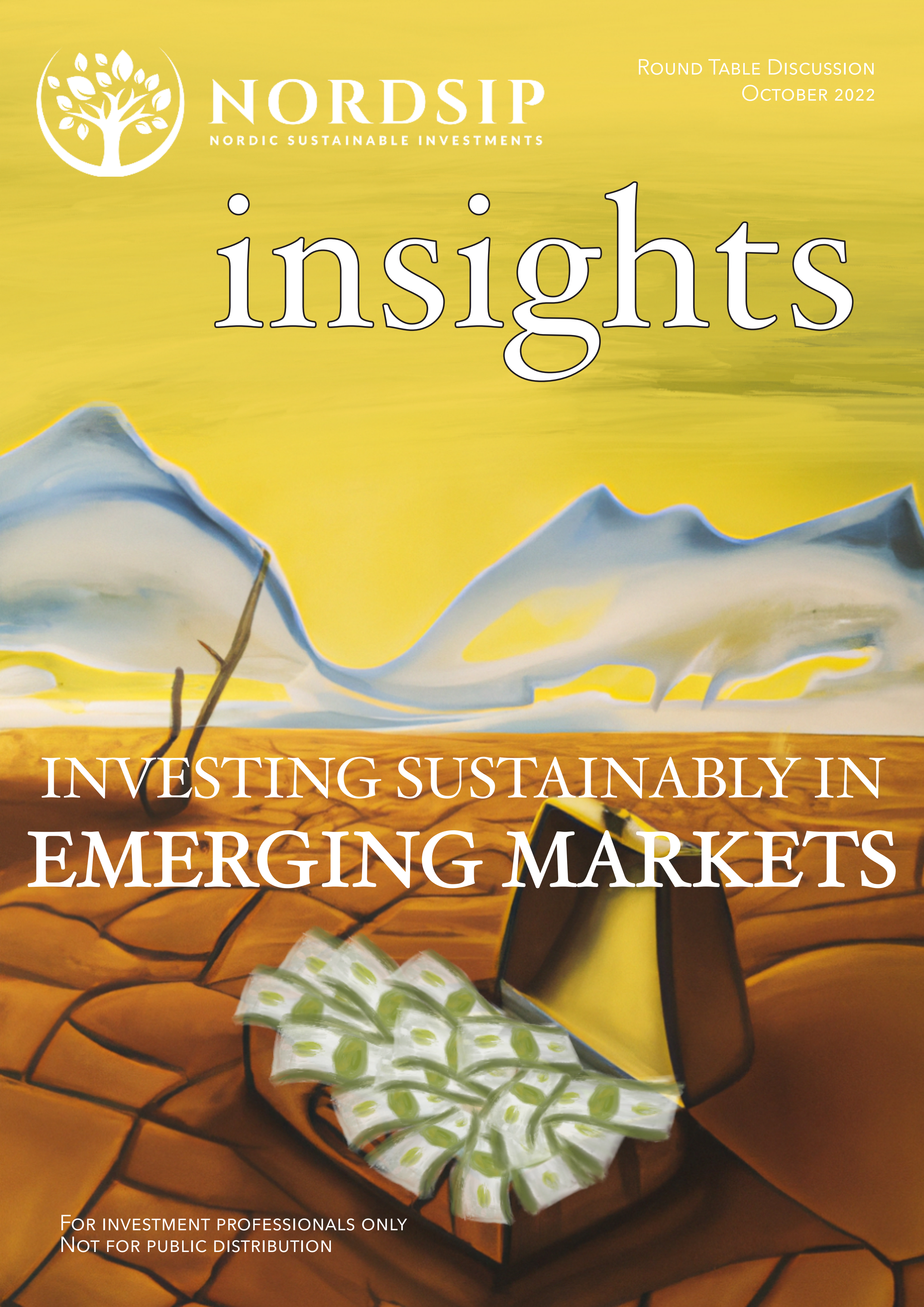

NORDSIP
NORDIC SUSTAINABLE INVESTMENTS

ROUND TABLE DISCUSSION
OCTOBER 2022

insights

INVESTING SUSTAINABLY IN EMERGING MARKETS

FOR INVESTMENT PROFESSIONALS ONLY
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NordSIP Handbooks are published by
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MENU

amuse-bouche

load the dice

Aline Reichenberg Gustafsson, CFA
Editor-in-Chief
NordSIP

For many risk averse institutional asset owners, Emerging Markets (EM) investing can seem like a bit of a gamble at the best of times. The attraction of high growth-driven returns can be overshadowed by the corresponding greater political risks and inconsistent access to key market information.

Once you add sustainability criteria into the mix, there can be a feeling that it might be best to cash in your remaining chips and take a taxi home. Nevertheless, with the right expertise in place, EM investing can be very rewarding, both from a returns standpoint and in terms of positive sustainability outcomes.

With this in mind, we travelled to Copenhagen to gather the thoughts of three large Danish asset owners along with two specialist asset managers representing the equity and fixed income perspectives.

How best to overcome the persistent ESG data gaps in developing countries? Is it reasonable to apply the same sustainability criteria in EM as for developed markets? What skills are required to navigate through stormy geopolitical waters and effectively engage with companies in a multitude of different cultures?

While the challenges remain and recent market conditions have created headwinds in EM investing, the overall tone of this latest NordSIP roundtable was one of cautious optimism.

If asset owners team up with partners offering the right level of skill and experience, it is possible to load the dice in your favour and achieve good long-term returns while supporting emerging economies as they move towards a more prosperous and sustainable future.

who is who?

Daniel Wekke Probst
Head of Equities
Realdania

Daniel W. Probst has worked in the finance industry the past 25 years. Starting his career as an equity analyst and holding various positions as Head of research, Chief strategist, Investment director and currently as Head of equities in the Danish philanthropic entity Realdania. Main responsibilities involve manager selection, portfolio construction and part of the asset allocation committee. He earned a BSc in Business administration and economics and a MSc in Finance and accounting (FIR) from Copenhagen Business School, where he has served as an external lecturer, supervising students at graduate level. Executive programmes at Wharton and Edhec Business School.

Kristoffer Birch
Head of Equities
LD Fonde

Prior to joining LD Fonde as Head of Equities in November 2016, Kristoffer Birch was Portfolio Manager at SEB Pension in Copenhagen. Previously Kristoffer worked in Sydney for State Street Global Advisors where he managed passive strategies and for J.P. Morgan as a transition analyst. Before moving to Australia, Kristoffer occupied various investment positions at Accunia Fondsmæglerselskab, Nykredit Portefølje Administration, and Nykredit Portefølje Bank.

