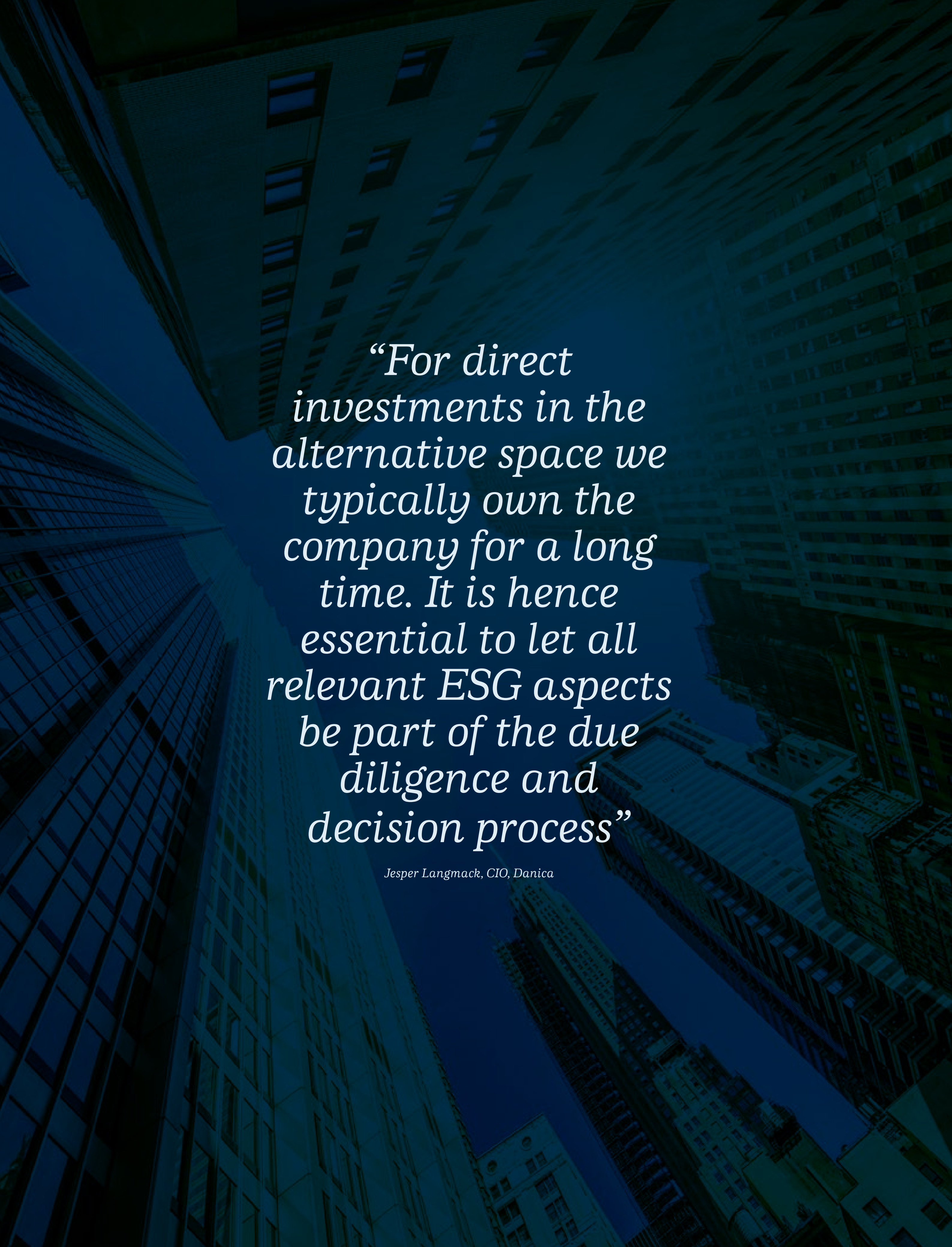
Our Sustainable Investment Journey 2019

ESG INSIDE
PROCESSES ADVISORY PRODUCTS

Danske Bank



"For direct investments in the alternative space we typically own the company for a long time. It is hence essential to let all relevant ESG aspects be part of the due diligence and decision process"

Jesper Langmack, CIO, Danica

Content

2019

Our Sustainable Investment Journey

Let there be no doubt. When our clients entrust us with their savings and assets, our focus is to deliver long-term competitive risk-adjusted return. Sustainable investment is a cornerstone of this duty to create value for our clients. It is a journey, not a race, which essentially means integrating environmental, social, and corporate governance (ESG) into the core of our business.

2018 was the year when we developed a new policy for Sustainable Investment, which we now implement across our investment processes and asset classes. The ambition is high as our vision is to become 'ESG thought leading'.

One of our senior portfolio managers said: "to become 'ESG thought leading' it has to be a bottom-up approach, not a top-down". That is spot on. We coined the term 'ESG Inside' to highlight that we bring ESG matters inside our investment organisation and our investment processes. It is not a side-track, a screening, or a PR geschäft. We believe that incorporating ESG matters into our investment processes is and should always be about investing. We say that ESG issues should be considered as factors along with financial factors, that our investment teams should treat them holistically, and manage them from a risk-and-return perspective to support better-informed investment decisions.

'ESG Inside' is our sincere effort to sustainable investing with impact.

'ESG Inside' is our sincere effort to sustainable investing with impact. With our new policy, we want to take more responsibility – not less. We want to be proactive – not reactive. We want to analyse, get the facts rights, understand and manage risks – not shy away from dilemmas or complicated matters. We want to influence through dialogue with companies to contribute to change, to improvement. It is in our role as investors where we can have real impact.

Developing our bottom-up approach involves our investment teams in Denmark, Finland, Norway and Sweden. It is truly encouraging to understand both the commitment and the sincerity to define what ESG integration really means to their respective strategy, process and asset class. We have set an ambitious goal that 100% of our portfolio managers should be able to tell their ESG integration story by end of 2020. Today 87% state that they integrate ESG into their investment process. However, only 5% perceive their approach to be strong and systematic. Hence, our journey includes not only hard work, education, and thorough deep dives into developing our ESG data platform, materiality framework, robust research, active ownership, and our reporting and disclosure. It also includes sharing our stories, and being transparent about our gained insights and our struggles as we go along. The Sustainable Investment team is on site across the Nordics to support our investment teams as well as our client organisation. This Sustainable Investment Journey report serves to share our progress so far and shed light on how the different perspectives provides value to our clients.

With our different perspectives, we will also have not one but many different ESG integration stories to tell. In this first report, we share a few of those stories, reflecting the width and breadth of our investment teams in terms of philosophy, asset class and geographic focus. They reflect our portfolio managers' and our investment teams' journey and address the simple question: what does ESG integration mean to you?

We invite you to join our journey and share your feedback.

Ulrika Hasselgren,
Global Head of Sustainability & Impact Investment,
Danske Bank Wealth Management

"We are firmly committed to sustainable investment; it is an integral part of our duty to our customers. Our journey to bring ESG inside our investment processes will help us make better-informed investment decisions and provide our customers with solutions that aim to deliver competitive, long-term performance."

Jacob Aarup-Andersen
Head of Wealth Management and member of the Executive Board, Danske Bank

Integrating ESG into our investments

Integrating ESG into the investment process is part of our fiduciary duty to achieve the highest and most stable investment returns for customers and beneficiaries. It is fundamental to identify environmental, social and governance factors that may pose a risk or an opportunity, and thereby affect financial performance, in our investment research, security selection, portfolio construction and decision-making process.

There is no 'one size fits all' for ESG integration. Since each strategy and asset class has its own unique features and characteristics, ESG integration must fit each strategy and asset class.

