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Responsible investing 2.0: Focus on generating sustainable returns

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When seeking to invest in ways that advance sustainability goals and deliver attractive risk-adjusted returns, it is important to focus on specific investment themes and monitor how those themes impact performance. Our team's approach offers investors exposure to sustainability related investment themes that we believe will have an enduring impact on financial and investment performance over time.

ATTRIBUTION MODELS HAVE LIMITATIONS

Given competing claims about the definition and utility of sustainable investing — particularly in public equities — asset managers, asset owners, corporate officers, directors and regulators are all looking for greater clarity and evidence-based guidance.

Some argue that incorporating environmental, social and governance (ESG) considerations with traditional investment approaches fails to achieve ESG's positive goals and compromises investment returns, while others insist it pays off in both societal benefits and investment performance. In reality, existing attribution models are not yet robust enough to isolate the effect of ESG considerations on risk and return due to the lack of standardized definitions, inconsistent disclosures and a scarcity of long-term data.

While attribution models are not yet robust enough to isolate the effects of ESG factors on risk and return, we do believe that the impact of specific investment themes can be measured. Themes like energy transition and innovation, inclusive growth and need for better corporate governance will likely influence macroeconomic trends as well as the financial performance of companies across industries and sectors. For these reasons, these themes are important considerations for equity investors.

The focus on these issues is likely to intensify given the uncertainties related to climate change and the rapid adoption of artificial intelligence. In this context, effective corporate oversight at the board level is critical to monitor enterprise risk and align the interests of management with those of shareholders and other stakeholders.

A WIDER APERTURE IS REQUIRED FOR MAKING INVESTMENT DECISIONS

Our team seeks hard data and evidence to select stocks, construct portfolios, manage risk and help clients achieve their investment objectives. Through tight collaboration, our team of fundamental analysts, quantitative analysts, portfolio managers and responsible investing specialists develops tools and processes to make realistic determinations about sustainable investing. We embed those insights into portfolio construction in ways that consider the ultimate impact on risk and return and offer insights to clients as they make long-term investment decisions.

Thematic investing focuses on secular trends and issues — rather than sectors or market indexes — and is a powerful way to approach sustainable investing. Investment themes often play out across multiple sectors and can influence competitive dynamics, financial performance and equity values in the short and long term. Moreover, thematic investing can be implemented across asset classes. To be effective, however, the investment themes must be measurable and powerful enough to influence a company's equity value or volatility.

We believe three important themes — energy transition and innovation, inclusive growth and strong governance — will alter the investment landscape in multiple sectors for the foreseeable future. In addition, our analysis shows that within specific sectors, these themes have also been correlated with excess return.

For these investment themes, we developed clear metrics to measure the extent to which companies in a broad investment universe were aligned with each theme. We then used traditional quantitative techniques to determine whether the theme was correlated with excess return, and if so, identify any variances by sector or industry.

By exploring each theme quantitatively, we sought to mitigate unintended biases that often influence investment decisions. We then married this analysis with fundamental analysis at the stock level to determine a specific company's alignment with each investment theme on a forward-looking basis.

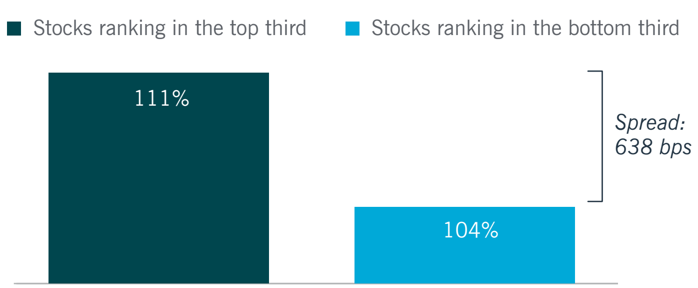
INVESTMENT THEMES MAY ENHANCE INVESTMENT PERFORMANCE

To confirm the relevance of the themes to investors, we identified metrics to help us to determine whether they can enhance investment performance and to guide us toward stocks that are aligned with the theme in our purchase universe. For example, metrics for the energy transition and innovation theme include emissions trends, carbon intensity relative to non-current assets, the change in carbon intensity relative to non-current assets and green patents relative to non-current assets.

In this case, we found that stocks that ranked in the top third of our purchase universe based on their alignment with energy transition and innovation outperformed stocks that ranked in the bottom third of our purchase universe during the period we examined (Figure 1).

Figure 1: Stocks more aligned with energy transition and innovation outperformed those less aligned

Compound returns relative to the S&P 500 Index, 2017 to 2023



Data source: MSCI, FactSet, Nuveen Analysis, 01 Jan 2017 – 31 Dec 2023. **Performance data shown represents past performance and does not predict or guarantee future results**. The energy transition and innovation theme includes four factors: 3-year change in Scope 1 and 2 CO_2e emissions, current carbon intensity (CO_2e emissions / non-current assets), 3-year change in carbon intensity, and green patents relative to non-current assets. The terciles are rebalanced annually at the beginning of each calendar year, and returns are calculated for the following 12 months. The constituents in each tercile are equally weighted.

Let's explore each of these themes in greater detail.

