Investment Insights

A multi-thematic approach to sustainable investing

February 2024

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A multi-thematic approach to sustainable investing

Key takeaways

- Our multi-thematic approach to sustainable investing seeks attractive risk-adjusted returns, with potentially fewer of the concentration risks and style biases often associated with single-theme strategies.
- We developed seven sustainable investment themes that align with United Nations Sustainable Development Goals (UN SDGs) and encompass a large opportunity set of both aligned and transitioning companies, which can evolve over time.
- For our new sustainable investment strategies, deep fundamental research guides our assessment of issuer eligibility – culminating in an impact thesis that includes analysis of UN SDG alignment, risk of misalignment, ESG key performance indictors (KPIs) and risk management and engagement priorities.
- Some of the more compelling opportunities of coming decades should, in our view, be reflected in our seven themes – among those companies that successfully innovate and adapt to structural change and disruption as the world transitions to a more sustainable future.

The benefits of a multi-thematic approach for sustainable investment strategies

Ask one-hundred investors to give one example of a sustainable investment opportunity, and there's a good chance many will mention something related to clean energy. Conversely, the odds of them citing "financial inclusion" or "health and well-being" are quite low. And yet, just like clean energy, these and other investable themes have a profoundly significant role to play in the world's transition to a more sustainable future.

Emme Kozloff
Equity portfolio manager

"While clean energy often grabs the headlines, there are also other investable themes being propelled by what we expect will be multi-decade environmental and societal tailwinds," says equity portfolio manager Emme Kozloff.

"Our multi-thematic approach empowers us to look broadly, using our research to uncover what could be some of the most compelling opportunities I'll see in my career. As a long-term investor, that's very exciting."

A multi-thematic approach to sustainable investing could also be advantageous for investors – helping mitigate the kinds of challenges witnessed in recent years. By contrast, single-theme strategies can be quite volatile, because their exposures can be quite concentrated.

For example, some clean energy-oriented strategies have endured a bumpy ride with significant declines relative to the broader market in part due to rising interest rates; notably, this has hurt solar project earnings. Unintended style bias is another potential risk sometimes seen in single-theme strategies: Historically, growth stocks (especially from the technology sector) have proven popular holdings.

Beyond the large investable universe and potential diversification, we believe a multi-thematic approach offers another important benefit: adaptability. We have identified seven themes that are, in our view, broad and durable enough to enable our investment professionals to adapt as innovations occur and regulations evolve over the coming decades.

Consider the auto industry, for example. A decade ago, many legacy auto companies were viewed as having business models that were fundamentally misaligned with the energy transition. Fast forward to now, most of these firms produce their own electric vehicle lines, with credible longer-term strategies to transform their businesses and product lines over coming decades.

Solving for sustainability

Balancing interlinking environmental and social considerations is a crucial aspect of our multi-thematic strategy and analysis of issuers. Achieving one goal may have unintended negative implications for another sustainable development goal.

When it comes to assessing the effects of the global energy transition, for example, our investment professionals look at the big picture. That means considering negative externalities that could impede the UN SDGs as well as assessing a firm's positive environmental impact. The vexed question of biofuels illustrates the idea.

Specifically, increased usage of biofuels made with corn and soy could increase costs for these food staples, creating potential for meaningful declines in food affordability among developing economies. For conventional feedstocks, therefore, achieving access to affordable and clean energy (associated with UN SDG 7[1]) may come at the cost of making progress toward zero hunger (UN SDG 2).

Cheryl Wilson
ESG senior manager

"Whenever you have competing demands on the same resources, there are trade-offs," explains Cheryl Wilson. "Our analysis has helped quantify how greater use of conventional biofuels could have negative consequences for the food value chain."

In other words, neither "E" nor "S" risks and opportunities exist in a vacuum. Interconnections are often multifaceted and unintended consequences are possible. We see this kind of dynamic playing out broadly, including in some areas that some investors may find surprising.

"E" and "S" don't exist in vacuums – and neither do the UN SDGs.

