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Sharper Focus on Sustainability

Insight from sub-adviser Wellington Management

Wendy Cromwell, CFA
Director of Sustainable Investment

Key Points

- In 2021, our Impact Investing Team will focus on opportunities in areas of the market that represent much-needed solutions in the COVID-19 era, including healthcare, digital connectivity, and technical support for small businesses.
- Our Climate Research Team will deepen its research agenda to more fully understand and value the advancing risks and high costs of climate change.
- Our ESG Research Team will engage on critical issues such as transparency, diversity and inclusion, executive compensation, and resiliency.

Campe Goodman, CFA
Fixed-Income Portfolio Manager

Tara Stilwell, CFA
Equity Portfolio Manager

THE DEFINING ISSUES OF 2020 WERE A STARK REMINDER OF THE INEXTRICABLE LINKS BETWEEN CAPITAL MARKETS AND REAL-WORLD EVENTS. Investors do not sit in a siloed world of earnings reports and Bloomberg screens. They are very much a part of the global economy, which is shaped by climate change, public health crises, and social justice issues.

Real-world events present both opportunities and risks for financial-market participants. COVID-19 jolted the world awake to the economic devastation a pandemic can cause, highlighting the need for market-based solutions that help society prepare for and manage such a crisis. A record year for heat, hurricanes, and wildfires displayed the advancing risks and high costs of climate change in real time. And increasing calls for companies to take a leading role in improving social justice and racial equity have permeated industry discourse.

Looking toward 2021, these challenges affirm the need for us to continue to engage with companies and issuers on their response to social justice concerns, their preparedness for physical climate risks, and their approach to human-capital management and supply-chain resiliency in the COVID-19 era. We believe that both engagement and market-pricing signals can prompt issuers to adapt and build resilience to real-world risks.

We also feel compelled to expand our offerings that invest in solutions to some of the world's most pressing problems. We plan to deepen our climate research agenda to more fully understand and value the impact of physical and transition risks on companies, economies, and society. And we will engage on social justice, diversity, and inclusion, and other material environmental/social/corporate-governance (ESG) issues. As always, our primary objective is to deliver competitive total returns for clients across the investment platform. We firmly believe that these initiatives will help us do so.

In this outlook, members of our Impact Investing, Climate Research, and ESG Research teams share the themes they plan to focus on and continue discussing with clients and portfolio companies.

IMPACT INSIGHTS

Impact Investing: Looking for Solutions That Matter Most

In 2021, we plan to continue our research into our 11 impact themes, with a particular focus on new opportunities in certain areas that we have identified as representing much-needed solutions in the wake of the COVID-19 pandemic.

> The pandemic has revealed a widespread lack of access of affordable, quality healthcare and chronic underinvestment in healthcare infrastructures.

Digital Connectivity

As the world went into lockdown, reliable digital connections became social and economic lifelines almost overnight. Expanding, improving, and securing digital connectivity remains an overarching concern as lockdowns and social-distancing requirements drag on.

As schools and higher-education institutions struggle to adapt and expand online teaching, the need for technologies that enable communication and connectivity has exploded. And as the societal benefits of remote learning become entrenched, we hope improved access will translate to better educational outcomes for more students, particularly in underserved populations.

The surge in remote connectivity also highlights the risk of cyberterrorism. Computer hackers targeting hospitals, food-supply chains, and other critical infrastructure have been more active during the pandemic, as have phishing scams aimed at destabilizing business activity. We will continue to try to identify innovative technologies with a positive impact in this area. In fixed income, we will look at the debt of companies providing telecommunications, broadband, and cellular solutions in rural areas and developing countries.

Healthcare

The ramifications of COVID-19 on healthcare systems will likely be profound and long-lasting. The pandemic has revealed a widespread lack of access to affordable, quality healthcare and chronic underinvestment in healthcare infrastructures. In 2021, we expect to continue our research into biopharmaceuticals companies developing novel treatments for diseases, including COVID-19. We also expect to focus on molecular diagnostics capabilities, as the public-health crisis has highlighted the need for real-time testing and diagnostics.

We'll be looking at businesses whose tools help healthcare professionals capture and analyze data, save time, and treat more patients safely and efficiently. These include pre-mixed-insulin delivery systems, remote sensors, and dictation software. Technologies such as these can reduce errors and increase the time that providers can spend with patients, all while helping to keep doctors and nurses safe by minimizing touchpoints on workstations and devices.

Within fixed income, we will focus on not-for-profit hospitals in the US. Many such facilities have launched efforts to increase or create virtual urgent-care consultations to treat patients at home. While the crisis pressured valuations of these and many other credit assets, the combination of easing lockdown measures, more short-term financing, and government support has helped us maintain confidence in these critical resources.

Support and Infrastructure for Small- and Medium-Sized Enterprises

When lockdown measures brought some sectors of the global economy to a screeching halt, small businesses scrambled for liquidity to stay afloat. The need for cash has prompted a significant increase in new public-bond issuance. Some of the commercial and international development-bank green bonds in which we invest make loans to small enterprises, and many have come to market with so-called COVID-19-relief bonds. While their function may not have materially changed, the moniker does highlight the impact these types of loans can have during a crisis.