Kristoffer holds a B.Sc. in Economics and Business Administration and M.Sc. in Applied Economics and Finance from Copenhagen Business School.

Simon Cooke
Portfolio Manager, Emerging Markets Fixed Income
BNY Mellon / Insight Investment

Simon is an emerging market corporate debt Portfolio Manager in the Emerging Market Debt Team, with a particular focus on responsible investment and high yield. He is lead portfolio manager for Insight's environmental, social and governance (ESG) strategies in emerging markets and global high yield, and a portfolio manager on other emerging market corporate strategies. Simon joined Insight Investment in 2011 as a Credit Analyst, spending six years covering high yield and emerging markets before moving to the Emerging Market Debt Team in 2017. He began his career in audit and corporate finance at Grant Thornton. Simon holds a BA in history from Durham University, is a Chartered Accountant and CFA charterholder.

Anders Kristoffersen
Head of Impact Investments
The Velux Foundations

Anders Kristoffersen heads impact investments at Velux Foundations and he is in charge of overseeing ESG integration across asset classes. Concurrently he sits on the investment committee of the V. Kann Rasmussen Foundation and on the board of impact investment portfolio company CPH Village.

Prior to joining Velux Foundations in April 2016, Anders worked at Novozymes as Head of Public Affairs Biomass Conversion. Previous positions include Project Lead at Dalberg Global Development Advisors and Policy Officer at the World Bank.

Anders holds an M.Sc. from DTU, Technical University of Denmark and completed executive education programmes at London Business School, Harvard Business School and MIT.

Jack Nelson
Portfolio Manager
Stewart Investors

Jack is a Portfolio Manager at Stewart Investors, having joined the team in September 2011 as a graduate.

He is lead manager of the Global Emerging Markets Sustainability strategies, and holds a MA (Oxon) in Politics, Philosophy and Economics from Queen's College, Oxford.

From left to right: Richard Tyszkiewicz, Simon Cooke, Kristoffer Birch, Anders Kristoffersen, Daniel Probst, Jack Nelson, Ketul Nandani, Chris McGoldrick, Aline Reichenberg Gustafsson, Johan Klevenstedt

Investing Sustainably in Emerging Markets

Harsdorffs Hus
Copenhagen
15 September 2022

Identifying the big (data) picture

Access to information has always been both a challenge and an attraction in emerging markets (EM) investing. Geographic disparity and multiple local reporting practices have allowed active managers with the requisite skills and local access to generate alpha that could be harder to obtain in developed markets. Asset owners and managers are increasingly expected to integrate environmental, social and governance (ESG) criteria into their investment process across all asset classes. How best to invest sustainably within EM strategies? NordSIP gathered representatives from three Danish institutional asset owners alongside specialist EM debt and equity managers to explore the subject and share their hands-on experience navigating the risks, opportunities and complex reporting frameworks associated with ESG investing in the developing world.

Emerging markets are still lagging in data coverage terms

Despite widespread progress, yawning data gaps remain that are hard to fill even for the most experienced EM managers. **Simon Cooke**, Portfolio Manager (PM), Emerging Markets Fixed Income at Insight Investment explains where the main problem areas lie. "There has been an explosion in data since about 2018, but it's still nowhere near where we want it to be. If I look back at 2017 when I started as PM on the EM side, I think coverage of the indices for basic ESG data was less than 50%. Now it's close to 90% for EM Corporate indices and 100% for sovereign indices. Information on physical and transition risk around climate change, which was non-existent five years ago and only at around 30% coverage even a year ago is now at around 80%. Now that basic ESG coverage is more adequate, especially regarding climate change, Cooke is eager for the coverage to extend to other corners of the market. "There are still gaps in the debt world, especially when you get to the smaller issuers, which are often high yield and privately owned. External data providers are more focused on larger companies and listed equities. That is why Insight has developed our own proprietary ESG survey which we use in some circumstances to try and fill in those data gaps. Those surveys have evolved as more data has been made publicly available, but there is still a long tail of smaller companies where you still need to do the data gathering yourself. Coverage of some data to fulfil regulatory obligations – such as SFDR requirements and information on ESG controversies – is still quite limited, meaning investment managers have to go and collect the data themselves. We would love to see more standardisation, allowing data providers to do it, but I think that's going to take years."

With climate metrics such as carbon intensity reasonably well covered in EM, Cooke finds it hard to keep up with the rapid expansion of sustainability themes. "For biodiversity or something like water usage, you're lucky if 10% of the universe is covered. And yet that is part of what clients are

"It's often the companies with the best sustainability reports that are actually the worst offenders in terms of the fundamentals of what they are doing. Not everything that matters can be measured and everything that can be measured doesn't necessarily matter."

"There has been an explosion in data since about 2018, but it's still nowhere near where we want it to be. If I look back at 2017 when I started as PM on the EM side, I think coverage of the indices for basic ESG data was less than 50%."

demanding, and SFDR Article 8 and 9 funds are also expected to report on those themes. The challenge is that many companies don't have the extra resources to start gathering the relevant data themselves. It's not easy and it will probably require a multi-year collaborative fix to try and solve that problem."

EM managers must adapt and do their own research

The overall emerging markets ESG data picture is similar from the equity perspective. For **Jack Nelson**, Sydney-based Portfolio Manager at Stewart Investors, there is a real need to look beyond the data and perform your own analysis on companies. Good disclosure does not automatically imply good governance. "I echo much of what Simon said, with most standardised metrics like carbon emissions, we do see greater disclosures. However, there are still gaps in the smaller cap space and the way we've tried to approach that is by simply writing to all the companies that we own, whether they have disclosures, targets or neither, to try to move them all towards a consistent level of compliance. The more esoteric data is often

missing, but our perspective is that there's often an effort in this industry to quantify everything and sometimes the data can tell you part of the sustainability story, but not the whole story. For instance, some companies are far better than their peers at disclosing water usage or different levels of waste but have fundamentally poorly positioned business models. We try and make that distinction, as sometimes as an industry we can be at risk of misidentifying disclosure with compliance or with having an ESG focus within the company. It's often the companies with the best sustainability reports that are actually the worst offenders in terms of the fundamentals of what they are doing. Not everything that matters can be measured and everything that can be measured doesn't necessarily matter. That's not to say that we don't need to keep pushing for more data disclosure, just that we sometimes can over metricate and rely too much on some of these numeric outcomes. What might be more important than water usage could be: what are they making with that water? Are they bottling Coca-Cola, or are they producing a healthier alternative? That more fundamental view is less prone to data gaps."

