Corporate Insights
Winter 2021-2022

The Investor Landscape: four evolving themes and their implications


CHINA
INDIA
Arabian Sea

Introduction

Investors play a critical role in the expansion and success of a corporation. They provide the liquidity and financing to keep corporates humming along. Consequently, it is vital for corporate decision makers to monitor and understand shifts in the investor landscape. Decisions that improve the risk-adjusted returns of a business are rewarded by investors, and investor perception can influence everything from capital allocation strategy to the day-to-day operations of a company. But not all investors are alike. The appetites of equity, debt, preferred/hybrid, long, short, convertible, active, passive, retail and institutional investors can vary greatly. Each plays a role, and the companies that understand these different roles can better manage relationships with investors.

It is important for corporates to be aware of changes to the investor landscape that will impact how they engage with investors of all types. There is also a set of developments in the equity and debt capital markets that, in large part, relate to these changes in the investor landscape, such as private pre-IPO equity, PIPEs (Private investments in public equity), direct listings, private debt, venture lending, structured credit and asset securitization, many of which will come into play at different stages of a company's lifecycle. In this issue of Credit Suisse Corporate Insights, we evaluate four evolving themes in today's investor landscape:

1) Retail investors will continue to play a larger role

2) Passive investing is on the rise… and becoming more "active"

3) Private companies are staying private for longer

4) ESG continues to grow

These four themes can influence market dynamics and valuations and so we set out to provide our clients with a primer on them.

Retail investors will continue to play a larger role

Anyone reading the financial press in the past year will have undoubtedly come across stories about the increase of retail investors in the markets. We all bore witness to the meteoric rise of "meme" stocks like GameStop and AMC and the volatile trading that ensued earlier this year, largely driven by groups of individual investors who communicated over social media platforms like Reddit. This retail-driven activity created significant volatility and disrupted long-held beliefs that market valuations should derive from underlying company operating fundamentals. Furthermore, the meme-stock frenzy puzzled and raised the attention of sophisticated institutional investors, corporates, advisors and regulators. What's driving this? Will these themes matter in the long-term?

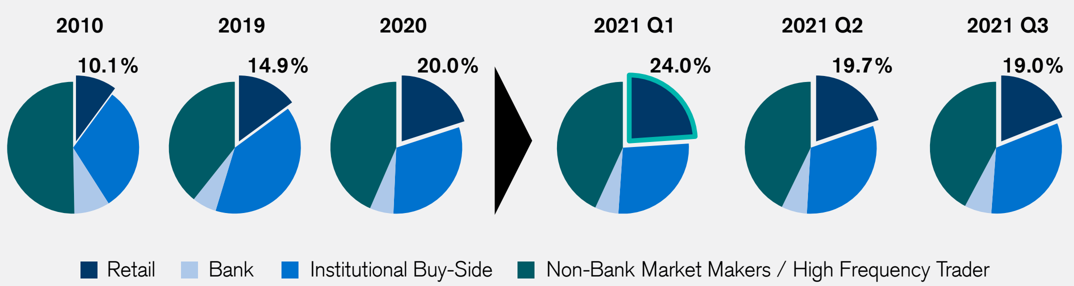
Direct retail is on the rise...

The pandemic environment created a perfect storm for a new wave of retail investors to participate in the stock market: the combination of many people working from home (free time), the arrival of significant government stimulus checks (free money), and the rise of zero-commission online trading apps (free trading) together all played a role.

Data on retail investors is not easy to come by, but there a few ways we can assess changes in the retail investor landscape. The first is by trading volume. As of Q3 2021, retail flow accounted for 19% of total trading volume in the equity markets, almost double where it was in 2010 (Exhibit 1). In fact, retail trading volume hit a peak (as a % of total participant activity since 2010) in the three month window of Q1 2021, representing nearly one-fourth of all trades that took place during that time.

Exhibit 1: Retail accounts for an increasingly high percentage of overall trading volume

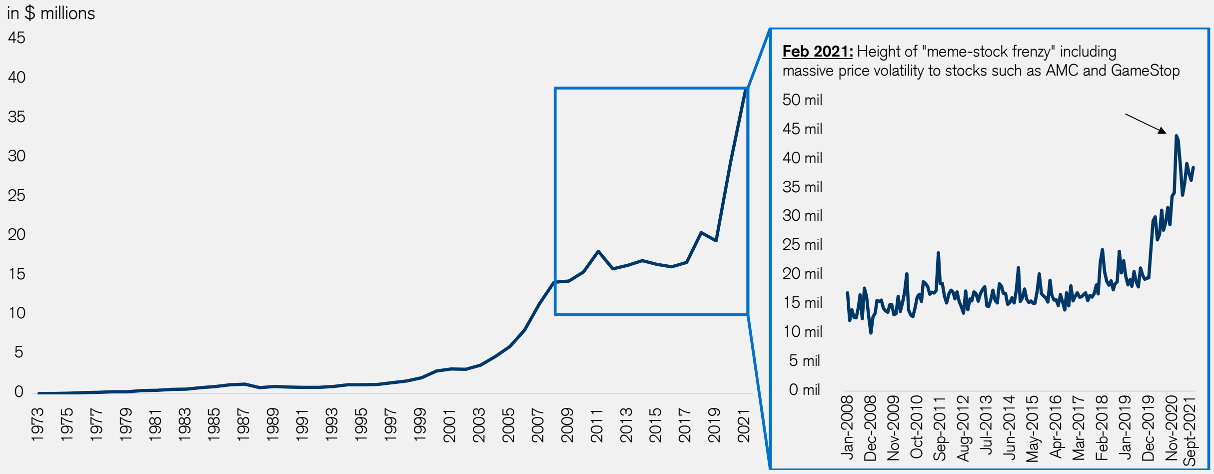
U.S. Equity trading volume (%) by market participant[1]



Another way to assess retail activity is to look at options trading, which has become widely embraced by retail investors.[2] Average daily trading volumes in options spiked in the last several months (Exhibit 2). Both Exhibit 1 and 2 draw the same conclusion; retail investor participation in the market has increased meaningfully.

Exhibit 2: Average daily volume of options trading has increased by 57% since January 2020

Average daily volume of option trades in the U.S.: annual since 1973, monthly since 2008[3]



... But we have seen this before

This isn't the first time retail investors have poured into the markets; direct retail investing has been on the rise since the 1950s and the recent new wave of retail is reminiscent of what we saw during the late 1990s to early 2000s dot-com era, when retail investors took advantage of trading brokerage platforms to participate in the tech stock boom. Inspired by the astronomical returns of early investors in emerging technology companies, speculation about the "next big thing" drove masses of individuals into the stock market at that time. We suspect retail investors were similarly compelled to participate in the markets over the pandemic period. Notably, an investment in the S&P 500 index during the market low in March 2020 would have more than doubled today, for an annualized return of over 50%.[4]

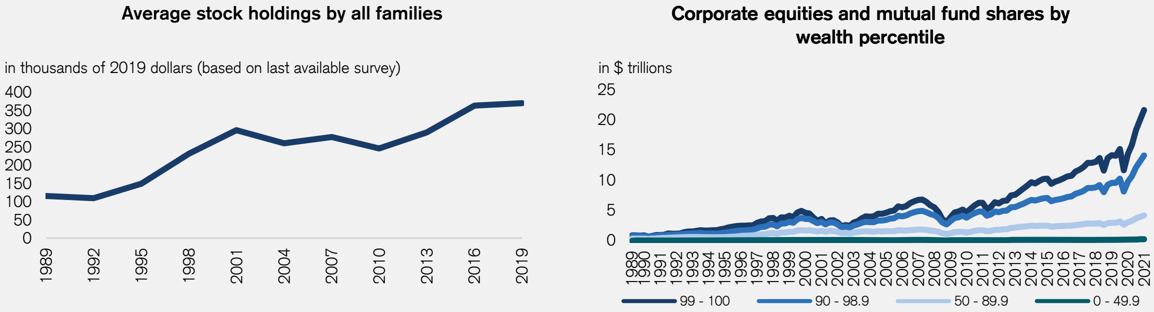
Investors are not the only ones keeping a close eye on retail-led volatility in the markets. On October 18, 2021, the SEC published a report on "Equity and Options Market Structure Conditions in Early 2021" in direct response to GameStop's trading activity. The report does not announce any definitive policy changes but it does identify several areas of potential scrutiny by the SEC as a result of the meme-stock frenzy including: forces that may cause a brokerage to restrict trading, digital engagement practices and payment for order flow, trading in alternative exchange venues and wholesalers, margin and leveraged products, and the market dynamics of short selling.[5]

Is this time different?

