ESG Essentials

Responsible investment for a sustainable future

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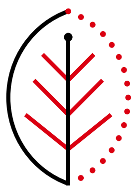
"Companies that conduct their business in a responsible and sustainable way are more likely to deliver value for investors and positive impacts on the world in the long term."

Responsible investment for a sustainable future

Environmental, social and governance (ESG) factors have become a growing focus among various sectors in recent years and a number of research reports have revealed the impact of ESG factors on companies' long-term performance. Companies that conduct their business in a responsible and sustainable way are more likely to deliver value for investors and positive impacts on the world in the long term.

What is ESG?

Financial fundamentals have always been given priority in traditional investment process. However, due to the rising concern for corporate social responsibility (CSR), some investment strategies are integrating environmental, social and governance (ESG) factors into analysis with an aim to arrive at the most favorable investment decisions. This approach can help investors achieve financial return without taking excessive risk, and it also contributes to a more sustainable future. These investment strategies are called responsible investments.



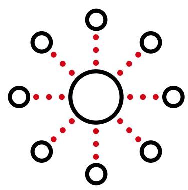
Environmental

Climate change

Pollution and waste

Energy efficiency

Water scarcity



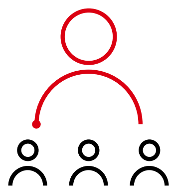
Social

Human rights

Gender equality

Occupational safety and health

Consumer and product responsibility



Governance

Structure of board of directors

Company ownership

Executive compensation

Cyber security

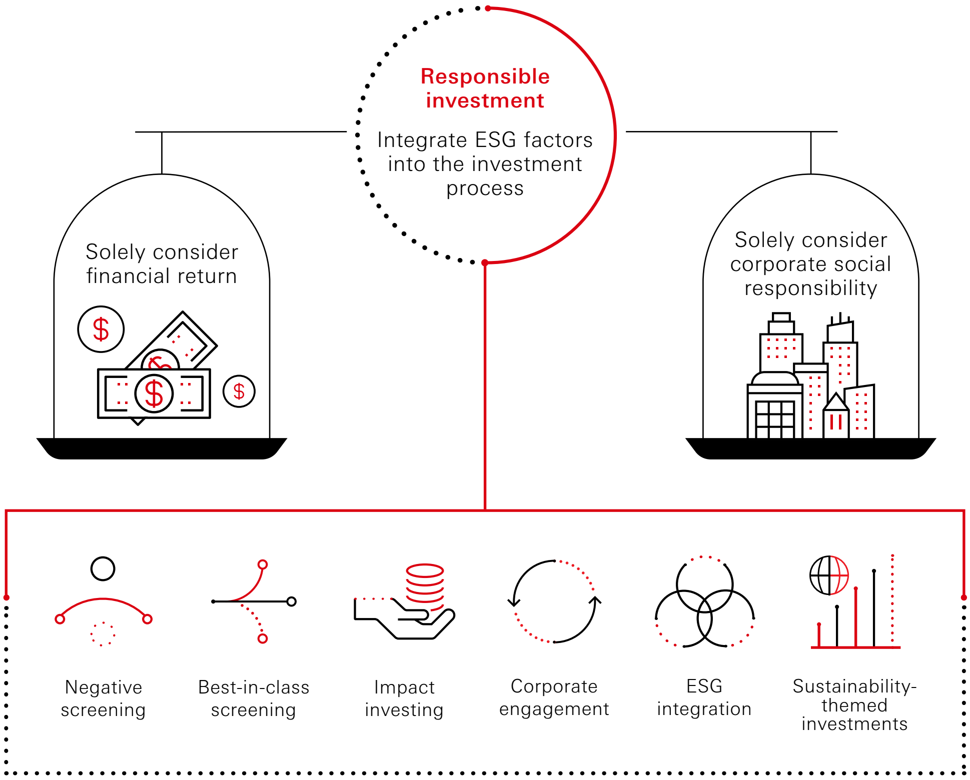
“Fund managers employ different strategies to integrate ESG factors into their investment processes.”

ESG investing: getting the best of both worlds

Corporate social responsibility does not necessarily conflict with profitability in the business world. On the contrary, it can improve a company’s financial performance.

With responsible investment, fund managers employ different strategies to integrate ESG factors into their investment processes.