Energy transition and innovation will likely disrupt many economic sectors

The energy transition and innovative responses to that transition will likely disrupt many sectors of the economy and impact equity valuations. This theme includes decarbonization, defined as efforts to transform the production of energy to reduce greenhouse gas emissions and remove emissions from the atmosphere, as well as "green innovation," the commercialization of technologies that enhance productivity, reduce environmental risks and expand access to energy, at scale.

For investors, this theme matters because it affects cost structures, competitive dynamics and equity valuations across sectors and industries. Moreover, companies that have developed patented discoveries may enjoy barriers to entry that can enhance profitability and returns on invested capital for long periods of time. Examples include carbon capture, bioenergy, carbon dioxide removal, carbon sequestration and electrification.

Inclusive growth is an investment catalyst for equity compounders

Inclusive growth is economic growth that raises standards of living for broad segments of the population. It emphasizes improving the standard of living for all individuals, regardless of their socioeconomic background or geographic location. Inclusive growth is achieved through policies and initiatives that foster employment, economic mobility, productivity and social stability. Historically, economic growth has been measured solely by gross domestic product, whereas more recently the focus has shifted toward ensuring that economic growth benefits substantial portions of the population and addresses socioeconomic disparities.

This change in thinking may have profound implications for institutional investors as innovative companies begin to recognize the potential financial advantages of adopting a strategy grounded in inclusive growth. These advantages include 1) the ability to penetrate large and growing addressable markets, 2) revenue diversification derived from diverse customer segments and geographic markets, and 3) for many, dominant and durable intangible assets, such as strong brands, intellectual property or network effects, which may create barriers to entry and protect their market position.

At scale, these companies may become high quality, franchise businesses, with recurring revenues and high returns on invested capital. These characteristics are the hallmarks of "equity compounders," stocks that have weathered economic cycles and generated consistent returns over time. Such stocks are core holdings in most equity portfolios.

Beyond the obvious candidates, how can investors identify companies aligned with inclusive growth?

The United Nations Sustainable Development Goals (SDGs) provide a comprehensive framework for addressing many global challenges, including inclusive growth. Several of the SDGs are aligned with the tenets of inclusive growth while presenting addressable business opportunities for public companies.

Inclusive growth has transformed from a mere aspiration to a fundamental driver of economic progress. As the world continues to prioritize equitable development, we believe embracing inclusive growth as a guiding principle is a sound investment strategy for a better future.

Figure 2: Several UN SDGs relate to inclusive growth

Source: Nuveen

Effective corporate governance is critical

Robust corporate governance stands as a cornerstone, encompassing policies and practices designed to promote accountability, cultivate long-term shareholder value and ensure ethical conduct. Its significance is underscored by the information asymmetry prevailing between corporate executives and minority shareholders.

In an environment characterized by unprecedented uncertainty, corporate boards grapple with multifaceted challenges such as geopolitical risks, capital allocation, cybersecurity and the transformative impacts of artificial intelligence. Navigating this complex landscape highlights the indispensable role of strong governance in fostering transparency, aligning interests and monitoring risks.

The three key pillars of strong governance — board composition, shareholder rights and executive compensation — combine to create an environment where transparency, accountability and alignment with shareholder interests prevail.

- Board composition is critical, measured through key indicators such as the presence of an independent chair, overall board independence, autonomy of key committees, unique skills representation, appropriate levels of board turnover and a commitment to board diversity.
- Meanwhile, shareholder rights focus on the proportion of votes controlled by shares with enhanced voting rights, annual election of directors, proxy access, ownership thresholds for proxy access and limitations on shareholder nominees to fill board seats.
- The compensation of executive officers and corporate directors is another mechanism to align the interests of managers and directors with those of shareholders and other stakeholders. It incorporates factors like specific guidelines for stock ownership by directors, the alignment of a company's pay percentile rank with its ranking on total shareholder return, and the level of support for Say on Pay proposals, among other considerations.

In an era defined by rapid change, strong governance emerges as an essential compass, guiding organizations toward enduring success in an environment where transparency, alignment and accountability are paramount.

THEMES PLAY A PIVOTAL ROLE IN SHAPING PORTFOLIOS

Investment decisions guided by a focus on distinct sustainability themes — rather than relying solely on third-party ratings or arbitrary exclusions — can significantly enhance the likelihood that investment portfolios will generate attractive risk-adjusted returns over the entirety of a market cycle, particularly when thematic insights are integrated with fundamental analysis and rigorous risk management tools.

Our conviction lies in recognizing key themes such as energy transition and innovation, inclusive growth and strong governance as not only meaningful but also enduring indicators. These themes serve as powerful signals to investors, conveying that companies embracing forward-thinking approaches are poised to adapt, prevail and create long-term value.

By aligning investment strategies with these transformative themes, financial services professionals play a pivotal role in shaping portfolios that not only deliver robust returns but also contribute to a sustainable and resilient future.

> *“**By aligning investment strategies with these transformative themes**, financial services professionals play a pivotal role in shaping portfolios.*

For more information, please visit nuveen.com.

Endnotes

Sources

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Important information on risk

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