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Investment Perspectives

The U.S. Inflation Reduction Act Signals Potential Opportunities for Climate Bonds

Our experts assess the potential impact of the Inflation Reduction Act—and the sectors that may benefit from its passage.

Annika Lombardi,
Managing Director, Portfolio Manager

Ritchie Oriol,
Investment Strategist

Key Points

- The Inflation Reduction Act (IRA) of 2022 includes the largest climate-related investment and incentivization package by the U.S. government to date.
- Companies behind clean energy generation, energy efficiency improvements, and clean transportation are likely to be significant beneficiaries of the climate-related provisions of the IRA.
- We think the Climate Focused Bond Fund is well placed to benefit from the capital flows and fiscal incentives created by the IRA through its thematic approach to sustainable fixed income and its focus on innovators in the sustainability transition.

For an in-depth review of the investment backdrop for climate bonds and other ESG-related investment topics at midyear, listen to the latest Green Shoots podcast featuring Annika Lombardi.

Inflation Reduction Act: An Overview of Key Climate Provisions

The U.S. Inflation Reduction Act (IRA) of 2022 was signed into law on August 16. Central elements of the Act are provisions supporting climate-related initiatives. The Bill is historic in its focus and magnitude, with $369 billion earmarked for a wide range of climate-related activities including production of renewable energy, increased adoption of electric vehicles, and energy efficiency improvements. A goal of the IRA's various provisions is to reduce emissions by 40% by 2030, compared to 2005 levels, thus representing 80% of the U.S. commitment to the Paris COP21 (the 21st Conference of the Parties to the United Nations Framework Convention on Climate Change) agreement.[1] The Bill seeks to incentivize sustainable investment through both tax incentives and direct spending, while emphasizing domestic content and production. Below, we highlight several of the key provisions related to fostering a green transition and their investment implications.

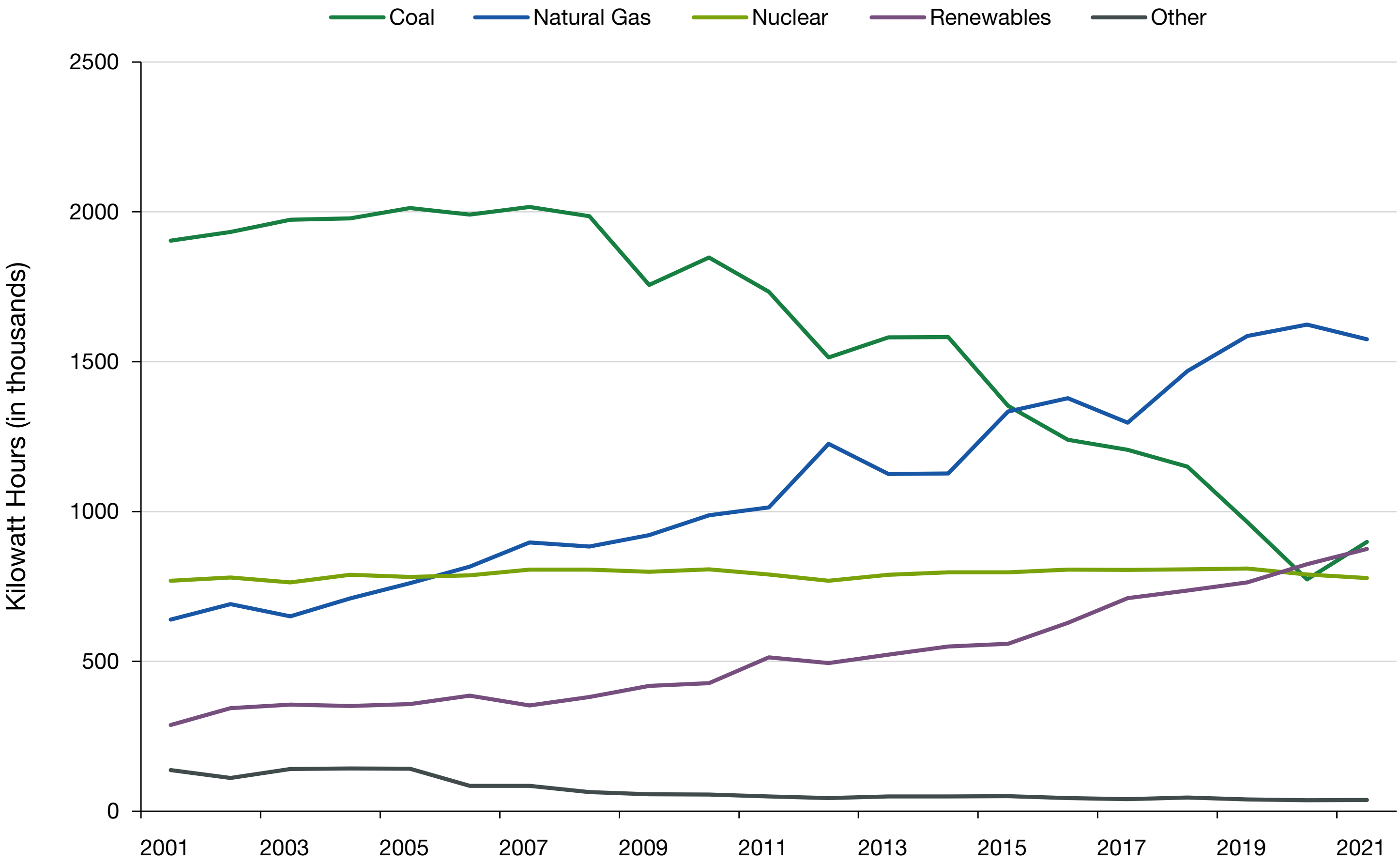
IRA's Key Climate Provisions and Potential Beneficiaries