- **Negative screening**
  Avoid investing in ‘sin stocks’ (e.g. tobacco and adult entertainment)
- **Positive screening**
  Invest in companies with relatively high ESG scores among peers
- **Norms-based screening**
  Conduct screening based on international norms such as those issued by the Organisation for Economic Co-operation and Development (OECD) and the United Nations (UN)
- **Impact investing**
  Target community investing, e.g. provide financing and assistance to underserved communities and small and medium-sized companies
- **Corporate engagement**
  Actively influence corporate behavior and create long-term value for investors



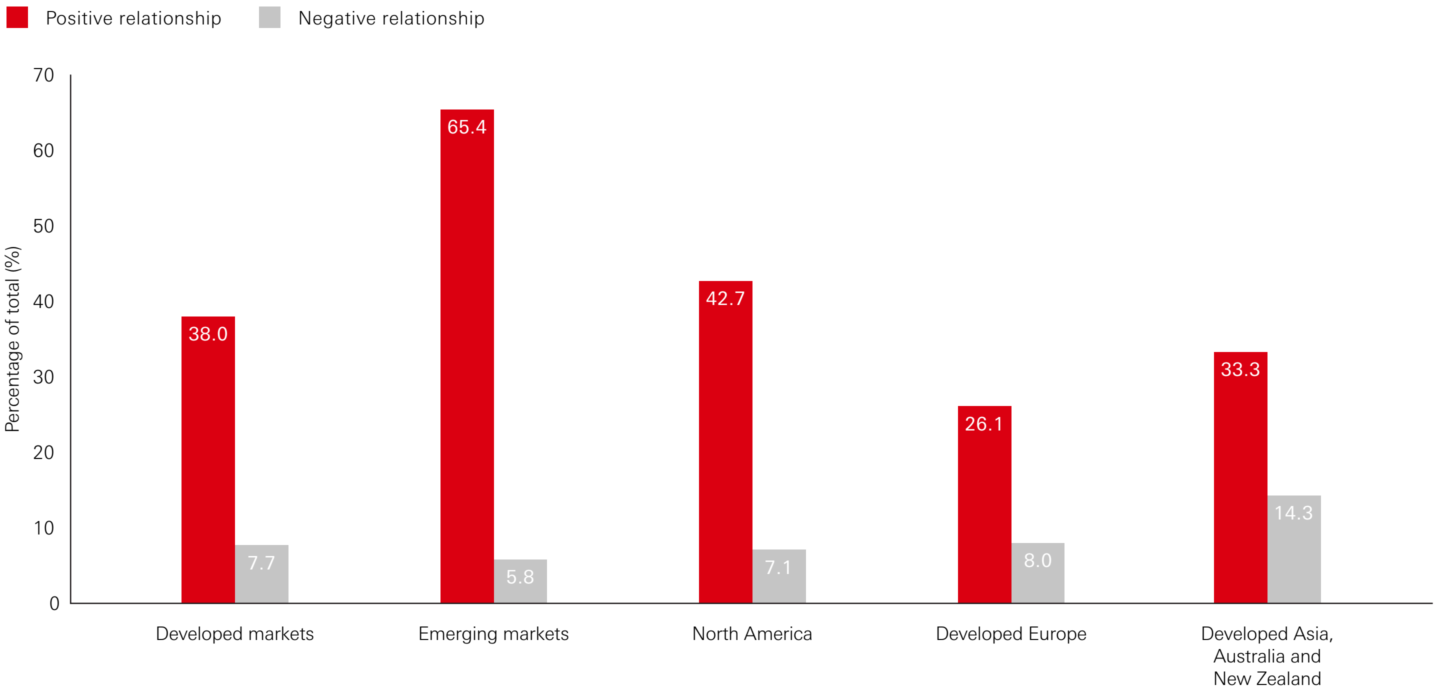
Source: HSBC Asset Management. For illustrative purposes only.

Good ESG scores lead to better financial performance

Studies in recent decades have demonstrated a positive correlation between companies' ESG scores and financial performance. Companies with good ESG performances are usually more competitive than their peers in the same sector. These companies have better earning capabilities and long-term cash flows, and are less susceptible to non-systematic risks, resulting in better financial returns.

It is also worth mentioning that the effects of ESG scores may differ across different markets. Research reports in emerging markets showed that companies with higher ESG scores generally enjoy better financial performances.

ESG performance and financial performance are positively correlated



Source: Friede, G., M. Lewis, A. Bassen and T. Busch. (2015) "ESG and Financial Performance: Aggregated Evidence from More than 2,000 Empirical Studies", extracted from Journal of Sustainable Finance and Investment No. 5, page 210 to 233.

"Companies with higher ESG scores generally enjoy better financial performances."

ESG investment outperformed in the long term

Contrary to the common misconception that corporate social responsibility and business interests are incompatible, companies with relatively high ESG scores outperformed the market in terms of stock prices, apart from having better financial results. The MSCI ACWI ESG Leaders Index which comprises companies with the highest ESG rating in each sector has achieved a better cumulative return than its parent index since 2007.

