LGT Capital Partners

your partner for alternative investments

ESG Report 2020

"A strong focus on ESG is an effective way for investors to respond to the global challenges we face."

Front cover: Spring Creek Wastewater Treatment Plant, Springfield, IL, using technology of Evoqua

Contents

Introduction

The first half of 2020 marks an unusual time to be releasing our annual ESG Report. We were finishing our ESG assessments of managers and assets in March, just as many countries were locking down due to the novel coronavirus. It may have seemed strange to carry on "business as usual" in such a context, but if the coronavirus has taught us anything, it is that ESG considerations are now more important than ever. The focus of ESG on themes like health and safety, supply chains and stable employment speak to the heart of the COVID-19 crisis.

In response to the coronavirus-induced economic crisis, governments around the world have committed to huge stimulus programs, totaling trillions of dollars. In many countries, there have been calls to embed sustainability goals into the new spending initiatives to ensure that money is deployed in a socially and environmentally responsible way. Such discussions are likely to keep ESG and climate change high on the political and economic agenda and will lead to an expanded opportunity set for sustainable investments. Therefore, now is the perfect time to reflect on the state of ESG in our portfolios.

In our multi-manager portfolios for private equity, hedge fund and long-only strategies, we have assessed 328 managers on their ESG practices this year. We find that private equity managers are continuing to further integrate ESG across a wide range of activities, such as linking ESG factors to value creation, combatting climate change and addressing diversity topics at portfolio companies. Meanwhile, we have enhanced our assessment of hedge fund and long-only managers, by combining bottom-up analysis of portfolios with our usual top-down evaluation of managers, resulting in a more comprehensive understanding of their ESG practices.

In our direct strategies, we focus on the carbon footprints of our Sustainable Equity and Bond Strategies, which are significantly smaller than their respective benchmarks. We also highlight how we have begun evaluating the carbon footprints of energy producers in our portfolios for their alignment with the Paris agreement's "below 2°C" target. At the same time, we zoom in on the ESG Cockpit, our proprietary ESG assessment tool for listed securities, providing a detailed breakdown of how one global manufacturer earned top ESG marks. In addition, we describe our approach to scrutinizing new green bond issues in a growing market where green washing is a concern.

This year's report includes a number of special features to illustrate some of the new ESG developments in our portfolios. For example, for the first time, we show how we integrate ESG into insurance-linked strategies with a focus on the ESG profiles of our transaction counterparties. We also describe how we have expanded the scope of our ESG Cockpit to include impact of companies on the Sustainable Development Goals (SDGs).

We are convinced that these wide-ranging ESG efforts make a strong case for sustainability in our portfolios. We also believe that a strengthened focus on ESG is an effective way for investors to respond to the coronavirus pandemic, as well as to the many other global challenges we face today and will face in the years to come.

As always, we would be pleased to discuss with you any questions or comments you may have on the information presented.

On behalf of LGT Capital Partners,

Tycho Sneyers
Chairman of the ESG Committee

Facts and figures

328 MANAGERS ASSESSED ON ESG

88

METRIC TONS OF CARBON ARE SAVED BY OUR GLOBAL EQUITY STRATEGY VERSUS THE BENCHMARK[1]

47%

OF PRIVATE DEBT PORTFOLIO COMPANIES TRACK THEIR CARBON EMISSIONS

81%

OF EUROPEAN PRIVATE EQUITY MANAGERS ARE RATED EXCELLENT OR GOOD ON ESG

9,000

NEW JOBS CREATED IN OUR PRIVATE EQUITY CO-INVESTMENT COMPANIES

47%

OF THE LGT SUSTAINABLE BOND STRATEGY IS COMPRISED OF GREEN BONDS

[1] per USD 1 million of revenue

ESG assessment of managers – how we do it

Each year we conduct an assessment of managers, which forms part of the firm's larger ESG due diligence, monitoring and manager engagement process. The assessment serves a two-fold purpose. First, it shows our investors the extent to which managers are considering ESG factors in their investment, ownership and reporting practices. Second, the assessment facilitates our engagement with managers on ESG, highlighting excellence in implementation and flagging areas for improvement.

In the assessment, we ask managers about, and score them on, four key areas of ESG practice:

- Manager commitment – the extent to which they have demonstrated their commitment to ESG through actions such as defining a policy, committing to an industry initiative like the Principles for Responsible Investment (PRI) and engaging with their portfolio companies
- Investment process – the extent to which they have formally integrated ESG into their investment processes, using it as a framework for evaluating investments and identifying areas for improvement
- Ownership – the extent to which they have exhibited active ownership through activities like defining ESG guidelines, establishing key performance indicators (KPIs) or assigning ESG responsibilities for portfolio companies
- Reporting – the extent to which they have provided regular and relevant reporting on ESG on a portfolio company level and on the aggregate fund level

Managers receive a score of 1 to 4 (where 1 = excellent and 4 = poor) on each of the four areas, resulting in an overall rating for each manager, which is then documented in our monitoring system. Managers who receive low scores (3 or 4) on specific indicators are encouraged to improve over time.

Rating	Description
1	Manager is genuinely committed to ESG, with institutional processes in place. Applies ESG criteria in investment decision-making, is an active owner and reports on ESG.
2	Manager has taken steps to integrate ESG into its approach and investment process. Process is institutionalized, but manager may not follow through on all levels (e.g. reporting).
3	Manager demonstrates some commitment to ESG or has begun some initiatives, but lacks institutionalized processes.
4	Manager demonstrates little or no commitment to ESG.

Source: LGT Capital Partners

Private equity

Large increase in managers assessed

The last 12 months have seen our largest ever year-on-year increase in managers assessed on ESG, with 34 new managers entering our portfolios, for a total of 251 globally. While we welcome the growth of our manager network, as we seek to deploy capital for our investors, such a large increase can have an outsized effect on portfolio ESG ratings. Many of these new managers entered our portfolios through secondary transactions, so they have not had the benefit of our engagement on ESG, through our annual assessment and follow-up discussions. As we might expect, the new group have lower ESG ratings than the managers already in our portfolios, which means that the 2020 ESG ratings in some instances slightly understate the positive developments in our portfolios over the past year. We accept that as a small price to pay for maintaining consistency in our approach to reporting on ESG, which is ultimately the most beneficial to investors. It also gives us an opportunity to highlight the progress being made in a more qualitative way, which we are pleased to do in the analysis and commentary that follows.

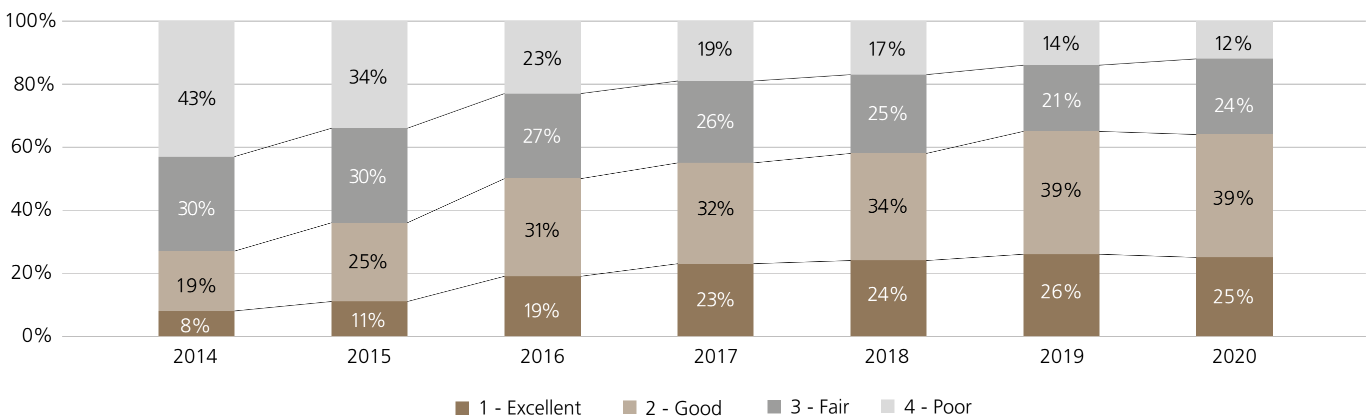
Significant long-term progress globally

Notwithstanding the new managers, the picture of ESG practice in our portfolios for our global group of 251 managers is largely in line with what we saw last year. We find that 64% have achieved our top ratings of 1 or 2 on ESG, which indicates that they have institutionalized processes in place for managing ESG issues within their portfolio companies. Taking the longer view, it represents a 37 percentage point increase since 2014 (when the number stood at 27%).

We focus on the cohort of managers rated 1 or 2 because achieving either of the top two ratings indicates that the manager has transitioned from a largely ad-hoc set of practices to a systematic one, where ESG is formally embedded into their investment and ownership activities. We also know from experience that managers who take this step tend to continue improving over time because they now have formal structures in place to facilitate further enhancements.

The overall picture we see is that ESG integration has become largely mainstream in private equity. Practices may vary widely between managers, but the overwhelming majority have started on their ESG journeys.

Figure 1 – ESG ratings globally

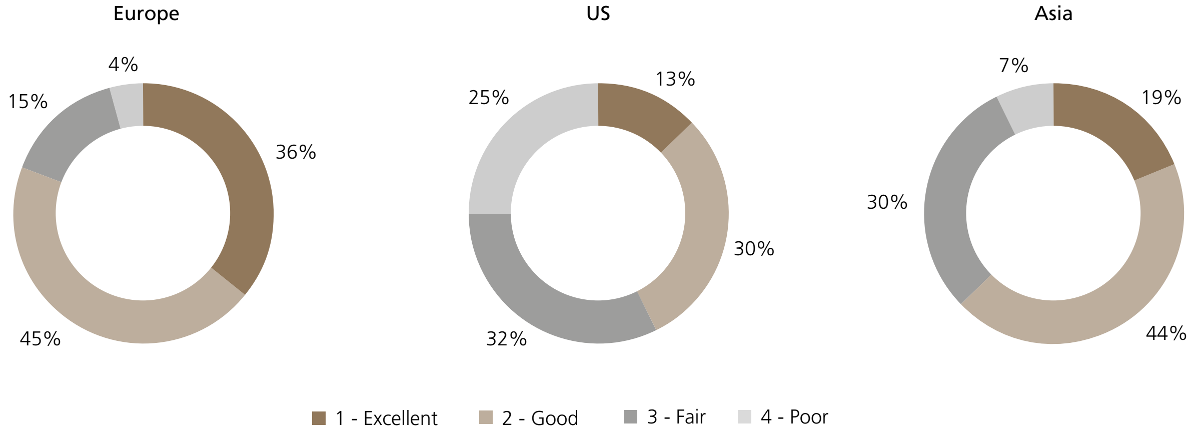


Source: LGT Capital Partners

All regions show significant ESG integration, with Europe and Asia still out in front

Looking at ESG practices across the three key private equity markets of the United States (US), Europe and Asia, we see continuity with past findings. Europe is still in the lead, with 81% of managers rated either 1 or 2 on ESG, followed by Asia with 63% and the US trailing somewhat with 43%. Nevertheless, we find examples of ESG excellence in each of the three markets, which we share in the following pages.

