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Responsible Investment in Emerging Markets Credits

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1. Introduction

As a long-term investor, PGGM Vermogensbeheer B.V. (PGGM Investments, hereinafter PGGM) is committed to investing responsibly. PGGM manages its clients' Emerging Markets Credits investments in order to contribute towards a stable pension for their participants while also taking into consideration its impact on the world. PGGM recognizes that environmental, social, and governance (ESG) factors have a material impact on the financial performance of the portfolio, especially in the longer term. As such, integrating ESG issues into investment analysis and decision-making processes is part of its fiduciary duty.

This guideline addresses PGGM's management of ESG issues with regard to Emerging Markets Credits. The guideline is a further refinement of PGGM's Responsible Investment Framework and its implementation guidelines and the relevant fund prospectus and ancillary documentation. In addition, the obligations arising from compliance with legislation and regulations apply. The guidelines cover all investments made by Emerging Markets Credits, effective as of 1 January 2021.

2. Investment strategy & approach

On behalf of PGGM's clients, the Emerging Markets Credit team invests in investment grade and non-investment grade emerging market corporate bonds and manages an investment mandate that is evaluated first and foremost by benchmarked financial returns. The Emerging Markets Credit team's high-level ESG objective is to be a best-practice investor within the confines of a benchmarked financial mandate.

The primary goal of the Fund is to generate a net return that over a credit cycle of 3 to 5 years generates a 0.25% outperformance compared to the benchmark return, through constructing a portfolio of emerging market corporate bonds with an investment grade or non-investment grade Credit rating.

Portfolio companies are analysed and monitored on their strategic and financial merits as well as their ESG performance. The latter is expected to help reduce investment and reputational risks or increase (expected) returns of the portfolio.

By having in place a transparent responsible investment guideline for Emerging Markets Credits, as further outlined in this document, and by actively taking into account ESG-related performance in investment decisions, Emerging Markets Credits believes that it offers a positive contribution that is best practice and in line with the clients' stated objectives.

The Emerging Markets Credits team aims is to be fully compliant with obligations arising from legislation and regulations. The relevant standards, codes of conduct or (inter)national initiatives or legislation that apply and have an impact on implementation are discussed below. For more detailed information please see PGGM Investments website.

3. Implementation

3.a ESG-integration

PGGM defines ESG integration as systematically taking into account those ESG factors that have a material effect on investment risk and return. Across its entire portfolio PGGM uses the Materiality Map of the Sustainable Accounting Standards Board (SASB) as the framework to identify material ESG issues per sector. Similarly, Emerging Markets Credits takes the SASB Materiality Map into account when analysing ESG risks and opportunities in the investment process. ESG risks are defined as risks for the financial returns that stem from material ESG factors.

The team's ESG objective is to be a best-practice investor within the confines of a benchmarked financial mandate. This goal is pursued by adopting a systematic approach for the integration of ESG factors into the internal research framework of the investment team. Data provided by third parties (Sustainalytics, MSCI) is used to perform ESG-due diligence and to improve knowledge and understanding of ESG risks. The introduction of a more systematic approach and the integration of third party research also works towards improving transparency and consistency of the Emerging Markets Credit team's ESG analysis.

Companies operating in emerging markets can be exposed to several ESG risks such as human rights controversies, governance and climate-related risks (both physical and transition) which are a source of potential financial and reputational risk and are therefore consistently included in investment decisions in the portfolio. The value of investments in companies with fossil fuel activities might decline when governments come up with stricter fossil fuel legislation. Public controversy around environmental topics like palm oil production and social issues like human rights controversies are perceived as risks on the return of the fund.

Emerging Markets Credits rates the ESG score of the investment portfolio against the benchmark. The Investment Grade Credit team will consult the Responsible Investments department (RI) for the high ESG risk companies. Any opinions and considerations provided by RI will be taken into considerations in The Investment Grade Credit team's decision process. The Investment Grade Credit team may still invest in companies with weak ESG practices when there is an improving trend. When possible PGGM engages with companies to raise awareness at the company level of the concerns and communicate the expectations of improvement. The goal is to improve specific ESG criteria at the company level as this will improve the investment risk of these companies in the portfolio

Emerging Markets Credits continuously monitors its investment portfolio and with a strong focus on inter alia ESG risks and positive impact opportunities. It is monitored whether the issuers of green or social bonds fit the criteria at the time when they were added in the portfolio. For the corporate green bonds in the portfolio the Emerging Markets Credit team has developed a decision tree which allows for structural integration of ESG and positive impact in the investment process.

3.b Impact

In addition to a better-performing portfolio, Emerging Markets Credits seeks to enhance the positive impact of its investments and to minimize adverse impacts even when they do not directly affect the financial performance.

1. Positive impact: investing in the SDGs

In 2016 PGGM and APG defined Sustainable Development Investments (SDIs) as "investments that yield market-rate financial returns while generating a positive social and/or environmental impact" (i.e. contribute to the Sustainable Development Goals). In 2020 Australian Super, British Colombia Investment Management Corporation joined APG and PGGM in the SDI-Asset Owner Platform which owns a taxonomy of products and services (solutions) that contribute to the SDGs. With a set of decision rules the taxonomy forms the basis for the classification of investments as 'SDI'.