For asset owners, appointing the right EM managers is crucial

Nevertheless, as the European Union continues the gradual implementation of its Sustainable

The power of regulation

"I've actually been a bit surprised how much the taxonomy and Article 6, 8 and 9 has taken off. In my view it's really meant for the retail segment, but it's gained traction and suddenly, all managers want to reach a higher level."

Finance Disclosure Regulation (SFDR) the reporting burden is bound to increase. In the meantime, **Anders Kristoffersen**, Head of Impact at the Velux Foundations is willing to be patient. "We don't have any requirements for our managers to follow SFDR yet. What is important for us is that they regard ESG as a way of minimising risks and creating value. We believe it is vital that our managers invest in companies that are well managed for the long run. How do they do that and with which ESG metrics? I would agree that instead of using a one-size-fits-all approach for all investments, we want them to dig into what is material for the particular company, and that differs across industries and regions. So rather than rigid frameworks, we want our managers to take a broader view on investments, not only looking at traditional metrics such as debt levels and cash flows."

Delegating the broad ESG strategy to external managers does imply close monitoring on behalf of the asset owner, as Kristoffersen explains: "We continuously screen our portfolios to see if the shared view that we have agreed on with our managers is being realised in the portfolios. We take a quite simple approach, screening our portfolios twice a year for UN Global Compact complianceand in addition we have a specific focus on fossil fuels. A lack of data and quality of data can be a problem, but we acknowledge that not everything can be quantified."

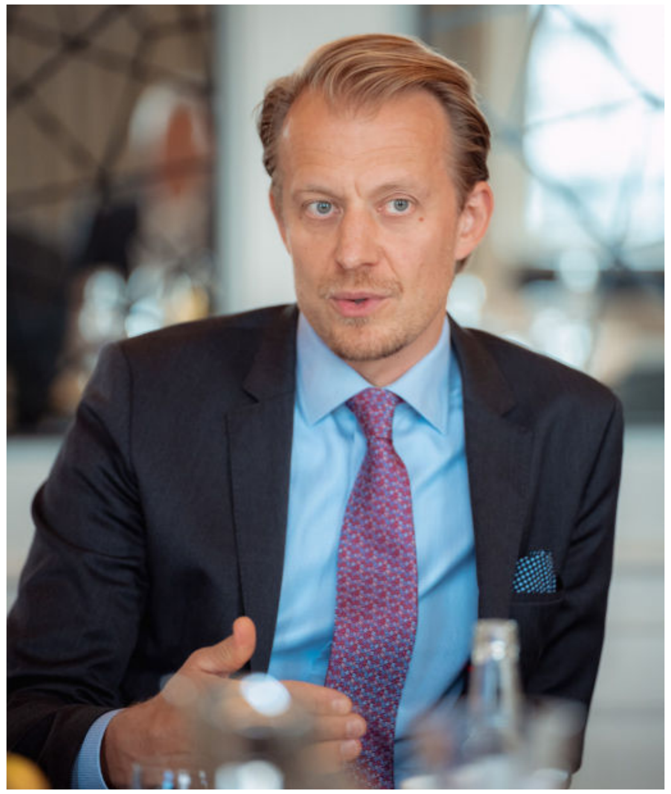
The Velux Foundations apply this approach across developed and emerging markets. "It's basically the same approach, but we are cognizant of how countries are constructed differently. There is a lot more exposure to fossil fuels, resource extraction, and commodities in EM so we do see a lot more investments of this sort in those markets. We are actually okay with that as long as we are convinced that our managers have properly considered it. The world is as the world is and we want exposure to the full world economy, and that goes for the developing markets as well."

For **Daniel Probst**, Head of Equities at Realdania, another job for the asset owner is to provide direction when ESG ratings providers and the foundation's external managers have differing views on a portfolio company. "Anders and I are probably in a very similar situation in that foundations have no SFDR requirements. I've actually been a bit surprised how much the taxonomy and Article 6, 8 and 9 has taken off. In my view it's really meant for the retail segment, but it has gained traction and suddenly, all managers want to reach a higher level. We do see our managers as a first line of defence, so relay on them to be aware of those issues. The challenge we see from time to time on the data front is when they reach a different conclusion about a company compared to the data provider that we use. If you use ISS or other providers you will see very different opinions about the same company, and that can be quite problematic. We must have the manager explain very carefully why they reached a different conclusion, perhaps based on a proprietary system with different weightings."

The SFDR framework better suits newcomers to emerging markets

For **Cooke**, Kristoffersen and Probst's approach chimes with that of many of his more sophisticated clients. "Those that already have more of an ESG focus don't focus on SFDR requirements because they already know what they want us to do. Other clients are more likely to focus on SFDR, which means we have massive data demand, which is not necessarily that useful. Some clients think it's the best way to understand ESG and achieve sustainable impact, but it does seem that while SFDR is very well intentioned, it presents unfortunate challenges. For example, a strategy may seek to allocate to the transition to a low-carbon world: but the allocation allowable under SFDR Article 9 is dramatically smaller because of the necessary structure of the portfolio and being able to demonstrate that the allocation doesn't cause significant harm. This presents a particular challenge regarding fossil fuels in EM, where the reliance on them is twice that of DM: if we really want to make a difference in this area, it's going to be by supporting fossil fuel producers as they transition, but this is difficult while operating in line with SFDR restrictions. SFDR seems more designed to fit European large cap listed equities, where most companies are already almost all the way there in terms of sustainability."

"SFDR is something that we will use and report on, but for now it's not going to be affecting my allocation decisions or selection of managers."



Kristoffer Birch, Head of Equities at LD Pensions believes that SFDR is something that you will have to adapt to and live with, but which has little relevance to the hands-on tasks of portfolio management. "If you're a large investor you could take the numbers reported by your individual managers and combine them into one number or into 18 PAI indicators, but you can't really use that as an allocation tool. For us it's mostly just a number that just gets aggregated up to fund level. SFDR is something that we will use and report on, but for now it's not going to be affecting my allocation decisions or selection of managers. Like my colleagues here, we look much more at how well we are aligned with the managers' intentions and how effectively they engage with companies.

