M&G Investments strategy statement:

Climate change

July 2019

At M&G, as an asset manager we recognise our responsibility to our customers, society and the environment to address the challenges and opportunities presented by climate change; the following sets out our strategy for assessing and managing these issues effectively over the long term.

Executive summary

- Investors recognise that **climate change is one of the greatest challenges** facing the planet, the population and the global economy; we also recognise the importance of maintaining resource security for the world's developing needs.
- **Policy developments and technological advances** are driving change in the long-term energy outlook, on both the supply and demand side.
- The 2015 **Paris Climate Agreement** set a clear ambition for countries (and businesses) to work together to keep global temperature rises within a safe threshold.
- For investors, **climate change represents a number of risks**, from direct physical impacts on assets and operations to faster-than-expected regulatory or technological developments that may affect the viability of sectors with high emissions of carbon dioxide or other greenhouse gases (GHGs). Reputational damage – and even litigation – based on historic and existing practices is also increasingly considered as a material risk.
- As long-term investors, **we consider the risks and impacts** of climate change and other environmental issues in our investment considerations.
- As responsible stewards, we recognise the need for a **strategy to assess and manage these risks** effectively on behalf of our customers.
- Initial steps include **quantifying the risks** at portfolio level, focusing on individual 'high-carbon' investments, via quantitative analysis of carbon dioxide exposures in our portfolios and qualitative engagement with investee holdings to understand how these risk are managed.
- Next steps include stress-testing portfolio resilience for different **climate change scenarios** and implementing a more structured engagement and proxy voting approach, holding companies to account over their climate change strategies, GHG emissions reduction targets and the overall sustainability of their business models.
- While climate change is a major challenge, we believe it also represents an **opportunity to support the financing** of long-term solutions, for example in renewables and clean tech.
- We look to work with our peers and other stakeholders, actively participating in a number of **climate-oriented collaborative initiatives**.

The climate context

Concerns around the risks of man-made climate change have been building for years, with retreating glaciers, rising sea levels, increased instances of droughts and other extreme weather events all indications of rising global temperatures. Potential knock-on effects, such as social unrest and mass migration, further highlight the importance of the challenge.

In December 2015, at the 21st annual Conference of the Parties (or COP 21) in Paris, for the first time a binding international agreement was arrived at: in order to address the threat of climate change, we would need to limit the global temperature rise this century to well below two degrees Celsius above pre-industrial levels, and ideally below 1.5 degrees Celsius. In order to be in with a reasonable chance of achieving this goal, it is understood that the concentration of atmospheric carbon dioxide needs to be restricted to 450 ppm (parts per million) – the level currently stands at circa 415 ppm.

> **"[We aim to] hold the increase in the global average temperature to well below 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5°C above pre-industrial levels."**
>
> **The Paris Agreement – COP 21**

Nearly 200 countries signed the Paris Agreement and committed to legally-binding Nationally Determined Contributions (NDCs), setting out their strategy for achieving appropriate GHG emissions reduction targets over the following five years, and every five years thereafter, with the expectation that efforts would become more stringent – and therefore self-reinforcing – in each of the subsequent cycles. The more granular responsibility for these reductions falls on industries, companies and individuals, with the bulk needing to come from high carbon-emitting industries (in particular oil and gas, power utilities and transportation).

In spite of some high-profile push-back on the goals of the Paris Agreement, a renewed sense of urgency was provoked by the release in 2018 of the landmark report by the UN Intergovernmental Panel on Climate Change (IPCC), which stated that urgent, far reaching and unprecedented action was needed to reduce global carbon emissions to net zero by 2050 and to keep global warming to a maximum of 1.5°C. While 'mitigation' efforts to reduce GHG emissions will be front and centre, understanding how business will adapt to a significantly warmer world will be equally important, and is receiving growing attention from governments and investors alike.

Evolving our climate change strategy

At M&G we have a long-term investment horizon focusing on businesses that we believe will support our customers to achieve their long-term savings and investment goals. We take into consideration all factors likely to have a material effect on investment risk and return. We believe ESG (Environmental, Social & Governance) issues such as climate change can have a significant impact on corporate performance and investor returns, and we look to investee companies to manage these risks appropriately. We also aim to use our influence in challenging these businesses when we consider that they are failing to meet expected standards.