For example, poverty is often accompanied by food insecurity, which in turn can be exacerbated by climate change. While fertilisers boost food production, and lower costs, they can also contribute to biodiversity loss and have a significant carbon footprint. Mindful of the complex interconnectedness of many environmental, social and governance issues, there seems to be broad openness to different approaches in sustainable investing: 47% of professional investors say funds that are aligned to the UN SDGs tend to overly focus on environmental issues, while 46% say that there is a need for multi-thematic ESG funds aligned to most of the UN SDGs.[2]

[1] For a full list of the 17 UN SDGs please refer to the UN website: https://sdgs.un.org/goals
[2] Source: Capital Group ESG Global Study 2023.

Durable themes, compelling opportunities

Development of Capital Group's seven sustainable investment themes was a rigorous and collaborative process. We explored the intersection between the progress required to move toward a more sustainable future – informed by priorities outlined in the UN SDGs – with the universe of companies that could be a part of moving the world forward.

Through all this analysis, we identified seven durable themes that we believe:

- Positively align to the UN SDGs
- Offer compelling long-term investment opportunities
- Include a sufficiently large investment universe for us to try to add value through our research-driven investment approach, The Capital System™

The 17 UN SDGs, adopted by all UN member states in September 2015 with a goal to achieve them by 2030, were built on the targets outlined in the UN Millennium Development Goals for 2015.

The ESG team partnered with investment professionals to carefully review all 169 of the 17 UN SDGs' underlying targets. Many of the SDG targets are written with a broader scope than what the private sector can provide, so we had to interpret how various business activities could support those goals. We identified business activities that both contribute to the goals and are investable through public markets, which informed our selection of the seven investment themes.

Importantly, we acknowledge that these goals are likely to evolve as we move closer to the UN's 2030 target date. We also recognise that the SDGs fail to consider certain topics, communities and groups, which we seek to capture within our themes.

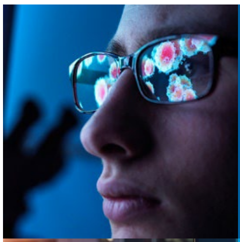
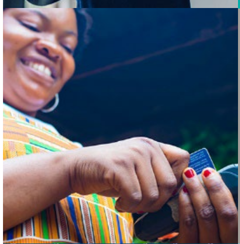
Julian Abdey
Equity portfolio manager

"Ultimately, we believe forward-looking companies with innovative solutions are needed to bridge the US$4.3 trillion[3] annual financing gap for the UN SDGs," says equity portfolio manager Julian Abdey. "The range of sectors and businesses reflected in our themes provides a rich, diverse opportunity set."

As shown in the table on the following page, each theme is connected with at least two UN SDGs, and as many as six, highlighting the interconnected web of sustainable challenges that the world faces.

[3] Source: UN, as at October 2022

Capital Group's sustainable investment themes

Theme			Aligned UN SDGs[1]	Potential investment areas
	**Health & well-being**	**The number of people over 60 will double by 2050[4]** Companies that are innovating to promote healthy living and well-being underpin our thesis for this investment theme.	3, 6, 8, 17	• Pharmaceuticals • Biotechnology • Health care equipment and services • Life science tools and services
	**Energy transition**	**Net Zero transition will create a $200 trillion investment opportunity by 2050[5]** Companies and issuers that can provide access to affordable, reliable and sustainable energy will be front and centre.	7, 8, 9, 11, 12, 13	• Electric utilities with renewables generation • Electric vehicle auto and battery manufacturing • Clean hydrogen • Semiconductor manufacturing
	**Sustainable cities & communities**	**Nearly seven in ten people will live in cities by 2050[6]** We are seeking out businesses which can build and support urbanisation in an inclusive, sustainable way.	6, 9, 11, 12	• Green building suppliers • Sustainable building products • Catastrophe insurance and consultancy provision
	**Responsible consumption**	**The equivalent of almost three planets could be required to sustain current lifestyles by 2050[7]** Companies that are innovating to support a transition to a circular and sustainable economy can help pave the way.	2, 8, 9, 11, 12	• Waste reduction, reuse & recycling • Chemical and waste management • Power management • Sustainable food production and manufacturing
	**Education & information access**	**Spending on education could reach $10 trillion by 2030[8]** Businesses building offerings that promote inclusive, quality education and information access can help bridge the knowledge gap.	3, 4, 8, 9, 10, 16	• Education providers • Internet, software and hardware providers expanding access to education / information • Cybersecurity
	**Financial inclusion**	**More than 1.4 billion people globally remain unbanked[9]** Companies increasing the affordability of, and access to, financial services and marketplaces are needed to support financial inclusion.	1, 8, 9, 11, 17	• Banks and asset managers providing access to under-served populations • Payment platforms • Marketplaces for small businesses
	**Clean water & sanitation**	**Urban population facing water scarcity is estimated to reach over 2 billion people by 2050[10]** Businesses are finding creative solutions to ensure availability and sustainable management of water and sanitation.	6, 12	• Water utilities • Chemical water treatment • Building product providers with management solutions

