THE BIG QUESTIONS OF THEMATIC INVESTING

Environmental Strategies Group

NOVEMBER 2023

BNP PARIBAS ASSET MANAGEMENT

The sustainable investor for a changing world

DRIVING SIGNIFICANT LONG-TERM REWARD FROM INVESTING IN REAL CHANGE

Sustainability has become a buzzword across the investment industry.

However, the rapidly growing array of green products is generating confusion and sometimes scepticism among investors. What should be a simple process of selecting a sustainable investment is often anything but.

Investors are torn over whether E (environmental), S (social), and G (governance) labelled products are a mechanism to authentically align portfolios with principles or merely a greenwashing gimmick; if 'green' investments will deliver genuine impact; or are vehicles simply an effective way to harness the latest megatrend.

As the investment industry grapples with this relatively new investment theme, the fundamentals of why investors are buying responsible investments in the first place have been misplaced, as well as what they should be expected to deliver and how fund managers can best go about delivering these commitments.

Yet, these big questions of 'why', 'what' and 'how' are arguably why environmental strategies investing in enablers, can be relied upon to deliver materially positive environmental outcomes that help facilitate net zero.

ENVIRONMENTAL STRATEGIES INVESTING IN ENABLERS CAN

be relied on

TO DELIVER MATERIALLY POSITIVE ENVIRONMENTAL OUTCOMES THAT HELP FACILITATE NET ZERO

WHY SHOULD INVESTORS CARE ABOUT THE ENVIRONMENTAL INVESTMENT THEME?

Responsible investment assets are forecast to surpass USD 50 trillion by 2025, representing one-third of the projected assets under management globally[1]. Given the relatively short timeline these strategies have been around not only underscores the continued interest in thematic investments but also implies is now a major part of the mainstream investment landscape with further room to grow.

ESG ASSETS WILL REPRESENT OVER A 1/3 OF TOTAL GLOBAL ASSETS UNDER MANAGEMENT

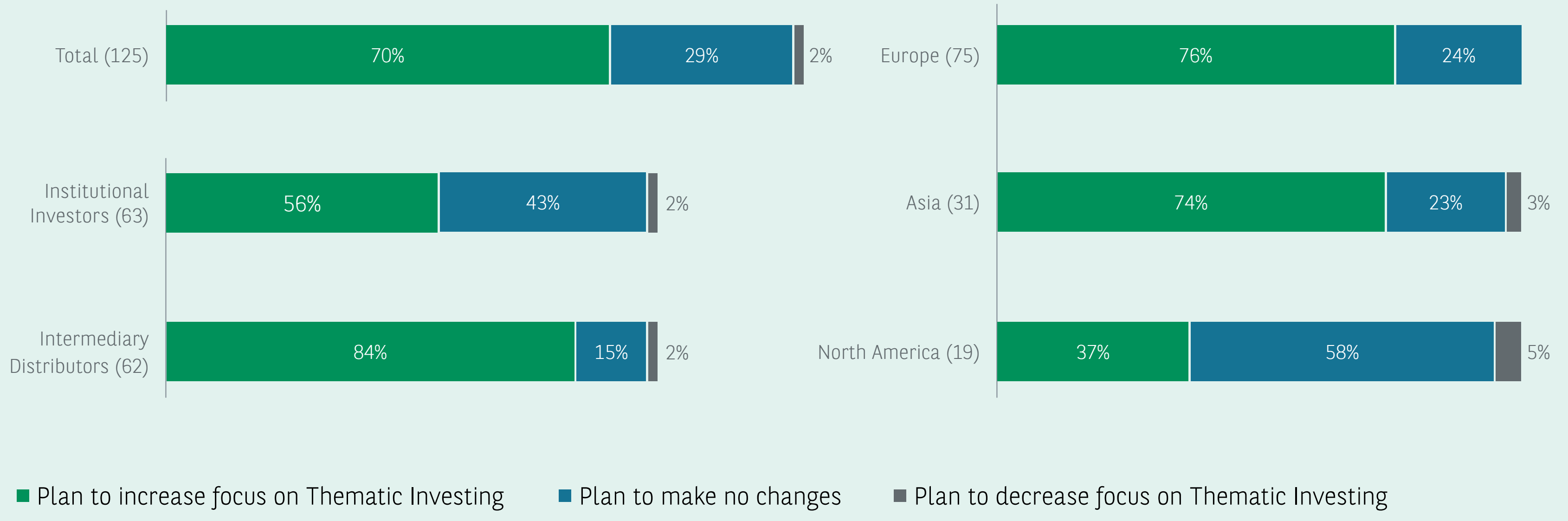
Source: https://sponsored.bloomberg.com/article/mubadala/the-future-of-esg-Investing

