Capital Partners
your partner for alternative investments

ESG Report 2018

Front cover: Novamont, bioplastics and biochemicals, Italy | Inside cover: Depcom Power, renewable energy, United States

Contents

Introduction

In this year's ESG Report, we are pleased to show how ESG considerations are being integrated into our portfolios across various asset classes. The particular approach taken in each asset class varies according to how we invest, whether through multi-manager portfolios or direct security selection. In each case, we seek to add value by identifying ESG risks and opportunities and managing them through the lifecycle of the investment.

In our private equity portfolios, we observe that our global set of managers has continued to make progress on ESG. Well over half of them now have an institutionalized process in place for managing ESG risks and opportunities. We are also pleased to report on a new approach to monitoring ESG risks in our portfolios at the individual company level.

This year, for the first time, we are reporting on our approach to ESG in private debt, where we consider the role of the private equity sponsor and the company itself. For the latter, we emphasize the importance of reporting on ESG-related key performance indicators (KPIs), which we are pleased to summarize in this report.

Through our annual ESG assessment of hedge fund managers, as well as our own engagement in the industry, we are seeing a surge in interest in the topic by hedge fund managers. Many are wrestling with tough questions on how to integrate ESG factors, and we are contributing to these discussions with a proposal of our own on how to develop an ESG-focused long/short equity portfolio.

For our sustainable equity and bond strategies, we look at how we are enhancing the depth of information in our proprietary ESG Cockpit by including assessment and scoring of ESG-related controversies. We also explore the carbon footprints of our sustainable investment strategies, which we find are significantly lower than their public market benchmarks.

Finally, we look back on a year of productive engagement in the industry on ESG. For example, the chair of our ESG Committee, Tycho Sneyers, was elected to the board of the United Nations-sponsored Principles for Responsible Investment (PRI) in a term that started in January 2018. We have also deepened our engagement with private equity managers by distributing our publication, "A guide to ESG in private equity," to the managers we assessed. In addition, we reflect on how investors are looking to the Sustainable Development Goals (SDGs) as a way of defining desired ESG outcomes.

As always, we would be pleased to discuss with you any questions or comments you may have on the information presented.

On behalf of the LGT Capital Partners ESG Committee

Sandra Keller

Keimpe Keuning

Jim Kosters

Thomas Kristensen

Olivier Méline

Mark Rall

Gallus Rechsteiner

Albertus Rigter

Tycho Sneyers (Chairman)

Werner von Baum

Alexander Zanker

Facts and figures

294 MANAGERS ASSESSED ON ESG

114 METRIC TONS OF CARBON ARE SAVED BY OUR GLOBAL EQUITY STRATEGY OVER THE BENCHMARK

58% OF PRIVATE EQUITY MANAGERS ARE RATED EXCELLENT OR GOOD ON ESG

91% OF HEDGE FUNDS IMPLEMENT OUR EXCLUSION OF CONTROVERSIAL WEAPONS

12 CASE STUDIES IN "A GUIDE TO ESG IN PRIVATE EQUITY"

>80,000 NEWS SOURCES ARE MONITORED FOR ESG CONTROVERSIES

ESG assessment of managers – how we do it

Each year we conduct an assessment of managers, which forms part of the firm's larger ESG due diligence, monitoring and manager engagement process. The assessment serves a two-fold purpose. First, it shows our investors the extent to which managers are considering ESG factors in their investment, ownership and reporting practices. Second, it facilitates our engagement with managers on ESG, highlighting excellence in implementation and flagging areas for improvement.

In the assessment, we ask managers about, and score them on, four key measures of ESG practice:

- Manager commitment – the extent to which they have demonstrated their commitment to ESG through actions such as defining a policy, committing to an industry initiative like PRI and engaging with their portfolio companies
- Investment process – the extent to which they have formally integrated ESG into their investment processes, using it as a framework for evaluating investments and identifying areas for improvement
- Ownership – the extent to which they have exhibited active ownership through activities like defining ESG guidelines, establishing key performance indicators (KPIs) or assigning ESG responsibilities for portfolio companies
- Reporting – the extent to which they have provided regular and relevant reporting on ESG on a portfolio company level and on the aggregate fund level

Managers receive a score of 1 to 4 (where 1 = excellent and 4 = poor) on each of the four measures, resulting in an overall rating for each manager, which is then documented in our monitoring system. Managers who receive low scores (3 or 4) on specific indicators are encouraged to improve over time.

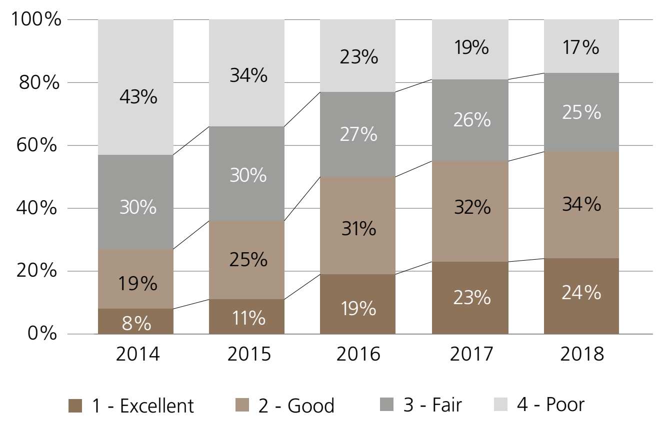
Rating	Description
1	Manager is genuinely committed to ESG, with institutional processes in place. Applies ESG criteria in investment decision-making, is an active owner and reports on ESG
2	Manager has taken steps to integrate ESG into its approach and investment process. Process is institutionalized, but manager may not follow through on all levels (e.g. reporting)
3	Manager demonstrates some commitment to ESG or has begun some initiatives, but lacks institutionalized processes
4	Manager demonstrates little or no commitment to ESG

Private equity

Continued progress globally

With this year's assessment of 202 private equity managers in the US, Europe and Asia, we are able to look back on five years of data. It shows that managers have improved significantly over the last five years, as an ever-increasing share of them have received ESG ratings of 1 or 2, indicating excellent or good practices for integrating ESG into their investment activities. Since last year, this group grew by another three percentage points to well over half of all managers (58%), which reflects steady progress on a longer trend. In the five years from 2014 to 2018, the group of managers rated 1 and 2 has more than doubled in size from the 27% percent of the first assessment. In this same period, managers with a rating of 4, indicating effectively no action on ESG, have decreased to 17% of our global set of managers, down from 43% in 2014.

