Asset Management

A Just and Inclusive Climate Transition

Investment Perspective

For professional investors only

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HSBC Opening up a world of opportunity

Content

Foreword

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We believe climate change is among the most significant threats to economic and social development worldwide – and particularly in emerging markets. The challenge is to decarbonise the global economy sufficiently to limit global warming to well below 2°C, preferably 1.5°C. Meeting this challenge will require an extensive transformation of both developed and emerging economies – especially in areas such as energy, power, manufacturing, transport and food systems. Enabling these changes will involve adopting new climate-critical technologies and investing in mitigation and adaptation infrastructure.

Whilst climate change poses a longer-term threat to global GDP growth, what's arguably more telling is its potential impact on GDP per capita. The latter measure is critical because it reflects social progress: the ability of society to fulfil its highest potential and maximise its living standards. This includes the provision of vital services such as education, quality employment opportunities and healthcare, as well as the development of basic infrastructure including water, sewage systems, and power. These support mechanisms enable living standards to rise, which in turn support social development and cohesion.

Nowhere is this more acute than in emerging markets, where the worst impacts of climate change are likely to be felt. Emerging economies are typically earlier in their economic growth trajectory than developed ones, and therefore access to affordable green or clean energy is critical. In no doubt the effect of global warming and net zero transition is also experienced in developed economies, where some industries and workforces are put at risk amidst an environment of rising energy prices.

Decarbonising the economy in a manner that is equitable and inclusive is at the heart of a just transition. To use a metaphor, we consider the climate transition and global inclusive growth as two ends of a barbell, with the just transition doing the heavy lifting. In order to be sustainable in the long term, the transition and innovation related to climate change must deliver benefits to the largest possible number of people (i.e., nobody should be "left behind").

Just transition considerations are critical within a country, a company, or a community, and also between countries as well as between industries. At the national level, a just transition can accelerate economic opportunities without widening social inequality, while at the global level, it will ensure that developing countries – which tend to be more dependent on energy-intensive industries than advanced economies – will not solely bear the brunt of our collective obligation to curb carbon emissions.

Supporting a just transition is critical in promoting social cohesion, economic growth and political stability over the long term, thereby stabilising the operating environment of the companies in which we invest. Concretely, it means that we have to monitor and assess the potential externalities that can manifest themselves if not managed well, as they could eventually become systemic detractors to the development and future profitability of a company.

To illustrate, when transitioning to a greener business model, a company might, for example, neglect the potential impact it might have on local communities. This could eventually reduce its ability to maintain or grow margins, shrink its customer base, or even harm its brand.

Therefore, when we evaluate companies, we look beyond financial performances and environmental impact, and pay specific attention to the 'S' of ESG. And it isn't always straightforward. While the measurement of environmental data is increasingly standardised, the scope of potential societal issues is relatively large, and assessing them in an exhaustive way remains a challenge. That said, there are still indicators that can help us to measure a company's societal footprint - labour policies, gender diversity and supply-chain management to name a few. What's critical is that having a local presence and an active engagement strategy allows us to gain valuable insights into these metrics.

We believe that incorporating just transition considerations into our investment philosophy and processes informs and strengthens our decision-making when investing at the corporate or sovereign level, which ultimately benefits our investors. And as a global asset manager operating in both developed and emerging markets, we know that directing financial flows only to the most advanced countries will not address the overarching problems that we are seeking to resolve collectively. So, we are proactively developing investment solutions that aim to speed up the transition globally, rather than only in countries that are already well placed to transition their economies and societies.

Overall, we believe that many investment opportunities will arise from the net-zero transition and other related sustainability areas. Our focus on a just transition helps our clients to allocate capital in a way that can drive positive change.

A widely used definition of a just transition

The International Labour Organisation (ILO) provides a comprehensive and widely used definition of a just transition that captures a holistic approach (Smith, 2017):

"It is a bridge from where we are today to a future where all jobs are green and decent, poverty is eradicated, and communities are thriving and resilient. More precisely, it is a systemic and whole of economy approach to sustainability. It includes both measures to reduce the impact of job losses and industry phase-out on workers and communities, and measures to produce new, green and decent jobs, sectors and healthy communities."[1]

1. Inevitable Policy Response: Why a just transition is crucial for effective climate action, September 2019

Just Transition - A north star for climate transition and sustainability

There has been considerable progress towards the implementation of commitments made by countries at COP27. But the chances of limiting global warming to 1.5°C are diminishing rapidly. Achieving our climate goals will only be achievable if developed countries deliver deep emission reductions within the time frames required. In addition, collective actions and national policies that support developing countries will be critical alongside financial flows to advance their transition.

The climate transition will be amongst the most significant economic transformations of our era. Like the industrial revolution of the 19th and early 20th centuries, the transition will revolutionise industries and economies. It will introduce technological advancements that are yet unknown or at experimental or development stages. It will reorient society towards a sustainable and resilient standard. This transformation holds immense potential to mitigate the worst impacts of climate change and transform living standards worldwide. However, if not managed with inclusivity considerations at the heart ,–it could exacerbate growing inequalities and/or damage the environments in which our companies and governments operate.

This is why we are progressively embedding just transition considerations into our investment process and frameworks. Just transition is threaded in our engagement strategy, how we direct financial flows and allocate capital and investment solutions we offer investors. The key challenge now is for the private sector – including companies operating in the real economy, financial institutions and investors – to align their respective activities to support the climate transition, whilst ensuring that wider society has access to the means and tools to contribute to and benefit from the transition.

In this publication, we set out our approach to investing within the framework of a just transition.