In fact, according to research conducted from February to April 2023 by BNP Paribas Asset Management and BNP Paribas Corporate and Institutional Banking in partnership with Coalition Greenwich, 70% of all investors intend to increase their focus on thematically orientated investments over the next three years with the themes of the energy transition and climate solutions being their top priorities.[2]

Thematic Investing Future Plans

70% of all investors plan to increase their focus on thematic investing over the next three years; the figure is 84% for intermediary distributors and 56% for institutional investors.

Thematic Investing Plans for the Next Three Years



Source: BNP Paribas Asset Management. 2023 Thematics Barometer. Figures may not add to 100% due to rounding
Question: Over the next three years, how do you plan to use thematic Investing in your portfolio? Total base: 125.

1 https://www.bloomberg.com/company/press/esg-may-surpass-41-trillion-assets-in-2022-but-not-without-challenges-finds-bloomberg-intelligence/
2 https://docfinder.bnpparibas-am.com/api/files/870BDD41-22F0-40FF-8C61-CC6CDEAF25DB BNP Paribas Asset Management. 2023 Thematics Barometer.

WHY SHOULD INVESTORS CARE ABOUT THE ENVIRONMENTAL INVESTMENT THEME?

A series of dramatic and unprecedented climate events have brought the urgency of the environmental challenge to the forefront of many investors' minds. To address the energy transition alone, the world will need to invest an additional USD 3-3.5 trillion annually between now and 2050[3] and investors are well aware that such a big number (equivalent to half of global corporate profits) also brings with it significant economic opportunity.

This is why UN special envoy on climate action Mark Carney has labelled net zero as the 'greatest commercial opportunity of our time.'[4]

Investors are increasingly excited about this theme not only because they need to care, but also because they can't afford to miss out on the potential rewards.

> “Net zero: the greatest commercial opportunity of our time.”
>
> **Mark Carney,**
> **UN special envoy on climate action**

3 https://viewpoint.bnpparibas-am.com/five-ways-to-fight-esg-scepticism/
4 https://www.climatechangenews.com/2020/02/27/net-zero-goal-greatest-commercial-opportunity-time-says-mark-carney/

WHY DO INVESTORS TURN TO ENVIRONMENTAL THEMATIC STRATEGIES TO CAPTURE THIS MEGATREND?