Birch is convinced that if LD Pensions' managers are truly forward looking and good at identifying material risks then engagement can be a powerful tool. "External investment managers are in a much better place to drive engagements than third party providers, because they've got the daily interaction with management anyway. When we select managers, we look at whether they are able and willing to do forward looking and change-focused engagements with companies. We also think voting is an important area. We require voting recommendations from our managers because we don't necessarily just follow a generic voting policy from a third-party provider. Managers should have more insight than an analyst from MSCI or ISS for instance."

There is no substitute for company engagement in EM

Given the information gaps and cultural differences inherent in emerging markets, the roundtable participants are all convinced that direct company engagement is key to success. **Nelson** explains: "Emerging markets is perhaps

Local culture & engagement

the most diverse asset class in terms of cultures around the world. Engagement in Brazil is very different from engagement in Korea. We have found that the best approach is to appear as a credible long-term shareholder and a friend to the management team. Engagement must be non-confrontational, particularly in Asia, where you can't turn up to a management team's office and wag a finger in their face while telling them what to do. That will get you nowhere, and they are more likely to be resistant. There are certain issues that are far better approached in a way which helps the company to see the opportunity rather than the challenge from the change."

Nelson illustrates the point with a concrete example. "We when went out to around 30 financial companies across emerging markets to talk about microinsurance. We felt that the savings and loans aspect of microfinance was very well documented and covered, but the insurance side was an area of huge opportunity because it is the people in emerging markets who have the least access to protection products while needing them the most. There are farmers who are one bad harvest away from taking their children out of school, or one rickshaw axle break away from not eating. We therefore approached EM insurance companies as credible long-term shareholders, having held positions for 5 or 10 years. Their business today was maybe car insurance or private healthcare, addressing the top 20% of society. We would present the view that the next 20 years was more about how you can use technology and different business models to address the next rung on the pyramid. The engagement was about not trying to frame it as philanthropy but rather to say, 'look at the opportunity and the millions of potential customers you could have. Look at the brand equity you could build in society through addressing this.' It can be the same for supply chain issues. Explaining that despite their local market not giving a hoot about plastic pollution, as a five plus year shareholder it matters to us and trying to explain why. Being supportive long-term shareholders is probably the most important thing we found to help the chances of success of engagement in the end."

This more thoughtful buy-and-hold approach to engagement in EM also applies on the fixed income side. Cooke gives his perspective: "In EM, 60% to 70% of the corporate universe we invest in is privately owned, which makes the bondholder the primary provider of capital to those firms. I'd echo much of what has just been said: it's about being a long-term credible partner for the company. If we buy their new issue and then dump it three weeks later, they're not going to want to talk to us. Similarly, if we just turn up and say, 'we think you should change these things', we are not going to get any traction. It's all about demonstrating that you are credible over the long-term and that it's not just an ESG-based relationship, that you actually care about the fundamentals of the company as well. You show your interests are aligned in that you want the company to do well."

Tuning into local and regional cultural differences

Cooke also agrees that tuning into regional differences is a crucial skill, and not just in EM. "When I was an analyst doing EM and high yield in European markets many years ago, the way I talked to a Dutch company was not the same as when I talked to an Italian company. They are completely different cultures in terms of how you deal with management and it's like that in EM – it's just amplified because you're talking about 100 countries across five continents rather than 20 or 30. That means you need to be sensitive. From a debt perspective, we don't try to force our local norms on companies when it's completely different to their local ones, or where it's just because of biases in terms of how we structure governance in Europe or the UK. What we want to do instead is present things in terms of best practices of their local or regional peers."

Sometimes standards do need changing regardless, as Cooke explains: "Where we see simple instances of bad governance, we might try to encourage them in the right direction, but it's more about collaboration. Regarding the outsourcing to third-party collaboration coordinators, I completely agree that they don't have the relationship with companies, and they don't have the expertise. Where they are useful is in coordination, and particularly in collaboration with local investors. We found the responsiveness of the company increases dramatically when you are engaging with them in their local language, and you are seen as a local, particularly with the larger companies."

Overall, contrary to his earlier expectations, Cooke finds his firm's ability to influence companies as a debt holder is quite similar to that of shareholders. "When I first went into the industry I thought that debt holders don't get a vote so their ability to influence would be practically zero. In fact, we have been involved in big things like developing sustainability frameworks with some companies. We worked with an agricultural company on tracking and reporting their water usage costs, which are massive for that sector. It was privately held and not covered by ESG data providers and so that's the kind of change that you can influence over time. It's important to be realistic in your expectations and focus efforts where you can see the potential to partner long-term. We have sometimes learned the hard way, it's not worth lobbying companies that have no interest in changing. It's just a waste of our time and theirs. Lobbying someone who doesn't want to change is just a waste of our client's capital at the end of the day. We would rather deploy it somewhere we can actually deliver change."

Anticipating and safely navigating political turmoil

Investing sustainably in far-flung corners of the developing world also requires keeping your finger firmly on the geopolitical pulse. In the light of recent events do EM investors need to consider rating and excluding not just companies but whole countries as well?

The global tensions certainly haven't helped, according to Probst. "The

situation has certainly worsened since the pandemic, and before that we already had the trade war between the US and China. It's hard to evaluate a country from the outside, and we are not able to engage with governments. For us it often helps to ask a very basic question of whether there is freedom of speech in that country. If not, a lot of other ESG issues like corruption or abuse of minorities often follows. This doesn't mean we won't invest in that country, if it's compliant with international conventions, but it's certainly a red flag for us. In many cases since we don't have to invest, we have recently become more worried about investing in emerging markets."

Birch agrees that it is not an easy call, and the risk/return ratio must be favourable. "The risk of investing in emerging markets has definitely increased and I'm not sure the return or premia alongside that risk have followed. I think the risk of your investments being taken hostage in a political situation, like with European firms investing in Russia that suddenly had to let go of their 10-year investments in local companies. You need to be compensated for that risk. I think investors are more wary than before Russia invaded Ukraine."

Many longstanding characteristics of emerging markets have changed, requiring a re-evaluation by investors. **Kristoffersen** explains: "It seems like globalisation is moving backwards, with supply chains shortened and production re-shored in many parts of the developed world. That definitely changes the investment universe. We have added country level screens to our portfolios over the last couple of years, so we now get an overview of which countries we are exposed to, and an assessment by experts of the risks in investing in these parts of the world. We take those assessments as a starting point for the dialogue with our managers. Again, we invest indirectly, and we pay our managers to do these very thorough risk evaluations. For instance, going into a country like Belarus carried risks, even before Russia invaded Ukraine. You invest in a country where politics and business are much more interlinked, and you add a lot of risks. That has always been the case, and we are quite comfortable that it's still possible to do it, but you should really exercise good macroeconomic and political evaluation skills. You cannot just look at an issuer or a company in isolation. You need to regard the context of the country in which the company sits. This is only becoming more important in our view."

