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Responsible Investment in Investment Grade Credit

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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' Investment Grade Credit 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 Investment Grade Credit. 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 Investment Grade Credit, effective as of 1 January 2021.

2. Investment strategy & approach

On behalf of PGGM's clients, the Investment Grade Credit team invests in high grade corporate bonds and manages an investment mandate that is evaluated first and foremost by benchmarked financial returns.
The Investment Grade 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 Investment Grade Credit is to generate a net return that over a credit cycle of 3 to 5 years at least equals the benchmark return, through constructing a portfolio of Euro-denominated corporate bonds with primarily an 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 Investment Grade Credit, as further outlined in this document, and by actively taking into account ESG-related performance in investment decisions, Investment Grade Credit believes that it offers a positive contribution that is best practice and in line with the clients' stated objectives.

The **Investment Grade Credit** 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

The Fund makes use of several instruments to promote sustainability and limit negative contribution to sustainability factors. On the PGGM level, the initiatives relate to exclusions, active ownership and the promotion of Sustainable Development Goals. On the team level, the initiatives relate to bottom-up ESG-integration, investing in sustainability bonds and a CO2 portfolio reduction target. These ESG strategies are based on a 'sustainable basis' (minimum requirements for companies in which in principle no investments are made and excluded from our benchmark) and the promotion of a 'sustainable world' (sustainable development investments that contribute to the SDG's). The main objective of the Fund is financial return, but the importance of the ESG philosophy of the Fund is recognized.

The fundamental analysis of companies encloses a dedicated ESG part, on which the team analyses the environmental, social and governance pillars. The input is based on multiple external ESG-rating providers; Sustainalytics (ESG risk ratings) and MSCI (ESG ratings). On top of that is the SASB materiality findings, which identifies the material ESG factors on a sector level. This approach gives the team insight on how the company deals with the risks and if management puts enough priority to it. The analyst scores the E, S and G pillars and judges the overall ESG risk of the company. ESG risks are defined as risks for the financial returns that stem from material ESG factors. On top it scores the most important ESG indicators (derived from SASB materiality findings) that combined leads to an overall ESG score. When any of the ESG matters are material shortcomings the analyst will discuss this in the next meeting with management. The material ESG risks are also discussed with the rest of the team to come to a mutual agreement on the next steps. Potentially this can lead to no investment or divestment.

Sustainability factors include environmental, social and employment issues, respect for human rights, and the fight against corruption and bribery. This definition has been given by European legislation and is further defined in the form of so-called principal adverse impact (PAI) indicators. Given upcoming Sustainable Finance Disclosure Regulation (SFDR), wherein sustainable investments must disclose mandatory PAI indicators, the fund will start to gradually take all into account. For the time being, the fund will become a product 8 without sustainable investments but with the promotion of E & S characteristics. A number of PAI indicators, namely the 1) GHG emissions and carbon footprint, 2) exposure to companies active in the fossil fuel sectors, 3) violations of numerous OECD Guidelines and UN Global Compact and 4) exposure to controversial weapons (exclusion policy) are fully implemented in our investment process through the following activities:

1) CO_2 emissions of the portfolio are reduced in line with PFZW's target set on the "Liquid Credit" mandate, engagement by the Responsible Investments (RI) department and divestment from high emitters.
2) Violations of UN Global Compact and OECD Guidelines are limited in the portfolio by excluding (very) severe controversies based on the RI Guidelines. Screening is on several indicators on the E, S and G theme.
3) The portfolio's exposure to the controversial weapons is limited through the exclusion list.

3.b Impact

In addition to a better-performing portfolio, Investment Grade Credit 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's 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, is currently related 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.

Therein addition to investing in corporate bonds of SDI-classified companies, 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 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.

Investment Grade Credit will invest in these 'use of proceeds bonds' that are classified as SDI for the following reasons:

- They are senior unsecured bonds.
- Risk relates to the issuer.
- The green and sustainability bonds are issued under the company's EMTN program.
- The bonds are part of the Investment Grade Credit investment universe.

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 are focused on (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.

In line with PGGM's clients' policies and their commitment to the Dutch Pension Funds Agreement on Responsible Investment (IMVB), PGGM screens and monitors investments made on behalf of its clients for their observance of the OECD Guidelines for Multinational Enterprises (hereafter OECD guidelines) and the UN Guiding Principles for Human Rights (UNGPs). Using data from external providers, PGGM prioritizes principle adverse impact (PAIs) based on likelihood and severity, with the latter defined as the scale and scope of the impact, and to what extent it can be remediated. Based on this, PGGM shall avoid investments that are in very severe violation of the OECD guidelines and/or the UN Global Compact.

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

The client has defined CO_2 intensity reduction plans for the Liquid Credit mandate. The CO_2 intensity is calculated for each company in the portfolio by dividing the CO_2 emissions (in tonnes) by the sales (dollar denominated), as determined by the Trucost database. Aggregation on total level will be done by multiplying this number with the relative weight of each company in the portfolio. CO_2 emissions will be calculated based on Trucost data scope 1 and 2 (as determined by the Greenhouse Gas Protocol). In case there is no Trucost data, the sector average of the benchmark is used. If no sector average exists, the portfolio CO_2 intensity is used. Cash will also be allocated in the portfolio average CO_2 intensity.

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

PGGM Investment Grade Credit actively 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 investment Grade Credit team engages with companies where high ESG risks are identified and on 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 Investment Grade Credit 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.

Investment Grade Credit 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 credit) and there is no established platform to effectively coordinate actions. The Investment Grade Credit team encourages cooperation between investors with the goal of promoting best practices in the industry.

Investment Grade Credit actively participates in the investor discussion of standardizing the green bond category and working on clarifying the common dilemmas related to monitoring of the proceeds, assurance, ring-fencing and what constitutes a green bond.

3.d Exclusion

The PGGM Implementation Guidelines on Exclusion are applicable to investments in all asset classes, including Investment Grade Credit. The PGGM-wide product-based Exclusion List consists of companies engaged in controversial weapons, tobacco, tar sands as well as production of thermal coal by mining companies and limits on generation of thermal coal by utilities.

Exclusion also relates to violations of UN Global Compact and OECD Guidelines which are limited in the portfolio by excluding (Very) severe controversies based on the RI Guidelines. These indicators are based on the E (e.g. GHG emissions, water use, biodiversity), S (communities, human rights, health & safety) and G (bribery and corruption) aspects.

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.

Each quarter the team provides an update of its responsible investment activities in the clients' quarterly report. This includes information regarding impact investing, CO_2-intensity and developments on ESG related topics. 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.

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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