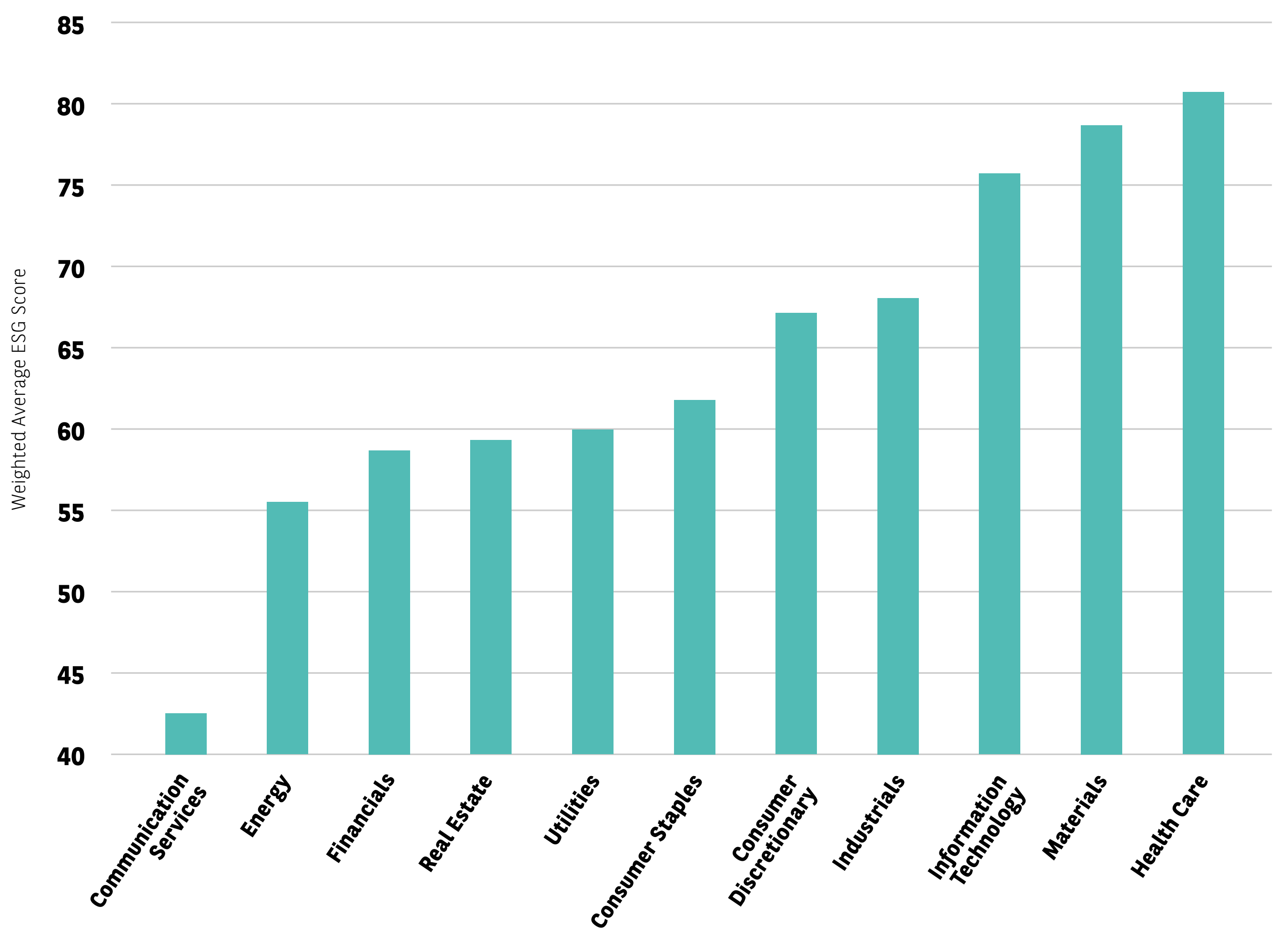
Not all sustainable investment products are equal.

The ESG label has become widely associated with a belief that these products offer a greater sense of social and environmental responsibility for investors, but not all ESG-labelled products explicitly target such aims.

ESG scores are applied to companies across a broader universe of industries that are typically ranking companies relative to their peers, this means companies in harmful industries achieve higher ESG scores than companies in industries with products like solar, wind and energy storage that directly aim at decarbonisation. Technology and financial companies, for example, emit low levels of carbon emissions and can often boast high ESG scores despite limited – or even negative – externalities.

On the other hand, a steel manufacturer may receive a poor ESG score due to the industry's high carbon emissions even though the company itself is undertaking ambitious decarbonisation plans that stand out among its competitors.

S&P 500 Sector-Weighted Average ESG Score



Source: S&P Dow Jones Indices LLC. Data as of April 30,2019. Past performance is no guarantee of future results. Chart is provided for illustration purposes
Source: https://www.spglobal.com/en/research-insights/articles/understanding-the-esg-consequences-of-factor-based-investing-part-2

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Similarly, smaller companies are often disadvantaged as they simply don't have the same level of ESG-related policies or resources as larger peers meaning their 'poorer' scores don't necessarily reflect the company's merit.

This system makes it possible to construct 'good' ESG portfolios simply by overweighting industries with structurally lower carbon emissions like technology or financials and underweighting manufacturing companies producing solar equipment, wind turbines, electrolysers, energy storage units because of the higher structural carbon emissions it takes to manufacture these products.

However, by targeting those industries and sectors directly involved in an environmental theme – for example the energy transition – a thematic approach cannot take such shortcuts. A thematic approach tends to go beyond basic scores to identify the specific E, S or G metrics they want to target, as well as those risks they seek to avoid. In this way, companies offering actual solutions to environmental and social harms are specifically targeted for the portfolio.

A THEMATIC APPROACH GOES BEYOND BASIC SCORES TO TARGET SPECIFIC

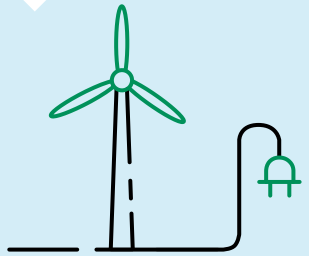
ESG metrics

Source: https://sponsored.bloomberg.com/article/mubadala/the-future-of-esg-Investing

WHAT ARE THE ADVANTAGES OF TAKING AN ENVIRONMENTAL THEMATIC APPROACH?