Each of our investment teams is responsible for integrating ESG from a factor perspective, as is relevant and applicable to their investment process and asset class. To support their efforts, they work with a large ESG data set, an ESG materiality dashboard, and internal subject-matter experts and support teams. Investment teams are tasked with the buying/selling decisions, are close to the target investment and have the best knowledge, so that they are the real agents of change. Through this portfolio-manager driven approach to ESG integration, we can manage risks in the portfolio, provide value to portfolio companies, contribute to positive outcomes, and meet customer demands.

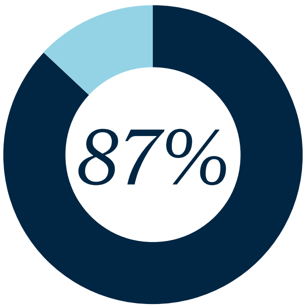
Our ESG integration approach covers three parts: 1. ESG data from multiple sources; 2. materiality assessments; and 3. systematisation of processes. This bottom-up approach, based on a solid foundation of data, tools and resources, supports the investment teams to integrate ESG on an effective basis, according to their strategy and asset class.

1. Investment teams review financial and ESG information from multiple data sources. The investment teams have access to all ESG data & research required.

2. Investment teams analyse relevant financial and ESG information to identify material financial and ESG factors affecting a company, sector and/or country. ESG data, research and scores are managed on the basis of an understanding of the underlying methodology, scope and application. The material financial and ESG factors that are systematically identified and assessed by the investment teams influence decisions to buy or sell, and/or weighting.

3. A systematic ESG integration process is characterised by a quantitative and/or qualitative approach. It does not mean that every ESG issue for every company/issuer must be assessed and valued, but it does mean that the portfolio manager takes investment decisions that consider all material factors, including ESG factors.

Building our foundation



of our PMs integrate ESG

Characteristics of the ESG integration approach

Strength of ESG integration approach	To some extent	Back of mind	Qualitative	Quantitative	Qualitative & Quantitative
5	0%	1%	0%	0%	5%
4	2%	2%	7%	3%	17%
3	5%	13%	5%	6%	7%
2	6%	5%	1%	0%	1%
1	3%	0%	0%	0%	0%

Type of ESG integration approach

We have set the ambitious goal that 100% of our PMs should be able to tell their ESG integration story by the end of 2020. A survey conducted during the autumn of 2018 concluded that 87% of our portfolio managers integrate ESG into their investment process, indicating that ESG integration is part of the everyday work of our investment organisation.

However, only 5% perceive their approach to be very strong and systematic. To ensure that PMs can tell their ESG story, we must continue to work on building a support infrastructure. The survey concluded that there was still work to be done to support the strengthening of the ESG data platform, provide better day-to-day support on ESG issues, and more education and training, and also make internal and external expertise and support more easily available.

We have expanded the number of ESG data providers from two to seven. We take an agnostic view and focus on finding data sources that complement each other, to support our ambition to understand what is material and to make an holistic analysis. We are building a data platform consisting of material high-quality ESG data that supports our integrated approach and our investment teams' ability to make better-informed investment decisions. At the end of the day, our portfolio managers make their investment decisions based on what is material in each particular case.

To strengthen the ability to identify material ESG, we are developing our ESG materiality dashboard – mDASH – aimed at decoding ESG data based on its material impact and relevance to companies within its specific sector. mDASH is one of several tools used by our investment teams to integrate ESG into their respective investment processes and decision-making.

Our home market is the Nordic region. Available ESG data and research do not cover all markets and therefore we have also developed our own proprietary research where coverage is lacking. As an example, we now have our own ESG research coverage for 70+ Swedish companies, including small-caps, in order to support our Swedish equity and fixed income teams.

We have rolled out an extensive educational and skill-building programme for our investment organisation, including overall strategy sessions, understanding which ESG data provides investment value, different methodologies for ESG assessment, and more in-depth consideration of specific topics and themes.

The ESG Integration Council with Heads of investment strategies has been created to support ESG integration into the core of our investment processes. Since 'ESG Inside' is about making better-informed investment decisions, addressing issues of risk, problems, and dilemmas, and influencing portfolio companies through active dialogue to contribute to a positive outcome, decisions must be anchored and supported by the investment organisation

The common sense of investing

Ivan Larsen, Chief Portfolio Manager, European Small Cap Equities, Denmark

The common sense of investing
Over the past few years the question "How do you make sure you invest sustainably" has been put to me over and over again. This important question confirms the general trend of a rising appetite for sustainability and, as a small cap manager, I really appreciate this question because it gives me the opportunity to explain what I call "the common sense of investing".

Under-researched universe
Having invested in European small cap for nearly two decades, I have experienced first-hand how important it is to understand the companies we invest in. Every now and then, small caps get hammered and I know it is part of the game. The market volatility is simply higher, something you both need to accept but also make use of. Academics have analysed this phenomenon for ages and I am convinced that one of the reasons for the higher volatility is the structurally lower research coverage of small caps compared to large caps. All other things equal, the price of a small cap company reflects less information compared to a larger company. That means more opportunity for anyone taking the trouble to dig out this information on its own. That's what we do – and we always try to do this with a common sense approach.

In terms of sustainable investments, common sense thinking tells us to stay away from anything we as an asset manager would not like to be known for or associated with. Whenever I am faced with a potential issue with a company, I ask myself: is the activity of this company something I would like Danske Bank to do and be known for? If I can't say yes to this question, I would simply not invest.

> *"ESG integration comes as a natural part when you fully look into understanding the company and its business potential."*

Problems with ESG scores
In a way this is the easy stuff. What is more complicated is to spot these issues in the first place. When I look at the ESG coverage of my investment universe, many companies do not have an ESG rating and, if they have, it is not seldom based on a superficial understanding, to put it mildly. So I need to do the analysis myself and understand all material aspects of the company – nobody does that job for me.

Cork as an investment opportunity
Common sense investing is not limited to understanding which companies to stay away from, it is also a way of understanding which companies grow as an investment opportunity when you apply ESG considerations to the analysis. I have several examples of small cap

companies that have been able to position themselves to benefit from different environmental trends. The thing with almost any company analysis is that the ESG integration comes as a natural part when you fully look into understanding the company and its business potential.

Take the Portuguese company Corticeira Amorim, the world's largest producer of cork products, made of 100% natural raw material. We have been investing in this company for a long time as we like its management, capital structure and pricing power. Very early on, when we were looking into the company, we also realised how well positioned it was from an environmental perspective.

Harvested every nine years, without any tree being felled during the process, cork gives rise to an endless array of products, from the traditional to the most innovative and unexpected, with the main product being the cork stopper. To us, this is a very sustainable way of using raw materials and, since the direct alternative to a cork stopper is a plastic one, we think the company is well positioned to take advantage of the major issues the world is facing from the extensive use of plastic. Moreover, the company's own studies have confirmed the cork stopper's superiority in terms of energy usage in the production process, compared to both plastic and aluminium. Identifying this perspective was, for us, a question of common sense, since it was a necessary key to understanding the company as such.

Corticeira Amorim is also a good example of a company that, in our view, is misjudged by the ESG rating houses. The company was one of the first to obtain FSC forest certification, something we do not see as fully reflected in the ESG scores from at least one of the major rating agencies, mainly due to slightly rigid ESG categorisation criteria. This is something we spend time working on in our dialogue with both the company and the rating agency. As long-time owner of the company, it is obviously very important to have as correct an ESG picture presented to the market as possible and we believe that this is where we have the opportunity to create real impact in terms of ESG.

Materiality is critical for ESG integration

Andreas Dankel, Head of Credit, European Corporate Bonds, Denmark

In recent years, when both client interest and demand to invest sustainably has grown significantly, it has become clear to me and my team that the crucial aspect of ESG integration is to identify what we call "material impact" or "material factors". Naturally, when we look at an individual company, there are many aspects that are both interesting and intellectually stimulating for discussion and analysis, but if this is already discounted, then we must conserve our resources and focus on other issues of more "materiality". At the end of the day, we do not integrate sustainability in order to live to "our values", but because we want to create even more value through good, risk-adjusted returns that are sustainable in the long term for our customers. When I look back at my time in the industry over more than 20 years, I realise more and more that ESG aspects have always been an important element of the corporate bond analyses - we just haven't talked about it before, at least not in the way or with the language that we employ in the field today.

