In focus

Starting ground for a Just Transition

June 2022

It is safe to say that sustainable investing is complex. Priorities can rapidly shift based on changes in consumer preference, policy and technological innovation. These changes don't affect companies in a vacuum; as they materialize, value chains are becoming more interconnected under increased pressures to strategically consider all stakeholders, including workers, the environment, regulators, suppliers, customers and communities. What has typically happened behind the scenes at companies is suddenly in the spotlight and investors want to see receipts.

Lazaro Tiant
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When we think about "what it means to be sustainable," there should be outcomes in mind. As we consider the value chain of *people* – workers and communities – that outcome can become personal to investors and require a more hands-on approach. While much of sustainable investing has focused on disclosure to understand how companies consider issues today, risks and opportunities focused on people has increasingly become about participating in what happens next.

Climate change is a social issue

A core component of sustainable investing is planning for future risks. As part of traditional financial risk analysis, investors at times consider how companies and markets reacted under previous scenarios – financial crises, oil price shocks, supply chain disruptions, as well as times of geopolitical and economic conflict. Historical data and quantitative modeling considering such events enable investors to learn from past experiences to make more informed decisions for the future. The use of sustainability factors as a lens through which we examine fundamental risk has led to an increased focus on helping investors to understand potential links to financial stability, such that they include climate risks alongside economic and market impacts.

Climate risks can be categorized as transition risks (driven by policy shifts, technology innovation, consumer demand) and physical risks, which can be chronic (rising temperatures and sea levels) and acute (damage caused by hurricanes, wildfires and floods). Impacts on economic sectors and the macroeconomy include property damage and business disruption, affecting income streams, which results in adverse reactions across product and labor markets. Impacts on banks and insurers includes credit, liquidity and operational risks.

Similar to financial risk analysis, investors leverage climate modeling to understand how companies and markets might fare against policy pressures and increased global temperatures. For example, they may try to determine to what extent a company or fund might experience loss in value through reduced profits due to climate forces. To ultimately make more informed decisions, while leveraging active ownership as a valuable tool, understanding how companies are planning to strategically and operationally transition their businesses to a more sustainable model is at the top of the agenda for investors. The SEC's recently proposed climate change rules also highlight regulatory pressures for companies to disclose carbon footprints and transition planning.

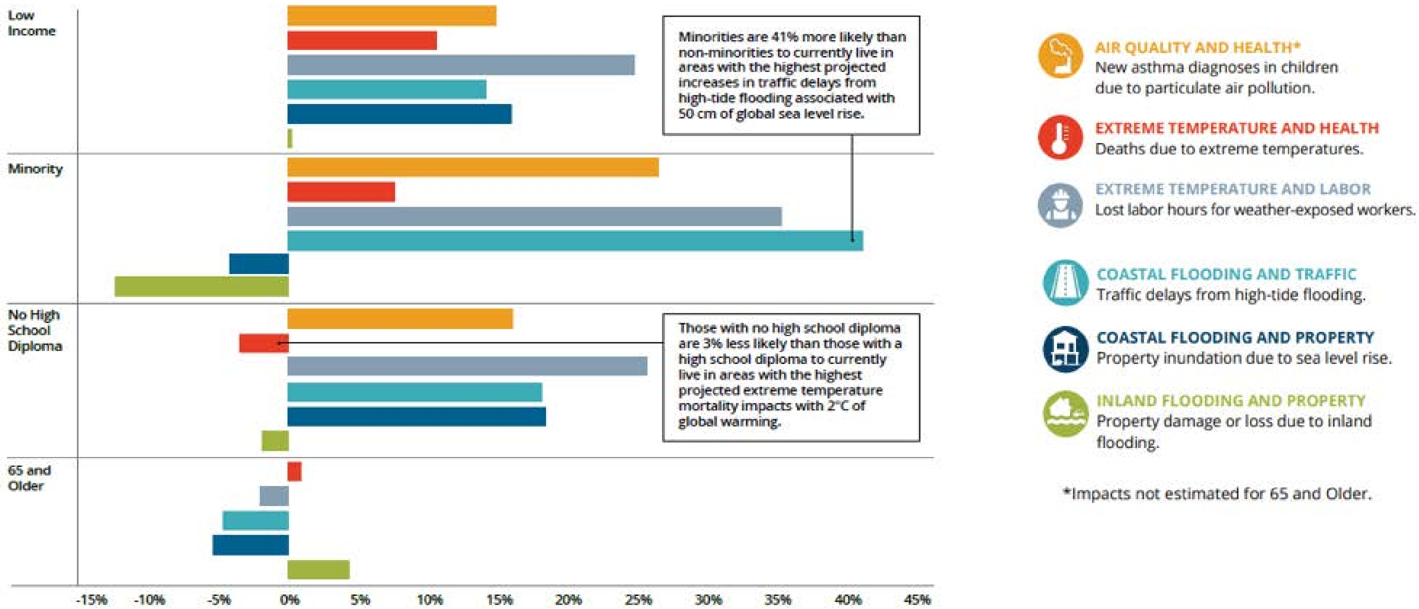
While individuals may have differing regional priorities among environmental and social factors, it is essential that we draw common links. That is to say, climate change is a social issue. Yes, it is now expected that investors understand a company's potential losses driven by climate change. However, at the same time we need to fundamentally understand how people are affected and plan the correct course.