"It seems like globalisation is moving backwards, with supply chains shortened and production re-shored in many parts of the developed world. That definitely changes the investment universe."

Should EM investors consider more whole country exclusions?

Excluding whole countries should not be done lightly, for Kristoffersen: "There are only about 200 countries, so every time you carve one out you reduce the investible universe quite significantly. We are therefore quite careful not to put too many restrictions in place, but it's definitely something that is moving up our internal agenda. We also share the observation that it seems like over the last decade or so, not all investors have been paid for the risk that they have been taking. As a long-term investor we are still very interested in EM as an asset class. Valuations are interesting and there are some positive structural trends, but we remain cautious."

Alongside the capital risk aspect, investors may consider more fundamental ESG-related values when deciding whether to invest in an emerging markets country. It is not always an easy call to make, as **Probst** explains: "Best ESG practice is a basic license to operate, at least in our part of the world. On the country level the elephant in the room is China. On the E side, there are some good prospects there now, but looking at the S and the G, it's not very good."

"If you look at different societies in EM, there's a very different balance across them in terms of the amount of space the state broadly gives to markets or to civil society." **Nelson** continues. We haven't invested in Russia for 10 years. We've never invested in Saudi Arabia, and we have very little in China, and it's purely because from a bottom-up stock picking perspective, it's so hard to find equities that you feel are sufficiently distant from central government. Unless you purport to understand the inner workings of CCP politics, if somebody's built up that business on patronage, you may well come in one day to find that the business is gone, and the person's been arrested. It's important to understand what clients want from their EM allocations. We have taken a very different approach to our allocation to those markets. We have barely 10% in China today and that's probably the highest it's been for a long time. It was zero not long ago. In contrast, India is 40% of the fund because in that country you have checks and balances. In China, if you try and find out about a founder or an owner there are no journalists to ask, whereas in India, you can build up information. That means what we offer in terms of the product is not exposure to emerging markets in the conventional sense of looking like the benchmark."

For Nelson, EM investors can take different directions: "It depends on what you want and that's probably ultimately a value judgment. Do you want stock picking in EM which incorporates the reputational risks relating to human rights, which affect not just the client, but also the corporates themselves, or do you simply want the value-add relating to the inefficiencies in the markets we operate in."

Investors' reaction to EM turmoil is a buying opportunity for **Cooke**. "Looking at EM overall, there are loads of opportunities because it's so big and so diversified. I don't know if it's the same in equities, but in the debt space right now there are more opportunities than there have been probably for the last five years. Many clients feel EM is just uninvestable right now, so lots of things are being sold off. People just want to dump their exposure and get out and it means you've got lots of opportunities for active managers to go and pick up bonds quickly in a way that wasn't the same when everyone was just in a bull market."

"In the debt space right now there are more opportunities than there have been probably for the last five years. Many clients feel EM is just uninvestable right now, so lots of things are being sold off."

Driving impact in Emerging Markets

Emerging markets should be ideal for impact investing, but how easy is it to achieve?

Sustainability-minded emerging markets investors may be looking for positive impact alongside financial returns. **Kristoffersen** prefers to keep his impact portfolio invested in developed markets for the time being since impact investments is a new asset class with substantial risks. "We see quite significant risk in moving into these emerging areas already, the technology risk, and project risk, and company risk. We therefore decided to carve away that risk element. We fully acknowledged that by doing so, we cut ourselves off from a lot of very interesting impact opportunities. We might revise that in future, and we do actually get a lot of fire for this decision from different stakeholders. For now, we've been quite satisfied with this decision. The program is young, and we still need to find our feet, but it might be revised down the road."

For **Birch**, impact measurement has to make sense in an EM context. "Obviously there's a bigger impact in investing in a sewage company in Africa than in hip replacements in the west. They both have a positive impact on humans, but the scale of change is much bigger in Africa. That means it makes total sense to direct your impact towards emerging markets. The problem is finding the companies with a direct impact goal. We have one such environmental and social fund, which has a possibility to invest in emerging equity markets. However, they are underweight emerging markets, because they can't really find the impactful companies at the right valuations, especially on the social side, so they are more focused on environmental impact. We don't prioritise the social or environmental impact. We prefer to look at the theoretical framework of the nine planetary boundaries, although the media and the public is focused on the E right now."

"Obviously there's a bigger impact in investing in a sewage company in Africa than in hip replacements in the west. They both have a positive impact on humans, but the scale of change is much bigger in Africa."

Probst finds it difficult to reconcile a philanthropic mindset with investing in the "S" part of ESG. "

“We have done quite a lot of work on conflict minerals, particularly in the semiconductor supply chain. One of the confusions and interest aspects of sustainability is that solving one problem can exacerbate another.”

When we invest, we expect a decent risk adjusted return, and can you justify it when investing in things like for example microfinance? You may say what’s the alternative, but you can end up in some difficult discussions, in our view.

Taking a holistic rather than granular approach to ESG is one way to avoid difficult choices according to **Kristoffersen**, with a certain caveat: “We signed the DivestInvest pledge back in 2015, and compliance with this pledge is of course very important to us. That means we do monitor the E slightly more and have done so for quite a while. We for instance believe that investing in companies that rely too much on coal can be a risky business decision. It can be short term and short-sighted, so that is something that we pay particular attention to. The E, fossil fuels and specifically coal is something that we are very attentive to and something that we screen our portfolio specifically against.”

The G in ESG is a given for **Cooke**, given the strong correlation between poor governance and bond defaults. “When it comes to E and the S, I think I echo what the others have been saying. We consider the two together because if you just look at the environmental and ignore the social, then I'm not sure you can really be claiming to deliver any impact. There are examples where the E and the S can have different priorities: take a coal-based energy company – how do you support a ‘just transition’ without undermining the employment of hundreds or thousands of people? That's a real complication. More broadly, if you're trying to invest in the E then the best business models are those that are also having some positive or at least neutral social impact. Regarding Africa, I think it's interesting because there are regions where, at least in the debt space, there are attractive infrastructure investments on the social side, particularly in telecoms. It seems that's a limited opportunity set that's going to disappear over the next 10 years, but right now you're connecting people to the internet who have had no access to it. That’s often in places where they don't have access to

road infrastructure or electricity grids, and that's transformational.”

