



## The Hexagon Briefing: A Global Perspective from HSBC

### Episode 3: ESGs and Value Creation

May 10, 2021

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**Jose Rasco:**

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I'm your host, Jose Rasco, thanks for joining us today.

Today, we're going to talk about sustainability, or ESG investing, with Willem Sels, our Global CIO here at HSBC. He's my boss and a man I've known personally for a little over a decade. So I think he's the perfect guest for this topic as it's near and dear to his heart.

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So thanks for joining me. And let's get into it.

One of the things that we're very focused on right now, and the markets are certainly focused on it, is what's going on from Washington in terms of spending and is that spending going to lift inflation? You know, is too much government borrowing going to kill the debt markets? And is that going to kill our stock portfolio and I'm going to have to work an extra 10 years? We don't think that's right. The question is, do higher deficits or does higher government spending and therefore the issuance of more bonds, does that really affect the economy in a positive way? And historically, it really has. If you look at the New Deal with FDR, if you look at Reagan with what Reagan did in terms of the deficit - Reagan really taught us to love debt again um in the 80s. It did propel the economy so that higher government spending, whether it was for creating jobs in the Depression or building the military establishment, which was a big issue for Reagan, and it really did help propel the economy. So I think what President Biden is trying to do is find that new issue and that new issue is moving America into the new age. And that new age is one of sustainability, one of alternative energy becoming a higher

proportion of our energy production and consumption. And so as a result, the hope is that this deficit spending isn't going to be in vain. It's going to be something that's going to set us up for the next 50 years in terms of the proper infrastructure, not just bridges, roads and tunnels, but as well for alternative energy and the digital footprint that we need to have to have America 2.0, as it were, look better.

So number one, hopefully it does lead to jobs, wealth creation, and a better economy. Number two: do these deficits necessarily result in higher interest rates? Not really. And so interest rates are driven by other things. They are driven by economic activity. They're driven by fear of inflation. Yes, if the government borrows a lot, you know people get nervous and they may sell their bonds and interest rates may start to climb. But on balance, deficit spending, you know, doesn't necessarily mean that interest rates are going to go soaring through to the moon. So that's one thing that I think we need to keep in mind. The fear of inflation, right? So a lot of people are very concerned about inflation and you've seen the headlines where all these producer price indexes and these regional manufacturing indexes are talking about the CRB is up 45% and commodity prices are soaring and inflation is going to take off. A couple of things going on, and we've talked about it before. Number one is what they call a base effect. Inflation was low last year. Oil prices went down. They were even negative. So prices this year are going to look much higher because of that year over year. It's coming from a deep hole of last year. So that's number one, the base effect. It goes away in three or four months.

Number two is we have a lot of pent up demand, right. Many of us are dying to get out of the house, go to concerts, take vacations. So we're going to spend a little more on that first or second thing we do because we have some money spent up, the consumer savings rate is extremely high and cash levels at the corporate level are very high. So people are going to throw some of that excess cash at those first two events or first two opportunities. But after that, things will normalize. More importantly, we've had supply constraints. So prices are looking higher because there isn't enough oil, there isn't enough toilet paper, there aren't enough homes to buy. So prices are up artificially in the short term because supply has been constrained due to the covid lockdowns and due to the recession. So cyclically you will see supply expand, covid restrictions lift as hopefully as we see the vaccines take hold and herd immunity hits in, clicks in at some point in the second half of the year, and therefore we think inflation goes away.

So bottom line, does more government spending, is more government spending a bad thing or a good thing? It can be both. We're hoping this one is a good thing, like some of these other programs were in the past with FDR and Reagan, which actually helped propel economic growth, job creation and wealth creation. Now, the government historically has not been the most efficient user of capital. But the bottom line is, if the money's out there and it gets used and it gets deployed, it will create jobs and will lift the economy so interest rates don't have to go flying due to inflation. In fact, one of the things that we're seeing is a lot of that money is being spent on digital infrastructure, which is going to lower inflation, not raise inflation. So those are all important things. And the more bridges, roads and tunnels we have that work, that means things can get to us more cheaply, more easily. Logistics are better. That also lowers inflation. So we're hopeful that this program, as scary as those numbers look, is actually a good thing, short term and long term for the economy.

