Nomura Asset Management Europe KVG mbH

Integration of Sustainability Risks – Fixed Income

10 March 2021

This document describes **Nomura Asset Management Europe KVG mbH** (the "**Firm**")´s the integration of sustainability in our investment decision-making process for **Fixed Income**. It covers Fixed Income strategies (related to sovereign debt) directly managed by the Firm, and should be read in conjunction with the Firm-wide Sustainability Risks Policy. For other fixed income strategies which are sub-delegated from the Firm to other Nomura entities, please refer to Section 2.6 of the Firm´s Sustainability Risk Policy.

Introduction

The EU Sustainable Finance Disclosure Regulation ("**SFDR**") requires the Firm to formalise how sustainability is integrated into our business and processes, and to make new public and client-facing disclosures on sustainability matters.

This document applies as from 10 March 2021.

1. Purpose

Under SFDR, "**sustainability risk**" means an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of an investment.

2. Sustainability risk management

The Firm's philosophy on sustainable investing/ESG integration is to focus on the issues with high impact and that have a direct link to growth potential, credit quality and investment risk/returns. Therefore, the Firm believes that proper management of sustainable/ESG risks in the investment process will improve the quality of investment returns over time.

In order to identifying ESG factors relevant to sovereign debt sustainability, the Firm takes into account time horizon and materiality for each factor, in light of macroeconomic performance, policy and institutional stability/strength and the level of financial flexibility sovereigns have to withstand environmental, social or external shocks. However, strictly identifying and selecting material ESG factors is arguably the most difficult component for sovereign analysis, and is fundamentally more complex than doing so for company analysis because of the interdependency among these ESG factors. In addition, given that sovereigns have different goals and aspirations, the firm also needs to consider the fact that the ability of a government to repay debt are different from that of a company.

In the context of fixed income investment, governance and some social factors have traditionally been regarded as the most material factors and have been partially incorporated in credit assessments and valuations. In emerging sovereign credit risk analysis governance factors and social factors have traditionally featured quite highly, so that ESG risks are not an entirely new concept for the Firm. Thus, given significant overlaps between sovereign ESG and macro fundamental considerations, Environmental, Social, and Governance factors for sovereigns could be material to long term potential GDP growth and productivity, which link back to credit and market risk premium. Many forces related to governance have an influence on the ability and willingness of sovereigns to pay back their debt, or levels of inflation that are expected in an economy. A country's governance profile can help exacerbate, prevent or mitigate social and environmental shocks.

Additionally, the Frim believe that a key difference between emerging government bonds and developed ones is the level of financial flexibility sovereigns have to withstand external shocks. However, in case of the developed countries which have little sovereign credit risk, certain ESG factors are unlikely to have meaningful impacts on their returns, as the economic cycle and monetary policy factors dominate. Therefore, the Firm instead evaluates how economies and markets in specific countries are impacted by macro trends in ESG investment and consideration. For instance, external balances including current account balances have been amongst the most important themes to consider over the super-long term, i.e. longer than ten years. In addition, decarbonization demands will affect global energy flows, and by extension the current accounts of different countries in different ways, which can in turn have direct implications on national growth rates and currency valuations.

For assessment of sovereign economic growth and creditworthiness, the Firm is applying Sustainalytics' Country Risk Rating/Country Screening in addition to the Firm's own proprietary Sovereign ESG score model, which can measure sustainability risk and monitor ESG quality for the portfolio. In this context, the Firm can adopt some techniques including Negative/Positive Screening based on these ESG data, depending on client needs.

By identifying sovereign level ESG risks that can affect sovereign economic growth and credit quality, the Firm's proprietary model generates Sovereign ESG scores based on publically available quantitative data from a spectrum of international and multilateral organizations. 54 individual factors selected for market relevancy are used to assess non-financial measures of a country's potential growth rate. These factors are organized by ESG pillar/KPI/ESG Risk Factor, with an average of 3 Factors per ESG Risk. Specific ESG factor weighting is based on (1) Impact to potential growth rate, (2) Expected time for growth impact to materialize.

The Firm also does supplement traditional credit risk analysis through a complementary perspective of sovereign risk by assessing its wealth and ESG factors, based on external data providers and certain NGOs, in addition to public information from international and multilateral organizations. Assessments of a sovereign include evaluating, among other things, macro-economic indicators such as GDP, but these macroeconomic indicators provide an important measure of economic progress, they measure only income and production and do not reflect changes in the underlying asset base. Since wealth indicates if this income growth can be sustained over the long run, the Firm takes into account the risk to a country's long-term prosperity and economic development by assessing national wealth of a country and the ability to utilize and manage this wealth in an effective and sustainable manner.