Managed well, the net-zero transition will not only help to mitigate and largely prevent the immense human and economic costs of climate disruption, but could also generate net new jobs and sustainable, inclusive growth now and in the future (Rydge et al., 2018). If it is managed poorly, however, countries and regions could see not only ‘stranded assets’ but also ‘stranded workers’ and ‘stranded communities’.[2]

2. Inevitable Policy Response: Why a just transition is crucial for effective climate action, September 2019

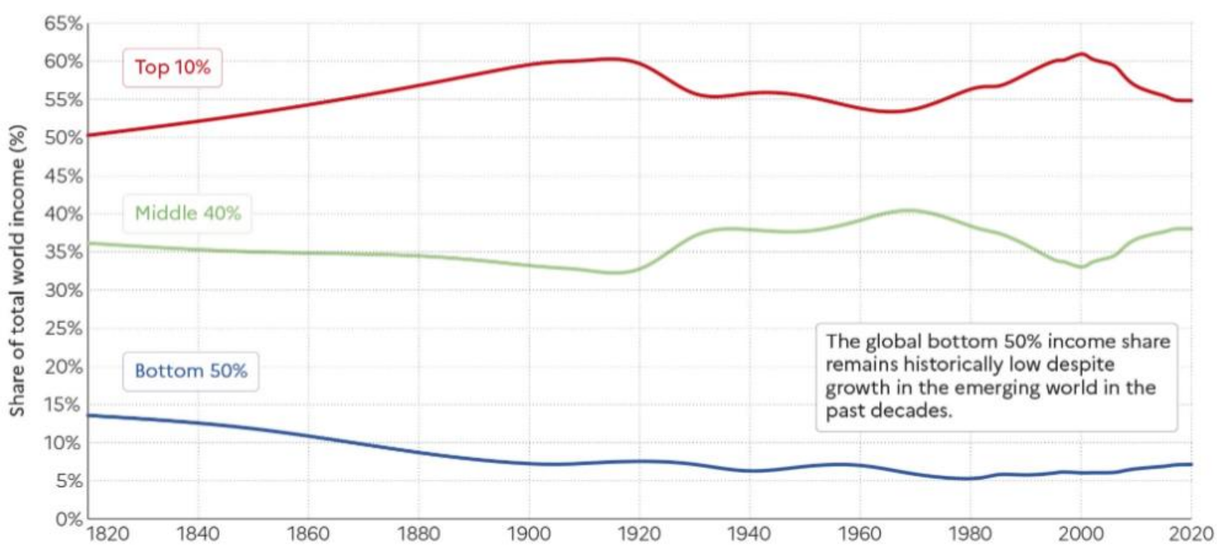
The need for a just transition

Income and wealth inequality has been on the rise almost everywhere since the 1980s. According to the World Inequality Report 2022,[3] income inequality is now as large as it was at the peak of Western imperialism in the early 20th century. The share of income presently captured by the poorest half of the world's people is about half of what it was in 1820, before the great divergence between developed and developing countries (see Figure 1). The trend is accelerating and is taking place both within countries and between countries.

Growing income inequality is exacerbated by the lower ability of governments to respond accordingly. This is due to, in part, recent events like COVID which resulted in many governments having borrowed the equivalent of 10–20% of GDP, essentially from the private sector. A government's financial capacity has important implications in its ability to tackle current and future inequality, as well as the key challenges of the 21st century such as climate change. This means the private sector may play an ever more important role in addressing inequality and global warming, especially in regions and economies where government capacity is more limited.

The risk of growing inequality

Figure 1: Global income inequality, 1820–2020



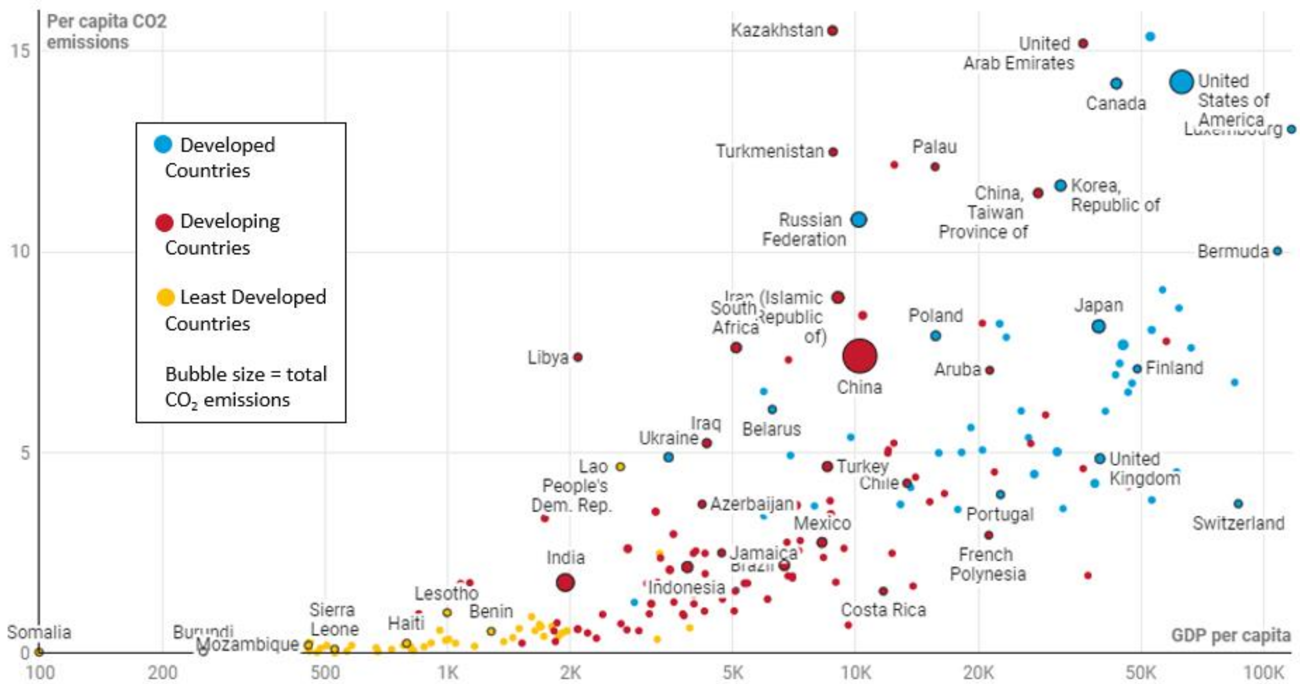
Interpretation: *The share of global income going to top 10% highest incomes at the world level has fluctuated around 50-60% between 1820 and 2020 (50% in 1820, 60% in 1910, 56% in 1980, 61% in 2000, 55% in 2020), while the share going to the bottom 50% lowest incomes has generally been around or below 10% (14% in 1820, 7% in 1910, 5% in 1980, 6% in 2000, 7% in 2020). Global inequality has always been very large. It rose between 1820 and 1910 and shows little long-run trend between 1910 and 2020.* ***Sources and series:*** *see wir2022.wid.world/methodology and Chancel and Piketty (2021).*