Figure 2 – ESG ratings by region in 2019



Source: LGT Capital Partners

Case study: Benelux buyout manager illustrates the power of ESG engagement

Central Amsterdam, the Netherlands

In 2019, a Benelux-based small buyout manager made significant strides on the back of proactive dialogue with us. Just two years ago, the manager had effectively no process in place for identifying or addressing ESG issues, so it appropriately held a rating of 4. Following several discussions in 2018, the manager's team took their first steps on ESG integration, which they built upon over the course of 2019, resulting in a rating increase to 2 in 2020.

The team is comprised of hands-on and operationally involved private equity professionals, who had until 2018 maintained that their portfolio companies did not need to spend extra time on ESG topics. They reasoned that their portfolio company management teams were already focused on health and safety, with key employee statistics part of normal human resources (HR) business operations. As such, they considered responsible investment practices an additional burden on management and the investment team.

The team was not unique holding these views, as we have encountered similar thinking among a number of other private equity managers over the years. In our discussions, we explained the importance of ESG to us and our investors, and we pointed out obvious first steps they could take. A big change in their thinking occurred when they more clearly came to understand the upside potential of managing specific material ESG factors in their portfolio companies and how this can add value to the investment.

In response, the manager developed a clear, practical ESG policy and appointed an ESG officer from within the investment team. The ESG activities are now part of their operational approach to investing and very much focused on value creation. For example, specific measures that mitigate ESG risk or realize an ESG-related opportunity are built into the value creation plan for each portfolio company and tracked with a number of different KPIs. Team members then discuss progress on these KPIs in their monthly meetings with company management. They also have plans to report on their ESG efforts, which we look forward to seeing in future reporting cycles. Overall, we consider their approach a textbook example of ESG integration with a focus on materiality.

Consistent progress in Europe

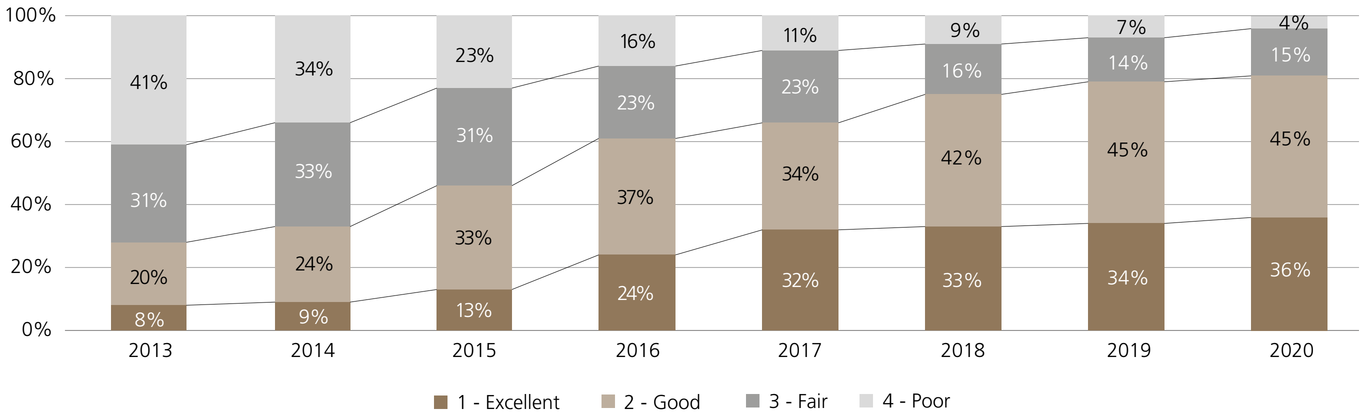
Europe represents our longest series of ESG data, 8 years, for viewing the evolution of ESG practices in our portfolios. As of today, 81% have achieved ratings of 1 or 2, with only a tiny minority, 4%, who have yet to begin their ESG journeys. It shows a nearly three-fold increase in top-performing managers on ESG since 2013 (from 28% to 81%) and a ten-fold decrease (from 41% to 4%) in our lowest-performing (4-rated) managers.

The European managers who improved on ESG over the past year represent all four market segments (small, medium, large and mega buyout) and three major regions, Northern, Western and Southern Europe. The group includes managers who began institutionalizing their ESG approach (moving from 4 to 3), others who transitioned from a somewhat ad-hoc ESG approach to a well-institutionalized one (from 3 to 2), and those who further enhanced already strong practices (from 2 to 1).

The work of one small buyout manager in Southern Europe illustrates how a manager can make the critical jump from a rating of 3 to 2 in our framework. In 2018, the manager implemented an ESG policy that seemed to commit the team to ESG integration, but provided little detail on processes, people responsible or training for the team. This earned them a 3, as they had taken their first critical steps on ESG. Over the course of 2019, the manager clarified the policy by defining ESG responsibilities both within the investment team and at portfolio companies. They also defined additional ESG due diligence to be carried out on investments, depending on the material issues present in the target company. For example, a company with manufacturing facilities will undergo extra environmental due diligence, focusing both on how the company impacts the environment as well as environmental risks specific to a particular location.

The results of ESG-related due diligence are now systematically included in the investment memorandum to ensure that the investment committee considers ESG matters when reaching a final investment decision. The manager has also begun tracking ESG metrics in its portfolio and reporting on this data in the information packages prepared for company board meetings. These metrics are discussed monthly, ensuring the topic is always on the agenda in discussions between investment team members and company management teams.

Figure 3 – ESG ratings in Europe



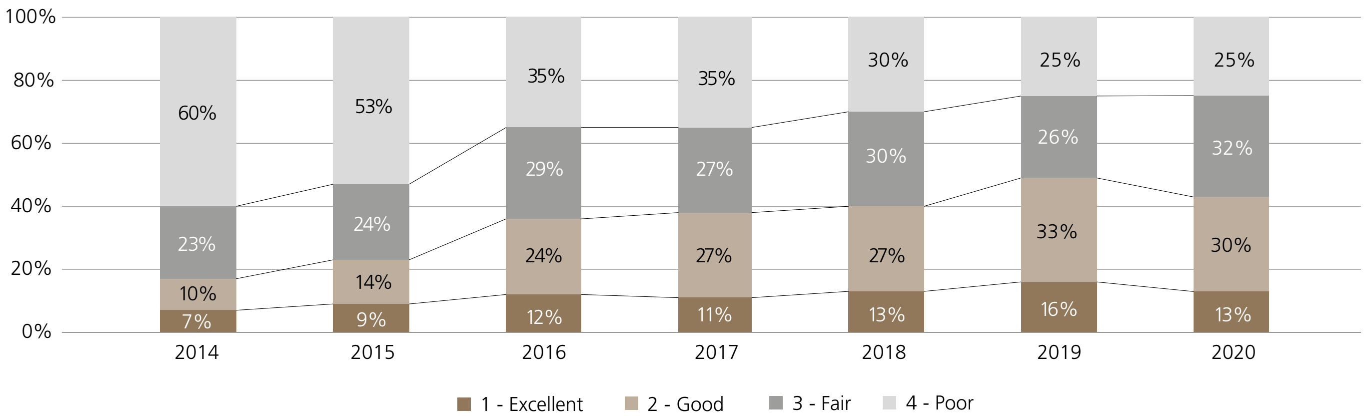
Source: LGT Capital Partners

New managers lower US ratings

The US private equity managers in our portfolios, as a group, lag behind their European and Asian peers on ESG, with 43% having well-institutionalized processes in place for managing ESG issues. This represents a noticeable drop from last year's 49%, which is largely the result of 14 new managers who joined the portfolio, including a number acquired on a secondary basis. The cohort has below-average ESG ratings, with no managers rated 1 and only 14% rated 2, so they have considerable scope for ESG improvement.

Nevertheless, there are many managers doing good work on ESG in our US portfolio. One example is a middle market buyout manager, which earned a rating of 2 this year (up from 3) on the back of strong efforts in further ESG integration. Prior to this year's assessment, the manager's approach was typical of many 3-rated managers, who express good intentions in a set of high-level ESG guidelines, but can provide limited evidence of how it effects their investment decision-making and oversight of portfolio companies. Over the past year, the team brought their approach to the next level, with an ESG policy that clearly spells out ESG priorities in the due diligence process, as well as the people responsible for managing them. The policy also describes the process for identifying ESG issues at companies, how issues will be addressed during the ownership period and how the team will communicate them to investors. For implementation, they engage an external advisor that carries out comprehensive ESG due diligence on portfolio companies, which helps them to identify and manage ESG issues from the very start of deal discussions. Overall, it is an impressive enhancement to their existing ESG framework, which will enable them to address issues in a focused, methodical way.

Figure 4 – ESG ratings in the US



Source: LGT Capital Partners

Proportion of top-rated Asian managers surpasses 60%

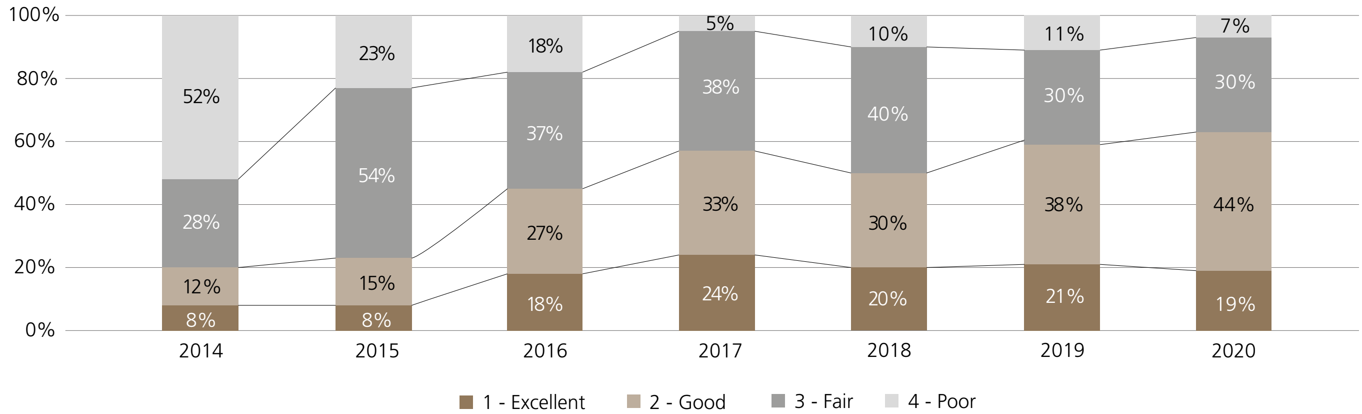
Asian managers have continued their forward momentum on ESG over the past year (Figure 5), with a small increase of three percentage points in top-rated managers (1 or 2). As a result, 63% of them now have robust ESG processes in place. The Asia sample reflects a mild impact from the seven new managers who entered the portfolio this year, as their ranks do not include any 1-rated managers and a disproportionate number who are rated 4. This means that our Asian managers achieved the overall improvement in ratings despite the "drag" of the new managers, an encouraging development that is further mirrored at the bottom end of the distribution. The proportion of managers rated 4 dropped to 7% of the total, down from 11% last year.