Longer term, small businesses may need to pivot away from brick-and-mortar dependency and develop a strong online presence to survive. This need creates vulnerabilities as the costs to shift business models can be high. We will continue to seek opportunities to invest in platforms that enable small businesses to scale up their online business and become proficient and competitive.

COVID-19 has underscored the direct and immediate effects that an existential threat can have on society and the global economy.

Clean Water

In many regions, water scarcity is a critical problem. The social and economic challenges of clean-water access will garner increasing attention from markets and policymakers, and 2021 could be a tipping point. As governments focus on infrastructure spending to ensure economic resiliency in the wake of the pandemic, updating aging water infrastructure is a likely goal.

Desalination technologies interest us, but the costs, logistical hurdles, and potential negative externalities have kept the market too small to invest in. With climate change exacerbating water scarcity, desalination may become a viable option in some regions in coming years. For now, we seek to invest in impact companies along the water-value chain, including delivery of clean water and water reuse. We believe businesses will increasingly find opportunities to consolidate and drive needed change, particularly by leveraging digital capabilities.

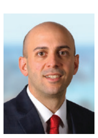
Impact of Green Deals

Discussions around potential large-scale "Green Deals" in the EU and US aimed at delivering fiscal stimulus and addressing climate change have underscored the linkage between economic recovery and environmental sustainability. As the scope and details of the deals are negotiated, we believe many strategies focused on alternative energy and resource efficiency will see their opportunity set accelerate as governments seek to direct regulation, policy, and capital.

Within fixed income, the issuance in 2020 of euro bonds and corporate issues aimed at funding green activities (green bonds) exceeded 2019's record-breaking pace, jumping from US$258 billion to an estimated US$350 billion.[1] With such a strong technical market backdrop, we expect issuance to further increase in 2021, across a range of issuers.

CLIMATE RESEARCH INSIGHTS

Climate Research: Drawing Connections and Going Deeper



Chris Goolgasian
CFA, CPA, CAIA
Director of Climate Research

Julie Delongchamp, CFA
Climate Transition Risk Analyst

COVID-19 has underscored the direct and immediate effects that an existential threat can have on society and the global economy. The need to understand the range, scale, and location of the risks and to establish coordinated policies based on scientific data are paramount. As we continue our climate research in 2021, we do so with the affirmation that climate change, like a pandemic, is an existential threat to global economic stability that investors and asset owners need to appreciate.

Continued Research on Physical Risks

In 2021, we will pursue an aggressive research agenda on the physical risks of climate change and the direct application into our investment processes.

[1] "Green Bonds Market 2020," Climate Bonds Initiative (climatebonds.net), 2020.

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Our work with Woodwell Climate Research Center continues, expanding to deepen and broaden our understanding of the intersections between climate change and capital markets. We will be researching the macroeconomic and microeconomic implications of climate migration, looking at physical, environmental, and geopolitical factors. We will also step up our work studying potential adaptive solutions to acute and chronic climate-related events, building on our evolving risk analysis. We will continue to expand our deep dive with country-level case studies to gain a broader understanding of the regional risks of climate change.

We will share our climate research with issuers and encourage them to develop climate-resiliency planning and set their own carbon-reduction targets. Our Physical Risks of Climate Change framework is designed to help issuers establish clear strategies for delivering and disclosing their progress in the near-to-medium term. Finally, we will explore practical ways of including the effects of physical climate change in the portfolio-construction process.

Expanding Global Focus on Transition Risks

Despite recent economic deceleration, the governments of several high-carbon-emitting economies, including China, Japan, and South Korea, have translated their commitment to the Paris Agreement into time-bound, net-zero, and carbon-neutrality commitments. In those countries and many others, stimulus plans to jump-start economic recovery are being seized as opportunities to create greener economies. The EU and UK in particular have focused explicitly on including green investments in economic-recovery funds, incentive schemes, and regulation.

And while the US formally withdrew from the Paris Agreement in 2020, significant state and local action continues, with 23 states (including five of the 10 highest emitters)[2] establishing their own greenhouse gas emissions targets. In the next few years, we expect an increasing number of local and national commitments to transition to a low-carbon economy, with potentially profound effects on nearly every industry and sector.

In 2021, we will continue to work with our colleagues on the Global Macro Team to identify opportunities to invest in companies that deliver products and services that support decarbonization. We believe government-sponsored recovery incentives and emerging carbon regulation, along with significant, sustained demand, should allow these companies to benefit from a lower cost of capital and revenue tailwinds.

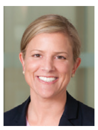
We find that market participants increasingly recognize climate mitigation and strategic transition efforts as having a material impact on investment returns and, more broadly, on the overall stability of the global financial system. In 2020, two global initiatives—the Paris Aligned Investment Initiative, started by the Institutional Investors Group on Climate Change (IIGCC), and the United Nations-convened Net-Zero Asset Owner Alliance—presented the first frameworks for asset owners to incorporate carbon neutrality as a core objective, alongside financial returns. We have seen, and believe we will continue to see, rapid and increasing momentum behind such initiatives, creating a call to action for large, global asset managers, including Wellington Management.