“I completely agree” concurs **Nelson.** “It is difficult to find genuinely impactful opportunities in those areas, and much of it comes down to business practice. There’s no shortage of listed finance companies targeting bottom of the pyramid consumers in EM, but if you look at the interest rates and the default rates, it borders on the usurious. You start to question the ethics around some of that, and looking at the way those businesses are run, even in education, another sector that from an SDG perspective we’d love to have more ability to invest in directly. The experience with for-profit education in Asia has been that with regulation and reform of the state system it ends up no longer required, so the actual investment opportunities in those areas are relatively limited. I’d echo what everyone else has said around the intertwined nature of these the E and S. We use a framework called Project Drawdown, which includes 82 solutions to climate change. The three most impactful are food waste, plant-based diets, and healthcare and education. Healthcare and education in that regard mean things like access to information through telecoms networks or more climate conscious agricultural practices. It could be better healthcare systems which mean people can live in a way which is more compliant with reduced impact.”

When looking at individual businesses, there are opportunities to combine the most fruitful solutions, as Nelson explains: “We invest in a number of drug retail chains that are affected by economies of scale. This means that as they consolidate, the cost of medicine falls which means the success of this company is improving the logistics and distribution of drugs and reducing medicine costs for consumers in those countries. The idea of the trade-offs is also interesting. I remember looking at a coal-fired cement company in Nigeria: of course they need roads, bridges and houses, so how do you weigh up the two things? I suppose one pertinent point is, at the end of the day the climate will win. It's people in emerging markets who will suffer the most if the climate continues to deteriorate over the next 30 years. You only have to look at the floods in Pakistan right now to start to think that housing people whether that be using coal fired cement or whatever it may be, is only a partial solution. For many of these opportunities we choose to try and find alternatives which don't have those risks rather than focus on transition. This is because our duty to our clients is for returns, and we feel that with some of those companies the risks of stranded assets are so large that we think we can be rewarded for owning those equities with lower risk and avoid those companies that are having to make that very acute trade-off between E and S.”

“There’s no shortage of listed finance companies targeting bottom of the pyramid consumers in EM, but if you look at the interest rates and the default rates, it borders on the usurious.”

Identifying niche markets for maximum impact

While covering the environmental and social bases, Stewart Investors also seek out opportunities to engage on less well covered themes where they feel they can instigate positive change. London-based Analyst **Chris McGoldrick** expands: “We have done quite a lot of work on conflict minerals, particularly in the semiconductor supply chain.

One of the confusions and interest aspects of sustainability is that solving one problem can exacerbate another. We’re all aware that electric vehicles would be very good for the environment, but they use twice the amount of semiconductors. That means extra demand on tin, tantalum, tungsten and gold, 90% of which are coming from mines with appalling conditions and people working under duress. We have been engaging on a collaborative basis with UN PRI and have managed to achieve a significant number of new signatories and to talk to the likes of TSMC and Intel about improving the provenance of these minerals. Everyone is talking to TSMC about climate and their electrical and water use, and that means that they’re not focusing on these other issues. We are trying to shine the spotlight on the things that are not necessarily in the press.”

Monitoring the progress and effectiveness of engagement activity is a key part of the process for asset owners, as **Kristoffersen** explains: “We have run statistics on the engagement efforts that we pay an external provider to do on our behalf, and it has this skew towards the E, so you could say that they tend to focus on the environmental side. We would ideally want them to look holistically, so it’s a bit out of balance. There is engagement on all parameters but there is a bias towards the E.”

Engagement is worthwhile but also time consuming, adds **Birch**: “It’s a question of engagement bandwidth. We don’t do emerging market engagements on our own, so rely on our external managers or a third-party provider. It takes time and a lot of energy and resources to do these engagements, so you focus first on the most material things and then drill down once you find enough resources for the next issue.”

Investors need to engage flexibly to achieve effective change

It may also be possible to push things too far and too soon, according to McGoldrick. "One thing we're observing is, perhaps rather worryingly, engagement fatigue with companies. They have a job to do, and in the case of TSMC it's to make semiconductors. They are getting bombarded with questions about electrical use, minerals, human rights atrocities, and you can feel them just thinking 'we've got to make semiconductors.' It's a concern, and maybe points towards more focused collaborations rather than each asset manager working separately. Cynically speaking, I feel engagement can often be confused with marketing in this industry, and the cynical asset managers can use engagement to acquire AUM. We must try to move away from that."

Cooke believes collaborative engagement on multiple issues works best with larger companies. "For smaller companies, it's often the case that you can focus on the S, and you can ask them what other investors are talking to them about. That means you can focus and direct your efforts so that they are only looking at one issue at one time. Once you get to larger corporates, that's where collaboration between managers is beneficial because you focus on driving change. together. It also means the industry is focusing on what is most pertinent to that company and what they can achieve over a reasonable timeframe. For smaller companies, because of the direct relationship, you can start to talk to them about your focus area and what others are talking to them about. Then you can work out what's best for that company. Small companies will typically have one investor relations person who is also trying to do everything related to ESG as well, so they have no real capacity to do anything other than one issue at a time."

When impact washing raises its ugly head

Cooke has little time for those using engagement as a marketing ploy. "The whole point of engagement is actually to drive positive change, not to make us look good. The encouragement to me is seeing people younger than me who are coming into the industry and genuinely care about delivering positive outcomes alongside financial returns. That is their mindset as they come into it, so there is some positivity out there. Working together to achieve changes would be a wonderful thing to see."

"Small companies will typically have one IR person who is also trying to do everything related to ESG as well, so they have no real capacity to do anything other than one issue at a time."

Asset owners also are also keen to avoid impact washing. Probst elaborates:

"At Realdania we have an ongoing discussion about whether you can really make an impact through the secondary market, without active engagement. We don't have exclusion lists, but practise engagement. If that does not work, we will in the end get out of the investment. I don't really see that you can do anything significant by exclusions. There are two schools of thought here, but it's an interesting discussion. How do you see it at Velux Foundations, is exclusion or engagement the way to go forward?"

Kristoffersen: "You could say that joining the DivestInvest pledge was maybe a little bit out of in synch with our overall approach of wanting to have exposure the whole economy, and you can only go so far by divesting. The main explanation is that we do clearly see that parts of the fossil fuel industry will come to a dead end at a point in time. You can of course always discuss when that will happen, or when will we phase out coal entirely, and we do see a backlash right now in Europe.

