Interview between Christof Kessler and Bryan Carter and Sandra Carlisle of HSBC Asset Management on the occasion of Gothaer's investment in HSBC Asset Management's REGIO Fund

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[CK:] Bryan, we have found that EMD is the most challenging asset class in the ESG context. Do you agree with this view?

[BC:] This is a common perception among outside observers to the asset class. From the outside, EM countries appear to be replete with ESG challenges. Yet our view is quite the opposite: because emerging markets cover such a vast array of issuers with 80+ countries eligible for investment, we are easily able to make gradations among the quality of E, S and G policies and tilt our investments in favour of strong ESG and away from weak ESG while maintaining a diversified, high yielding and alpha-orientated portfolio. India, for example, is one of the world's leaders in green technology adoption and the setting of ambitious decarbonisation targets. South Africa has joined the club of nations that have pledged to achieve net zero emissions by 2050. Many of Latin America's energy and mining companies are among the most forward thinking in the world about ESG improvement, among them as an example Colombia's Ecopetrol.

Another potential misconception that may be embedded in this question is that EMD issuers have little ESG or impact awareness. This is simply no longer true: many EM countries and EM companies have leapfrogged the developed world in terms of their focus on sustainability and decarbonisation, their ESG transition, and their directive of meaningful impact. One might argue that as EM countries have had to deal with ESG issues for centuries -- slavery and colonization, exploitation of natural resources, extreme weather, dictatorships and coups – they are much more fluent with the importance of ESG in their day-to-day operations and more sensitive to the benefit of ESG improvements.

[CK:] What would you describe as the biggest challenge in implementing ESG in EM?

[BC:] A strict ESG implementation based on an exclusions philosophy and an absolute cut-off for ESG risks could fail a number of EM investments. This would have an obvious performance impact if it means avoiding many of the highest yielding, and most exciting, investment opportunities. That consideration, or the fear of it, is probably the biggest challenge in implementing ESG in EM.

We must remember that the world is changing so quickly – especially when it comes to awareness of ESG in emerging markets – that we believe such an exclusions approach would be a mistake. Many of the greatest opportunities for ESG improvement, especially when it comes to climate change and decarbonisation, are found in the emerging world. Simply writing off these opportunities foregoes the opportunity to invest in positive change.

At HSBC Asset Management, our approach focuses on the transition to a greener future, ESG improvement and the potential improvement set for EM issuers. In the words of Bob Dylan, "For the loser now will be later to win / For the times they are a-changin'."

[CK:] How do you integrate ESG into your EMD portfolios?

[BC:] The HSBC EMD team has a four pillar ESG approach:

(1) Forward-looking proprietary ESG engagement assessments

Each one of our fundamental sovereign and corporate credit analysts undertakes a proprietary analysis of a country or company's ESG quality based on a prospective assessment of the issuer's policies and willingness to engage and improve on E, S or G dimensions. As our analysts have ongoing and continuous interactions with issuers and know their credits deeply, we believe this pillar gives HSBC a real edge in ESG investing. Our portfolios will not overweight any issuer we deem to be deteriorating in its ESG trajectory.

(2) High standard for labelled bonds that preferences investment in green, social and sustainability instruments

We preference investment in green, social and sustainability bonds anywhere and everywhere they are available, provided they pass our high standards of due diligence examining use of proceeds, ex-post funds tracking, and impact analysis. The most common reason we fail labelled bonds is if they do not ring-fence proceeds for a specific list of projects, or if the projects do not prohibit excluded activities. Use of proceeds bonds are the most extreme version of ESG in that they confirm additionality of the investment, providing a measurable level of impact to our ESG portfolios.

(3) A dynamic approach to investment exclusions

We do exclude issuers from investment based on criteria such as UNGC designation, dirty sectors (weapons, tobacco, thermal coal and inefficient utility) as well as very low scoring ESG countries. However, unlike other static exclusion lists, our approach to exclusions is dynamic. Our intimate engagement with issuers via our forward-looking proprietary assessments at the analyst level provide us an edge, and we are able to identify whether excluded issuers are quickly addressing and resolving major ESG impediments, and resume investment before their score improvements are picked up in the backward-looking ESG data scores.

