Integration of Sustainability Risk Considerations

April 2024

Schroders

Schroders' Sustainability Risk Definition and Philosophy

Under article three of Regulation (EU) 2019/2088 (the Sustainable Finance Disclosure Regulation or 'SFDR'), certain Schroders entities are required to demonstrate how they integrate sustainability risk considerations into their investment processes.

This document describes how sustainability risks are factored into the investment management processes of Schroders entities that are directly subject to the SFDR's requirements. It demonstrates how our Investment teams seek to deliver long-term risk-adjusted returns whilst incorporating the consideration of sustainability risks consistent with client preferences.

This document applies to the following Schroders entities:

- Schroder Investment Management (Europe) S.A.
- Schroder Real Estate France
- Blue Orchard Asset Management (Luxembourg) S.A.
- Schroders Capital Management (France)
- Schroder Real Estate KVG Mbh

Definitions

Integration of Sustainability Risk Considerations

The process of identifying, analysing and incorporating relevant and material sustainability risk factors into investment decisions as well as the ongoing monitoring of portfolios and engagement with investee companies' and assets' management teams. We consider that examining a wider range of factors than may be captured in traditional investment analysis allows a more complete view of potential investment drivers and better-informed investment decisions as a result.

Sustainability Risk

An environmental, social or governance (ESG) event or condition that, if it occurred, could cause an actual or a potentially material negative impact on the value of investments.

Active ownership

In the context of sustainable investing, this refers to the influence that can be applied to management teams and relevant stakeholders of investee companies and assets so that more sustainable practices are properly considered in managing the companies and assets. This is intended to protect and enhance the value of investments.

Schroders' philosophy

Our purpose is to provide excellent investment performance to our clients through active decision making. In our view, sustainability risks and industrial trends are intrinsically linked to the performance of many investments over the long term. Investee companies and assets face competitive pressures from a wide range of sources, on a larger scale and at a faster pace than ever before. Investment teams no longer have a choice over whether to seek exposure to sustainability risks and opportunities; all portfolios may be impacted.

We believe that considering sustainability factors across the investment strategies we manage, in line with those strategies' investment objectives, can help us to deliver our purpose. Where appropriate, we also engage with many investee management teams and/or their key stakeholders, vote on our clients' shareholdings or otherwise seek to use our influence, with the objective of improving investee company or asset performance in sustainability-related areas and their long-term financial health and resilience. We may choose to make an investment with a more challenging sustainability profile if we believe the opportunity is consistent with the relevant investment strategy and has an appropriate risk-adjusted return profile.

We recognise that tackling social and environmental challenges will require a reallocation of capital over time and have therefore developed a range of specific sustainability, thematic and impact strategies, for clients who have environmental and social preferences.

Integration of sustainability risk considerations

Sustainability risks could be investee company or asset specific, or impact multiple investee businesses.

Examples of sustainability risks that could negatively affect the value of a particular investment may include the following:

- Environmental: extreme weather events such as flooding and high winds, pollution incidents, damage to natural capital, biodiversity or marine habitats;

- Social: labour strikes, health and safety incidents such as injuries or fatalities, product safety issues;

- Governance: accounting fraud, discrimination within a workforce, inappropriate remuneration practices, failure to protect personal data; or

- Regulatory: new regulations, taxes or industry standards to protect or encourage sustainable businesses and practices may be introduced.

We integrate sustainability risk considerations into our research and investment decisions across Investment teams and asset classes with the aim of maximising risk-adjusted returns for our clients. We confirm the integration of sustainability risk considerations by our Investment teams using an internal accreditation framework.

Our approach is pragmatic: we want to integrate sustainability risk considerations into established investment processes rather than create separate processes. Our Investment teams should be able to articulate and demonstrate how relevant issues are identified, investments are examined, portfolio decisions are influenced and how they monitor and manage emerging sustainability risk considerations in relevant investment cases. The extent to which sustainability risks may be relevant to an investment process will depend upon considerations like the materiality of an issue, investment objectives, the policy of the strategy/client and the investment universe. The central Sustainable Investment team provides research, proprietary models, and support through these steps.