Improvement in ESG ratings globally

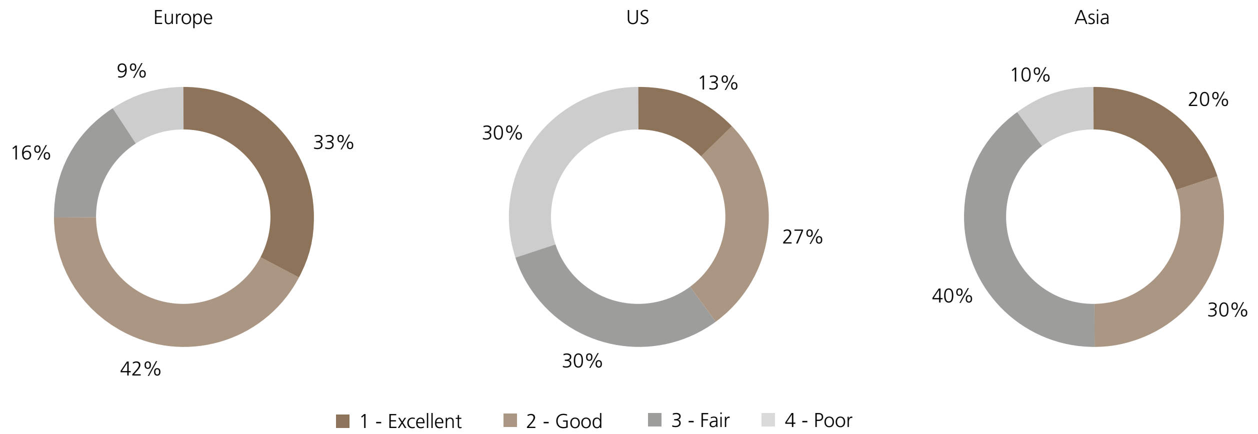


Source: LGT Capital Partners

How the regions compare – Europe still leads, but US gaining ground

Looking at ESG practices across the three key private equity markets of the US, Europe and Asia, we see both continuity with past findings, as well as new signs of forward momentum. Europe continues to lead, with 75% of managers now having excellent or good ESG processes in place. At the same time, while starting from a very low base relative to Europe, the US seems to be waking up to ESG integration, as now 40% of managers have achieved ratings of 1 or 2. While a large proportion of US managers (30%) are still largely ignoring ESG considerations, as indicated by their 4 ratings, this group shrank by five percentage points since last year. Asia represents a somewhat more complicated picture this year because of the addition of many new managers, but still half of managers there (50%) are rated excellent or good for ESG integration.

ESG ratings by region in 2018

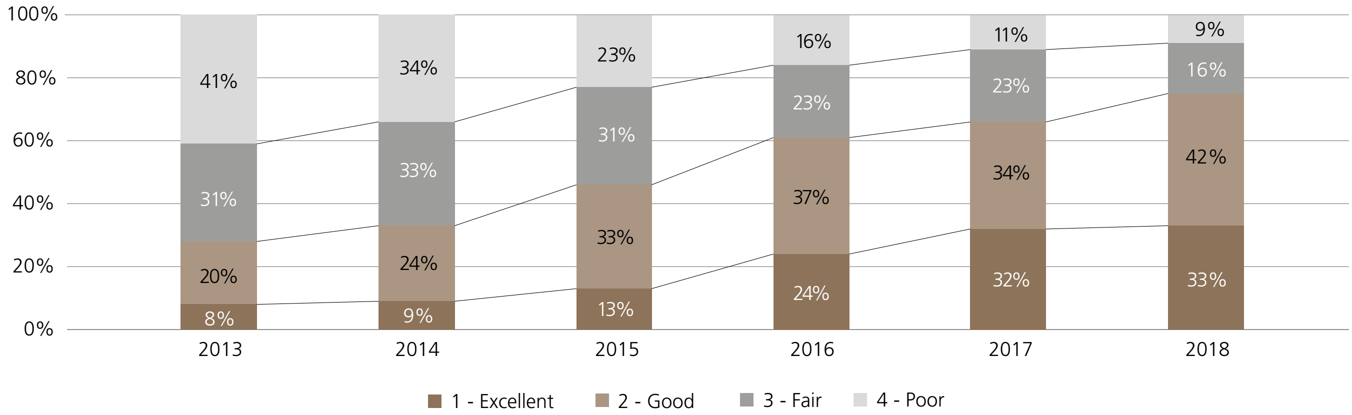


Source: LGT Capital Partners

Strong ESG practices becoming the norm in Europe

With 75% of European managers now having good or excellent ESG processes in place, ESG has become the norm in the region. Our data for these managers now goes back six years, and it shows that they have been improving their approaches to ESG at an especially fast pace between 2014 and 2016. Since then, with practices in most firms well established, we have seen a more measured pace of improvement at the top end (managers rated 1) and the bottom end (managers rated 4) of the ratings. Nevertheless, a number of managers improved from a rating of 3 to 2, resulting in the proportion of 2-rated managers growing to 42%, an increase of eight percentage points since last year. Seeing a large shift from 3 to 2 is especially encouraging for the future of ESG development in the region. Managers who do so are making a critical jump from a somewhat ad-hoc approach to ESG integration to a systematic one, where they consider ESG across the value chain, from investment selection to the management of portfolio companies.

Improvement in ESG ratings in Europe



Source: LGT Capital Partners

Case study: from 3 to 2 – small buyout manager crosses critical ESG threshold

This kind of transition is well illustrated by one of our small European buyout managers that focuses on special situations. When we assessed them in 2017, their approach to ESG bore all the hallmarks of a 3-rated manager. They had begun drafting an ESG policy, but still had much work to do in order to finalize it. Their investment process formally included a review of ESG issues at a target company, but there was very little structure to the process. Furthermore, during their ownership of the company, they had a nascent process in place for addressing ESG issues if they arose, but no systematic way of identifying or tracking them, to say nothing of incorporating them into their value creation plans. Unusually for a manager rated 3, they did seem to acknowledge the relevance of reporting on ESG, but it was limited to one sentence in the quarterly report, and only where a specific issue had come up.