(4) The adoption of ESG benchmarks

Managing portfolios against ESG benchmarks is the most sensible way to track additive performance as a manager, because of the exclusions list. For many managers, ESG exclusions drive their relative performance especially if the list is highly concentrated in specific sectors or ratings segments. By correcting for this in the index composition, we feel we are more transparent in our ESG performance drivers, separating ESG exclusions from investment performance in our attribution analysis.

We believe no other manager uses this same combination of ESG enhancements, providing our portfolios a unique fingerprint as far as EMD responsible investing.

[CK:] From your comments, we understand that a deep ESG knowledge of the companies you invest in is an important pillar of your ESG approach (for example, for the application of dynamic exclusion criteria). This can only be achieved through in-depth analysis and an intensive dialog with investee companies. However, this is very resource intensive. Does this mean that ESG funds are

more expensive than non-ESG funds? Especially considering the higher reporting and documentation requirements?

[BC:] There is no question that savers are benefitting from declining fees across the industry, and this trend will continue regardless of the ESG phenomenon. However, active managers can offer something that passive managers cannot when it comes to ESG implementation, and that is the intimate knowledge of ESG issuers and the ability to spot ESG improvers. In that regard, ESG funds will likely maintain some pricing power relative to non-ESG funds as investment managers retool their fundamental investment processes to leverage this knowledge edge. For thematic or impact strategies, the reporting requirements and impact documentation required under SFDR constitute additional services that only skilled investors with sophisticated ESG processes can reliably provide.

[CK:] ESG data is essential for sound ESG analysis and thus for avoiding greenwashing. However, the availability of ESG data is a major challenge, especially in emerging markets. How do you deal with this problem?

[BC:] This is actually a fairly simple matter: we insist on ESG data providers that have complete coverage of our universe. Yes, this reduces the number of potential inputs to our process, but we believe with confidence that comparing countries across a wide spectrum of geographic, historical and economic dimensions mean that apples-to-apples evaluations are the only way to draw sensible ESG conclusions. Of course, our deep knowledge of EM issuers through our longstanding analyst team coverage gives us an edge when it comes to fundamental ESG comparisons across the EM universe and our ability to identify ESG improvers.

[CK:] Does ESG reduce your investment universe? If so, what effect does this have on your performance?

[BC:] ESG limits the investment universe in three ways: one, by truncating the investment set of active overweight positions from deteriorating ESG issuers; two, insofar as managers create lists of investment exclusions; and three, if the fund is thematic. We are comfortable with these reductions, as we believe our forward-looking proprietary ESG screens will predict relative performance, so that excluding ESG sliders will not harm (and may actually boost) relative returns. In addition, our exclusions list is dynamic; we do not forget about our excluded credits, rather we continually evaluate them for re-inclusion. Once an issuer initiates an ESG improvement journey, and sends genuine signals of ESG engagement to our HSBC analyst team, we can quickly include that name back into our universe and consider it for investment. As far as thematic investments, HSBC packages and labels these products clearly as such for full transparency of our objective and measurable outcome. Last year's launch of REGIO – the largest EM corporate green bond fund in existence, though our partnership with the IFC – is a great example.

[CK:] Sandra, Gothaer AM is one of the founding partners of REGIO. Can you please give us some background on the development and motivation of the Product and what is the role of the IFC in this context?

[SC:] We have a long-standing and close working relationship with IFC and they were our partner of choice when we started to think about creating an emerging market impact bond fund. IFC has been operating for more than 60 years in emerging markets and we knew that we would have the benefit of their knowledge, skill, and expertise in creating what become the REGIO fund. The fund is designed to meet the needs of investors who want to align financial return with strong ESG characteristics and measurable and quantifiable impact metrics that further the aims and ambitions of the Paris Agreement and the UN Sustainable Development Goals. IFC plays a number of important roles in the fund. First, they are an anchor investor alongside HSBC and have co-invested with our

institutional investors, including Gothaer Asset Management. Secondly they worked with us to create the impact framework for the REGIO fund, the Green Impact Investment Guidelines. These guidelines set out eligible activities and exclusions and define the impact metrics and objectives that issuers have to meet to be considered for investment by the fund. Thirdly, IFC is our impact reporting partner and will provide an annual impact report for the REGIO fund to investors. Finally, they can act as standard setters for emerging market issuers and help to ensure that borrowers who come to market meet the ESG and impact objectives of our institutional investors.