Investment teams complete an accreditation proposal annually, which describes how sustainability risks are considered in their relevant investment processes. The accreditation process is managed independently from the Investment teams by the central Sustainable Investment team so that there is consistency across all asset classes and sectors.

To achieve accreditation status, each Investment team must:

- Articulate their investment philosophy;

- Describe the key steps of their relevant investment processes and the role ESG factors may play in these;

- Describe their approach to active ownership (as appropriate for their asset class);

- Describe how they identify, assess and monitor climate-related risks and opportunities, as relevant;

- Provide information on the ESG resources utilised by their Investment team; and

- Evidence practical implementation of ESG integration through at least three new case studies.

For certain businesses acquired more recently, we have not yet accredited the integration of sustainability risks into investment decision-making. A small portion of our business where the integration of sustainability risks is not practicable or possible is also excluded, for example, certain legacy businesses or investments in the process of being liquidated, and certain joint venture businesses.

Proprietary sustainability models, tools and frameworks

We have invested in developing a range of proprietary research models and tools to gain insights into social and environmental investment factors and help inform investment decisions where relevant to a particular investment strategy. We may also supplement our proprietary models and tools with ESG data from third-party sources.

Proprietary models may be used by our Investment teams to support the assessment of sustainability risks and opportunities, along with supplementary metrics from external data providers and our own due diligence, as appropriate to the goals of any given strategy. This analysis may form a view of the potential impact of sustainability risks on a specific investment or an overall investment portfolio and, alongside other risk considerations, the possible impact of such risks on investment returns over time. Such models are also utilised to help meet various ESG-related product requirements. However, the use of any given tool or model by an Investment team will depend upon factors like the asset class and the investment objectives and policy of the strategy/client.

Our suite of proprietary models and tools include CONTEXT™, SustainEx™, ThemEx™ and our Climate toolkit (which includes both proprietary models and third-party inputs), as well as a number of team-specific tools, frameworks and models. The models are generally focussed on public market investments only.

CONTEXT™ uses a selection of data to assess a company's relationship with its stakeholders such as customers, suppliers, regulators and employees. This tool is interactive and customisable, enabling our investment analysts to select and weigh material sustainability trends for each sector and select the most relevant metrics for assessment in any given case. The tool gives our analysts the flexibility to make company-specific adjustments to reflect their specialist knowledge.

SustainEx™ provides an estimate of the potential social and environmental 'costs' or 'benefits' that an issuer may create on a net basis. It does this by using certain metrics with respect to that issuer and quantifying them positively (for example when a company pays 'fair wages') and negatively (for example when a company emits carbon), to produce an aggregate notional measure of the effect that the relevant underlying issuer may have on society and the environment.

The model enables our Investment teams to integrate sustainability risk considerations by assessing issuers having regard to such measures, and the risks they face if the social and environmental 'costs' they externalise were to be pushed into their own financial costs.[1]

ThemEx™ seeks to measure the alignment of a company's products and services to a range of sustainable investment themes, including Schroders' "Super Themes" (climate change, demographic shifts, natural capital management, societal change, technological innovation) and the UNs' Sustainable Development Goals (SDGs). Alignment is estimated systematically based on the company's revenue from its underlying business activities. ThemEx's revenue data is taken from third party sources.

In the absence of reliable third-party data sources to extend ThemEx to private market investments, we have developed a private assets SDG Alignment framework aligned with the ThemEx methodology to enable the assessment and reporting of SDG alignment across both public and private universes.

We have also developed a suite of climate tools called the Climate Analytics Framework, which assesses companies' exposure to climate risks and opportunities, the mitigating actions they are taking, and the outcomes of those actions.[2] The aim of this toolkit is threefold:

1. to support the Group to monitor and manage its progress towards its net zero targets;

2. to provide Investment teams with insights to help to identify unpriced climate risks and untapped opportunities to generate value in the transition; and

3. to support our clients in attaining their climate and decarbonisation objectives.

[1]SustainEx utilises and is reliant on, and subject to the limitations of, third party data as well as Schroders' own modelling assumptions, and the outcome may differ from other sustainability tools and measures. Like any model, SustainEx will evolve and develop over time as we continue to assess, refine and add to the metrics and their relative contributions.
[2]Further details of our Climate Analytics Framework can be found in our latest Climate Report, available via our dedicated sustainable investment policies, disclosures & reports webpage (here).

