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Dear Manager,

Cardano's Latest Thinking on Sustainable Investing

Since we wrote to you last year, ESG and sustainability topics have continued to dominate headlines, from the recent COP 26 summit in Glasgow, to flooding in Germany and power-black-outs in South Africa and Texas; and rightly so - ESG issues represent fundamental challenges to our economy and our society.

In the UK, sustainability is now a primary area of focus of the DWP (Department for Work and Pensions) and FCA. We expect this increasing focus will lead to more disclosure and reporting requirements for pensions schemes and asset managers alike, ranging from more detailed climate reporting metrics to more stringent investment product labelling.

Against this backdrop, we have been pleased with how our managers have engaged with us on this important topic. Our clients invest in more than 100 managers across geographies, asset classes (public to private markets) and strategies. Of these, 95% are demonstrating positive momentum on ESG issues. Positive behaviours include a growing willingness to engage, more comprehensive policy setting, increasingly substantive ESG assessment and improved reporting transparency. On the latter, we particularly welcome manager efforts to disclose carbon metrics, including climate scenarios, and target setting, consistent with UK pension funds' TCFD reporting requirement. We summarise a few of these trends in our 2021 Sustainability Report.

Whilst positive steps have been taken, a lot more is still required. Our aim is to invest with best-in-class managers in everything they do and ESG is no different. We want to see more robust policy setting, covering all assets under management and tying to industry standards, comprehensive diversity and inclusion policies and better use of ESG data analytics in investment decisions and reporting. We recognise that no one approach fits all and therefore we offer ourselves up as thought partners as you move your organisations forward on this front.

2022's Focus Theme: Stewardship

In this year's letter we wanted to specifically focus on stewardship as we don't think the topic gets the attention it deserves.

The UNPRI define stewardship (also referred to as 'engagement') as "*the use of influence by institutional investors to maximise overall long-term value including the value of common economic, social and environmental assets, on which returns and clients' and beneficiaries' interests depend*".

Global corporations, in aggregate, are one of the largest allocators of capital in the financial system – as such, engagement is one of the critical levers we have for creating real economy change. We recognise, however, that it is a lever that can be pulled to varying degrees of effect depending on the investment. The ability to create real-economy influence in a private equity investment (where a manager has control), or in a public equity context (where managers exert influence as a voting shareholder), is clearly different cardano

from a derivative investment (providing economic exposure but offers very limited real-economy influence).

In recognition of this and to assist our thinking, we have developed an 'Influence Model' which ranks different investment activities by their ability to influence sustainable outcomes:

Cardano's Influence Model

We believe there are three key mechanisms by which investors can influence real economy outcomes:

- Tier One Influence - Direct
    - Supplying new capital, debt or equity to a company or government, where this has an environmental or social objective.
    - Collaborative company engagement on sustainability-related topics, for example through the Climate Action 100+ initiative.
    - Engaging with public policymaking to create a more sustainable economy, for example engaging to decarbonise the electricity grid or rollout electric vehicles.

- Tier Two Influence - Direct
    - Engaging with companies as an individual investor on sustainability-related topics – this is less impactful than collaborative engagement, but nevertheless has an important impact.

- Tier Three Influence - Indirect
    - The third tier of influence to achieve real-world sustainability impact is one many institutional investors are already using to some degree: integrating ESG factors into buying and selling of securities which influences the cost of capital and signals to management what is expected.
    - This includes incorporating into a portfolio mandate specific capital allocation objectives such as climate change-related objectives, exclusions, weighting capital allocation towards more sustainable businesses and targeting allocations to impact focused investments.

There is scope for managers to be more active across the spectrum of our Influence Model. As you assess your own approach to stewardship, we encourage you to consider your ability to maximise influence by taking stronger actions across all three tiers. In particularly, we encourage you to take the following actions, if you haven't already done so:

- Publish a stewardship policy (we include a link to Cardano's Stewardship Policy, for reference);
- Consider appointing a stewardship provider and / or proxy voting provider, working with them on sustainability topics;
- Apply the UK stewardship code (we view this as the global gold standard) and / or consider regional equivalents;
- Define a set of stewardship priorities and disclose on progress against those priorities;
- Participate / lead in collaborated engagement initiatives in climate (e.g. Climate Action 100+), biodiversity and / or human rights;
- Publish engagement activities (including case studies, where possible); and
- Publish voting records and / or principles (preferably publicly).

