pggm.nl

Responsible Investment in Investment Grade Credits

January 2021 (v2021.10)

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 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 Investment Grade 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 Investment Grade Credits, effective as of 1 January 2021.

2. Investment strategy & approach

On behalf of PGGM's clients, the Investment Grade Credits 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 Credits 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 Credits, as further outlined in this document, and by actively taking into account ESG-related performance in investment decisions, Investment Grade Credits believes that it offers a positive contribution that is best practice and in line with the clients' stated objectives.

The **Investment Grade 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, Investment Grade 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 what concerns the integration of ESG factors into the internal research framework of the investment team. This includes third party output to improve knowledge and understanding of ESG issues. The team uses external ESG data providers (Sustainalytics, MSCI) to determine the ESG performance of companies. The coverage by external ESG rating agencies corresponds to nearly 100% for the companies in the Fund. The introduction of a more systematic approach and the integration of third-party research also works towards improving transparency and consistency of the Investment Grade Credit team's ESG analysis.

Investment Grade Credits will rate individual companies based on ESG scores. Due to the emphasis on capital preservation, the Investment Grade Credit team does not invest in companies which have excessively poor ESG performance. These are companies that have a lower ESG score than their peers in the same industry or on a portfolio level. The Investment Grade Credit team has an unbiased approach towards sectors, and it differentiates between good and bad ESG performers within a sector. As a beta investor the fund is equally exposed to all the sectors in the benchmark: financials, cyclicals, non-cyclicals, TMT and utilities.

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.

Investment Grade Credit for the Developed Markets enjoys a good reputation in terms of ESG performance. This largely results from the economic reality of operating in a good economic and social infrastructure. Because of this favourable position, the systematic ESG integration and constant monitoring, the probability of a significant structured deterioration of the portfolio value due to ESG risks is considered limited.

Nevertheless, the companies operating in the developed markets are also exposed through their supply chains to ESG risks more common in the emerging markets. Moreover, individual incidents cannot be ruled out. The following ESG risks are thus monitored with particular attention: human rights controversies, deforestation, and loss of biodiversity.

Transitional and physical risks deriving from climate change are considered a sub-set of ESG risks and are therefore covered by the ESG integration process of Investment Grade Credits.
Changes in regulation, particularly in the field of GHG emissions and/or pollution (transition risk), would impact companies, although some sectors more than others. Depending on political action, the likelihood and magnitude is rather unpredictable. Similarly, for changes in taxation (higher carbon prices in exchange for e.g., lower income taxes or green subsidies). Physical climate risks will expose companies in flood- or draught-prone areas, as well as companies depending on suppliers in those areas.

Investment Grade Credits continuously monitors its investment portfolio and on a monthly basis reviews all of its investments, 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 plain vanilla green bonds in the portfolio the Investment Grade 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, Investment Grade 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'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, 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 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 Credits 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.

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.

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

The Investment Grade 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.

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

PGGM Investment Grade Credits 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 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.

Investment Grade 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 Investment Grade Credit team encourages cooperation between investors with the goal of promoting best practices in the industry.

Investment Grade Credits 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.

1 In Dutch "Klimaatakkoord"

3.d Exclusion

The PGGM Implementation Guidelines on Exclusion are applicable to investments in all asset classes, including Investment Grade 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 Investment Grade 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.

PGGM
Noordweg Noord 150
PO Box 117, 3700 AC Zeist, Netherlands
T +31 (0)30 277 99 11
www.pggm.nl

21-12068 maart 2021