Schroders

Integration of Sustainability Risk Considerations

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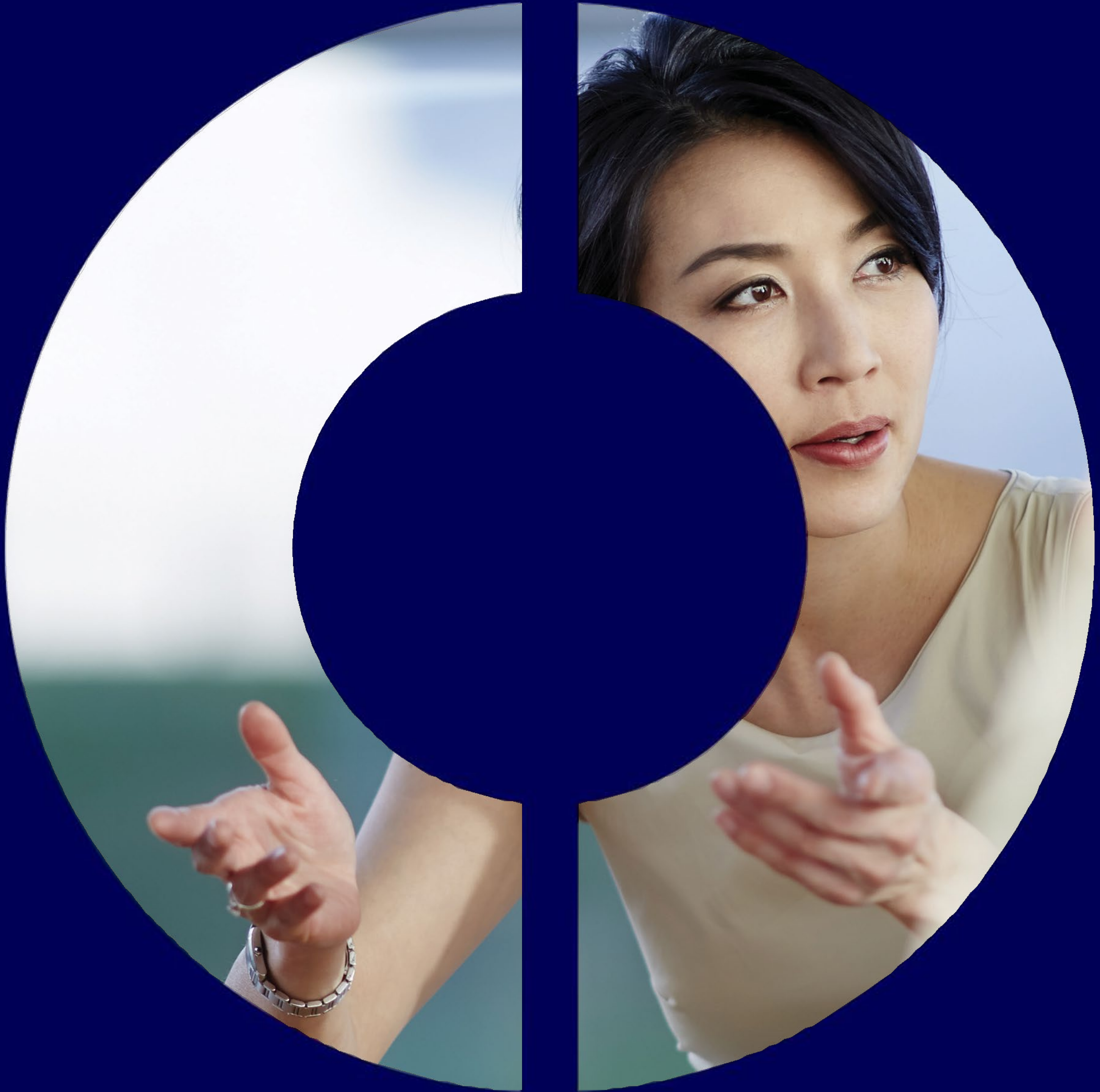

Schroders Wealth Management Sustainability Risk Definition and Philosophy

The Regulation (EU) 2019/2088 (the Regulation on sustainability-related disclosure obligations in the financial services sector or **'SFDR'**) is part of the EU Action Plan for sustainable finance, which aims to align investments with a more sustainable economy and introduce new disclosure and reporting obligations in relation to sustainability. These apply to various Schroders units and their products. According to Article 3 of this SFDR regulation, Schroder & Co Bank AG is obliged to demonstrate its integration of sustainability risk considerations into the investment decision processes. A sustainability risk is an event or condition in the areas of environmental, social or corporate governance, the occurrence of which could have a significant negative impact on the value of an investment.