[2] Center for Climate and Energy Solutions, World Resources Institute.

We will engage with our clients in 2021 to develop, evaluate, and implement methods for approaching carbon neutrality in the portfolios we manage on their behalf. Our team will work with each portfolio manager to ensure consistency with their investment philosophy and process. The transition to a low-carbon economy depends in large part on markets. Our goal is to actively support that shift while continuing to deliver competitive investment returns for our clients.

ESG INSIGHTS

ESG and Stewardship: More Opportunities for Engagement



Hillary Flynn
Director of ESG
Private Investments

Carolina San Martin, CFA
Director of ESG Research

COVID-19 has highlighted the potential for ESG factors to become even more relevant to our clients' investments. This year, an unprecedented number of our conversations with companies have broached ESG topics, and we expect that trend to continue in 2021. Keeping workers and customers safe, building supply-chain resilience, better aligning executive compensation with long-term success: Issues like these are recognized by parties on both sides of the table as material to our investment framework.

Transparency in the Wake of COVID-19

One of the biggest shifts we've seen during COVID-19 is an increased openness among boards and management teams to engage on a wider range of ESG issues. The pandemic's black-swan nature has crystallized a realization that company leaders cannot predict everything, yet they must be prepared for anything. We find that companies are now acknowledging that long-range topics such as climate change, scenario planning, and crisis management are not outside their planning horizon.

With companies welcoming this dialogue and given our continued focus on risk management, we will discuss issues such as the following:

- What were your priorities at the onset of the pandemic, and how have they shifted? What would you have done differently?
- How has this crisis informed your strategic planning?
- How are you proactively mitigating the unique risks facing your company? What new opportunities or risks might emerge after the crisis has passed?
- How have you sought to maintain your company culture and values during the pandemic?
- What steps are you taking to ensure employees are safe and have the physical and mental health resources they need through this challenging time?
- What feedback have you received from customers, vendors, suppliers, and shareholders on how your company has responded to COVID-19?
- How do you approach burden-sharing across leadership, employees, customers, and shareholders? Are there metrics in place that allow the board to use discretion over CEO compensation?
- Has the crisis exposed a need for additional skills or backgrounds on your board?

Executive Compensation

We have been seeing greater scrutiny of the size and structure of executive-compensation plans, a trend that will almost certainly continue in 2021. Boards in many industries are struggling to manage incentive plans, since the

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performance hurdles established at the beginning of 2020 are now unachievable. We are seeking opportunities to engage, provide feedback, get ahead of detrimental behavior, and support pay/performance alignment in our clients' best interest.

We will be considering how companies plan to rebuild their balance sheets while encouraging growth, and asking how boards gauge executives' engagement with employees, now that so many are working from home.

The international context of US executive pay may also be a focus in 2021. Over the past few years, the quantum of pay has become a sensitive topic in Europe and Australia, occasionally leading to low shareholder support for executive-pay plans. European companies are already required to enhance compensation disclosures, and plans are subject to annual shareholder reviews and votes. A few companies had acknowledged late last year that global pay discrepancies were hampering talent recruitment and retention, especially at the CEO and CFO positions. We wondered which way the pendulum would swing: Would US companies continue to enjoy a talent advantage, or would this global trend eventually put pressure on US pay packages?

And then COVID-19 happened. In the face of layoffs and furloughs, outsized executive-pay plans suddenly fell out of favor globally, including across the US. While many companies showed solidarity with employees early on, with C-suite executives announcing voluntary pay cuts, we will be looking for signs of companies' future plans. For example, will this behavior continue throughout and after the crisis? Will performance targets stay reduced? Will incentives see a permanent shift?

Diversity and Inclusion

Assessing companies' efforts to improve diversity and inclusion (D&I) has long been an engagement priority for us, as we see this issue as a material input to performance. In 2020, we heightened our focus in this area following multiple instances of racial inequity and injustice across the US. In 2021, we plan to redouble our engagement efforts to better understand our portfolio companies' response to racial inequity. This dialogue will form the basis of a practice-sharing document that we plan to share publicly.

In 2020, we hosted our first diversity panel, featuring D&I executives from leading consumer-sector companies, who discussed challenges and lessons learned. Our goal is to gain deeper knowledge of the companies we invest in on behalf of our clients, enhance our internal approach to D&I by learning from others, and facilitate practice-sharing across a wide swath of companies. We expect that the lessons we learn in this process will change how we hold portfolio companies accountable, including via our proxy-voting policies.

Private-Sector ESG

In 2020, we created a dedicated ESG analyst role focused exclusively on the private market. We plan to deepen and broaden that work in 2021. We believe helping portfolio companies understand and address material ESG issues early in their life cycles is a long-term benefit for them. It also helps us make better investment decisions and develop stronger relationships with young companies. We find that private-company management teams increasingly realize that enhancing ESG practices can translate into better potential financial returns, broader investor appeal (especially among sophisticated institutional investors), stronger brands with wider competitive moats, and reduced risk of shareholder activism once they go public.

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