For many investors, investing in sustainable investment products results from their desire to achieve a certain environmental or social outcome or solution that will change the world for the better. Indeed, its human nature to want to create real impact.

In the fight against climate change, decarbonisation has become key to measuring progress in the shift to a net-zero economy as well as successfully navigating climate risk. Investment strategies aiming to reduce carbon exposure within portfolios should be a good way to achieve these goals, but once again there are wide discrepancies in how climate-aligned portfolios are constructed.

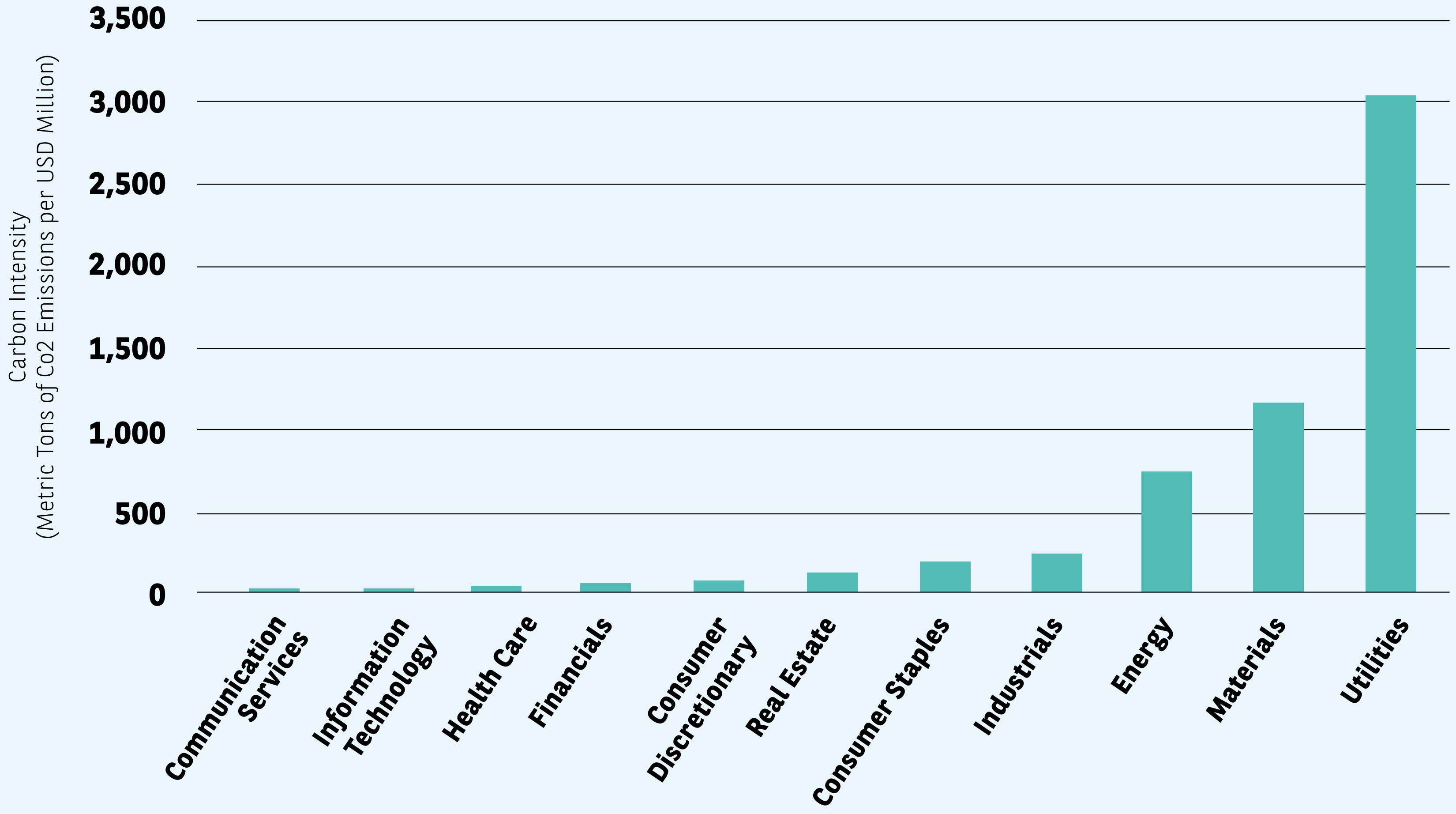


DECARBONISATION HAS BECOME KEY TO MEASURING PROGRESS IN THE SHIFT TO A

net-zero economy

Some approaches load up on low carbon assets – i.e. companies in industries that are largely irrelevant to the net-zero challenge and already have low carbon emissions – which results in the portfolio having a good carbon footprint today but little overall impact on decarbonisation.