3. The World Inequality Report 2022

The glaring disparity of CO2 emissions per capita

Emissions vary greatly from country to country, with developed countries having contributed disproportionately more to greenhouse gas emissions compared to developing ones. To add, areas with the greatest proportion of wealth are responsible for the highest proportion of emissions.[4]

Figure 2: C02 emissions per capita vs GDP per capita, 2020



Source: Global Carbon Project (emissions) and UNCTAD Statistics (GDP per capita).
Note: CO_2 emissions correspond to territorial emissions from fossil fuels. • Get the data • Created with Datawrapper

4. United Nations Conference on Trade and Development: In the pursuit of an inclusive energy transition, April 2022

According to the World Inequality Report 2022, the richest 1% of the world's population accounts for 17% of total emissions. The next 9% accounts for 31.8%, while the middle 40% accounts for 40% of total emissions. The remaining comes from the poorest 50% of the world's population who unfortunately are most likely to face the harshest consequences of climate change with the least means. To illustrate this geographically, people living in sub-Saharan Africa produced 1.6 tonnes of CO_2 equivalent (tCO_2e) each on average, while in North America average per capita production of CO_2 equivalent was more than 10 times higher.[5]

In addition, further research by Dr Lucas Chancel of the Paris School of Economics found the top 1% of the world's population was responsible for almost a quarter of the growth in greenhouse-gas emissions between 1990 and 2019. The study found that the bulk of emissions attributable to the top 1% of the world population predominantly came from their investments, rather than their consumption.[6] Strikingly, Chancel told the publication Carbon Brief that "when someone invests in a company, they are in part responsible for the emissions produced by the day-to-day activities of that firm".[7]

The above figures illustrating the inequalities in terms of greenhouse gases emission levels between the developed and developing world may be alarming, yet they do not constitute the full picture. The past few decades have seen a significant part of the carbon-intensive industrial activities being relocated from developed countries to emerging economies where production cost is lower and scrutiny over environmental issues is less severe. For developed countries, this leads to lower levels of territorial-based emissions while they can still benefit from the final products or processed materials used in later production stages, which are typically less carbon-intensive and therefore still locally based.

A just transition approach can ensure that developing countries will not bear a disproportionate burden in the transformation to a lower carbon global economy. At a more local scale, it avoids people and communities reliant on high carbon emitting sectors - like energy-intensive manufacturing or heavy industries – being left behind as a result of the transition. This means supporting communities as they pivot their industries to adapt to a lower-carbon environment and train their workforce. For regions that lack abundant clean energy resources, investment support will be required to build up their sustainable infrastructure and clean energy supplies without hampering their growth.

Structural shifts arising from the transition towards net zero will impact people and communities foremost, whether they be workers facing redundancies, consumers bearing higher energy prices, or communities that have depended for years on the socioeconomic benefits of a nearby coal mine or power plant. Therefore, a just transition approach is critical – it takes a human centred approach by minimising the negative impacts whilst maximising the potential positive impacts for as many people as possible. For these reasons, we are embedding the concept of a just transition into our investment process and philosophy. This creates challenges but also enormous opportunities for investors, as we outline in this publication.

5. The World Inequality Report 2022
6. Chancel, L: Global carbon inequality over 1990–2019, Nature Sustainability, September 2022
7. Carbon Brief : Top 1%' of emitters caused almost a quarter of growth in global emissions since 1990, September 2022

> “Fifteen years ago, nobody was talking about ESG at all. Today, I don’t have a single conversation where ESG, responsible investment, sustainability, impact, etc. are NOT mentioned – and a just transition, in particular where it relates to energy, is increasingly discussed. That’s because the investors and asset owners we talk to are clearly exposed to coal or other fossil fuels.”
>
> - Edith Lin, Head of Institutional Sales, Asia Pacific

If social impact of transitioning to a low carbon future are discussed more than ever in today’s investor community, it is mostly because overlooking it can translate into risks for their portfolios.

As witnessed in previous transitions, there are winners and losers in the process of transforming an economy or a business. The biggest group of stakeholders put at risk is typically workers who are forced out of their jobs. If the employer does not invest in either upskilling or reskilling these workers, or provide sufficient assistance in their redeployment to greener or more sustainable jobs, the consequent labour disputes may cause disruptions to the company’s operations and even lead to legal liability in some countries.

Nowadays, the public and investors are much more sensitive to issues related to human rights and social justice. A lack of social dialogue or mismanagement in the transformation of polluting businesses could put companies under public scrutiny and incur reputational risk. Accordingly, investors holding companies that fall into the above scenarios risk can suffer a negative impact on their investment return. Yet, integrating the notion of just transition into one’s investment approach can mean more than risk management. There are also opportunities that come with it.

Anticipating the impact of climate transition on stakeholders and involving them in discussions at an early stage can help build trust in a company and underpin its social licence to operate. Having the support of local communities and unions is a key factor in whether a transition plan (or closure plan in certain cases) can be effectively implemented or not. If managed well, a just transition of polluting operations would improve the company’s perceived brand value and potentially help the company gain access to a wider source of capital as more and more investors look at the social value of their investments. These are just a few examples of benefits that investors can ripe by considering just transition in the screening of companies.

Case study: Look out the window – climate change and Asia

Countries across Asia are experiencing the negative effects of climate change, as illustrated by the floods that devastated Pakistan and Afghanistan in 2022 and the super-typhoons that increasingly strike the Philippines. For these reasons and others, attention to climate change is gaining prominence in Asia because the region is on the environmental front line.

The urgency to respond to climate risks is growing across central banks, governments, quasi-governmental organisations, asset owners and other stakeholders– and they are keen to do so in a way that mitigates the physical impacts of climate change as well as the financial impacts of the transition. Complicating the matter is the fact that many Asian economies still derive a large share of their output from fossil-fuel production. Recently, the importance of the sector to some regional economies has increased due to external developments beyond their control.