Renewable Utilities & Generation

The IRA benefits renewable utilities in several ways, primarily by using tax credits to incentivize the development and deployment of clean energy technologies. The Act extends income tax credits (ITC) and production tax credits (PTC) for solar and wind generation and allows for new ITC and PTC for energy storage, green hydrogen, and nuclear projects. These tax credits reinforce the cost advantage of non-emitting energy resources.

Figure 1. Electricity Generation from Renewables Will Receive Additional Support from the IRA

Annual U.S. electricity generation from all sectors in billions of kilowatt-hours (kWh) for the period 2001 to 2021



Source: U.S. Energy Information Administration (EIA). Data as of 12/31/2021. Most recent annual data available. The kilowatt-hour is a unit of energy equal to one kilowatt of power sustained for one hour and is commonly used as a measure of electrical energy. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

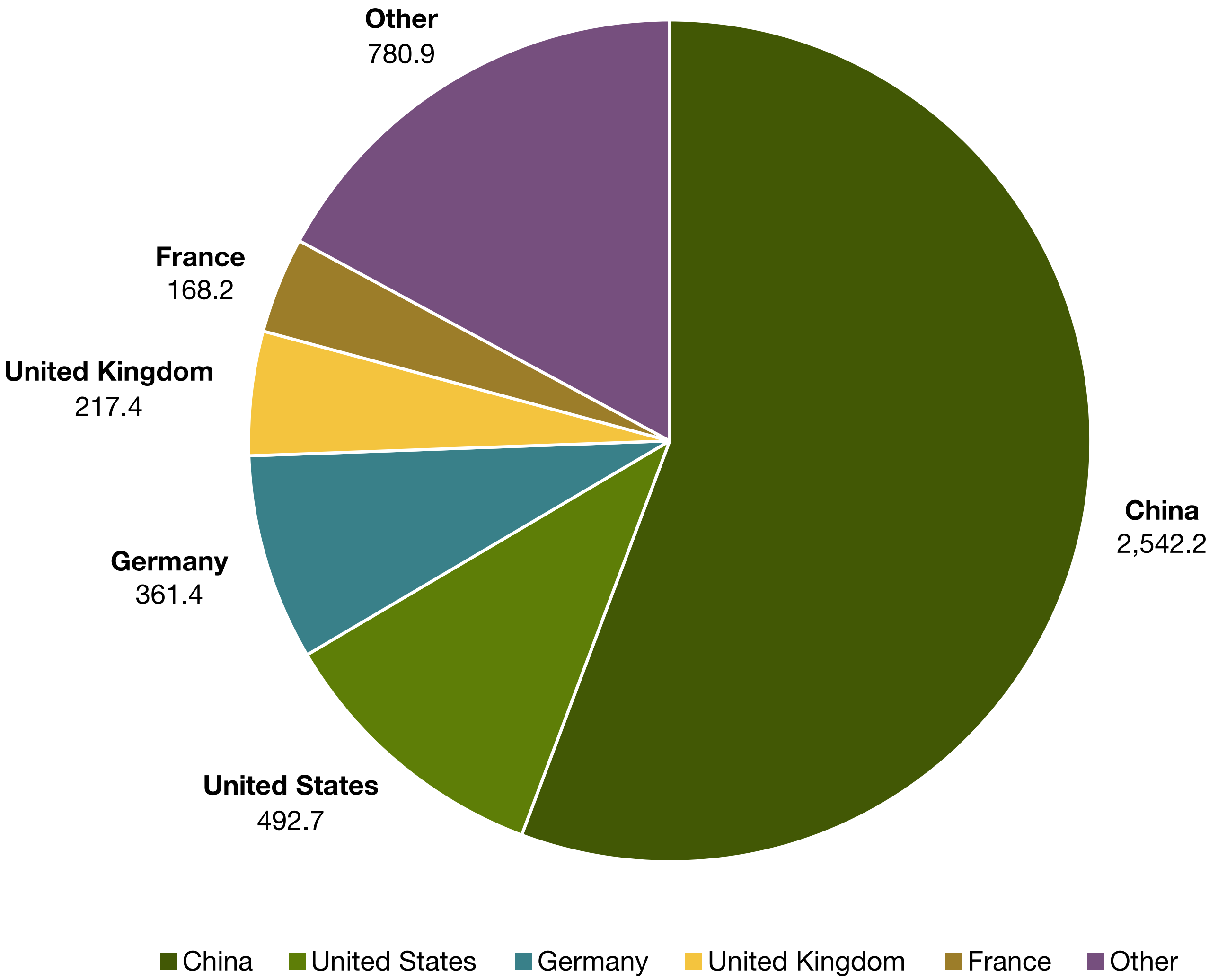
In addition, a 30% ITC for battery storage will make countering intermittency more affordable and expand demand for utility-scale battery installation. Renewable project developers like NextEra Energy and AES may potentially benefit from the addition of battery storage to existing generation projects and the increasing presence of storage in utility RFPs (request for proposal) for greenfield projects. Wind turbine manufacturers, such as TP Composites, and commercial-scale solar panel manufacturers may also see increased demand. Green hydrogen is a burgeoning industry, and the inclusion of tax credits for the energy source may potentially benefit hydrogen-related business models like Plug Power and Bloom Energy.

Electric Vehicle (EV) Manufacturers & Suppliers – Significant Room for Growth in U.S. EV Sales

The IRA offers up to $7,500 toward the purchase of a new electric vehicle and up to $4,000 toward the purchase of a used electric vehicle, while also offering credits for qualified, commercial clean vehicles. Clean vehicle credits for consumers and commercial buyers will last through 2032. Additionally, the IRA will extend and modify the tax credit available for electric vehicle charging stations.

Figure 2. While the U.S. Already is the Second Largest Battery EV Market by Volume…

2021 battery EV sales volume by number of vehicles sold (in thousands)



Source: Bloomberg. Data as of 06/30/2022. Other represents EV vehicle sales in countries worldwide, including battery electric vehicles sold in unspecified countries. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

Consumer and commercial demand for EVs has already been growing steadily. In our opinion, these provisions will accelerate existing demand and cause increased EV capital expenditures by the Original Equipment Manufacturers (OEMs). Key beneficiaries may include EV manufacturers like Tesla (and increasingly Ford, General Motors, and other U.S. OEMs), as well as parts suppliers like Borg Warner and Aptiv. In the near- to medium-term, however, we think EV supply will remain constrained due to raw material shortages and supply-chain constraints.