S&P 500 Sector-Weighted Carbon Intensity



Source: S&P Dow Jones Indices LLC. Data as of April 30, 2019. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.
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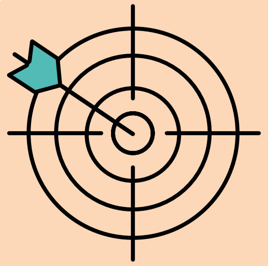
While other approaches can be constrained by benchmark requirements to invest in sectors or industries less relevant to decarbonisation aims, unconstrained environmentally-themed approaches are more likely to have the flexibility to directly focus on action within the real economy, such as decarbonisation.



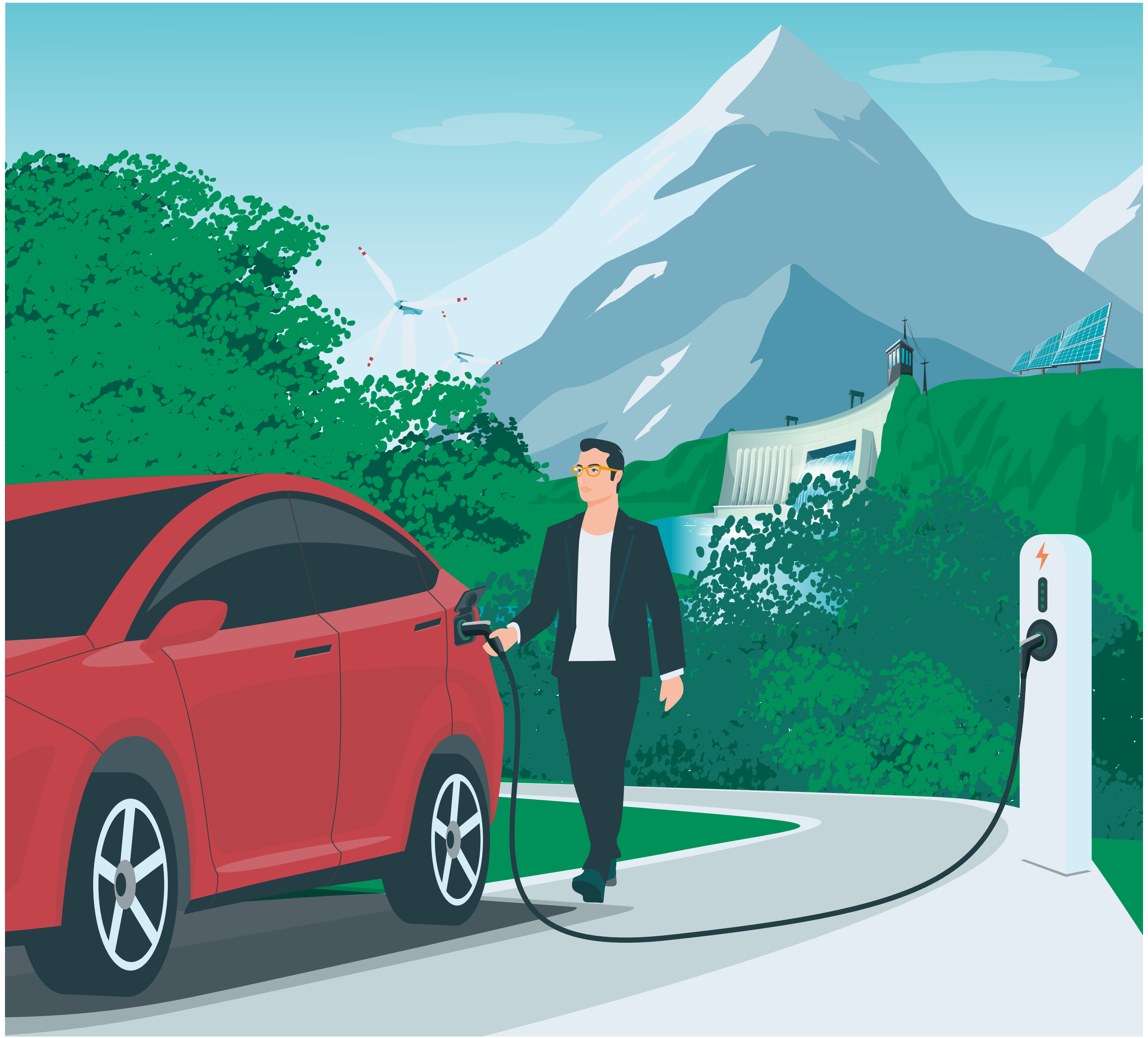
UNCONSTRAINED ENVIRONMENTALLY-THEMED STRATEGIES CAN TARGET THOSE INDUSTRIES OR SECTORS PIVOTAL TO THE

