Thematic Investment Insights

Are SDGs the right yardstick for portfolio sustainability outcomes?

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For professional investors only

HSBC Asset Management

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Foreword

Our quantitative research considers how sustainability priorities can be more effectively incorporated into portfolios. This involves an innovative and flexible approach to integrating available reporting data in order to capture desired outcomes.

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Welcome to the first edition of our Thematic Investment Insights publication, where we explore the intersection of major trends and investment strategy.

In this edition, we delve into the complexities surrounding the Sustainable Development Goals (SDGs) as investment metrics. While the SDGs serve as a universal framework for sustainability, their qualitative nature and inherent limitations can pose challenges in accurately measuring corporate contributions. Asset owners must navigate the risks of greenwashing along with missed opportunities within portfolios due to the lack of clarity and standardization in third-party data solutions.

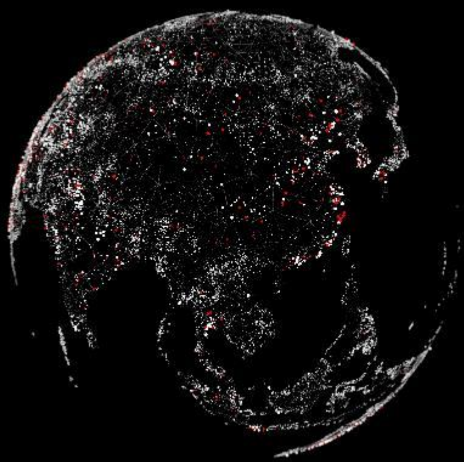
We propose a shift in perspective: viewing SDGs not merely as reporting tools but as investment themes like any other. The emphasis should be on the quality of tracking a specific theme within SDGs, instead of trying to map all portfolios to all SDGs simultaneously.

By breaking down SDGs into investment themes and granular sub-themes linkable to company activities, we can create diversified investment universes for thematic portfolios. Leveraging granular data via advanced analytics can enable the capture of evolving trends within themes, supporting a more dynamic, flexible approach. This can enhance the alignment of investment portfolios with sustainability objectives, allowing for a more proactive strategy.

Our analysis also highlights the importance of integrating technology such as artificial intelligence into the investment process, to allow scalability given large, granular data inputs.

We believe that by understanding the nuances of SDGs and leveraging advanced data solutions, desired portfolio outcomes can be more effectively achieved. We trust that you will find our insights both informative and applicable as you consider the integration of sustainability into your investment strategies.

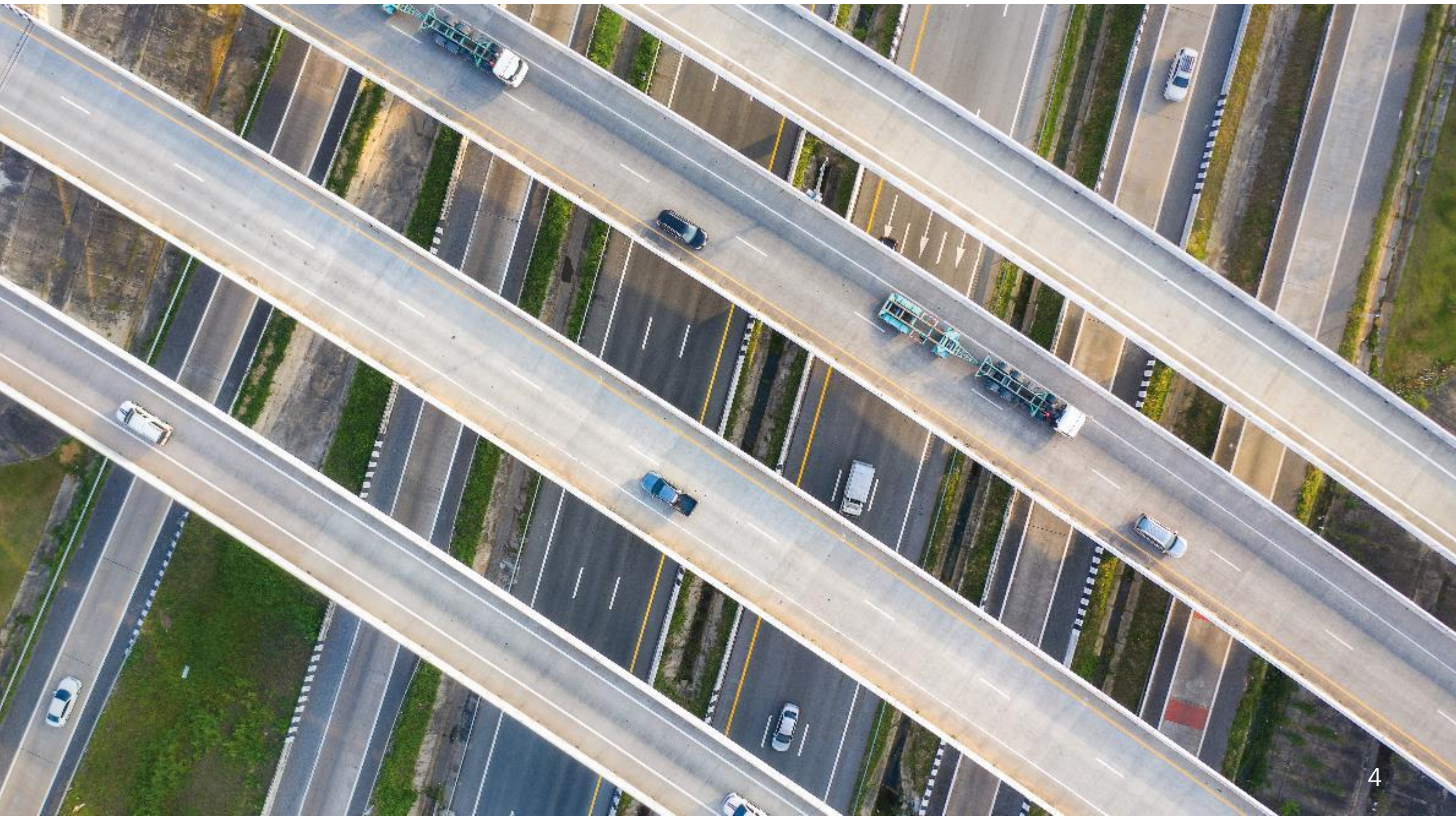
In the coming months we will share more of our quantitative research findings, covering topics such as physical climate risk, an area of material financial risk where consensus on impacts, and portfolio preparedness, continues to be broadly lacking.