The improvement at the bottom end is in part driven by a small buyout manager that took its first steps on ESG this year, earning it an increase in rating from 4 to 3. Over the past year, the manager developed a set of ESG guidelines and began working with an external advisor to conduct ESG due diligence to ensure they identify material ESG issues prior to investment. In addition, the team began to monitor ESG matters post investment, which they have been able to document in their reporting with concrete examples from their portfolio companies. The manager has gotten a strong start in their ESG efforts, and we look forward to seeing them develop over time.

Small managers demonstrate the most progress this year

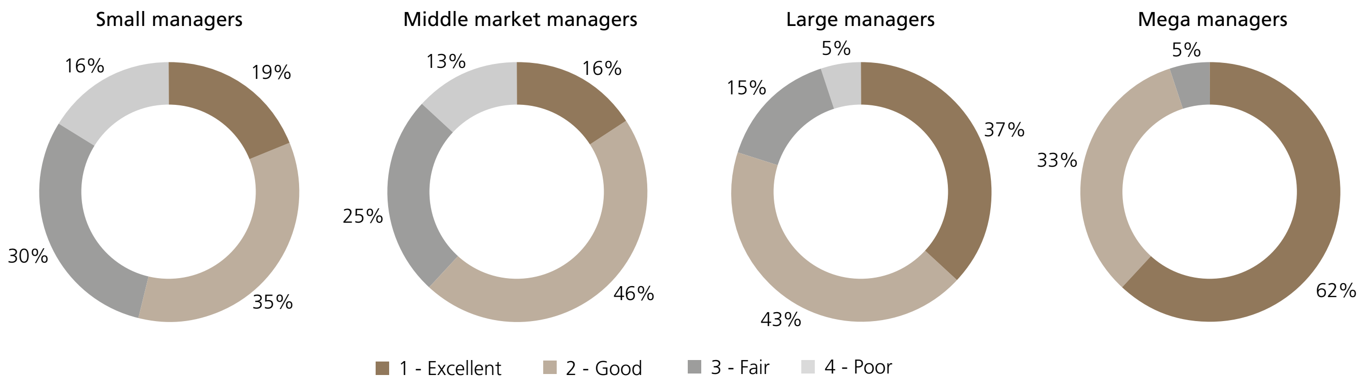
We have long noticed a difference in ESG ratings across our portfolios, when segregating managers by fund size. Overall, a greater percentage of large and mega buyout managers earn top ratings on ESG, owing in part to the economies of scale they enjoy, which enables them to dedicate more resources to ESG matters. This year's ESG ratings once again bear this out (Figure 6), with top-rated managers (1 or 2) comprising more than 80% of the large and mega buyout cohorts. Having said that, managers rated 1 or 2 still account for the majority of small buyout (54%) and middle market buyout (62%) managers in our portfolio. Furthermore, more small buyout managers improved their ratings over the last 12 months than any other category of manager. Three of the examples described earlier in this report, two European and one Asian, illustrate the kinds of steps small managers are taking to develop their ESG know-how.

Figure 5 – ESG ratings in Asia



Source: LGT Capital Partners

Figure 6 – ESG ratings by size of funds (EURm)



Source: LGT Capital Partners

How managers integrate specific ESG practices into their businesses

The ESG assessments we carry out each year on our managers ultimately culminate in a rating that provides a quantitative snapshot of the ESG work they do in their portfolios. It can be useful to look below the surface of these ratings to see exactly how managers are progressing on specific ESG activities. In this section we provide an overview of this, focusing on some of the key aspects of ESG practice that concern investors.

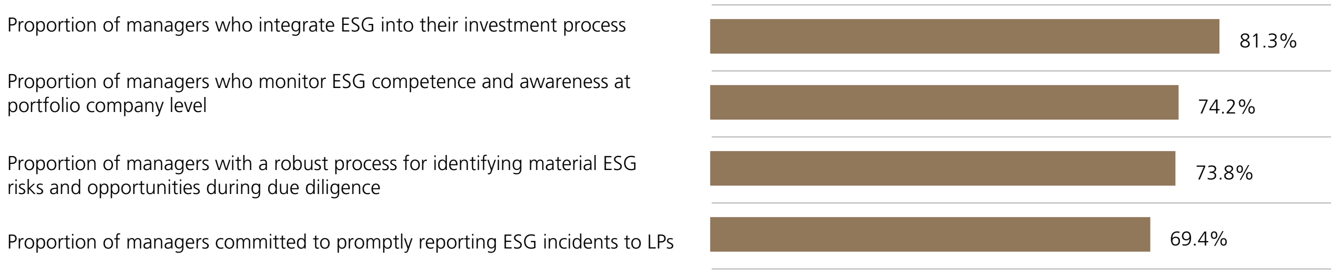
We have singled out four practices that form the core of ESG best practice and highlighted them in the charts below. These include:

- integrating ESG into the investment process
- having a robust process for identifying material ESG risks and opportunities during due diligence
- monitoring ESG competence and awareness at portfolio company level
- promptly reporting ESG incidents to investors

Managers who have all four elements in place are clearly fulfilling their ESG responsibilities in an essential way. Looking across our global set of 251 managers, we see in Figure 7 that the overwhelming majority of them, 69% to 81% (depending on the element) carry out these core activities.

These elements of ESG practice can also be used to measure progress over time. For example, we analyzed the proportion of managers who began carrying out these four activities for the first time over the last four years. We found that 14% to 15% of them (depending on the activity) have started efforts in these areas over the last four years, which provides further evidence of forward momentum on ESG in our portfolios.

Figure 7 – Proportion of managers carrying out four core ESG activities



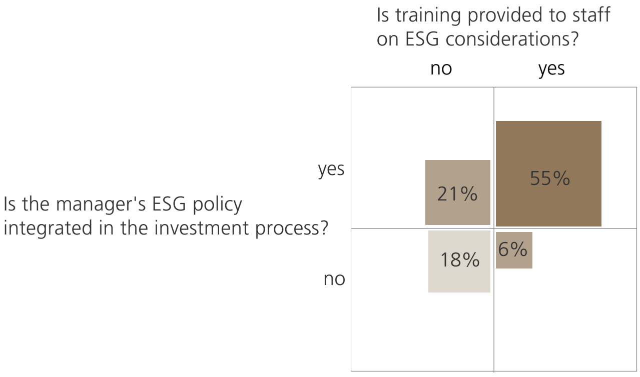
Source: LGT Capital Partners

ESG integration and training

We can also leverage our ESG data to explore relationships between different ESG activities to check whether there are any gaps in their process. For example, if a manager claims that ESG is integrated into their investment process, you would expect that they would carry out training on it from time to time, especially as new techniques and standards emerge. Plotting these two elements on a box chart can show this relationship more clearly.

We find in Figure 8 that 55% of managers both integrate ESG and provide training on it, a clear majority of cases and in line with expectations. The 21% who integrate ESG but do not provide training are typically managers who have started their ESG efforts more recently and are still developing their approaches. Often such managers will be rated 3 in our assessment framework.

Figure 8 – Integrate ESG vs. provide training



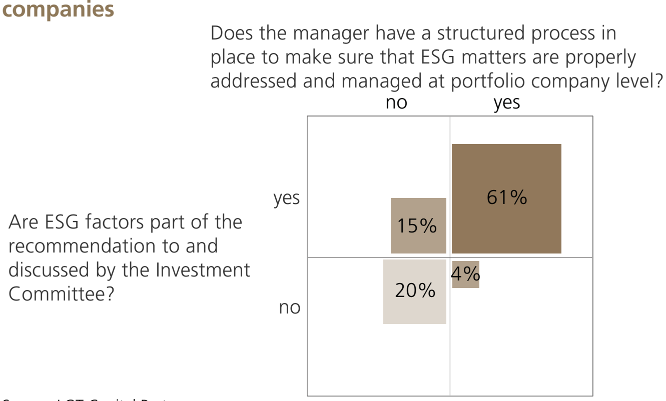
Source: LGT Capital Partners

ESG committee discussions and portfolio company follow-through

Another area worth exploring for consistency is the relationship between ESG discussions by the manager's investment committee and how ESG matters are actually managed at portfolio companies. You would expect the two to go hand in hand, but it is easy to imagine set-ups where ESG is duly considered prior to investment, but little follow-through is done post investment to address the issues raised. Figure 9 shows this relationship in our portfolio, where the vast majority of managers, 61%, do indeed address the issues identified in due diligence during their ownership of the company.

The 15% who fail to follow through post investment are, again, typically managers who have only recently begun their ESG journeys, or have gotten off to a good start, but have not yet integrated ESG in a fulsome way. They will normally be rated 3 in our framework and will be targeted for additional ESG engagement over time.

Figure 9 – ESG considered by IC vs. ESG addressed by portfolio companies

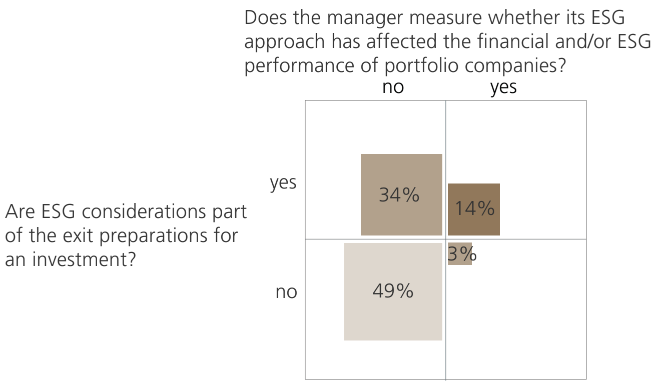


Source: LGT Capital Partners

The final frontier: measuring ESG impact

The area of ESG practice that is the least developed among our managers, and which represents something of the "final frontier" for private equity is measuring the impact of ESG work on the performance of the company. This is difficult to do, as disentangling the effects of ESG actions from other types of value creation at the portfolio company is a daunting task. Nevertheless, as the Figure 10 shows, some 14% of our managers attempt to measure this impact as part of their preparations for exit. As we would expect, the largest group of managers, 49%, are neither considering ESG in exit preparations nor trying to measure its financial impact, while 34% are at least integrating it into their exit plans. We anticipate the proportion of managers doing one or both activities will rise in the next few years, as techniques for measuring ESG value creation improve.