A new language in dialogue with customers….

I am convinced that an important and perhaps at the same time an underestimated aspect of our development and journey over the last four to five years is that we have now identified and learned a new language for sustainability. It may sound contradictory and may give a slight impression of being simply PR-speak, but this language has given us a new tool when we engage in a dialogue with individual companies, when we discuss specific investment opportunities within the team, as well as when we talk about corporate bonds with customers. As far as the latter is concerned, we, as managers are used to explain a rather complex asset class in an educative way and in this respect, several of the new concepts in the sustainability field have helped to develop the customer dialogue further.

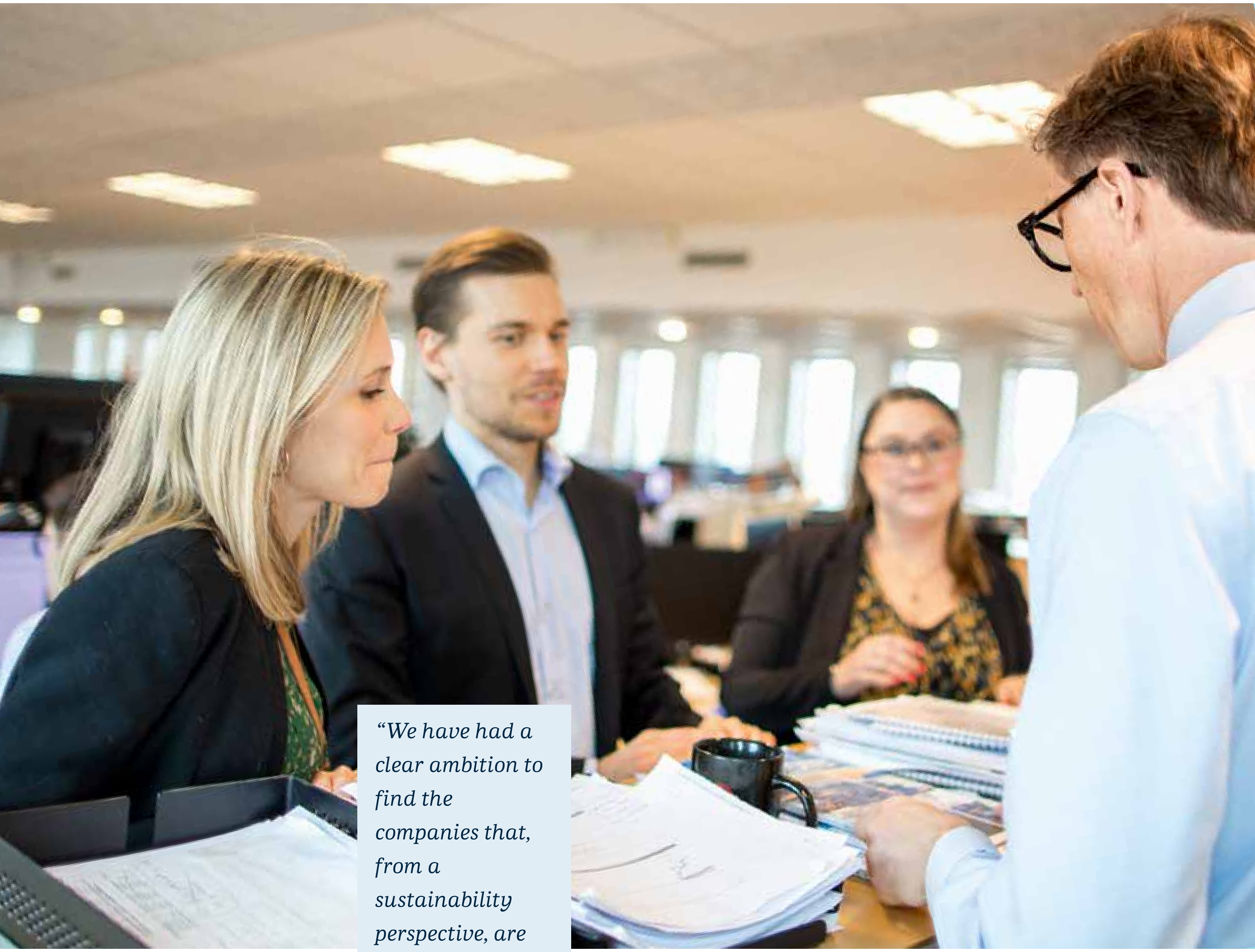
> *"We want to create even more value through good, risk-adjusted returns that are sustainable in the long term"*

…companies…

If we look at the dialogue we have with the companies in which we invest, this has also developed significantly in recent years. I am absolutely convinced that companies are very interested in hearing how we, as the asset manager, think and reason about sustainability. Traditionally, there has been a tendency for companies to listen more to their shareholders than their bond investors. Much has happened in this regard thanks to the fact that we now address sustainability issues in a systematic and more consistent way. In the dialogue on strategy and development, where the individual company describes to us what they want in terms of sustainability and where we ask questions and give our view in the context, then some thoughts and considerations arise that I believe the company takes on board as important input. At the same time, we remain humble and realise that patience is a virtue in this context, but with more than seven billion euros under management on the corporate bond side, we believe that we fulfil a role as an important and relevant counterpart, both in the initial lending situation and then in the ongoing dialogue with the company.

…and internally within the team

The third area where the language has had a great importance is internally within the team I lead. We have strategies within both European investment grade and high yield, covering many different jurisdictions and sectors, and the



> *"We have had a clear ambition to find the companies that, from a sustainability perspective, are on a journey of improvement or change"*

various members of the team hence have different approaches and focus in the daily portfolio management tasks. It has become a natural part of our team dialogue to consider and discuss sustainability across our strategies and to carry out comparative cross-sector analyses.

Binary influence

In recent years, we have had a clear ambition to find the companies that, from a sustainability perspective, are on a journey of improvement or change. By investing and influencing, we can contribute to a positive development, and above all a positive yield development. To put it short, we look at companies with a relatively low ESG score to see if the company can improve. However, it has been quite evident that these "watch-list companies", which we have chosen to call them, in some cases have become more about controversies that have to be addressed in a specific way, rather than about a dynamic change agenda. In other words, some of the cases have been reduced to more of a binary discussion of yes or no, and less of dialogue about the intended changes and their long-term implications.

Essentially, asset management is a long-term commitment, but in the context where we opt to invest in a "watch-list company", there are sometimes unreasonable expectations that a positive development will be achieved within a fairly tight time horizon. In this respect, I believe it is important that we in the investment team with the ultimate responsibility for the investment decisions are not too tied to an expectation of rapid development. This adds pressure and risk reducing important issues to a matter of headline changes without any real impact. Regardless of whether the companies in our portfolios have high or low ESG scores, the key to all our management is diligence, patience and endurance.

In pursuit of sustainable growth

Bo Bejstrup Christensen, Chief Portfolio Manager, Hedge Funds, Denmark

Bo Bejstrup is back where he belongs. After a short session with IFM in Luxembourg, he returned to Danske Bank Wealth Management in June 2018 – back to the place where his career started 15 years ago.

"It's almost like a dream scenario for me. For many years, I have had a long-term ambition to set up and be the lead manager of a macro hedge fund. When Danske approached me in 2018 offering me precisely this, it was too good to resist."

When Bo left Danske Bank in 2016, he had been the Chief Analyst and Head of the Macro and Tactical Asset Allocation team for almost 10 years. Starting in Danske as a graduate back in 2004, he has spent his whole professional career analysing global macro economics and trends, transferring them into concrete asset allocation decisions. Or as he puts it:

"When I wake up in the morning, I continue to think of the global macro economy from the point I left off the evening before."