In a nutshell

Are SDGs the right yardstick for portfolio sustainability outcomes?

- In addition to or in support of seeking returns, asset owners sometimes target specific themes in their investments, such as climate change, health care or digital transformation.
- When it comes to sustainability, asset owners and their asset managers are increasingly turning to the UN Sustainable Development Goals (SDGs) as a guide for their portfolio's sustainability outcomes.
- However, SDGs may not be the most effective metric for corporate investments due to their design for sovereigns, the overlapping themes, and the lack of quantitative metrics.
- We propose practical solutions, including reimagining SDGs as an investment theme rather than a reporting metric.
- Supported by a quantitative investment approach that leverages granular data and AI to capture evolving trends, this presents opportunity for more effective alignment of investment strategies with themes.
- Such an approach ultimately facilitates the design of diversified thematic portfolios which aim to deliver both returns and the thematic outcomes desired.



Are SDGs the right yardstick for portfolio sustainable outcomes?

> In cases where asset owner investors target a specific theme or outcome within sustainability, they are increasingly turning to the UN Sustainable Development Goals as a guide for their portfolio's sustainability outcomes. However, at a first glance, SDGs might not be the best sustainability metric for investment portfolios.

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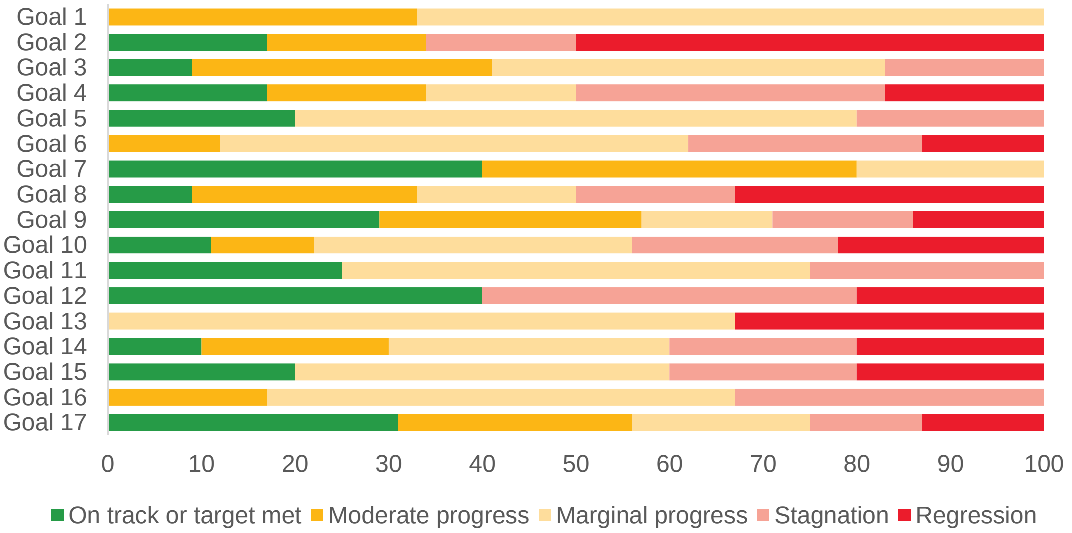
The limitations of SDGs as an investment metric

