ClearBridge Investments

The Outlook for Sustainable Investing

December 10, 2020

Key Takeaways

- We expect many of the drivers of strong returns for stocks with strong sustainability characteristics to continue in 2021, including efforts to fight climate change by lowering carbon emissions.
- Companies overcoming resource scarcity through the use of recycled materials and waste reduction will continue to provide value, as will companies innovating in sustainable packaging and healthier, more humanely raised food products.
- Another area of continued focus for investors will be corporate diversity, not only at the board level, but also through the ranks of the workforce and middle management.

Renewable Energy Innovation and Transparency Are ESG Priorities

We expect many of the drivers of strong returns for stocks with strong sustainability characteristics to continue in 2021. These include efforts to fight climate change by lowering carbon emissions. There is some expectation a Biden administration will be supportive of renewable energy within the federal scope; this appears likely although it is not an essential part of our investment case there, which rests mainly on much larger state and corporate commitments. We believe renewable energy will enjoy long-term secular growth as the world transitions to a less carbon-intensive economy and as solar and wind power has become more cost-competitive with fossil fuels. We are constructive on this growth in both residential applications, where companies like SolarEdge Technologies and Enphase Energy are leaders, and utilities such as NextEra Energy and Brookfield Renewable.

The push to lower emissions and increase energy efficiency will continue to support the growth of electric vehicles and their evolving supply chains. Electric vehicles contain more and more electronic content, for example, and will continue to grow demand for makers of electrical connectors such as TE Connectivity and Aptiv. We are also watching technologies such as green hydrogen, lithium-ion batteries and carbon capture and storage as they develop and potentially change the renewable energy landscape.

Companies overcoming resource scarcity through the use of recycled materials and waste reduction will continue to provide value. One example is sustainable decking company Trex. Helping to reduce demand for fossil fuel production, Trex manufactures outdoor decks and railings using recycled plastic materials. Trex should also benefit from a shift in home buying from urban to suburban centers, enhanced partly by lockdown measures and millennial home formation trends.

While the economy will continue to open and spending will partially migrate away from staples-focused purchases during the pandemic, companies innovating in sustainable packaging and healthier, more humanely raised food products will continue to see demand growth and have a long runway. Ball, which primarily makes aluminum packaging products, has also seen steady demand under COVID-19 for the household items it packages. Home consumption is the largest component of Ball's can business, though its recyclable stadium cups offer another promising line when large events can return.

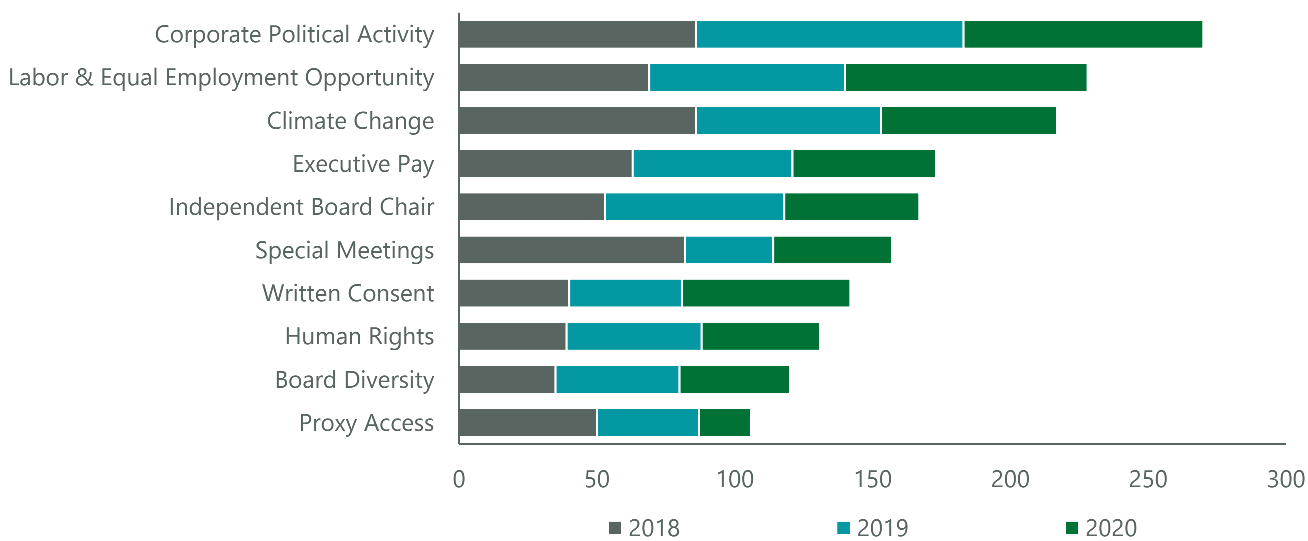
The COVID-19 pandemic has also served as a reminder of the value of drug innovation, and those health care companies that can drive this, or help address unmet medical needs or ensure patient safety and health care coverage, should continue to thrive.

Another area of continued focus for investors will be corporate diversity, not only at the board level, but also through the ranks of the workforce and middle management. ClearBridge has added Diversity & Inclusion among the major engagement themes for 2020–21. This will be a multiyear endeavor by both corporates for recruitment, training and promotion, as well as investors for more disclosure and engagements.

Transparency is increasingly a competitive necessity. Shareholders are having success pushing for more transparency and changing the landscape of what are considered industry norms. While proxy voting topics continue to focus on climate and gender, we expect a renewed focus on social equality, in particular racial equality, to feature more prominently in shareholder engagements and 2021 proxy proposals.

One proxy topic that continues to gain a lot of attention is disclosure of annual political spending, and most investors are voting for more disclosure (Exhibit 1). This is notable because in some senses the pendulum has swung toward valuing fair business practices and transparency. In the past, a common reason given for not disclosing was potential damage to competitiveness, something shareholders would not want. Now, the wave is gaining force, and the more companies disclose, the more it is a competitive disadvantage to not disclose.

Exhibit 1: Leading ESG Issues 2018–2020 by Number of Shareholder Proposals Filed



Source: US SIF Foundation, ISS ESG and Sustainable Investments Institute. From the US SIF Foundation's [Report on US Sustainable and Impact Investing Trends 2020](#).

Overall, we are positive on the outlook for economic growth in 2021, as society has learned important lessons in mitigating the spread of COVID-19 while operating businesses under relatively safe conditions, if at less than optimal output levels. Hopes for a broad vaccine deployment by midyear 2021 seem reasonable, and while that may not mark the immediate end of the virus, economic activity should pick up, supporting more cyclical areas of the market. The large technology platforms that dominated returns in 2020 by helping a stay-at-home environment, however, should see continued strength both as this environment remains with us and as their solutions offered to society remain innovative and valuable. In our view, a diversified portfolio favoring companies with strong sustainability characteristics is best aligned with our long-term investment approach.

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