetings, CMDs, conferences, roadshows)
- Reactive (Company actions/decisions)
- Thematic
- Market/Sector (Is there a trend? Is or will Something affect many companies?)

MEASURABLE – Tracking progress against goals/objectives

- Targets
- Clear strategy and policy
- Disclosure and reporting
- Feedback and monitoring

ACHIEVABLE – Realistic and positive expectations

- Best Practice
- Current status -> required status -> ideal status
- Alignment with our policy or position

RELEVANT - Common or individual

- To our clients
- To our policy or position
- To our performance/reputation
- To market demands

TIME-BOUND

- Agreed timeframe for corporate action and further engagement, based on targets/objectives to be achieved

Source: HSBC Asset Management, Stewardship team

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