Our transition towards a lower carbon economy needs to be a fair and just one, with workers and communities in mind. After all, we believe people (workers) are appreciating assets and communities are key stakeholders that cannot be overlooked. Thus different countries and companies are pursuing what is called "a Just Transition."

Painting a picture through a U.S. lens

A Just Transition considers and accounts for the future of workers and communities as we embark on the next industrial revolution. Communication with workers, unions and the communities that will be affected is a first step. Next we provide them with a plan during the transition, such as training or the reskilling of employees to establish or continue a sensible career path. These

Figure 1: United States



Source: Climate Change and Social Vulnerability in the United States: A Focus on Six Impacts, EPS September 2021.

are the only ways forward. To achieve them, we need to research and understand best practices, industry labor standards, local processes and representation.

Today, the midwest United States hosts the most power plants, such as coal-fired power, in the country. The region also has the highest number of plant retirements, which affect both workers and communities alike. In fact – according to the U.S. Energy Information Administration (EIA), coal is planned to account for 85% of U.S. electric generating capacity retirements in 2022 – while solar power will account for nearly half of new U.S. electric generating capacity (followed by natural gas, wind, batteries and nuclear).

Workers within certain highly carbon-intensive sectors should experience a safe and responsible path towards decarbonization, supported by protected well-being, income and productivity; after all, people suffer at the hands of heat stress and pollution. This extends to workers in socially vulnerable groups, such as low income individuals, minorities and those with no high school diploma; they face lost labor hours due to extreme temperature, according to an Environmental Protection Agency (EPA) report on climate change and social vulnerability in the US.

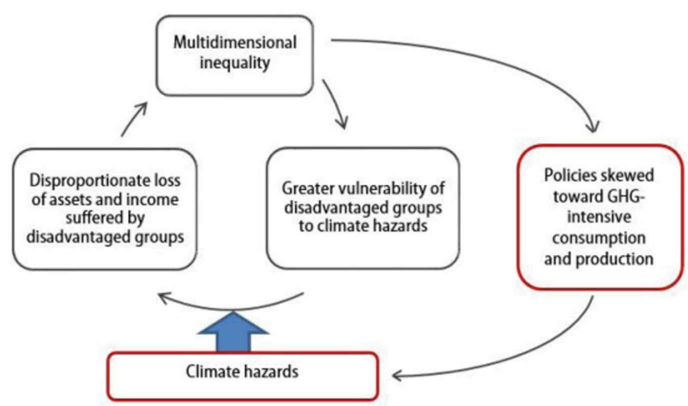
When certain risks materialize, communities within highly exposed sectors face spillover impacts, such as property damage due to a wildfire or flooding. In order to manage the distributional issues of phasing out fossil fuels and moving into a decarbonized energy landscape, people should have a voice on resilience measures, including adequate building codes and disaster recovery plans.

