White Paper
Fundamental Growth and Core Equity

July 2022

Investing in Sustainable Growth

Q2 Newsletter

STATE STREET GLOBAL ADVISORS

Contents

Navigating the Inflationary Impact on Quality and Growth

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Equity markets declined sharply in the second quarter with inflationary concerns and tightening financial conditions driving risk aversion in the period. Investors retreated from growth and quality into defensive segments of the market, favoring low volatility, high yield and value.

Inflationary pressure related to supply-side constraints and shifting demand have been compounded by the war in Ukraine and continued COVID disruption. Moreover, there is still much debate surrounding the direction of rising prices as headline inflation levels continue to move higher. We are likely near the peaks of the inflation cycle but unlikely to return to the low levels experienced in recent years given the current environment.

Central banks are responding with predictable measures, but are implementing a demand-side response to a largely supply-side problem. Nevertheless, the shift in expectations towards tighter monetary policy is delivering the intended result — slower economic growth and falling earnings expectations.

Global growth expectations have deteriorated and consumer confidence has weakened, but activity levels around infrastructure, supply chain reshoring, and "green" capex remain positive. Analyst earnings forecasts generally remain constructive in Energy, Materials and segments of Technology and Industrials, while the Consumer segments are seeing downgrades as advertising slows and the effects of inflation and war are realized.

This edition of our newsletter follows on the heels of our latest white paper, where we explored three climate transition examples.[1] As businesses continue to invest heavily in climate transition and innovation, it is our general belief that firms with strong strategies and sound fundamentals will position themselves to generate long-term returns in the future. Both of the articles in this newsletter are specific examples of these themes. The first article outlines the importance for companies to prepare a climate transition strategy and the second article describes the digital transformation strategies being deployed within the consumer world.

The Climate Transition Imperative

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As the world advances efforts to slow the pace of global warming, businesses that recognize and take action to mitigate climate transition risks will be well positioned to take advantage of related opportunities and create long-term value for stakeholders.

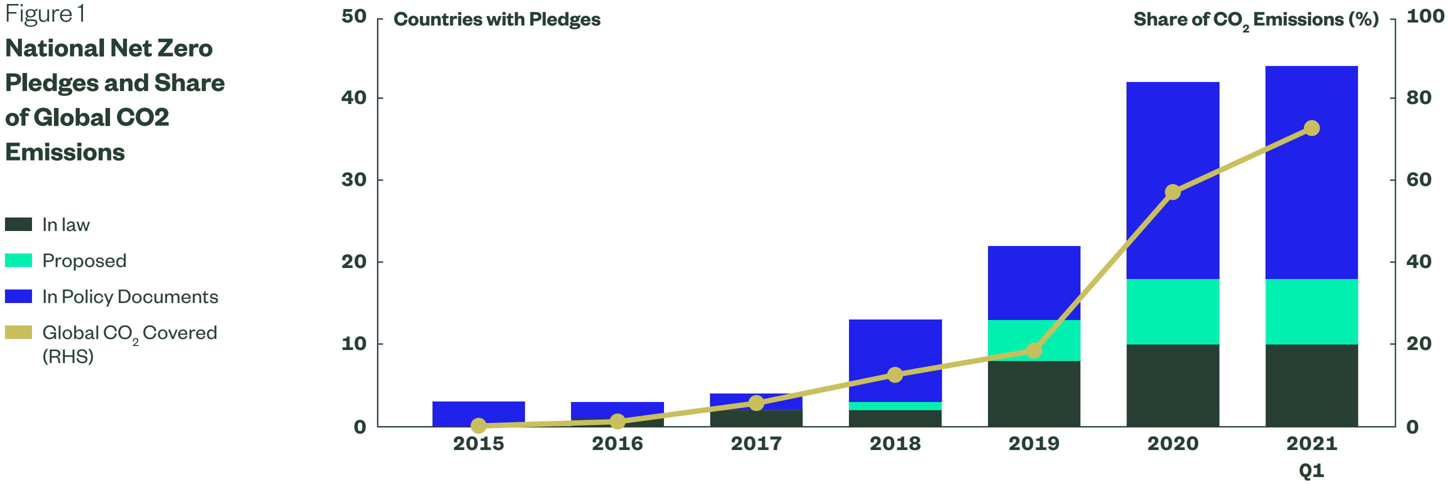
Science has proven that global warming is caused by humans and scientists have emphasized that greater efforts must be made to limit the increase in the global mean temperature to below 2°C above pre-industrial levels. Some have argued that a target of 1.5°C is necessary. To achieve either target requires a drastic reduction in net greenhouse gas (GHG) emissions. According to the Intergovernmental Panel on Climate Change, meeting the 2°C goal requires a 25% GHG reduction from 2010 levels by 2030, and net zero emissions by 2070. The 1.5°C goal will require a 45% GHG reduction from 2010 levels by 2030, and net zero emissions by 2050.[2] In 2019, a team of eminent scientists warned that "we are in a state of planetary emergency."[3]