Retail investors are not new, but there seems to be a new dynamic this time around. As of 2021, the top 10% wealthiest households owned about 90% of all household-owned stocks in the U.S. market.[6] Exhibit 3 below shows this disparity in stock ownership in more detail.

Exhibit 3: Average stock ownership has risen for American households and is most concentrated in wealthier households

Historical stock ownership by all families and by percentile of income[7]



There is a prevailing view now that the most recent wave of retail investor activity may be concentrated amongst young, millennial investors that are not yet in that high-net-worth individual category. According to a Broadridge study, "Millennials represent the newest, fastest-growing share of the investor market. They will continue to drive growth in the Mass Market segment—and eventually higher wealth tiers as they increase in both numbers and assets for years to come."[8] Apps like Robinhood, which experienced explosive user growth during the COVID-19 pandemic, have popularized trading and made it appealing to new retail investors.

There also seems to be more infrastructure being built to support and meet the needs of retail investors than in prior decades: large asset managers, global exchanges, banks, and FinTech payments companies all recognize the opportunities that retail investors present. For example, CBOE Global Markets, a leading provider of global market infrastructure and tradable products, recently announced a new options contract called Nanos, which is designed to make options trading more accessible for the retail trader.[9] In addition, Robinhood highlights this sentiment:

> "The markets in which we compete are evolving and highly competitive, with multiple participants competing for the same customers. Our current and potential future competition principally comes from incumbent discount brokerages, established financial technology companies, venture-backed financial technology firms, banks, cryptocurrency exchanges, asset management firms and technology platforms."[10]

Moreover, this data point struck us as indicative of a shift in how the average individual investor engages with the market: Google Trends data shows "GameStop", "AMC" and "Dogecoin" were the top three rising search topics in the finance category over the last twelve months. Compare that to 2018, when "Dow Jones" and "Certificate of Deposit" were the top rising search topics.[11]

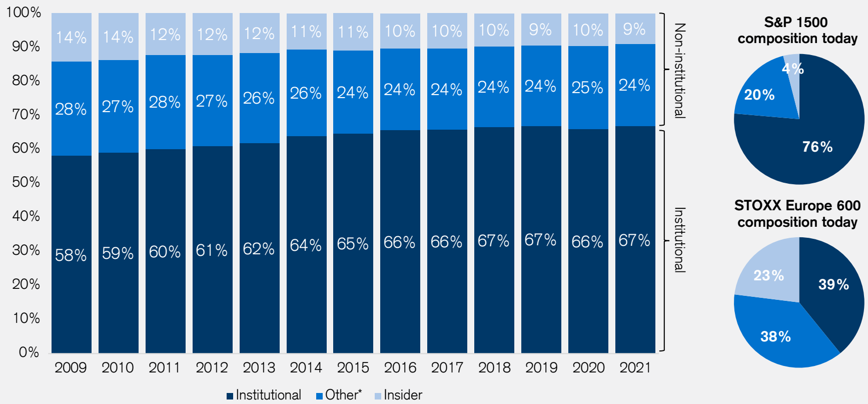
Putting retail into context

Retail investors seem to be a growing force but they still account for a relatively small portion of overall trading activity and stock ownership. In Exhibit 4, we observe that retail investors have typically represented a minority of overall stock ownership in the U.S. and European markets. Institutional investors still account for about two-thirds of stock ownership in the U.S. and Europe. Notably, in an informal survey of large U.S. and European fund managers which we conducted this fall, only 6% of investors agreed that the rise of retail has influenced their fund's investment philosophy.

Though retail is dwarfed by institutional capital, we should still consider its impacts. Regulators are certainly still focused on the events that occurred in the beginning of 2021 and its implications to market valuations, disclosure and market structure.

Exhibit 4: Despite higher trading activity, retail still represents a small portion of total stock ownership

Current S&P 1500 & STOXX Europe 600 | % ownership of Institutional vs. non-institutional capital based on weighted average market valuations[12]



Note*: "Other" represents the difference between shares held by Institutions & Insiders and shares outstanding and includes the following:

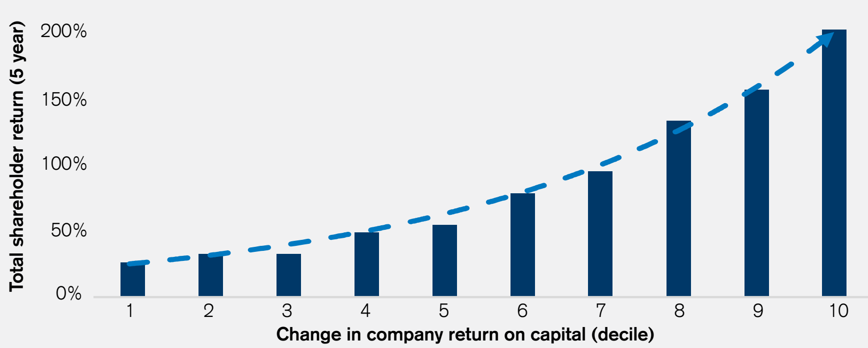
- **Individual investors** who have not crossed a disclosure threshold
- Mutual funds not covered due to non-disclosure laws e.g. Cayman Islands
- Institutional investors in U.S. managing less than $100 million and do not file 13F
- Institutional investors outside the U.S. who disregard 13F requirements or manage less than $100 million

What might this mean for corporates? The increased participation of retail investors in the market may have implications to new equity issuances in the primary market. Post-IPO or post-follow-on trading activity may be more difficult to predict with the rise of this type of retail activity. Also, retail investors have historically had access to allocations in IPOs – retail typically receives 5-15% of the total allocation of shares in an IPO. Notably, Robinhood announced earlier this year it will give its retail investors access to IPO shares as a distribution.[13]

In the secondary market, the power of the retail investor can be highly disruptive to short-term trading activity. The meme-stock frenzy we saw in early 2021 – while confined to a very small number of companies – led to stock prices becoming disconnected from underlying fundamental performance. Interestingly, distressed public companies that have found it difficult to raise capital by traditional sources may see the rise of retail as a unique opportunity to be able to raise the capital they need to fund operational improvements and strengthen balance sheets. Companies with challenged fundamentals are getting a boost in their valuations thanks to Reddit investors and they thus may be able to cash in on that trend to raise capital. For example, AMC Entertainment raised $587 million in new equity in June of this year after its meteoric share price rise that was propelled by retail investors.[14] But despite all of the furor about retail and meme stocks, ultimately what drives long-term valuations are underlying operating fundamentals, as Exhibit 5 shows.

Exhibit 5: What really drives share prices in the long-term is fundamental performance

Average total shareholder returns for each decile of change in CFROI: last 5 years[15]



Passive investing is on the rise… and becoming more “active”

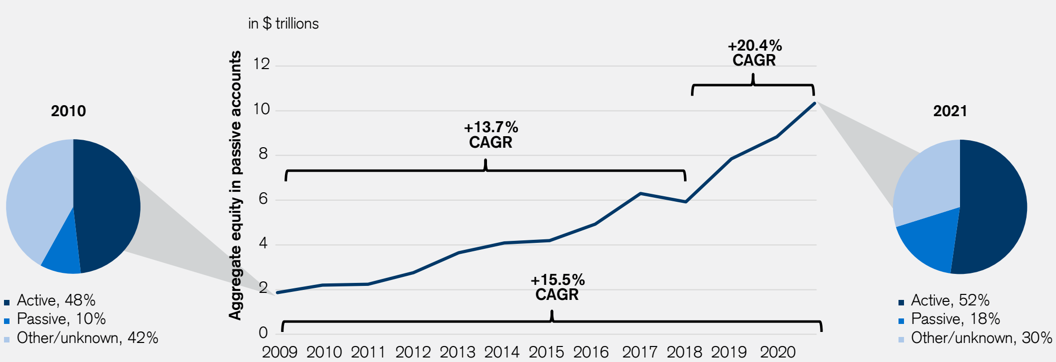
Understanding passive capital today

Jack Bogle, the legendary investor and founder of Vanguard, is credited with popularizing passive investing with the creation of the first index investment. Unlike actively managed funds that seek to beat the returns of a market index and create “alpha” for its investors, passively managed investments seek to simply track a market index or portfolio. These index-tracking passive investments are known for very low fees compared to actively managed funds, which will employ a skilled manager and often invest in resources (research teams, innovative tools) in order to identify attractive assets. Passive investments also enjoy transparency; since they match an index, it’s easy to know what exact investments a passive fund contains at any given time.

