

Schroders

Integration of  
Sustainability Risk  
Considerations

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# Schroders' Sustainability Risk Definition and Philosophy

Regulation (EU) 2019/2088 (the Sustainable Finance Disclosure Regulation or "SFDR") is part of the EU Action Plan on sustainable finance, which aims to reorient investment towards a more sustainable economy, imposing new sustainability related disclosures and reporting requirements on various Schroders entities and their products. Under article 3 of this regulation, certain Schroders entities are required to demonstrate their integration of the consideration of sustainability risks in investment decision-making processes. A sustainability risk is an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of investments.

This document describes how sustainability risks are factored into the investment management processes of Schroders entities that are 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.

## Definitions

**Integration of Sustainability Risk Considerations** – means our consideration of a range of Sustainability Risks in connection with the investments that we make on behalf of our clients alongside other factors. In principle, this leads to a broader assessment of the environment in which investee companies operate and their performance in managing different stakeholders' interests, giving a fuller understanding of future opportunities and risks than traditional financial analysis alone.

**Sustainable Investment** – as defined in Article 2(17) of SFDR, means (a) an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and on greenhouse gas emissions; or on its impact on biodiversity and the circular economy, or (b) an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or in economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

**Sustainability Risk** – means an environmental, social or governance event or condition that, if it occurred, could cause an actual or a potential material negative impact on the value of investments.

## Schroders' philosophy

At Schroders, we see ourselves as long-term stewards of our clients' capital. This leads us to focus on understanding the prospects of the assets in which we invest in order to achieve superior risk-adjusted returns in line with our clients' objectives. It is central to our investment 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 and to vote with the objective of improving performance in these areas.

We believe the responsibility of our investment teams 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 investment processes.

In our view, sustainability risks and industrial 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. Investment

teams 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 equities, fixed income, multi-asset and alternatives managed by relevant Schroders entities as at March 2021. 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 recognise in our investment processes that different asset classes, investment strategies and investment universes may require different approaches to the integration of such risks in investment decision-making.

Sustainability risks could arise within a particular business or externally, impacting multiple businesses. 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

We will typically analyse potential investments by assessing (alongside other relevant considerations), for example, the overall costs and benefits to society and the environment that an issuer may generate or how the market value of an issuer may be influenced by individual sustainability risks such as a rise in carbon tax. We will also typically consider the relevant issuer's relationships with its key stakeholders – customers, employees, the environment, suppliers and regulators - including an assessment of whether those relationships are managed in a sustainable manner and, therefore, whether they present any potential material risks to the market value of the issuer.

The impact of some sustainability risks may have a value or cost that can be estimated through research or the use of proprietary or external tools. In such cases, it will be possible to incorporate this into more traditional financial analysis. An example of this might be the direct implications of an increase in carbon taxes that are applicable to an issuer, which can be incorporated into a financial model as an increased cost and/or as reduced sales. In other cases, such risks may be more difficult to quantify, and so we may seek to incorporate their potential impact in other ways whether explicitly, for example by reducing the expected future value of an issuer or implicitly, for example by adjusting the weighting of an issuer's securities in a fund's portfolio depending on how strongly it believes a sustainability risk may affect that issuer.

We measure and track levels of sustainability risk integration in our investment decision making framework via an internal accreditation framework. 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 investment processes is supported by a range of resources including a number of proprietary tools. The Sustainable Investment team provides regular research updates, advice and subject matter expertise, as well as training to investors on a range of sustainability themes.

A range of proprietary tools are used by our investment teams to support the assessment of sustainability risks, along with supplementary metrics from external data providers and our own due diligence, as appropriate. This analysis forms our view of the potential impact of sustainability risks on a fund's overall investment portfolio and, alongside other risk considerations, the likely impact of such risks on the financial returns of the Fund.

CONTEXT and SustainEx are two of the main tools currently available to our investment teams.

**CONTEXT** looks at wide ranging data to assess a company's relationship with its stakeholders such as customers, suppliers, regulators and employees, as well as its potential impact on the environment and social communities. This tool is interactive and customisable, enabling our investment analysts to select and weigh the 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. It incorporates both mandatory and selected voluntary principal adverse impact data points alongside other data.

**SustainEx** provides an estimate of the potential environmental or societal impact that an issuer may create. It does this by using certain metrics chosen by us, and quantifying the positive (for example by paying 'fair wages') and negative (for example the carbon an issuer emits) impacts of each of those metrics to produce an aggregate measure expressed as a notional percentage of sales of the relevant issuer. SustainEx utilises and is reliant on third party data as well as Schroders' own modelling assumptions, and the outcome differs 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. The model enables our investment teams to integrate Sustainability Risk Considerations effectively 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.