Fast forward one year, and our assessment team found that the manager now has a well-articulated and comprehensive ESG policy in place, with firm commitments on many different aspects of ESG practice. It also specifies the people responsible for ESG within the firm and clearly describes the scope of their responsibilities and processes to be followed across investment, ownership and reporting. The manager has also conducted two ESG training workshops for the investment team, led by an external specialist. They have fully embedded ESG due diligence into the investment process, working with a specialist advisor. Importantly, the findings of their ESG due diligence are integrated into their 180-day value creation plans, where specific ESG action points are spelled out. Their approach to reporting is still basic, but that is often the case with 2-rated managers. We know from experience that this tends to be the last piece of the ESG puzzle to fall into place. In a word, the manager is now a very solid 2 in our rating framework, with a well-developed process for identifying and managing ESG-related risks and opportunities.

Differing ESG practices within Europe

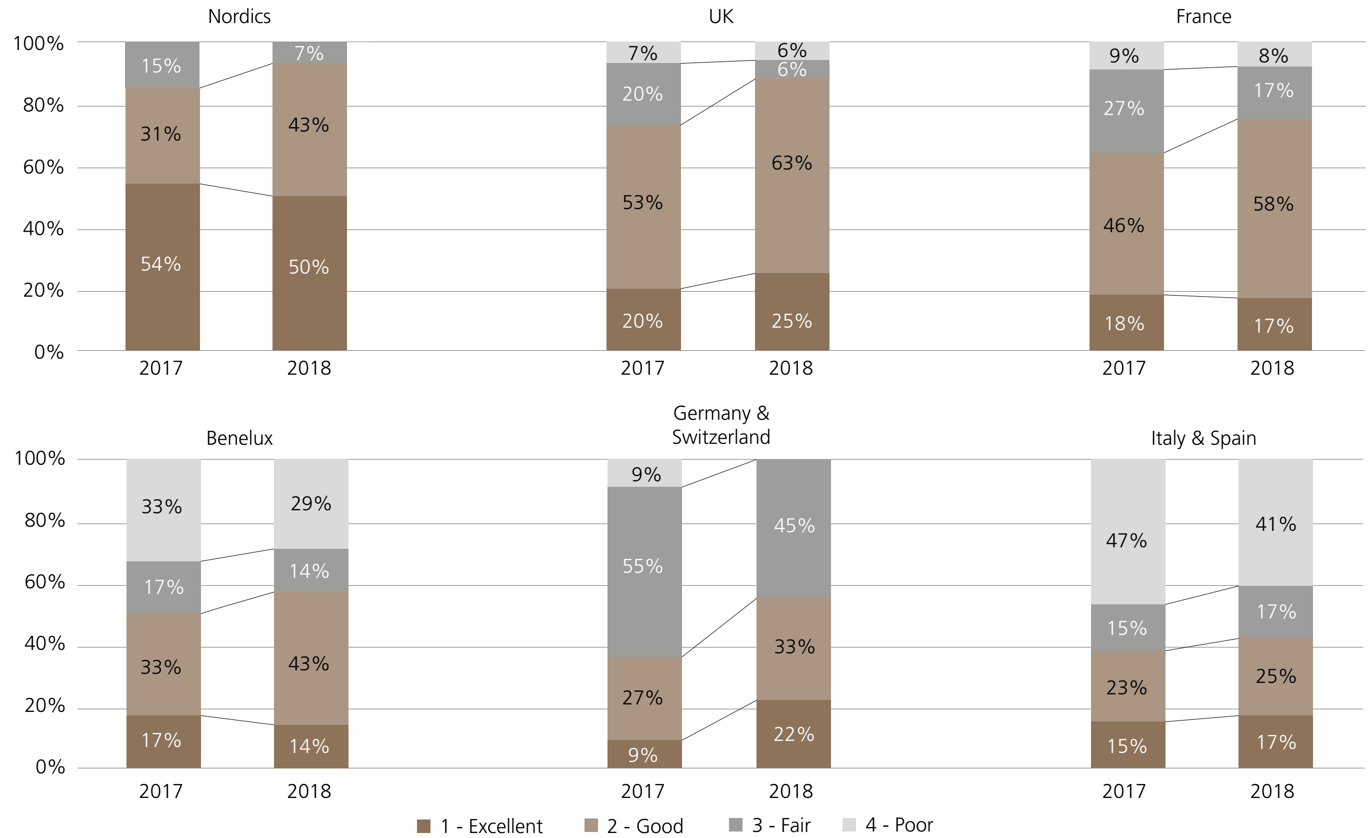
We observe that there is a great deal of variety in the state of ESG practices in different parts of Europe. The Nordics and UK are the clear leaders, while France is also strong but slightly behind them, with a mixed picture in Benelux, the German-speaking countries and Southern Europe. Looking at this data one year on, we see a similar dynamic, where the overwhelming majority of managers in the Nordics and the UK, 93% and 88% respectively, are rated excellent or good on ESG. Furthermore, the small gap in ESG excellence between the Nordics and the UK has narrowed over the year, such that it is now difficult to argue that one region has stronger practices than the other. At the same time, practices in France have also improved over the year, with 75% managers having earned a rating of 1 or 2.

We remarked last year about Benelux, where a high proportion of our managers largely ignore ESG in their investment approaches. With 29% still rated 4 in a market where Dutch pension funds are some of the most vocal asset owners on the ESG agenda, this group of managers has considerable room for improvement. Yet, there has been progress over the year, as the proportion of managers doing little on ESG (those rated 3 or 4) dropped seven percentage points to 43%.

The state of ESG practice in the German-speaking countries has also surprised us over the years, as it is a country with high standards for environmental and social protection. Nevertheless, as of last year, the majority of our managers had not yet embraced ESG in a structured and institutionalized way, judging by the low proportion of those rated 1 or 2. This has now reversed, as we see that 55% managers there have achieved excellent or good ratings on ESG, and not a single manager remains a 4. We have also seen interest in the topic among investors, as LGT Capital Partners (LGT CP) has held a number of well-attended ESG roundtables in Germany, Austria and Switzerland over the last 18 months.