Businesses are responsible for a great deal of current GHG emissions. Approximately one-third of emissions result from energy production and use, agriculture and deforestation account for about one-quarter, while transportation, industrial production, and building use and construction account for most of the rest.[4] To meet either the 2°C or 1.5°C targets, operating in a "business-as-usual" manner is not sustainable given that GHG emissions must reduce substantially. Firms will have to realign their business models (product and service offerings) to enable a smooth climate transition.

There has been a significant increase in the number of governments making pledges to reduce GHG emissions to net-zero. As of 23 April 2021, 44 countries and the European Union have pledged to meet a net zero emissions target: in total, they account for around 70% of global CO2 emissions and GDP.[5]

The above targets are estimates based on certain assumptions and analysis made by the Intergovernmental Panel on Climate Change. There is no guarantee that the estimates will be achieved.

Figure 1
National Net Zero Pledges and Share of Global CO2 Emissions



Source: International Energy Agency (April 2021), Net Zero by 2050, IEA, Paris Notes: In law = a net zero pledge has been approved by parliament and is legally binding. Proposed = a net zero pledge has been proposed to parliament to be voted into law. In policy document = a net zero pledge has been proposed but does not have legally binding status.

According to research by BloombergNEF, 111 out of the 167 Climate Action100+ "focus companies"[6] had set a net zero or equivalent target as of August 2021, pledging to fully reduce and/or offset their emissions at a level equivalent to what they emit annually. Despite current efforts to curb GHG emissions, climate scientists predict a warming of above 2°C if we continue at the same rate.[7]

Climate Transition: Risk Mitigation and Opportunities

For businesses to develop a credible climate transition strategy, they must first understand the magnitude of risk posed by climate change on their operations. As per the Taskforce on Climate-related Financial Disclosures (TCFD), these risks can be divided into two major categories: (1) risks related to the physical impacts of climate change, (2) risks related to the transition to a lower-carbon economy.

1 **Physical Risks** These risks, aggravated by the global mean temperature rise, may result in both direct and indirect financial impacts on the company, supplier and customer production facilities, and other parts of their supply chain. Such risks can be in the form of a severe climate change event (acute) or may have lasting effects due to shifting climate and weather patterns and cycles (chronic).[8] Physical risks are apparent in the form of flooding and rise in sea levels, water stress related to droughts, and more frequent extreme weather events. These risks may have severe negative financial implications for companies in the form of structural damage to assets and indirect impacts from supply chain disruption.

2 **Transition Risks** Transitioning to a carbon-free economy carries risk, notably for companies that rely on carbon to produce their products and services. This may involve substantial policy, legal and regulation risks, but also changes in customer preferences driving companies to adopt climate change mitigation plans and adapt their business strategy to make them more sustainable. Depending on the nature, speed, and focus of these changes, transition risks may pose varying levels of financial risk and ultimately could render some business models obsolete.