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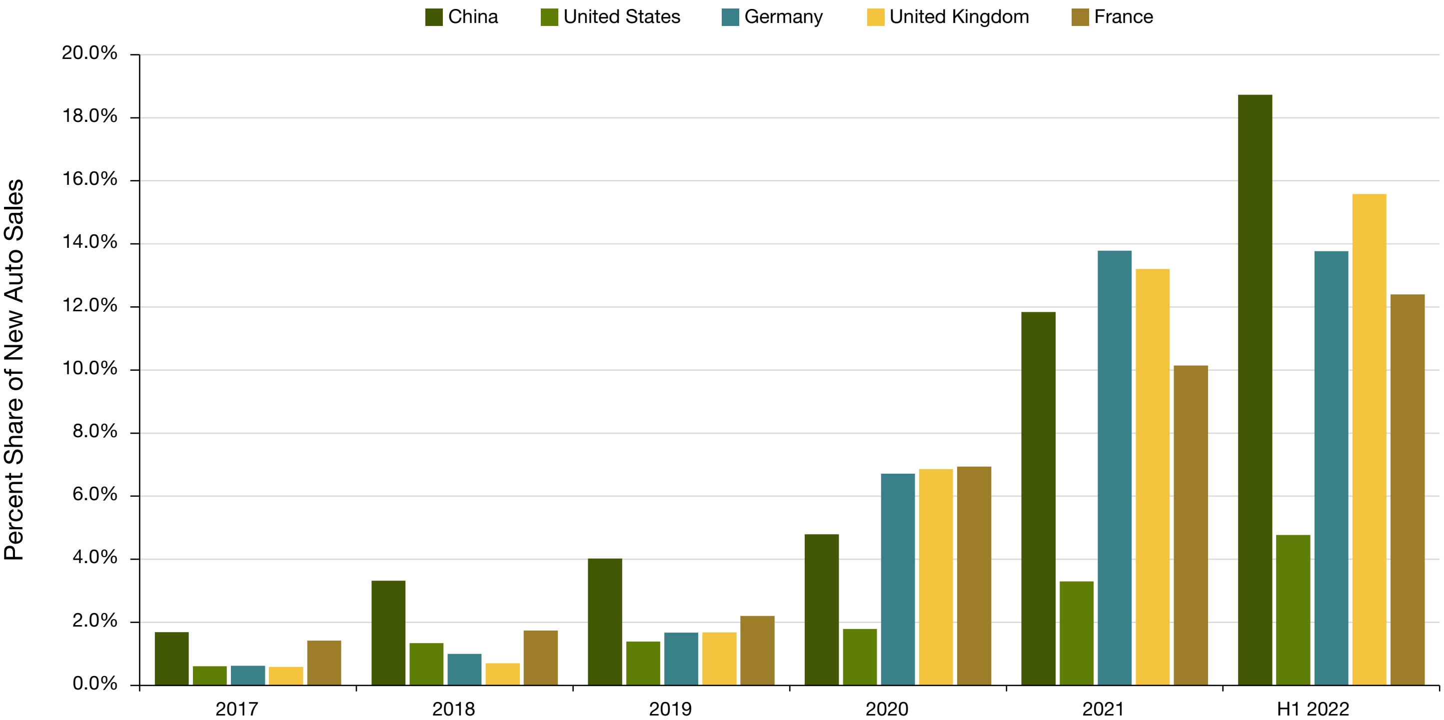
Figure 3. …EV Sales in the U.S. are Poised to Increase Further with New IRA Provisions

Annual new battery EV sales as a percentage of total new vehicle sales for the periods shown



Source: Bloomberg and Lord Abbett. Data as of 06/30/2022. H1 = first half. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

