

Responsible Investment Guidelines for EMC



1. Introduction

On behalf of its clients, PGGM's Emerging Markets Credit team (EMC) internally manages mandates that invest in debt instruments (loans, bonds and other instruments) of companies that operate in Emerging Markets (EM).

This document discusses the guidelines that apply to EMC's management of environmental, social and governance (ESG) issues.

These guidelines form part of PGGM Investments' Responsible Investment Implementation Framework (a collection of specific implementation guidelines). The framework and the underlying implementation guidelines in turn are part of the Policy Framework for Responsible Investment and are a detailed elaboration of the PGGM Beliefs and Foundations for Responsible Investment.

The rationale for formulating a set of specific responsible investment guidelines for the EMC mandates is that the internally managed nature of the mandates lends itself particularly well for management of ESG risks. Furthermore, the fact that EMC is managed internally allows for room to explore ESG-related investment opportunities.

This document sets out the approach to identification and management of ESG risks within the investment process, with the goal to embed ESG-related analysis more clearly in the decision-making process and enable oversight of ESG risk exposure at portfolio level.

The guidelines cover all investments made by EMC, effective as of 1 December 2014.

With the introduction of these guidelines EMC aims to effect an overall improvement in transparency and governance.

This policy does not confer any rights to any third parties.

2. Vision on ESG in EMC

Definition

PGGM defines 'ESG risk' as the risk that environmental, social and/or governance-related issues may inhibit an issuer's ability to meet their financial commitments. In addition to financial implications, such ESG-related, company-specific issues may have significant reputational implications for both issuers and (therefore) investors.

EMC Beliefs

EMC believes that ESG factors may have a material impact on the financial performance of companies. EMC aims to mitigate potential material risks relating to ESG by analyzing the ESG-related performance of the companies in its investment-, risk- and portfolio management processes.

EMC believes that companies with good ESG practices generally are better managed and are likely to have better corporate management systems in place (for operations, accounting, human resources, etc.) and are therefore better equipped to deal with changing market circumstances. Companies with forward-looking strategies to mitigate ESG risks are competitively better positioned and less vulnerable to unforeseen situations. Poorly managing ESG risks on the other hand can lead to inefficiencies, operational disruption, litigation and reputational damage.

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

Emerging Markets

Emerging Markets (EM) typically suffer a poor reputation in terms of ESG performance. This largely results from the economic reality of being 'emerging' and the intrinsic (economic, social and political) challenges faced by such countries. The economic infrastructure is often old and polluting, EM countries typically have a relative economic bias towards environmentally challenging sectors (heavy industries, extractive industries, etc.), the legal framework is generally weak and governance frequently underdeveloped. However, EM economies are inextricably linked with Developed Markets (DM) economies in the global production and consumption chains and as such these risks should be viewed holistically rather than isolated.

Industry/sector views

As is the case in other asset classes, investment opportunities for EMC arise across all types of industries. Investments in EMC are skewed towards industries with potentially heightened ESG exposure such as metals,

mining, oil and gas.

Furthermore, themes such as water shortage, carbon emissions, financial sector transparency, obesity, deforestation, overfishing of the seas, etc. increasingly stir intense debate and touch on a variety of industries such as paper and pulp, bottlers, agriculture, utilities, etc. which all present investment opportunities in the EM universe (as they do in the DM universe).

EMC is sector agnostic and its approach is to differentiate between good and bad ESG performers within an industry or sector.

3. Objective

EMC operates an investment mandate that is evaluated first and foremost by benchmarked financial returns. EMC's high-level ESG objective is to be a best-practice investor within the confines of a benchmarked financial mandate.

EMC will work towards achieving this objective by means of the following lower-level objectives.

Systematic approach & Integration of 3rd party output

While ESG analysis has always been part of EMC's credit analysis, its growing relevance in society merits a rethink of the methodology. Going forward EMC will score all investment holdings on a risk scale ranging from 1 (best) to 5 (worst).

In determining the ESG score, EMC will include 3rd party analysis and assessments as a key source of information.