Passive investors have increasingly influenced the financial markets over the last twenty years. Financial Times journalist Robert Wigglesworth cites that over $26 trillion is now invested in passive funds – which is more than one year’s economic output in America.[16] Within the current S&P1500 and STOXX Europe 600, passively managed equity values have risen from $2 trillion in 2010 to over $10 trillion today, representing a compound annual growth rate of more than 15%. More recently, we have observed equity values in passive investments increase by over $1.5 trillion since the beginning of 2020. Exhibit 6 below highlights the substantial rise of passive capital.

Exhibit 6: Passive capital growth has been robust, and represents a growing portion of total equity under management

Aggregate equity value of investments categorized as passive in the current S&P 1500 + STOXX Europe 600[17]



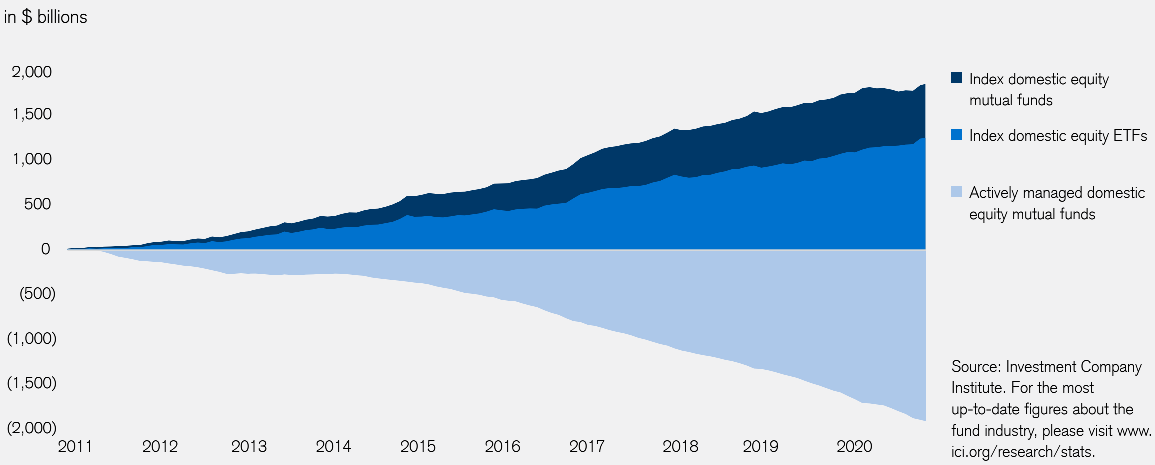
What's driven the rise of passive capital?

One clear reason is performance. Recent studies show that actively managed strategies have not outperformed respective benchmark indices when evaluated after fees over the last decade.[18] In the 12 months ending June 2021, Morningstar reports that roughly 53% of the nearly 3,000 active funds either did not survive or underperformed their average passive peer in their respective Morningstar category.[19] The development of ETFs have also facilitated passive investing, as ETFs are very practical vehicles for a retail investor. ETFs can provide an immediate means of diversification and exposure to stocks and bonds that a retail investor may not come across in their own research.

The benefits of ETFs specifically and passive capital more generally have driven the significant shift in capital over the last ten years. There has been a clear pattern of passive versus active fund flows, as it seems that for every dollar taken out of actively-managed investment accounts, a dollar has been deposited into a passively-managed investment account or product. In fact, as seen in Exhibit 7, since 2011 about $1.9 trillion has flowed into U.S. index mutual funds and ETFs, while about $1.9 trillion has flowed out of U.S. actively-managed mutual funds.

Exhibit 7: Inflows into bond ETFs has been fairly consistent over the last three years, while we have observed steep increases in net new cash flow into equity ETFs

Cumulative flows from U.S. Actively managed equity mutual funds to Passive equity mutual funds and ETFs: 2011-2020[20]



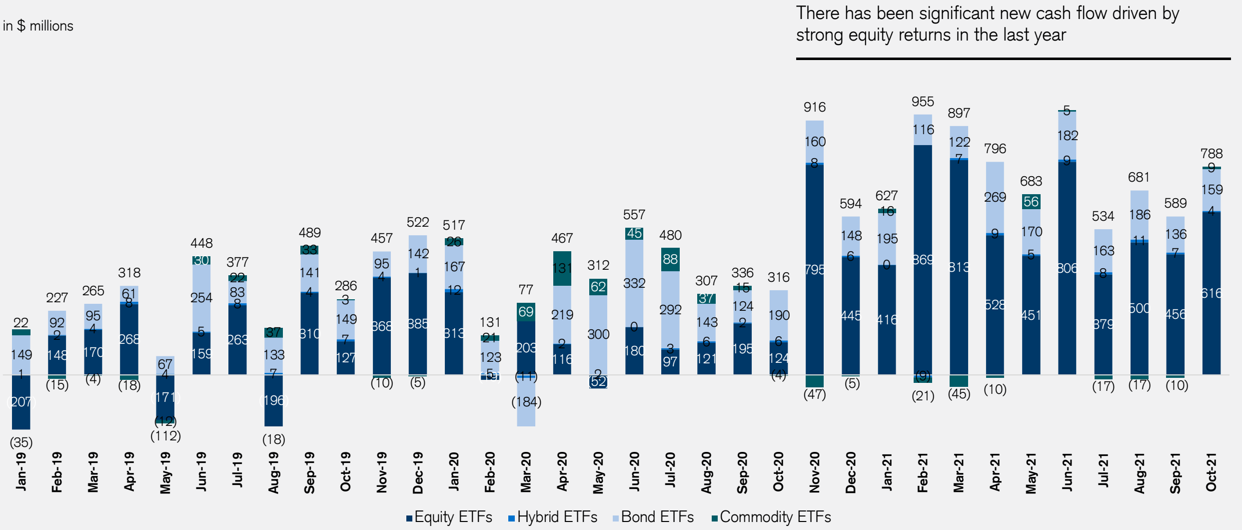
Source: Investment Company Institute. For the most up-to-date figures about the fund industry, please visit www.ici.org/research/stats.

As an aside, it's worth noting that ETFs have been a catalyst for new investor entrants in the fixed income market. Ten years ago, corporate debt was not a popular investment vehicle for registered investment companies (RICs) – which primarily include ETFs and long-term mutual funds. The value of corporate bonds held by RICs increased more than two-fold from $1.5 trillion in 2010 to $3.5 trillion by the end of 2020. RICs now hold a 22% share of the U.S. corporate debt market as compared to 14% in 2010.[21]

The increase in net new cash flows over the last few years is evidence of the ETF explosion. Interestingly, the "Big Three" asset managers – BlackRock, Vanguard Group and State Street – collectively own about 22% of the average S&P 500 company, signifying an increase from about 13.5% in 2008.[22] Cumulative ETF net new cash flows have added a whopping $14.4 trillion to the ETF market since 2019, accelerated by the $6.3 trillion inflow of equity ETF net cash flows in the last 12 months. Since the beginning of 2019, monthly net new cash flows into bond ETFs has been fairly consistent. More recently, investors have flocked toward equity ETFs.