Designed for sovereigns, rather than corporates

The SDGs were created to tackle significant societal challenges like poverty, healthcare, and education – issues often resulting from market failures and thus requiring government intervention. For example, SDG 1 (No Poverty) has explicit policy-specific targets.[1] Unfortunately, halfway through their implementation period, from 2016 to 2030, for most SDGs, the world is not on track (Figure 1).

Figure 1: Halfway through their implementation, the world is not on track to achieve most SDGs by 2030



Source: The United Nations Statistical Division, "The Sustainable Development Goals Report", 2024, Progress Report

1 - For example, Target 1.3 "Implement nationally appropriate social protection systems and measures for all, including floors, and by 2030 achieve substantial coverage of the poor and the vulnerable".

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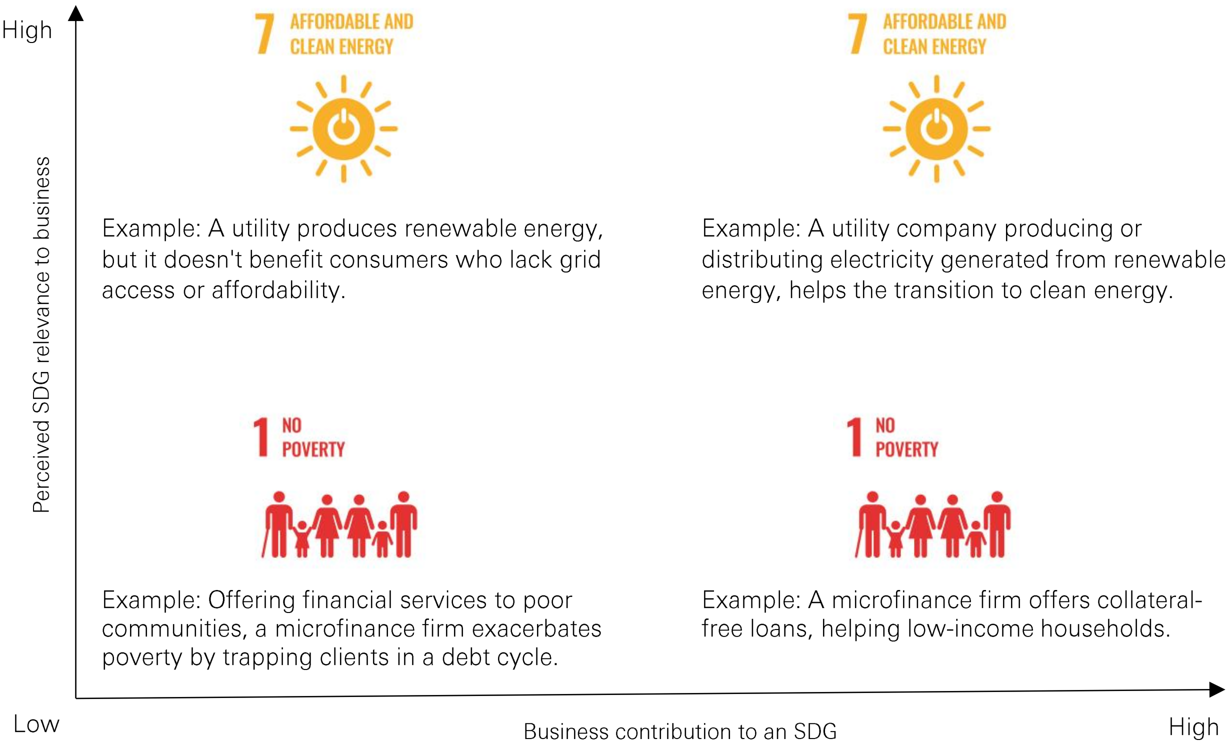
At the same time, one can argue that the challenges associated with SDGs typically fall beyond the direct control or primary commercial interest of companies, making it difficult to link their businesses to these goals. This is also reflected in the fact that the 2030 Agenda text describing 17 SDGs and 169 Targets has no explicit mention of how businesses should contribute to them. Instead, it makes high-level statements, such as "Private business activity, investment and innovation are major drivers of productivity, inclusive economic growth and job creation. […] We call upon all businesses to apply their creativity and innovation to solving sustainable development challenges".[2]

The current lack of specificity leaves considerable room for interpretation and ambiguity regarding which SDGs are most relevant for businesses. As illustrated in Figure 2, some SDGs might be considered more or less closely linked to the industry. However, this alignment could be largely speculative and could be swayed either way, depending on interpretation.

