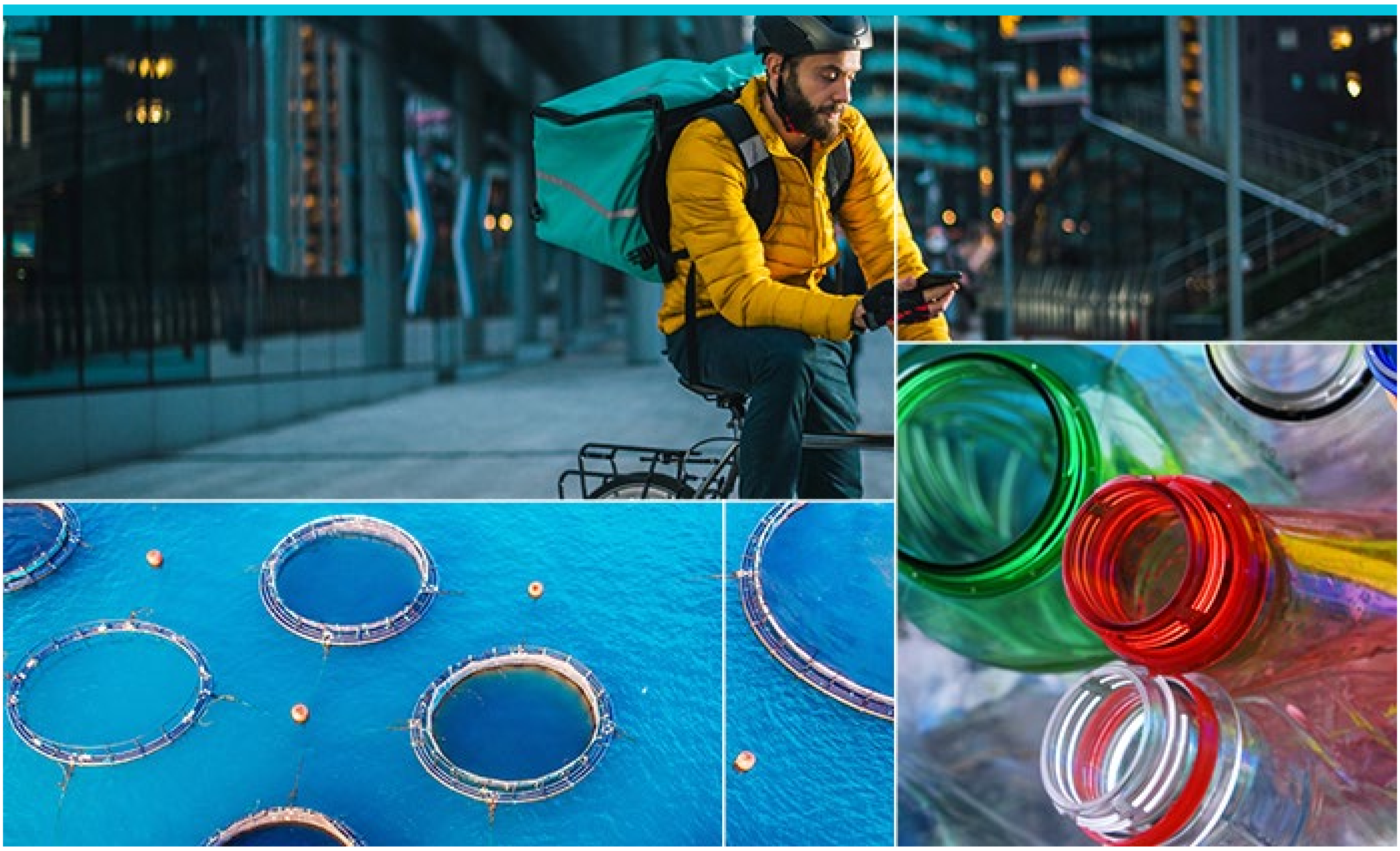
T. Rowe Price
INVEST WITH CONFIDENCE

ESG Integration in Action— Energy Transition



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Energy Transition

A cornerstone of the circular economy is that it needs to be underpinned by a shift to renewable energy. Energy transition is an issue that permeates all sectors and asset classes.