Exhibit 8: Inflows into bond ETFs have been fairly consistent over the last three years, while we have observed steep increases in net new cash flow into equity ETFs

Global monthly net new cash flows of ETFs[23]



Source: Investment Company Institute. For the most up-to-date figures about the fund industry, please visit www.ici.org/research/stats.

Passive institutional money managers have become more "active" as corporate engagement increases

An interesting recent development is that passive money managers have become more actively engaged with corporates. Generally speaking, passive investors have three broad routes they can take to voice their views on a company: 1) engage directly and privately with portfolio companies, 2) support shareholder proposals not put forth by management and/or 3) support dissidents in proxy contests.

Passive investors that own stock will have different concerns than active investors. Unlike active investors, they cannot sell their position if they are unhappy with an investment. As long as a company is in their tracked index, a passive investor must hold the stock. In that sense, passive investors are long-term investors, and, consequently, passives are focused on a long-term game – corporate governance – and how decisions are made in the board room.

Passive investors having a voice in corporate governance is not a new concept: large cap institutional money managers like BlackRock, State Street, and Vanguard have a long history of engaging with corporates on governance issues or voting in proxy contests. But the rise of ESG specifically and of shareholder activism more generally – and the willingness of passive investors to lend support to both initiatives – means that these passive investors now have a louder voice in the room and a more impactful seat at the table. Passive investment does not mean passive governance. A 2016 study found that activists are more likely to seek board representation when a larger share of the target company's stock is held by passively managed mutual funds.[24] Large institutional money managers have increased their corporate engagement on governance and ESG issues. Two of the biggest passive institutional money managers, BlackRock and State Street, have commented publicly on their corporate engagement philosophies in this regard:

“We firmly believe in the value of engaging with companies. Encouraging responsible business operations serves the interests of long-term investors in both equity and fixed income securities issued by public companies. BIS engages companies on behalf of BlackRock’s index funds and accounts and coordinates with portfolio managers with active positions in a company. When BIS engages a company, we do so from the perspective of a long-term investor. Engagement enables us to have ongoing dialogue with companies and build our understanding of the challenges they face. This is particularly important for our clients invested in indexed funds, which represent a significant majority of BlackRock’s equity assets under management, as they do not have the option to sell holdings in companies that are not performing as expected.” **– Blackrock, 2021 BlackRock Investment Stewardship**[25]

“State Street’s main stewardship priorities for 2021 will be the systemic risks associated with climate change and a lack of racial and ethnic diversity. In particular, I want to explain how we intend to use our voice — and our vote — to hold boards and management accountable for progress on providing enhanced transparency and reporting on these two critical topics.”
– State Street, CEO’s Letter on Our 2021 Proxy Voting Agenda[26]

An interesting example of an ETF taking an active stance is the recently launched Engine No. 1 Transform 500 ETF which intends to invest in 500 of the largest U.S. public stocks and seeks to “strategically hold companies and leadership accountable” on ESG and “actively work with companies to strengthen investments they make…to drive company performance.[27]

Implications for corporates

We have not found consensus in the academic research on the impact of passive capital on equity prices. Early academic research referenced “the downward sloping demand curve hypothesis” to explain the upward price effect on a company being added to the S&P 500 index.[28] A 2020 meta-study by the Federal Reserve Bank of Boston cited that more recent research has found that stocks no longer experience permanent price increases when they are added to an index and that “in theory, rising prices can lead to more indexed investing, and the resulting “index bubble” eventually could burst.”[29,30]

Passive investors track indices and are disconnected from individual company-specific catalysts that drive share prices, so a change in the rest of the index or the market may result in a passive investor selling down a position to match changes in their tracked index. Said differently, passive investors typically make choices not on fundamental performance but on market trends – so we wonder whether the rise of passive investors in a particular company’s shareholder registry may in a way “dilute” short-term price reactions to company-specific earnings or other corporate actions.

Passive investment is not only on the rise but also increasing in its complexity; there are a myriad of funds that track different indices within which a single company may be included. Collectively, large cap passive investors are becoming more vocal about their need for more disclosure from corporates. Passives are long-term investors and so are likely to have interest in corporate messaging of strategy and vision, and longer-term value creation principles. Passives are not usually concerned with quarterly reporting of individual companies. Instead, passive investors focus more on disclosures around long-term risks and non-traditional financial issues such as ESG metrics, corporate governance and company values.

There is an interesting contrast that can be made between the implications of the rise of passive investing versus the rise of retail investors. It is easy to argue that the new wave of retail money is short-term and fickle, where retail investors are making decisions that may not be connected to underlying fundamentals and may trade quickly in and out of stocks based on the hype driven from social media platforms. In contrast, index-tracking investors by definition take a buy-and-hold approach and are long-term focused, “permanent” investors in a company. This suggests opposing forces in today’s market structure of short-term vs. long-term investing.

Private companies are staying private for longer

There are far fewer public companies in the U.S. now than there were 25 years ago, even though the total market valuation of public companies has substantially increased.

Exhibit 9 shows that there are about 4,300 public companies today (based on latest records) versus over 8,000 in 1996. This sharp decline is a function of significant consolidation driven by M&A activity, de-listings, as well as perhaps fewer companies choosing to go public due to the associated regulatory and disclosure burdens, and the ability to raise private capital much deeper into a company's lifecycle. That said, the number of IPOs has actually been on the rise since the pandemic and reached record-breaking levels in 2020-2021 (including SPACs).

Exhibit 9: The number of public companies has declined, but market caps have risen

Number of publicly listed companies in the U.S. (in thousands) vs. Total market cap of U.S. companies[31]

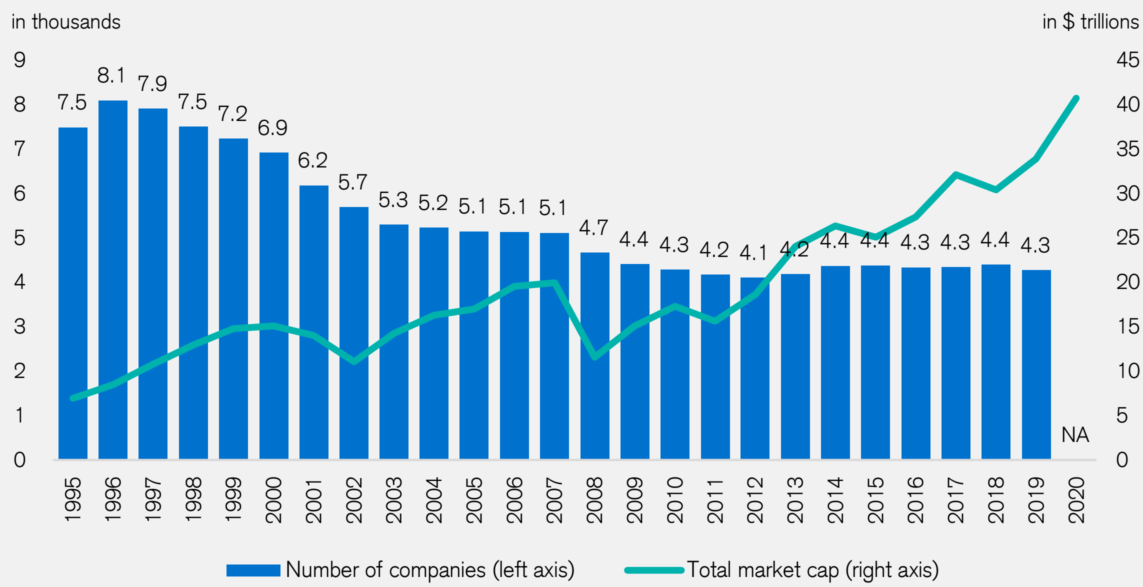
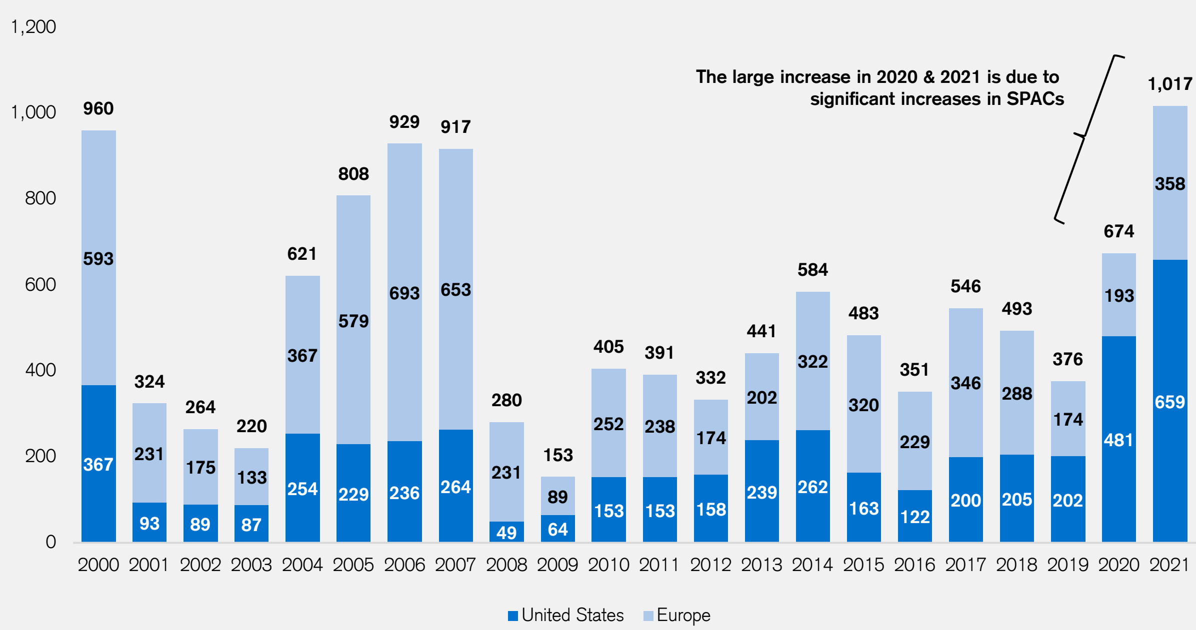