The conflict in Ukraine, for example, has disrupted energy supplies to Europe and sparked a scramble amongst European countries for Indonesian coal and Malaysian liquefied natural gas (LNG). [8,9] Whilst this may boost export earnings in the two Southeast Asian countries and address energy shortages in the nearer team, such activities can push economies backwards when it comes to their competitive positioning in the future low-carbon economy, not to mention the greenhouse gas emissions generated as a result. This is even more of a reason that the energy transition be supported and funded, particularly during periods of disruption.

As an example of the role we wish to play, HSBC Group has teamed up with Temasek, the Singaporean state investment company, to direct capital to sustainable infrastructure projects, with an initial focus on Southeast Asia. The platform will target renewable energy and storage, water and waste treatment, and sustainable transport to help meet carbon-reduction targets and build resilience to offset the impact of climate change.

For other investors who have yet to include just transition in their agenda, issues of inequality mentioned in the previous section may be perceived as a remote problem in the emerging countries far from their reach. Yet, even in this era where globalisation has been put again under question, developed countries and the rest of the world cannot be viewed in isolation, not simply because our economies remain highly intertwined, but also that social instability can be exported through migration and global demographics can be impacted, as witnessed in the aftermath of the Russian-Ukraine conflict.

Inflationary pressures in developed countries or economic fragility in emerging countries can be a threat to social and political stability, elements which are paramount to the development of a healthy global economic ecosystem. Without these systemic factors in place, it would be difficult to drive consumption and encourage companies to make long-term investments.

Economic impact aside, climate change is still a collective problem that can only be solved when all countries join forces. Each country is responsible for plotting their own transition pathway but the chance of successfully limiting global warming to 1.5°C is higher if investors help to tackle it from a systemic, holistic global standpoint.

8. Nikkei Asia: Indonesian coal miners pump up production, eye European winter, September 2022
9. Newsbase: GLNG: Malaysia's Petronas Plans To Expand Investments In LNG Exports From Egypt To Europe, June 2022

A deepening perspective: from sustainability to a Just Transition

"We can't view a company in isolation; it can only be analysed as part of a complex, inter-dependent system, a wider economy. And we must take into account all of the positive and negative impacts that a disorderly or non-inclusive transition – as opposed to an orderly and more inclusive transition – might have."

- Eric Zwickel, Client Sustainability Director

Extract from the ICCR Statement of Investor Expectations for Job Standards & Community Impacts in the Just Transition

As long-term institutional investors representing nearly USD $4.3 trillion in assets under management, the Interfaith Center on Corporate Responsibility (ICCR) recognizes that the global shift to net-zero requires an unprecedented economic transformation that will impact industries, jobs, and communities.

A just transition to a net-zero economy can address the interconnected issues of climate change, racial injustice, public health, and economic inequity. The transition must create an inclusive, stakeholder-driven economy, where those most impacted by the transition — workers and local communities — are central in its design.

Investors have a critical role to play in supporting the integration of just transition principles into the economic activities that empower the clean energy transition. There is growing recognition of the fiduciary case to manage the risks associated with this transition: if not responsibly managed, existing systemic risks associated with racial and economic inequality, lack of decent work, adverse impacts on human rights, as well as environmental degradation, may be exacerbated, creating significant financial uncertainties.

Healthy and equitable communities, the provision of quality jobs with strong labor protections and fair wages and operating within the limitations of the Earth's resources are essential to a thriving economy and are therefore material to investors' long-term interests.[10]

Clearly, the global discussion around sustainable investing is now broadening out from climate change to encompass other issues such as labour rights, placing just transition squarely in focus.

One example of this pertains to pension funds that are linked to sponsoring companies employing large numbers of 'blue-collar' employees. At the behest of their plan participants, these pension funds are increasingly requiring their asset managers to consider labour practices of investee companies as key inputs to their investment process. These considerations are naturally extending to include just transition elements given the potentially large but uncertain changes to labour markets that the climate transition necessitates.

10. ICCR, Statement of Investor Expectations for Job Standards & Community Impacts in the Just Transition, February 2023

An estimate of the global labour implications of the transition

The New Climate Economy (2018) report quantifies a range of benefits from strong climate policy action – for example, resource-efficiency gains and energy-efficiency gains. It finds that over 65 million additional jobs in low-carbon activities could be created by 2030 (equivalent to the labour force of Bangladesh or Japan today), compared with the baseline. This more than offsets the loss of around 28 million high-carbon jobs over the same period. However, expressed annually, a net positive addition of around 3.7 million jobs per year globally is relatively small when compared with labour-market churn, which is many orders of magnitude larger.[11]

Recognising this inter-dependency between climate and societal issues, an Asian public pension fund selected HSBC AM in 2022 to implement a quantitative equity portfolio where issuer activities that aim to achieve climate-change-specific objectives are in sharp focus. This is yet another example of the dramatic transformation that is taking place among institutional clients in Asia, with more and more investments being deployed towards specific goals.

Pressure for change is being seen right across the board in the institutional sector. For instance, it has been witnessed that more insurance companies have specific requirements related to issues such as climate change. As an example, at the end of 2021, a multinational insurance and finance corporation based in Hong Kong, sold off its US$10 billion portfolio of coal investments, becoming the first major Asian insurer to end its exposure to the fossil fuel.

Insurance companies also tend to invest assets linked to life-insurance liabilities over longer periods of time – 15 years or more. These long-term strategies covering both listed and unlisted assets (infrastructure debt, private debt, private equity, etc.) increasingly consider ESG/climate elements along with traditional financial indicators, given the greater linkage of these elements with long-term outcomes. But even for non-life insurance companies with shorter-dated liabilities, sustainability/climate considerations have become more of a concern, given the physical risk that climate change poses to insured assets.

The trend we observe in the insurance sector is representative of the major shift initiated across the entire institutional investors community. Many have joined the Net Zero Asset Owners Alliance,[12] where signatories commit to:

1. Transition their investment portfolios to net-zero GHG emissions by 2050, consistent with a maximum temperature rise of 1.5°C
2. Establish intermediate targets every five years
3. Regularly report on progress.

