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Dear Manager,

Cardano's Latest Thinking on Sustainable Investing

In terms of progress towards a more sustainable world, 2022 turned out to be a year of contrasts. That said, we believe the longer term direction of travel remains unchanged, with many of the macroeconomic and geopolitical events that took place over the year, making the need for transition away from fossil fuel dependency even more evident.

Regulation and investor sentiment has set strong ESG foundations across the asset management industry. Sustainability regulations cover a considerable proportion of the market. Data is becoming ever more available, driving better analysis and reporting. Incoming corporate reporting requirements have reduced the burden on investors to get companies moving forward. This has been a step change, with the benefits being obvious. Looking ahead, we believe now is the time for implementation, accountability, and ambition.

In this year's letter we discuss:

2022 IN REVIEW	Key ESG manager trends across our portfolio
REGULATION	Developments in sustainability disclosure regimes & our client requirements
2023 FOCUS AREAS	Future ambitions, across several themes

2022 in Review: Key ESG Manager Trends

We assessed more than 170 funds on ESG in 2022; public and private strategies across US, Europe and the Rest of the World. We saw a material improvement in our ratings across managers versus prior years with:

- A higher proportion of managers achieving our highest ESG rating, and fewer received our lowest rating,
- 75% of managers continue to display positive momentum, (expected material improvement in ESG over the medium term),
- Rating upgrades overshadowing downgrades by three to one.

Our focus on managers with solid ESG credentials remains, with >85% of new investments made rated either "Good" or "Strong" per our scoring methodology.

Notable improvements were made around climate:

- 53% of managers now publicly support TCFD,
- 50% signed up to Climate Action 100+,
- >50% are tracking their portfolio's carbon footprint.

While the trends are positive, we want to see continued progress in these areas – we believe there is still more to do. Areas for further development include:

- **Decarbonisation Targets:** Only a quarter of managers have targets in place. We look for Science-Based Targets which include medium-term milestones and consider absolute levels of emissions as well as emission intensity of the portfolio. Importantly, managers should be assessing the alignment of the underlying companies they own; what proportion have set decarbonisation targets, have credible Science-Based Targets and have plans to meet those ambitions.

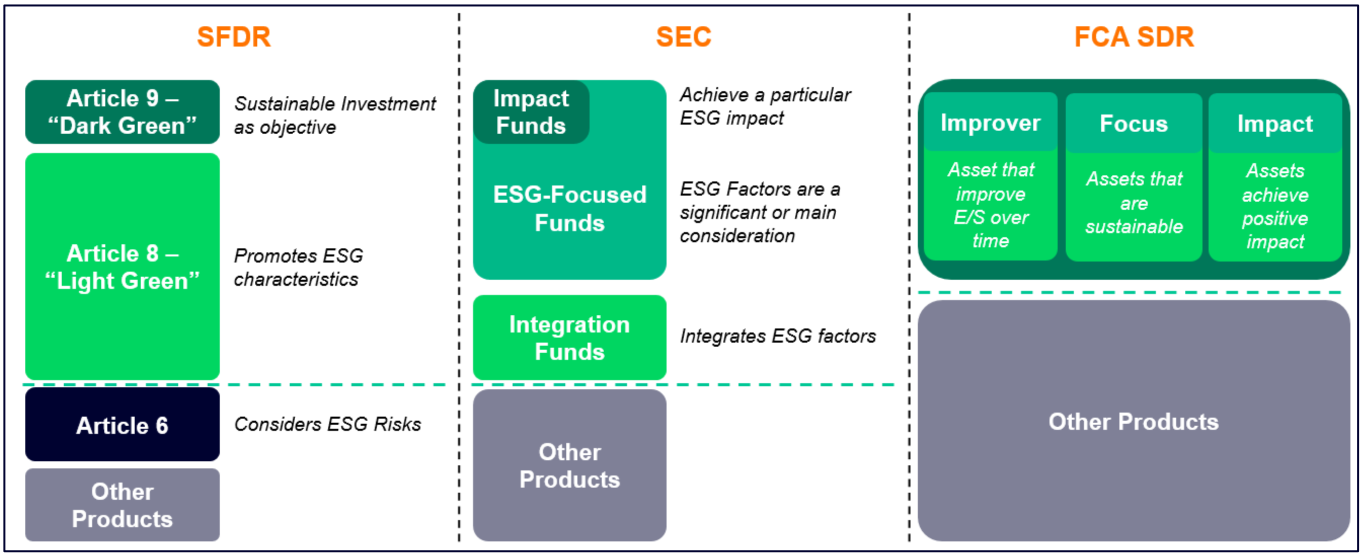
- **Private Markets:** We have seen limited progress in private markets, particularly in the US where managers lag their European counterparts. For an asset class with significant ability to drive positive change, we expect ESG policies, practices, and targets to keep pace with or surpass public market peers.