I'm still of the perception that in the long run this will be a phase out, so it makes sense to at least monitor your exposure to that part of the industry. At an overall level we are firm believers in engagement, owning stocks in companies well managed for the long run and having a dialogue, first and foremost through our managers, but also through the third-party service provider that engages on our behalf."

Engage or divest? That is the question

The question of owning or divesting from problematic industries such as mining is a dilemma for sustainable asset owners like Kristoffersen. "We would like to have exposure to the real-world economy and that includes extractive industries for now. That's a very important part and will remain so for the foreseeable future. Down the road, in many decades time, we might end up in what people call a circular economy, but we are not there yet. We still need to dig out things such as lithium for batteries out from the ground. We want exposure to the well-run companies that do it in the right and forward-looking ways. We are not in favour of excluding whole sectors because they are dirty or polluting, because they also contribute to making the world go around."

It can nevertheless be hard to determine the right time to divest, according to **Nelson**: "It comes down to whether the focus is on impact or return, or what the balance is in the sense that perhaps the greater impact would be to own a coal mine or a coal fired power plant and then engage. As you say, divestment, does that change anything, and what impact can that have in the real world? On the other hand, from a purely

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financial perspective, maybe the divestment argument is logical in the sense that if we agree that this is a dead-end industry, you can't wait until the day it's phased out. It will be financially impaired long before that. We therefore don't invest in fossil fuels, mainly because of the financial argument because we don't know when that will happen. We don't know what discount rate we should use, but does that mean we have less impact? We could go and buy equity in India's largest coal fired power company, which is now also rapidly becoming India's largest renewables company, and engage with them, but we're not sure what the returns profile would be and whether the risks to our clients is too great."

Kristoffersen believes one should be rewarded for this uncertainty as an investor. "If you are looking to invest in an ESG momentum case, such as your Indian example, then you should

definitely look at a bigger risk premium because it could go both ways. You could definitely make the argument there that you can have an impact, but you should do your homework before investing because in some cases it's too late once you're invested. If you end up in dialogue with a management team that won't change its course, then it can turn out to become a very bad investment. We have a manager that only invests in stocks where they have had a good dialogue with the company beforehand. They also seek to invest in ESG momentum cases, not the current ESG darlings because they're highly priced, but rather the ones that could become ESG darlings down the road."

Searching for gems in the grey areas

For investors like **Cooke**, spotting clever bargains beyond these "ESG darlings" is key skill for an EM portfolio manager. "That's the opportunity, isn't it? Coal utilities in particular are discounted at the moment because people see they are going to die at some point, and that to me is the opportunity. It's one of the advantages that debt has over equity in that we can go and lend to them via green bonds, so we know exactly where that money is going to in terms of renewables. We are not having to look at the risk of overall entity. But there is one example where while they are massively moving in renewables, they are also expanding in coal. That to me is the difficulty as I've got a company that has got a transition story but is still two things. They are shutting down their coal supply and building renewable supply, and on a path to doing that over a period of time. That is a very powerful story, and we are increasingly seeing that in emerging markets. The complicating factor is where you have companies that are expanding both, or even a country like China with massive renewables expansion and massive coal expansion. How do you marry those two up? It also means you could end up with stranded assets or with companies that may just switch back from renewables to coal because it seems more attractive. The other situation we've increasingly seen, perhaps more in developed markets than EM, is where companies say they are moving from fossil fuels to renewables, but all they do is sell their fossil fuel business and buy a renewables business. That's not a real-world impact. Nothing has changed in terms of renewables capacity and there's no less fossil fuel capacity. There are increasing numbers of opportunities that are really attractive where you are seeing clear transition stories and we can finance just the renewables component."

Another danger in these scenarios is where "bad assets" get snapped up by "bad actors", as Cooke explains. "The sad thing we have seen, particularly around coal, is when companies get excluded by people then their equity value diminishes. They then get swept up by a private equity firm that doesn't focus on sustainability and generates large returns because they don't need to put any debt on the business having bought it at a low valuation. They make their money back very quickly, and don't need to spend any CapEx because it's a run-off business. What's not clear at this point is when does coal actually disappear? It will at some point, but we would rather be involved in those companies and help them phase it out rather than wash our hands of the problem."

Sometimes the nuances of sustainability get lost, as Cooke explains with the previous example of the coal industry: "There is a massive difference between an open cast coal mine extracting low quality coal, versus high quality coal from a closed coal mine. The environmental impact is not just double, it's exponential between the two. We know that coal is an installed fuel source in EM and will be for 10 or 20 years, hopefully less, so I wish I could direct capital towards the less environmentally destructive part of the universe, but people just don't want any coal.' For me, that's not a good environmental and social mix, it's more about the reality of where we are today versus where we'd like to be. It's about trying to invest to minimise the negative impact today. Right now the cost of capital between those two types of coal mine is zero, and I'd really like it to be very different."

dessert

The SDGs and the future of emerging markets

The UN SDGs are too blunt an instrument for investors

In trying to capture these nuances and make sensible decisions, many sustainable investors will turn to recognised frameworks such as the UN sustainable development goals (SDGs), but these are not always entirely useful. **Birch:** "The Planetary Boundaries are just the starting point of our thinking about the sustainability." "We use a concept called Future-Fit from the UK, where they took the planetary boundaries and turned them it into 23 benchmarks that companies could actually follow and see how far away they are from the planetary boundaries in terms of E and S. And that, so looking at those 23 benchmarks that would be thinking about the whole. It's more like a philosophical framework. The problem with some of the mapping to the SDGs is that sometimes it's just about aggregating numbers from different managers and then mapping them to a framework, not really the other way around. We struggle a bit with using the frameworks that are out there to drive allocation decisions."

Kristoffersen has had a similar experience: "We have looked at the SDGs, but we are not using them actively in our investment decisions. We could easily look through our portfolio and come up with numbers, but as you say, it's at a very aggregated level. Basically, as I explained earlier, we want the managers for our listed equities and listed debt portfolios to be invested in well-managed companies representing the entire economy. We do have a carve out, which is our green impact investments. There we are very thematic, and we know what we want to do. That's for 15% of our endowment. For the remaining 85%, we want to be fully exposed to the rest of the economy. There you could use the SDGs, but you would also miss out on a lot of sectors of the economy where we also want to be invested."

Probst agrees. "We have chosen six of the SDGs that we want to prioritise in our work – both in the philanthropic work and in our impact investments – because they address Realdanias field of work. You can't really take all 17, and not many of them are investible. It's not an investing tool in my point of view."