$4tn

Worth of assets will be at risk from climate change by 2030*

Climate Transition: Risk Mitigation and Opportunities

The climate transition presents businesses with an opportunity to realign and redesign their business models while mitigating and adapting to climate change. This can be achieved through resource efficiency which can drive cost savings via (for example) the adoption of low-emission energy sources or building resilience along the supply chain. The development of new products and services can also enable access to new markets. Some companies are capitalizing on this opportunity by meeting a growing consumer demand for low-carbon versions of products and services, while others are investing in and developing current and future technologies that will eliminate carbon from their customer operations. Companies that are able to seize this opportunity should be better placed to gain competitive advantage in the race to net-zero, and to create long-term value for stakeholders.

$53bn

Worth of savings identified by companies responding to the CDP climate change program*

As long-term investors, the State Street Fundamental Growth and Core (FGC) equity team understands the risks that climate change can have on their investments. The team also recognizes the opportunity to invest in companies that have robust climate transition plans in place to overcome this challenge.

* Source: CDP , 5 July 2022.

The Regulatory Scenario

Financial regulators across the globe are intensifying their focus on climate risks — both physical and transition. More and more regulatory bodies are seeking business disclosures around climate, with the US Securities and Exchange Commission (SEC) among the latest. The new SEC climate disclosure proposal requires companies:[9]

1. to disclose information on their climate transition plan (if adopted) and the supporting metrics and targets used to identify and manage physical and transition risks;

2. to disclose information about the use of an internal carbon price (if any) for business decision-making;

3. to disclose information on the impact to financial statement line items of climate-related events, such as severe weather events, and of risks related to the transition to a low carbon economy, such as regulatory, market or competitive changes;

4. to report on their Scope 1 and Scope 2 emissions, or those from direct operations or through purchase of energy. The new proposals also recommend companies report on Scope 3 emissions if they are material, or if the company has a stated emissions reduction goal that includes Scope 3.

Similar requirements have been laid down by other regulators, mostly aligned with the recommendations of the TCFD. The momentum towards climate disclosures will encourage businesses to modify their strategies, gradually transitioning out of fossil fuels into renewable technologies and solutions that facilitate the path to net-zero. Additional requirements from regulators, along with investor demands around climate, will also put more pressure on market participants like asset managers to more closely scrutinize companies on their green claims. This will ensure capital flows into companies and projects that actually contribute to the climate transition agenda.

The Investment Opportunity

The FGC team believes that companies which identify and manage both the risks and opportunities associated with climate change and energy transitions will be best positioned to create long-term value for stakeholders. The team strives to understand how companies align their climate strategies with their business models, and how they convert the energy transition challenge into an opportunity to drive long-term financial performance.

The FGC team has developed a comprehensive scoring mechanism which looks at a company's plan around climate transition, along with the risks and opportunities that lie ahead as it transitions into a low-carbon economy. These climate score cards are based on available data from company disclosures but also leverage the extensive experience and knowledge of the FGC equity research analysts. The FGC team targets investment opportunities in companies that have best-in-class climate transition plans which, in combination with our Confidence Quotient (CQ) proprietary research framework, allows us to identify those we believe will be long-term winners.

Consumer Strategy in a Digital World

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Digital technology has transformed how people consume goods and services and how product manufacturers and retailers engage with their target market. Many companies have recognized the importance of interacting with consumers within the digital space. In our view, companies that embrace this changing world and pursue the opportunities that arise have the potential to improve their competitive advantage and improve their "Market Position" score in our investment process. In contrast, the companies that fail to invest the necessary time, energy and resources in adapting to change will likely fall further behind.

