

Accelerating Transition

Episode 4

With Kara Mangone and Sarah Lawlor

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Kara Mangone: Hello, and welcome to another episode of *Accelerating Transition*. I'm Kara Mangone, global head of Climate Strategy here at the firm.

As we've discussed in previous episodes, one of the many catalysts for companies to pursue sustainable goals has certainly been increased interest in focus from the investor community. And as ESG continues to be a growing part of investors' strategies, it's up to financial firms like ours to help clients find the themes they're seeking and help them access it. That's why I'm particularly glad to be joined today by Sarah Lawlor, who is chief operating officer for the Sustainable Solutions Council in our Global Markets Division. We're going to learn more about the work Sarah and her team do each and every day, as well as what they're seeing and hearing from their unique perspective at the intersection of ESG and markets. Sarah, thank you so much for joining us today.

Sarah Lawlor: Hi Kara, thank you for having me.

Kara Mangone: So, Sarah, you have quite the title—can you tell us more about the purpose of the Sustainable Solutions Council in Global Markets and your role within it? And I will start by saying that these councils, which we have around the firm representing each division, has been really crucial in helping us find the right opportunities to really engage our clients and build out our capabilities on sustainability and climate, so I'm excited to hear from you on what this looks like within your business and division.

Sarah Lawlor: Thanks and yeah, I agree, it's certainly quite a long and mouthful title. I usually try and shorten it to: I am held responsible for helping drive sustainability within our division. I think when you take a step back—and how I explain it to people externally is—we have the EO [Executive Office], we have the Sustainable Finance Group and your team, which are responsible for the overall direction of the firm, our external engagement, our partnerships, and also help coordinating all these different divisions. But we also need to look internally to our division and that's what we as a council do.

So we set the Council up maybe 18, 24 months ago—or it certainly the work was being put into it about 24 months ago. And the aim at the time was to help, I would say sort of draw a line in the sand; understand what we as a division were doing, understanding what our capabilities were, and thinking about how we could drive that forward. I think the structure for our division is probably different to that of the IBD SSC or, sort of, Asset Management, because we have a new unique role: We work with so many different client types, investor types, who have so many different aims, what they're trying to achieve. So I think we view our role as trying to make sure that we have the capabilities to partner

and deliver solutions to our clients. And I think really that's something that's evolved quite quickly over the last sort of 18 to 24 months.

I think when we looked under the hood and we found out what all the different businesses within the division were doing, it was it was pretty impressive. But trying to connect them and make people understand, you know, "Hey, somebody in Equities is doing this, you should actually talk to your counterpart in Credit." Like you need to sort of collaborate and make sure that we, as a division, make sure that we connect different businesses so that we are able to provide this very differentiating service to our clients. And really identifying those opportunities can help us build as different types of analytics. We can be looking to build tools for ourselves to manage our own risk, as well as identify those opportunities and metrics for our clients as well.

Kara Mangone: Thanks, Sarah. Those points you're making on integration, I just want to underscore, because this is something that we talk about a lot with our clients, which is you gave that example of fixed income and equity. And in many organizations, ours included, there are a lot of pockets of expertise—and, as you mentioned, there's a wide diversity of client types and issues—and so part of what this looks like in practice for big organizations like ours, who are really trying to put this at the forefront of what they're doing in their business each and every day, is actually figuring out how do you operationalize that? Like, how do you make those connections? And I think the Council has been a really effective way to do that, and I think one of the things that we talk a lot about with our investor community and other stakeholders is, for us at the firm, this certainly is not our first foray into sustainable finance, our \$750 billion commitment, but what it does represent is a very significant acceleration of our commitment. And that continues to evolve every single day as we spend time with clients and we listen to figure out what is it that they actually need to advance on their sustainability objectives. So I'd love to hear a little bit more from you about, in these client conversations with institutional investors and other clients, what is this evolution that you've seen over the past 18 months or so? How are clients approaching ESP today? What do the fund flows show us—which have been quite remarkable—about client sentiment? Where do you think it's going?