Figure 2: Linking business activities to SDGs is largely down to investor and company interpretation



Source: HSBC Asset Management, December 2024. For illustrative purpose only.

Overlapping and evolving themes of SDGs

The SDGs and their underlying targets are extremely broad and deeply interconnected, further complicating the measurement of companies' contribution to these goals. For example, the circular economy directly relates to SDG 12 (Responsible Consumption and Production) but also ties into several other SDGs, such as 8 (Decent Work and Economic Growth), and specifically Target 8.4 "Improve progressively, through 2030, global resource efficiency in consumption and production…". This overlap makes it difficult to pinpoint a company's exact contribution to any single SDG or multiple goals. It may also result in double counting the impact.

2 - United Nations, "Transforming our World: The 2030 Agenda for Sustainable Development", A/RES/70/1, 2015.

The quest for quantitative portfolio-level metrics

The SDGs and underlying targets are qualitative in nature. Their use in portfolio management is thus impeded by the absence of clarity on exactly which corporate activities contribute to which SDGs and targets, and also by the lack of standardised quantitative metrics to measure this contribution.

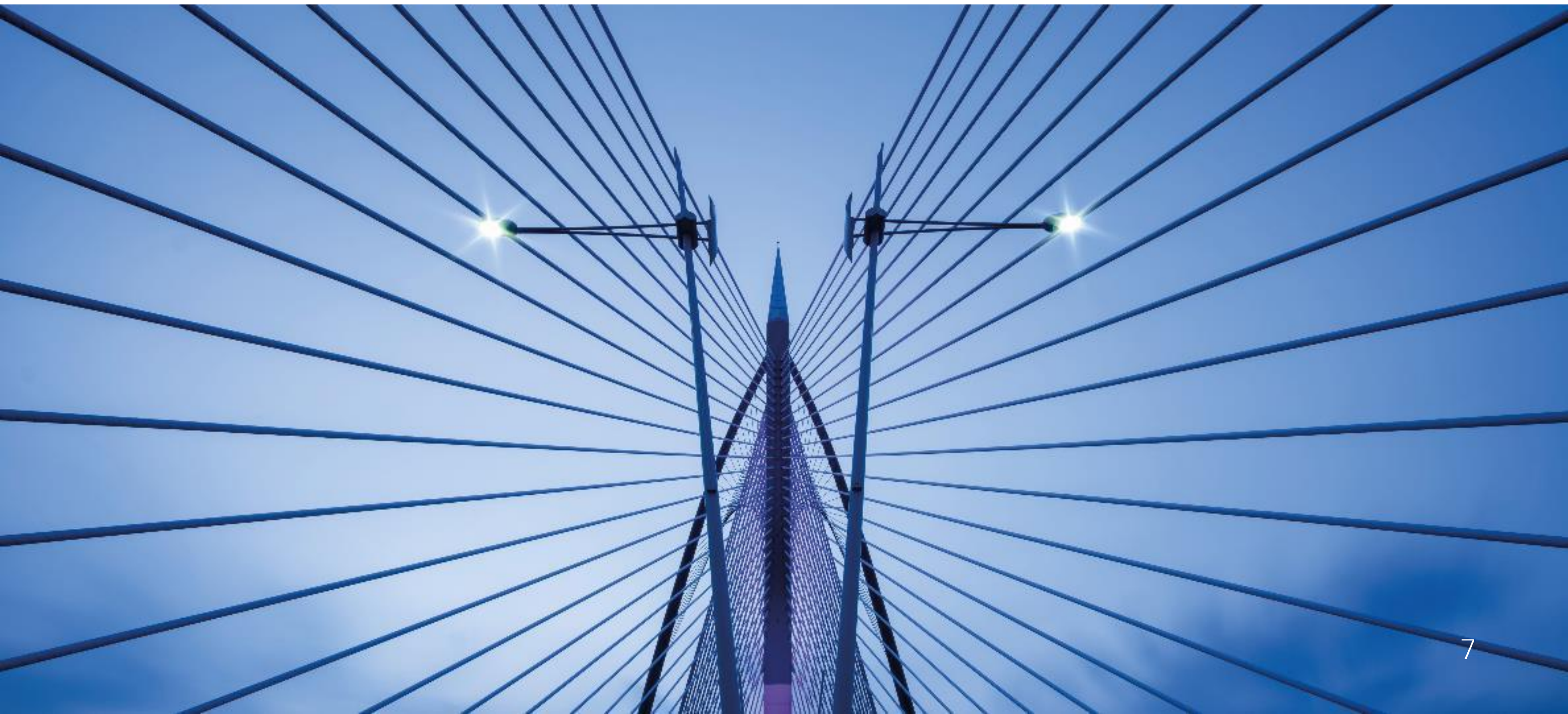
Numerical metrics that do exist in the original UN text about SDGs primarily relate to national goals and policy objectives, such as Target 3.1 "By 2030, reduce the global maternal mortality ratio to less than 70 per 100,000 live births." This makes it extremely challenging to measure companies' contribution to any given goal or target.