Figure 10 – Consider ESG at exit vs. measure ESG impact

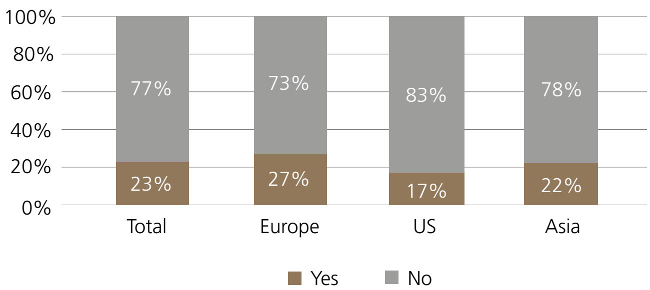


Source: LGT Capital Partners

How managers are responding to the challenge of climate change

Climate change is climbing higher on investor ESG agendas, as the signs of global warming become ever clearer. In an ESG study LGT Capital Partners (LGT CP) carried out in 2019, institutional investors told us that climate change is their number one concern by a wide margin.[2] Our ESG assessment this year suggests that private equity managers are starting to respond, as 23% of our managers globally (Figure 11) have a framework in place for assessing climate change risk in their portfolios. As we see with ESG factors in general, there is significant regional variation in the response, as 27% of European managers and 22% of Asian managers have implemented an approach to climate change, while 17% US managers have done so. The particular approaches taken to climate change vary as much as the managers themselves. For example, an Asian middle market buyout manager focuses on the carbon footprint of portfolio companies. Metrics on these topics are included in the manager's ESG checklist for the investment, and the team carries out an assessment of environmental risk for each portfolio company they consider. Post investment, the manager uses its influence on the company's board to encourage measures that improve energy efficiency and lower carbon emissions.

Figure 11 – Does the manager have a framework for assessing risks related to climate change?



Source: LGT Capital Partners

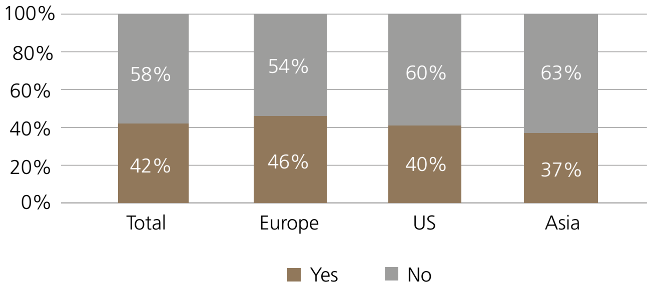
[2] "ESG to SDGs: the Road Ahead," LGT CP, 2019

In another example, a US impact manager has developed a proprietary methodology for environmental assessment, which analyzes a company's impact on climate, pollution and natural resources over the entire lifecycle of its products or services. This includes impacts that are generated directly by the company, as well as those stemming indirectly from the company in its supply chain or in the marketplace. Their analysis applies best practices and standards, including those of the IPCC and the Greenhouse Gas Protocol to ensure uniformity and comparability.

Managers are increasing their focus on diversity and inclusion

We began exploring the approach of our managers to diversity and inclusion (D&I) in our report last year, and we observe a small uptick in action on the topic this year. Today, 42% of managers consider D&I factors when making investment decisions, which is up two percentage points from last year. As with climate change and other issues, there is some regional variation in uptake, with Europe in the lead at 46% of managers considering D&I, versus 40% in the US and 37% in Asia.

Figure 12 – Does the manager consider D&I in its investment decisions?



Source: LGT Capital Partners

Managers are taking a variety of approaches in integrating D&I into their investment processes. A US small buyout manager makes a point of working with portfolio companies to diversify their board post-investment. Where board diversity is lacking, they look to add qualified female candidates, either by engaging a specialist search firm or tapping their own network. They are able to show significant female participation in the boards of all current companies, including one company with four female non-executive directors, and another where two-thirds of the board members are women.

In another example, a French large buyout manager also works closely with its portfolio companies on diversity through HR policies and in governance bodies. Governance and HR issues are discussed and assessed on a systematic basis within each portfolio company through an annual ESG review. In doing so, they track a wide range of metrics, including: the number of women on the board, in management positions and in the executive management team, as well as the workforce overall. They use these statistics to guide the HR and recruitment strategies of the company.

ESG in co-investments

This is the second year that we have collected and aggregated a set of ESG key performance indicators (KPIs) for our co-investments. The KPIs on our 42 companies provide us with insights on where companies and management teams are focusing their ESG efforts and where more attention may be required.

Figure 13 – ESG KPIs

	ESG metric	Portfolio score
General	Implemented an ESG policy	45%
	Provide ESG training to employees	49%
	No ESG-related litigation	90%
Environment	Implemented an environmental policy	38%
Social	Implemented diversity initiatives	55%
	Established a remuneration committee	45%
	Net job creation	9,000
Governance	Adhere to a code of conduct or ethics	88%
	Women in executive management	20%
	Independent board members	26%
	Established an independent audit committee	50%

Source: LGT Capital Partners

Generally, we find that results this year are in line with last year, with some indicators slightly improving and others slightly decreasing. We observe relatively high concern for ethics and conduct, with 88% of companies having a code of conduct or ethics in place, while less attention is given to environmental issues, with 38% of the companies maintaining a formal environmental policy.

Looking beyond the KPIs themselves and focusing on areas that get the most attention from company management teams, governance-related KPIs stand out as the most closely tracked, followed by social indicators and environmental indicators.

Given the global attention to climate change and increased regulatory pressure, one might expect a higher priority given to environmental topics. Most of the companies in our portfolio, however, produce products and services where the consumption of energy and other natural resources is less material than for manufacturing and other energy intensive industries.

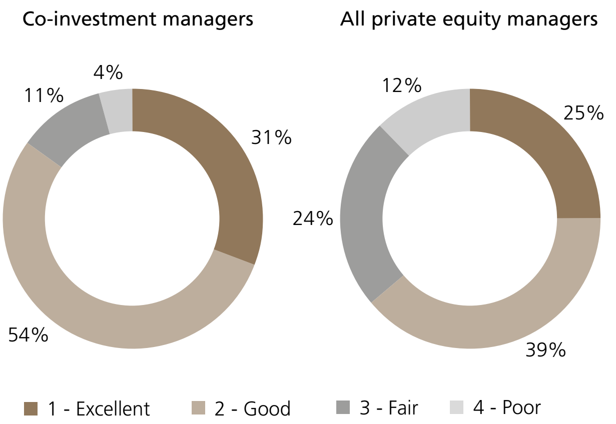
As strong performance on social factors contributes to a healthier, more engaged workforce, it is reassuring to see that the majority of our portfolio companies provide training to employees on a range of topics, from health and safety to D&I. Most companies also provide training on their code of conduct, often including anti-bribery and corruption issues, as well as on information security and data protection.

Another significant observation is that our group of 42 companies created approximately 9,000 net new jobs in 2019.

ESG practices of the managers with whom we co-invest

ESG is an important part of our investment and monitoring process for co-investments, as ESG analysis is used to identify potential risks in co-investments as well as to capture upside opportunities. We look at both the individual portfolio company as well as our co-investing private equity manager. We tend to co-invest with managers that have higher-than-average ESG ratings, where 85% have achieved ratings of 1 or 2, versus 64% for our global set of private equity managers. We regard this as a positive sign, suggesting that we "walk the talk" when selecting co-investment opportunities.

Figure 14 – ESG ratings: co-investment vs. all private equity managers



Source: LGT Capital Partners

Solar solution of Depcom Power, Scottsdale, AZ

Private debt

Portfolio company KPIs and ESG engagement

Each year we collect a range of ESG KPIs on the companies in our private debt portfolio, which provide us with insights on how companies are responding to their ESG challenges and opportunities. The portfolio is comprised of small and mid-sized European companies, with a tilt towards those in the service, technology and light industrial sectors. In addition to collecting KPIs, we regularly engage with portfolio companies on ESG to gain a better understanding of how they approach the topic. In Figure 15, we aggregate a selection of KPIs across our portfolio of more than 40 companies to provide a snapshot of how our private debt portfolio overall is performing on ESG.[3]

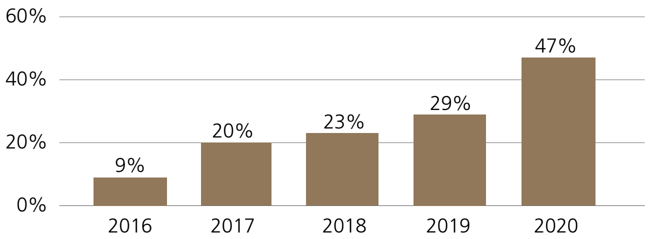
Figure 15 – ESG KPIs

	ESG metric	Portfolio score
General	Implemented an ESG policy	67%
	Track ESG initiatives with KPIs and reports	56%
	No ESG-related litigation	94%
Environment	Implemented an environmental policy	44%
	Assess carbon footprint	47%
	Track water or energy consumption	58%
	Track waste volumes, cost and % recycled	39%
Social	Net job creation	755
	Diversity – female headcount	47%
	Provide training opportunities	86%
	Company-wide profit sharing	56%
Governance	One or more independent board member(s)	50%
	Average number of board meetings per year	7
	Adhere to a corporate code of ethics	50%
	Established independent board committees (management, audit, remuneration, etc.)	56%

Source: LGT Capital Partners

A steadily growing proportion of our portfolio companies, 47%, currently report on CO_2 emissions (Figure 16), which represents a five-fold increase from 2016.[4] We take this as an encouraging sign that more and more companies are starting to monitor this KPI, acknowledging the growing importance of playing their part in the global fight against climate change. Our ESG engagement with companies also suggests significant interest by executive staff in learning more about how they can address climate change in their corporate strategies. In this year's assessment cycle, 47% told us they would welcome support on climate change topics. Among them, 71% cited an interest in getting access to tools to help them take action against climate change or get training on the topic.