Regulation: Sustainability Disclosure Regimes

2022 was a significant year for regulatory developments in the EU, US and UK. The FCA and SEC released their sustainability disclosure regime proposals and level two Sustainable Finance Disclosure Regulation (SFDR) requirements came into effect on January 1st. These regimes are designed to increase transparency across the industry and allow investors to track and compare quantitative ESG metrics.

We would like to make it clear that a fund label is not what will drive our selection of managers. We will remain focused on the content, process, and people as per our ESG rating framework. However, we will pay attention and view any exaggerated claims as a negative.

For those less familiar with recent developments, the diagram below provides a depiction of how the different regimes compare, with the horizontal lines separating ESG / sustainable funds from traditional strategies.



The FCA's approach differs the most from the other two; the basis for the regulation is a non-hierarchical labelling regime to allow retail investors to understand how their capital will contribute to a sustainable objective.

Broadly, we see the FCA regulations as a step forward from the SFDRs. It is an elegant and well-done framework, and we are in conceptual agreement with the approach. Areas of particular benefit include:

- **Dual objective requirement:** Setting a separate real world impact objective creates tremendous clarity of thought and maximises the ability to achieve sustainable real-world outcomes. Where appropriate, we would like to see managers implement this alongside their financial risk/return objectives.

- **Distinct label for transitional Improver strategies:** This highlights our industry's ability to create real economy change via the critical lever of engagement. This is as essential to the transition to a sustainable world as investing in Impact opportunities.

For those less familiar with the FCA's framework, more information can be found in the Appendix. If you are interested in discussing this further, please let us know.

Regulation: Our Requirements

There is a growing need for evidence to back ESG claims; we believe a significant portion of managers do not do a good job of explaining what they do.

We encourage managers to disclose ESG related metrics, engagement activity and voting statistics as part of regular reporting. This reporting should include time series data that tracks progress against targets. The ESG related metrics we expect managers to report on can be found in the latest ICSWG tools and guidance.

In 2022, the UK Department for Work and Pensions (DWP) introduced new requirements for UK pension funds, a significant majority of our clients, on the oversight of votes undertaken on their behalf.

Pension funds are required to have sight of, to oversee, and scrutinise the "most significant" votes, and to ensure those votes are consistent with their own sustainable beliefs, reporting the outcome in their annual implementation statement.

As such, we've worked with our clients to identify their priority sustainability themes, which we share with you in the expectation that you incorporate these themes in your engagement and voting decisions.

Our clients' implementation statements (publication of which is a statutory requirement) will then disclose voting activity, the outcomes of most significant votes, and the extent to which voting is consistent with their priority themes.

The themes are:

Priority	Focus Area	Example topics at shareholder AGMs
Climate Crisis	• Climate Change • Net Zero Greenhouse Gas Emissions	• Climate change governance, including board accountability and oversight of risks and opportunities • Corporate disclosure, including TCFD and Taxonomy reporting • Decarbonisation of company products, operations and supply chains • Investment in low carbon energy solutions
Environ-mental Impact	• Biodiversity • Deforestation • Water	• Deforestation governance, including board accountability and oversight of land use • Deforestation-related disclosure and water foot-printing • Water governance, including board accountability and oversight of water withdrawal, consumption and pollution
Human Rights	• Living Wages • Gender Equality • Health & Nutrition	• Adopt and implement the UN Guiding Principles, including board accountability • Human rights-related disclosure, including transparency across operations and supply chains, and political engagement

We ask that you set out your responses to these themes in your stewardship reporting and encourage you to disclose examples via the PLSA template (where applicable). Should you wish to discuss this further then please let us know.

2023 Focus Areas: Future Ambitions

The past few years have been characterised by a push to keep pace with ESG regulation and reporting requirements. Substantial progress has been made but we encourage managers to continue to do more. This is echoed in the PRIs five key themes from COP 27, which highlights the need for bold action to be taken by investors to transition to a net-zero economy.

The key ways we would like to see managers taking action are:

1. **Plan:** Develop a holistic plan to support the transition to a sustainable economy and demonstrate progress via reporting,

2. **Engagement:** Leverage your influence via collaborative engagement opportunities.

In our view, a sustainable economy should operate within planetary boundaries and have a strong stable social foundation. With this in mind, we highlight several important factors and best practises for your consideration:

Planetary boundaries

For many industry participants, greenhouse gas emissions are the primary sustainability risk factor. We believe that viewing sustainability only through emissions negates several key factors. Biodiversity, water usage and pollution and land change play a significant role in ensuring the ongoing viability of a functional, cohesive, and productive society. Managing the risks these factors pose is going to gain increasing focus from investors, and we ask that these be considered in your framework.