Alternatively, across supply chains in industries such as renewables, sustainable transportation, environmental resources and energy efficiency, there is a focus on creating good jobs in traditional places. States such as Michigan, Ohio and Indiana are home to the country's largest number of motor-vehicle manufacturing jobs. Motor-vehicle manufacturing is currently experiencing shifts towards an electric future. Experience and knowledge remain essential across energy production and sustainable transportation. Additionally, new and diverse expertise in an increasingly software and technology-based form is also important, creating new hurdles for entry and retention.

Learning from the rearview

It is enlightening to consider historical infrastructure developments, particularly those that benefit the auto industry. One of the largest public projects in US history was The Federal-Aid Highway Act of 1956, which led to over 40,000 miles of interstate highway systems. According to the U.S. Department of Transportation, over the course of two decades, the program displaced nearly half a million households and over one million people while spurring economic and racial divide.

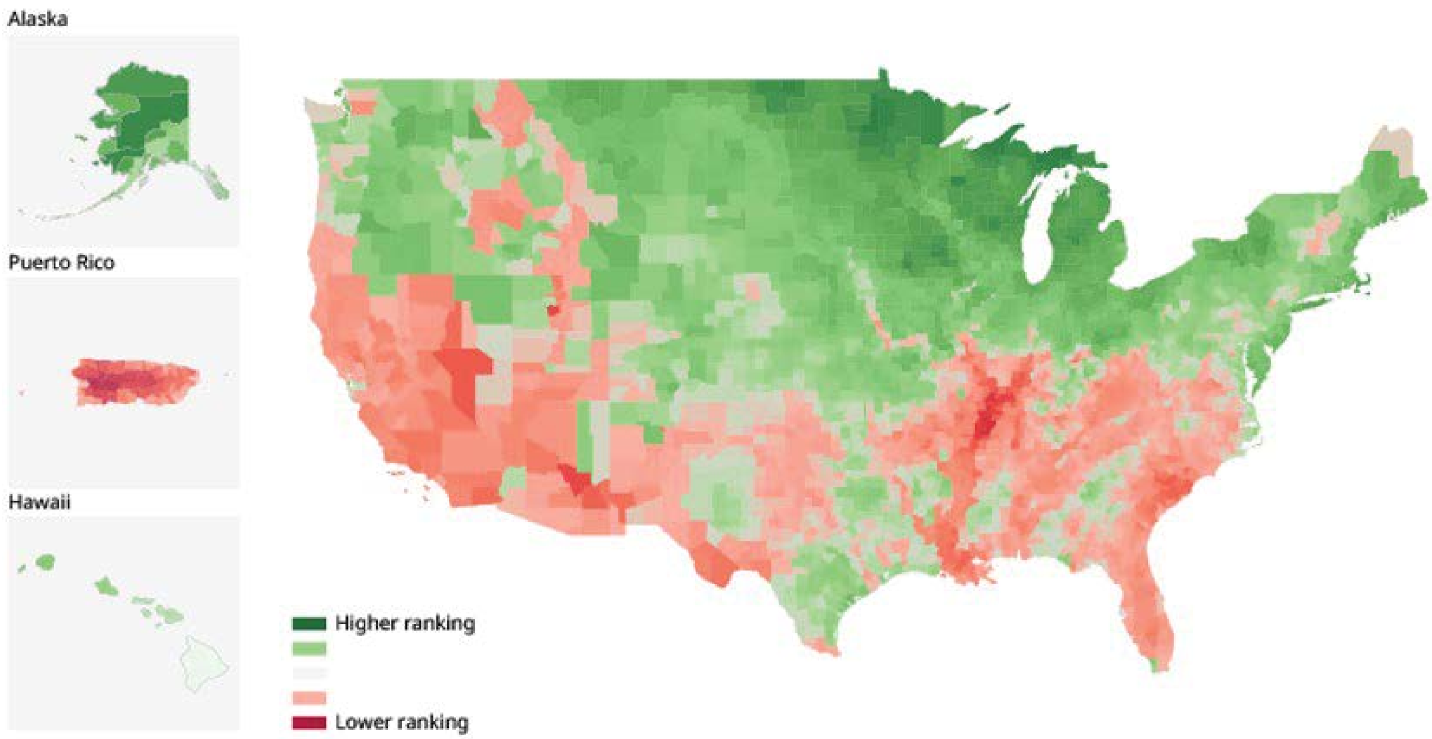
Figure 2: Reinforced cycle between inequality and climate change