The situation in Southern Europe remains largely unchanged since last year.

How European countries compare on ESG



Source: LGT Capital Partners

Case study: middle market buyout manager earns top ESG rating

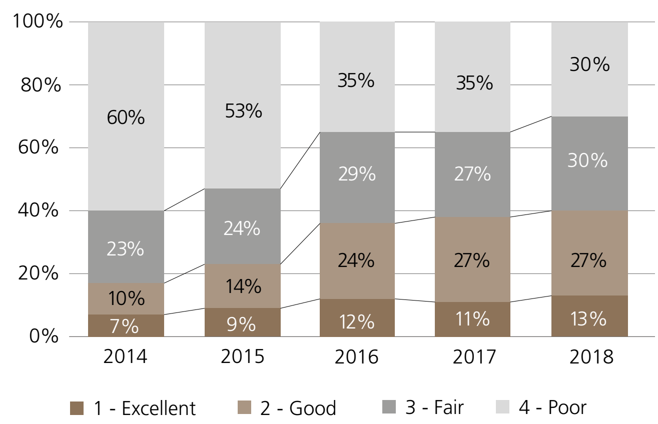
We can point to a concrete example of positive change, as one of our middle market buyout managers improved from 2 to 1 since the last assessment. They already had a well-documented ESG policy in place, but did not share it publicly, and they were considering joining an investor body focused on ESG in order to help them prioritize next steps. In addition, they had solid processes in place for ESG due diligence prior to investing, but their approach to monitoring and addressing issues post-investment was somewhat unstructured. Over the last year, they published their ESG policy on their website and they joined the PRI in order to clarify their commitment. More importantly, they implemented a robust portfolio monitoring process, in which each portfolio company completes a comprehensive ESG questionnaire to identify salient issues. These are then translated into formal ESG metrics, which are used to track the performance of companies. The manager featured the metrics in its first comprehensive ESG report, published in 2017. In addition to describing the manager's approach in detail, they provide statistics on gender diversity, environmental footprint, supply chain issues and employee engagement.

US managers gaining ground on ESG

We are pleased to see some ESG progress among our US managers, especially after last year's report, where it seemed that forward momentum had stalled. While the proportion of our top-rated managers, 1 and 2, remains largely unchanged, it is encouraging to observe a five percentage point drop in the share of managers rated 4, down to 30%. It is still much higher than we would like to see, but we know from experience that taking the first steps on ESG is a critical move that typically points to continued progress in the future. Looking across the full five years of data also paints a reassuring picture, as the proportion of managers with excellent or good ESG practices has increased from a very modest 17% in 2014 to a solid 40% today.

We believe this reflects the greater traction that ESG has gained in the US among asset owners and asset managers alike. For example, US signatories to the PRI now total 361 organizations, or nearly 20% of its signatory base.[1] Asset owners are also becoming more vocal in their endorsement of ESG as a framework for due diligence. For example, the public pension fund giant, California Public Employees' Retirement System (CalPERS), announced in 2017 that it will be more closely scrutinizing ESG issues in its manager-selection decisions across asset classes. As more investors join ESG-focused bodies and signal that they are prioritizing ESG, private equity managers will have to respond by improving their approach.

Development of ESG ratings in the US



Source: LGT Capital Partners

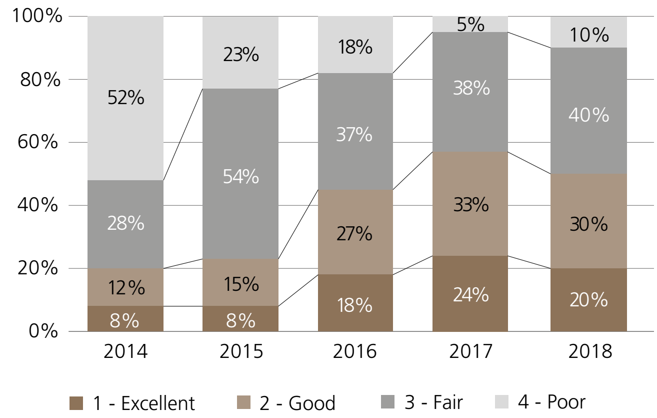
[1]Source: PRI, March 2018

New managers create opportunity for engagement in Asia

Our portfolio of Asia-focused managers has increased in size significantly since last year, largely through transactions on the secondary market. This has resulted in an influx of newly rated managers on ESG, the majority of which received ratings 3 or 4 in our assessment. At the same time, one of our long-standing, top-rated managers on ESG liquidated the last asset in the portfolio, so it is no longer counted among the 1-rated managers. These changes in the sample set result in a chart that seems to show decline in ESG commitment among our Asian managers. Looking more carefully, however, on a like-for-like basis, we observe that this is not the case. Nearly all of the managers who were doing good work on ESG last year, as indicated by their ratings of 1 or 2, are still doing so this year, and they still account for 50% of Asian managers.

The addition of new managers to the portfolio represents an opportunity to engage with a number of firms that have not yet seriously considered ESG or that have only taken tentative initial steps. This has already begun, when we sent all of them a copy of our publication, "A guide to ESG implementation in private equity," along with the ESG questionnaire as part of this year's assessment. The guide is a set of 12 case studies on ESG best practice, highlighting fund managers from our own portfolios that excel in certain areas of ESG practice. It provides practical examples for managers wishing to enhance their approach. We anticipate that this will spark a productive dialogue with them on the topic.

