ClearBridge
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2025 ESG Outlook: Sustainability as a Business Driver

December 2024

Key Takeaways

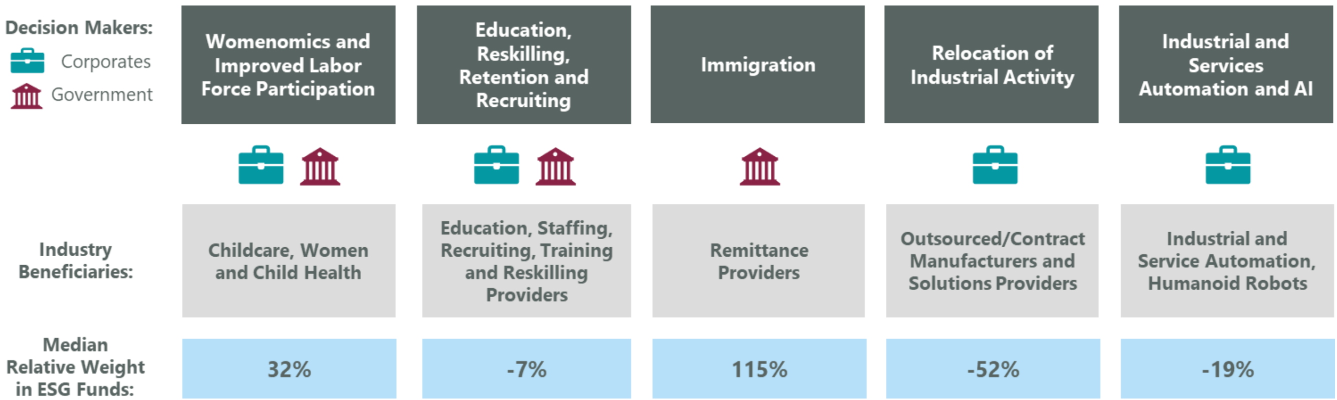
- Major sustainability themes entering 2025 are closely linked to major market themes, touching on the dynamic regulatory environment in the U.S., big tech's green capex to meet the power demands of growing AI, and efficiency as a means of lowering costs, reducing emissions and supporting biodiversity.
- While some federal involvement in sustainability goals may wane temporarily, a full repeal of the Inflation Reduction Act is unlikely as it compounds economic growth and sustainability goals widely across the country.
- The energy transition is a global reality and open conversations with companies on emissions reductions will continue as they seek to augment their competitiveness in a lower-carbon economy. Despite a rapidly changing business landscape, the business case for diversity, equity and inclusion not only holds but grows stronger.

Sustainability Central to Major Market Drivers

How companies manage their environmental and social impacts, and how they govern themselves to the benefit or detriment of their shareholders and other key stakeholders will remain a fundamental concern for investors, companies and governments around the world in 2025. As the value of considering these ESG or sustainability factors becomes clearer amid more extreme weather events, the progressing energy transition and the growing recognition of the competitive advantage of effective human capital management, so too do the ways in which sustainability adds value as a business driver, risk reducer, cost compressor and productivity enhancer.

Major sustainability themes entering 2025 are closely linked to major market themes, touching on the dynamic regulatory environment in the U.S., big tech's green capex to meet the power demands of growing AI, and efficiency as a means of lowering costs and reducing emissions. Circularity will continue to emerge as a key governing concept as well as biodiversity, which would benefit from greater water and land efficiency. We also expect more company and government efforts to support climate resilience and adaptation as climate change realities intensify — these have important social implications. Likewise, we expect companies and governments to contend with the social as well as business impacts of changing labor force dynamics as populations age, immigration slows and tariffs disrupt global supply chains. We highlight key industry beneficiaries to be aware of amid these evolving economic conditions (Exhibit 1). Efforts to responsibly source critical raw materials are also ongoing.

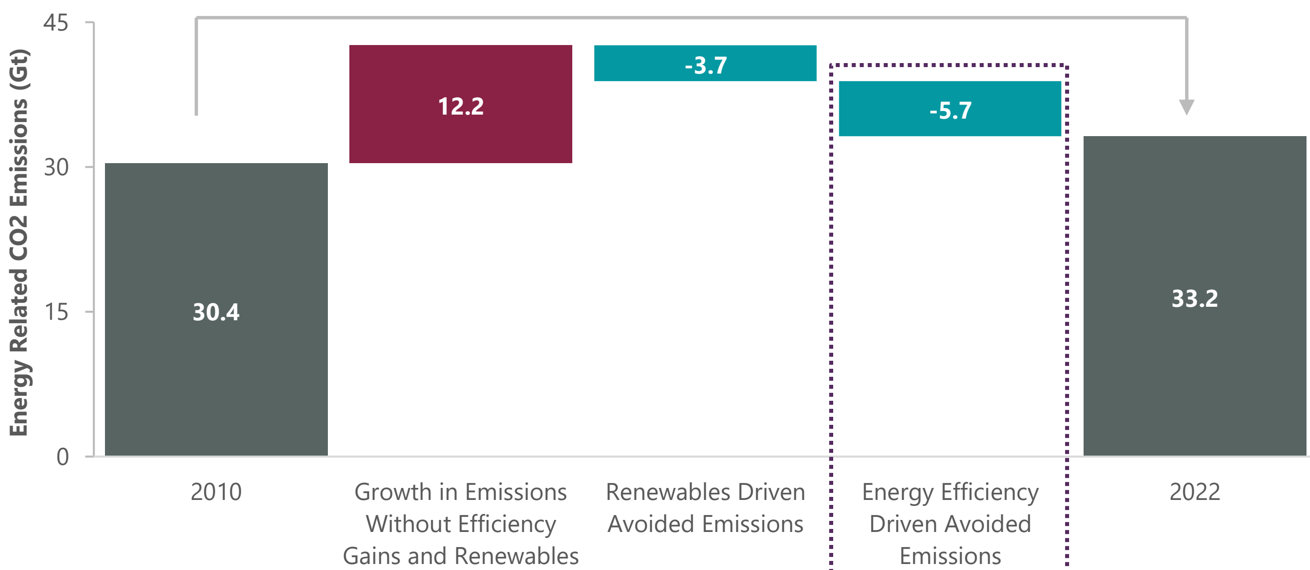
Exhibit 1: Key Solutions to Aging Populations Might Be Underappreciated



