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Responsible Investment in Emerging Markets Credit

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1. Introduction

As a long-term investor, PGGM Vermogensbeheer B.V. (PGGM Investments, hereinafter PGGM) is committed to investing responsibly. PGGM manages its clients' Emerging Markets Credit 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 Emerging Markets Credit. 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 the internally managed part of investments made in Emerging Markets corporate bonds and loans, effective as of 1 January 2023.

2. Investment strategy & approach

On behalf of PGGM's clients, the Emerging Markets Credit team invests in investment grade and non-investment grade emerging market corporate bonds and manages an investment mandate that is evaluated first and foremost by benchmarked financial returns. The Emerging Markets 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 the Fund is to generate a net return that over a credit cycle of 3 to 5 years generates a 0.25% outperformance compared to the benchmark return, through constructing a portfolio of emerging market corporate bonds and loans.

Portfolio companies are analysed and monitored on their strategic and financial merits as well as their ESG performance and outlook. 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 Emerging Markets Credit, as further outlined in this document, and by actively taking into account ESG-related performance in investment decisions, Emerging Markets Credit believes that it offers a positive contribution that is best practice and in line with the clients' stated objectives.

The Emerging Markets Credit 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

ESG factors are relevant for EMC in various ways. Two important areas are:

1) Risk management
2) Responsibility to society

The EMC team continues to do research on ESG factors for risk management purposes as well as to keep up with all the developments with respect to ESG.
Our responsibility to society has to do with limiting negative contributions to sustainability factors. Sustainability factors comprise of environmental, social and governance subjects, respect for human rights and contest of fraud and bribery. This definition is set by EU law and further expanded on in the so-called Principal Adverse Impact (PAI)-factors.

For EMC several PAI factors are relevant, amongst others the factors that concern the CO2 footprint, the exposure to companies that are involved in fossil fuel sector, violators of OECD guidelines and UN Global Compact as well as exposure to controversial weapons:

• Exposure of the portfolio to controversial weapons is limited through the exclusion list.
• Violators of UN Global Compact and OECD-guidelines are limited in the portfolio by exclusion of the adverse controversies through RI guidelines.
• The CO2 emissions of the portfolio are reduced in accordance with the targets set by PFZW.
• Investments in the fossil fuel sector are actively reduced through the engagement program that is linked to divestments of laggards in the sector.

Besides this, the EMC team is actively using engagement (see 3.e) and invests a part of the portfolio in "Sustainable Development Investments" or SDI (see 3.f). In short, these are investments that contribute to one of the 17 SDGs. To conclude, the EMC team is actively engaging with other relevant institutions and teams within PGGM, in order to contribute to thought leadership of PGGM (see 3.g).

3.b Sector studies

One of the beliefs of the EMC team is that companies which take ESG factors explicitly into consideration are better managed companies than companies which do not take ESG factors into account.
A significant part of ESG integration in the investment process targets assessment of financially relevant ESG risks. Given the fact that all companies are unique, we chose a sector-based approach. For the most important global sectors, we have described and researched the most relevant ESG risks per sector. Dominant questions are:
Which metrics are relevant?
What is the financial risk?

The EMC team (sometimes in cooperation with the wider Credit team) conducted research for a.o. the following sectors:
- Basic Industries
- Transportation
- Metals & Mining
- Pulp & Paper
- Power & Utilities
- Real Estate
- Automotive
- Financials
- Telecommunication

Several initiatives are promoting ESG integration, both for investee companies and investors. The most relevant initiatives are Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB) and Task Force for Climate-related Financial Disclosures (TCFD), which also adopted a sector-driven approach.

Although there are attempts to combine these initiatives, for now there is no definite clarity on guidance for specific risks for specific sectors. To illustrate, for the Environmental factor, the team engages with companies to disclose water consumption, energy usage and GHG emissions. The team tries to assess and determine sector leading companies and laggards.

The Social factor in emerging markets context could relate to violating human rights (for example new projects with negative community-impact). These are hard to identify but the controversy scores that are supplied by external rating agencies can be of help. Governance in many companies is weaker in emerging markets than in developed markets. Concentration of property and control in combination with a lack of checks and balances is a point of attention. The background of dominant families or persons, their relations with politics and previous behavior towards capital providers could be of great importance. These factors are taken into consideration for investment decisions.

3.c Risk management

The EMC team believes that sustainability risks could impact financial results materially. A sustainability risk is an event on the Environment, Social or Governance domain that could have a real and significant negative impact on the valuation of the investment. This definition is from the EU regulatory framework. The way how sustainability risks are integrated in the investment process will be further explained.
The main sustainability risk is climate change and a so-called carbon tax is obvious. Although these factors have always been part of credit analysis, there has been a lot of progress lately in data disclosure and data quality. Independent parties like Trucost, MSCI or Sustainalytics provide data, analysis and scoring of companies and keep track if companies behave controversially.

The integration of sustainability risks are implemented a.o. through the following instruments:
- The client’s exclusions list
- CO2 reduction (see 3.d)

3.d CO2 reduction

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

3.e Engagement

Engagement is the link between risk management and responsibility to society. The EMC team believes that it has a responsibility to use its “power of money” in order to improve society. An important element is that the team asks the investee companies for their policies and approach on sustainability risks. This also includes the relevant metrics (for example emissions, water usage etc.), their targets and their plan to realize them.

On one hand, the team tries to promote awareness at the investee companies as well as the importance of ESG integration, while on the other hand, we learn and assess how good or bad a company is, as well as what the main challenges are.

3.f Sustainable Development Investments (previous BiO)

In November 2014, the EMC team set specific goals to invest part of the portfolio in “Beleggen in Oplossingen” (BiO). The goal was the invest at least 10% in companies that contribute to “solutions” from the 4 main themes as set by PFZW. The themes were climate change, scarcity of water, food security and health care sector. In the meantime the BiO framework has been replaced by the better known UN SDG framework and total SDI has reached more than 20%.

PGGM is co-founder of the Asset Owner Platform (AOP). This platform has appointed Entis as provider for SDG data. The EMC team also uses these data to label SDGs. Moreover, green bonds and sustainability-linked bonds are labelled as SDGs as well as property investments in case of a high enough GRASB score.

The team continues to explore and assess all the products that are available within credit. Possible new initiatives will be aligned with the client's needs and wishes. Data collection remains crucial to weigh these new initiatives.

3.g Thought leadership

The EMC team makes itself available for certain relevant discussions in the field of sustainability and credit. For example, the EMC team was actively involved in the working group that was established by the United Nations Principles for Responsible Investment (UN PRI) for "Fixed Income Credit Rating Agency engagement". The goal of this working group, which was widely supported by the global fixed income community, was to engage with the credit rating agencies in order to improve ESG integration.

Furthermore, the EMC team was involved in setting up the SASB reporting standards. Wherever the team can contribute relevant knowledge, the team is also actively involved in internal discussions.

3.h Exclusion

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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 Emerging Markets 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.

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