Some SDG frameworks do offer company-relevant metrics, such as the number of individuals provided with access to microfinance for SDG 1 (No Poverty) or the amount of renewable energy generated to support SDG 7 (Affordable and Clean Energy). However, the data required to calculate these metrics at scale across the entire investment universe of thousands of companies presents an immediate challenge. Additionally, if these metrics are not expressed in consistent units – such as the share of revenues contributing to the SDGs – it becomes difficult to assess alignment at both the company and portfolio levels.

Even when a company's sector seems to closely align with a specific SDG – like pharmaceutical companies with SDG 3 (Good Health and Well-Being) – questions arise. Should all revenues of this company be considered aligned, or only certain revenue streams should be considered, for example, combating deadly diseases like HIV or malaria, or reducing women's mortality from pregnancy and childbirth?

Moreover, companies' operational performance and the impact of their business are often conflated. Should the impact of companies' products and services, or companies' operational sustainability, or both, be counted towards SDGs? For example, to meet SDG 10 (Reducing Inequality), should we consider companies that contribute through their business models, like microfinance organizations aiding women gain access to finance in developing nations, or should we count a company's own diversity practices?

This ambiguity in measuring portfolio alignment to SDGs poses both risks and opportunities. On the one hand, it may expose companies, and asset owners and managers investing in them, to the risk of greenwashing. On the other hand, there is potential for innovation and developing new methodologies to guide SDG investing, as we discuss in the next section.



Shortcomings in third-party SDG data solutions lead to missed investment opportunities

There are numerous SDG portfolio alignment solutions on the market offered by different third-party data providers. However, given the challenges discussed, these data solutions face several issues, possibly resulting in missed investment opportunities by asset managers and their clients.

Over-generalisation leads to unhelpful conclusions

Efforts to link SDGs to corporate activities, either positively or negatively, often result in over-simplification. For instance, UNEPFI offers mapping of SDGs to sectors, providing both a negative and positive assessment of sectors' contribution to specific SDGs. This mapping states that "Child labour is prevalent in all agriculture, forestry, and fishing sub-sectors." Consequently, solutions using this framework might conclude that all companies within these sub-sectors should automatically score negatively on child labour and, by extension, on SDG 8 (Decent Work and Economic Growth) and 16 (Peace, Justice and Strong Institutions) that this issue is linked to.

This broad-brush approach conflicts with the objective of portfolio managers who aim to differentiate between leaders and laggards within a sector, to make the best stock picks. Such generalisations can lead to unhelpful assessments and importantly missed investment opportunities. That said, in situations where detailed company-specific information is unavailable, it can be useful to generalise the relationship between sectors and specific SDGs. For example, sugar is frequently associated with negative health impacts, thus negatively contributing to SDG 3 (Good Health and Well-Being). However, comprehensive nutritional data on individual products may not always be accessible, and historical data to verify company claims of reduced sugar content over time is often lacking. As a result, it may be appropriate to link a sub-industry, such as soft drink production, to the relevant SDG.