Coverage by external ESG rating agencies is however still only partial. For example, less than 40% of the companies in EMC's High Yield portfolio is currently covered. We further note that this is still a relatively young ratings industry and that 3rd party output is not necessarily comparable or consistent. Furthermore, 3rd party assessments reflect underlying assumptions which may or may not be shared by PGGM. However, by including 3rd parties in our analysis in a structured way we believe we improve the quality of our internal assessment.

Improve Transparency & Consistency

Introducing a more systematic approach also works towards improving transparency and consistency of EMC's ESG analysis. EMC will record 3rd party ratings where available, discuss key insights by external agencies on a name by name basis, and will provide reasoning for its final internal assessment.

Improve Knowledge & Understanding

Working in a more systematic way, having ongoing discussions with companies about their ESG considerations and with external agencies on their ratings considerations

and methodology will improve EMC's knowledge and understanding of key ESG related issues across the various sectors and industries in which it invests. As the process matures, internal considerations will increasingly be of higher quality.

Keep informed of Industry Trends & Peer Activity

EMC aims to keep abreast of Fixed Income industry trends and developments at peer investment managers in terms of managing ESG, and may contribute to thought leadership, to maintain a best practice ESG performance.

Actively discuss/engage ESG with Issuers

EMC as a rule avoids investing in companies with excessively poor ESG performance (deeply polluting, wasteful, unethical etc companies). Furthermore, EMC does not invest in companies that are included on the PGGM Exclusion List. However, there is a sizable grey area and (also in view of its benchmarked mandate) EMC will have to invest in companies that may not yet be performing up to best practice ESG standards.

Against this backdrop, EMC engages with companies in more than one way:

- I. In the run-up to an investment, EMC considers ESG as part of the overall credit analysis, and where required, will contact the company for more/better information to allow an informed investment decision.
- II. Once invested, if the company is considered by EMC to have poor practices in certain aspects of its operations, EMC will engage with the company to raise awareness at the company level of the concerns and communicate the expectation of improvement.

PGGM notes that engagement from fixed income investors is a new phenomenon¹. Historically, equity holders, as (minority) owners of a company, have voting rights, and can use these, alone, or in consort with other investors/voters, to achieve change. Bond/loan holders have no such direct control over a company's behavior and will have to rely on indirect pressure. In its most extreme form this could take the form of the public threat of exclusion in combination with media pressure, however, this approach falls outside the scope of EMC's mandate. Instead, on an ongoing basis EMC will focus on applying soft pressure, such as raising concerns, educating and raising awareness. EMC may consider reducing or exiting an investment if it considers the response to engagement activities inadequate or unsatisfactory.

PGGM further notes that in the global capital markets, there is still considerable room to improve communication

¹ With the possible exception of project finance loans, where application of equator principles effectively enforces engagement with the borrower.

between the various asset classes (such as equity and fixed income), and even between investors within an asset class (such as EM Fixed Income) and that there is no established platform to effectively coordinate actions. This makes it challenging to bring together like-minded

investors which stands in the way of effective 'investor activism'. However, working within these confines EMC on a case by case basis may consider bringing together likeminded investors to increase its leverage in engagement with a company.