This document describes how sustainability risks are incorporated into the portfolio management and advisory processes by Schroder & Co Bank AG.

Definitions

Integration of sustainability risk considerations – explicitly and systematically includes analysis of a range of Sustainability Risks. In principle, this leads to a broader assessment of the environment in which companies operate and their performance in managing different stakeholders, giving a fuller understanding of future opportunities and risks than traditional financial analysis alone.

Sustainable investment – As defined in the SFDR, it means (a) an investment in an economic activity that contributes to an environmental objective, measured for example by key indicators of resource efficiency in the use of energy, renewable energy, raw materials, water and soil, for waste generation, and greenhouse gas emissions, or for the impact on biodiversity and the circular economy, or (b) an investment in an economic activity that contributes to achieving a social goal, in particular an investment that contributes to combating inequalities or promotes social cohesion, social integration and labour relations, or an investment in human capital or in favour of economically or socially disadvantaged population groups, provided that these investments do not significantly impair any of these objectives and the companies in which investments are made apply good corporate governance practices, especially in solid management structures, relations with employees, remuneration of employees and compliance with tax regulations.

Sustainability risk – An event or condition in the areas of environmental, social or corporate governance, the occurrence of which could actually or potentially have significant negative impacts on the value of the investment.

Direct investments – an investment in a listed equity, listed credit or sovereign bond security.

Indirect investments – an investment in an equity, fixed income or alternative collective investment scheme.

Schroders' Wealth Management philosophy

At Schroders Wealth Management, we see ourselves as long-term stewards of our clients' capital. Our primary focus is on growing and preserving our clients’ wealth in a responsible manner to fulfil their lifetime and multi-generational goals.

This leads us to focus on understanding the prospects of the assets in which we invest for or which we recommend to our clients in order to achieve superior risk-adjusted returns in line with our clients' objectives. Some clients may have dual objectives to achieve financial and sustainability or impact outcomes, which are the focus of our sustainable and impact offerings. For all clients, it is central to our advisory and portfolio management process to analyse each investment's ability to create, sustain and protect value to ensure that it

can deliver returns in line with our clients' objectives. Where appropriate we also look to engage with the objective of improving performance in these areas.

We believe the responsibility of our portfolio managers and client advisors includes protecting our clients' investment portfolios from the impacts of both financial and non-financial risks. As a result, assessing and engaging on sustainability risks has become an important part of our advisory and portfolio management processes.

In our view, sustainability risks and economic trends are intrinsically linked. Companies face competitive pressures from a wider range of sources, on a larger scale and at a faster pace than ever before. Portfolio managers and client advisors no longer have a choice over whether to seek exposure to sustainability risks and opportunities; all companies and portfolios will be impacted.

The processes outlined in this document apply to sustainability risk integrated strategies, spanning direct and indirect investments as at May 2023 across our discretionary and advisory businesses. We expect our approach to the integration of sustainability risks to continue to evolve.

Integration of sustainability risk considerations

We include the consideration of sustainability risks alongside other factors in investment decision making. We believe that assets that have increased sustainability risks are more likely to suffer risk events that could lead to significant financial losses for investments linked to them. These risk events are likely to differ across different investments and across different time horizons but are increasing in frequency and severity as a result of external environmental and social factors.

Sustainability risks that could negatively affect the value of a particular investment might include the following:

– Environmental: extreme weather events such as flooding and high winds; pollution incidents; damage to 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

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

How these sustainability risks are estimated – through proprietary or external tools and data – and how they are considered differs for direct and indirect investments (see more details below).