Active Ownership

As described above, a key element of our integration process is active ownership. We believe that active ownership, in particular engagement, plays a central role in helping to identify sustainability risk considerations within our investment processes. We believe that constructive and committed engagement with management teams and wider stakeholders, as appropriate, at the companies and assets we invest in is a key element of our responsibilities as investors and of the value we can bring to our clients' investment returns. That is why we have a firm-wide commitment to active ownership, with many of our analysts and fund managers undertaking engagements directly.

Our Engagement Blueprint for listed assets, originally published in 2022, outlines the six priority themes for our engagement: climate change, natural capital and biodiversity, human rights, human capital management, diversity and inclusion, and corporate governance.[3] The document sets out the long-term outcomes we expect will be important for the companies and assets we invest in to be successful.

Our Engagement Blueprint for private assets, published in 2024, aligns to the wider Group priority themes while highlighting asset class and strategy specificities, notably taking into account our level of influence and the illiquid nature of private assets.

Investment teams and strategies which invest through third party managers, such as certain Wealth Management and Solutions teams, are encouraged to align their engagement approach to Schroders priority themes in relevant cases.

Where we have engaged repeatedly with an investee and seen no meaningful progress, we may escalate our concerns. Decisions on whether and how to escalate are based on the materiality of each issue, its urgency, the extent of our concern and whether the company has demonstrated progress through previous engagements. The possible actions we may take to escalate an engagement are outlined in the Engagement Blueprint for listed assets.

Our approach to investing in different asset classes

We recognise that different asset classes and investment strategies may require different approaches to the integration of sustainability risks in investment decision-making. Below, we have set out some specificities to particular asset classes.

Company analysis (Equities and bonds)

We believe that our awareness and analyses of sustainability risks enhances our fundamental understanding of a company's value and its ability to deliver attractive long terms returns, whether through its share price or dividends paid, or in its ability to service and repay its debt.

We pay attention to how a company manages relationships with its key stakeholders such as its customers, employees, suppliers and regulators, as well as its impact on the environment and local communities. We believe this focus aligns with our position as debt and/or equity investors on behalf of our clients.

Some of our teams invest through a quantitative approach. They take a similar approach by identifying sustainability risks or 'signals' that have been empirically shown to improve the expected risk or return profiles of our clients' portfolios. These factors are used in some cases to arrive at a composite ESG score per company and are also used in portfolio construction to determine position sizing.

For privately held companies, sustainability analysis is rooted in our internal Raising Impact, Sustainability and Engagement ('RISE') framework. This proprietary methodology looks at multiple underlying indicators through seven focus areas: climate change, conservation, workforce, diversity, equity and inclusion ('DE&I'), community impact, transparency, and policies and practices.

[3]Our Engagement Blueprint be accessed via our dedicated sustainable investment policies, disclosures & reports webpage (here).

Sovereign analysis

The social and environmental backdrop facing countries and their governments is changing quickly. As these pressures become more acute, the financial importance of effectively managing social and environmental change for sovereign issuers is rising. We believe that identifying and understanding relevant sustainability risk issues, and assessing how challenges are being met, help with our long-term analysis of sovereign risk.

We approach sovereign analysis by identifying the building blocks of a country's economic growth (such as capital, labour or productivity) and then analysing sustainability risks that impact those building blocks. For example, we look at health and education metrics as indicators of the capability, and potential, of a country's labour force.

Convertible bonds analysis

Convertible bonds are hybrid securities that allow the investor to convert a bond into a certain number of associated shares. They combine the protection of a fixed income investment with the potential return of an equity investment. The blend of individual elements that make up a convertible bond – bond, equity and right of conversion – produces an asset class that has unique risk-return characteristics.

Sustainability risks may be one of the factors that affects an issuer's creditworthiness. Sudden shocks are often more costly than gradual credit declines. From a sustainability risk perspective, this means that we are concerned with sharp moves driven by new information, particularly around controversies. Analysis of sustainability risks is therefore part of our fundamental, bottom-up research, the idea generation process, the modelling and pricing of convertibles and hence has an impact on the top picks in each region.