Given the materiality of the issue of climate change, we are developing a more structured approach to assessing and managing our climate risk exposures. Central elements include: identification of areas of high-carbon exposure; portfolio-level carbon analysis; engagement with investee companies to understand their management of climate-related risks; and reporting to our clients on these activities. An understanding of how companies across sectors are managing potential supply chain disruptions due to rising biodiversity-related risks is also of growing importance. Evaluating companies' approaches in the areas of governance, strategy and disclosure will form the core of our assessment. Alongside this, we are exploring the use of scenario analysis or stress-testing to understand how portfolios and investee companies are positioned for various climate change scenarios. It is important for us to understand the full range of climate risks and opportunities faced by our investments across industries and geographies.

We also participate in the debate alongside our investor peers and other stakeholders in order to ensure preparedness for an evolving policy and technological backdrop. We are members of a number of organisations and initiatives, including the Institutional Investors Group on Climate Change (IIGCC), Climate Action 100+, Climate Bonds Initiative, Green Bond Principles and, in a broader sustainability context, the UNPRI and UKSIF. These initiatives provide a valuable network for investors and a forum for collaborative engagement on a range of climate change-related risks and opportunities.

What are the risks?

Climate change presents a range of risks to investors, primary among which are:

- **Physical risk**: the risk that assets or operations (e.g. buildings, factories, infrastructure, crops, etc) are negatively affected by the physical impacts of climate change (e.g. flooding, drought, rising sea levels).
- **Policy/regulation risk**: the risk that evolving climate regulation or carbon pricing detrimentally affects the economics or viability of a business or project.
- **Stranded asset risk**: the risk that high-carbon assets (e.g. fossil fuel reserves) are left unviable or 'stranded' as a result of changes in demand or a shift to lower-carbon and/or lower-cost alternatives.
- **Technology risk**: the risk that technological developments disrupt or supersede business models for individual companies or entire industries.
- **Litigation risk**: this is a developing risk and could affect companies or industries producing excessive greenhouse gases, leaving them exposed to the rising risk of litigation, if climate change-related damages can be traced back to their emissions.
- **Reputation risk**: companies that are considered to lack a sufficient environmental policy or emissions mitigation strategy may be at risk of losing customers, employees and potentially their license to operate.

The TCFD framework discussed below – increasingly widely adopted by corporates and investors alike – distils these risks into three categories: Transition risk, Physical risk and Litigation risk.

What are the opportunities?

Climate change may also present investors with a range of long-term opportunities, some of which are increasingly supported by national policy and international regulation:

- Opportunities to invest in the transition to a lower-carbon economy, e.g. renewable energy, new technologies and sustainable solutions.
- Opportunities to fund the development of low-carbon infrastructure and industries.
- Opportunities to support higher-carbon companies in their transition to a lower-carbon economy.
- Opportunities to support companies in building resilience to the impacts of climate change through adaptation projects.

Task Force on Climate-related Financial Disclosures (TCFD)

The Financial Stability Board (FSB), under the leadership of Bank of England Governor Mark Carney, launched the Task Force in 2015 and appointed Michael Bloomberg to chair the initiative. Its aim is to promote better understanding of climate-related financial risks in the economic system. It pushes for voluntary corporate disclosures that are clear, consistent and comparable, thereby providing useful information on these risks to investors, lenders, insurers and other stakeholders.

> "Increasing transparency makes markets more efficient, and economies more stable and resilient."
>
> **Michael R. Bloomberg, Chair**

The Task Force has published a set of guidelines encouraging companies to report on the financial impact of climate-related risks and opportunities. Importantly, one of the central recommendations is for this information to be reported in companies' financial statements, elevating climate change to the equivalent importance of other material financial risks.

We have publicly endorsed the TCFD's recommendations and support the Task Force's framework across four main areas, which we are incorporating in our assessment of – and dialogue with – investee companies. These are: Governance, Strategy, Risk Management and Metrics & Disclosure.

Governance: the organisation's governance around climate-related risks and opportunities.

Strategy: the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning.

Risk Management: the processes used by the organisation to identify, assess and manage climate-related risks.