The transparency imperative

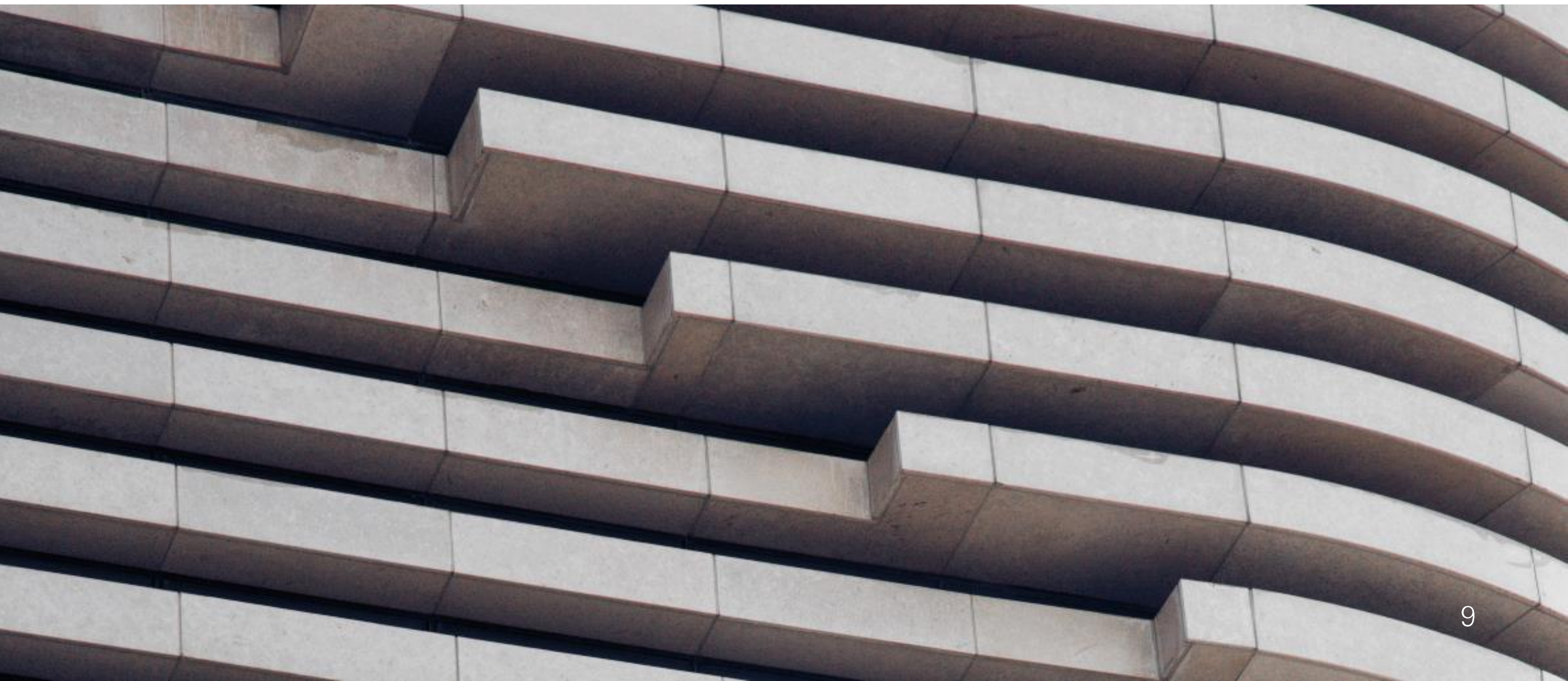
Third-party data solutions also often lack transparency, required to validate the results. For example, a provider might offer a score without disclosing the underlying data or the exact methodology used to derive it. When a provider does present a breakdown of revenues aligned to a specific SDG, they might not reveal the model's inner workings or the exact analyst's reasoning. Finally, even when the analysis is transparent, asset owners and asset managers might disagree with its conclusions. For example, linking 100% of revenues of a tire manufacturer to pollution prevention because the company made energy efficiency claims might be considered far-fetched.

This lack of transparency makes it challenging to build high conviction in the results. Take the case of sparse datasets with many zeros or missing values in companies' contributions to SDGs. It raises a question: Is it the genuine state of the market that the majority of companies are not contributing to SDGs, or is it due to data gaps, and model or analyst assumptions? It is rarely clear how far an analyst has looked to find information about a company and the precise logic they employed to make the judgement. This ambiguity may impede the validation of results across an entire investment universe, even if individual company assessments seem plausible.

Difficulty in pivoting into new evolving thematic directions

Investment themes are constantly evolving and new, complex ones are emerging, such as GenAI or natural capital. Moreover, SDGs themselves as a 2030 Agenda are expected to be revised and evolve in a few years. Coming with a pre-defined set of themes and company activities that they track, off-the-shelf solutions often lack the flexibility to easily derive a new theme or break down an existing theme into more granular components. To our previous example on healthcare and SDG 3, an investor might be interested to build a portfolio of companies resolving healthcare issues in developing countries, which might not necessarily be the focus of a third-party assessment of companies' SDG 3 alignment. This lack of flexibility limits the ability to capture emerging trends and opportunities in the market.

Third-party SDG alignment metrics might still be a useful guide and reference point to look at the sustainable outcomes of an investment portfolio. Like with any other ESG data, there is value in drawing upon a variety of data providers to gauge the differences and similarities in their assessment of the same companies and investment portfolios. As we will demonstrate in the next section, this data works best when complemented by a proprietary view.