Some of these sustainability risks, whether they be in direct or indirect investments, may have an explicit cost that can be easily integrated into financial analysis, whereas others may be more difficult to quantify and therefore more challenging to explicitly reflect in the underlying portfolio management or advisory process.

We measure and track levels of sustainability risk integration in our investment decision making framework which is subject to an internal accreditation. Schroders' Sustainability Accreditation is our approach to formally recognising investment teams who have successfully integrated sustainability into investment decisions.

Our approach

The integration of sustainability risk considerations into portfolio management and advisory processes is supported by a range of resources including a number of proprietary tools and frameworks. This analysis forms our view of the potential impact of sustainability risks on a client's overall portfolio and, alongside other risk considerations, the likely impact of such risks on the financial returns of the client portfolio.

For discretionary direct investments in listed equities, listed credit and sovereign bonds, we use CONTEXT and SustainEx.

CONTEXT looks at a wide range of data to assess a company's relationship with its key stakeholders such as its customers, suppliers, regulators and employees, as well as its impact on the environment and social communities. This tool is interactive and customisable, enabling our investment analysts to

select and weight the most material sustainability trends for each sector and select the most relevant metrics for assessment. The tool gives our analysts the flexibility to make company specific adjustments to reflect their specialist knowledge.

> *SustainEx* is Schroders' proprietary measure of the social and environmental impact that a company may create. Based on independent data and research, the model combines measures of both the harm companies can do (for example, through activities like carbon emissions) and the good they can bring (for example, through paying a 'living wage') to produce an aggregate measure of each company's social and environmental impact. The model enables our portfolio manager or client advisor to integrate sustainability risk considerations effectively by assessing the extent to which companies are in credit or deficit having regard to such measures, and the risks they face if the social and environmental 'costs' they externalise are pushed into their own financial costs.

For advisory direct investments in listed equities, listed credit and sovereign bonds, we may also use external ESG data e.g. Refinitiv or MSCI if there is a lack of coverage of our proprietary tools.

For discretionary indirect investments, we use the Wealth Management Sustainability Fund Selection framework.

> *Wealth Management Sustainability Fund Selection framework* is a proprietary scoring process that we apply to at two levels: the firm and the strategy-level. For both levels, we send out an annual due diligence questionnaire. The reason for this two-fold analysis is because investment managers can have very robust sustainability policies and capabilities at the firm-level, yet these are not being adopted in the actual strategies in which we invest. The reverse can also be true: a strategy can have exceptional consideration of sustainability risks and engagement, yet the wider investment management firm has very little capability. We believe this two-fold approach acts as a 'checks and balances' system and is the best way to protect our clients' capital from ESG risks when using pooled funds.

For advisory indirect investments, we may use external ESG fund data e.g. Refinitiv or MSCI if there is a lack of coverage of our proprietary tools

Company analysis

We approach company analysis through a lens of 'stakeholder capitalism' in order to assess both financial and non-financial factors and their potential impact on returns. We pay particular attention to how a company manages its relationships with its key stakeholders such as its customers, employees, suppliers, and regulators as well as its impact on the environment and social communities. We believe this focus aligns with our position as debt and/or equity investors on behalf of our clients.

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

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, firstly, identifying the building blocks of a country's economic growth (such as capital, labour or productivity) and then we identify 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. We also consider the risks to economic growth in the form of a country's ability and willingness to repay its debt, such as the strength of a country's institutions and the rule of law.

Indirect investment selection

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. We do this using environmental, social and governance questionnaires which have the same overarching objective of seeking to understand external managers' sustainability approach. The questionnaire may have different questions depending on the relevant asset class. Secondly, at the investment strategy level, we assess the extent to which the manager integrates sustainability risk considerations within their own investment processes. Both of these levels of assessment contribute to our research and analysis on the suitability of the external fund manager for inclusion in our portfolios.

Our manager selection teams are one-step removed from the underlying security selection (for example a specific equity) because we are invested through funds. Our approach is focused on engaging with our external managers, rather than specifically with companies, to increase the robustness of their own sustainability risk integration and their active ownership practices.

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