Driving Growth Through Digital

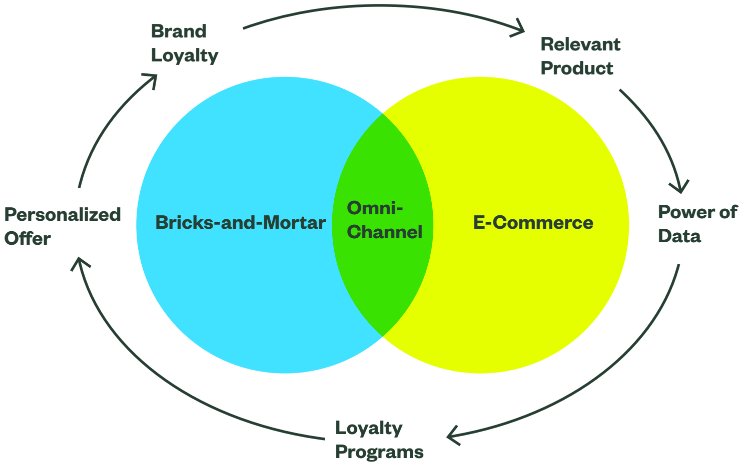
We see four key areas of focus for companies to drive growth through digital: (1) direct consumer data, (2) channel-agnostic commerce, (3) real-time analytics and (4) building digital capabilities.

1 **Direct Consumer Data** The foundation of long-term digital engagement is the consumer data record. Knowing exactly who their consumers are allows businesses to engage with them directly and to develop more effective marketing through personalized content and products. Companies need to build and maintain these databases on a very large scale.

2 **Channel-agnostic Commerce** Historically, the methods of brand-led consumer engagement (tv, print media) were largely separate from the point of purchase. Today, these two universes are inter-connected in one end-to-end experience from awareness to shopping. Producers need to be 'channel-agnostic' and ensure that their brands have shelf-space anytime anywhere. Such an approach means allocating more digital media spend directly with e-commerce platforms and addressing practical challenges such as developing fit-for-purpose packaging solutions and managing the "stacking" of retailers' online shelves.

3 Real-time Analytics Harnessing the power of data analytics is a major opportunity for all players. The challenge is to ensure that the insights generated are strategic, predictive and in real time. Optimizing pricing and promotional activity and identifying innovation opportunities should make brands more agile and effective.

Figure 2
Reaching Consumers Via Multiple Channels



Source: State Street Global Advisors, June 2022.

4 Building Digital Capabilities All of this should be enabled by strategically building digital capabilities across the organization. Many companies have been upskilling employees through digital literacy programs, prioritizing the development of in-house talent, and encouraging a culture of fast-paced trial and error.

Case Studies: Benefiting from Going Digital

Advances in technology and evolving consumer demands have transformed how many companies are approaching business. The companies noted below are among those that meet our criteria for investment and we have highlighted some specific examples that illustrate their strengths.

L'Oreal

L'Oreal has been at the vanguard of embracing a digital-first engagement strategy. Over 60% of the company's media spend is now on digital, and e-commerce sales now account for over 25% of the group total. At the height of the initial COVID-19 crisis in April 2020, the proportion of its e-commerce sales reached 34%, up from 17% in January of the same year.**

L'Oreal has been particularly innovative in digital beauty technology, as demonstrated by its Modiface "virtual try-on" service, which has had over a billion visits.** Having acquired the business in 2018, L'Oreal has now developed it to offer make-up and hair color "try-ons", skin diagnostics, shade finders, live streaming and tele-consultation. By integrating this with social commerce, the company has created a powerful ecosystem of online advocates. In our view, this is a great example of engaging consumers in the digital world whilst acquiring consumer data, personalizing products, using analytics, and building internal digital capabilities.

** Source: L'Oreal Capital Markets Day 2020.

Nike

At Nike Inc., digitization is the key enabler of the company's consumer-direct strategy. This strategy has allowed the company to transition from a traditional wholesale model to a more direct-to-consumer (DTC) model with higher margins and selling prices.

In 2011, DTC sales represented only 10% of end consumer sales. Of these direct sales, only a tenth were Nike e-commerce sales with the balance mainly made up of lower-priced goods sold through company-owned factory outlet stores.

In the decade since then, Nike invested heavily in its digital ecosystem, driving brand engagement and direct sales:

- **Digital Membership Program** Nike created a digital membership program to connect directly with customers rather than allowing retail partners to own this relationship. Digital allowed Nike to reach the customer without having to build out expensive flagships or store networks. After launching the program, Nike tripled its membership over five years and, as of 2022, has over 300 million members.[10] By 2017, Nike's digital strategy led to members spending three times more on Nike products compared to non-members while members who shop on the company's apps spent three times more than guests on the company's website.[11]

- **E-Commerce Platforms** Nike built out and drove member traffic to owned e-commerce platforms like Nike.com and the SNKRS app. These platforms were given exclusive products, limited releases and shoe customization capabilities to help migrate demand away from traditional retail channels.