Reimagining SDGs: An investment theme, rather than a reporting tool

SDGs can be a powerful trend for sustainable investing when treated as any other investment theme rather than a reporting metric. The key lies in emphasising the quality of tracking a specific theme within SDGs, instead of trying to map all portfolios to all SDGs simultaneously.

The current ambiguity around measuring investment portfolio impact on SDGs also presents opportunities for asset managers to develop proprietary methodologies for SDG-related investment strategies. By breaking down SDGs into investment themes and granular sub-themes linkable to granular company activities, and doing so in a scalable manner, we can create diversified investment universes for thematic portfolios. This approach involves three core pillars to address existing challenges we discussed earlier (Figure 3), such as avoiding generalisation, ensuring transparency at every step, and maintaining the flexibility to easily construct portfolios for new themes.

Figure 3. A quant solution for building thematic portfolios includes three key components

Comprehensiveness

1 Forward-looking investment themes

Identify continuously **dominant** and **emerging** investment themes and build comprehensive thematic taxonomies

Precision

2 High-quality, granular activities data

Reliably capture companies' **detailed business activities and their impact on investment themes**

Scalability

3 Linking investment themes to activities

Link companies to investment themes in a **scalable manner with GenAI interpretation capabilities**

Source: HSBC Asset Management, December 2024. For illustrative purpose only.

Capturing investment themes in their entirety for diversified thematic portfolios

The first step is to develop a dynamic and comprehensive taxonomy of investment themes, both dominant and emerging, prioritising the quality over the quantity of the themes tracked. These themes would range from large mega-trends like the individual SDGs, energy transition, or AI, down to granular sub-themes that can be linked to company activities. Ensuring that investment themes are tracked in their entirety, which requires capturing sub-industries contributing to the theme, can create new investment opportunities and more diversified portfolios.

A good place to start is tapping into existing industry taxonomies. For example, the energy transition is not just about the familiar names in renewables, batteries or electric vehicles. The International Energy Agency (IEA) identifies over 550 different technology designs from nascent to mature contributing to the energy transition.

Existing taxonomies, such as the EU Taxonomy, work best when complemented by original research, given off-the-shelf solutions might not fully reflect new, evolving themes which take time to develop and for the industry to reach a consensus on. Beyond green themes, taxonomies are also rare.

Leveraging the power of high-quality, granular company activity data to make better security picks

The second step is to identify companies and their business activities linkable to investment themes. For example, a portfolio manager might want to pick pharmaceutical companies that are producing specific drugs for weight management or diabetes, or food companies that produce plant-based meat. With granular data, these companies can be identified and invested in. One way to achieve this is through detailed datasets which break down corporate revenue streams into hundreds of categories. These datasets are powerful for the themes focused on products and services. For example, we can distinguish between utilities generating revenues from renewable or fossil-fuel-based power generation, or between companies producing meat vs plant-based products.

However, when the question is about how a certain product was produced, traditional revenue hierarchies might fall short of the required detail. For example, we might know all about the crops an agricultural company is producing, but not necessarily whether they were produced in a sustainable manner through organic farming. This type of analysis requires additional data about companies' production practices, answering the question we posed in the previous section on whether SDGs are about the products and services a company is producing or also about its operational characteristics.

Using AI to scale and easily pivot into new thematic directions

The final step is to scale the analysis conducted in the first two pillars and bring the results together, linking granular company activities to investment themes. Scalability without sacrificing the detail and avoiding generalisation can be achieved by leveraging the data ingestion and interpretation capabilities of Artificial Intelligence (AI) models. The use of AI can support analysts and portfolio managers in capturing the systematic component of an SDG assessment, freeing their focus for the areas where a human input works best.

There are several use cases here for Generative AI and Natural Language Processing (NLP), for example:

- Identify key investment themes and sub-themes from unstructured market data to build granular thematic taxonomies that can be mapped to structured company data, such as revenue hierarchies or production data. This will help capture emerging themes, as well as the continuously dominant themes.
- Link granular company activities data, for example, revenues, products and services, to investment themes, to quantify the alignment of companies to a specific theme. This will support measuring portfolio alignment to any theme conceivable. This will also help to easily construct investment universes for thematic funds and accurately measure companies' contributions to investment themes, sufficiently capturing the associated complexity (as illustrated in the example that follows). Finally, linking historical revenue data to investment themes can create time series for back testing financial performance of thematic funds.
- Where the link to a theme is not obvious, AI can help generate an impact tag from large volumes of company and market data, linking company products and services to a specific theme. For example, a portfolio manager might know that a company produces certain drugs but their impact on specific diseases might not be clear. Or a company might produce technologies, such as heat pumps and traditional air conditioners, which while similar might contribute differently to climate change. Sourcing additional information on the impact tag of certain products and services will support identifying more companies connected to investment themes, capturing the themes with greater detail and precision.