So listen, number one, taxes were going up either way. We spent a ton of money trying to handle the covid crisis and the covid recession and that, that had to be paid for, so we knew taxes were going up either way, no matter who was in the White House. Right? That's number one. Number two is more deficit spending is bad if it doesn't lead to anything productive. This is going to lead to a boom in technology spending and building the infrastructure for the next 25 years. Keep in mind, deficit spending, if it's leading something productive, can actually be a good thing.

One of the things that's excited me following the market is the opportunity presented in the environmental sector, in what's going on with social policy, and today, I'm very thrilled to announce that I'm joined by one person who I think is the perfect person to discuss a lot of these trends. Willem, welcome to the program.

**Willem Sels:** Glad to be here. Thank you.

**Jose Rasco:** Thank you. And now Willem Sels is the Global Chief Investment Officer at HSBC, and he focuses on expanding the bank's investment strategy around the globe. He has more than 23 years experience in the industry and also happens to be my boss. So Mr. Sels was most recently featured in City Wire Selectors latest edition of the top 30 Super Allocators. So it is super to have you with us. Welcome to the Hexagon Briefing, and how long have we known each other and have I worked with you? I think it's more than a decade now?

**Willem Sels:** Yeah, 11 years.

**Jose Rasco:** Time does fly. All right. So listen, it's not every day that, you know, people get to interview their own boss. So being that I feel that you are the most relevant person at the bank in terms of this particular issue and how it all sort of fits together for our clients. Can you tell the listeners a bit about what you do at HSBC?

**Willem Sels:** I run the Global Investment Committee, so we set out to house view. We have a big input from global research colleagues and then obviously with them yourself, Jose, and the other CIOs of the different regions. And we come to a view on equities, fixed income, FX effects, that we integrate alternatives as well. We have thematic ideas and that we all write it up. And then obviously we have the real pleasure is to meet with clients and to try to make sense of it all in a client portfolio.

**Jose Rasco:** Yes. And that and that is true. And that's what we do for our clients from an investment perspective more broadly. But now trying to narrow down to this one theme in particular, which is to say that it's an emerging theme sort of undersells what's going on, don't you think? I mean, this is something you and I have been passionate about since I've known you. And I've been we've been doing this for a long time, decades. We've been looking at some of these issues on the environmental and social side and trying to figure out how this all fits in given the structure and global capital markets.

So call it sustainability, call it ESG investing, impact investing, SRI, it has more names behind it than we can shake a stick at. So can you tell us what is sustainability? Right. How does the bank define it? And when we talk to

clients about it, what are we exactly talking about from an investment perspective?

**Willem Sels:**

Yeah so from an investment perspective and actually as a bank, what we try to do is to support our clients aspirations to make that positive change in the world, right? And everybody is a little bit different from a client perspective as to where they want to be on that spectrum from, you know, pure return generation to, you know, doing good in the world. Actually, you can do both. You can do well whilst doing good. But clearly, the investments that we're looking at don't necessarily need to be perfect on a sustainability basis. As long as you feel that you invest in a company that is improving, that is getting their act together, and that is going into the right direction from a sustainability perspective, we do include that into our definition of sustainability.

So it's a whole entire spectrum from traditional investor investment where you don't look even at ESG factors to on the other the other side's probably philanthropy, where you give away your money to good causes. The least you can do, I think at the very minimum, and almost every fund does this now is what we call ESG integration. So you will start to incorporate environmental, social and governance factors in your analysis on top of your financial ratios and your earnings analysis that you typically do. That's really the very minimum. We think that to be defined as a sustainability and sustainable investment, you need to go a little bit further. You need to skew your investments to really invest in the companies that have very good ESG scores are improving those or are trying to make a positive change.

The other way to do it, which is also another way to do sustainable investments, is to look at it from a thematic perspective. So you're going to go and look for low carbon transition clean energy, gender equality, health and education, and you look for companies that are interested in that and then you a little bit further still, then you have impact investing and impact investing can have slightly lower returns, but you're really making a very positive change. So that's microfinance. That's green bonds. And you're really going to finance projects that make a real difference. So whole spectrum, really. And that's the exciting bit, because also the industry is developing and more and more opportunities are there for investors.

**Jose Rasco:**

I just want to mention, because sustainable investing can be so broad, it's important to ensure that the definition of any investment in sustainability, within that investment or the company your investing, in is consistent with your definition of sustainability. So you should review this before investing.