With more than 70 members, the Alliance represents some US$10 trillion of assets under management as of end of 2022.

In summary, pressure for change is building in all sectors and regions, and across societies. We believe a just transition can channel this energy in a positive way. But failure to advance the climate transition in a fair and equitable manner threatens to derail progress to a greener planet and create greater societal discord.

11. Inevitable Policy Response: Why a just transition is crucial for effective climate action, September 2019
12. More information can be found on the website UN-convened Net-Zero Asset Owner Alliance

Our perspective

As an asset manager committed to net zero – and a signatory to numerous industry initiatives advocating for fair and inclusive economies, restoration of biodiversity, and broader efforts to support the realisation of a global system conducive to ecological balance and economic growth – HSBC AM believes a just transition is an important lens for investing. As an agent acting on behalf of our investors, we believe applying a just transition lens to our investment and engagement approach supports our investors in achieving outcomes that better reflect the evolving risk-and-return drivers that will influence asset-class performances over time.

Moreover, with our deep heritage in emerging markets, we are acutely aware that even though developing countries have contributed the least to global warming, they are paying a heavy price for its existence. This price includes both the cost of transitioning their economies and the physical effects of climate change, which are already disproportionately impacting them. In fact, the most severe economic consequences of climate change are expected in developing countries, where fewer resources are available for adaptation.

The view from the investment floor

> "The Just Transition is a journey. We see it as the bridge that links climate change to a more inclusive economy. It's increasingly intertwined with a widening range of social and environmental issues and themes beyond climate change. As such, how it's reflected in our investment process and products is evolving - with different manifestations across the regions where we invest.'
>
> - Andrea Griffin, Global Head of Responsible Investment Specialists

We believe our role as investors and allocators of capital is to direct financial flows towards activities and companies that deliver agreed outcomes for clients and which support and drive a just transition. We provide investment strategies across core and alternative asset classes and across investment styles. And our strategies cover the full range of issuers – from fintech and climate-tech venture capital through to core strategies focused on established industries where companies are pivoting their businesses to more sustainable models. We are embedding just transition considerations into our investment processes because we believe this will support long-term value creation and risk mitigation.

While there is currently a focus on issues such as climate change, a just transition, which considers the way businesses treat people and the impact of a company's actions on the wider community in which it operates, clearly brings benefits to investors and businesses alike.

> "Emerging markets have all the problems of developed countries, but they are even more complex and magnified by a huge degree. That reflects the lack of NGOs and civil-society organisations that could support women or oppressed minorities. The informal-working sector is much bigger in emerging markets than it is in developed countries, so it is challenging to ensure people will have employment as the energy transition gathers pace."
>
> - Bryan Carter, Head of Global Emerging Markets Debt

We have focused on ESG as a whole for many years because we believe that companies that place an emphasis on ESG are likely to be more sustainable and stable over time[13] – and thus are better long-term investments – than those that are simply driven by short-term profit considerations.

As part of our ambition to be long-term investors, we seek to identify the externalities that a company is generating and may generate in the future, to inform a more holistic and long-term view of the business's prospects. However, assessing the financial implications of these externalities and relating them to the valuation of companies is not straightforward. For example, measuring a company's scope 1 and 2 carbon emissions and reflecting the implied cost in its valuation is relatively commonplace, while integrating scope 3 emissions remains a real challenge but would offer a better overview as carbon intensive inputs in the supply chain can be included for instance. Reflecting other direct and indirect impacts of a company on communities and the environment is much more complex, given the lack of data and metrics. Although some indicators are available, it's difficult to validate or independently confirm the data quality.

Increasingly, companies — in response to stakeholder pressure – are mapping their activities or revenue to the UN Sustainable Development Goals (SDGs). But even companies with detailed knowledge of their own activities find this much harder to do for social SDGs than for environmental SDGs.

In addition, while environmental data points can be applied across a range of industries, there are many aspects of societal issues and different ways of measuring them. None of this has been formalised by any governing body; there is no best practice when it comes to societal factors.

13. Please read our Multi-Asset Insights on Exploring the currency mismatch and the impact of ESG integration, March 2023 for more details

> There is simply more data available in the environmental world. Financial data feeds can give us numbers on carbon and toxic emissions, water usage, waste policies, recycling percentages, and so on. But when it comes to the social issues at play, it's much harder to find the information. It requires a deeper understanding of the business, its practices and its culture. We use the expression 'the DNA of the business'. That's because we've found that companies repeat their practices, good and bad."
>
> \- Benedicte Mougeot, Head of Climate Equity

Consequently, our investment teams carry out fundamental research to have a better vision of the full picture. To illustrate, evaluating and pricing negative externalities into the analysis of a company's business model embeds costs that aren't included in the company's financial statements. Conversely, the benefits that a company accrues from operating in a sustainable manner should be incorporated in the valuation approach.

> Data shows that long-term-oriented investors deliver superior performance, and long-term-oriented companies outperform in terms of revenue, earnings, and job creation. But despite overwhelming evidence of the superiority of long-term investments, short-term pressures are hard to avoid. A majority of corporate executives agree that longer time horizons for business decisions would improve performance, and yet half say they would delay value-creating projects if it would mean missing quarterly earnings targets."[14]
>
> \- Darryl Lucas, Head of Sustainable Long-Term Equities

> Emerging economies will be more resilient in the long run if they have Paris-aligned decarbonisation plans. Reducing their reliance on global energy markets also means they are less subject to large fluctuations in their balance-of-payments accounts, or in their fiscal accounts due to volatile energy prices."
>
> \- Stephanie Wu, Head of Global Emerging Markets Equity

To this end, rather than simply focusing on shareholder returns, the emerging-market equities team seeks out companies that are having a positive impact in areas such as financial inclusion, job creation, digital inclusion, and provision of affordable and accessible healthcare. Therefore, the team's investment strategy considers the UN SDGs, which encompass environmental and social goals.