Schroders' proprietary sustainability tools including SustainEx may not cover all of a fund's holdings from time to time, in which case Schroders may use a range of alternative methods.

## Company analysis

We approach fundamental 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 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.

Our quantitative investment teams have their own individual investment approaches. However, 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 environmental, social or governance score per company and are also used in portfolio construction to determine position sizing.

For privately held companies, a similar approach is undertaken by our private equity and debt investors. This approach is limited by the lack of availability of publicly available data, as private companies typically disclose less sustainability risk information, as well as our ability to transact given the lower liquidity and higher transaction costs common in private markets. Typically, this means upfront due diligence and on-going company engagement is even more important.

## 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.

## Structured Credit analysis

We believe an in-depth understanding of collateral cash flow and the impact of the securitised loan's structure is the foundation of generating returns in a market where size and complexity leads to exploitable inefficiency. The consideration of sustainability risks provides a more holistic assessment of the quality of the collateral and the sustainability of the cash flows. We have developed a sustainability assessment framework based on five principal pillars – lawfulness, fairness, purposeful, contractual and sustainability.

Fundamentally embedded within our research is a review of governance, fair lending or predatory lending, climate-related risk, and the health of the loan for the consumer. Counterparty considerations are a part of the asset consideration and governance. Additionally, we have developed proprietary analytics consisting of asset specific models, surveillance and forecast/trend analysis to assist in assessing the sustainability of investment ideas.

## Convertible Bonds analysis

Convertible bonds are hybrid securities that entitle 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 a stock. 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.

An important element of capital protection is delivered through the “bond floor” which is influenced by the stability and quality of the issuer. Sustainability risks are one of the key factors which affect an issuer's creditworthiness and in particular, sudden shocks are more costly than gradual credit declines. From a sustainability risk perspective, this means that we are more concerned with sharp moves driven by new information, particularly around controversies. We therefore explicitly incorporate a number of Governance focused metrics in our modelling which drive credit spreads and ultimately, valuation. Sustainability risks also feature in portfolio construction whereby we use typically environmental, social and governance inputs based on internal research systems in a scorecard approach.

## Multi Asset

Our Multi Asset team integrates sustainability risk considerations directly into their investment processes, including asset class research, asset allocation, and portfolio construction. Sustainability risk considerations are incorporated into the research process using the firm's proprietary tools such as Sustainex or CONTEXT, in order to understand potential implications for risk premiums across asset classes.

During portfolio construction, strategies are selected by our Multi Asset teams to meet objectives from a range of Schroders' strategies or externally managed strategies. Schroders' strategies will have been through the Sustainability Accreditation framework and have been accredited as 'ESG integrated' using the approaches summarised above. Where external active strategies are used, these will have been through the approach described under the Third Party Manager Selection section below.

Our teams also seek to incorporate the potential implications of climate change on long term asset class return and risk forecasts.

## Third party manager 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.

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.

## Derivatives

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.

Where financial derivatives are used to achieve client-specified return and risk objectives, for example, within our Portfolio Solutions business, our primary exposure is to the counterparties of our trades rather than to the underlying asset on which the derivative contract is based. As such, we focus on sustainability risks during our on-boarding and annual review of counterparties which are primarily financial institutions.

## Infrastructure Finance

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 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).

Sustainability risk considerations form a core part of our investment scorecard which is applied to all transactions we analyse. We use CONTEXT, one of the firm's proprietary tools for sustainability risk analysis, as the framework for understanding and assessing the major environmental, social and governance themes which apply to infrastructure investments in different sectors. We have also developed an on-desk proprietary tool that assesses the sustainability risk and impact of an investment and its contribution to the UN Sustainable Development Goals.

## 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, e.g. catastrophe bonds, in themselves are already exposed to social and environmental trends such as climate change. We follow and examine social and environmental 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 environmental, social and economic impacts, positive and negative, to deliver resilient investment returns for the long term and manage exposure to material risks. We believe that understanding these issues and their impacts is integral to our investment process and applies 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. 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.

Our investment process includes consideration of sustainability credentials and risks throughout the investment lifecycle. We conduct pre-acquisition environmental, societal and governance 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 hold period and reviews are regularly conducted, for example 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 and physical risks. From a social perspective we are interested in optimising the tenant experience, fostering community relationships and contributing to local prosperity. We are also focus 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.

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