Figure 16 – Proportion of companies assessing their carbon emissions

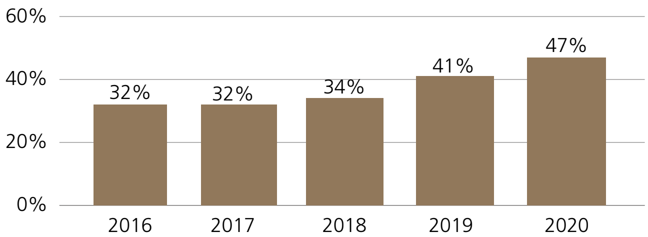


Source: LGT Capital Partners

One way LGT CP is helping companies gain this support is through our participation in the PRI-endorsed "Initiative Climat International", which we joined in 2019. The initiative was founded by French private equity firms, who have collaborated to develop a simplified tool aimed at kick-starting carbon footprint assessments at portfolio companies, and they continue to work together to share best practices on climate action. We believe this will be an effective additional channel for giving our portfolio companies access to climate change know-how, regardless of whether they are just starting to monitor their CO_2 emissions or beginning to think about an emissions-reduction plan.

This year we also observe a positive trend in the diversity statistics of our portfolio companies, where currently 47% of employees are female, which is in line with the population as a whole. This marks a steady improvement from 2016, when women comprised 32% of company workforces in our portfolio.

Figure 17 – Proportion of female headcount at portfolio companies



Source: LGT Capital Partners

[3] Based on our survey of LGT CP private debt portfolio companies as of 31 Dec 2019, featuring a selection of key items.
[4] 2019 and 2020 figures include companies that have already assessed their CO_2 footprint or are doing so in the year of the survey.

Hedge funds

Enhanced ESG rating process integrating bottom-up analysis

Since last year, we have enhanced the way we rate our hedge fund and long-only managers, going beyond top-down assessments. Our new assessment framework incorporates a bottom-up ESG assessment of the publicly listed assets in our portfolios managed by external partners, allowing for a more comprehensive ESG evaluation. We do this by reviewing and rating the assets with our ESG Cockpit, a proprietary tool that draws on publicly available ESG data to generate ESG scores for individual securities. It analyzes the ESG attributes of a company's operations, ESG controversies and the impact of the company's products and services on the Sustainable Development Goals (SDGs). Further details about the ESG Cockpit can be found in the chapter on Sustainable Equities and Bonds.

We start every assessment by deciding the balance between a top-down assessment and a bottom-up evaluation for determining the final ESG rating of a manager. The decision is largely driven by the managers' strategy, the available transparency on their portfolio and the method of implementation. For example, a long/short equity strategy executed via a managed account will usually lead to an overweight on the ESG attributes of the portfolio in determining the manager's final ESG score. On the other hand, an assessment of a CTA/global macro manager will typically emphasize the top-down assessment, as they manage fast-moving strategies with short-term investment horizons and the instruments they trade in do not readily lend themselves to meaningful ESG evaluation.

We are pleased to present the first results of this additional analysis on the pages that follow. The new approach has led to a downgrade of ESG ratings for some managers, where we saw that aggregate ESG scores of portfolios fell short of the ESG practices described in managers' qualitative responses. We believe that the additional transparency on our managers' ESG effort will enhance our assessment and engagement with them going forward.

Case study: Long/short credit manager Lodbrok

LODBROK CAPITAL

In our engagement with hedge funds, we find that managers in certain strategies are better positioned than others to drive change in the underlying companies. Lodbrok is a manager that focuses on small companies in distress and integrates ESG factors into the investment process to broaden the scope of risks considered. Post-investment, the manager works to systematically improve identified ESG weaknesses in companies. Figure 18 highlights two of Lodbrok's efforts during the last year to improve the ESG profile of their portfolio companies.

Figure 18 – Lodbrok engagement with portfolio companies

	Portfolio company A	Portfolio company B
Type of company	Light industrial and logistics company, which currently owns 63 properties across Germany.	Asset manager focused on real estate for both retail and institutional investors in Europe.
Issue	Environmental – Lodbrok identified the risk of contamination in some of the company's properties, as well as potential weaknesses in their policies for managing this risk.	Governance – Lodbrok recognized that the company's governance practices could be improved, as the founder still received advisory fees as the largest shareholder. Moreover, he controlled the supervisory board.
Engagement and outcome	Lodbrok engaged with the company's CEO and CIO on the contamination risk and their approach to managing them. The company reviewed their original assessment of risk and cooperated with an external adviser to confirm that properties are free from contamination. They also clarified their procedures for monitoring this risk going forward.	Lodbrok addressed the governance issue with management in various meetings. The company responded by terminating the advisory contract with the founder (who subsequently sold his shareholdings). The company also enlarged the supervisory board and introduced broader ESG initiatives.

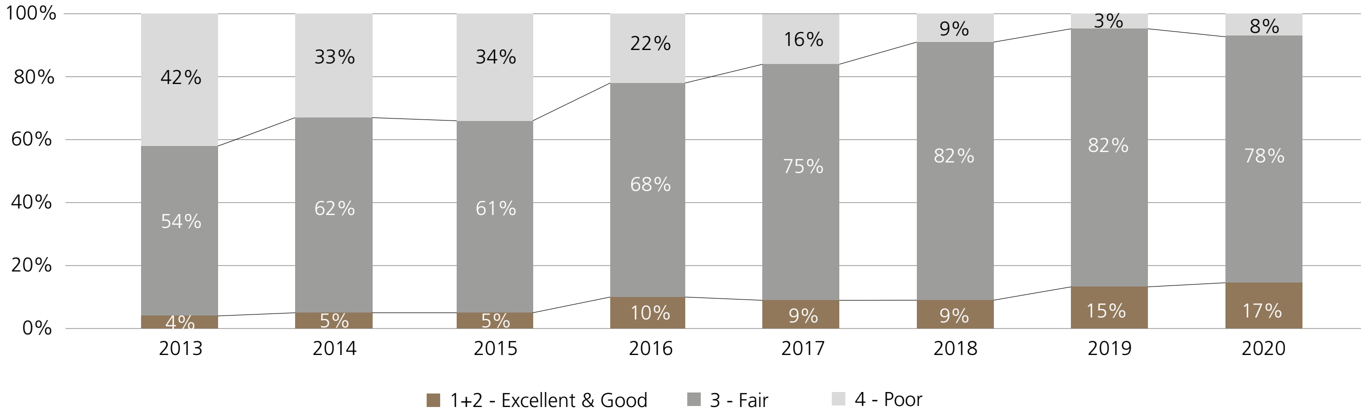
Source: Lodbrok Capital

Current ratings and the long-term ESG development of our hedge fund universe

We find (Figure 19) that 17% of our managers achieved the top ESG ratings of 1 or 2, compared with 15% last year. At the same time, the assets invested with these managers (Figure 20) have remained largely the same at 14% of total hedge fund assets.

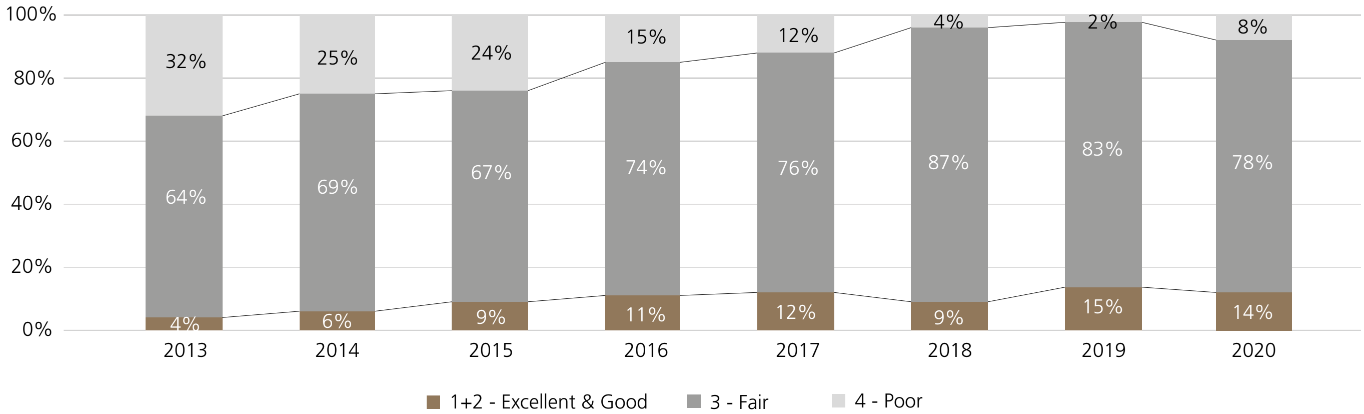
Similar to last year, a large majority (75%) of our hedge fund managers have a rating of 3 (versus 82% in 2019), and we invest 78% of our assets with such managers (versus 83% last year). We also observe an increase in the number of managers rated 4 on ESG since last year, from 3% to 8%, with assets invested with them increasing from 2% to 8%. This shift in ratings is largely driven by the arrival of a new set of relative value/CTA managers into our portfolios, who incorporate artificial intelligence (AI) into their investment strategies, and who are less familiar with the increasing ESG standards for hedge funds. We describe these managers – as well as their expected transition from rating of 4 to 3 – in more detail below, in the section titled "Relative Value/CTAs: the arrival of artificial intelligence."

Figure 19 – ESG ratings by number of managers



Source: LGT Capital Partners

Figure 20 – ESG ratings by AuM

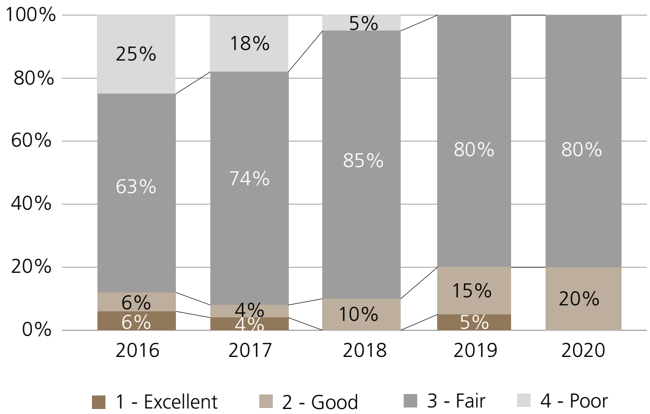


Source: LGT Capital Partners

Equity-related strategies

Within the equity-related strategies (event driven and long/short), one ESG-oriented quantitative equity manager was downgraded from a 1 to a 2 this year, after taking into account our ESG assessment of the manager's portfolio. We are pleased that all the managers previously rated 2 retained their ratings, thereby validating the findings of our original top-down assessments. The remaining 80% of managers are rated 3, which is unchanged from last year.

Figure 21 – ESG ratings of equity long/short managers



Source: LGT Capital Partners

Our conversations with managers indicate that ESG practices are becoming better embedded in this strategy. It is also clear from our discussions that regulatory pressures and technology-enabled improvements in asset transparency have helped to drive this adoption, which points to further progress in the years to come.