We embed just transition considerations into our investment processes and take a multi-stakeholder approach when evaluating potential investments on a case-by-case basis. Looking at the impact of a company's activities on its stakeholders underlines the emphasis we place on inclusivity. Issues aren't viewed in isolation. Although environmental factors are clearly at the centre of our climate solutions, the societal footprint of a company can still be part of the assessment to check that the company does no significant harm in this area.

At the sovereign issuer level, our emerging-market debt team has an increasing focus on sustainability and how governments are aligning with the Paris Agreement. Looking at these issuers through a just transition lens means we consider labour rights, the treatment of women and minorities and other social issues, in addition to environmental problems.

14. FCLTGlobal

> “Where governments seek societal approval for their policies, and those policies are in the best interest of communities and people generally, you tend to have a pretty good proxy for creditworthiness and long-term investment sustainability.”
>
> - Bryan Carter, Head of Global Emerging Markets Debt

On top of conducting in-depth analysis on sovereign issuers, the emerging-market debt team engages with authorities on community consent and the budget process. For example, when governments set their budgets, we encourage them to talk to interested parties – including NGOs and civil-society organisations – to get their input and eventually their support.

This is particularly important given that government budgets increasingly include decarbonisation and green transition goals as part of their Paris-aligned Nationally Determined Contributions. If those decarbonisation policies result in job losses, and if already disadvantaged populations suffer because of measures taken to address climate change, those policies could fail, simply due to a lack of grassroots support. Thus, there is a need for governments to talk to all sections of society when setting these goals. That doesn’t always happen in emerging markets, so this is an area where we believe we can make a real difference through engagement.

Overall, just transition is beginning to have an impact on the way we invest. We believe that viewing companies through a just transition lens provides a much clearer vision of their long-term prospects, such that we can now more fully understand all the risks and opportunities facing an entity.

The role of alternatives

Alternative assets such as infrastructure and private equity will play a critical role in ensuring a just transition to a cleaner, greener and more equitable future. This is because significant investment in infrastructure will be required – investment that the traditional public-funding model cannot meet alone. McKinsey estimates that "Capital spending on physical assets for energy and land-use systems in the net-zero transition between 2021 and 2050 would amount to about $275 trillion, or $9.2 trillion per year on average, an annual increase of as much as $3.5 trillion from today. To put this increase in comparative terms, the $3.5 trillion is approximately equivalent, in 2020, to half of global corporate profits, one-quarter of total tax revenue, and 7% of household spending."[15]

Moreover, the fight against climate change will inevitably require innovation, led by companies that are currently in initial stages of development. Private equity (including venture capital) is key in financing this innovation.

Responsible investment is being increasingly considered in the alternatives sector, and the pressure for a more sustainable approach will only grow, driven by emerging investment opportunities, client demand and regulatory changes. Real assets such as infrastructure projects and innovation driven by private companies can demonstrate more tangible impact outcomes, given the more singular focus of their activities. Direct investment in these private-market assets may also provide the investor with greater ability to shape the sustainability focus of the operating companies or projects, given that a direct private-market holding may provide easier access to management.

Moreover, ESG themes that play out over an extensive time frame, like climate transition, may better align with the long-term horizon of private-market investment opportunities and that of selected investors. For example, a reforestation project may take up to 20 years to reach maturity. An investment in an infrastructure asset might produce an income stream for 30 years, providing a liability-driven investor with what can be an inflation-linked cash flow. The trade-off for the investor is the illiquidity that comes with an unlisted holding, which cannot easily be sold, creating the so-called "illiquidity premium".

Evaluating all these attributes in combination, we believe private assets – especially real assets – offer considerable opportunities for investors to contribute to the transition towards a sustainable economy and to the commitments of the SDGs while benefiting from traditional financial outcomes.

Read our Responsible Investing Insights Private Assets: The Future is Sustainable, October 2022 to know more.

15. McKinsey and Company, The net-zero transition: What it would cost, what it could bring, January 2022

The stewardship and engagement toolkit

> "Too often, the focus on climate change means we lose sight of the overall goal of building a greener, more inclusive and more equitable world. We cannot look at climate goals in isolation; we have to combine them with actions that help all members of society. If we don't strive for that just transition, our ambitions for the environment will be at risk."
>
> - Fatima Hadj, Climate Investment Strategist

> "Stewardship, as realised through voting and engagement activities, is one of the most powerful tools asset managers and investors have available to influence corporate behaviour and government policy. As it ideally involves an ongoing and constructive dialogue with relevant stakeholders, it may ultimately be more effective in nudging changes in policies and behaviour than more blunt approaches like disinvestment."
>
> - Will Ng, Senior ESG Engagement Analyst

Effective engagement provides greater transparency and insights into companies' carbon footprints, climate strategies, in addition to other material societal and governance factors. This may help us identify companies with better sustainability profiles or, conversely, discover issues that pose a risk to a company's investment potential, in turn creating idiosyncratic risk for the portfolio. A company that lags in terms of the S criteria in ESG may struggle to transition. If its plan does not have the support of impacted stakeholders, this can give rise to operational disruptions, strikes and even reputational risk, thus undermining its valuation. A just transition lens helps us look at climate risks more holistically and thus contribute to enhancing or protecting the value of our clients' investments. This is why supporting a just and inclusive transition is one of the priorities in our stewardship approach.

More than just a part of the screening process, engagement is also a powerful tool for change. As an investor with international presence, we can exercise our influence on invested companies or those that we intend to invest in to promote sustainable and inclusive behaviour. In particular for companies in emerging markets, we have a critical role to play in raising awareness of social and environmental risks and opportunities, as well as sharing best practices across borders and between SMEs and large corporates. To illustrate, we can prompt companies to develop a transition plan that takes all impacted stakeholders into consideration.

Through encouraging holding companies to take a longer-term perspective with a focus on the social and environmental aspect instead of going for the short-term low hanging fruits, we create value for our investors through improving the climate resilience and perceived brand value of these companies.

Undeniably, the awareness, understanding and receptiveness of corporate issuers to a just transition varies. For example, some companies in the energy sector are happy to share their transition policies with us, while others may be more hesitant due to the sensitivities of potential job cuts. We understand that in the journey of progressing towards net zero, some jobs will inevitably disappear. Nevertheless, we are convinced that generating alternative jobs, offering training and support to those whose livelihoods would be disrupted, can help to offset the impact of those job losses and support a just transition.