Bo Bejstrup is now setting up the framework for a new macro hedge fund together with Senior Portfolio Manager Lars Tranberg, who he also worked with in his old role in Danske. The idea is simple: to analyse the global macro situation, transfer these analyses into concrete investable macro factors and expose the portfolio as precisely as possible to these factors, both on the long and short side.

So what is his view on ESG integration, seen from a hedge fund perspective?
"In a way a hedge fund is the perfect setting for true integration of ESG matters into the portfolio. The wider variety of opportunities you typically have in a hedge fund setting, including the ability to short and invest through derivatives, allows you to make very precise exposures to the risk factor you like and want in your portfolio."

> *"In a way a hedge fund is the perfect setting for true integration of ESG matters into the portfolio."*

So, with a given set of solid and reliable ESG data, you could theoretically set up a very precise portfolio, chasing some well-defined ESG goals?
"Exactly. Having said that, I think this is more of an idea which works out in theory, more than in practice. I recently read a very thorough analysis of factor investing, comparing a huge amount of back testing data with real investment data. To make a long story short, the Sharpe ratio dropped significantly when you moved from theory to practice, mainly due to data mining and different kind of behavioural biases affecting the data. I would not expect this to be less true in an ESG context, where data quality and interpretation seems to be an issue as well."

If you move from theory to your reality, do you see any room for ESG integration in your own portfolio?
"The very blunt answer is no. This kind of, what I would call, 'direct' ESG integration is not anything I would consider in my portfolio. I will spend my time understanding exactly what ECB and FED are doing and invest accordingly, rather than analysing the environmental, social or governments aspects of these decisions per se."

Per se? Please explain.
"Yes per se. Because I still need to understand what the central banks and sovereign governments think of these things. Take China for example. We all know that over the past 30-40 years China has been the most successful example ever of lifting people out of poverty within a given period. But at what cost? We are now seeing some of the severe consequences of this

transformation, with air pollution probably being the severest. It is evident to everyone that some of the biggest Chinese cities are now paying a significant price for this success."

Mr Bejstrup continues:

"So I do need to understand the future sustainable growth rate in China, seen from an environmental perspective, or to put it differently: at what rate does the Chinese government consider growth to be sustainable seen from this perspective? To understand this, you need to understand the current environmental backdrop itself and in order to do so, read analysis which are not macroeconomic but rather socio political by nature."

So China is one clear example of where ESG matters are intrinsically linked to your analysis. Do you have more examples?

"Well I think Turkey is very interesting in this respect. Here you probably look more into the governance aspects of the sustainable growth story. Is the budget deficit being run by the Turkish government sustainable? What about Turkish Central Bank's monetary policy and its independence vis-à-vis the government? Then you have the current deficit in Turkey. Is that sustainable and what implications does it have for future growth? These are just a few of the extremely important questions in this area."

"So I do need to understand the future sustainable growth rate in China, seen from an environmental perspective"

How do you go about understanding these perspectives?

"By reading the analyses and papers published, and talking to the analysts covering these markets. I don't feel there is a shortage of information here, the content is out there for anyone taking the trouble to read it. For me, it is a natural part of my job, and I suspect that this will be true for more and more portfolio managers and analysts in the future."

We engage to influence

Active ownership is regarded as one of the most effective mechanisms to manage risks, maximise returns and contribute to positive impacts on society and the environment. It is part of our fiduciary duty to customers and beneficiaries to achieve the highest and most stable investment returns.

ESG Inside is about making better-informed investment decisions – addressing risk issues, problems and dilemmas, and exerting active ownership to influence portfolio companies to contribute to a positive outcome.

Active ownership – through direct dialogue and voting at annual general meetings – is an important aspect of creating long-term value for the companies we invest in, and for our customers.

We believe it to be more sustainable to address ESG matters as investors, rather than refraining from investing when issues of concern or risks arise, leaving the problem to someone else to resolve. Our portfolio managers are the change agents who can influence how companies manage their ESG risks and opportunities.

It is the portfolio manager driven dialogue directly with companies that is the most effective approach, since our investment teams are the experts in their respective strategies and portfolios. Our investment teams hence regularly engage with companies on material ESG matters, in order to understand their risks and opportunities, and to support their growth and development.

We primarily exert active ownership through:

Single engagement: Investment teams engage regularly with portfolio companies on material ESG matters, seeking performance and process improvements in order to enhance and protect investment value. Dialogue may also focus on clarification of information disclosed by a company, discussion of voting decisions, or fact-finding dialogue.

Collaborative engagement: When appropriate, we collaborate with peers, like-minded investors and other relevant parties to exert our active ownership, engage through joint dialogue, and contribute to a positive impact. This might be appropriate in instances where Single Engagement has not led to the preferred outcome.

We also participate in and support a number of different investor initiatives to encourage increased transparency and sustainability standards in companies and financial markets, such as the Carbon Disclosure Project, Institutional Investors Group on Climate Change, Paris Pledge for Action, The Task Force on Climate-Change Financial Disclosure, The Montreal Pledge, The Task Force for Climate Related Disclosure, and the UN-supported Principles for Responsible Investment.

Voting: We use our rights to voice our opinion at annual general meetings (AGMs). In general, we will support the company management; yet we will use our shareholder rights to vote in line with our fiduciary duty to consider the best interests of our customers.

We vote at the AGMs of Nordic and European companies, where we represent relevant holdings. We vote on a variety of management and shareholder resolutions, although the majority target corporate governance issues subject to local listing requirements, such as approval of directors, approval of reports and accounts, approval of incentive plans, capital allocation, reorganisations and mergers.

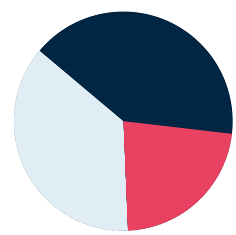
Investment teams assess resolutions, and apply our voting policy and market standards to each agenda item. The teams have access to relevant expertise in order to understand the corporate governance context. If there is insufficient information on a particular matter, we may decide not to vote.

Engagement in 2018

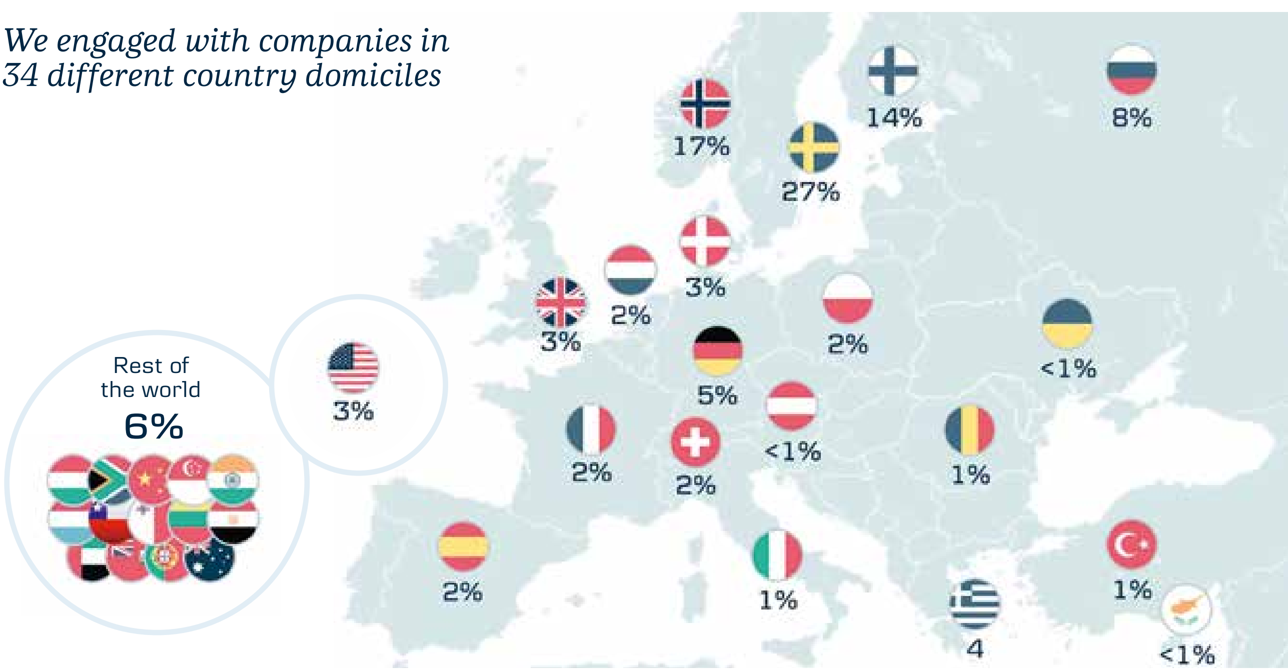
In 2018, we had 643 interactions with 422 companies, addressing 59 different ESG topics