The Firm manages sustainability risk by using the identified ESG assessment for a particular investment as against the Firm's sustainability risk appetite and risk limits. The Firm can also apply Exclusionary Screening for particular countries, which it has identified as unusually high risk.

The Firm applies ESG integration investment criteria, which the Firm believes can improve the risk profile of the Firm clients' portfolios. In overview, the Firm applies the Firm's sovereign ESG score assessment to relevant issuers, portfolio managers constantly keep track of ESG assessment for individual countries and monitor overall portfolio's ESG risk profile by comparing it to the benchmark to avoid unintentional ESG risk and invest according to the rules. However, given the varied nature of the investment strategies managed by the Firm, ESG-based exclusion criteria are kept to a minimum at Firm level. Further ESG-based exclusion criteria are applied more extensively to individual strategies.

As ESG risk is integrated in a manner that is tailored to each market and asset class, emerging market sovereign debts, for example, can apply Sovereign ESG scores directly to the risk assessment, whereas for currency-focused strategy and developed market sovereign debts, the focus is on considering certain long-term ESG trends such as structural decarbonisation and how these may affect specific economic variables including growth and inflation in specific countries.

The Firm's portfolio managers and analysts use a mixture of quantitative and qualitative analysis within the research process to identify and understand ESG influences on the securities held within the Firm's fixed income accounts. At all times, the Firm's aim is to identify sustainability issues that may impact the ability of a fixed income security issuer to meet its financial obligations. By doing so, the Firm seeks to avoid the down-side risk of the Firm clients' portfolios due to potentially serious events.

While the Firm's portfolio managers and analysts are provided with information on sustainability risks, and are encouraged to take sustainability risks into account when making an investment decision, sustainability risk would not by itself prevent the Firm from making any investment. Instead, sustainability risk forms part of the overall risk management processes, and is one of many risks which may, depending on the specific investment opportunity, be relevant to a determination of risk. However, the Firm does not necessarily apply any absolute risk limits or risk appetite thresholds which relate exclusively to sustainability risk as a separate category of risk.

The Firm's Portfolio Risk Management team conducts periodic monitoring of the existing client portfolios, to check that positions remain within sustainability risk limits, and takes corrective action if those limits are breached.

The Firm monitors existing investments for ESG policy compliance and success. ESG specialists in Responsible Investment Department and Fixed Income Investment Department work with portfolio managers and analysts to monitor ESG scores of issuers in portfolios and related data such as climate-related risks/opportunities and controversies. These analytical data compiled are regularly reported to senior management to monitor ESG related risk and opportunities.

As part of ongoing monitoring, the Firm's portfolio managers are encouraged to engage in Active Ownership, with a view to reducing the sustainability risk of particular positions. Active Ownership is the process of entering into dialogue with issuers on ESG issues, with a view to monitor or influence ESG outcomes within the issuer. For sovereign bond engagements, in addition to issuer stakeholders the Firm engages with Originators and primary dealers, Index and ESG data providers, Supranational organizations, NGOs, think tanks and academics etc. to promote the engagement objectives.

3. **Relevant sustainability risks**

As noted in section 6 of the NAM EU Sustainability Risk policy, the Firm has taken steps to identify key environmental, social and governance risk which could, if they occur, cause an actual or potential material negative impact on the value of an investment.

Environmental sustainability risks for the value of our Sovereign ESG framework include:

- Energy and Climate Change
- Energy Security
- Resource Use
- Environmental Vulnerability

Social sustainability risks for the value of our Sovereign ESG framework include:

- Basic Needs
- Health and Well-being
- Gender Inequality
- Equity and Opportunity
- Human Development
- Human and Civil Rights
- Social Cohesion
- Socio-Economic Inequality
- Demographic Pressure

Governance sustainability risks for the value of our Sovereign ESG framework include:

- Government Effectiveness
- Corruption
- Investor Protection
- Regulatory Environment
- Economic Competitiveness
- Rights and Freedoms
- Internal Stability
- Geo-Political Risks
- Market Development
- Innovation

International convention risks that can be signed by countries:

- Controversial Weapons

- Human Rights
- Labour Rights
- Environment

Sanction risks that are economic and political tools that governments use to penalize breaches of international norms or to initiate a change in behaviour.

- Asset Freezes
- Travel Bans
- Arms Embargoes
- Economic/Trade Restrictions

Each of the issues noted above is formally defined and assessed across a variety of factors, updated regularly and tracked over time.