Exhibit 10: The number of IPOs in the U.S. & Europe continues to rise[32]

Count of IPOs over time (inclusive of SPACs[33]) – U.S. and European companies



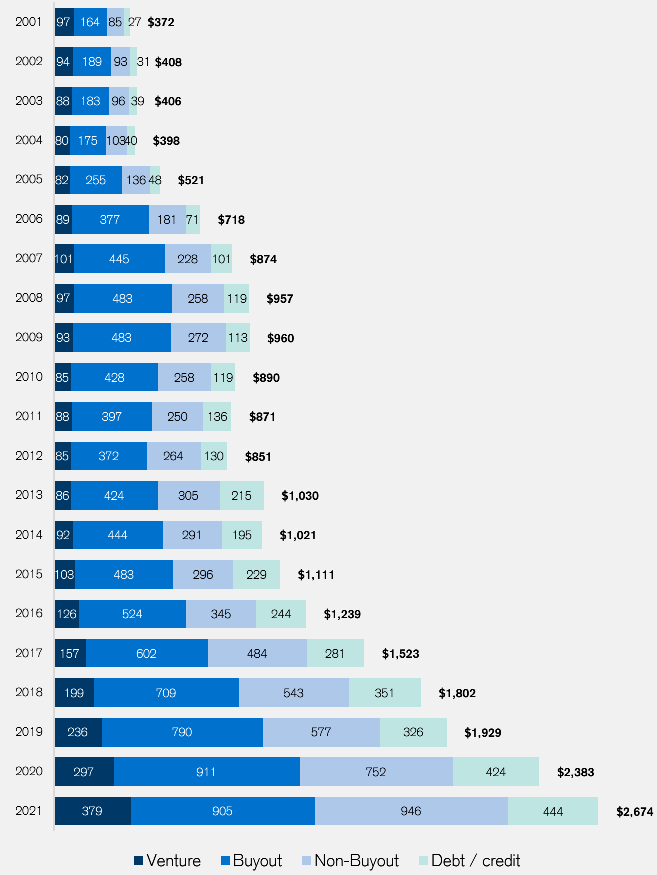
There are a number of factors driving the desire for some private companies to stay private for longer. First, regulators have been gradually relaxing laws and regulations in the private markets.[34] Second, returns – over the long-term – tend to be higher in the private markets.[35] In the same vein, private markets provide founders and early investors the opportunity to cash out through buyouts. Going public has always had costs that need to be weighed against the potential benefits. For example, going public can be an expensive endeavor. There are more stringent reporting and disclosure requirements and regulatory scrutiny, and short term stock price action can create perpetual stress (relating to our earlier section, retail investors do not have the ability to drive price volatility in the private markets as they can the public markets). By staying private, companies have fewer reporting and compliance concerns and subject themselves to significantly less market volatility.

Dry powder is at an all-time high

Along with the regulatory differences and the outsized historical return over the long-run, we can point to the colossal amount of dry powder in today's market as a significant contributing factor as to why companies choose to stay private or to go public. Global private capital dry powder is at an all-time high. According to the SEC, more capital has been raised in the private markets than in public markets each year for over a decade.[36] Private equity funds are sitting on a stockpile of cash that has now surpassed $2.6 trillion which, coupled with low interest rates and an appetite for leverage, points to significant purchasing power in the private markets.

Exhibit 11: Global private capital dry powder is at an all-time high - over $2.6 trillion in capital is available in the private capital market, which may help explain why some privates are choosing to stay private for longer[37]

Global annual dry powder ($ in billions)



Continuation funds are on the rise

Additionally, continuation funds have increasingly become a viable exit avenue for financial sponsors, alongside the more traditional exit routes of IPO or strategic sale, to extend the lifespan of an investment and consequently, keep private companies private for longer. Prior to 2018, this transaction structure was predominantly used to recapitalize whole funds approaching their expiration date. In recent years, an accelerating investor appetite to participate in continuation funds involving individual “trophy” assets has enabled fund managers to simultaneously monetize and extend ownership of their best companies. The pandemic has fueled this trend into single asset continuation funds, as limited partners and co-investors have gravitated towards concentrated bets on companies that are well-insulated and/or benefitting from the impacts of COVID-19 on the broader economy. Credit Suisse estimates that over $30 billion will be committed to single asset continuation funds in 2021. Single asset CVs estimated to be at least 60% of the $50 billion expected total CV volume (single- and multi-asset) in 2021, as shown in Exhibit 12.

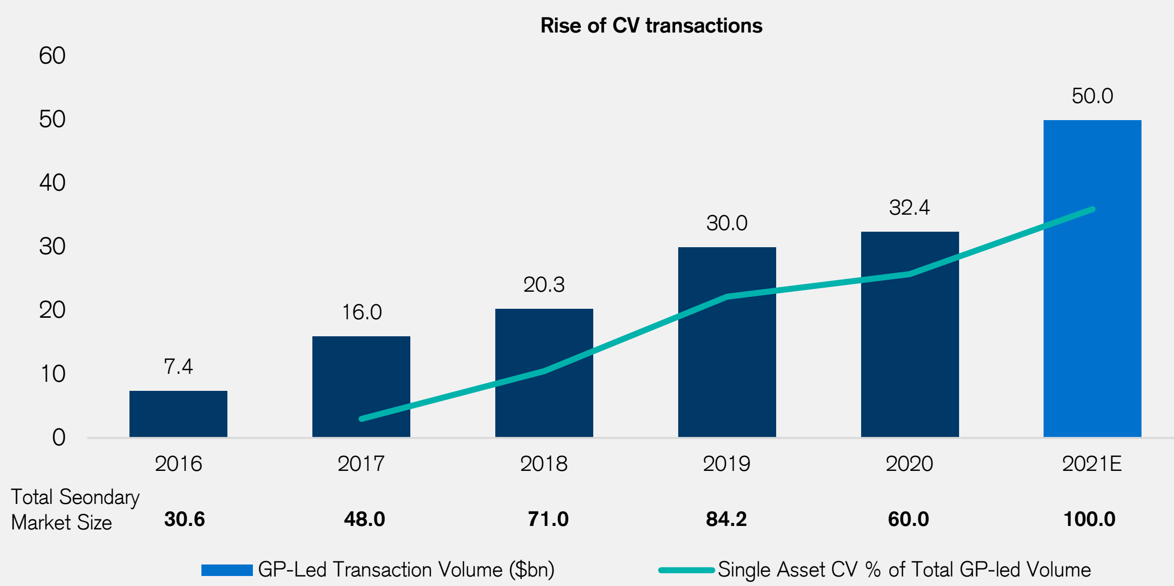
Exhibit 12: Continuation vehicles have been an increasingly popular option for financial sponsors