According to studies, companies with higher ESG rating are less likely to encounter systemic risk. As a matter of fact, the MSCI ESG Index series slightly outperformed the MSCI All Country World Index during the peak of the Covid-19 pandemic and the most volatile periods of equity market in 2020, supporting the fact that companies with good ESG performances are more resilient to unexpected economic adversities and market volatilities.

Performance of MSCI ESG indices in Q1 2020

-21.3%
MSCI All Country World Index (ACWI)

-19.9%
ESG Leaders Index

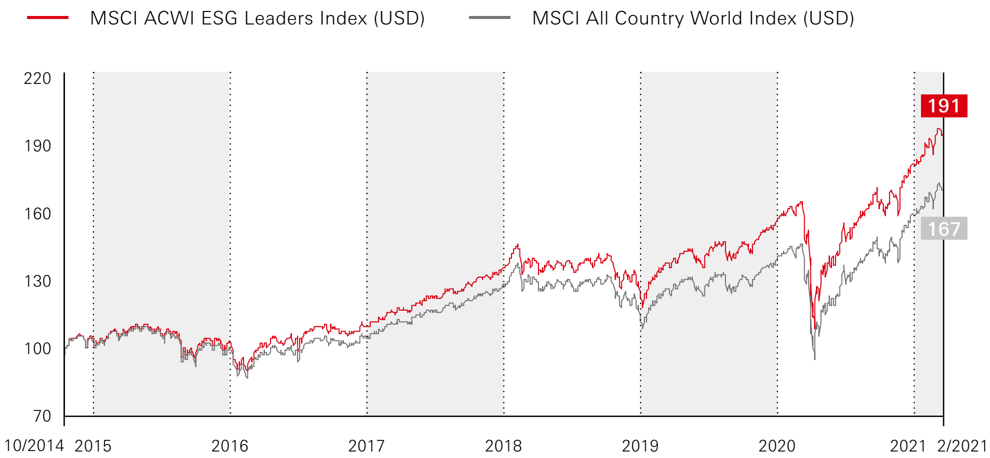
-20.1%
ESG Universal Index

-18.4%
Responsible Investment Index

-20.6%
ESG Focus Index

Source: MSCI. Data as at 31 March 2020. ESG Universal Index: MSCI ACWI ESG Universal; ESG Focus Index: MSCI ACWI ESG Focus; ESG Leaders Index: MSCI ACWI ESG Leaders; Responsible Investment Index: MSCI ACWI SRI.

ESG equity index outperformed the wider market



Source: Bloomberg. Data from October 2014 to February 2021. MSCI ACWI Index and MSCI ACWI ESG Leaders Index are in USD terms and are rebased to 100 in October 2014. Past performance is not an indicator of future results. For illustrative purposes only.

Material costs of ignoring ESG factors

On the other hand, ignoring ESG issues may result in not only poor financial return, but also huge losses for investors. Over the years, many large multinational corporations have suffered substantial drops in stock prices following ESG risk events.

Stock prices plummeted following major ESG risk events

Decline in stock prices in the first year (%)

2001

US energy company's accounting scandal
▼ 99.6%

US telecom company's accounting scandal
▼ 98.6%

2010

US energy company's coal mine explosion in West Virginia
▼ 52.7%

UK energy company's oil spill in Gulf of Mexico
▼ 28.2%

2014

Japanese company's defective airbags recall
▼ 53.5%

2015

Canadian pharmaceutical company's accounting fraud
▼ 91.5%

German auto maker's diesel emission scandal
▼ 26.4%

2019

US social media company's data breach
▼ 9.4%

2020

Chinese beverage firm's accounting fraud
▼ 76.0%

Source: HSBC Asset Management, Bloomberg, Morgan Stanley. Data as at 28 February 2021. Past performance is not an indicator of future results. For illustrative purposes only.