energy transition

Source: https://sponsored.bloomberg.com/article/mubadala/the-future-of-esg-Investing

This means they target those industries or sectors with solutions pivotal to the energy transition, which have the potential to contribute greater reductions in emissions. This may be through companies providing innovative technologies to decarbonise the way we consume energy in buildings, transport, power grids, manufacturing and industry.

Investing in solution providers – or so-called "enablers"–will not only be impactful for the climate transition, but their importance to the global economy should also be recognised by global markets in terms of increased valuations. Moreover, by prioritising the companies 'enabling' transition, their impact (and consequently that of the portfolio) in delivering change will be more meaningful and more measurable, over the long term.



ARE THEMATIC FUNDS MORE EXPOSED TO RISK?

Environmentally-themed investing is not purely about principles and impact, the potential to capture meaningful growth is also a major attraction. But growth tends to come alongside increased risks and a high degree of innovation. For many investors, the prospect of embracing this innovation can be daunting; our behaviour is often pre-programmed to favour safe options rather than opting for more risky, pioneering possibilities. That is why learning from the past is so essential.

The transition to a climate-positive economy will be as transformational as prior industrial revolutions and history teaches us that times of revolution present significant opportunities as vital components of the economic infrastructure are reimagined.

From an investment perspective, this will involve identifying the leaders of the new paradigm, recognising existing companies that will survive and prosper, but also avoiding companies that fail to address change and fall behind. The propensity of so-called ‘stranded assets’ is just one of the potential risks.

Investors must also bear in mind that despite the tremendous opportunities of this megatrend, growth will not be linear. In fact, history tells us that it typically comes in the form of an S curve where growth in adoption once it’s reached 20% can rise exponentially.

There will be times when outside risks take centre stage. This is certainly, what we have evidenced from a macroeconomic standpoint since the beginning of 2021 and as a result of supply and demand imbalances. These created significant inflation, supply chain disruptions and other related shocks to the economy. In the last year, macroeconomic and geopolitical forces have caused major market disruption which has impacted the valuations of companies providing sustainable and environmentally-positive solutions.

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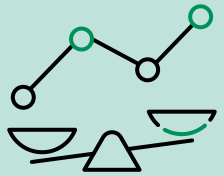

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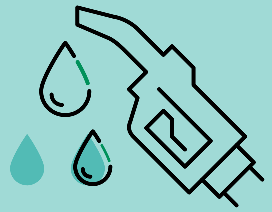


Over USD 1 tn

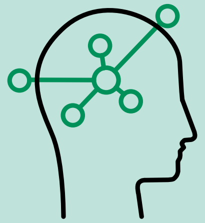
VALUE OF FUTURE LOST PROFITS IN THE UPSTREAM OIL AND GAS SECTOR

Source: https://www.nature.com/articles/s41558-022-01356-y

ARE THEMATIC FUNDS MORE EXPOSED TO RISK?

In addition, many of the companies whose valuations were impacted in the last year due to macroeconomic and geopolitical forces, came to market amid a burst of optimism and assumptions of a different macroeconomic backdrop that resulted in their initial valuations being inflated. With markets now being more focused on "today" rather than "tomorrow", some of these stocks may take a while to recover to their previous highs.

No investment strategy can completely avoid risk, but a robust thematic approach is generally supported by a deep sector knowledge of the industries, sectors and technologies associated with that theme and this should enhance its ability to not only capture the best alpha opportunities across the whole value chain, but to shield its portfolio from some of the inherent risks.