To limit global warming to a maximum rise of 1.5°C, carbon dioxide emissions must be contained to defined levels over a period of time—this is known as the world's carbon budget. Assuming a two in three probability of staying within the 1.5°C scenario and with greenhouse gas emissions at 2021 levels, the world's carbon budget will be exhausted in just six years. The figure jumps to 16 years assuming a one in three probability.

The finite nature of the carbon budget emphasizes the urgency for the energy transition effort and the need to bend the emissions curve quickly. The upshot is that, to stay within a 1.5°C global temperature rise, the world needs to reduce greenhouse gas emissions by 50% by 2030 and achieve net zero emissions by 2050.[1]

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For Europe, Russia's invasion of Ukraine has only added to this sense of urgency, with the conflict resulting in oil and gas price shocks and sparking fears over security of supply from Russia.

The Russia-Ukraine conflict has proved deeply concerning. First and foremost is the humanitarian crisis and the egregious impact that events have had on the well-being of people caught in the midst of the combat. While we continue to assess the overall, long-term ESG implications, one thing has become clear: The conflict has the potential to accelerate the energy transition—particularly in Europe. Russia accounts for 12% of global oil production and 18% of global natural gas production.[2] Given its proximity, the European Union's (EU) dependence on Russian oil and gas supplies is high. In 2020, more than half of Russia's oil exports and about 85% of its natural gas exports went to Europe.[2]

It is not easy to switch energy supply quickly without incurring higher costs and hurting the economy. However, the EU is arguably better positioned to do so today given the availability of economical non-fossil fuel alternatives, more innovation in energy consumption patterns, concerns that foreign energy reliance could be used as a weapon, and consumer awareness of the climate and security crises.

This gives the EU a strong reason to push the energy transition harder and faster. In our view, this will mean increased investment in renewables and, perhaps more importantly, in energy efficiency (such as smart appliances and green buildings), electrification, and other innovations.

Several countries have been reconsidering their path to reducing reliance on Russian oil and gas following Russia's invasion of Ukraine. However, stepping back from Russian gas raises salient questions over whether there is an alternative to gas for building the base for electricity supply. Nations can certainly ramp up the growth of renewables and other fossil-free alternatives but will need to take a pragmatic approach to changing the pace of phasing out legacy fuels—until renewables, hydrogen, and storage technology can reliably and economically deliver. While this will mean short-term disruption, the long-term outlook for clean energy looks more positive.

[1] Net zero means achieving a balance between the greenhouse gases put into the atmosphere and those taken out. This state is also referred to as carbon neutral.

[2] Source: International Energy Agency (based on 2020 production levels).

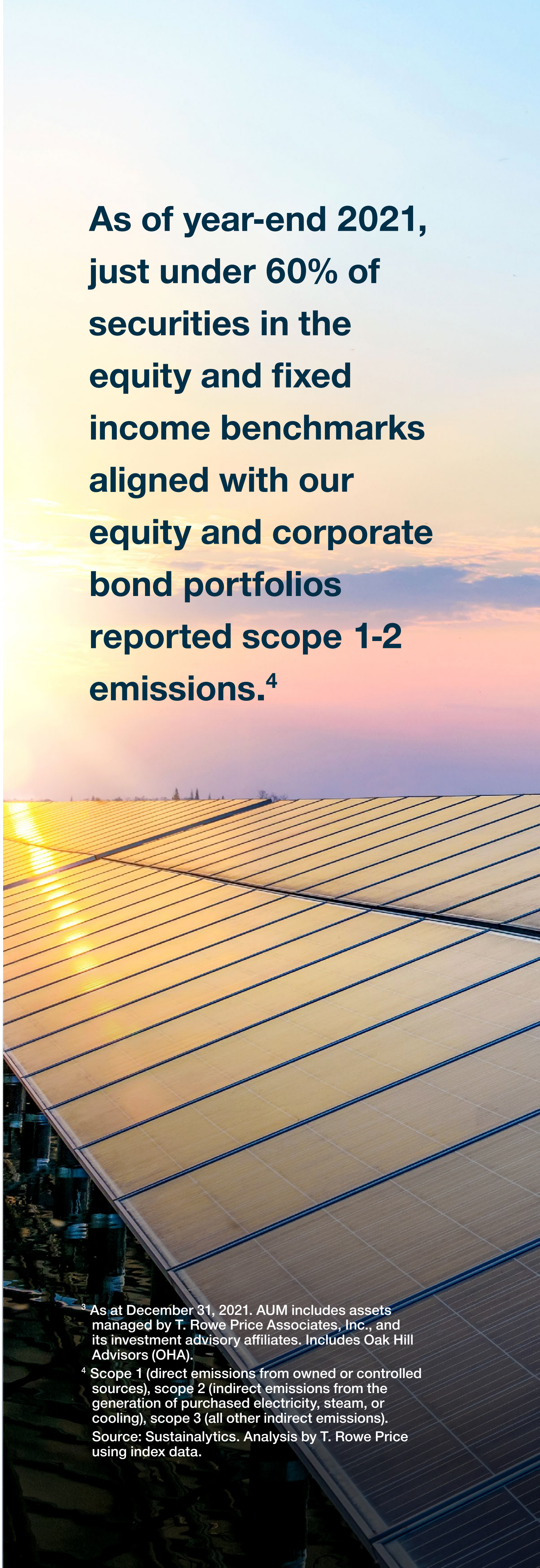
Energy Transition in RIIM—Disclosure Improvements in 2021