Companies	Country domiciles	ESG engagement topics	Interactions
422	34	59	643

Split between ESG engagement themes



We engaged with companies in 34 different country domiciles



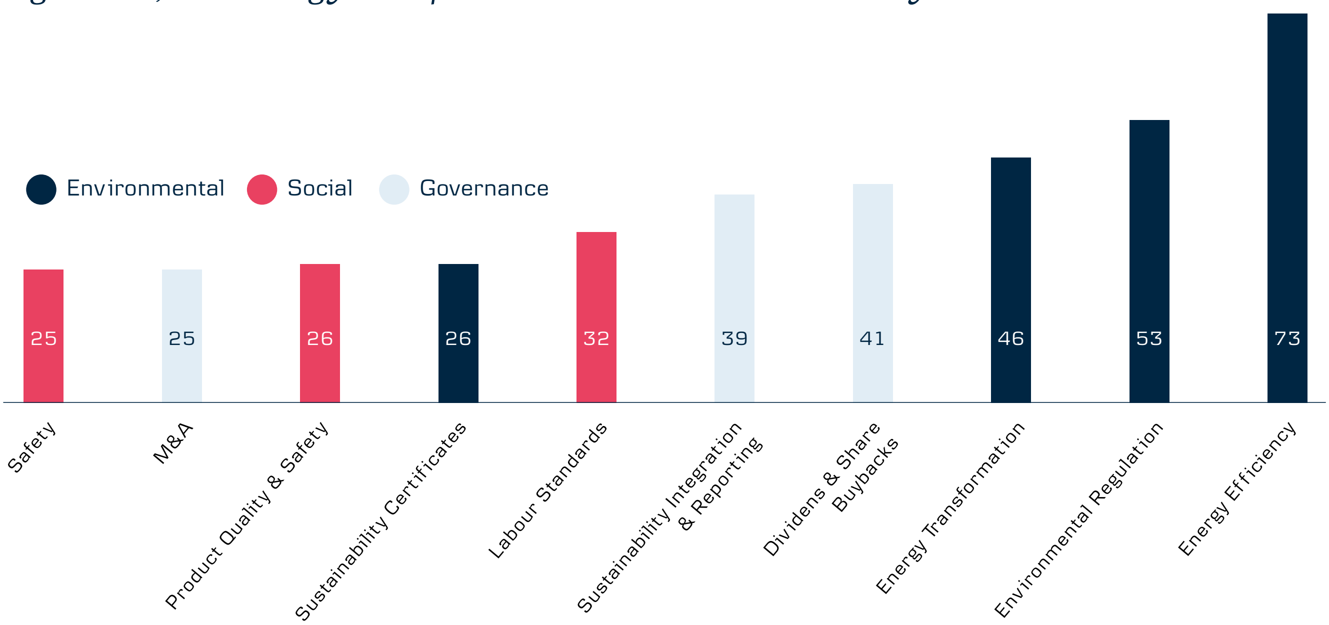
Note 1: Five interactions lack domicile data.
Note 2: Countries with one company engagement and/or outside the map (excl. USA) are bundled in 'Rest of the world'

Engagement in 2018

Most commonly addressed ESG topics

The following 59 ESG engagement topics were addressed and discussed

Among the 59 ESG engagement topics, Energy efficiency, Environmental regulation, and Energy transformation are the most commonly discussed



Voting in 2018

In 2018, we had the following voting activities

Meetings
313

Country domiciles
22

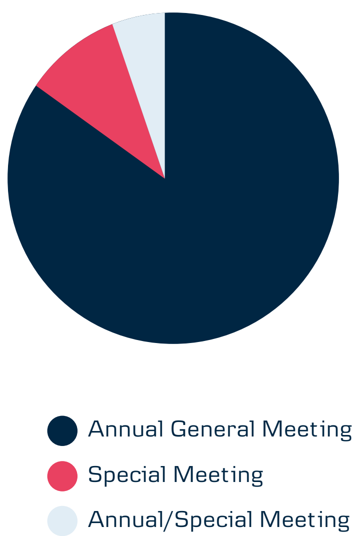
Proposals
4,627

We predominantly voted FOR the proposals

4627 proposals

For	Against/Withhold	Abstain
96.8%	*2.6%*	*0.6%*
(4478 proposals)	(121 proposals)	(28 proposals)

We voted primarily at Annual General Meetings (AGM)



Exert influence and make a difference

Lars Erik Moen, Senior Portfolio Manager, Norwegian Equities, Norway

To me, active ownership is the most important aspect of sustainable investments. A formal and obviously vital part of our activities is to vote at annual general meetings (AGMs). We do that more or less on a continuous basis with a yearly peak every spring. Typically, most companies get support for all of their proposals at AGMs because we play our role as active manager ahead of these meetings. It is in these direct dialogues with the companies we can exert influence and make a difference.

Calibration ahead of AGMs

In the old days, when companies tended to have less dialogue with investors, you could actually end up having major disagreements at an AGM. Now that the trend is for companies to listen to and calibrate proposals before the AGMs, we know how crucial it is to be close to the companies, and to talk to them and give our opinion, in order to ensure as much influence as possible.

To me, the number of votes we cast at different AGMs every year is less relevant. The question to ask is rather how many company meetings we have held, and the results of these meetings. I have had more client meetings regarding ESG in 2018 than I have had in total during the preceding 20 years. One of the things we talk to our clients about are our recurrent company meetings: on average, our Norwegian equity team meets a company every day. In the course of ten years, this totals 2,500 meetings to discuss everything from vision, strategy and key financial indicators, to sustainability.

This is the arena of active ownership; this is where we make a difference; and this is where we – as long-term investors with an in-depth knowledge of and strong network within the Norwegian stock market – can have a real impact.

> *"It is in these direct dialogues with the companies we can exert influence and make a difference."*

Fuel-efficient aircrafts

To give just one example of a company dialogue that has been ongoing for many years, I could mention Norwegian. We have invested in this company for a very long time and know the management very well. A while ago, as part of our analysis of Norwegian, our own calculations showed that the CO2 emissions from their transatlantic flights were lower than those of any of their competitors. This was due to newer, more fuel-efficient aircraft without space reserved for business class, which means more passengers on each flight. Seen from Norwegian's perspective, this was primarily a cost-cutting exercise, as lower fuel consumption means higher margins. In a series of meetings, I urged them to use this as a basis for formulating environmental ambitions and presenting these in a publication. A few meetings later, I actually received a copy of this publication. The publication as such is not the most important aspect here. The key issue is the attention and focus this publication created, either directly or indirectly. We can see that companies which have set out sustainability principles in their vision and strategy, and which adhere to the principles in practice, are also the companies that we intuitively believe are operated on a sustainable basis.