GP-Led Transaction volume and Single Asset CV % of Total GP-led Volume[38]

in $ billions

... capital is available in the private equity market, which may help explain why privates stay private for longer35

... dry powder ($ in billions)

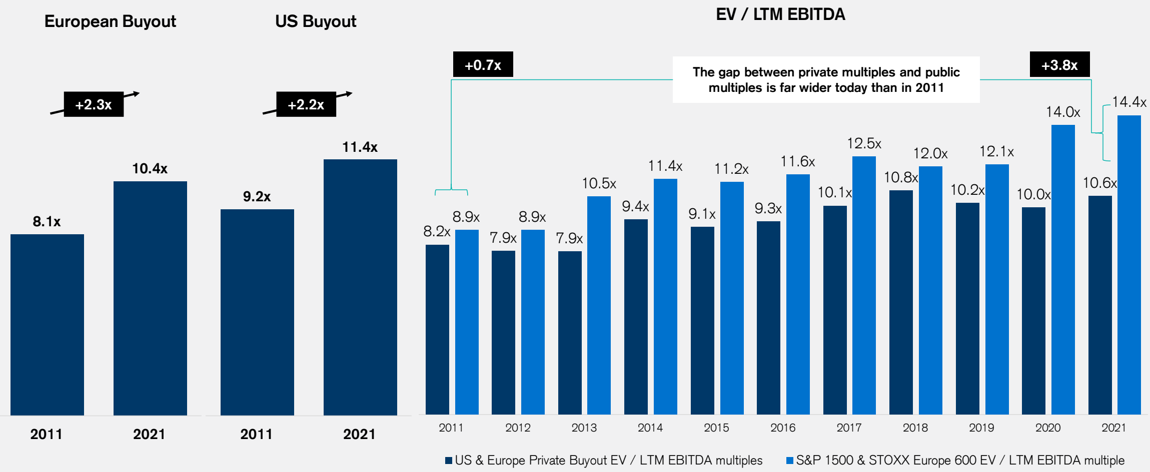


Private buyout multiples have increased, although they remain well below public multiples

The median EBITDA multiple for U.S. and European leveraged buyout transactions is roughly 25% higher today than it was a decade ago, as shown in Exhibit 13. In spite of the market volatility caused by the pandemic, purchase multiples remained relatively flat in 2020 and have gone up slightly in 2021YTD, suggesting some resilience in the price private equity investors are willing to pay for assets. That said, both public and private market valuations have gone up more dramatically over the last decade, particularly for public companies. Despite being on par with each other 10 years ago, public equity multiples are currently about 36% higher than leveraged buyout purchase multiples. Said differently, one can loosely consider that $1 of EBITDA “costs” approximately $14.40 in the public U.S. and European market versus $10.60 in the private markets. Our data suggests that private and public market valuations in 2011 were more on par with each other, at least on a multiple basis.

Exhibit 13: The public vs private market multiple gap has widened

Median purchase EV/Last Twelve Months (LTM) EBITDA multiples of private companies in the U.S. & Europe vs. median multiple of the S&P 1500 and STOXX Europe 600[39]



Note: Private Buyout EV/LTM EBITDA multiples consists of 3,840 LBOs since 2011, and are based on the median purchase multiple (purchase price / LTM EBITDA) at the time of deal announcement. The multiple for "U.S. & Europe" takes the median EV/LTM EBITDA multiple for the current combined S&P 1500 and STOXX Europe 600 (2,069 companies) annually over the time horizon.

What the growth in private capital means for corporations

We believe that the growth of private capital will continue to provide liquidity to companies and may still drive up valuations. As the capital pool to invest increases, so will the valuations of the companies that are the targets of private investor attention. Private capital serves as a way to provide liquidity to existing shareholders, while simultaneously diversifying the investor base of the company, potentially contributing to a lower cost of capital as the number of investors willing and able to provide capital grows. It is still a key source that companies – especially early-stage ones – can tap in order to fuel growth.

For private companies, staying private for longer may be beneficial as it provides additional time for companies to prepare for an eventual IPO and allows them to execute on their growth or restructuring strategies without the spotlight of being on the public stage. Private investors generally have a longer investment horizon and more patience which can give firms more leeway to operate in a setting focused more on the long-term value creation and less on next period's earnings. Private investment may also enable companies to avoid some of the scrutiny and short-term pressure of public markets.

For public companies, this theme of companies choosing private capital markets may influence how investors view the competitive landscape. For example, if a business is the "last player standing" in the public markets because many of its industry competitors have gone private, that may influence the company's public equity valuation multiples as investors may view the company as the only public asset available to participate in the industry. Additionally, there may be M&A implications of privates staying private for longer in terms of deal activity dynamics.

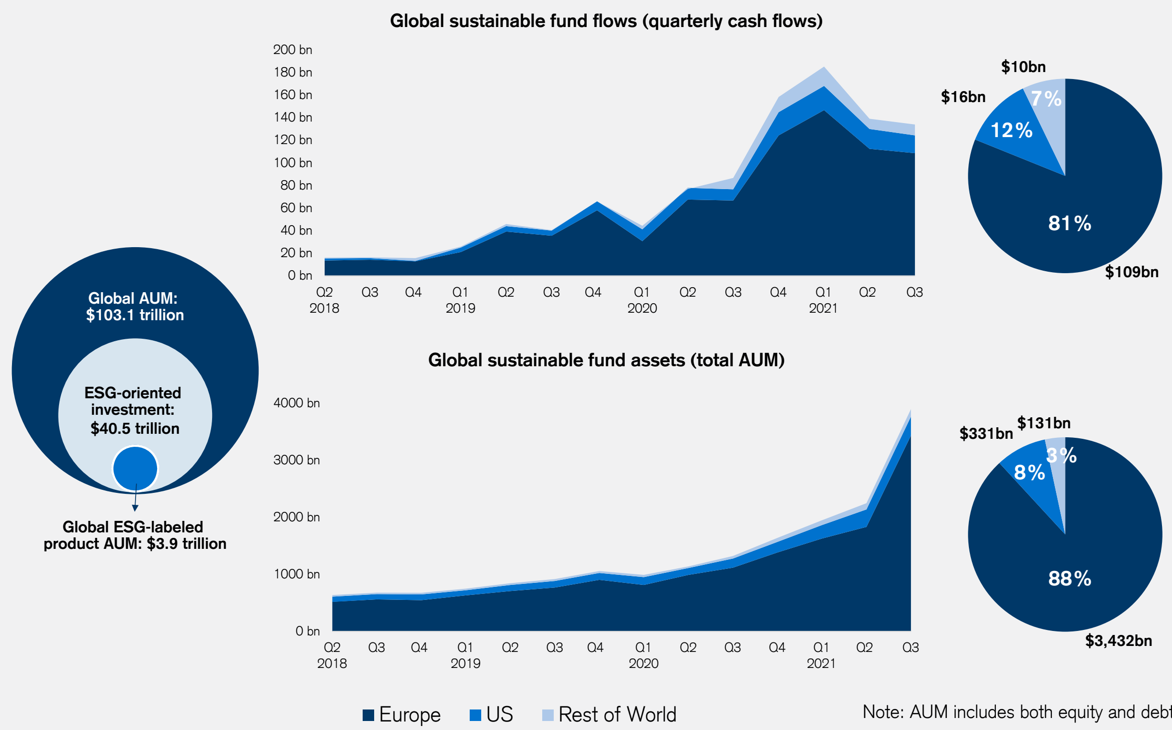
ESG continues to grow

No discussion on current investor priorities is complete without mention of Environmental, Social and Governance (ESG). More and more investors focus on ESG and there is increased scrutiny by ratings agencies, the press, analysts, consultants, politicians, government agencies and regulators as to how investment funds manage their ESG integration practices. We expect that regulatory changes around greenwashing and fund disclosure requirements will increasingly impact this space. In Q3 2021, there were $134 billion of fund flows into ESG-labeled funds and the total assets under management (AUM) dedicated to ESG-labeled investment has reached $3.9 trillion. Global sustainable fund assets are expected to double by 2025.