[CK:] That sounds Investors can add real impact by investing in this Emerging Markets Fund through HSBC AM. How does HSBC AM classify the fund under SFDR and could you elaborate a bit on related impact reporting measurements?"

[SC:] Yes, that is true. The fund has very clear ESG and impact metrics, set out in the Green Impact Investing Guidelines. These guidelines define impact in a number of ways. At an initial level, every security in the fund has to meet one or more of the SDGs. In addition, every security has to meet one of more of the SDG sub- goals which are much more detailed and specific. Then every security has to have a defined impact objective that is quantifiable and reportable e.g. shift in green baseload power, improvements in water efficiency etc. The fund's focus on real economy EM borrowers is unique in today's market and it means that that our investors will be able, over the life of the fund, to track the real impact of their invested capital.

HSBC Real Economy Green Investment Opportunity Global Emerging Market Fund (REGIO) is classified as article 9 fund under SFDR.

[CK:] Can you please give us some examples of a typical investment for this Green Impact Fund?

[SC:] Sure, i.e. we invested in a Costa Rican based utility. The Bond is as close to the perfect green bond as we have seen in the Emerging Markets space. It has been at the leading edge of non-conventional renewable infrastructure development in underserved countries throughout Central America, increasing installed capacity in wind, solar and hydro generation, with a clear commitment to being a leader in the region going forward.

At the opposite extreme I can give you an example of a bond, which we rejected for REGIO. We looked at a Chilean utility. This company issued a perpetual green bond structured such that initial proceeds were to be allocated to existing refinancing, and would be fungibly applied to green eligible projects at a later date. This set off flags for us based on our emphasis on traceability. Upon further review we determined that at least some of the initial proceeds would be replacing debt originally incurred to finance now-stranded coal-based generation plants. As a result, this bonds did not make it into the REGIO portfolio.

[CK:] Is there a tradeoff between ESG and return objectives?

[BC:] At HSBC, we have unified the duelling objectives of ESG quality and investment performance by innovating the concept of ESG improvers. In EM countries especially, it is not the historical ESG leaders but rather those issuers who are making a rapid and unmistakeable ESG transition that are most interesting for investment. We believe these ESG improvers will lead returns, both because long term sustainability is synchronous with ultimate investment returns, as well as because ESG policies are good proxies for responsible long-term management and decision making. Our active, forward-looking emphasis sets us apart from other mangers, by capturing ESG improvement earlier in the evolution, allowing us to own positive ESG credits before other managers are passively crowded-in by the backward-looking ESG data.

[CK:] What are your perspectives on Greenwashing in the asset class?

[BC:] Greenwashing is a very real phenomenon in the EMD asset class. There are two types of greenwashing that we identify and control against in our processes: one, lax standards for labelled bonds; and two, fund grade 'inflation' by managers.

Not only is greenwashing not going away; we reckon that the array of new ESG instruments including sustainability-linked bonds with varying conventions and KPIs are confusing investors and lowering overall standards. In our view, bonds that are issued using pre-COVID ESG targets or that do not commit to measurable decarbonisation within the next five years are not viable ESG instruments. We take a constructive view in the sense that our deep-dive due diligence, analyst-led forward view and high bar for ESG investment differentiate us from other managers and insulate us from the 'wild west' aspect of greenwashing.

HSBC takes a very conservative approach to our fund labelling and ESG integration. Our Article 8 and 9 funds are managed with the highest best-in-class standards including strict definitions for impact and thematic investing, a thorough internal process review for standardization, and integrity with regard to ESG scoring and independent oversight of our ESG frameworks. We know we are more prudent than we need to be in this regard, but we take pride in our conservatism.

[CK:] Is there investor demand for ESG products in the Emerging Markets Debt assetclass?

[SC:] There is no question that the mass migration to ESG investments is only just beginning. Over the next five years, we expect that sustainable investing will become absolutely mainstream, and that concepts of E, S and G scoring will become as commonplace in credit analysis as EBITDA, free cash flow and leverage ratios. Going forward, changes to our world will mean that issuers ignoring ESG considerations will no longer be viable. Their investment ratings will reflect this, and their access to financing will be reduced. Indeed, we are already at the point at which long term macroeconomic forecasting is inseparable from assumptions about global environmental scenarios, social stability and governance trajectory.