T. Rowe Price equity and credit analysts consider energy transition as a key part of their normal fundamental analysis. They draw upon the analysis of our ESG specialists, who provide a more granular view of the environmental characteristics of specific companies and industries. Areas of focus include greenhouse gas (GHG) emissions; decarbonization strategy; investment in renewable energy sources; physical risks; environmental track record, such as oil spills; and overall ESG accountability and transparency (particularly in relation to climate change). These factors are systematically identified in our Responsible Investing Indicator Model (RIIM).

In last year's ESG Annual Report we wrote about a step-change in corporate attitudes toward disclosure. The tone of our interactions with company management teams had changed dramatically, with more actively seeking guidance on what ESG data to disclose and how best to go about it. In 2021, we continued to see improvement, with the level of reported data growing—particularly GHG emissions and other relevant climate data. We also have seen an uptick in companies setting net zero targets.

The improvement in disclosure has enabled an upgrade to some of the quantitative data indicators that feed into our RIIM analysis to measure performance in the energy and emissions category. Whereas historically we included factors related to emissions or renewable energy programs, we can now focus analysis more precisely on performance indicators (e.g., renewable energy use), targets (e.g., scope and quality of emissions reduction targets), and controversies/incidents.

At year-end 2021, roughly USD 1.2 trillion of our AUM resided in portfolios holding equities or corporate bonds.[3] We found that just under 60% of securities within the benchmarks of this universe were reporting scope 1-2 emissions.[4] (This calculation used the weighted average reported data for the benchmarks of our portfolios). For the equity benchmarks, the figure was slightly higher than 60%, while the weighted average for the fixed income benchmarks was dramatically lower, coming in at less than 20%. The range of reported data was extreme across both asset classes (4-93% for equity benchmarks and 3-77% for fixed income benchmarks).



As of year-end 2021, just under 60% of securities in the equity and fixed income benchmarks aligned with our equity and corporate bond portfolios reported scope 1-2 emissions.[4]

[3] As at December 31, 2021. AUM includes assets managed by T. Rowe Price Associates, Inc., and its investment advisory affiliates. Includes Oak Hill Advisors (OHA).

[4] Scope 1 (direct emissions from owned or controlled sources), scope 2 (indirect emissions from the generation of purchased electricity, steam, or cooling), scope 3 (all other indirect emissions).

Source: Sustainalytics. Analysis by T. Rowe Price using index data.

Energy Transition in Stewardship Activity

In 2021, we held 207 engagements where greenhouse gas emissions were a topic for discussion. We continue to guide companies toward industry best practice disclosure standards—including advocating for disclosures aligned to the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-Related Financial Disclosures (TCFD). These are globally recognized frameworks that emphasize financial materiality. We also continued to emphasize the importance of reporting of scope 1–3 GHG emissions data.