Europe continues to dominate ESG-focused investment

European investors continue to lead the charge here, representing over 80% of the global sustainable fund AUM and fund flows, as shown in Exhibit 14. Europe's leadership in ESG is not surprising: culturally, corporate sustainability has long been widely adopted in much of Europe, and many European countries have had regulatory policies in place for a very long time with regard to environmental factors. In addition, European companies are more heavily owned by families and foundations – or insiders. Referring again to Exhibit 4, we see that 23% of equity within the STOXX Europe 600 is owned by insiders, as compared to just 4% in the S&P 1500. Companies owned by families or foundations tend to measure success over generations or decades rather than fiscal quarters or years.

Exhibit 14: Sustainable investing is a small but rapidly growing portion of global AUM; Europe dominates sustainable fund AUM and current fund flows[40]

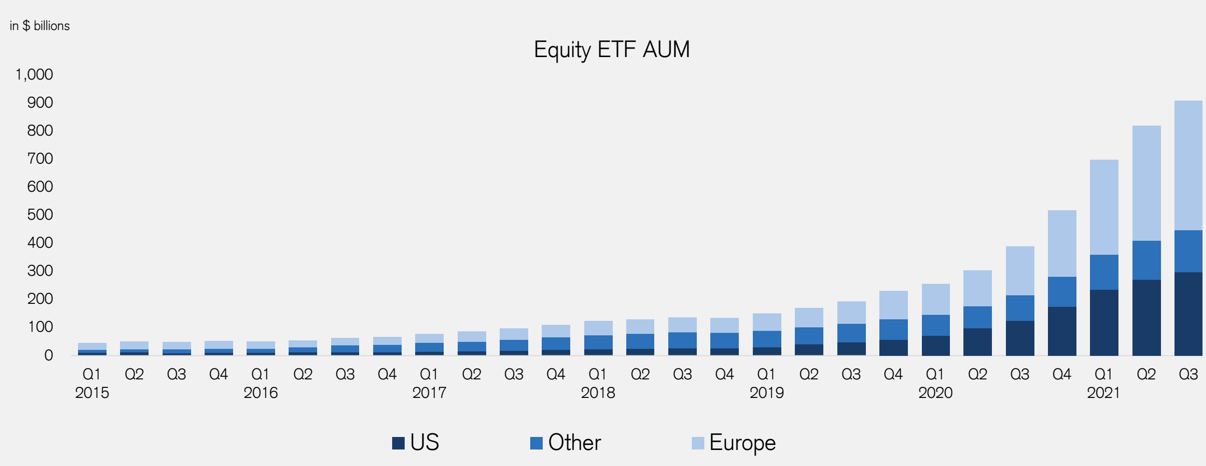


Note: AUM includes both equity and debt investments.

The question remains whether U.S. investors will catch up to European ones in ESG dedicated investment. In an informal survey of institutional investors in the U.S. and Europe we recently conducted, 69% of investors surveyed believe that the U.S. will catch up to Europe in sustainable investment AUM in the next five years. Further detail on the informal survey results can be found at the end of this paper. And while Europe still accounts for the vast share of sustainable fund assets, the amount of capital in U.S. ESG-themed Equity ETFs has increased meaningfully since 2020.

Exhibit 15: U.S. is closing the gap on ESG-related equity funds[41]

Global equity ESG-themed ETF AUM – ESG total equity broken down by geography



Asset managers may have funds that are not officially ESG-labeled (possibly because of the increased scrutiny from regulators, rating agencies and the like) but where ESG metrics may nonetheless have been integrated into their investor criteria. In other words, it is not imperative that an investment fund be labeled as "ESG" to have an ESG component to it. In fact, one estimate suggests that "the overall value of assets under management (AUM) at funds leveraging Environmental, Social and Governance (ESG) data has increased significantly over the past four years ... to over $40 trillion in 2020."[42] We suspect this "under-reporting" of ESG may be a reason that U.S. numbers for ESG funds look much lower than what we see for Europe. The definition of what constitutes ESG-labeled products continue to evolve; notably, a new disclosure rule in Europe has recently reclassified certain new fund assets as sustainable.[43] This has nearly doubled global sustainable fund assets to $3.9 trillion in Q3 2021, up from $2.2 trillion in the previous quarter.

To that point, we believe there are three primary avenues in which investors are engaging on ESG:

1. New ESG-linked product development: the creation of new products / funds dedicated to ESG

2. ESG integration into existing funds: refining investment criteria to capture ESG elements

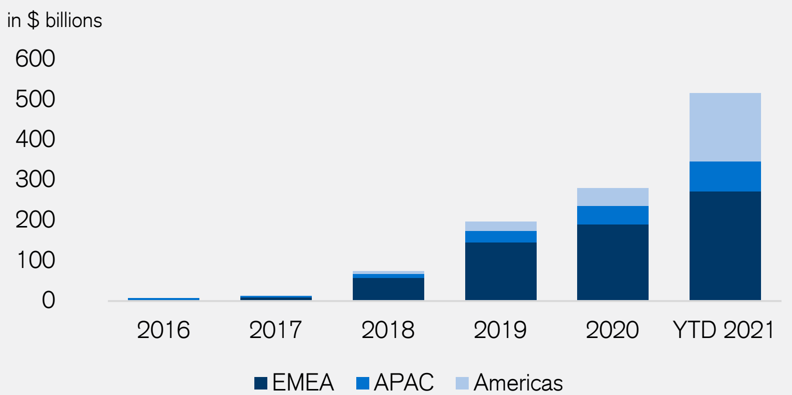
3. In-house policy development on ESG: developing organizational ESG policy and strategy

Demand for ESG labeled product continues to increase

Demand for ESG-labeled product has risen, as evidenced, for example, by the sustainable loan market. 2021 ESG issuance has reached over $500 billion with sustainable bond issuance constituting more than a fifth of total Euro-denominated bond issuance in the first half of 2021. ESG issuance has been supported by sharpening investor focus on climate action. For example, Fidelity International announced it would vote against company management if its three minimum environmental criteria are not met: 1) having a policy on climate change; 2) disclosing "emissions data"; and 3) more discussions on climate change happening at the board level. Notably, green bonds have caused investors to ask more and more about the sustainability of corporate operations. Green bonds have led to greater impact reporting, so investors can see the Social value of their decisions and investments.

Exhibit 16: Green and sustainable linked loan (SLL) market continues to rise[44]

Annual USD-equivalent global green & SLL volume by region



The “S” factor moves to the spotlight

2020 was a turning point on the social aspect of ESG. The last two years have attracted much greater attention on how companies have managed human capital, safety, and resilience with new working practices and a heightened focus on data security and privacy issues. The COVID-19 pandemic of 2020-2021 and the racial reckoning of 2020 have both served as a great leveler of “S” relative to “E” and “G”; prior to this, social issues had been considered the more vague amongst ESG issues. The social pillar of ESG is complex, broad in scope, and harder to define from a materiality perspective. Given potential financial and reputational risk, investors increasingly are considering the Social factors when making investment decisions and in their engagement with companies.