On the asset management side, using the SDGs can be unavoidable due to client demands, as explained by **Nelson:** "Rather reluctantly we have mapped outcomes to the SDGs because a lot of the clients do want that. However on the investment process side, in terms of how we actually go about constricting portfolios, it doesn't have a role. On the other hand Kate Raworth's Doughnut concept of social and planetary boundaries is a great concept. We would define sustainable development in a similar way. We use a slightly different framework, sourced from the Footprint Network, but it's the same idea: high human development within resource constraints. When we try and unpack what that means, for the environmental restraints, we use Project Drawdown, which is this science-based list of the most important solutions. On the human development side, some of the themes in the SDGs are very relevant, but we eventually designed and came up with our own proprietary framework for that in terms of what we actually have in the listed EM equity space that we can invest in. Only then we can talk about the problems. Rather than referring to sustainable communities in the SDG sense and the corresponding indicators, which are a bit different from what we're looking for, we use housing and describe how the housing finance companies or the construction materials companies can contribute. This is both a stock picking framework and a way of trying to report. Clients want more clarity and transparency around what are you actually owning. Much of our earlier discussion around data comes from this very good place of trying to make sure that asset managers are doing what they say they do. Numbers and data can be helpful, but the alternative is simply to say, 'here's what we own'. It's radical transparency, putting every holding on the website, using some of these frameworks and then we can be challenged on it by clients if it doesn't make any sense. The SDGs do have their limitations, and I suspect we might have already reached peak SDG. Maybe in five or 10 years it will be a different acronym."

For **Cooke**, the SDGs have their place but are not designed for investors. "They are useful in terms of broad themes but their main use would be in public policy rather than investment. If you have an investment in a sub-Saharan telecom provider, that would map to an SDG indicator, but that's one indicator out of how many hundreds that we can't map to directly. Where they do serve a purpose is, a bit like SFDR, that they are becoming a standard. Do we wish that there were other ways that people looked at the world? Probably, but they are a useful thematic to help people understand what you're trying to do. We are trying to support people, planet and prosperity. The ability to aggregate is a thing that we are working with, as we actually want to present meaningful KPIs at a fund level under those three themes that can demonstrate the impact we are achieving. It's about transparency, we want to be able to show people every holding we have in the funds and explain why they are there. People can challenge us and say that's not actually achieving what you say it's going to do, but there is a need to be able to demonstrate something measurable and tangible. Otherwise, the risk of impact washing or just feeling good without actually demonstrating anything is really high. Pharmaceutical companies can be really challenging, as a lot of what goes for impact is just capitalism. There is a need to show what they are doing in terms of additionality on the impact side and how you can measure that. If they are operating mainly in the west and rich countries and mainly selling paracetamol, the additionality is just not really there. They are not really making a difference to anything, whereas with a company selling pharmaceuticals or vaccines in sub-Saharan Africa, I can see additionality. Another question is then the materiality to the business? If it's only 3% of the business, then I'd question what I'm doing with my capital. There has got to be a better use for it in that case. The other risk we're seeing is impact washing, with some funds claiming 20% alignment with the SDGs, or to be on a path to 20% alignment. What does that even mean? It's so generic and so waffly."

"The problem with some of the mapping to the SDGs is that sometimes it's just about aggregating numbers from different managers and then mapping them to a framework, not really the other way around. "

What does the future hold for sustainable EM investors?

Despite the frustrations, **Cooke** sees a bright future for EM debt investing: "Because of the market implosion over the last eight months, the entry point into EM corporate debt is really attractive. In terms of getting paid for the risk you face, right now everything's obviously backed up in yield, but the yield premium of EM versus DM is the highest it's been for about 10 years. This means you're suddenly getting a risk premium in EM. As we have also been talking about during most of this discussion, the evolution in impact opportunities right now means you build funds where it's possible to generate attractive financial returns and alongside attractive impact. That wasn't the case three or four years ago. I think that the opportunity to have incremental impact and generate those attractive returns in EM is probably unparalleled right now."

The broader development picture in EM is also quite positive in **Nelson's** view: "Emerging markets are going through hopefully a one-time leap in living standards. If you look at the reduction in poverty in China over the last three decades, it's probably the greatest in history. Hopefully, the next three decades is a parallel reduction in poverty and increasing opportunity in South Asia and Africa in particular. Hopefully, that will be done through a series of leapfrogging steps, which means a different development path from where we are today. The exciting aspect is that on that time horizon, there are so many opportunities in the equity space. Our benchmark is such a poor representation of the opportunity set because it is comprised of Chinese state-owned banks or state-owned extractive companies, which are not very well run, or erstwhile Russian political entities masquerading as companies. The opportunities for active stock picking are huge. Whether the world has the outcomes we all want will be decided in EM, and the most impact of that will also be felt in EM, which means it's the most exciting space and probably the one with the most opportunity to make a long-term impact in sustainability."

Birch hopes politics will not get in the way of that progress. "I hope that nationalist and populist ideologies will disappear in the west, but also in the emerging markets. The world's problems include climate change, but also other issues, like who owns data and what can you use them for. These can't be solved nationally. As long as climate change is still a distant enemy

at least for some people, I think it will be very difficult for nationalists to see beyond short-term profitability, national growth and that type of thing. I hope that what will happen at some point is that people accept that you create a global identity by going across national borders, because it will be expensive and it will be hard to battle climate change. Financial markets can't do it alone if their ultimate beneficiaries don't change their nationalistic or egotistic perspective."

Kristoffersen takes a pragmatic view of sustainable investing in EM, which he believes requires patience. "We are firm believers in the value of integrating ESG, understood as investing in well-run, well-managed company for the long-term. We truly believe that is a big value creation opportunity and an opportunity to reduce risks and volatility in our portfolio. This sort of thinking started in developed equity markets, and it has spread over the last couple of years. It's fair to say that we're not quite there yet across all asset classes. I think the biggest opportunity is to find the approach that works in this part of the world because as you say, it's not a case of one-size-fits-all. You can't ask the same questions to all companies. You can't expect Western standards in Africa, but you can find companies that are at the forefront in their part of the world. The biggest challenge we see is constructing investment processes that capture that in an environment where data is sorely lacking and where it's a matter of finding other ways of finding investment signals."

Probst ends with a sense of the current optimism among EM managers: "There is a huge opportunity set as has been pointed out. We don't currently have a dedicated EM manager, but the managers are coming around to our office again and hopefully we will see that valuation premium give good returns, because it's been a tough time looking back at this past 10 years."








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