Residential Solar

The domestic solar industry is potentially a huge beneficiary of the IRA, as Act provisions should drive increased demand for residential solar installations. The Bill provides for 30% off the cost of rooftop solar, which amounts to an average savings of $7,000.[2] The Bill also offers 30% off the cost of home batteries for the first time and incentivizes domestic manufacturing of components related to clean energy equipment production, including solar PV (photovoltaic) cells, through production credits. The incentives in the Bill make residential solar increasingly attractive from a financial perspective, and we believe the domestic solar industry, including manufacturers and installers, will benefit. For example, Sunrun has 726,000 customers, but CEO (Chief Executive Officer) Mary Powell believes the market has barely been tapped. She says that "77 million homes in the U.S. could adopt solar, and only 4% of them have done so."[3]

Carbon Capture, Utilization & Storage (CCUS)

While still a small market, the IRA is increasing the tax credits for CCUS and direct air capture. CCUS involves the capture of carbon dioxide (CO_2) emissions from coal-fired and other power plants and from industrial facilities. The captured CO_2 is either reused on site or compressed and transported for permanent storage, where it is injected into deep geological formations including depleted oil and gas reservoirs or saline formations. Tax incentives from the IRA may be the catalyst needed to bring these technologies more into the mainstream, and while there are limited direct ways to invest in them in the public markets, we think this is a sector to watch closely.

Green Buildings

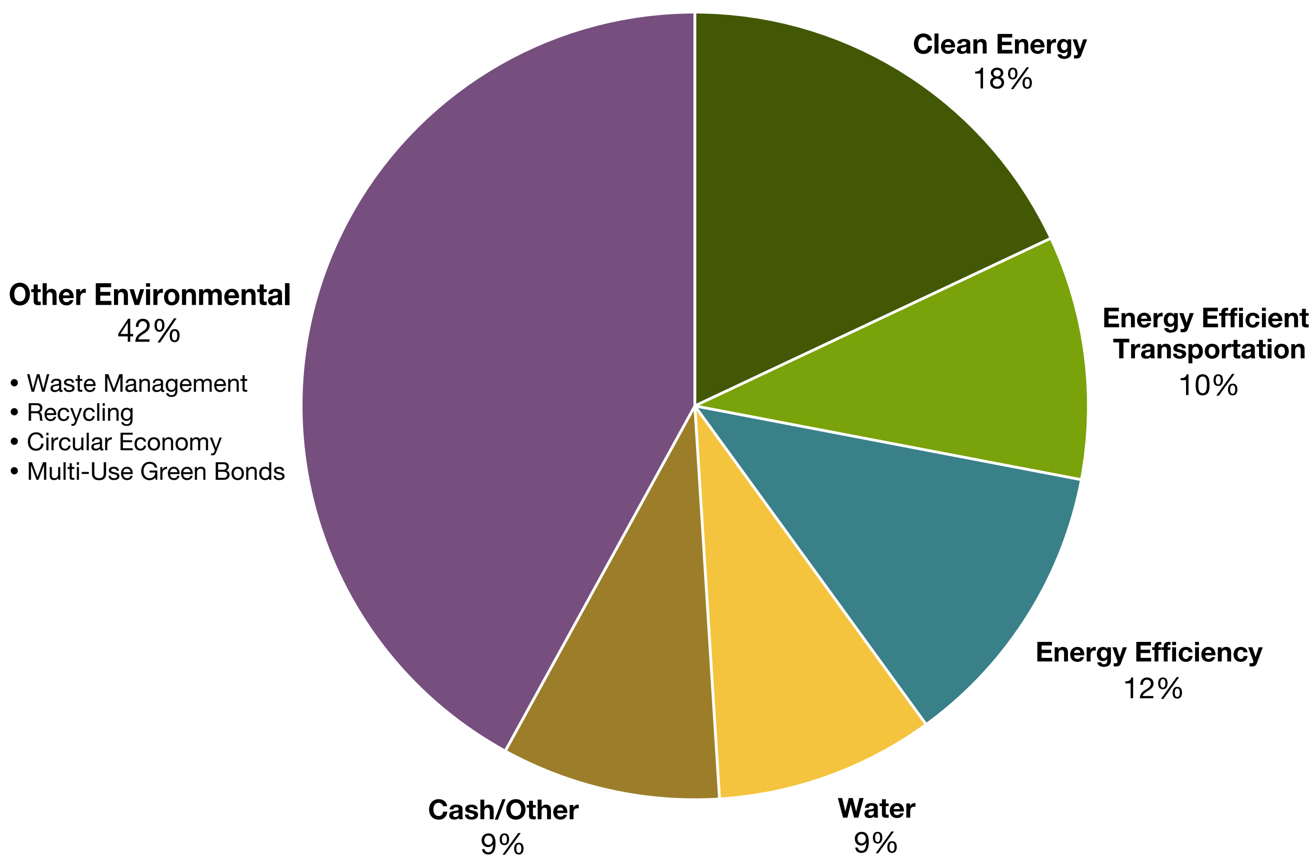
Both commercial and residential properties potentially stand to benefit in efforts to improve energy efficiency. The Inflation Reduction Act offers homes up to $14,000 in rebates to switch over to electric appliances—covering up to 50% of the costs for moderate-income households and 100% of the costs for low-income households. An alternative rebate option offers to cover more than 50% of the cost of whole-home energy efficiency retrofit or more than 80% in the case of homes occupied by low- or moderate-income households. Commercial properties and new home construction stand to benefit from expanded and extended commercial building-deductions to incentivize energy efficiency.