Development of ESG ratings in Asia

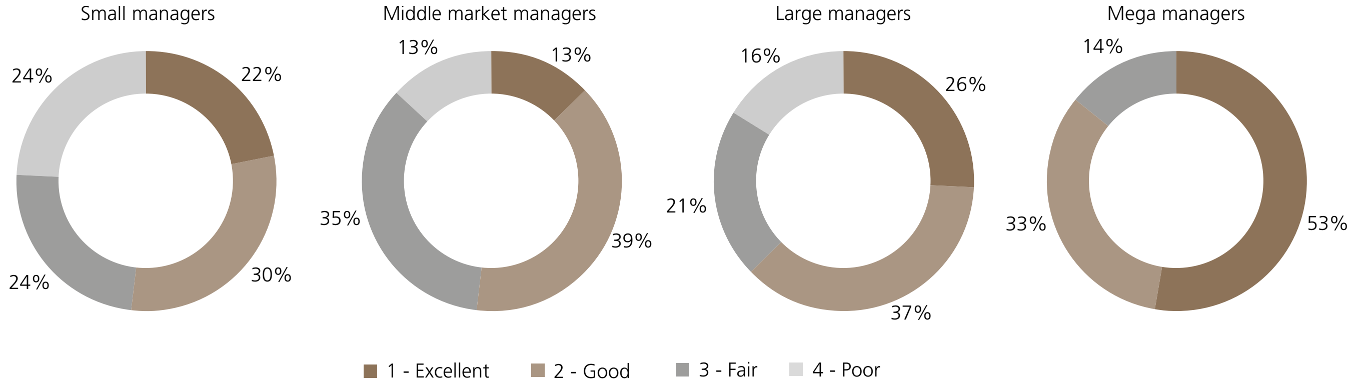


Source: LGT Capital Partners

Larger managers continue to lead on ESG

We have long noticed a correlation between fund size and the depth of a manager's ESG practices, and this year is no different. Our mega managers are the best example of this, as 86% of them have either excellent or good processes in place for managing ESG risks and opportunities, and over half of them have achieved our top rating of 1. At the same time, not a single manager in this category completely overlooks ESG. A significant majority of large managers are also strong on ESG integration, with 63% having achieved ratings of 1 or 2. For small and middle market managers, this proportion drops to just over 50%, with small managers slightly ahead of their larger peers in the proportion of managers rated 1. This illustrates that while larger organizations have greater economies of scale for dedicated ESG resources and other activities that will strengthen ESG processes, size is not a barrier to ESG excellence. A significant number of smaller managers have fully integrated ESG into their investment and ownership policies.

ESG ratings by size of funds in 2018 (EURm)



Source: LGT Capital Partners

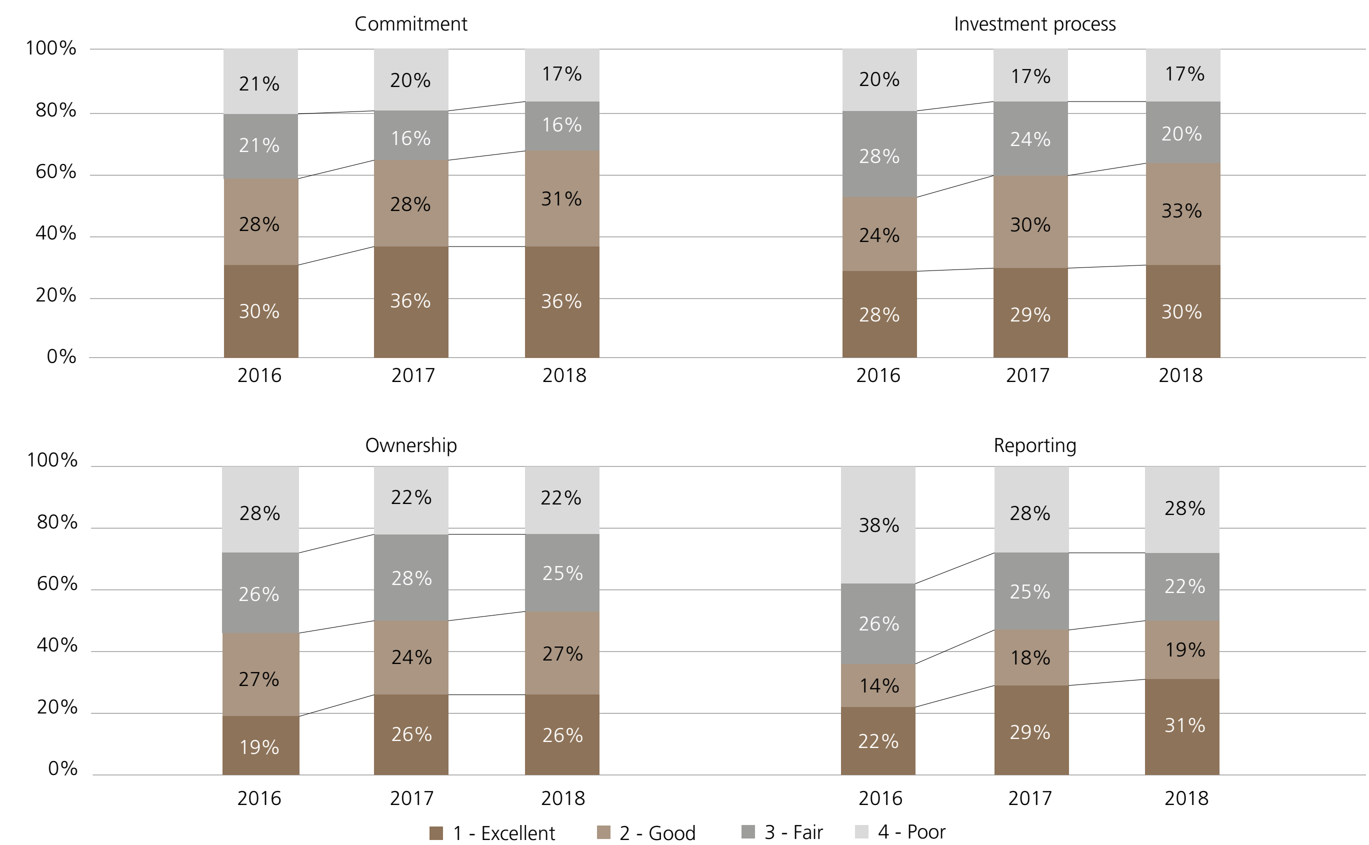
Continued ESG development across the four themes

In addition to analyzing ESG development in our portfolios by geography and fund size, we think it is insightful to look at changes in practice across the four themes that we assess: commitment, investment process, ownership and reporting. Each one offers a different perspective on what managers are doing. Commitment emphasizes policies and intentions, while investment process and ownership focus on how managers are analyzing ESG issues prior to investment and addressing them post-investment. The reporting metric reflects their level of transparency on ESG.