Multi Asset analysis

Our approach to multi-asset investing goes beyond allocating just by asset class; instead, our research, asset allocation and portfolio construction are based on an analysis of the fundamental drivers of risk and return called 'risk premia'. We believe that asset classes are proxies for risk premia – they are essentially baskets of returns that an investor receives for taking on exposure to the systematic risks associated with an investment. In some cases, an asset class may be represented by macro risk factors. For example, global equities are exposed to economic, inflation and sustainability risks. Some sub-asset class allocation decisions are also exposed to more specific risks. For example, the Japanese corporate governance reforms in 2023 had a major impact on Japanese equities.

Our approach to sustainability considers both a top-down view when allocating to asset classes and a bottom-up view when selecting securities. The cornerstone of our ESG integration is our internal Sustainability Cross-Asset Research Group, which sits across our seven risk premia research groups (equity, credit, term, commodities, currency, private assets, alternative risk premia) as part of our Global Research Platform. The Sustainability Cross-Asset Research Group focuses on identifying ESG trends that could impact markets and portfolios, with an emphasis on political, regulatory, social and positioning trends that could result in externalities being internalised in the performance of companies and markets.

Structured credit analysis

Our securitised credit universe is comprised of fixed-income investments created by pooling together underlying assets and issuing securities backed by those assets. It includes Asset-Backed Securities (ABS), Mortgage-Backed Securities (MBS), Commercial mortgage-backed securities (CMBS) and Collateralised Loan Obligations (CLO).

In order to assess risk-adjusted returns, factors that impact cashflows such as borrower health (ability and willingness to pay), value of collateral we can recover against, and alignment of interest, are core components in the calculations we make.

The consideration and integration of ESG factors into our cashflow analysis incorporates the assessment of the quality of the collateral and the sustainability of the cash flows. We also assess the impact of the lending and the asset footprint on the environment.

Insurance Linked Securities

Insurance Linked Securities ('ILS') are primarily linked to the (re-) insurance of natural catastrophe, mortality and pandemic risks, and extreme events that can cause severe disruption to individuals' lives and the communities they live in. Our approach to integrating sustainability risk considerations focuses on the covered risks, sponsors of, and structures used for such transactions.

By nature, certain types of ILS products, such as catastrophe bonds, in themselves are already exposed to social and environmental trends such as climate change. We follow and examine the trends we believe will emerge over the investment horizon and consider their potential impact on returns. For example, we adjust Natural Catastrophe models to reflect our own views on the frequency and severity of extreme weather events. In non-weather related ILS we seek to avoid investing in risks that may contain ethical or social concerns (for example where investment returns are dependent on the outcome of insurance lottery jackpots or life settlements).

Depending on the type of sponsor, we consider different sustainability risks to help us assess the quality of the sponsor and to ensure that stakeholders' interests are aligned.

Real estate

Real estate investing on behalf of our clients carries the responsibility to understand and manage ESG impacts (both positive and negative), to deliver resilient investment returns for the long term and manage exposure to material risks. We believe that understanding and improving the impacts of real estate investment sits alongside our priority to maximise returns for our clients in a manner consistent with our funds' risk profiles.

We also believe that understanding these issues and their impacts is integral to our investment process and may be applied to all aspects of real estate investment across the lifecycle stages of: acquisition and ownership, asset management, property management and operation (which may be provided by third parties), renovation and construction. For example, we conduct pre-acquisition ESG due diligence to understand the sustainability credentials and risks and to reflect into our investment decisions. Post-acquisition, sustainability objectives are established for each asset. Implementation follows throughout the asset holding period and reviews are regularly conducted (e.g. typically twice a year at portfolio level).

The environmental factors of most importance to us include energy, carbon and water use and efficiency, as well as waste management and disposal, pollution, physical climate risks and biodiversity. From a social perspective we are interested in optimising the tenant experience, fostering community relationships and contributing to local prosperity. We are also focused on good governance of our assets and portfolios including, for example, compliance with building regulations, oversight of third-party property managers where they may be responsible for the daily support to a building, and ensuring product level reporting meets regulation and industry best practice.