Relative Value/ CTAs: the arrival of artificial intelligence

2019 saw the emergence of a new kind of relative value strategy, in which hedge fund managers make heavy use of AI to create trading signals. This new approach enabled many of them to generate attractive returns over the past year, resulting in sharp inflows for them and inspiring many traditional relative value/CTA managers to adapt their approaches in a similar direction.

These new AI managers were not able to meet our expectations for a 3-rated manager, when we approved them last year. However, based on our positive engagement with them on the topic, we believe that most of them will soon achieve this rating. In keeping with our commitment of investing only with hedge fund managers rated 3 or above on ESG by the end of June 2020, any manager that does not achieve this rating by then will be eliminated from our portfolios.

Apart from the addition of the new AI managers to our portfolios, the breakdown of ESG ratings for our CTA/global macro and relative value managers remains largely the same as last year, with 14% rated 2, 72% rated 3 and the remaining 14% rated 4. One manager previously rated 3 enhanced its ESG approach, resulting in a new rating of 2, with the other managers retaining their previous ratings.

Regulation takes center stage with a unified taxonomy on sustainability

Over the past year, we have seen rising public momentum on climate change, with students around the world holding demonstrations, inspired by the frequent public appearances of teenage activist, Greta Thunberg. Many governments took notice, and European regulators in particular forged ahead with a far-reaching regulatory agenda, which will shape the region's sustainability landscape in the years ahead. The new regulations will require all asset managers who market investment solutions in Europe to:

- Report on the sustainability risks that affect the manager, as well as the implications for their risk management framework
- Substantiate and quantify the sustainability impact of investment offerings that are marketed as "sustainable" based on the newly defined European Union (EU) Taxonomy
- Provide evidence of sustainable impact in the offering's annual report, starting in 2021 and scaling up over time

While it will be a challenge for the industry to comply with these new requirements, LGT CP welcomes the development, as it will provide investors with more transparency and consistency in the sustainability solutions they consider. The new EU Taxonomy will have a significant impact on how we assess and monitor portfolios on ESG, as it will ultimately enable us to measure ESG attributes using a single standard. It also supports efforts by the PRI and other industry bodies to develop common standards for evaluating and reporting on ESG factors.

Iberdrola wind park, United Kingdom

Insurance-linked strategies (ILS)

ILS and ESG: a top-down view

When investors think about ESG, ILS may not be the first thing that comes to mind. After all, in this market investors do not gain exposure to assets that directly impact the environment or society, but rather they take on the natural catastrophe event risk faced by insurers. In doing so, they benefit from a return profile that has very little correlation to financial markets, but their returns can be impacted by a large insured loss. Although it is less obvious than in other asset classes, in LGT CP's experience, ILS is well aligned with most notions of good ESG stewardship.

For example, the risk capital provided by ILS investors may ultimately be used to rebuild homes and infrastructures after natural disasters. Furthermore, the ILS market takes on peak risks to support the availability of insurance protection for people living in areas prone to damage by natural disaster. In addition, for market participants like LGT CP, governance plays an important part in the investment process. We focus on transactions with counterparties that are bound by solid governance frameworks, which help to ensure transparency in our relationship.

ILS as an asset class is highly exposed to climate change risks, as the increasing likelihood and severity of weather events has a significant impact on insured losses. This underscores the importance of working with counterparties who have a strong track record in managing environmental factors in their businesses, which our assessment framework seeks to identify.

Figure 22 – ESG due diligence process

Source: LGT ILS Partners

ESG due diligence process at LGT ILS Partners

LGT ILS Partners is our in-house provider of reinsurance capital to insurers and reinsurers worldwide in the form of catastrophe bonds and collateralized reinsurance contracts. Our reinsurance counterparty panel consists of nearly 100 individual firms, ranging from large, multinational companies to small, local insurance carriers. We believe that applying ESG criteria to our counterparty due diligence process creates value by enabling us to better identify counterparties who are resilient to a wide range of long-term risks. Our ESG due diligence process in ILS consists of four key steps, as shown in Figure 22.

Step 1 – Scoring the counterparty ESG performance

The counterparty's ESG performance is assessed with the help of the firm's proprietary ESG assessment tool for individual companies, the ESG Cockpit. It draws on publicly available ESG data from well-established information providers to generate ESG scores for companies. It does so by assessing them on the ESG attributes of their operations, controversies and the impact of their products and services on the SDGs.

Figure 23 – Scoring a counterparty on ESG

		Total ESG score	E	S	G
Industry group: Insurance	Score	75.7	59.4	75.8	78.0
Country: France	Percentile	96.0%	65.7%	86.1%	90.9%
Region: Europe	Weight		5%	65%	30%

Source: LGT Capital Partners, Refinitiv

In the example, this European property and casualty insurance company has been on our panel of counterparties for many years. It is considered a top-quality partner due to its excellent underwriting track record, stable book of business and high level of data transparency. The results of our ESG Cockpit analysis add an additional dimension to our overall view of the counterparty.

A total ESG score of 75.7 (out of 100) means the company is among the top four percent in its peer group. The insurer has a high score in corporate governance (78.0), due to its effective and well-balanced board and measures in place to protect minority shareholders. It also has an effective strategy for promoting diversity and equality, as well as training and career development opportunities for employees, which results in a high social score (75.8). Lastly, the company does moderately well within its peer group with regards to environmental aspects (59.4). The insurer has policies and measures in place to improve its energy efficiency and reduce waste, but it underperforms its peers with regards to the use of renewable energy and the financing of environmental projects.

Step 2 – Counterparty review
As part of our regular sourcing activities, we meet with key executives (e.g. CFO, CEO) of a company to discuss their upcoming reinsurance purchase. This enables us to address topics such as ESG reporting requirements or the company's ESG score, particularly if it is low within its peer group or has decreased over the year. As a key provider of collateralized reinsurance, we are in a strong position to engage in a pro-active dialogue with our counterparties to bring up ESG-related issues. In this way, we aim to positively influence ESG standards within the insurance and reinsurance industry in the long-term.

Step 3 – Counterparty monitoring
Our regular monitoring meetings with counterparties include a review of their ESG practices. This takes place on an annual basis and is done in preparation for the key renewal dates of the reinsurance industry. During these meetings, we provide our counterparties with feedback on their approach and ESG score to encourage further development of ESG practices.

Step 4 – Discuss results and take action (if necessary)
The majority of our reinsurance counterparties (especially publicly traded companies) have a strong incentive to commit to an ESG framework and report on their activities in this area, as their stakeholders typically expect this. However, if a company fails to live up to expectations, even after multiple review cycles, it will be put on a watchlist. A further decrease in the ESG score and/or the absence of a commitment to improvement may lead to the decision to cancel the business relationship with the counterparty.

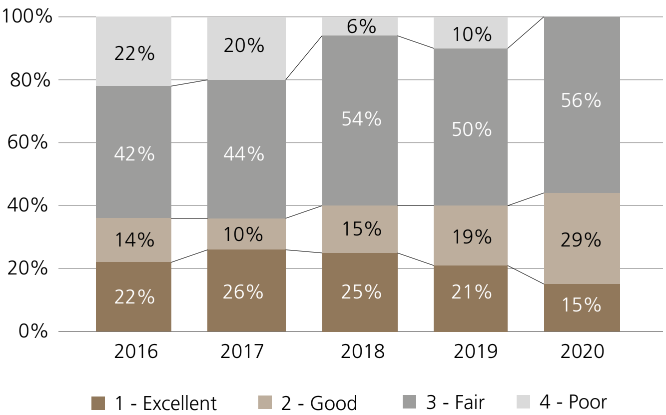
Overall, we find this approach of assessing counterparties on their ESG attributes helps us to select strong counterparties who share our commitment to high ESG standards.

Long-only managers

Making steady progress

Similar to the hedge fund industry, long-only managers are preparing to embrace the new ESG/sustainability regulation in Europe. Given the increased ambition level and advances in data collection, we carried out the same bottom-up ESG analysis of our long-only portfolios as we did for hedge funds. We found (Figure 24) that the number of managers with the top rating of 1 decreased to 15% (from 21% in 2019) because, like for some hedge fund managers, the ESG profile of the portfolios did not always reflect the seemingly top-caliber ESG processes described in ESG questionnaires. Still, the ESG breakdown of our portfolios overall, even after the enhanced assessment approach, paints a reassuring picture, with 44% rated 1 or 2, versus 40% last year. In addition, and in line with our overall strategy for managers of liquid assets, we divested from all remaining 4-rated managers over the course of the year.

Figure 24 – ESG ratings of long-only managers



Source: LGT Capital Partners

A new look at ILS

In addition to our in-house team, LGT CP is also invested in external ILS managers. In last year's ESG Report, we commented on our increased allocation to managers investing in ILS and pointed out the difficulties in analyzing their approach to ESG, using the traditional ESG tool box. Nevertheless, given the importance of ILS in our portfolios, we have increased our engagement on the topic with stakeholders in the field. These discussions revealed broad agreement on the positive social impact of ILS managers in the reinsurance market, as they enable insurers to provide better coverage to companies and people seeking to protect themselves from large-scale risks. ILS as a strategy ultimately enables insurers to support communities in rebuilding after catastrophic events, where many people suddenly find themselves without adequate shelter and other vital resources.

As a result, in our annual assessment of ILS managers this year, we observed that all of them are involved in business activities with a positive social benefit, with some further advanced than others. This resulted in 38% of our ILS managers achieving ratings of 2 and the remaining 62% receiving ratings of 3.

Case study: REIT manager B&I Asia

B&I Capital

This relatively small fund manager focuses on global listed real estate investment trusts (REITs) and shows that managers of all sizes can develop robust ESG processes – they are not just the province of well-resourced large managers. After joining the PRI in 2019, B&I Capital hired a young and enthusiastic new team member to drive its ESG implementation. Since then, the firm has formalized its ESG policies, subscribed to the real estate ESG benchmark, GRESB, and enhanced its ESG data collection via a proprietary ESG questionnaire for current and prospective investments. The manager has also begun offsetting its climate footprint at the corporate level to highlight its commitment to ESG issues. Overall, we view B&I Capital's improvements as positive, and therefore upgraded their ESG rating from 3 to 2 this year. Since these developments are very new, we look forward to monitoring them going forward. We are especially interested in following the evolution of their bottom-up rating, which we would expect to improve over time as the ESG enhancements they implemented start to bear fruit in the portfolio.

"Although less obvious than in other asset classes, in LGT CP's experience, ILS is well aligned with most notions of good ESG stewardship."

Public equity and fixed income

Substantially lower level of carbon emissions than the benchmark

Our Sustainable Equity and Bond Strategies have continued outperforming their respective benchmarks on carbon emissions over the past year, as Figure 25 shows. In addition to showing the carbon emissions relative to their benchmarks, we also show a breakdown of how each industry sector in the portfolio affects the total carbon emissions of the portfolio. With this data, we hope to give our investors a better understanding of how our investment decisions ultimately shape the carbon footprint of these strategies.