This year we again see that the largest share of managers are rated highly on manager commitment (67%) and investment process (63%), as indicated by their ratings of 1 or 2, while a smaller proportion achieve such ratings on the other themes (53% for ownership and 50% for reporting). We take the small gap in the ratings between commitment and investment process – just four percentage points for managers rated 1 or 2 – as an encouraging sign. It suggests that firms no longer simply make a public commitment to ESG, without also taking concrete steps to integrate it into their investment process.

Development along the ownership and reporting themes remains largely consistent with last year's results, with only minor changes in the proportion of managers in each rating category. This is consistent with what we know typically takes place as managers invest in their ESG processes. They will develop a framework for assessing ESG issues in their investment process, but they will need to commit more time and resources to fully implementing a system for prioritizing, monitoring and assigning trackable metrics on them. As a final step, these metrics will serve as the basis for comprehensive reporting on ESG.

ESG ratings by theme



Source: LGT Capital Partners

Private equity conclusions

This year's assessment of managers on ESG shows continued progress globally, as the proportion of firms rated 1 or 2 has grown by three percentage points since last year, reflecting steady progress on a longer trend. Furthermore, improvements have taken place at every level of ESG commitment, with managers progressing to ratings 1, 2 and 3. Europe remains the most advanced geography for ESG, with 75% of managers having received ratings of excellent or good. Within Europe, the German-speaking region has moved forward the most since last year, as there are no longer any managers there with a rating of 4.

We also see the US gaining some ground on ESG, albeit mostly on the lower end of the rating spectrum, with the proportion of managers with our lowest ratings decreasing by five percentage points to 30%. We are also encouraged by the fact that ESG appears to be gaining traction in the US.

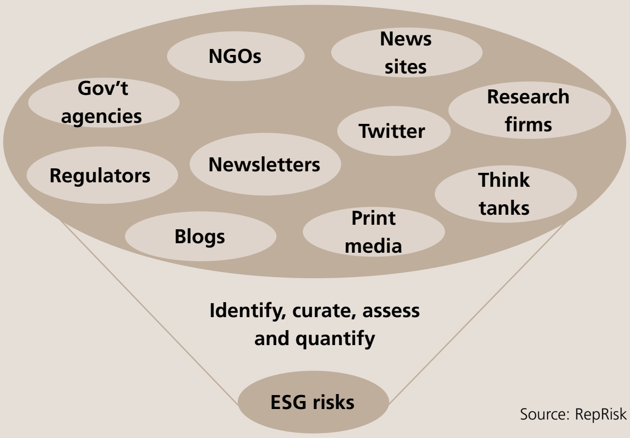
At the same time, the number of managers in our Asian portfolios grew significantly since last year, largely through secondary acquisitions. This has created an opportunity for engagement, as many of them have not yet established ESG processes.

Overall, we see a positive picture of forward ESG momentum in our portfolios, but one that will require continued engagement to keep it moving.

Monitoring companies on ESG

With thousands of private companies in our portfolios, monitoring for ESG-related risks on an ongoing basis is a daunting task. Unlike for listed companies, it is difficult to access information on private companies. Most investors, as limited partners, are a step removed from the companies. They rely on quarterly reporting from managers, which reflects a time delay of at least three months. Nevertheless, companies with poor ESG practices pose a significant financial and reputational risk to the investor.

80,000+ data sources screened



Source: RepRisk

We address this concern by actively monitoring ESG controversies of private equity investments with RepRisk, our monitoring partner. We have used their services to monitor our sustainable equity and bond portfolios for many years, and now we are leveraging this approach for private equity. The Swiss-based company provides a proprietary solution to monitor more than 80,000 online information sources in 15 languages for controversial news items relating to ESG. Information sources include research firms, think tanks, government agencies, NGOs, regulatory agencies, internet blogs, news websites and many more.

RepRisk's solution searches for news items on 28 different themes, looking for various types of controversies:

- Controversial products and services
- Health and environmental issues
- Violations of international standards
- Violations of national legislation
- Supply chain issues

When we receive notice of a controversy related to one of our portfolio companies, we discuss it internally and decide on next steps, depending on the nature and materiality of the controversy. This can include engaging with the manager to get more information on the incident and discussing possible remedial action to mitigate the ESG risk in our portfolio.

Our RepRisk monitoring solution is still in the implementation phase, with a growing number of portfolio companies actively monitored. The rest are in the process of being onboarded into RepRisk's framework, as company names are matched and tested to ensure that all related legal entities are in scope, but no false positives creep into the reporting stream. Once implementation is complete, we are convinced that we will have a robust system for identifying ESG risks in real time.

23 different ESG themes

Environment	Social		Governance
Environmental Footprint	**Community Relations**	**Employee Relations**	**Corporate Governance**
▪ Global pollution (incl. climate change and GHG emissions) ▪ Local pollution ▪ Impacts on ecosystems and landscapes ▪ Overuse and wasting of resources ▪ Waste issues ▪ Animal mistreatment	▪ Human rights abuses, corporate complicity ▪ Impacts on communities ▪ Local participation issues ▪ Social discrimination	▪ Forced labor ▪ Child labor ▪ Freedom of association and collective bargaining ▪ Discrimination in employment ▪ Occupational health and safety issues ▪ Poor employment conditions	▪ Corruption, bribery, extortion, money laundering ▪ Executive compensation issues ▪ Misleading communication, e.g. "greenwashing" ▪ Fraud ▪ Tax evasion ▪ Tax optimization ▪ Anti-competitive practices

Source: RepRisk

Private debt

Integrating ESG into private debt

This marks the first year we are covering our direct lending activities in our ESG Report, following our acquisition of European Capital, a private debt specialist, in 2017 (now known as LGT European Capital). Our team provides debt capital to private companies in the European lower middle market, working alongside private equity managers, known as "sponsors." The team maintains relationships with more than 65 sponsors and has completed 70 private debt transactions since 2005.

ESG is an important part of our investment and monitoring process in private debt, where we look at how both the sponsors and the portfolio companies approach the topic. We also ask companies to report on a number of ESG key performance indicators (KPIs) as part of our ongoing monitoring.