- **Limited Retail Partnerships** As Nike migrated demand to its own digital channels, the company cut back on supply to its 30,000 retail partners. Starting in 2017, Nike stopped wholesaling product to one-third of its retail partners that it deemed undifferentiated. In doing so, Nike could better control distribution, limiting discounting and elevating brand presentation. This also allowed Nike to strengthen its relationship with differentiated retailers such as Dick's Sporting Goods, Zalando, Tmall and Nordstrom.

Nike's digital strategy has enabled better management of the customer's relationship and interaction with the brand through membership, digital connectivity and e-commerce. Over the past decade, Nike Direct sales have grown to 28% from 10% of sales, with owned e-commerce growing to 15% from 1% of the company's distribution. As the company now sells more product directly or through differentiated retail partners, selling prices and margins have increased. Finally, Nike's strategy provided the company with much-needed flexibility during the pandemic to meet customer needs at a time when physical retail was severely restricted.

Canadian Tire

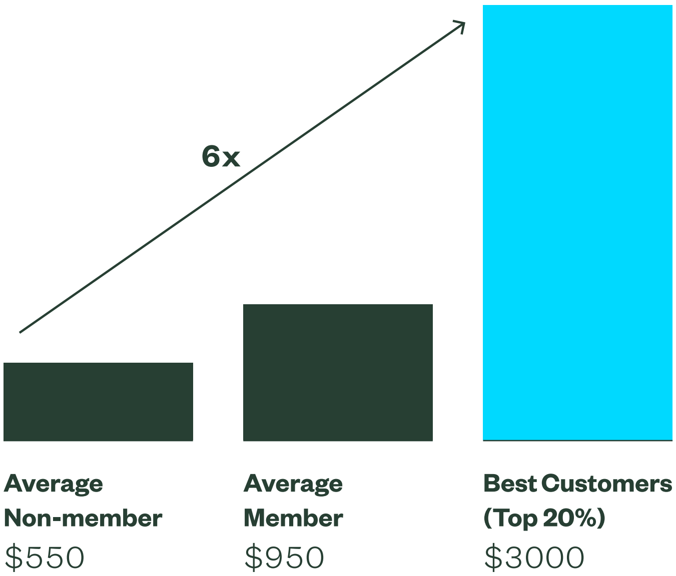
Data-driven loyalty programs are among the important tools that companies can utilize to improve the stickiness of customer engagement, thereby helping them build stronger relationships with clients. Canadian Tire (CTC) is one of the oldest, largest and most trusted Canadian household names. The company operates across different retail formats and has been evolving from running isolated banners to developing a single marketplace that serves the needs of Canadians. It has been enhancing its business model by creating a connected omnichannel customer experience.

Its loyalty program, The Triangle Rewards, has been a powerful source of growth as CTC has built one of the most extensive and comprehensive customer data sets in Canada.

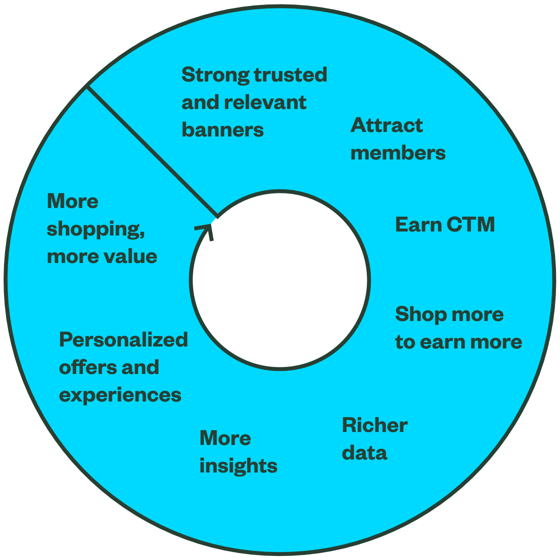
- It added 2.4 million new members in 2021 to take total active Triangle Rewards members to 11 million (28% of Canada's population)
- Integrates their data across 300 categories
- 11 banners with credit card spend data
- 14 million app users and email subscribers
- 1 billion digital site visits

Figure 3
Cultivating Customer Loyalty

Average Spend Per Member



The Triangle Customer Flywheel



Source: State Street Global Advisors, Canadian Tire Investor Day 2022, as of 12/31/2021.