The chart shows the aggregated normalized greenhouse gas emissions for three different strategies against their respective benchmarks, with carbon footprints that are 36–47% lower than the benchmarks. As an example, the portfolio of our Global Equity Strategy generates 98 metric tons of carbon emissions per year, while the corresponding benchmark produces 186 metric tons, a difference of 88 tons, or 47%.

In Figure 26, we provide a breakdown of greenhouse gas emissions by sector for the LGT CP Global Equity Strategy versus the benchmark. The first two columns show the weight of each sector in the portfolio and the benchmark, while the third column shows how much of the overall reduction in greenhouse gas emissions is attributable to the various sectors. Differences in emissions per sector can result both from the weighting of the sector itself in the portfolio as well as the mix of companies selected.

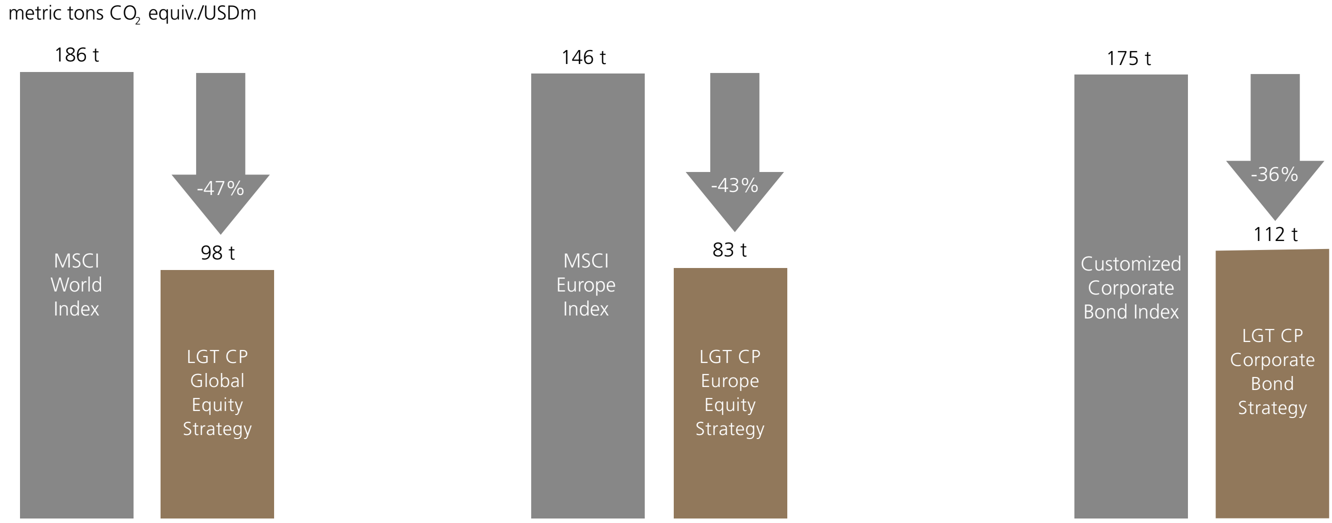
In this case, most of the difference in emissions between the two portfolios results from the utility sector, where we have been able to achieve an emissions reduction of 90.1 metrics over the benchmark. This is in spite of the fact that our allocation to utilities, historically one of the most carbon intensive industries, is more than double – 9.4% versus 3.8% – that of the benchmark. This is because the companies we have selected within the utilities sector are mainly active in renewable energy, which has little exposure to carbon intense fossil fuels. The approach shows that it is possible for investors to be well diversified across industries, while still beating the benchmark on carbon emissions.

Figure 26 – Sector breakdown of LGT CP Global Equity Strategy vs. benchmark

	Weight (%)		Total emissions reduction
	Portfolio	Benchmark	
Utilities	9.4	3.8	-90.1
Materials	7.8	4.1	13.7
Energy	1.7	3.4	-7.4
Industrials	4.0	10.3	-0.9
Real Estate	3.6	3.2	-3.2
Consumer Staples	16.1	9.1	-13.0
Consumer Discretionary	1.5	10.2	12.0
Communication Services	15.1	8.8	-13.4
Information Technology	12.3	19.1	15.6
Health Care	13.4	14.6	-0.7
Financials	11.8	13.5	-0.7
Total	100.0	100.0	-88.2

Source: LGT Capital Partners; data as of 31 March 2020

Figure 25 – Metric tons CO_2 equiv./USDm



Source: Refinitiv, LGT Capital Partners. All data in metric tons CO_2 equiv./USD 1 million company sales per calendar year. Data as of 31 March 2020

New measurement framework supports alignment with Paris agreement

With increasing investor focus on climate change, it has become clear that global energy production will have to shift toward renewable resources in order to reduce CO_2 emissions. LGT CP supports the framework to limit global warming to below 2°C over pre-industrial times, which has been signed by over 190 countries in the Paris agreement.

In order to better align our portfolios with the goal of limiting global warming, we have developed a climate change framework. We have started with a focus on the role of utility companies active in power generation, as they are the largest emitters of CO_2.

Utilizing our framework, we analyze the universe of utility companies active in power generation, leveraging data that shows the proportion of power generated from various power sources. We use it to calculate the aggregate carbon intensity for each company, comparing the resulting figures with the maximum level that is still in line with the Paris agreement. We then exclude all companies whose carbon intensity levels exceed the threshold spelled out by the guidelines.

The table in Figure 27 shows how this framework supports an investment decision on two hypothetical utility companies with different approaches in regards to renewable and fossil fuels.

Using this approach results in excluding companies, such as Utility Company A in the chart, in a smart way. Company A is clearly wedded to fossil fuels, and it is far out of alignment with the Paris agreement, so it has no place in our Sustainable Strategy. At the same time, Company B has developed a strong position in renewables, even as it retains significant natural-gas driven assets. The framework enables us to intelligently assess utilities like Company B, which still have a foot in the old world of fossil fuels, but are working on their transition to renewables. Using our framework to select such companies is a way to encourage the market to continue ramping up energy sources that help in the fight against climate change.

Figure 27: Selecting companies that align with the Paris agreement

Energy source	Carbon intensity (g CO_2/kWh)	Utility Company A	Utility Company B
Hydropower	0	-	5.6%
Liquid fossil fuels	675	4.7%	-
Natural gas	400	16.1%	42.6%
Nuclear energy	0	-	-
Renewables	0	0.6%	51.7%
Coal	940	78.6%	-
Aggregate carbon intensity (g CO_2/kWh)		835	171
Current threshold for 2° alignment (g CO_2/kWh)		429	429
Investable?		**No**	**Yes**

Source: LGT Capital Partners

The ESG Cockpit in action: dissecting a high-scoring global manufacturer on sustainability

The ESG Cockpit is the engine that drives asset selection for our Sustainable Equity and Bond Strategies. It enables us to generate ESG scores for individual securities, drawing on ESG data from a variety of well-established information providers. The holistic evaluation includes three different dimensions:

- Operations – assesses 50 different KPIs on topics like carbon emissions, health and safety, and governance
- Controversies – identifies and evaluate instances of negative media coverage related to ESG issues
- Impact of product and services – new since 2019, considers the impact of a company's products and services on the SDGs

The scores enable us to define our investable universe by, for example, eliminating securities that score too low, as well as by identifying high performers on ESG. In this example, we show how one manufacturing company is scored, using the ESG Cockpit.

Geberit is a Swiss-based manufacturing company specializing in sanitation products, from water piping systems to bathroom fixtures. Given the company's central role in the sanitation supply chain, its approach to ESG can make a material difference in the efficient use of water. Furthermore, with over 11,000 employees globally, Geberit's approach to social and governance factors can also have a meaningful impact on a large group of stakeholders. As it happens, Geberit is strong in all three areas, which earns it top marks in the ESG Cockpit, with an overall ESG score of 82.0 (on a scale of 0 to 100).[5]

The E, S and G of Geberit's operations

The company is strong on environmental factors, as it is committed to keeping its ecological footprint as small as possible. For example, smart eco-design principles are embedded into its sanitation products, ensuring that they deliver enough water to users for a comfortable experience, but with very little wasted. It also works to reduce the amount of material used in packaging, using recyclable cardboard wherever possible.

Geberit's 2015 acquisition of Sanitec, a maker of ceramic bathroom fixtures, posed an environmental challenge. The production of these essential products is intrinsically resource and energy intensive, resulting in significant CO_2 emissions. Geberit responded by equipping the ceramic furnaces with the latest burner technology, which significantly reduced emissions. Steps like these have helped the company to adhere to its long-term CO_2 reduction target, which is in line with the Paris agreement.

Geberit production facility, Pfullendorf, Germany

As a result of these various environmental efforts, Geberit has been given an environment score of 77.4 in our ESG Cockpit, which puts the manufacturer in the top 13% of our investment universe.

The company also does well on social factors, with an ESG Cockpit score of 79.0. It has a strong focus on occupational safety, which is highly relevant for a company that operates 29 production facilities in eight different countries. In 2018, the manufacturer adopted a new in-house safety system that covers all manufacturing plants. It defines best practices in safety for a wide range of activities within the plants, resulting in nearly all of its production sites getting certified as compliant with the ISO 45001 occupational safety standard in 2019.

The company achieves above-average results on corporate governance as well, with a score of 65.9 in the ESG Cockpit. For example, the board of directors has an effective and independent audit committee, which is important for monitoring financial reporting. In addition, the compensation committee consists of fully independent board members, which facilitates alignment of the compensation policy with the interests of shareholders.

There is one point in Geberit's governance, where we see the potential for improvement, specifically in the area of leadership structure. The current chairman of the board served as CEO and chairman until 2015, when he stepped down as CEO but remained on as chairman. We believe that such a set-up may limit the ability of the current CEO to exercise his full discretion over corporate strategy, so the ESG Cockpit quantifies this risk with a 5-point deduction in the overall governance score.

[5] As of 31 March 2020

Scoring ESG controversies

As part of our ESG scoring, we check whether the company has been subject to any negative publicity in the media on ESG issues. We do so using a solution that tracks in real time more than 80,000 independent information sources in 20 languages. This helps to balance the information we review on company operations with an additional, independent source. Companies with material ESG controversies are marked down in our final ESG score. In the case of Geberit, the controversy check has no effect because the company has not experienced any negative publicity on ESG.