We'd be happy to discuss all of these actions, to the extent having our input would be helpful. For more input we would also recommend reviewing the ShareAction Voting Matters 2021 report.

Looking Ahead

Over the next 12 months, you should expect us to raise our discussion levels around sustainability topics in general. In particular, we will be engaging with you (as applicable) around voting decisions on significant ESG issues. Our goal is to understand how you have assessed the issue(s) and how this has translated into your company engagement and voting action.

We plan to expand our own efforts in this area and will be partnering with a leading external stewardship service provider to engage with companies on our behalf. We believe this approach will provide greater access to companies and allow us to tailor our engagement around certain issues for our clients and Cardano.

Finally, we wanted to highlight two particular ESG issues that are close to our hearts at Cardano. We ask that you consider these topics when engaging with corporate management teams.

Climate Action

In retrospect, 2021 is likely to be recognised as a key inflection point; the point in time when climate change moved from a talked about headline to a critical and unified agenda item across politicians, pension funds and the broader investor community. 136 of 198 countries have now made Net Zero commitments; of the 167 companies on the Climate Action 100+ list of largest emitters 110 have now made a Net Zero commitments, up from 34 the year before. Progress is positive but there remains so much still to do; none of 167 largest emitters have yet to fully develop a plan in line with IIGCC standards on how to get there.

We believe that to truly effect real economy change the focus should be on bottom up forward-looking alignment plans of individual companies and sovereigns to Net Zero objectives. This means challenging companies to develop clear science-based plans that target a transition over realistic but ambitious timescales based on the nature of the underlying business or country, and tracking and holding management and governments accountable to those plans.

We encourage all our managers to make Net Zero commitments and to report on climate metrics; we recommend (i) emissions intensity; and (ii) absolute emissions.

We also welcome progress on transition alignment metrics. For comparison, at Cardano we have chosen three scenarios to report against: 1.5 degrees, 2 degrees and 3 degrees. In doing so, we acknowledge there remain data challenges / gaps, particularly around scope 3 emissions but we firmly believe perfection should not stifle progress.

Tackling Inequality

The relationship between inequality, financial returns and fiduciary responsibilities can be unclear. When it comes to investor action, there is substantially less political or regulatory clarity in this space than, say, tackling climate change.

We believe in supporting a fairer society. Issues which fall under this topic are wide ranging and vary by company, sector and geography. We see increased attention being paid towards –

- Executive compensation;
- Tax fairness;
- Diversity and inclusion;
- Supply chain standards and verification;
- Labour rights.

There is an opportunity to create value by improving lagging businesses' standards – thereby avoiding reputational and investment harm, and perhaps upgrading them into sustainable leaders, driving outperformance as they improve. Businesses focused on their impact and building a reputation for addressing inequality are likely to gain competitive advantage by attracting talent and human capital from a younger generation far more attuned to sustainability issues; and building a customer base who engage and consume based on their alignment of values, as much as on price value.

We ask that you consider how to tackle inequality in your investment decision-making and engagement approaches and welcome manager's efforts to provide case-study examples.

Closing Remarks

We are keen to learn and develop our own thinking alongside you around these topics and would welcome further discussion and challenge. As we move forward, your usual contacts on the team are available to address any queries or questions. Will Martindale, our Head of Sustainability, has a significant amount of expertise in this area and remains on-hand should you find that helpful.

As we stated last year, our aim is to work with you to meet our portfolios' and clients' objectives in this area, together.

Wishing you every thanks for your efforts in 2021 and all the very best for 2022.

Yours sincerely,

Ben Cooper
Head of Manager Research

Keith Guthrie
Deputy CIO

Will Martindale
Head of Sustainability