Sarah Lawlor: I agree, Kara, it's been super interesting and very dynamic over the last 18 months. When I sort of take a step back and I think big picture, how clients integrate or think about ESG and sustainability, it's three broad buckets: The first one is this concept of exclusions or screening, and we all know that that's been around for 50 or a hundred years, whether you're thinking about sort of these ethical funds, but what I think has been interesting is that the list and exclusions had continued to get larger and larger and larger and actually, over the last 18 months, we've seen this sort of evolution where our clients have said to us "Fine, we have one or two core sectors that we no longer want to invest in, or we can't invest in, or it's a hard no for us to maybe our end clients." But rather than now excluding, they're choosing much more to engage, right so, it's a broader approach, you have a seat at the table and you're having conversations with those clients. Our investor community feels responsible and they feel that they are the ones

that can direct capital, and if they divest, they lose that opportunity, whereas if they continue to invest and they continue to engage and have those conversations they feel that they can drive change. So that's sort of the first bucket that I would certainly say I have seen some change in.

The second one is in terms of what I call ESG integration, so that broad bucket of taking into account all different risks and opportunities and making sort of a financial decision on the back of that. And probably two years ago, the vast majority of people I would have spoken to said "We buy third-party scores and we apply them and we tilt, or we exclude, or we use them in many different ways," but that was sort of the go-to method. And yes, many, many people still use those third-party headline scores, but people are becoming more sophisticated. So in addition to the headline score, they are asking for the underlying data, or they're asking for the pillar score, they want to understand what the E means, what the S means, and what the G means. There are certain teams that are more relevant to them and they say "Okay, we need to understand the underlying ESG data, rather than just relying on third-party scores.

And then I will also say that, you know, there has been a shift, particularly with the larger investors, to creating their own proprietary frameworks. So, again, they will rely on data vendors for scores or for different inputs, for controversy flags or things like that, but they themselves will feel like their sort of value add is to really think about it through their own lens, so that's certainly a sort of an another evolution we've seen.

And then the third and also the largest one, is what I kind of, again, sort of umbrella bulk under the title of 'Thematic Investing' and that can be a green bond fund or is that sort of an impact fund, but it's a theme and a type of investing and that's really where I've seen an acceleration of interest from our clients and from our investor clients. The Growth has come from a much lower base, but that's what they are finding resonates with their end clients as well, right? When there's a story to tell, when there's a reason behind it—if it's, sort of, "secular growth" or "you can have impact"—that's really where we're noticing that there's a real hook, and that's where we're seeing a lot of the new fund launches and a lot of the fund flows are directed at the moment.

Kara Mangone: Thanks, Sarah. I'm going to take you back to the start of Covid, because this, I think, for the industry and for ESG and sustainability in particular, I think, really did create a bit of a pause where a lot of market participants were asking questions about the resilience of ESG and whether ESG asset performance would continue to hold in the midst of a global pandemic and health crisis. Fast forward to today and, as you just described, there's been an incredible, it seems, not only acceleration but maturation, if you will, of the level of sophistication. You gave this great example of moving from just a reliance on headline third-party ESG scores, which you know very much there's a role for, but a lot of market participants actually doing a lot to roll up their sleeves and unpack the underlying data to measure and assess companies. So could you talk us through what has actually played out over the past few years and do you still see in your client conversations a level of skepticism around ESG and sustainability?

Sarah Lawlor: I definitely think what was striking last year was that equity ESG funds continued to see positive inflows all through Q1 when the broader market was essentially falling apart and there was a lot of turbulence and there were a lot of outflows, and that's continued all through this year. It's always had positive momentum, and I think already by the end of Q3 of 2021, we'd seen about \$370 billion of inflows versus \$270 billion for all of last year, so the numbers are immense.

But it's not just in the equity space that we're seeing it. If we take a step back and we think about the ESG-labeled bond universe, that space, I mean the growth there has been breathtaking. So we've had probably total issuance by the end of Q3 of this year is over \$750 billion, and that's up over by 50% from last year. And green bonds, of course, continue to dominate, but what we really saw at the beginning of the pandemic, you know, instead of an answer to what the market needed, was a big growth in the social bond issuance. And then, at the same time we also saw more sustainability linked bonds so corporates who are no longer using it for use of proceeds, but they were trying to meet certain KPIs that they had set themselves so that's also been a sort of a large growth in the market, and what that's also brought is a diversity of issuers, because the problem with the ESG-label bond market is the supply/demand dynamic is very tricky, not only do you have green bond funds trying to buy green bonds, you obviously just have the broader market as well, so that pushed up a lot of premium into the market. We've seen a little bit of that dissipate away, I think, as you've seen more issuance this year, but I still think there's a strong, strong demand and I think you'll continue to see that growth into next year.