Our ESG process consists of five steps:

Step 1. Evaluating the sponsor's ESG performance – we assess the sponsor's overall approach to ESG, leveraging existing due diligence material where available. This includes, for example, any ESG assessments of the manager, which may have been prepared by our private equity team. Insights gained from this review are documented in an assessment template, where we rate the manager on various aspects of ESG practice. This culminates in an overall ESG rating for the manager, based on a scale of 1 to 4, where 1 indicates excellence and 4 indicates little or no commitment to ESG practice.

Step 2. Assess ESG matters at the company level – we assess the company's overall approach to ESG, taking into account the industry and geography in which it operates. We also consider ESG due diligence materials from the sponsor, where available. The findings of the company and manager ESG assessments are further documented in our investment committee notes, which are the key documents used in finalizing an investment decision.

Step 3. Negotiating ESG reporting provisions in transaction documentation – we negotiate ESG reporting provisions, which are included (when possible) in the term sheet and subsequently in the loan agreements. Such provisions are generally in line with the sponsor's ESG requirements.

Step 4. Monitoring of ESG performance – we begin monitoring the ESG performance of a portfolio company as soon as the investment closes, and we continue monitoring it throughout the holding period. Towards this end, companies are asked to report on KPIs. Issues addressed during monitoring are logged into an ESG assessment template in our investment monitoring database.

Step 5. Reporting on ESG matters – our reporting activities serve as the starting point for our engagement with sponsors and portfolio companies on ESG. Quantitative rankings and qualitative assessments enable us to identify leaders in managing these risks and those who need advice and encouragement in further developing ESG best practice within their firms.

ESG due diligence process

Source: LGT Capital Partners

Portfolio company KPIs

We collect a range of ESG KPIs on companies in our private debt portfolio, which provide us with insights on how companies are responding to their ESG challenges and opportunities. Below we aggregate a selection of those KPIs across our 30 portfolio companies to provide a snapshot of how our private debt portfolio is performing on ESG.

ESG KPIs[2]

	Items	Score	Commentary
General	Existence of an ESG policy	43%	43% of the companies have an ESG policy. Two companies stated they are currently developing one.
	Tracking of ESG initiatives	37%	37% of the companies track their ESG initiatives with specific KPIs, sometimes featured in a dedicated annual report.
	Absence of litigation (in environmental, social and ethical affairs)	90%	Three companies dealt with ESG-related litigation in 2017 (one environmental, one product recall, one HR-related).
Environment	Existence of an environmental policy	57%	57% of the companies have an environmental policy, the primary focus of which is waste management.
	Estimation of CO_2 footprint	23%	23% of the companies have assessed their carbon footprint at least once.
	Water or energy consumption	53%	53% of the companies track their consumption of water and energy (primarily electricity and fuel).
	Waste volumes, cost, and % recycled	37%	37% of the companies track their waste volumes. 27% of the companies monitor waste recycling.
Social	Job creation	90%	Net 2017 job creation throughout portfolio was 499, with 90% of companies having increased their headcount.
	Diversity – female headcount	34%	34% of the portfolio's headcount are female.
	Availability of training opportunities	90%	90% of the companies provide training opportunities to a significant portion of their employees.
	Company-wide profit sharing	50%	50% of the companies grant extra bonuses to their employees depending on financial performance.
Governance	Independent member(s) at Board	43%	43% of the companies have boards comprising at least one independent member.
	Board meetings per year	6	Board meetings are scheduled six times per year on average.
	Existence of a corporate code of ethics	53%	53% of the companies have a corporate code of ethics.
	Existence of other specific committees	47%	47% of the companies use specific committees (management, audit, remuneration, etc.) to assist the board.

[2] Based on LGT European Capital's 2017 survey on portfolio companies as of 31 December 2017, featuring a selection of key items.

Biscuit International case study

Biscuit International is a leading European manufacturer of private label sweet biscuits and waffles, which LGT European Capital has financed since 2006. The partnership has lasted through two different leveraged buyouts, including the last one, led by Qualium Investissement in 2014.

The company began prioritizing ESG issues in its business in 2007, when its CEO pioneered a new approach to employee engagement and governance. He dramatically increased staff autonomy at one production facility by transferring most of the production team's managerial responsibilities to self-governed staff committees. The CEO also introduced a policy enabling staff members to add new responsibilities – such as for production planning or waste management – to their normal production roles. In doing so, they acquired new skills and began taking greater ownership for achieving corporate objectives. The success of the experiment led to rolling out the policies to the entire group in 2010.

The firm further increased its focus on ESG in 2011, when the CEO introduced specific environmental performance targets to the company's management objectives. This translated into taking strong measures to ensure the sustainability of the company's cocoa supply, one of key inputs of its production process.

In December 2014, the company obtained certification by UTZ, the largest certification program for sustainable coffee and cocoa in the world. Implementation of the effort was overseen by some 15 senior managers – primarily in the purchasing and health and safety departments – who were given responsibility for monitoring environmental objectives.

Over the past ten years, the company has also been encouraging staff to take initiative and provide ideas for improving the production process or for innovating products. The practice has led to many improvements in company operations in the areas of waste management and water consumption, while also enhancing employee engagement.

Biscuit International, food production, France

Hedge funds

Steady at the top – awakening at the bottom

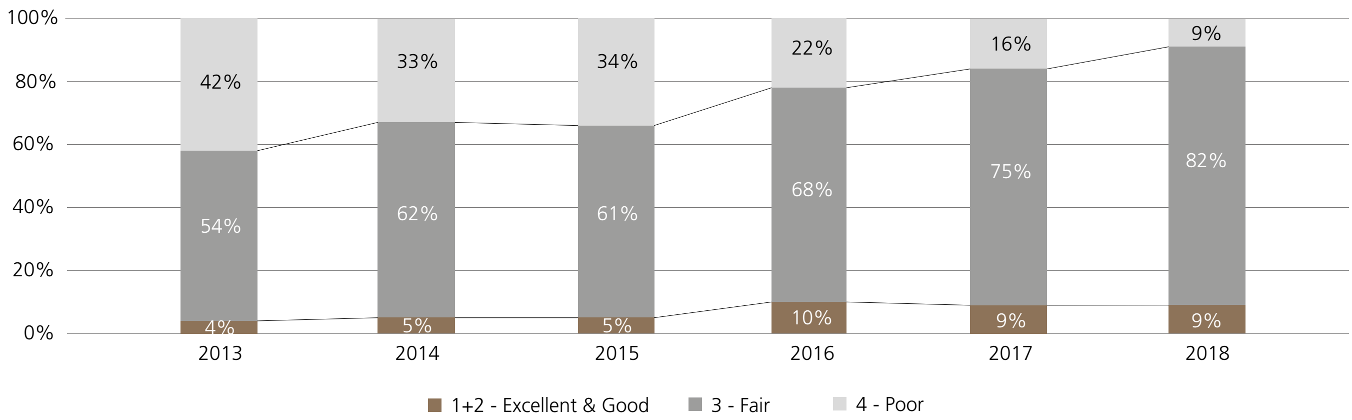
Hedge fund managers have taken an increased interest in ESG over the last year. A renewed focus from PRI, resulting in a standard ESG questionnaire for hedge funds, has put the topic firmly back on the agenda. Unlike past years, most of them now have a basic understanding of ESG, and some have begun engaging with the Sustainable Development Goals. Even quant managers, who used to think that ESG expectations do not apply to them, are now looking for angles to make their trading strategies relevant to ESG-oriented investors.