PGGM main client's ambition is to increase the SDI volume to 20% of the total portfolio by 2025. The effort to measure portfolio companies' real-world impact, however, is currently limited to seven focus SDGs: #2 (zero hunger), #3 (good health and wellbeing), #6 (clean water and sanitation), #7 (affordable and clean energy), #11 (sustainable cities and communities), #12 (responsible consumption and production) and #13 (climate action). To estimate and monitor the impact on these focus SDGs, the indicators suggested by the Working Group on SDG impact measurement of the DNB-facilitated Sustainable Finance Platform are used.

There are several opportunities in the corporate green and sustainable bond space to invest in SDI's. Green bonds enable capital raising and investment for new and existing projects with environmental benefits. Social bonds focus on social themes such as healthcare or social housing. The Emerging Market Credit fund can also invest in Sustainability-linked bonds where the interest coupon of the bond over the life of the bond is linked to the performance of the company on specific sustainability themes.

The supply of corporate green and sustainable bonds which are eligible to invest has been limited but is growing. At this moment the market needs further standardization in order to attract a more diverse investor base.

The team's engagement activities include (improving) portfolio companies measurement of impact, on improved reporting and on integrating the SDGs into the business strategy of portfolio companies.

2. Minimise negative impact

The social and environmental impact of the capital entrusted to PGGM by its clients is significant. PGGM can stimulate a positive contribution to a sustainable world and has the responsibility to minimise adverse impact. Adverse impacts refers to negative impacts (harm) to individuals, workers, communities and the environment.

As from 1 January 2022 at the latest, PGGM shall avoid new investments in companies that are in very severe violation of the OECD Guidelines for Multinational Enterprises (hereinafter OECD guidelines) and/or the UN Global Compact principles. When feasible, PGGM shall undertake best efforts to divest existing exposures to these companies all together and/or shall engage with the companies, or a selection thereof, that are in (very) severe violation of the OECD guidelines and/or the UN Global Compact principles.

The Emerging Markets Credit team has a strategic focus towards specific sectors, and it differentiates between good and bad ESG performers within a sector. A low performance on specific ESG indicators can be a reason for further engagement with this company.

Based on its high likelihood and severity, climate change as a driver of adverse impact its prioritized. Clients of PGGM's have committed themselves to the Dutch Climate agreement[1] and to the Paris Climate Agreement to align policies consistent with the objective to limit the global temperature rise to a maximum of 1.5 °C. The ambition is

1 In Dutch "Klimaatakkoord"

to have a climate neutral investment portfolio by 2050 - in line with the ambition of the European Union and the Paris objectives.

The Emerging Markets Credit team is committed to gather data to allow for the measurement of portfolio emissions. The team is currently developing a methodology how to gather emissions data for its portfolio. This can be achieved via external sources like Trucost or the company itself.

3.c Stewardship (engagement, voting, shareholder litigation)

PGGM Emerging Markets Credits uses its influence as a bondholder to achieve improvements in the ESG field, thereby contributing to the quality, sustainability and continuity of companies and markets. PGGM sees it as its responsibility to engage with market parties and companies about their policies and activities. In this way, it attempts to realise ESG-related improvements. If PGGM is also shareholder in a specific company it applies customized voting principles, written down in the PGGM Voting Guidelines.

The Emerging Markets Credit team engages with companies on specific ESG topics where a company has higher ESG risk on specific ESG factors that are material for its industry. The engagement themes can be on environmental, social and governance topics. The SASB Materiality Matrix provides input for the engagement topics. The team can have direct engagement with the company or can also participate in collaborative engagement activities with other investors.

PGGM notes that engagement from fixed income investors is a new phenomenon. Historically, equity holders as shareholders have voting rights and can use these, alone, or in consort with other investors to achieve change. Bondholders have no such direct control over a company's behaviour and will have to rely on alternative tools.

In the engagement activities of the Emerging Markets Credits the focus is on applying soft pressure, such as raising concerns, educating and raising awareness. Engagement activities are considered successful when the company starts implementing the measures suggested in the engagement process.

Emerging Markets Credits may consider reducing or exiting an investment if it considers the response to engagement activities inadequate or unsatisfactory. This is determined on a case-by-case basis. Input for the decision to reduce or exit an investment can the development of ESG scores over time. There is no hard limit or timeframe to make such a decision.

PGGM further notes that in the global capital markets, there is still considerable room to improve communication between the various asset classes (such as equity and fixed income), and even between investors within an asset class (such as corporate credits) and there is no established platform to effectively coordinate actions. The Emerging Markets Credit team encourages cooperation between investors with the goal of promoting best practices in the industry.

3.d Exclusion

The PGGM Implementation Guidelines on Exclusion are applicable to investments in all asset classes, including Emerging Markets Credits. The PGGM-wide product-based Exclusion List consists of companies engaged in controversial weapons, tobacco, tar sands as well as thermal coal utilities and mining companies.

By excluding companies on the basis of the above elements, PGGM seeks to prevent PGGM-managed investments contributing financially to practices incompatible with the standards and values of PGGM, its clients and their beneficiaries.

4. Transparency

Each quarter the Emerging Markets Credits team provides an update of its responsible investment activities in the clients' quarterly report. This includes information regarding stewardship activities, impact investing and integration of ESG-factors in its investment decisions. Also, any relevant negative impacts and our monitoring of these impacts, are reported. In addition, the team contributes to PGGM Investments annual Integrated report and report on its responsible investment activities in the Principles of Responsible Investment (PRI) annual survey.

5. Annex

Please note that there is an Annex applicable for this ESG-guideline. This Annex forms an integral part of this ESG-guideline and may be updated from time to time. The applicable Annex is available on our website.

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