And it's interesting because what we're seeing is that what I'm what I've begun to call Activist Alpha. Right. So customers of a particular product will prefer Company A over Company B, just from the economics perspective, because this company defines my value set or they understand my values. Right. Whether it's an LGBT investor, a green investor, somebody who believes in doing the right thing for women, whatever your cause is. Right, we're seeing that play out in the economy. I mean, books have been written, papers have been written about these things. And there's no question that a company has lower acquisition and retention costs when it comes to customers just economically when they're doing the right thing and they're tapping into that market. And we've seen that play out repeatedly. Now, this also works out in the investment community, right, where we're beginning to see that the market is, in fact, rewarding companies that, in fact, do the right

thing. And we've seen it play out at the beginning of this year. Right Willem, where we saw some of this more activist investing in the marketplace begin to affect portfolio returns. So it's something that we're keeping an eye on, no question about it.

And you talked about this continuum. There's different ways to do it, right. So clearly and you talked about some of the different strategies. Right, and whether it's in the private equity space or the public equity space is all part of that asset allocation matrix that that you and I look at pretty much daily. Right. So when we look at the concept of asset allocation, one of the knocks on ESG investing or sustainability or impact, whatever you want to call it, one of the knocks on it has been, well you know, you're going to give up performance. Yeah, it's great to do the right thing, but you're going to give up performance. Now, you and I, we both every quarter we publish the quilt and the quilt is an asset allocation matrix that shows all these returns across the past 20 years. And there is not one year when one asset allocation strategy performs or outperforms the market every single year. It's a mix and it changes and rotates all the time. So but on balance, do you have to give a performance to do the right thing as an investor?

**Willem Sels:**

No, you don't. So that that's what we can say, certainly from a medium to longer term perspective. And so basically, I said that you can do well while doing good so you don't give up on returns. And the reason is that we really believe that companies that take into account all of their stakeholders will outperform in the long run. So that's obviously their consumers, their customers who want cleaner products. That's their employees who want to work for a company that behaves in the right way. Regulators, if you are a company that anticipates and works with regulators to see how regulation is going to change, those companies are going to have better foresight, are going to do better. You know, your investors, more and more investors obviously want to invest in cleaner companies. So that is going to impact your cost of capital or not following the ESG rules or not thinking about those, your cost of capital is going to be impacted.

Your equity analysts are going to have a worse view about your stock or see bigger ESG related risks to your stock and therefore your cost of capital is going to go up. So all of that basically means that it is going to have an impact on on your returns. And actually, in the longer term, you should have a better risk return relationship for those companies that have high or improving ESG scores. Now in the short term that's not necessarily the case, obviously, because you could have periods where the market is so unenthusiastic, that there is the dash for trash or people going into the riskier companies to for a very short period of time. We believe that ESG, high ESG scoring companies tend to have a better quality, so. In most periods, quality stocks have the better risk return relationship, but for very brief periods, you could have short time frames where junk outperforms, but generally it should do better. That's what the data tells us as well. And basically, since 2013, according to our friends at AMG, the top 30 ESG scoring companies outperformed the bottom 30% scoring companies by 0.9% in Europe, 0.2% in the US, 0.5% in Asia Pacific. Europe, a little bit higher in terms of our performance, because I think there is a lot of interest in ESG from the investor community. But that interest is growing around the world. So maybe those figures come closer to each other.

**Jose Rasco:**

And as time goes on, obviously it's something we've talked about a lot. It is definitely a demographic shift, right? As generation shift and money flows to

younger generations where this is more of a really passionate discourse, I think you'll see more of that. Right. So I think that activist alpha, again, I think will even come more to the force. So on the forefront, I should say.

**Willem Sels:** But it's not just the young, right? It's not just the Europeans or the young. It's basically growing the climate action one hundred plus five hundred institutional investors who with 45 trillion under management. And so you could imagine an environment where it's a bit like in the bond market, those with the bad ratings in the bond market as credit ratings here, it would be ESG ratings where certain parts of the investor community just doesn't want that poorly rated ESG stocks and therefore they have to be cheaper. They have to have a higher risk premium.