Be aware of skeletons in the closet

There is also a timing perspective to be taken into account on evaluating a company's sustainable visions and principles. An example was a case of very serious corruption, where we requested a meeting with the company's chairman and Group CEO. We categorically stated how unacceptable this matter was. The special aspect was

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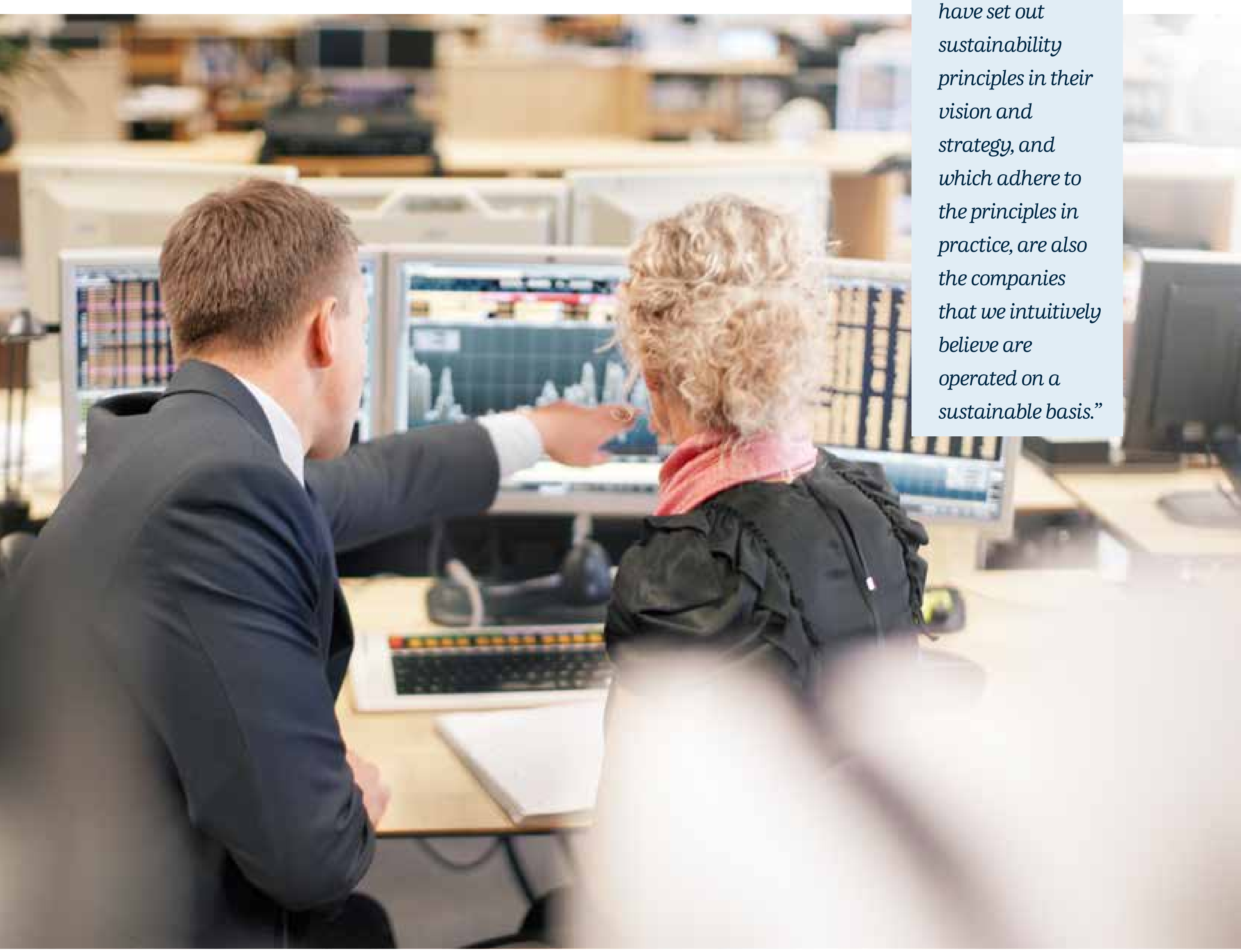


that I had noted at previous meetings how this company had best-in-class anti-corruption systems. The problem here was that this concerned things that went back more than ten years, before the Group CEO, or the chairman, was appointed, and before the current procedures were implemented. So the important aspect for us was that during this meeting we became confident that the company was doing everything necessary to clean things up, and they had already taken measures to ensure that this would not happen again.

Own quality assessment

Rather surprisingly, we can see that calculated ESG indicators often have a low correlation with whether the companies are actually operated sustainably. We can therefore see how external ESG scores can lead us in the wrong direction. As a rule, it is better to make a qualitative assessment of the company. The portfolio management area is developing, and our aim is for future management to be better than today's active management. Active ownership will undoubtedly play a crucial role in this development.

Far from finished with ESG

Riitta Sinikka Louhento, Senior Portfolio Manager, Finnish Fixed Income, Finland

Riitta, how do you see sustainable investments in a fixed income context?
I think there is a tendency for people to regard sustainability as non-significant when you invest in fixed income. It's obviously true that you can't vote at the AGMs but to me sustainable investment is so much broader. At the end of the day, we still invest in companies and therefore we need to understand the companies also from an ESG perspective.

How has this changed over the past 10 years?
One obvious change is the declining yields we have seen since the financial crisis. Being an investor in short-term securities, as I am, this has meant a propensity to add risk in order to avoid unsustainable return. Moving into credit risk territory has meant that I need to understand other risk aspects than just curve and duration risk.

Could you give an example?
Speaking of the financial crisis, I do remember when I attended an investor meeting with one of the Icelandic banks I was invested in back then. Two senior executives were giving the presentation, which inspired a few questions from the audience. During the presentation I realised something was wrong – that is, nothing in what they said was wrong as such, it was more the body language and signals they were sending that convinced me to exit my positions. Of course, I already had my worries before the presentation and this was just another small, but important, element in my understanding of the company. A few months later the financial crisis hit and we all know what happened. To me, this story illustrates the importance of meeting the management teams, to have all senses wide open in order to capture all aspects of an investment. In this way I was able to capture a governance related issue that otherwise would probably have passed unnoticed.

> *"Being an investor in short-term securities, as I am, has meant a propensity to add risk in order to avoid unsustainable return."*

How do you normally interact with the companies?
The most vital part of my job is to monitor existing holdings. In addition it is important to keep track of all new bond launches and commercial programmes hitting the market. We need to understand all aspects of a new investment opportunity and this is where we typically have the chance to meet with the issuers. From time to time, we also take part in quarterly meetings and if some negative news emerges, we always try to meet the company to form our own opinion. The good thing is that the increased demand for sustainability from clients and society in general has meant that companies nowadays are much better in terms of communicating their ESG-related goals and actions.

How do you see your work as a fixed income portfolio manager developing in terms of sustainability?
The short answer is: a lot! We have done this partially for years. However, the value and meaning of sustainable investment is changing rapidly these days, posing a real challenge to understand all the nuances and their meaning. I would like to do much more, for example, in terms of active ownership. Our clients ask us to do it, and a lot of cases over the past few years have confirmed this to be the right thing to do.

Screening as a tool

We use screening as a tool to 1) identify ESG risks across our investment universe, 2) apply customer-specific criteria in mandates and products, and 3) apply Danske Bank's Group-wide restrictions on certain sustainability positions.

Identify ESG risks and opportunities

We use screening as a tool to identify many different kind of ESG risks or opportunities. This includes both negative and positive screening and allows for risk mitigation and opportunity identification for a given company, sector or country.

Apply preferences and values

Certain investment strategies or funds apply restrictions to investing in companies, sectors and/or countries according to fixed criteria, commonly applying thresholds based on revenue, exposure or activity.