First-party customer data is helping CTC build more personalized marketing capabilities. A powerful example of data use was demonstrated in 2021 around the time of historically high home sales. The majority of movers were typically relocating from densely-populated cities to the suburbs and detached houses with more space and back yards. Aware that residents were searching for retailers in their new neighbourhoods — as evidenced by the increase in generic Google "near me" searches — CTC sought to establish itself with movers as the retailer of choice in their new community. Taking advantage of this tailwind, in Q2 and Q3 of 2021 the company sent customers who had recently moved (identified by a change of address in the Triangle system) loyalty offers that were tailored on the basis of whether CTC thought they lived in a condo or detached house. The offer activation-to-redemption rate was one of the highest ever seen. CTC teams have been using data to better understand life stage and life events of customers to make more relevant and timely offers.

CTC's data-driven, customer-centric Triangle program is also a remarkable competitive advantage in helping Canadian Tire to refine its offerings, identify new growth product categories and new brands for introduction and acquisition. The program also helps to improve the overall customer experience and build customer loyalty, therefore providing a deeper moat against its competition. The ability to acquire data across all channels and banners, tie it to a single customer profile, drive business decisions and then measure their impact across those channels is what will keep CTC connected to their customers in Canada in a very unique and powerful way.

The Value of Data

Accumulating and using customer data enables companies to better connect with customers and fine-tune the offer. It allows firms to identify efficiencies across the entire business cycle, from improved merchandising and inventory management — i.e., driving inventory localization through geography-specific, AI-generated store assortments, and building truly connected stores — to more effective data-led marketing. These efforts can result in competitive moats that help companies outperform their peers over the long run. As part of our investment process at FGC Equity, these competitive attributes are reflected in higher CQ scores, which helps us select stocks that we believe will be long-term winners.

Contributors/ Contacts

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Endnotes

1 https://ssga.com/us/en/institutional/ic/insights/three-climate-transition-stock-stories.

2 Source: IPCC, 2018: Global Warming of 1.5°C. An IPCC Special Report on the impacts of global warming of 1.5°C above pre-industrial levels and related global greenhouse gas emission pathways, in the context of strengthening the global response to the threat of climate change, sustainable development, and efforts to eradicate poverty [Masson-Delmotte, V., P. Zhai, H.-O. Pörtner, D. Roberts, J. Skea, P.R. Shukla, A. Pirani, W. Moufouma-Okia, C. Péan, R. Pidcock, S. Connors, J.B.R. Matthews, Y. Chen, X. Zhou, M.I. Gomis, E. Lonnoy, T. Maycock, M. Tignor, and T. Waterfield (eds.)]. In Press.

3 *Climate tipping points — too risky to bet against*. Nature.com, 27 November 2019.

4 Climate Watch, The World Resources Institute (2020).

5 Net Zero by 2050 — A Roadmap for the Global Energy Sector, IEA.

6 Climate Action 100+ is an investor-led initiative to ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change. These focus companies have been deemed the world's heaviest emitting, accounting for over 80% of global industrial greenhouse gas emissions.

7 IPCC Special Report on the impacts of global warming of 1.5°C above pre-industrial levels and related global greenhouse gas emission pathways.

8 Based on the TCFD terminology.

9 https://sec.gov/news/press-release/2022-46.

10 Source: Nike company accounts, Q1 2022.

11 Source: Nike Investor Day 2017.

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- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

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* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as June 30, 2022 and includes approximately $66.43 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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