4. Implementation

Investing

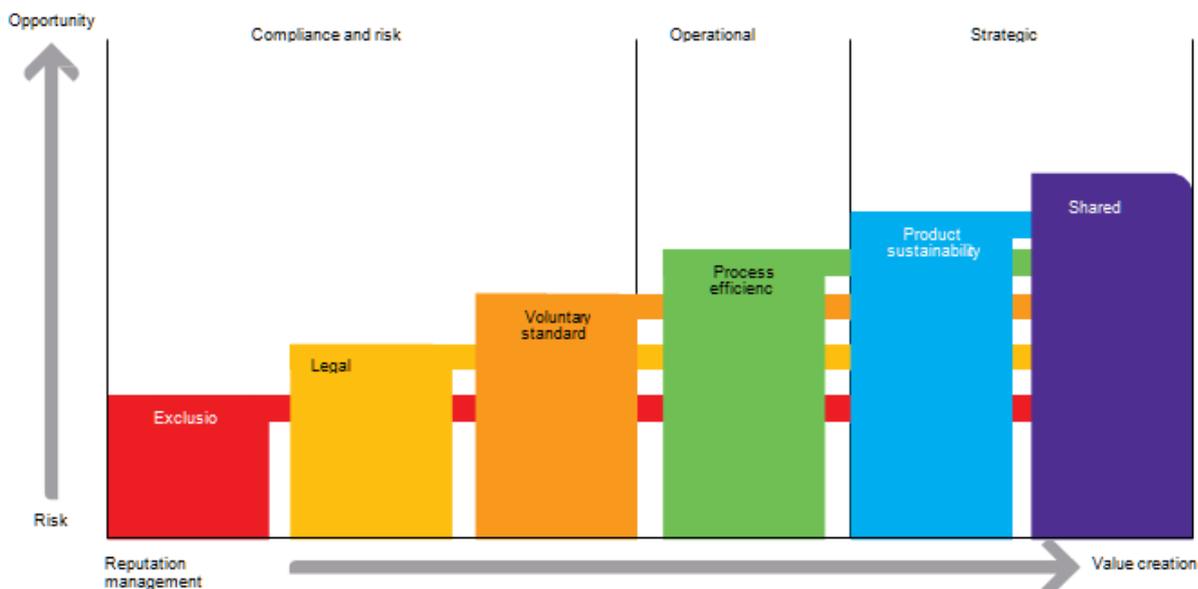


Figure 1. Sustainability Stairway (source: PGGM)

With the implementation of this set of guidelines, EMC aims to ensure that it structurally and systematically takes material environmental, social and governance issues into account in the investment process. The ways to approach ESG issues are illustrated by PGGM's Sustainability Stairway (figure 1.) and set forth the expectations PGGM has with regard to the ESG performance of investments.

As EMC's investment analysis focuses on avoiding downside risk (as opposed to seeking upside, as is the case with equity investments), most of the focus of EMC will be on the left side of the stairway.

EMC will, going forward, apply the following methodology to its discussions on ESG related performance of corporates:

Exclusion

Every potential investment is checked against the PGGM exclusion list. All EMC investments will have to comply with PGGM's Implementation Guideline on Exclusions;

Legal

EMC expects its investment companies to comply with all applicable environmental and social laws and regulations.

Voluntary Standard

- EMC will check 3rd party ESG coverage of the company in question;
- EMC will screen on UN Global Compact violators (noting that currently screening tools are limited);
- Any high-level output the agencies provide (flagging of controversies, 'E', 'S' and 'G' pillar scores and/or company ESG rating) will be recorded in EMC's database;
- EMC will add its own considerations in relation to ESG related performance of the company, which also incorporates generally available information such as information from bond prospectus, the company (contacted if considered necessary), internet searches, etc.
- When deemed required, EMC will consult the Responsible Investment department (RI). Any views and considerations provided by RI will be taken into account in EMC's decision process, and will be recorded in the EMC ESG database.
- EMC will determine an ESG company score on a scale from 1 (best) to 5 (worst). EMC may override third party assessments in both directions (e.g.

EMC could regard a 'B' rated company as a 'BB', or vice versa). In such instances EMC will record its reasoning in the comments.

As mentioned, the focus of the mandates in managing ESG is mostly on the left side of PGGM's Sustainability Stairway. EMC is currently in the process of setting up a dedicated portfolio for positive impact investments, with the intention to source investments that have a positive impact in the field of climate change, food security, water management and healthcare. This should gradually introduce more focus on the right hand side of the stairway – value creation.

5. Monitoring

EMC continuously monitors its investment portfolio and on a quarterly basis reviews all its investments, as reported in its quarterly 'EMC Investment Report'. Any significant events that have taken place in the preceding quarter are reported on.

EMC will additionally on a semi-annual basis review all the companies in the portfolio on ESG performance. This review will be performed on the back of an updated set of ESG rating scores for companies in the benchmark and portfolio.

For more information on PGGM Responsible Investment Guidelines for EMC please contact our Responsible Investment department, +31 30 277 99 11 or visit our website www.pggm.com