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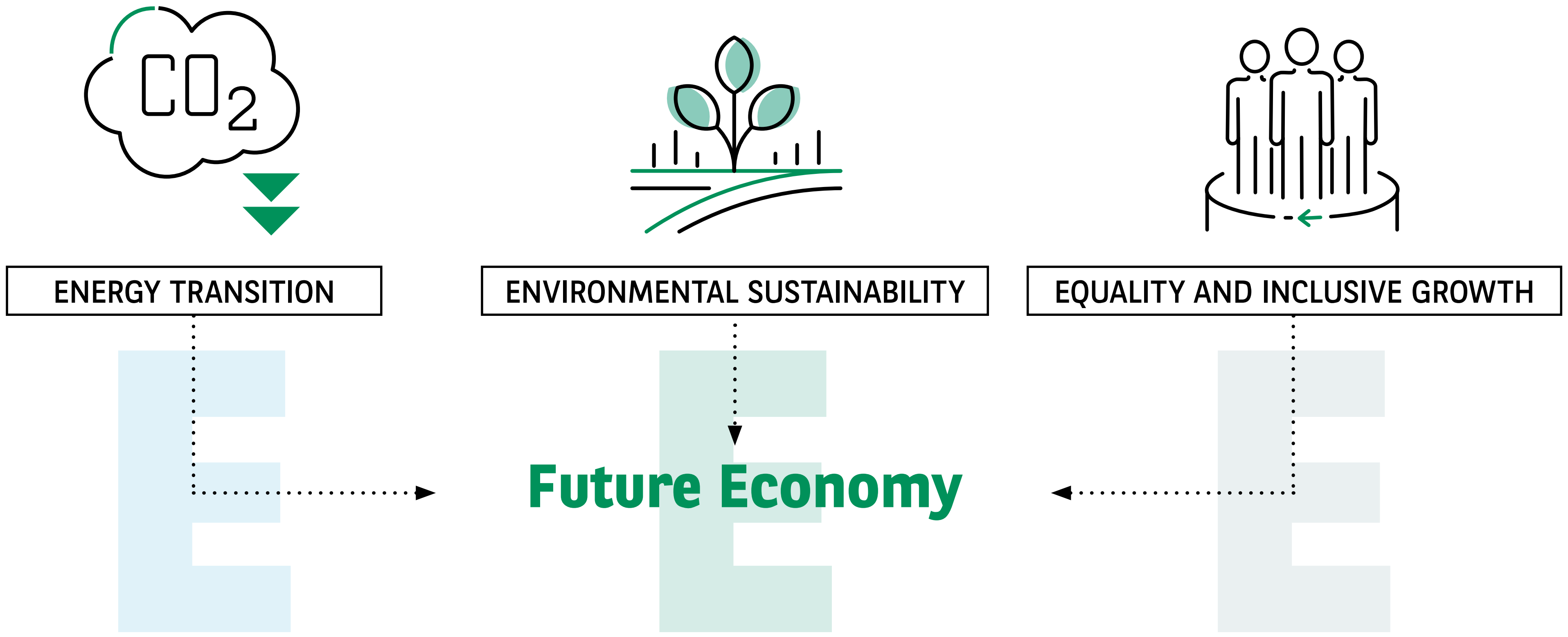
AN ENVIRONMENTAL THEMATIC APPROACH CAN DELIVER ON THE PROMISE OF SUSTAINABILITY

The need to protect our planet from climate and environmental threats is only growing with time. The financial sector is in a critical position to help make the world a better place, the global economy more sustainable and inclusive, while also delivering value to its clients.

At BNP Paribas Asset Management, we have identified three areas of action that will be crucial in achieving this goal that will enable us, as investors to safeguard long-term returns: our 3Es the energy transition to a low carbon economy, environmental sustainability, and equality and inclusive growth.

Three challenging areas of action: Our 3Es

These are critical preconditions that together represent the pathway to the economic sustainability that enables us, as investors, to safeguard long-term returns.



AN ENVIRONMENTAL THEMATIC APPROACH CAN DELIVER ON THE PROMISE OF SUSTAINABILITY

Our thematic strategies leverage these structural trends to generate both impact and alpha. These strategies enable investors to be 'part of the solution' required for a just energy transition and ecosystem restoration.