Investment themes map to the UN SDGs, but also take into consideration topics, communities and groups not specifically referenced in the SDG framework. References to the UN SDGs do not imply the endorsement by the UN of Capital Group, its products or services, or of its planned activities.

All figures quoted are in US dollars.

[4] Source: World Health Organisation, as at October 2022
[5] Source: BloombergNEF, under a Net Zero Scenario, as at December 2022
[6] Source: World Bank, as at April 2023
[7] Source: UN, as at August 2021
[8] Source: HolonIQ Education Intelligence Unit, as at June 2018
[9] Source: World Bank, Global Findex Database, as at July 2022
[10] Source: UN World Water Development report, March 2023

In or out? For eligibility, we consider both alignment and ESG risk management

Our approach to sustainable investing considers firms that we view as already "aligned," as well as those making demonstrable efforts to transition their businesses to contribute towards a more sustainable future.[11]

To determine whether a company is considered eligible for investment, we assess how its core business activities contribute toward environmental and social goals. We see two broad categories of eligibility:

- **Aligned companies** typically have core businesses that are mostly aligned to the UN SDGs:
  - Some align through their products and services, with significant positive contribution by dint of their size, scale, and market presence.
  - Others are successful industry disruptors and innovators whose business activities focus on solving unmet needs or addressing under-served populations.
- **Transitioning companies** are moving toward higher positive alignment over the long term:
  - While business alignment may be low, we would expect to see material positive change in the near-to-medium term (3-5 years).

In addition to positive contribution to the UN SDGs, eligible companies need to 'do no significant harm'[12] or impede other development goals and appropriately manage material ESG risks. We leverage our sector-specific ESG research and investment frameworks to assess how a company or issuer operates within a particular sector.

Assessment of issuer eligibility culminates in a detailed impact thesis, which outlines our insights on UN SDG alignment and risk of misalignment, ESG risk management, as well as the relevant key performance indicators for each company and engagement priorities.

Research collaboration

Empowered by proprietary tools

Our investment professionals conduct thousands of company meetings around the world each year. They meet and assess the quality of management, analyse the company's financial strength, its resources, its products and the services it provides – all of which inform our long-term perspective on the company. Our dedicated 40+ ESG team is embedded within the Investment Group, enhancing insights with their deep sector-specific ESG knowledge.

We have also developed a suite of proprietary tools to help investment analysts and portfolio managers identify, explore and track material ESG issues. For example, Ethos is the platform that houses ESG data to support our sector-specific ESG investment frameworks and monitoring process. Logos is a dedicated tool to evaluate and monitor the eligibility of companies and issuers for our sustainable strategies.

[11] Aligned companies have 50%+ business alignment. We typically use revenue to assess business alignment but will leverage other metrics if there are more sector relevant financial metrics for a company and its industry (e.g., energy production mix for utilities).
[12] The Do No Significant Harm (DNSH) principle is to be applied for all EU 'Sustainable Investments', and stipulates that in addition to contributing to an environmental or social objective, the investment must prove it does not significantly harm any other environmental or social objective.