**Jose Rasco:** The point I was trying to make was I think if you look at that, this this stuff on the fringes where the retail investor is getting more involved, it just adds to the momentum of it. And it just it's just telling people more and more we want to do the right thing and we want to do the right thing, not just for individual causes, but just things that make sense. Right. You talked about some of the some of the financial ratios and the incorporation of ESG scores into those. So we talked a lot about what ESG, what is ESG? It's environmental, social and corporate governance. We talked about that. Explain the bank's views, if you don't mind. And I've done this a little bit in prior episodes of this of our podcast. But what is environmental from the bank's perspective and how does it fit into our portfolios? And if you look at in the US, for example Willem, the Biden administration is putting out a new 2 trillion dollar plus plan for over the next 10 years to rebuild infrastructure in America and the real focus on environmental issues and social issues. So they are very focused on that ESG framework. So it's not just the private sector, it's the public sector as well kicking in. So what does environmental mean from our perspective and how can our investors benefit?

**Willem Sels:** So you're right to start with environment, because I think that's probably the easiest one to implement for investors, probably also the most high profile, although the other ones are important as well. So to some extent, we probably have a thematic here around the environment that is one of the most broadly supported thematic that you can imagine, right, all of the governments around the world, that huge commitment. But also it's not just that those governments want to do the right thing. It's probably also because there is a race between the US, China and Europe to dominate a new growth industry. And there's not that often that you have a growth industry. So from an investment perspective, this is a very broadly supported, quite exciting long term opportunity. So that's why so many people are interested in it. So we focus on climate change mitigation and opportunity.

So another study by global research colleagues this time showed that companies with higher revenue exposure to those climate solutions outperformed the FTSE All-World in the last decade and even have a slightly better dividend payout as well. The build out of that whole infrastructure will require a lot of financing. For example, the EU recovery funds that you've heard of will finance 30% of its funding through green bonds. So a huge opportunity there for investors and then also outside of the US, opportunities in Europe and in China. So we have we're seeing China's green revolution within a target of carbon neutrality by 2060 requiring huge investment. So we see opportunities there in solar, in wind adaptation, the [electricity] grid. And they're also looking at the carbon pricing mechanism. So opportunities there for the electric vehicle supply line, utilities and then also waste and water. It's

not just electricity generation. It's also a waste water treatment. So a lot of thematic opportunities in this area.

**Jose Rasco:** And I think that's the development of that smart grid is one that I think is really interesting, because it provides the logistics and the feedback mechanism where you can create your own energy and actually get paid for it so it's really incentivising people to look at the alternative energy space, individuals as well as companies.

How would you include this in a global, diversified portfolio? A lot of our clients, Willem, tend to be, as you know, I don't have to tell you, global in nature. Their thought process is very global. And they want to diversify risk, but they also want to diversify the opportunity set. So, how are we implementing this for clients around the world?

**Willem Sels:** Yeah, so I talked about the examples of climate change, China's green revolution, gender diversity. Those that we typically think of as thematic kind is so those are additions to a well-diversified portfolio. So you can see that as you can see the satellites around a core portfolio.

But it's not just in the satellites that we think one should include sustainable investments. Because basically you can buy almost any asset class, whether it be US equities, European equities or emerging market bonds, developed market bonds.

You can buy them in a traditional way or you can buy them in a sustainable way because there's so many funds that have now been launched and even ETFs as well that do those investments for those different asset classes on a sustainable basis. So it's really a choice from an investor perspective. How far do I want to go on this sustainability path and how much do I want to incorporate not just in my thematic satellite ideas, but also in the core portfolio?

I would also add to one observation that sometimes people believe that those companies that are active in the sustainability themes, that they are expensive. Well, that might be true for some of the, what we call the pure play companies who only do those types of activities, some of the new growth companies. But there's a lot of companies that are more traditional companies that have very quickly grown activities in the sustainability space. So by adding those in the portfolio, that adds as well to the exposure into sustainability. So a lot of areas to consider. And basically, our view would be to just look at sustainability in whatever you do, and then it will add up quite quickly to a lot of exposure to quite exciting new themes and growth opportunities.

**Jose Rasco:** So, Willem, I think we've covered a lot of ground. Thank you very much for your time. And we will continue to delve into this as we go forward. And hopefully you can join us again and give us updates on how the strategies are working and some new ideas as the months go by. So thank you again for your time.

**Willem Sels:** Real pleasure. Thank you.

**Jose Rasco:** Thank you for listening to The Hexagon Briefing: A Global Perspective from HSBC. I'm your host, Jose Rasco.

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