Lord Abbett Climate Focused Bond Fund—Themes & Potential Investment Implications

The Lord Abbett Climate Focused Bond Fund invests across five key climate-related themes—clean energy, energy efficiency, water, energy efficient transportation, and other environmental (recycling, circular economy, and other small but growing areas of opportunity). We believe this thematic investment approach has become more relevant over the past two years as global regulatory trends and capital flows into sustainable business models continue to accelerate. We believe the passage of the Inflation Reduction Act further reinforces the relevance of the thematic approach as it will direct a significant amount of capital toward the issuers that are prominent in the themes in which the Fund invests. In our opinion, the core fund themes like clean energy, energy efficiency, and energy efficient transportation stand to benefit the most from provisions we have highlighted within the IRA.

Figure 4. Climate Focused Bond Fund Thematic Exposure

The five climate-related themes as a percentage of total Fund assets as of 06/30/2022



Source: Lord Abbett. Thematic exposure as of 06/30/2022. The Fund's portfolio is actively managed and is subject to change. The percentage of the portfolio in positive climate impact bonds is based on our own assessment of the holdings in the portfolio. Cash/Other may include U.S. government-related securities.

Clean Energy: Clean energy historically represents the largest single theme by investment allocation of the Climate Focused Bond Fund, and we believe this theme is one of the primary beneficiaries of the IRA. The Fund invests across the clean energy supply chain—from component manufacturers to developers and renewable generation companies. We think the IRA may benefit renewable-focused utilities and solar panel manufacturers.

Energy Efficiency: The Fund seeks to invest a meaningful proportion of its total assets in issuers that improve energy efficiency across a wide range of applications—from appliances and vehicles to industrial operations. In our opinion, a number of provisions in the IRA, such as tax credits for building or remodeling residential properties that meet Energy Star requirements, may benefit these types of issuers.

Energy Efficient Transportation: Electric vehicle demand continues to strengthen. In our opinion, the provisions in the IRA will accelerate the trend further. We think EV OEMs and suppliers will benefit from the extension and modification of tax credits for purchasing new and used EVs and for installing charging stations.

Closing thoughts

One of Lord Abbett's core beliefs as it pertains to sustainability is that **the global transition to a low carbon economy will lead to unprecedented innovation**. This innovation, in our opinion, will drive capital flows towards new technologies and products, which in turn leads to attractive investment opportunities for active managers like Lord Abbett.