For many managers, carbon-intensive businesses and industries form part of their investible universe. We believe this provides an attractive risk adjusted return opportunity, if you can successfully identify companies where their transition potential has been overlooked. Businesses of this nature may be avoided by some investors due to their carbon intensity today. Not all businesses in these hard to abate sectors will be at the same point on their decarbonisation journey; some may need a push in the right direction, which we hope you can do.

Social foundation

Engagement with investments on social factors is often being done well by managers and we hope this continues. That said, our own industry is lagging the broader economy. Diversity and Inclusion is a key focus for Cardano, and we track it across our portfolio. We look to leading industry organisations such as the Diversity Project for guidance and reference in its appraisal process. Medium term targets we would like to see progress towards:

- 20% female portfolio managers by 2026,
- 50:50 male/female graduate and school leaver recruitment,
- Asset managers to collect diversity data for their people and to track promotions.

In the year ahead, we would like to see an increase in the disclosure rates particularly around ethnicity data. We acknowledge the challenges which managers face in this area particularly around staff privacy, and legal and regulatory challenges, but encourage managers to engage with their staff to fully embrace diversity and inclusion.

Collaborative engagement

As per our 2022 letter, we continue to view collaborative engagement as a critical tool for managers in our model of influence and our manager ESG rating methodology reflects this. It provides the dual benefit of amplifying influence and reducing individuals time burden for both managers and companies, increasing the likelihood of executives enacting change. We believe approaches should be pragmatic and set out how a manager:

- prioritises engagement topics,
- aligns with Science-Based Targets,
- engages with investee and non-investee companies,
- measures outcomes and escalates issues if milestones are missed.

The PRI provides a guide to building the foundations of successful collaborative engagement. Joining industry bodies can set the ball rolling but participating in the engagement efforts is necessary; we want to see a well thought through and actioned approach, not just headlines and logos.

Closing remarks

Cardano remains at your disposal as a partner and sounding board for all discussions around sustainability. We are always keen to learn and develop our own thinking alongside you and would welcome further debate and challenge on any of the topics raised. This collaborative approach is something that we believe is crucial to ensuring a swift transition.

As we move forward, your usual contacts on the team are available to address any queries or questions.

Best wishes,

Ben Cooper
Head of Manager Research

Keith Guthrie
Deputy CIO

Will Martindale
Head of Sustainability

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The FCAs Sustainability Disclosure Requirements (SDR) and investment label consultation paper (CP)

The consultation paper outlines the FCAs approach to SDR with the aim to reduce the effect of "greenwashing" while building trust amongst retail and institutional investors, building on TCFD reporting requirements. A key attribute for being able to achieve a sustainable label will be a specific and measurable (i.e. backed by KPIs) Environmental and / or Social (E/S) objective that forms part of an investment's objectives. This can include:

- The profile of assets has a plausible, purposeful and credible link to producing positive E/S outcomes
- Influence and direct positive outcomes via manager additionality for E/S (not exclusively stewardship)

The FCA are pragmatic in their approach and have put a focus on "intentionality". The three labels the FCA expect to use are outlined below

Sustainable Improvers

- This category is aimed at funds which do not necessarily have strong E/S characteristics at present but has the potential to deliver measurable improvements over time. The managers approach to improvements include but are not limited to stewardship activities.
- Funds would be expected to demonstrate their ability to influence and accelerate the rate of positive change.

Sustainable Focus

- The objective of the fund will include a reference to invest in assets with a certain degree of E/S credibility or along an E/S theme.
- The FCA expect to set a 70% threshold for assets meeting a credible E/S standard (Article 9 SFDR has a 100% ex cash and derivative threshold).
- Proof of assets E/S credibility or themes is expected to be aligned with accepted standards.

Sustainable Impact

- The objective would commit to deliver and report on contributions to positive E/S outcomes through financial as well as other types of investor additionality.
- Investments would be made in line with a clearly articulated theory of change and show how they align with positive outcomes as well as seek to avoid unintended negative impacts.
- These funds would be expected to pursue a highly selective asset selection process.

The labels are mutually exclusive. Blended funds would have to conform to a given label and cannot claim partial attainment.

If a fund doesn't claim a given label, nothing will signal this fact. These funds will also be precluded from using marketing material that labels the fund and include overarching references to "Sustainable", "ESG", "Paris aligned", "Green" etc. They will still be required to produce given disclosures, but the scope would be reduced relative to labelled funds.

The FCAs proposed regulations are not without limitation. Fortunately, they have been receptive to feedback and want to work with the industry to meet at common ground. The consultation closed on 25 January 2023, and we hope that amendments are made to align the labels with preeminent industry standards. We responded to the FCA and if you are interested in our comments, please let us know and we would be happy to share it.