Our engagement approach is sensitive to regional and sectoral differences while still respecting global standards for companies and assets. Taking again the energy sector as an example, companies in Europe may be much further ahead than their peers in emerging markets in terms of the development of a transition plan. We understand that more engagement effort and dialogue may be needed before significant progress can be seen in the later group.

Read our white paper A Just and Inclusive Climate Transition, An Investment Stewardship Perspective, 2022 Q4 for more insights on integrating just transition in stewardship.

HSBC AM is committed to promoting sustainable investing and high industry standards. We are building frameworks that will help investment strategies to be implemented in line with a just transition across our business.

We like to think of a just transition as a barbell – a bar, with weights attached to each end. In our metaphor, the weights – or goals – at either end of the barbell are 1) to address the challenge of climate change by transitioning to a net-zero economy over the coming decades, and 2) to support fast-growing economies where everybody shares in prosperity such that societies remain stable and gain in affluence. Just transition is the bar connecting the two weights, promoting equal effort to each objective.

Our investment approach and the Just Transition Finance Challenge

HSBC AM is one of the founding participants in the Just Transition Finance Challenge, a flagship initiative to mobilise more public and private capital into investments that support a just transition to net zero in developed and emerging markets. HSBC AM is an active contributor in the shaping of this framework.

Launched by the Impact Investing Institute, the Challenge aims to move the world towards net zero by focusing on three interlinked and equally essential elements that must all be present to ensure alignment with a just transition.

According to the Institute, the elements are:

- Advance climate and environmental action – Moving the world to net zero can be achieved through two complementary investment areas: climate mitigation or reduction action, and carbon removal. To reduce net emissions to zero, focus is needed on both pathways: those that accelerate the reduction of emissions of harmful greenhouse gases, and those that protect and restore natural capital and accelerate the development of new solutions that capture or remove those gases
- Improve socio-economic distribution and equity – Positive climate and environmental outcomes must be complemented with those that support the needs of people. Funds must ensure that the assets in which they invest do not unfairly distribute wealth creation or exclude local communities from fair opportunities and jobs. They must also ensure that the goods and services they produce are affordable, and that any costs are evenly distributed, both globally and regionally
- Increase community voice – Actions should incorporate a spectrum of components that help to improve social dialogue and agency, from local engagement to participation in decision-making. It is paramount that investors and asset managers ensure all stakeholders are heard. This includes workers, communities and consumers – particularly marginalised and indigenous communities, and those who are affected by transition action. Their views and needs must be responded to in any financing transaction that purports to contribute to a just transition

These three elements are in complete alignment with the way HSBC AM views a just transition and our approach to sustainable investing. For more information on the Just Transition Finance Challenge, please visit the following link: https://www.impactinvest.org.uk/project/just-transition-finance-challenge/

Creating a framework for a Just Transition

We're actively integrating just transition considerations into our sustainable investment processes. This helps us to craft investment strategies that will address climate change together with societal issues. It includes strategies that are aligned with the target of limiting global warming to 1.5°C, for companies from sectors that need to go through transition, but also – and even more importantly – thematic strategies that focus on areas such as circular economy, healthcare, education, nutrition, and food systems.

We already have a history of promoting the green transition in emerging markets, supporting issuers with green bonds which fund projects aiming to cut greenhouse-gas emissions, support adaptation to climate change, increase energy efficiency, or expand the use of renewable energy. Indeed, partnering with the International Finance Corporation, we were the first asset manager to launch green-bond funding in emerging markets.

Building on these foundations, we are currently developing an impact framework, which will look at the 'E' and 'S' outcomes that our strategies seek to generate. This ties back to the idea of a just transition both through the investments we make and through the activities we, as investors, are helping to promote.

> "We are actively building a product proposition that reflects climate transition, social themes, and innovation across emerging and critically important asset classes, such as climate technologies and natural capital. We see this as an important aspect of how we will develop products, continue to provide investors with new opportunities across themes and regions, as well as support multiple-stakeholders – whilst delivering on our client's investment objectives."
>
> - Ruwan Madura, Global Head of Investment Process Management

As these frameworks are developed and progressively applied over time, we will seek to further integrate just transition considerations in our investment strategies, by first identifying the various 'E' and 'S' factors that we believe to be material. In parallel, we will develop engagement plans for companies built on SMART (Specific, Measurable, Achievable, Relevant, Time-bound) performance indicators for our goals in these 'E' and 'S' factors. We play to our strengths, focusing on areas in which we have the most expertise and the ability to make a difference, for instance within emerging markets.

Our commitments and policies

> We believe a just transition affects our overall sustainability drive in two main areas: the way we invest – notably in emerging markets – and our ambition to direct financial flows to support the transition and broader sustainability objectives."
>
> - Erin Leonard, Head of Sustainability

We recognise that each country must determine its own way to decarbonisation – and that each may take a different path at a differing tempo, reflecting the complex combination of forces across affected stakeholder groups.

Our policy on coal, introduced in September 2022, incorporates consideration of the need to be considered for a just transition especially for investing in emerging markets. Our commitment is to transition our actively managed portfolios away from exposure to thermal coal in the European Union (EU) and Organisation for Economic Co-operation and Development (OECD) markets by 2030, and globally by 2040. Those companies that don't have credible plans to transition away from thermal coal within this time frame will lose the support of HSBC AM. This can mean voting against company chairs at Annual General Meetings (AGMs) or, ultimately, divesting. Our coal policy is part of our Net Zero Asset Managers initiative commitment..

The longer time frame for emerging markets reflects our recognition that many of these countries are still dependent on coal as a main source of power and to ensure energy security. In addition, the funding required to transition are important considerations. We also accept the reality that eliminating the use of coal in countries such as India would impose immense hardship on hundreds of millions of people, particularly the poorest if not well managed.