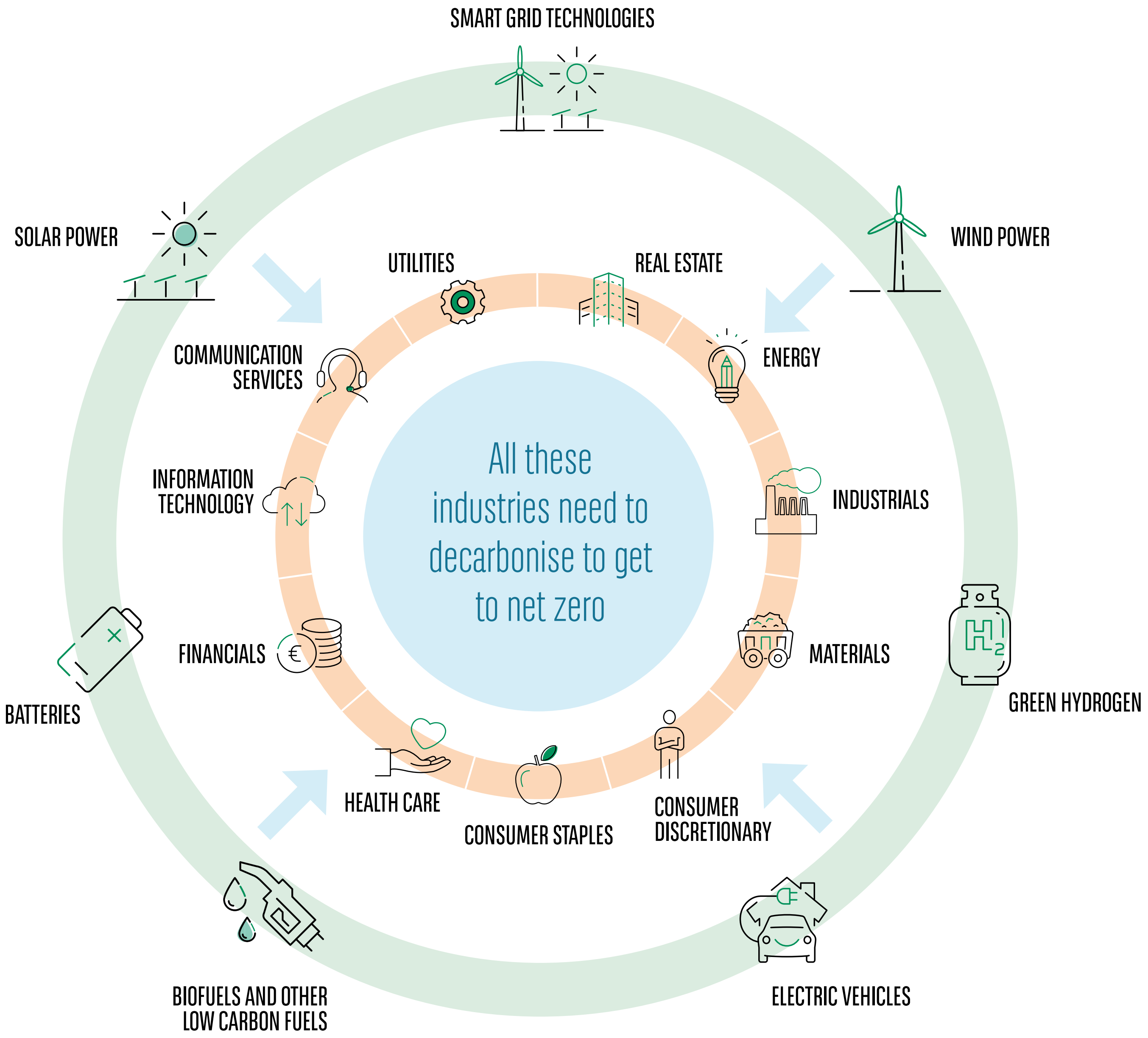
In the context of evaluating future long-term investment opportunities, our Environmental Strategies Group consider the past as well as the present. Why? Because by examining the interconnections between the drivers of previous industrial revolutions, and technological advances, they can assess the role and value of those of today. The combination of a deep thematic expertise and technical know-how help them to better understand the effect of new technologies on related industries and target those businesses that could prove to be the long-term winners and that are truly helping to decarbonise the economy.

In this way, we – along with clients – can invest to influence a better future.

Ulrik Fugmann
Co-Head & Senior PM
Environmental Strategies Group

Edward Lees
Co-Head & Senior PM
Environmental Strategies Group

Be part of the solution by addressing the gap between purpose and profit



VIEWPOINT

BNP PARIBAS
ASSET MANAGEMENT

The sustainable investor for a changing world