Impose Danske Bank Group restrictions

Danske Bank Group has adopted restrictions concerning lending, procurement and investment in certain companies involved in tar sands, thermal coal, and controversial weapons.

All of our screening is based on established criteria and robust processes to identify companies, sectors or countries, and to apply the result in a strategy, a fund and/or funds, or across our investment universe.

Our extensive set of external data and research services, as well as companies' disclosed data and our own proprietary research is the basis for our screening approach. We continuously work to develop our understanding of available data, and also challenge data and service providers in enhancing methodologies and data quality.

The Swedish rookie

Stefan Rocklind, Head of Swedish Fixed Income, Sweden

Stefan Rocklind likes to talk. Usually straightforward, he says what he thinks and is honest about what he believes in. A portfolio manager with more than 20 years' experience of managing Swedish fixed income, it is probably not a bold statement to say he's one of the most competent people in his field. At the same time, Stefan is a firm believer in ESG integration even though – as he put it himself: "I'm still a rookie".

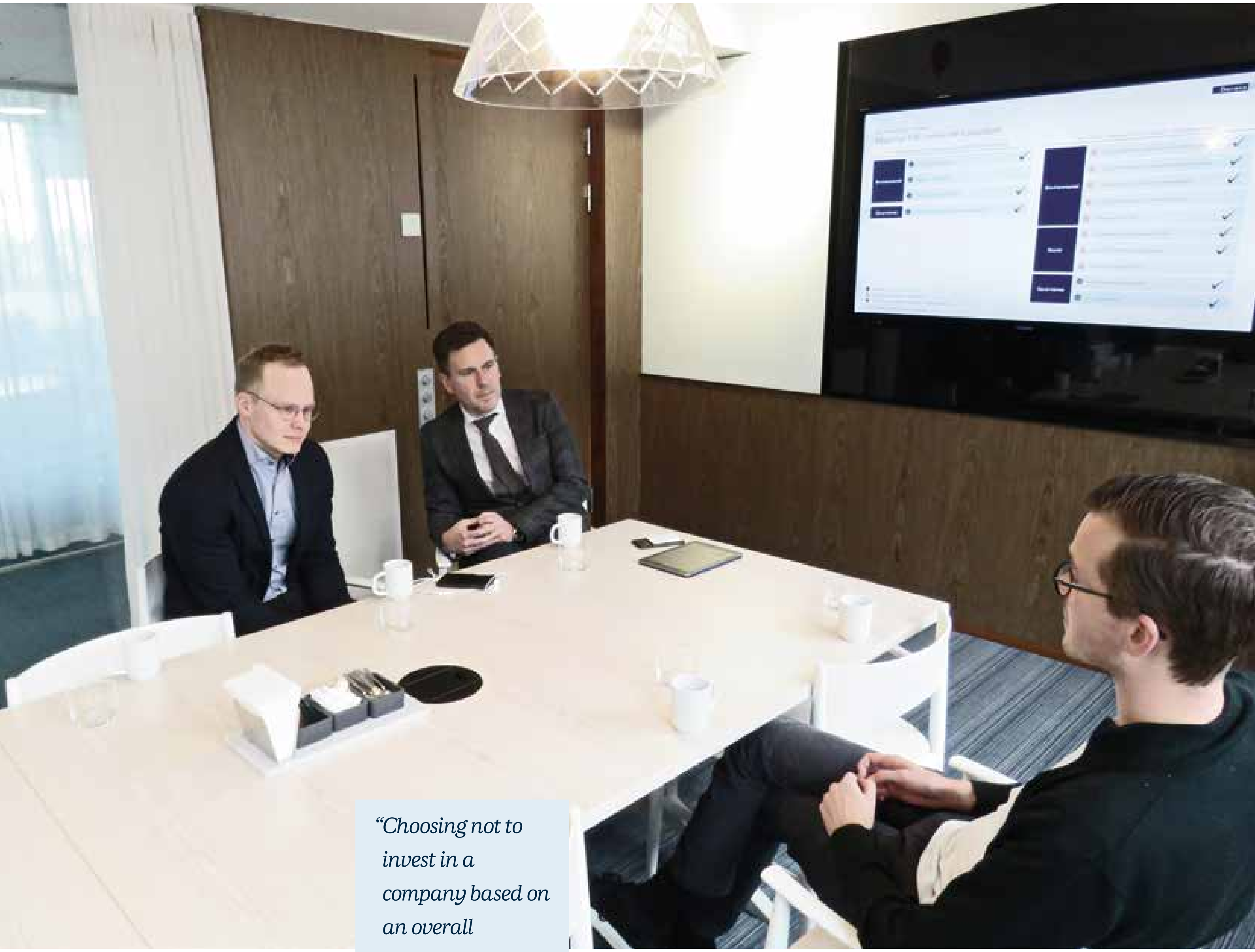
Being a rookie is probably not doing justice to the word. Stefan admits that he is a manager who has espoused this philosophy for a long time, having "imbibed it with his mother's milk", as he likes to say. That said, words like "humility", "early days", and "rookie" came up time and again over the course of the discussion. In this context, then, how does he view Danske Bank's decision not to adopt a top-down ESG approach as a uniform house view?

"All you do is to follow the directives and keep doing what you did before – nice and comfortable."

"I would put it this way: I subscribe to this approach and the decision one hundred per cent. At the same time, there is a cultural aspect to be taken into account. It is very difficult in our industry to admit to your weaknesses. After all, you are offered a contract because you are one of the best in the market. So, when you are asked to move into a new territory, there is a natural desire among many to have someone come in, show the way, and say: this is how it should be. There are many players in the industry who act in precisely this way: you receive directives from above that define what should be done when it comes to ESG. Then all you do is to follow the directives and keep doing what you did before – nice and comfortable."

What is the problem with a working method like that in your view?
"The biggest problem is exclusion, i.e. reducing ESG to a question of the size of your investment universe. It is not particularly hard for any ESG analyst to look at a universe, point to the 20% most controversial companies from an ESG point of view, ask the portfolio manager to remove them, and just say that he or she can continue to work just as before. However, having a well-functioning view of how my team and I should address ESG integration is a completely different ballgame."

Could you expand on that?
"Take screening, for example. In and of itself, screening is an incredibly important tool. It helps us to keep track of a lot of things in our portfolio in terms of ESG. I just think there is this misconception about screening that is also automatically implies exclusion. Again: screening is a way to better understand your holdings, whereas exclusion is a decision not to invest. And it's precisely here that the house view becomes an interesting point. Exclusion



has always and will always be part of my work as a portfolio manager. I exclude a lot of companies all the time in so much as I refuse to invest in them, more often than not because of financial factors or pure valuation considerations. Once again, though: excluding a company solely on the basis of its ESG performance is not as difficult and it's something that a lot of people can do; but choosing not to invest in a company based on an overall assessment, of which ESG is one consideration, requires an in-depth understanding of all material aspects of the company. Although, in some situations, it'd be convenient, following an ESG screening, to accept top-down directives advising us against investing in specific companies, I believe that the final decision should ultimately rest with those of us who are responsible for the investment side of the portfolio."

"Choosing not to invest in a company based on an overall assessment, of which ESG is one consideration, requires an in-depth understanding of all material aspects of the company"

So, responsibility for ESG integration rests with you yourself. To conclude, how do you look at incentives and KPIs in this context?

"I've given this considerable thought and I'd say that I'd become incentivised when I feel a push from clients and client managers. There is a great demand on me as a manager to integrate ESG aspects into my portfolio. I do not allow myself to be guided by formal KPIs, and the fact that our clients ask for such activities is a sufficient incentive for me. I firmly believe that our clients ask us to do this because they believe that, by doing so, we'll better be able to generate strong returns in the long run – and that's a view that I wholeheartedly share myself."