Source: S. Nazrul Islam and John Winkel, https://www.un.org/esa/desa/papers/2017/wp152_2017.pdf, October 2017.

Infrastructure expansion creates jobs, transportation improvements and innovation. Today it also includes a view of a sustainable future. As we experience a decades-long energy and infrastructure transition, there is an opportunity to avoid a vicious cycle driven by previously disregarded and inequitable outcomes that are only worsening in terms of climate change. While we are

Figure 3: Schroders' Municipal US Sustainability Explorer (MUSE)



Source: Schroders. Shown for illustrative purposes only. Our proprietary tools are designed to enhance the research process but do not guarantee favorable investment outcomes

making slow progress, policies have traditionally favored carbon-intensive consumption and production, which have not curbed climate hazards. Lack of pressures and planning leads to a higher probability of risks facing socially vulnerable groups due to climate hazards, such as the negative effects of droughts potentially leading to disproportionate loss of assets and income.

Just, in time: Identifying local risks and opportunities in the US

As an active manager, we recognize that in transitioning to a sustainable economy we must ensure that the benefits are shared widely, reducing inequality and ensuring we protect those people at risk of being left behind. Across asset classes, our investment analysis includes understanding the impact of a Just Transition on key stakeholders, including employees, suppliers, customers and the broader society. In order to fund a Just Transition, Schroders will continue to create new products that help move capital towards areas that need the most support, as well as encourage the companies in which we invest to support job creation and retraining for the green economy through engagement.

In practice, for insights into municipal bonds, Schroders Municipal US Sustainability Explorer (MUSE) investment tool allows fund managers and analysts to access insights into over 40 factors across 3,100 counties and close to 13,000 school districts in the U.S. This capability is designed to provide a forward-looking lens on the population that supports the municipalities that comprise each county.

Analysts leverage the interactive tool's structured lens to better understand sustainability risks and opportunities among US counties, including a view into environmental vulnerabilities across physical risks (wildfire, seismic hazard, flood river), and well-being risk (air and water quality). Focusing on society, human capital perspectives includes insights into the uninsured and severe housing problems, while social stability focuses on factors such as income inequality, schooling and graduation rates, as well as the unemployment rate and presence of mental health care. To assess local oversight, environmental governance, including biodiversity measures and policies on carbon and recycling, provide a lens into how counties are planning ahead.

MUSE aims to enhance our longer term perspective combined with traditional municipal fundamental analysis. While the capability was built by and for our fixed income professionals, it can also enable investors and sustainable investment team members to understand local risks where companies currently operate or intend to do so, providing insights into strategic and project-based planning.

Where do we go from here?

We believe sustainability has shifted the investor mindset to better understand the negative effects that have transpired under investment, industry and political watch. With historical context and a growing number of commitments to demonstrate responsibility, we should look at these human dimensions in this transition to set society up for future success through investment strategy and corporate engagement, as well as policy advocacy and partnership.

Through increased disclosures and value-chain engagement, we expect to learn of the changes relating to a company's transition towards a net zero business, as well as plans to communicate with and aid the workforce, while also taking into account how investments in transition plans impact earnings and free cash flow to shareholders in the short and long term. This also extends to industries that may be considered undesirable by some who want to invest sustainably. Companies called on to deliver drastic change will require support and investors can take a thoughtful approach to help cushion the impact. Like all things sustainability, there is no one-size-fits-all approach. Treating each situation in a humane and pragmatic way is the best start we can think of.

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