Now to touch on the question or the point you made about performance: There was a lot of very positive stories again last year, about how well ESG funds that held up and, yeah, they did—of course they did, but you could pick through that, and you can say, “Well, maybe it was because it was the time that energy was having a difficult quarter, therefore ESG funds look better because they've tended to be underweight oil.” You can say, “Oh look, the amount of funds flowing in there is closed like a premium, and therefore you know, maybe in the long term, the performance is not going to be there.” So you can look at it through many different lenses, but what I would say, now, the view is: You no longer need to, sort of, give up on your returns if you're going into something that's sustainable ESG, right? So there's, this is a historical mentality “Oh, if I'm going to do good or I'm going to be investing in this impact fund, I have to accept lower returns.” Now, of course, there are investments that still follow that path, but I don't think that's the sort of the base case anymore. So I think you need just be thoughtful about the lens you use when you're thinking about returns.

Kara Mangone: Thanks, Sarah. and that I think that “value to values”—you can continue to be focused on sustainable finance because it does resonate with your values as an organization, but really importantly, there's a multidisciplinary approach where, for many stakeholders, many market participants, this is also about value. And sometimes it's primarily driven by value, and so I think thinking through those different use cases

the way you just did and appreciating that there's different drivers for what may ultimately be contributing is very well put.

Sarah Lawlor: I'm just gonna interrupt and say one thing that it's probably that, I should have mentioned that there's obviously the backdrop also of regulation. So in the beginning of this year, March of this year, we had the Sustainable Finance and Disclosure Regulation coming into Europe. And really what that was is, it's a regulation that says all asset managers need to say or designate how their funds are classified, right. Are they ESG or are they not ESG? And that's a little bit of a day of reckoning. So you've got to really look at yourself in the mirror and if you feel that there is a drive, and you feel that there is a demand in the market for this, you're going to see an awful lot more fund launches that are going to be, you know, positioning themselves as Article 8 or 9, which is the ESG sort of classifications. You're going to see repositioning of existing funds, reclassification of funds, repurchasing of funds.

Kara Mangone: Well, this is a sentiment that we hear a lot from clients, which is: You can have different drivers or motivation for why you may be integrating climate and sustainability broadly into your business or into your portfolio allocation. Some of that may be value, some of that may be consumer preferences, some of that may be, you know, investor interest if you're a corporate, some of that may be regulation or policy driven. So I think, to your point, it is hard to dissect what is the singular driver, if you will, but this progression is certainly something that we have seen accelerate quite quickly, and expect off the back of COP26, very likely to continue to have this level of active dialogue.

Sarah, as you know, part of the goal of this podcast is to provide a really just granular view of what you know sustainable finance looks like in practice, in the industry, across different parts of markets and economies, and you gave a really terrific overview of the different buckets of how this shows up for your clients in terms of exclusion and screening, ESG integration, thematic investing, but can you give us an example of how your clients may be approaching this today.

Sarah Lawlor: When our clients come to us they're looking for a couple of different things. Sometimes they're a little bit overwhelmed about what's out there in the market, right. So I would say index providers, benchmark providers are doing an amazing job of bringing a huge variety of sustainable or ESG themed product to the market. But that sometimes can sort of overwhelm and confuse our clients, so I feel that our role is to sit down and listen to what our clients are trying to achieve: What are they looking for, help them understand what all those different things are and then find them the best thing that might fit them out there in the market, and then give them access and liquidity to that product. And often when people are transitioning, it can be some very large AUM, right, so being able to provide them certainty of execution and helping him in that transition is one way we do it.