The heightened focus on social matters can been observed through the increasing number of shareholder proposals submitted to companies in this domain. Within the S&P 1500, 332 social proposals were submitted in 2021, representing a 14% increase from 291 in 2020. The momentum within the social pillar of ESG can be further demonstrated by increased investor support; average shareholder support for social proposes in 2021 has been 33%, which is an increase from 27% 2020.[46]

The rise of shareholder activism focused on ESG

Investors have intensified engagement with corporates on ESG-oriented policies.[47] We believe that new data and metrics on corporate performance related to ESG will provide activists with new angles for pursuing campaigns. The increased levels of support for ESG-related proposals by BlackRock, Vanguard and State Street are notable:[48]

- BlackRock supported 54% of environmental shareholder proposals, which was an increase of 38% from last year (2020/21)
- Vanguard supported 30% of Social shareholder proposals, which was an increase of 15% from last year (2020/21)
- State Street supported 48% of diversity/EEO shareholder proposals, which was an increase of 20% from last year (2020/21)

This increase in support by these large asset managers reinforces our earlier point that that passive investors can be “active” when it comes to sustainability and ESG matters.

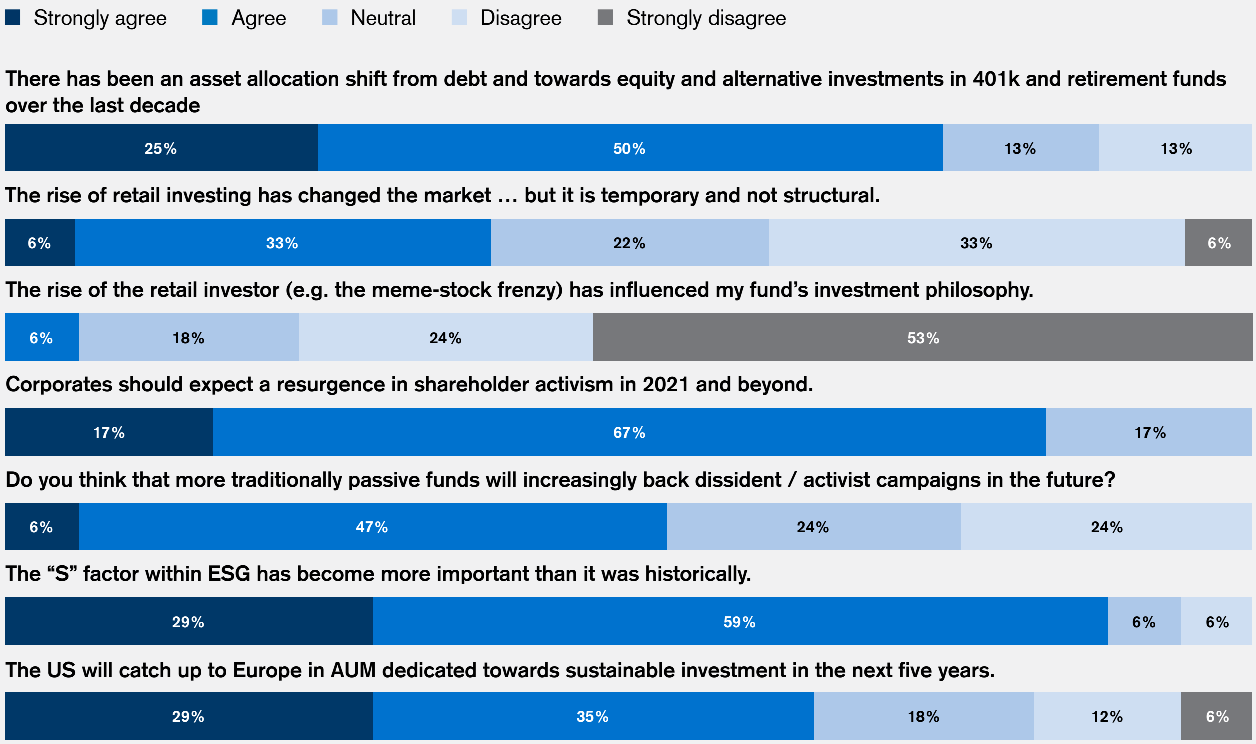
This year we saw a landmark win from activist fund Engine No.1 when they gained three board seats at ExxonMobil, after the activist fund pushed for higher emission reduction targets, amongst other agenda items. The initial issues identified were poor long-term capital allocation, lack of relevant skill and experience on the board, lack of long-term plan to enhance value and failure to align management compensation with TSR. The activist demands signified a duel threat, focusing on both the Governance and Environmental pillars within ESG. An additional noteworthy example this year was when 61% of Chevron shareholders voted in favor of an activist proposal (from campaign group Follow This) that demanded the company cut its carbon emissions.[49]

ESG is also influencing the private markets

ESG criteria also seem to be increasingly relevant for the private markets. While private equity does not face the same scrutiny from shareholders that public equity faces, private equity fund managers are accountable to their Limited Partners (LPs) who are asking for ESG-oriented due diligence – pressure from LPs and regulation is driving a greater focus on ESG in the private markets.[50] Many private equity funds now issue impact reports and are reporting (and measuring performance) on ESG metrics at the portfolio level, which is driving transparency in private markets. This seems to be happening in both the U.S. and European private markets: Carlyle announced this fall that the first-ever LP and General Partner (GP) partnership on standardized ESG reporting was created “to advance an initial standardized set of ESG metrics and mechanism for comparative reporting”.[51] The rise in sustainable investment is driving a “structural reboot” of private market investing in Europe with a new wave of private capital focusing on ESG investing.[52] Moreover, LP manager selection is increasingly incorporating ESG factors.

Investor Survey
What do investors have to say about these four growing themes?

Credit Suisse informally surveyed a select number of European and U.S. institutional investors to further understand these investor themes



Key takeaways

- **75%** of survey respondents agreed or strongly agreed that asset allocations have shifted towards **equities** and away from **debt** in the last decade
- **77%** of survey respondents believe that the recent rise of the **retail investor** did not change their investment philosophy
- Over **80%** of survey respondents agreed or strongly agreed that **shareholder activism** is expected to increase beyond 2021
- About **half** of the survey respondents agreed or strongly agreed that **passive funds** will increasingly back activist campaigns in the future
- **88%** of survey respondents agreed or strongly agreed that the **social** aspect of **ESG** will become increasingly important than it has been historically
- **64%** of survey respondents agreed or strongly agreed that the **US** will indeed catch up with **Europe in sustainable assets under management** in the next five years

Final Thoughts

These four themes – retail money, passive money, private capital, and ESG capital – have much bigger collective influence than what their individual assets under management may suggest – and consequently, are worth monitoring.

The Engine No. 1 Transform 500 ETF makes for a neat example of interconnection across these aforementioned themes in today's investor landscape: the ETF is a passive investment vehicle that gives retail investors access to participate in activism campaigns that are ESG-oriented. Changes in the investor landscape influence how companies engage with their investors and how companies are valued in the market. We see fouWr key implications to these investor themes that are relevant for corporate decision makers to keep in mind today:

1. Companies may want to consider modifying their **investor relations polices** and how they engage with different investors. Companies need to cognizant of the how, when and why behind each investor type that they engage with and understand what each brings to the table. Benefits can include demand tension, a diversified investor base, patient capital, liquidity, and the ability to penetrate your customer base or amplify your stock's narrative. On the other hand, companies must be wary of volatility, capriciousness, a lack of appreciation to fundamentals and the ability to amplify rumors or mistruths. Companies that are particularly exposed to the new wave of retail trading may want to consider new avenues of investor outreach and engagement.

2. Companies may want to consider reassessing their **disclosures** beyond the SEC and other regulatory body requirements to accommodate the interests of these different types of equity and fixed income investors.

3. It's important to formulate a **strategy and narratives to address ESG issues** and give them board-level attention. ESG is particularly important to active, passive, retail investors and increasingly so, to private capital as well.

4. Investor messaging around the **long-term vision and targets** of the business is more important than ever. Passive investors in particular will demand long-term stewardship and sustainable outlooks.

Investors remain vital to providing the lifeblood – financing and liquidity – to companies around the world, public or private. Keeping abreast of developments such as these will continue to be a important duty of the management teams of successful companies. Today, the net has never been wider in terms of investors to court, though companies have businesses to run, and thus will need to wisely prioritize where to focus their efforts.

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