Damir Bettini
Fixed income portfolio manager

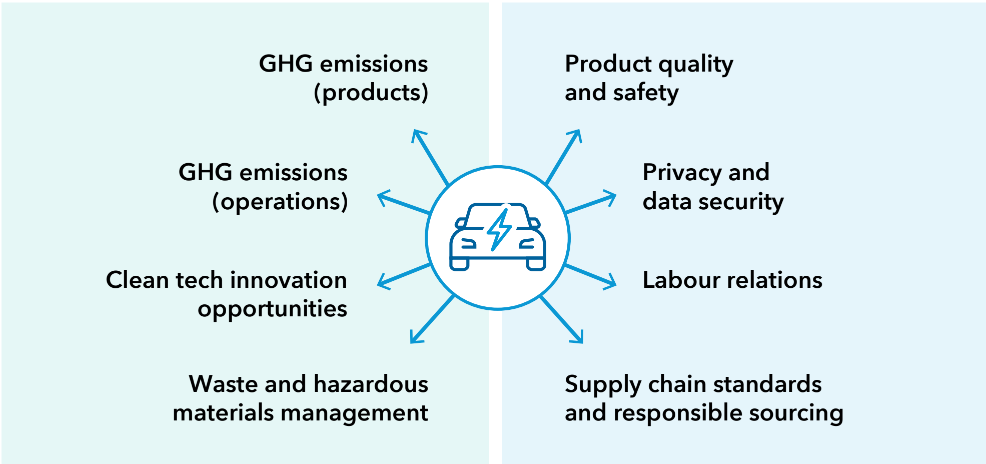
"We do not believe it is sufficient for a company to simply score well on ESG issues or demonstrate good governance," says fixed income portfolio manager Damir Bettini. "In addition to managing material ESG risks, we look for genuine alignment to sustainable investment themes and the growing contributions transitioning companies may have in the future."

Investment professionals and ESG analysts work together to assess eligibility for our sustainable strategies. Recent analysis of a US-listed auto company illustrates the kinds of considerations our ESG analysts and investment analysts weighed during the eligibility process. The firm in question is putting significant additional capital into electric and autonomous vehicles (EVs and AVs, respectively).

Private autos are responsible for more than a quarter of global oil use and nearly 10% of global CO_2 emissions, as of 2022, according to the International Energy Agency (IEA). In order to achieve Net Zero emissions targets by 2050, all car and van sales will need to be zero emission by 2035.[13] Production of EVs clearly positively aligns to UN SDG 7 – access to affordable and clean energy. What's more, the company's work on autonomous vehicles also seemed to hold some potential to support meaningful progress toward UN SDG 3 (good health and well-being) through improving road safety.

Eligibility? Rigorous research helps explore positives and negatives.

Examples of key environmental and social topics we consider for auto manufacturers



For illustrative purposes only.
Source: Capital Group. GHG: greenhouse gas

[13] Source: International Energy Agency, Net Zero by 2050

"It became clear, as we dug deeper, that autonomous vehicles also presented meaningful regulatory risk that the firm needed to manage," says ESG analyst Carol Cuello. "We also flagged supply chain risks related to the sourcing of rare earth metals and minerals."

Next, Carol thoroughly analysed the firm's supply chain, and assessed the company's sourcing of raw materials used in the production of batteries, paying close attention to the company's labour practices and respect for human rights. In addition to environmental degradation considerations, analysts assessed the potential for human rights abuses and substandard safety/work conditions in lithium and cobalt mining, for example.

This type of company analysis illustrates the complex interplay of sustainable issues. Understanding the trade-offs – through fundamental research – can help us arrive at a more considered investment universe.

On balance, we decided that the auto firm was eligible to be considered for investment. Among other topics, we will prioritise updates on the firm's supply chain monitoring when we meet with company management in coming months and years. It is through company engagements like this that our ESG analysts and investment professionals deepen their insights and build understanding of a particular issuer's management of ESG risks.

Conclusion

We have seen innumerable transformational changes in our world in the ninety-plus years since Capital Group's foundation. Entirely new industries have emerged, while others have transformed or disappeared. Through it all, our commitment to using deep fundamental research has helped us remain focused on finding compelling long-term opportunities that serve our clients' investment objectives.

Coming decades will undoubtedly bring more innovation and disruption. We feel confident that many of the developments that will move our world towards a more sustainable future will prove to be fertile ground for selective investors who can take the long view.

Our sustainable investing capabilities build on some of the qualities that have helped define us through our 90-plus year history, namely the deep research and collaboration that is at the heart of our multiple-manager investment approach, The Capital System™.

Nick Grace
Equity portfolio manager

"Whether you're considering companies delivering sustainable solutions today or trying to identify those that are poised to succeed in the future, our view is there's no substitute for bottom-up fundamental research," says Nick Grace, equity portfolio manager. "With more than 470 investment professionals and over 40 ESG specialists dotted around the globe, I believe few firms can match the scale and scope of our research effort."

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Risk factors you should consider before investing:

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