Proxy voting played an important role in our stewardship activities around energy transition in 2021. Climate-related shareholder resolutions were prominent, particularly within high-impact industries, such as the energy, industrials, and financials sectors. According to data from sustainability organization Ceres, there were 136 climate-related shareholder proposals tabled between July 1, 2020, and March 31, 2021,[5] with just under half of these progressing to a vote at the respective company annual general meetings (AGM).

Climate-Related Resolutions—Voting Examples

ExxonMobil
AGM-May 26, 2021

T. Rowe Price Voted—For

- ExxonMobil faced a contested director election and seven shareholder resolutions, six of which related in some measure to environmental issues. This highly unusual meeting was the result of many factors, not least being the company's general resistance to genuine investor engagement and a perception by investors that it is an outlier on climate transition strategy.
- T. Rowe Price supported three of the four board nominees proposed by the dissident investor. We also supported a shareholder resolution seeking independent board leadership, one for increased shareholder authority to convene meetings, one for climate scenario analysis reporting, and three seeking better transparency on the company's lobbying on climate issues and general political giving. We did not support a resolution brought by an investor who opposes any efforts to mitigate climate risk.
- Apart from the anti-environmental proposal, all the resolutions received strong support from shareholders. In addition, three incumbent directors were replaced.

Mitsubishi UFJ Financial Group
AGM-June 29, 2021

T. Rowe Price Voted—Against

- Kiko Network, a Japanese NGO,[6] along with three individual shareholders, filed a proposal requesting that Mitsubishi UFJ Financial Group (MUFG) amend its articles to disclose a plan to align the company's strategy with the goals of the Paris Agreement.
- Subsequent to the filing of this shareholder resolution, MUFG announced a Carbon Neutrality Declaration, aiming for net zero emissions from its finance portfolio by 2050 and in its own operations by 2030. To facilitate this goal, MUFG became the first Japanese bank to join the Net Zero Banking Alliance.
- T. Rowe Price is an active member of the Asian Corporate Governance Association (ACGA). The ACGA-hosted dialogue between the company and the proponent, Kiko Network, informed our vote decision.
- The company's commitments meant that the resolution had effectively already been addressed, so we did not support it. At the AGM on June 29, 2021, the item received 23% support.

[5] As of March 31, 2021

[6] Non-government organization. A nonprofit organization that operates independently of any government, typically with the purpose of addressing a social or political issue.

The securities identified and described are intended to illustrate the case-by-case analysis of climate-related shareholder proposals by T. Rowe Price's governance and responsible investing teams and do not necessarily represent all of the securities purchased or sold by T. Rowe Price. No assumptions should be made that the securities mentioned were or will be profitable. This is not a recommendation to buy or sell any security. The views and opinions above are as of the AGM date noted and are subject to change.

The analysis of climate-related shareholder proposals by our governance and responsible investing teams is conducted on a case-by-case basis. To reach a vote recommendation, we consider:

- The specific circumstances of each company (including the current level of disclosure)
- The company's climate strategy
- The materiality of the issue for the company, i.e., the extent to which it relates to the company's operations

We are unlikely to support resolutions that are excessively prescriptive (be they climate-related proposals or otherwise), as this usually equates to the proponent, in essence, attempting to micromanage the company. Similarly, if we think that the company is already taking sufficient action to address the stated concerns, we will likely withhold our support.

While the nature of our assessment of a company's actions can vary according to the region and industry, specific measures we consider include those detailed on the right.

In 2022, T. Rowe Price plans to step up its current voting against directors who fail in the oversight of material environmental, social, or governance risks. Companies in sectors that are highly exposed to the impact of climate change and that have failed to demonstrate sufficient preparedness for a low-carbon transition will be in scope for a vote against the board chair or other relevant committee member.

Framework for Assessment of Climate-Related Action

ASSESS LEVEL OF DISCLOSURE

- Identify if GHG emission disclosures are TCFD-aligned.
- At a minimum, report scope 1 and 2 GHG emissions.