In addition to the alignment of internal policies to our sustainable beliefs, we are actively involved in industry initiatives to encourage collective action to support a just transition towards a lower carbon future. To illustrate, as part of the working group, we have contributed to the report 'Tackling inequality: An agenda for business action (2023)' issued by The Business Commission to Tackle Inequality, where our Global CEO Nicolas Moreau is also one of the commissioners. The report which listed 'realize the just transition to a net-zero and nature positive economy' as one of the concrete actions that corporates can take to narrow the inequality gap serves as a call to action for the private sector.

Case study: India, coal and a Just Transition

Fossil fuels have been an important source of energy to support India's industrial growth and modernisation, among which coal is the most abundantly used. It accounts for around 70% of the country's energy needs.[16]

A report by the BBC in November 2021 cited figures showing that the coal sector provides more than 300,000 direct jobs and nearly 1 million indirect jobs in coal supply chains and service sectors in the state of Jharkhand alone. Moreover, "several million additional people work as illegal coal miners, mostly local villagers who scavenge coal from abandoned mines. Together, these jobs constitute nearly 10% of employment in the state."[16]

We recognise that coal has fuelled the rapid development of the Indian economy in recent decades, lifting millions of people out of poverty, and that phasing out coal rapidly would affect the livelihoods of millions of people who depend on the coal industry. Transitioning the economy towards lower-carbon energy sources will take careful calibration of environment and societal factors.

Even with the potential social and economic impact in sight, India's ambition in fighting against climate change has not been hampered. The Energy Transitions Commission forecasts that India's electricity demand could increase by 5x in India, by 2050. Low-carbon energy like renewables and green hydrogen will play a key part in meeting this future energy demand17. At COP26, the government of India committed to meeting 50% of its electricity requirements from renewable energy sources by 2030 and reaching net-zero emissions by 2070. According to the International Energy Agency (IEA), this transformation will require hundreds of billions of dollars in investment.[18]

With substantial effort invested in growing the renewable energy sector, India now stands 4th globally in Renewable Energy Installed Capacity as per REN21 Renewables 2022 Global Status Report. This capacity has increased by almost 400% in the last 8.5 years and stands at ~160 Giga Watts (GW) as of 31 March 2022.[19]

Nonetheless, require significant funding to achieve its 2030 target of 500 GW.[20] Investors certainly have a vital role to play in supporting this transformation and the expansion of low emission technologies and alternative fuel such as green hydrogen and biofuels.

Of course, we are also concerned about the impact of the transition to a net-zero economy on jobs and wealth distribution in advanced economies such as the UK. Effectively, we must strive to be aware of how investments affect economies and societies everywhere, always taking account of local factors.

16. BBC: How a just transition can make India's Coal History, November 2021
17. https://www.energy-transitions.org/publications/roadmap-to-indias-2030-decarbonization-target/#download-form
18. International Energy Agency: India's clean energy transition is rapidly underway, benefiting the entire world, January 2022
19. Invest India (National Investment Promotion & Facilitation Agency)
20. Climate Action Tracker on India, November 2022

Supporting the transition of financial flows to broader sustainability objectives

Embedding just transition considerations into the way we approach sustainability also reflects the changes that have taken place in the asset management industry in recent years. Initially, the focus was simply on investment returns and risk. We analysed companies on their ability to generate future profits, and we took account of ESG factors only in terms of their potential impact on the business.

Today, we take a much wider perspective. One way of doing that, as an example, is to look at the contribution that companies are making towards a better environment or towards more diversity. Accordingly, we have invested in a company that is investing in nature, as well as in a female-owned fund manager. And importantly, these partnerships provide us with valuable insights that support the enhancement of our proprietary ESG integration system.

In addition, we are supporting the flow of investment capital to projects that are driving a just transition, launching new funds that focus on companies that are contributing to a better world. For instance, one of our funds is investing in farms in East Africa, helping to improve soil management and biodiversity. The project is helping to restore the productive capacity of those farms, and bringing climate benefits in the form of reduced emissions, while also making the farms more efficient. That's a rare investment opportunity, because there is both a natural capital benefit and a carbon benefit. Channelling investment into natural capital helps farmers become more efficient and less carbon-emitting.

In other words, we are making investments that produce multiple benefits, stacking up on one another in the form of potential positive impacts on climate change, biodiversity, improved food supply, and better-paid jobs that align with certain standards in relation to employee rights.

The just transition principles enable us to build a framework within which to integrate all of the many factors that need to be considered as we strive to build a more sustainable world. It allows us to demonstrate to a multitude of stakeholders that their long-term interests are best served by embarking on this path, while minimising adverse impacts on the most vulnerable, and also taking into account our clients' investment goals.

Conclusions – HSBC AM embraces a Just Transition

The next few years will prove crucial in setting the world on a course to reach net zero. Such pervasive demands require a forward-looking approach. We must rethink how we assess the future and how the investment strategies we provide may best support thriving economies and societies.

So, while helping investors prosper, our ambition is to help shape a sustainable world that is fair and inclusive through the lens of a just transition. We are adamant that nobody gets left behind.

To achieve this objective, the starting point is to enhance and innovate our investment processes and capabilities to support the management of sustainable investments. Rooted in more than 20 years of experience in responsible investing, we continue to further develop our capabilities across asset classes and geographies. And the prospect for driving positive change is especially strong in the emerging markets where our expertise continues to bring new growth and opportunities as technological, social and climate disruptions gather pace. Meanwhile, we continue to mobilise the funding needed for a just transition by developing innovative investment solutions in new investible asset classes.

We fully acknowledge that advancing change can only be made in partnership with our clients and a multitude of stakeholders around the globe. Today, we and many of our customers contribute to greenhouse gas emissions. This is why HSBC Asset Management, together with other asset managers, have an important role to play in supporting the transition to a net zero economy. Step by step, we are developing strategies to reduce our own emissions and to help our customers reduce theirs.

As the Just Transition Finance Challenge[20] says:

"The just transition is a complex agenda for investors and other stakeholders, one that requires strategic engagement both within investment institutions and in multi-stakeholder collaborations where investors can play important roles.

As investors, we will engage on the topic in the spirit of open inquiry and innovation, with the goal of developing widely shared best practices that link climate-related investment, decent jobs, thriving communities and sustainable development."

20. Impact Investing Institute: Just Transition Finance Challenge

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