Infrastructure finance

Schroders makes infrastructure investments in both public and private markets via a range of Investment teams. The long-term nature of this asset class makes understanding and managing sustainability risk issues particularly critical. As investors on behalf of our clients who generally look to hold to maturity, sustainability risk analysis is fundamental to the investment decisions we make. These considerations are both a driver of infrastructure growth (e.g. the energy transition shift to low carbon transport) and potential sources of risk (e.g. poor governance can lead to mismanagement of infrastructure assets with real human costs as well as financial implications).

Specifically in respect of renewable infrastructure and energy transition equity investments, we may consider potential sustainability risks such as the environment, workplace standards, health and safety practices, environmental management, supply chain, community engagement and employment (where possible). Sustainability risks are considered prior to investment as part of early-stage screening, detailed due diligence and the Investment Committee's decision-making, and managed post-acquisition in accordance with our wider asset management practices.

Sustainability risk considerations also form a core part of our investment process in our infrastructure debt business and we have developed a comprehensive toolbox to perform a qualitative and quantitative risk assessment of transactions contemplated. Our selection phase includes a preliminary ESG assessment of the transaction and then a thorough review of the due-diligence package and report findings. These feed into an ESG scorecard and inform the sustainability opinion presented to the Investment Committee. The subsequent execution and ongoing monitoring phase includes a quarterly report on any noticeable ESG-related issue and the collection of ESG data points on an annual basis to monitor ESG performance at portfolio level. Where relevant and appropriate, we also engage with our counterparties.

Third party manager selection

A number of Investment teams across the Group invest through third party managers. To integrate sustainability risk considerations into our manager selection process, we first examine the manager at firm-level, where we aim to understand if the consideration of sustainability risks is a central part of the firm's ethos and investment and corporate culture. Secondly, at the investment strategy level, we assess the extent to which the manager integrates sustainability risk considerations within their own investment processes. We do this using ESG questionnaires which have the same overarching objective of seeking to understand external managers' sustainability approach. Taken together, these questionnaires contribute to our research and analysis on the suitability of the external fund manager for inclusion in our portfolios.

Manager selection teams at Schroders are an additional step away from asset or security selection. Our active ownership approach therefore is focused on engaging with our external managers to increase the robustness of their own sustainability risk integration and their active ownership practices.

Commodities

Our commodities teams invest in both commodity futures and commodity producers (equities). The latter is covered under the Company Analysis section above. Sustainability risks can influence commodity prices and therefore we integrate these considerations into our forecasts for commodity market returns. We use our proprietary tools (e.g. CONTEXT™) as well as our own understanding of specific commodity markets, to identify key sustainability risks that may impact either the supply or demand of the commodities in which we trade. For example, we have identified that unsustainable sourcing of nickel supply from Indonesia presents sustainability risks and yet nickel is an important input into electric vehicles, which are integral to the energy transition.

Important information

For information purposes only. This material is intended to be for information purposes only and is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The material is not intended to provide and should not be relied on for accounting, legal or tax advice, or investment recommendations. Reliance should not be placed on the views and information in this document when taking individual investment and/or strategic decisions. Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested. All investments involve risks including the risk of possible loss of principal. Information herein is believed to be reliable but Schroders does not warrant its completeness or accuracy. Some information quoted was obtained from external sources we consider to be reliable. No responsibility can be accepted for errors of fact obtained from third parties, and this data may change with market conditions. This does not exclude any duty or liability that Schroders has to its customers under any regulatory system. Regions/ sectors shown for illustrative purposes only and should not be viewed as a recommendation to buy/sell. The opinions in this document include some forecasted views. We believe we are basing our expectations and beliefs on reasonable assumptions within the bounds of what we currently know. However, there is no guarantee than any forecasts or opinions will be realised. These views and opinions may change. To the extent that you are in North America, this content is issued by Schroder Investment Management North America Inc., an indirect wholly owned subsidiary of Schroders plc and SEC registered adviser providing asset management products and services to clients in the US and Canada. For all other users, this content is issued by Schroder Investment Management Limited, 1 London Wall Place, London EC2Y 5AU. Registered No. 1893220 England. Authorised and regulated by the Financial Conduct Authority. 530306. 612124

Schroders