Source: Goldman Sachs Investment Research, "The Demographic Dilemma: Aging Populations and the Social Investing opportunities from potential solutions," Nov 19, 2024.

Following the Republican sweep in November, some fear a hostile environment for sustainability-themed investing and sustainability goals broadly. But while some federal involvement in sustainability goals may wane temporarily (in areas such as the Paris Agreement, the SEC's climate disclosure rule, electric vehicle tax credits and EPA regulations), a full repeal of the Inflation Reduction Act (IRA) is unlikely as it compounds economic growth and sustainability goals widely across the country. And while the IRA propels emissions reductions, energy efficiency has been a major contributor to lowering emissions before the IRA, a reminder that renewables and clean energy are not the only solution (Exhibit 2). Regulation and competitive dynamics in the U.S. may lead to a more challenging environment for EVs, biofuels, offshore wind and green hydrogen, while capex for wind and solar should continue to be healthy.

Exhibit 2: Energy Efficiency Has Avoided More Emissions than Renewable Energy Deployment



Attribution analysis of avoided emissions from renewable energy deployment and energy efficiency gains (2010 baseline). Sources: IEA, UN, World Bank, Goldman Sachs Global Investment Research.

The energy transition is a global reality and open conversations with companies on emissions reductions will continue as they seek to augment their competitiveness in a lower-carbon economy. The investment community may be less vocal about sustainability activities and engagements, although open and transparent communication with clients as well as portfolio companies about best practices, enabling all financial participants to make informed decisions, will remain the standard.

In a dynamic business landscape, the business case for diversity, equity and inclusion (DEI) on executive teams not only holds but grows stronger. As McKinsey & Company notes, the business case for diversity on executive teams has more than doubled in the past decade as part of a steady upward trend. The likelihood of financial outperformance for diverse firms has grown, with a 39% increased likelihood of outperformance for those companies in the top quartile of ethnic representation versus bottom quartile (versus 15% in 2015). Diversity-leading U.S. companies have reached 50% representation of women on executive teams. In addition, leading companies in the U.S. now have on average 39% of executives from historically underrepresented ethnicities.[1] As the appointment of a new SEC chair would likely remove the Human Capital Management Rule from the regulatory agenda (involving corporate disclosure of human capital data), we have observed investors are increasingly encouraging portfolio companies to voluntarily disclose EEO-1 data going forward (many companies voluntarily do so already).

The sustainability profile of artificial intelligence (AI) will remain a market priority, with hyperscalers, incentivized by both consumers and shareholders to source renewable energy for data centers, driving demand along the renewable energy value chain, in particular wind and solar. As carbon-free nuclear energy is enlisted to meet accelerating global power demand, we'll see vigorous debate globally on safety and efficacy, and its viability is by no means certain. The negative climate impacts of more carbon-intensive sources like natural gas should be partially mitigated by more opportunities for lowering emissions profiles (via methane leak reductions) and innovative carbon capture projects.

Circularity remains a key opportunity, being at once a consumer preference, an environmental positive, an opportunity for boosting the bottom line via operational efficiency (as well as revenues in many cases), and an increasing regulatory imperative. While available and reliable data remains a challenge for biodiversity-themed investing, businesses offering solutions that improve water resilience and land management and remediation have direct revenue opportunities that would fall under the biodiversity banner. Most businesses also have biodiversity risks to manage in their operations; these form part of the business fundamentals investors must take it upon themselves to understand as they underwrite securities they invest in.

To this end, while some protections may be called into question, the new U.S. administration looks to be supportive of nature, specifically on drinking water legislation and PFAS (forever chemicals); this has been a bipartisan issue that in fact originated with the Trump administration in 2019 (and a long-standing topic of ClearBridge engagements), and which the Biden administration continued with more regulations to support clean drinking water.

From an active manager's perspective, in our view there is no change to the fiduciary obligation of understanding how sustainability factors woven into companies' operations and adhering to their products and services reflect material risks and opportunities. To the extent that policy in the U.S. temporarily ceases to be the tailwind it has been at times, and amid a potentially rightward shift in policy in Europe toward simplification and competitiveness, the case for identifying where sustainability innovation and leadership is advancing company fundamentals is all the more important.

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[1] "Diversity matters even more: The case for holistic impact," McKinsey, Dec. 2023.

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