Impact on the Sustainable Development Goals (SDGs)

As the final step of our assessment, we consider the impact of the company's products and services on the SDGs, using the approach described in the box below. We find that Geberit makes a positive contribution to the SDGs, and in our view, especially on "Good Health and Well-Being" and "Clean Water and Sanitation." Efficient water management and hygiene are critical for achieving these goals, and Geberit's role in producing high-quality, eco-friendly products help to deliver on them. As a result, the ESG Cockpit gives Geberit an uplift of 7.6 points in its final ESG score.

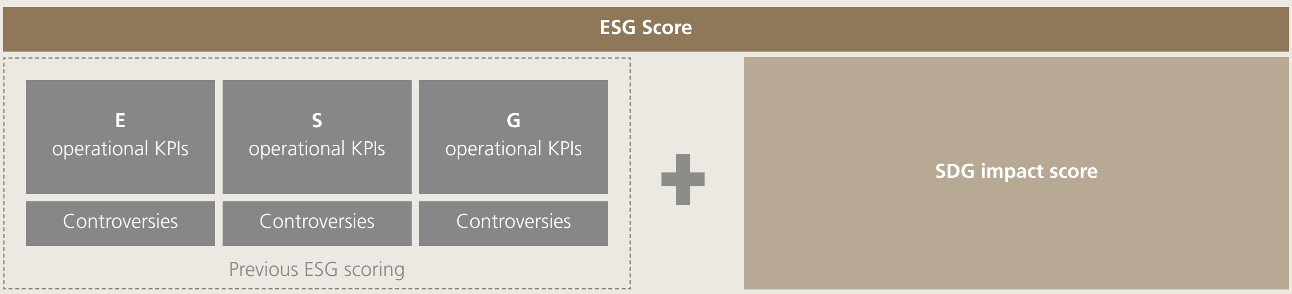
SDGs integrated into ESG scoring for additional insights on sustainability

After developing a framework for assessing the impact of companies on the SDGs in early 2019, we have now integrated the framework into the ESG analysis and scores of our ESG Cockpit. The result today is a tool that gives us – and our investors – much better insights into how the products and services of our portfolio companies affect the world. By linking impact to the SDGs, we enable investors to see how companies in their portfolios help (or hinder) in achieving the SDGs.

The starting point for our SDG assessment framework is the ability to evaluate both the positive and negative impacts of companies' products and services on the various SDGs. Towards this end, we sourced a consistent and comparable set of data from one of the large data providers, and we sorted it into approximately 300 different revenue categories of products and services, covering broadly all of the possible business activities of listed companies. Based on the pre-assessment of the data provider, we then attributed an SDG impact measure ranging from -20 to +20 to each product and service category on the respective SDG.

Adding the SDG product and services impact to the overall ESG scoring draws a much more complete picture of a company's ESG performance, but also adds a layer of complexity, and sometimes even ambiguity. For example, a company may have slightly above average ESG practices in its operations (e.g. how it manages its supply chain and treats its employees), but the final assessment is significantly lowered by the negative impact of its products/services on select SDGs, such as a fast food chain's impact on Good Health and Well-Being. The new SDG scoring module enables us to capture this complexity in a quantitative way that enriches the overall ESG scoring for making better informed investment decisions.

Figure 28 – Integration of SDGs into ESG scoring



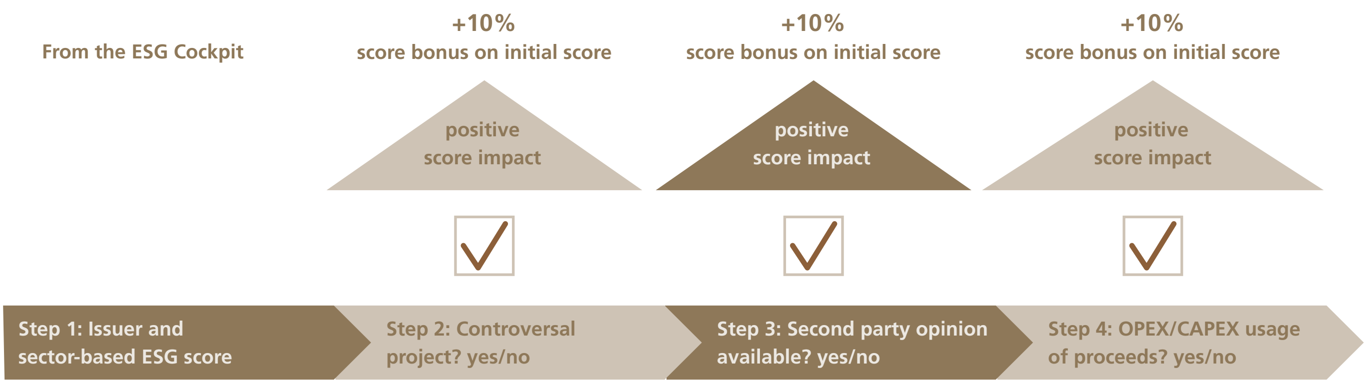
Source: LGT Capital Partners

Proprietary green bond scoring system cuts through green washing in a fast-growing market

Since 2009, our Sustainable Bond Strategy has focused on selecting bonds of issuers with strong ESG profiles, whether they are companies, sovereigns or supra-nationals. The key tool for this is our ESG Cockpit, which assesses companies on their ESG attributes and impact on the SDGs. It can also assess sovereigns and supra-nationals on a broad range of ESG criteria, such as compliance with international treaties on controversial weapons (land mines, cluster bombs, etc.), respect for human rights, transparency and other attributes. In our Sustainable Bond Strategies, we look to make investments in green bonds, where possible, as they target specific projects that can have a positive effect on the environment.

Green bonds currently represent 47% of our Sustainable Bond Strategy, and the number of new issuers and green bonds is growing rapidly.[6] With this increasing opportunity set comes the challenge of critically examining claims of issuers to ensure that the impact described corresponds to meaningful impact on the ground. Towards this end, we carefully analyze how the proceeds of the bonds will be used to ensure that the issuer is not simply engaging in "green washing," or overstating the positive impact of the project to be financed.

Figure 29 – Checklist for new green bonds



Source: LGT Capital Partners

[6] As of 31 March 2020

In order to make an informed decision on each bond we reviewed, we carry out a four-step evaluation of the security:

1. Review of the ESG score for the issuer – this is generated by our ESG Cockpit, and the score provides visibility on the ESG profile of the issuer and the sector in which it operates. The score serves to identify issuers with strong ESG practices, which are likely to initiate bonds that finance credible sustainable projects. It also red flags organizations with weaker reputations in this space, which would require additional scrutiny. This initial ESG score can then be increased with additional "uplifts" of 10% each by additional analysis described below in steps 2 to 4.
2. Our own qualitative assessment of the underlying bond project – we evaluate what is being financed, and seek to identify any possible controversial use of proceeds, such as the airport and refinery examples mentioned below. In our investment universe, 78% of green bonds get a clean bill of health on this measure.
3. The availability of a "second-party opinion" (SPO) on the bond – the SPO is carried out by a trusted evaluation firm, such as Sustainalytics, ISS-Oekom, Cicero or Vigeo Eiris. It provides an assessment of the issuer's green bond framework, analyzing the project to be financed, and it may assign a sustainability rating to the project. Around 75% of all the green bonds we cover have an SPO.
4. Whether the bond will be used for capital expenditure or operating expenditure – we favor bonds that are primarily focused on capital expenditure, as we are seeking to further develop new projects with a sustainability impact, not simply finance existing operations. In our investment universe, some 78% of green bonds are earmarked for capital expenditure.

Two recent examples underscore the importance of this critical evaluation of green bonds prior to investing. In one case, we reviewed the issuance of an airport operator, which was planning to finance enhancements in infrastructure that would make the airport more energy efficient. This may be a worthwhile goal for the issuer, but given the massive carbon footprint of the aviation industry, we did not think that the project would ultimately benefit the environment. In another example, an oil producer issued a green bond to fund improvements to the energy efficiency of its refineries. Again, perhaps this will benefit the operating margins of the issuer, but we did not feel that allocating capital to a producer of fossil fuels will help to reduce CO_2 emissions or achieves any other meaningful environmental goal. As a result, in both cases we passed on the bonds.

Continued market growth underscores the need for green bond scrutiny

It is clear that taking this critical approach to bond selection will become ever more important going forward, as the market continues to grow. The market for sustainable bonds currently consists mainly of green bonds, whose proceeds are used exclusively for climate and environmentally friendly projects. These bonds set a new issuance record of USD 327 billion in 2019, versus USD 195 billion in 2018 and less than USD 55 billion in 2015. The majority of proceeds were used in projects relating to energy (approximately 31%), buildings (28%) and transportation (20%). Nevertheless, the share of sustainable new issues corresponds to around 5% of new global issues only, which illustrates their huge growth potential.

For 2020, market participants expect total new sustainable bonds worth over USD 350 billion (about 85% of which are expected to be green bonds). The appearance of new issuers and the expansion of volumes by already established issuers such as sovereigns and financial companies play a major role. Regions such as North America and Asia could continue to make up ground in terms of new projects, especially since the US has the largest share of newly installed wind turbines, and China and India have the leading role in the production of newly installed photovoltaic systems. However, in order to satisfy the constantly growing hunger for energy worldwide, significantly more investment in renewables is required, which will drive the growth of sustainable bonds.

About us

LGT Capital Partners is a leading alternative investment specialist with over USD 60 billion in assets under management and more than 550 institutional clients in 39 countries. An international team of over 500 professionals is responsible for managing a wide range of investment programs focusing on private markets, liquid alternatives and multi-asset class solutions. Headquartered in Pfaeffikon (SZ), Switzerland, the firm has offices in New York, Dublin, Frankfurt, London, Paris, Vaduz, Dubai, Beijing, Hong Kong, Tokyo and Sydney.

LGT CP has a long-held commitment to incorporating environmental, social and governance (ESG) considerations into its client programs and its business overall. Since 2003, many of our programs have had a responsible investment clause written into their governing documents, authorizing us to exclude investments that are substantially exposed to arms-related activities, violations of human rights, irresponsible treatment of the natural environment or other non-ethical conduct of business. Consideration of ESG issues is an integral part of our investment process, as our investment teams are responsible for taking into account ESG considerations when performing due diligence on investments. Any opportunity that is pursued will have been vetted for such issues.

LGT CP has been a signatory to the Principles for Responsible Investment (PRI) since 2008. In 2018, Tycho Sneyers, a managing partner and chairman of the Firm's ESG Committee, joined the board of directors of PRI, where he helps to provide strategic direction to the global body of asset owners and asset managers. LGT CP also participates in the Carbon Disclosure Project (CDP) and the European Sustainable Investment Forum (Eurosif), the Montreal Carbon Pledge, the Institutional Investors Group on Climate Change (IIGCC) and Climate Action 100+.

In 2019, the PRI awarded LGT CP scores of A or A+ across all modules evaluated in its annual RI Assessment Report.

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