Governance at the heart of the investment process

Thomas Haugaard, Senior Portfolio Manager, Emerging Market Debt Hard Currency, Denmark

Being an analyst in the emerging market debt hard currency team at Danske Bank, you would perhaps think that ESG analysis is a far-fetched concept, way beyond what would normally be on our radar. But for us it is easy: we focus on ESG because it contains important information about sovereign credit risk. It should therefore be a key ingredient in any investment process, including ours.

A need to see empirical evidence

To be a bit more specific, I would argue that analysing the governance aspects of our investments is at the very core of what we do. In fact, the policy makers we meet – be it central bank governors, finance ministers or even prime ministers – are those responsible for the governance of the economies we invest in.

In terms of the environmental and social aspects of our investments, they are also important, but on more of an ad hoc, unsystematic basis. Here I lack the empirical argument for applying these aspects to our process, the same empirical data that supports our analysis of governance issues. At the end of the day we need to constantly assess whether a single country has the ability and willingness to service debt. Whereas traditional sovereign credit analyses, such as public finances, external balances and inflation, say something about the ability, World Bank Governance indicators inform us about the willingness. The latter indicators are directly linked to the fundamental analysis of the rule of law, level of corruption and political stability in a given country and our own empirical analysis shows a very high correlation between these indicators and sovereign bond performance.

A sustainability journey

Exclusion is a dimension that will always be part of our game. Personally, I get a bit concerned whenever I see a major institutional investor excluding investment opportunities from the emerging market debt universe. First of all nobody knows what the consequence would be from a return perspective. But we do know that any exclusion limits the universe and deprives us of an investment opportunity. Our clients have entrusted us with their money to invest in emerging market debt with the goal of delivering a competitive and sustainable risk-adjusted return. Hence, I would need a very strong argument to freely give up opportunities that could help us deliver against this promise. On the sustainable side, we arguably invest in regions of the world that, in terms of ESG, do not perform at the same level as we do. But if we see this as a journey, what good does it do if we leave the country and make no investments at all? Take Georgia as an example. In terms of World Bank Governance Indicators, Georgia was behind Venezuela 20 years ago, but has since then been on a journey that has seen constant convergence towards the USA. For these two reasons, the exclusion initiatives we occasionally see does not, in our eyes, represent a sustainable way of making ESG investments, it is more about attention. I would rather have the opportunity myself to decide whether to invest or not.

"Nobody knows what the consequence would be from a return perspective. But we do know that any exclusion limits the universe and deprives us of an investment opportunity."

Future outlook

More nuanced approach to active ownership

Active ownership is regarded as one of the most effective mechanisms to manage risks, maximise returns and contribute to positive outcomes for society and the environment. A nuanced approach to active ownership entails greater focus on ensuring that investors devote their efforts to where they can make a real difference.

We foresee that the Nordic active ownership landscape will become more nuanced. Initiatives that have been customary in the USA will also prevail in markets closer to us, including vote-no campaigns against directors, requests for books and records, and running candidates for the board, as well as class-action lawsuits.

For us, this gives an opportunity to influence companies to integrate sustainability into their business models, governance and reporting. We can also challenge how companies manage e.g. climate-related risks, or how they identify and follow up on supply-chain issues.

We believe there are three main drivers of this development: increased understanding that active ownership can improve risk-adjusted returns; the enhanced maturity and competence of smaller institutional investors to exercise active ownership; and regulations and guidelines supporting the development.

Clarifying values versus value will intensify

According to the latest Eurosif survey[1], ESG integration grew by 60% among European asset managers from 2015 to 2017. This trend concerns over €4 trillion assets under management, and indicates that most asset managers and owners in the survey implement some form of ESG integration. This development translates into less appetite for more dogmatic approaches. In fact, even though Exclusions and Norms-based screening remain dominant strategies, both approaches now have a lower asset base compared to two years ago.

A common practice in the Nordic region has been to exclude companies based on a set of values, or to manage reputational risk. The exclusion approach is often based on a pre-defined set of criteria to identify companies in breach, in contrast to ESG integration whereby financial and ESG factors are integrated in the portfolio structure and security selection process. We believe that values will continue to be a driver for many investors when implementing investment strategies and selecting products. We also believe that both institutional and private investors' appetite for ESG integration, active ownership and impact will grow. Among retail customers, a recent study by Danske Bank showed that a larger proportion prefer to exclude companies, even though only around 10-15% of these customers were willing to accept lower returns because of this. We therefore believe that the need to distinguish between values (ethical) and value (financial) will intensify, in order to meet customers' preferences and expectations of external managers' ability to describe their strategies and processes.

ESG data demands will change

The growing range of firms dedicated to providing ESG data and research to institutional investors signals a clear market demand. It is likely, however, that the growth in ESG data providers would not be possible, or at least would not be as strong, were it not for the fact that ESG data is non-standardised and chaotic in nature. This has opened up a generous go-to-market opportunity for ESG providers claiming 'innovative research framework', a 'truly differentiated approach', or 'objective AI-driven research' to be the best approach to ESG. The data providers' domicile, home market characteristics and business scope are also reflected in their different methodologies and offerings.

We believe the need to find quality data with investment value and standardised reporting frameworks that focus on ▶

1. http://www.eurosif.org

Future outlook

business materiality will drive investors to use multiple sources of ESG data. For us, this is already the case, as we power up our investment strategies with data from multiple sources, and use mDASH, our ESG materiality dashboard, to identify and assess material ESG information, while also identifying data gaps, errors or subjective assessments.

We believe that this trend will continue, the main driver being the increased focus on linking ESG to financial materiality and finding data and metrics to identify investment risks and opportunities. While data volumes are plentiful, data quality, coupled with the lack of standard definitions, presents a challenge. It is thus of great interest to the financial markets to support the development and adoption of standards, metrics and materiality tools. The Sustainability Accounting Standards Board[2], which connects businesses and investors on the financial impacts of sustainability, is one such valuable standard, alongside academic think-tanks such as the Center for ESG Research[3], which provides guidance on how to develop, treat and relate to ESG. These and other market initiatives will support the increased systematisation of ESG integration going forward.

Appetite for measuring impacts

Investors are eager to find metrics and data to measure the non-financial impacts of their investments, positive and negative alike. Yet this has proved to be a challenging task and investors often have difficulty in understanding the real impact of investments in companies or projects.

We see a need to differentiate between exposure to sustainability themes and the real impact of these investments. The first is possible to understand and measure, while the second will require significant work and brain power. We are currently at a stage where we can talk about the potential impact of our ESG integration, active ownership or screening, on our investments. Yet more effort is needed before we can measure the real impact. We believe there will be more partnerships between investors, asset managers, subject-matter experts and academia to develop impact metrics.

A regulatory tsunami will strike sustainable investments

Since the financial crisis, banks have been subject to greater regulatory scrutiny. The new regulation proposed by the European Commission includes statements that, for example, establish the criteria for determining whether an economic activity is 'environmentally sustainable' and determining the 'degree of environmental impact and sustainability of an economic activity'. The debate among investors and asset managers across Europe is healthy, since it is of utmost importance that new regulation is fit for purpose.

We consider it important that new regulation does not become a measurement exercise whereby too much is measured, and not enough is understood. A one-size-fits-all approach should not be forced on an industry whose strength lies in diversity. Investors should not be penalised for failing to meet prescribed and possibly confusing standards. Instead, they should be encouraged and rewarded to engage and change.

It is important that new regulation addresses the divergence of existing national taxonomies and market-based initiatives at national level, tackles the risk of potential greenwashing, and establishes a level playing field for all market participants. The regulatory tsunami that will strike sustainable investments will have a catalytic effect on the financial industry. If designed thoughtfully, it will contribute to sustainability becoming a natural aspect of asset and wealth management for all market participants.

2. http://www.sasb.org 3. http://esgresearch.dk

“More than anything else, ESG is to me about good business”

Claus Heimann Larsen,
CEO & Managing Partner, Danske Private Equity

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