But another way might be creating off-the-shelf product. Just, you know, our view on what is the best way to access a theme. How we work with our research team, we work with our strats, and we come up with what we think is a quick and easy way to access a theme. We do it across all of the markets anyway, right. It might be a Brexit, it might be reopening theme, this might just be a sustainability theme. But when I think about sort of a granular way of how we work with our clients often it's more than that kind of bespoke category where they come to us and they say "We're trying to achieve something. We have a sort of an end goal in mind, can you help us?" And that might be something as simple as they've had an inflow into a fund. They're transitioning and they say "Look, we have \$200 million, we want to invest in a corporate bond space. These are our criteria." And not only is the criteria now "We need a certain duration, a certain rating, a certain yield." Now they're also looking for ESG criteria as well. So we're able to build that into our portfolio construction for them. And we can tweak it and we can go back and forth, they might have talked about the exclusion list, right, they may have their own proprietary scores. We can help them optimize that. So there's a bunch of different tools that we can use to help them achieve their ultimate outcome but it's never in isolation for what they're trying to achieve as an investment in itself, it's always trying to build from the fundamentals as well.

Kara Mangone: That's a great overview, and I expect one of the themes that you're getting a lot of questions on is probably Net Zero. We're coming off of the back of COP26 and we saw a really significant acceleration in private sector commitments around net zero. We as a firm have a commitment to align our business with the goals of the Paris Agreement. And very core to that approach is the way we've thought about our sustainable finance offering broadly, which is not just investing in the greenest of green companies, which is important, but also building capabilities across our business to support our clients as they think about how they can deliver on climate alignment and next year's objectives, so talk us through—how are you all implementing in the Global Markets Division this theme of Net Zero, and how are we supporting our clients in this area?

Sarah Lawlor: This one has is being super interesting for us for the last 12 to 18 months and it's been a very much a collaboration. So we first started having incoming from clients at the beginning/middle of 2020, and they were trying to access lower-carbon investments or they were trying to tweak their portfolios, to the example I just gave, to be lower carbon. And when we could have looked at our toolkit of what we what we had ourselves, you know for data and analytics, we just weren't able to answer that question for them. So we spent the last 12 months building what we call our Carbon Analytics Platform. We launched it—actually, sort of nice timing in time for the first of November, the launch of COP26.

Kara Mangone: Congrats.

Sarah Lawlor: Thank you very much. It was a deadline that was looming for quite a while and we're excited that it's out there and the response has been overwhelming. It sounds

very simple, right? It's literally a tool that allows our clients to upload an equity or corporate bond portfolio and analyze it through a corporate lens. But it allows our clients to sort of measure and manage their carbon emissions and choose to take action if they wish. So many of our clients haven't been able to do it, or they it's just it's expensive and it's difficult to do or, yeah, they bought the data from other people, but it's very hard to consume, right. So some of the simplest, but most positive feedback has been "I can visualize what I have, I understand it now, now I'm ready to take action." And some of the action might just be identifying companies in their portfolio that they need to engage with more, , so it's not necessarily like you have to run out and suddenly you think you need to do a lot of trading. It's understanding what your portfolio looks like, understanding what's driving the emissions in your portfolio, and then sort of giving you the power to have sort of the next steps and what you want to do with that, right—whether it's reduce, optimize, or engage. So it's been a very busy one month, post launch, but super positive feedback.

Kara Mangone: Well, congratulations and I do think this is a very good example of the innovation that we're going to continue to see in sustainable finance. The measure/manage framework that you walk through, I think, is spot on, in the sense that, ultimately, so much of what delivering on sustainability looks like in practice is having the right set of tools to actually evaluate where you want to go, and then make those decisions, and I think this is such a great example of that.

I want to transition to a critical issue that we've been exploring in our other episodes in this miniseries which has been just transitions. We know we have a big challenge but also opportunity on our hands, in terms of meeting global climate goals. And we've been discussing in some of the prior episodes, you know, what is the opportunity that we have to ensure that this transition is one that works for all parts of markets and all parts of economies. And we've explored that through the corporate lens, through the Public Private Partnership lens and would like to hear from you—how are we taking into account these important regional and demographic considerations from an overall investing perspective and working with our clients in the space?