Metrics & Targets: the metrics & targets used to assess and manage relevant climate-related risks and opportunities.

Our approach

M&G manages customers' assets across four main asset classes: Equities, Fixed income, Real Estate and Infrastructure. Across all of these, while there are a number of environmental and climate considerations that are pertinent, irrespective of the asset class, in practice our approach is tailored in ways that are most appropriate to the asset class in question. Increasingly we see the value and benefit of collaboration across asset classes, where we have investments in companies through multiple asset classes and aligned long-term interests.

In **Equities**, fundamental company research is at the core of our investment process, with in-house analysis vital to generating insights independently of the wider market. We take into consideration material factors that can affect company performance, including environmental and climate-related factors given their impact on risk and return. We utilise in-house and third-party analysis (e.g. carbon foot-printing and scenario analysis) to inform our investment views, and see company engagement as a valuable tool for supporting investment decisions and pushing for change where appropriate. We have joined collaborative engagement initiatives to advocate collectively for improved transparency and accelerated progress on managing climate-related risks and opportunities. We take account of climate considerations in our proxy voting activities (supporting a majority of climate-focused shareholder resolutions and recently co-filing a resolution alongside other institutional investors pushing for strategy and capex aligned with the Paris Climate Agreement).

In **Fixed Income**, an environmental assessment forms a central part of our understanding of the downside risks we are exposed to as investors, as well as highlighting opportunities. ESG themes, such as climate change, are considered by our analysts and portfolio managers and reflected in portfolio positions in the context of their impact on the credit fundamentals of the borrower. While integration in credit analysis is at the heart of our approach, investment in environmentally-themed opportunities has grown in importance; for example, we financed the largest single solar site in the UK at the time, and debt refinanced the UK's two largest solar portfolios. We are also invested in similar investments outside of the UK. We have substantial designated 'positive environmental impact' assets across fixed income.

Our **Real Estate** business is recognised as a leader in the field of Responsible Property Investment and considers environmental sustainability as a central factor for all its investment and portfolio management activities. As well as actively managing its investment portfolio from a sustainability perspective, M&G Real Estate has set specific targets to reduce carbon emissions in its direct property portfolio. Since 2013, M&G Real Estate has achieved a 23% reduction in the energy intensity of its global real estate portfolio, with a goal of reaching 25% by 2025, and has reduced absolute global carbon emissions by 17% from 2013 levels through the procurement of green energy and the provision of on-site renewable energy facilities. In addition to these achievements, 27% of our global real estate AUM has a green building certificate, making good progress towards our 2025 objective of 50% of real estate AUM to be certified. These commitments not only align us with the ambitious goals for sustainable real estate established by the Paris Agreement in 2015, but also enable us to manage environmental risks while future-proofing assets to ensure we capitalise on the benefits that such positive change will also create.

M&G Infracapital, one of Europe's leading infrastructure investors, provides significant support to renewable energy projects in the unlisted arena. It has invested substantial amounts to drive both new build renewable projects and also to support existing infrastructure businesses in the transition to greener energy sources. Through taking controlling or significant minority stakes in our investee companies, we apply an active asset management approach to our investments, enabling us to drive the climate change agenda and manage other ESG risks effectively, as well as improving standards across our portfolio.

More broadly, we invest across asset classes in numerous businesses that are positively exposed to developing trends in sustainability. For example, our bond and equities funds hold investments in providers of environmental solutions and technologies that aim to enable clean energy to be generated economically. A number of our funds make thematic investments in this area, or in businesses with the explicit intention to contribute to solutions to climate change.

Risk Assessment

Developing a better understanding of the risk exposure in relation to climate change is a crucial first step, and for this we have conducted carbon foot-printing portfolio analysis on funds across our Equities business. Meaningful carbon foot-printing analysis has so far been limited to Equities, but we are beginning to assess portfolio carbon exposure in other asset classes as the tools become available. We regularly review funds using this foot-printing analysis to understand their carbon exposure and to look for areas of high risk and potential mitigation.