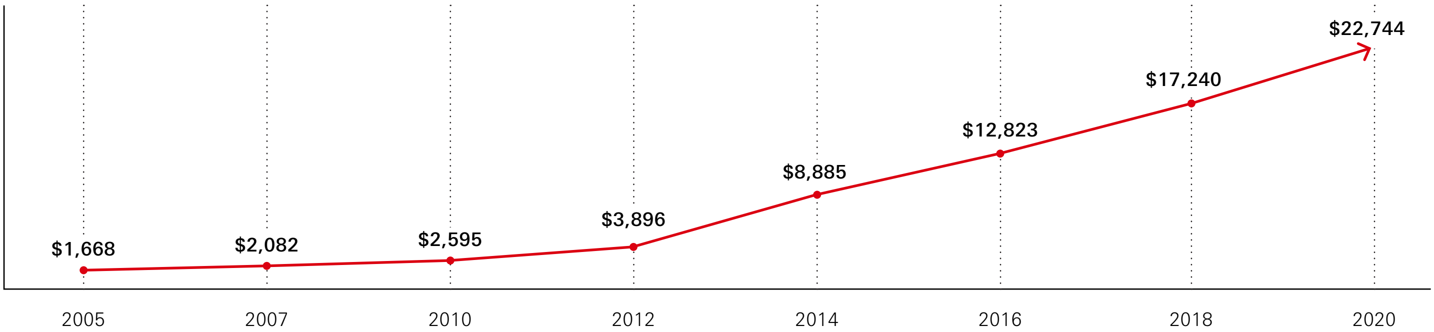
Responsible investment is going mainstream

Responsible investment has been rapidly developing during the past 15 years. Related assets under institutional investors and professionally managed funds have grown by over 12 times. While the United States and Europe are still leading in responsible investment, Japan is catching up quickly during the COVID-19 outbreak, with a 160% quarter-on-quarter expansion in related investments in the third quarter of 2020.

When it comes to responsible investment, green bonds are worth noting for their growing recognition in recent years. Global issuance of green bonds has reached USD 754 billion and Hong Kong is also keeping up with the trend. The government of Hong Kong has announced a successful offering of USD 2.5 billion of green bonds in January 2021 and the capital raised will be used to finance green public works projects in Hong Kong.

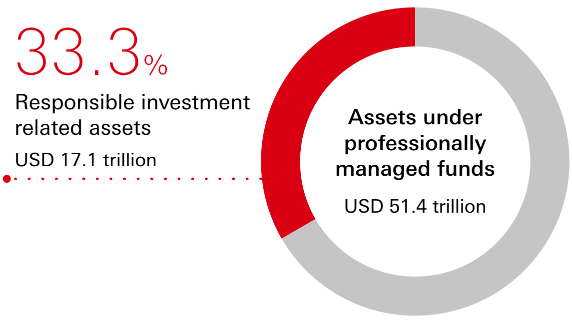
Growing responsible investment by institutional investors and professionally managed funds

Total assets (USD billion)



Source: The Forum for Sustainable and Responsible Investment (US SIF). Data as at early 2020.

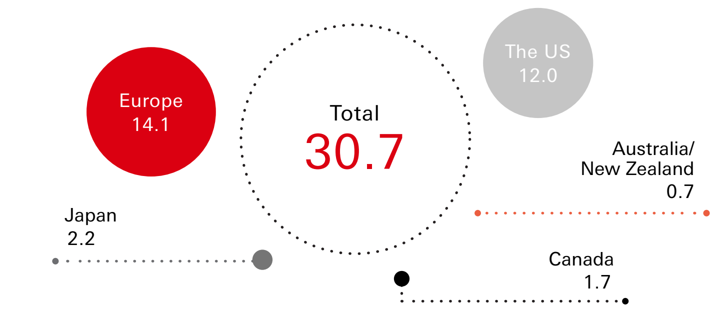
Responsible investment is going mainstream in the US



Source: The Forum for Sustainable and Responsible Investment (US SIF). Data as at the end of 2019.

Leading regions in responsible investment

Asset size (USD trillion)



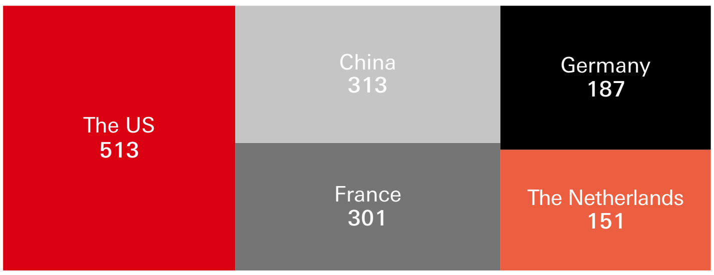
Source: The Global Sustainable Investment Review 2018, the Global Sustainable Investment Alliance. Data as at early 2018.

Conclusion

Sustainable development is in everybody's interest. As responsible investment is growing in significance, it is going mainstream in the global investment market. By investing in companies which care about ESG factors, we can not only achieve better potential long-term financial returns and avoid substantial losses, but also fulfil our corporate social responsibility and contribute to a better world.

Leading regions in green bonds issuance

Size of issuance (USD 100 million)



Source: Climate Bond. Data as at the end of 2019.

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