By integrating these three components – applying AI to link comprehensive, forward-looking investment themes with granular activities data – investors can develop a robust quantitative intellectual property for thematic portfolios. This approach meets both the evolving client demand for granular investment themes and provides a competitive edge by enabling precise, informed, and scalable thematic investing in a rapidly changing market.

In practice: Using AI to map IEA clean technology designs to companies' granular revenue streams

The International Energy Agency (IEA) has compiled an inventory of nearly 600 technology designs that contribute to the energy transition and the achievement of net-zero emissions. These technologies span across different sectors from energy to e-waste recycling and vary in maturity, ranging from widely used solutions like solar panels to solutions at their early concept stages, such as nuclear fusion.

Linking these technology designs to companies that produce them can help identify a broad investment universe of firms active in clean technologies. For example, one could connect these technology designs to granular revenue data, such as FactSet RBICS dataset, at the sub-industry level, utilising datasets that follow granular industry classifications. Industry classifications could easily contain thousands of categories.

Manually researching the connections between 600 technology designs and thousands of industry categories would be an extremely labour-intensive and time-consuming task. To address this challenge, we experimented with using AI to link revenue classification systems to technology designs in a more scalable manner.[1]

By employing a transformers-based and small language model, we successfully mapped over 100 technologies with high confidence and another 100 with low confidence to a common granular revenue dataset on the market. The low-confidence mappings indicate that there may not be a clear link, necessitating human assessment to evaluate the connection between the technology design and revenue classification. The remaining 400 technologies were linked with medium confidence, suggesting that additional work may be required to confirm the connections. This could involve utilising more advanced AI tools, such as Generative AI, which offer superior interpretation capabilities, while also incorporating human validation to ensure the accuracy of the results.

[1] Source: HSBC Asset Management, FactSet Business Industry Classification System (RBICS) with Revenue, as of November 2024. FactSet revenue data offers a comprehensive breakdown of revenues for over 40,000 companies across six levels of depth and more than 1,700 individual sector groups.

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Concluding remarks

Sustainable Development Goals are imperfect portfolio measures, but powerful investment themes

While the SDGs provide a universal call for action on sustainability, their design and qualitative nature pose challenges in accurately measuring corporate contributions. Investors face risks of greenwashing and missed opportunities due to the lack of clarity and standardisation in third-party data solutions.

By reimagining SDGs as an investment theme rather than a reporting tool, and leveraging granular data and AI, investors can systematically capture evolving complex trends and develop smart investment processes to deliver diversified thematic portfolios. This approach aims to offer practical solutions to enhance and scale up the alignment of investment portfolios with sustainability goals in an evolving world.

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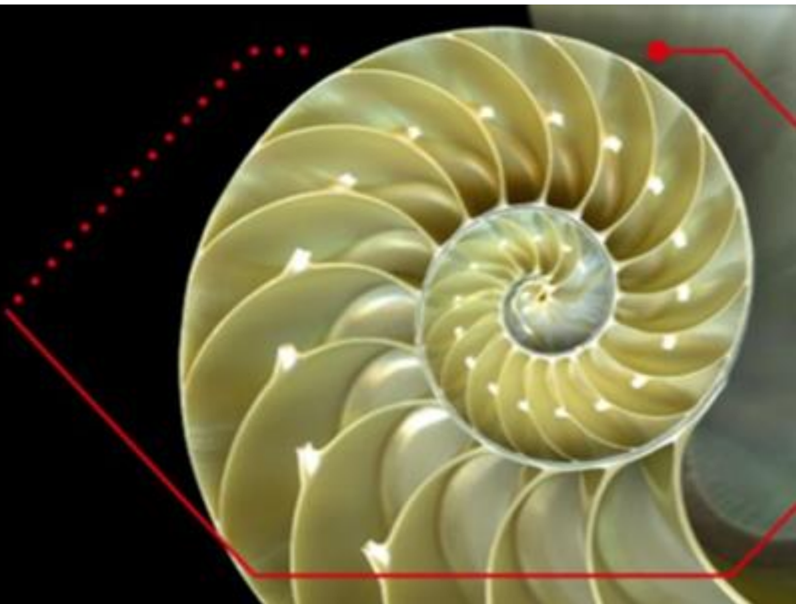

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