This belief was one of the key drivers behind the launch of our Climate Focused Bond Fund in 2020, which invests in environmental-related sectors and companies that we believe will benefit long term from the energy transition and an increasing focus on sustainability. Our global multi-sector approach that focuses on both labeled and unlabeled green securities seeks to actively allocate to the most attractive investment opportunities in these sectors, with the ultimate goal of delivering sustainable, risk-adjusted returns to our clients.

We would like to thank Alan Kurtz, Managing Director and Portfolio Manager, and Richard Bateman, Research Analyst, for their contributions to this article.

[1] Mark Strouse, CFA, Drew Chamberlain, J.P. Morgan, "*Alternative Energy and Services Summer Series*," August 2022.

[2] "*Inflation Reduction Act Expected to Become Law*", Barker Hostetler, August 8, 2022.

[3] Avi Salzman, "*Leading Solar CEO Says Bill Will Accelerate Green Shift*", Barron's, August 8, 2022.

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Important Information

New Fund Risk: The Fund is recently organized. There can be no assurance that the Fund will reach or maintain a sufficient asset size to effectively implement its investment strategy.

A Note about Risk: The Fund is subject to the general risks associated with investing in debt securities, including market, credit, liquidity, and interest rate risk. The value of your investment will change as interest rates fluctuate and in response to market movements. When interest rates fall, the prices of debt securities tend to rise, and when interest rates rise, the prices of debt securities are likely to decline. The Fund is subject to the risk that its climate-focused investment strategy may select or exclude securities of certain issuers for reasons other than investment performance considerations which may negatively affect its performance relative to unconstrained peers. Certain climate-focused investments may be dependent on government policies and subsidies, which are subject to change or elimination. The Fund may invest in high yield, lower-rated debt securities, sometimes called junk bonds and may involve greater risks than higher rated debt securities. These securities carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. The Fund may invest in foreign or emerging market securities, which may be adversely affected by economic, political, or regulatory factors and subject to currency volatility and greater liquidity risk. The Fund may invest in derivatives, which are subject to greater liquidity, leverage, and counterparty risk. The fund performance history at this time is very limited; therefore, performance achieved during its initial period of investment operation may not be replicated over longer periods and may not be indicative of how the Fund will perform in the future. These factors can affect Fund performance.

The Fund's portfolio is actively managed and is subject to change.

Mentions of specific companies are for reference purposes only and are not meant to describe the investment merits of, or potential or actual portfolio changes related to securities of those companies.

Unless otherwise noted, all discussions are based on U.S. markets and U.S. monetary and fiscal policies.

Asset allocation or diversification does not guarantee a profit or protect against loss in declining markets.

No investing strategy can overcome all market volatility or guarantee future results.

The value of investments and any income from them is not guaranteed and may fall as well as rise, and an investor may not get back the amount originally invested. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon, and risk tolerance.

Market forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

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The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

Fixed-Income Investing Risks

The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price.

The credit quality of fixed-income securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

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Glossary & Index Definitions

Environmental, social, and governance (ESG) criteria are a set of standards for a company's operations that socially- conscious investors use to screen potential investments.

Green bonds: Labeled green bonds are bonds that earmark proceeds for climate and environmental projects. Labeled green bonds are often verified by a third party, which certifies that the bond will fund projects that include environmental benefits. Unlabeled green bonds (or climate-aligned bonds) are securities whose proceeds are supposed to be used for climate-aligned projects and initiatives but are issued without formal certifications.

Paris COP21 Agreement: The Paris Climate Conference is officially known as the 21st Conference of the Parties (or "COP") to the United Nations Framework Convention on Climate Change (UNFCCC), the United Nations body which is responsible for climate and based in Bonn, Germany.

Income tax credit is an amount of money that taxpayers can subtract directly from the taxes they owe. This credit applies to the costs associated with installing a solar photovoltaic (PV) system in that tax year.

A Production tax credit (PTC) provides a tax credit of a certain amount per kilowatt-hour over a specified amount of time of electricity generation.

Energy Star is a widely recognized and trusted label on products that meet strict energy-efficiency requirements set by the U.S. Environmental Protection Agency (EPA).

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