Sarah Lawlor: That's a more challenging question and I think it's more challenging because a lot of the time what we're doing is, we're partnering with our clients to help them achieve how they approach it right. So we have to take that into account, but what I would say there's a couple of things that we are aware of, and our clients need to be aware of it, and it can be things as simple as ESG scoring, right? There's a bias in a lot of scores towards Western European companies: they disclose more, they're further along in the journey. There are certain economies and businesses that probably need more focus. So being aware of that bias is a first step, and if I think about it, the work our team in GIR have done around EM ESG scores, sovereign scores, when they first started doing the work they came up with a very simple, very strong framework, but they immediately spotted that there was a very strong correlation to stronger credits, to high ESG scores, higher credit, but what are you going to do there? You're going to direct capital to the stronger economies. So they said, "How can we think about this through another lens?"

And their view was "Let's try and look at the momentum, let's try and look at the improvement." So rather than directing capital towards necessarily the stronger credits, you're still driving capital to those that need it, but just using a different lens to make sure that you're selecting the companies or the sovereigns the correct way.

Another way we think of that in the Global Markets perspective is we think about themes. The Sustainable Development Goals started out as a sort of a sovereign leveling up approach. Then they've been really adopted by corporates, but we're also seeing investor clients adopting them too. They can set up whether it's an SDG generic fund, or their specific themes under the 17 SDGs that they want to set up those funds. So a lot of its water, energy transition, sustainable cities, so the sort of looking again through a different lens rather than trying to achieve what I would put a just transition. It's a little bit more challenging to think of it that way when I think about the investor universe.

Kara Mangone: Those are all great points and I think there has been a good reason for such a heavy sectoral focus, and Michele Della Vigna and I spoke about this in the context of Carbonomics and I think, to your point, we're still in somewhat early stages and figuring out how do we actually implement these emerging markets considerations, but it is clear that there's very good reason why there needs to be continued work to advance upon that.

Just a last question before we close. Sarah you've been so generous with your time and you've talked in depth about how we've operationalized climate strategy within the division and how we've really integrated it into our work with clients. I'd love for you, maybe, just to share some professional, personal reflections of how has this overall process worked. What have been some of the learnings maybe for our business, but then also for you as part of this effort? And I'll say, I know from our early days, working on this, you do not have, you know, 15 years of experience in climate and sustainability, but you've gotten up the learning curve superfast, so I think that would be a great area to share.

Sarah Lawlor: It's been a very steep learning curve over the last two to three years, but I actually think, having come from within the business has also aided me greatly. So, often people will have a very sort of holistic view of how they would like to achieve something, but when you get into the detail it's not possible to do it that way, right? So what I think I now do is bring a nice balance of understanding and saying "That's great, but actually when you try to implement that, that is not going to work." Or like "These are all the different issues that I can see, let's think about doing another way." So I think, I was strong in one sense and I've had to build up my skills in the other sense and that's sort of, I would say, still balancing out, but I think we're in a better place today.

I also think that when we started the journey we started out as sort of trying to get the SMEs within the division together and try and sort of like teach each other. What I think we learned was we needed to reach back out into the businesses very quickly. There's no point trying to build something in a silo, or as a sort of a group that is the experts, outside

of what the core day to day businesses is. So that's what we chose to do with the sort of the beginning of this year. We said, "Okay, let's try and nominate business leads and let's make sure that we use our expertise to help them drive their business forward rather than us trying to drive their business forward," and that's been a huge leap of differentiating change for us. And then the last thing is the amount of interest from, I would say, our more junior colleagues in this topic is immense. They are so willing to work, and focus, and give input and it's just they're so engaged and I think it's just an army of knowledge and sentiment that we really need to sort of ride that wave and really bring them along with us because they are the voice of the future, they can spot the themes and the opportunities as well, so I think we need as a firm and as a division.

Kara Mangone: I couldn't agree more, I think it's a tremendous opportunity, I feel that interest very much as well, and I think it is such an opportunity for the firm to continue to grow and take advantage of that.

Kara Mangone: Sarah this has been an incredible conversation Thank you so much for your insight your perspective, these in-depth examples. We really appreciate having you.

Sarah Lawlor: Thank you so much for having me, it's been great Kara.

Kara Mangone: We're taking a short break and will be back in the new year with more conversations about sustainability and the path to Net Zero with experts from Goldman Sachs as well as our partners and clients. Until then, I'm Kara Mangone. Thanks for listening to Accelerating Transition; have a great holiday.

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