> "Climate change is referred to by leading economists as the greatest market failure in human history, with potentially disruptive implications on the social well-being, economic development, and financial stability of current and future generations: conservative estimates see unabated climate change leading to global costs equivalent to losing in-between 5 to 20% of global GDP each year, now and forever."
>
> **UN Environment Programme – Finance Initiative**

Once portfolio carbon exposures have been assessed, the next step is to stress test portfolios for different climate change scenarios. As part of this analysis, we have teamed up with other leading investors as part of a pilot scheme convened by the UN Environment Programme – Finance Initiative (UNEP FI) to develop a tool to conduct these stress tests in portfolios across Equities, Fixed Income and Real Estate. The analysis assesses both transition risks (the risk that investments are impacted by tightening regulation or technological developments) and physical risks (the risk to physical assets from the effects of climate change); it also enables us to identify corporate exposures to low-carbon opportunities, an important aspect in navigating the transition to a lower-carbon economy. We have also been looking into other scenario analysis tools to understand their methodologies and identify which is most useful when analysing M&G's holdings. While these climate risk assessment tools represent a new and developing area of analysis, and are therefore not the finished article, the results are already proving useful in facilitating a more informed understanding of the risks and opportunities to which our portfolios are exposed.

Engagement

As active managers, engagement is a central element of our climate change-focused work. M&G has an established approach of engaging with investee companies on a broad range of subjects, including relevant environmental issues. We engage with companies to gain a deeper understanding of their performance as it relates to climate change, as well as to assess progress towards targets the company may have set. We look for targets and Key Performance Indicators (KPIs) to demonstrate alignment with the company's business model and long-term strategy, positioning it for greater likelihood of long-term success. These engagements with boards and management teams give us invaluable insight into the risks and opportunities that our different investee businesses are facing. It also means we are able to hold companies to account for their actions and influence fundamental behavioural change where desired.

To divest or not to divest?

As one of the largest active fund managers in the UK (and a major investor in many global markets), we consider it one of our core responsibilities to engage the companies in which we invest on important strategic topics. We recognise that divestment campaigns can be effective as a tool for raising the profile of climate change-related risks, however, our general view is that wholesale divestment from carbon-intensive sectors is not the most effective approach to take, nor one that is likely to solve the challenges of climate change. Our seat at the table is a valuable instrument, which we give up if we adopt a divestment approach. In particular, we believe large investors have an important role to play in encouraging businesses in the energy and other sectors to embrace the low carbon transition, meeting society's long-term energy and infrastructure needs in a sustainable and responsible manner. We recognise the importance of an equitable transition to a low carbon economy, which addresses environmental issues such as pollution and climate change while also recognising the importance of other ESG issues such as health & safety, workers' rights and community relations.

On certain issues, we believe companies are more likely to react when active investors exert pressure collectively; hence we participate with other investors and stakeholders to encourage positive change. We recognise that such interactions will not always result in the desired outcome. In such circumstances, if we consider that the company is failing to manage the risks discussed previously in this paper, and there is no likelihood of behavioural change, the decision to allocate our capital elsewhere of course remains open as a viable option.

Supporting a stable and consistent policy environment

While we recognise the role fossil fuels continue to play in supporting energy security for a significant proportion of the world's energy needs, we are acutely aware that policy developments and technological advances are driving change at a rapid pace, influencing the long-term outlook for the global energy supply mix.

M&G believes that a robust and stable government policy framework – realised via a transparent carbon pricing mechanism for example – will be necessary to provide the right basis for long-term investment in a well-diversified and sustainable energy future. This is an area where we and other investors are playing an active role, engaging in dialogue with policy makers via direct engagements, consultations and through our membership of industry associations.

Climate initiatives and organisations

As mentioned above, we are involved in policy-oriented engagements with a number of initiatives and organisations as part of our efforts to address the risks and opportunities related to climate change. Alongside their policy focus, these initiatives also provide issue-specific insights and opportunities for collaborative engagement on climate-related issues alongside other investors. These include:

PRI Principles for Responsible Investment

UKSIF UK Sustainable Investment and Finance Association

IIGCC Institutional Investors Group on Climate Change

Climate Action 100+ Global Investors Driving Business Transition

UNEP FINANCE INITIATIVE

Climate Bonds Initiative

The Green Bond Principles

BBP Better Buildings Partnership

GRESB

The views expressed here should not be taken as a recommendation, advice or forecast.

The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

M&G INVESTMENTS