IDENTIFY EMISSIONS TARGETS

- Seek GHG emission reduction targets.
- Ideally, targets are aligned with goals of the Paris Agreement.

EVALUATE CLIMATE STRATEGY

- Assess if company has a credible decarbonization plan.
- Best practice includes a net zero 2050 carbon emissions target (or national/regional equivalent). A path to achieving the target is key.

CONSIDER ENGAGEMENT ACTIVITY

- Assess responsiveness to stakeholder concerns, including willingness to engage and reflect feedback.
- Determine if company demonstrates robust governance procedures around direct and indirect policy advocacy, including board oversight.

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Impact Investing in an Era of Change

How do you think of ESG factors within your investment process?

It is important to state at the outset that impact investing is not ESG integration, and it is also a different discipline from sustainable investing. It incorporates both, but takes it a step further. Impact investing's modus operandi is to target positive, measurable social and environmental impact, alongside an excess financial return when compared with recognized global equity indices (for example, the MSCI All Country World Index). Impact investing directly aligns and measures investments according to their ability to contribute to particular social and environmental outcomes.

We leverage our ESG integration process to help understand environmental and social risks, alongside the dynamics related to a company's conduct. At the stock level, all our investments begin with a clearly defined positive impact thesis, which proactively and systematically integrates ESG considerations. We believe that ESG factors aren't tangential parts of a traditional investment thesis. Company fundamentals, including the consideration of environmental, social, and governance factors, play a critical role in the stock selection process.

HARI BALKRISHNA
Portfolio Manager,
Impact Investing

How important are ESG factors in the global equity market?

We believe that ESG is crucial to reaching the right investment decision. Large shareholders especially can move the ESG debate forward by actively engaging with companies on issues that are material to their activities. Many companies are already moving to actively shift investments and policies to address distinct regulatory changes and environmental and societal pressure points. Either through compulsion or a desire to influence positive change, these trends are rapidly shaping the way companies behave, invest, and innovate.

However, if we aspire to accelerate these and other initiatives that target social and environmental transitions, it is essential to fund them at scale and in a liquid manner—so public equity markets will be critical to that effort. The enormity of issues like the clean energy transition will not be possible without the backing of large and well-funded publicly listed firms.

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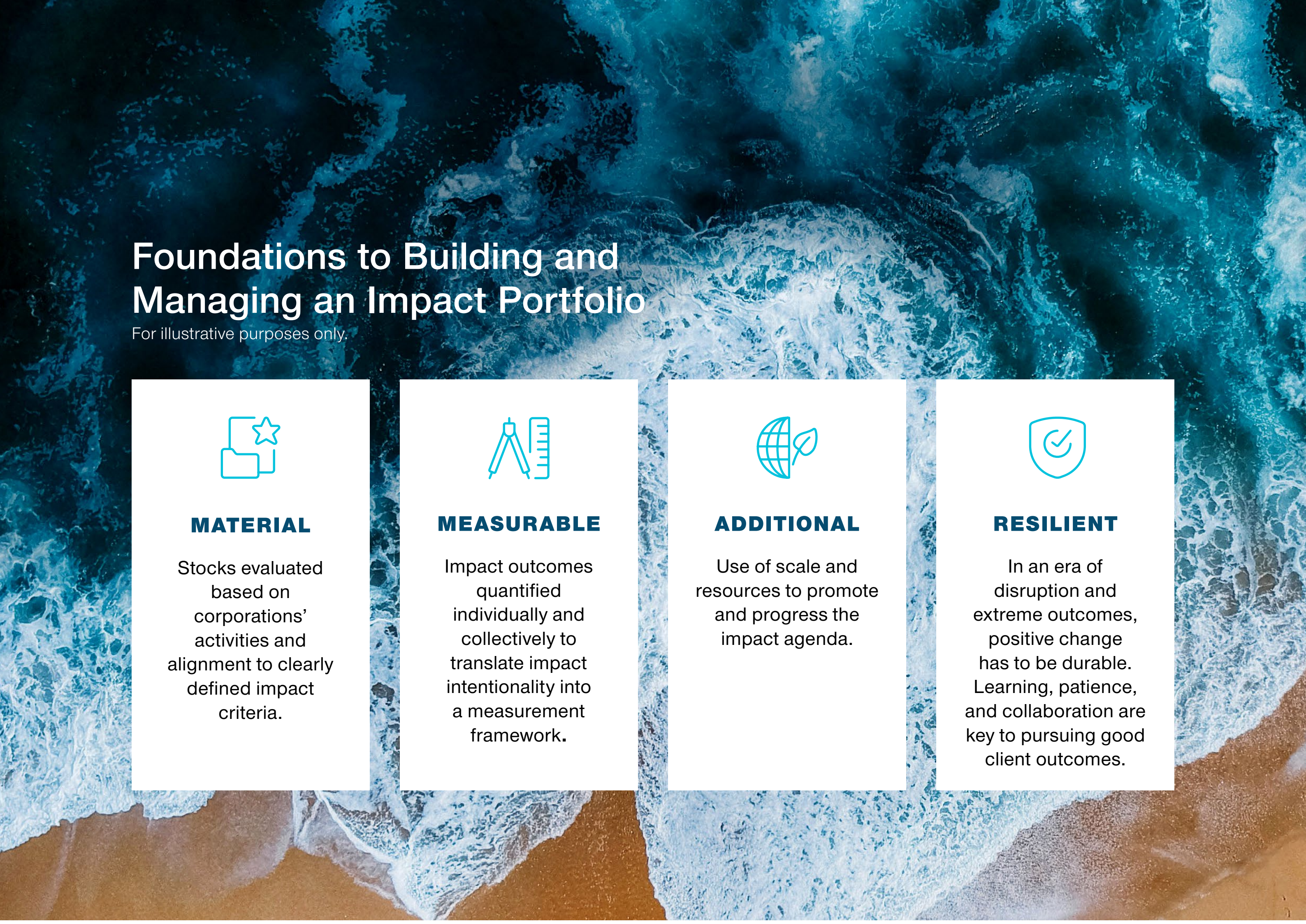
Alongside investing in companies making distinct impacts as a direct consequence of their actions, we aim to be additional through our stewardship program, which includes company engagement and a custom proxy voting policy. In our view, active engagement is a key to the ultimate delivery of impact. The journey to change takes time, however, so a long-term investment horizon is essential. Given the time required to achieve measurable environmental and social impacts, patience and resilience are key requirements to help monitor and evaluate change.



Foundations to Building and Managing an Impact Portfolio

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MATERIAL	MEASURABLE	ADDITIONAL	RESILIENT
Stocks evaluated based on corporations' activities and alignment to clearly defined impact criteria.	Impact outcomes quantified individually and collectively to translate impact intentionality into a measurement framework.	Use of scale and resources to promote and progress the impact agenda.	In an era of disruption and extreme outcomes, positive change has to be durable. Learning, patience, and collaboration are key to pursuing good client outcomes.

What are the ESG trends to watch within global equities?

Excitingly, the opportunity to own businesses that create a positive environmental or social impact is greater than ever before in public equity markets, as companies evolve to address environmental and societal pressure points. Striving to be on the right side of this societal and environmental change creates a real opportunity to select stocks that convey a positive impact profile and, with it, the added return potential that this can bring.

One way of targeting these types of impacts is to align and anchor investments according to globally recognized frameworks such as the UN SDGs. This identifies pressure points and targets the companies whose activities are working to address them by 2030. The potential investment opportunity set that the UN SDGs open is, however, vast and complex. This means an active, high-conviction, and forward-looking perspective is essential to screen, identify, and capture desired positive impacts and to target the financial returns they can generate.

We look for impact beyond the obvious. We are well versed in areas such as renewables or health care, but a range of market areas feature underappreciated impact. For example, they include industrial gases companies solving our future decarbonization needs with green hydrogen, health care firms that reduce the cost of and accelerate the pace of innovation, and companies that improve social equity through financial inclusion and digital connections. We also look to own companies that offer technological solutions to social or environmental issues as well as those engaged in smart city infrastructure or smart manufacturing business models.

This is an illustrative example of how ESG factors could be incorporated into the investment process. The views expressed may differ from those of other investment professionals at T. Rowe Price.

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