Current ratings of hedge fund managers and long-term development

With this year's assessment of hedge funds, we see progress by managers in most of the key cohorts we have examined. The share of managers rated 4 (largely ignoring ESG) has decreased to 9%, down from 16% last year and 42% in 2013. The assets invested with them is now 4%, compared with 12% last year and 32% in 2013.

Such managers typically have not agreed to engage with us via our managed account platform or have not adopted ESG practices in other ways. Managed accounts are considered ESG

ESG ratings by number of managers



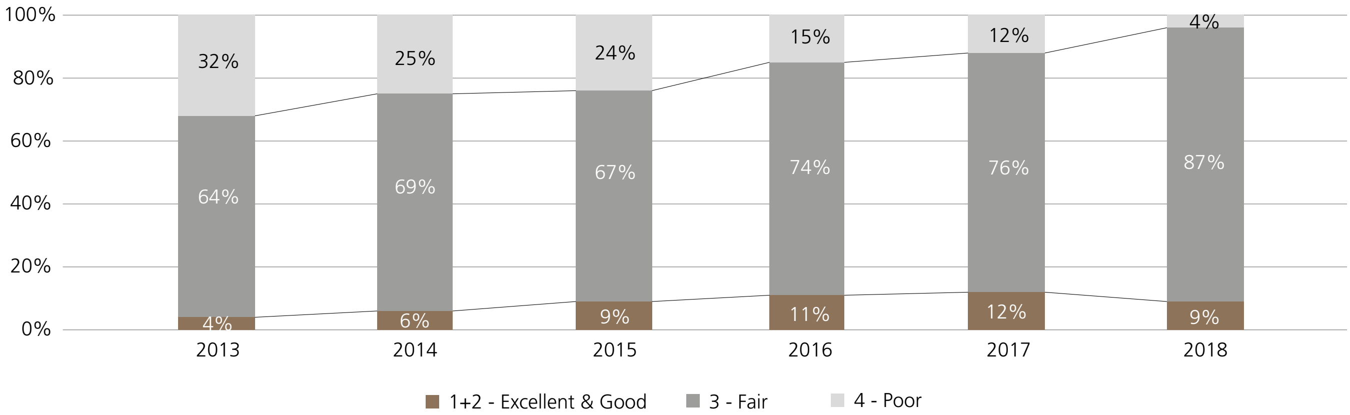
Source: LGT Capital Partners

best practice according to guidance from PRI, as they allow for direct access, liquidity, transparency as well as the exclusion of specific companies, sectors or other exposures. Operating on LGT CP's platform enables us to exclude companies involved in the manufacturing, storage or transportation of controversial weapons. This compares favorably to the conventional style of hedge fund investing via commingled funds, where ownership rights are much harder to control and focused ESG strategies are difficult to implement.

As in the previous years, the overwhelming majority (82%) of our managers are given a rating of 3, up from 75% last year and 54% in 2013. This is in line with the assets invested with these managers, which grew to 87% over the reporting period, up from 76% in 2017 and 64% in 2013.

Our assessment also shows that the proportion hedge fund managers rated 1 or 2 on ESG remains unchanged at 9% (by number of managers) and the proportion of assets invested by us with those managers is also 9% of our total hedge fund assets (down from 12% last year).

ESG ratings by AuM



Source: LGT Capital Partners

PRI's due diligence questionnaire for hedge funds

In May 2017, the hedge fund working group of the PRI, in which LGT CP participated, published its due diligence questionnaire for hedge fund investors, focusing on four key areas:

- Why? Policy, codes, beliefs
- Who? Governance, oversight, responsibility, training, incentives
- How? Investment process, data, tools, active ownership, investment decisions
- What? Monitoring, reporting, metrics

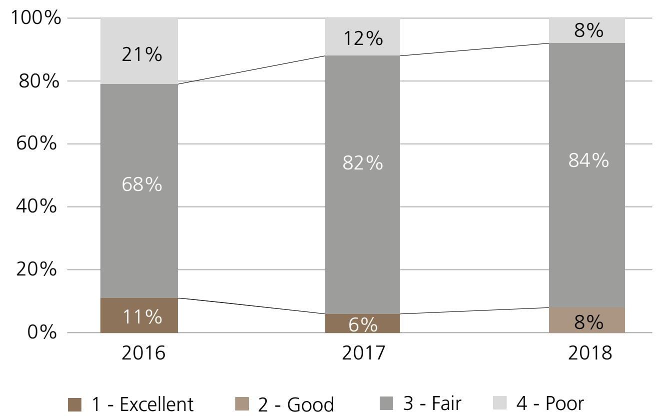
It includes 14 pointed questions for managers to answer and provides a common basis for objectively judging the ESG approach of managers and monitoring them over time. We welcome its strong focus on the investment process, which echoes our own approach, and we have largely adopted the PRI format and content. At the time of this report, the PRI is continuing to push ahead. It is in the process of establishing new working groups aimed at developing guidelines for incorporating ESG factors into the investment decision-making of a variety of different hedge fund strategies.

ESG ratings by hedge fund style

Analyzing the style-specific ratings of equity-related strategies (long/short and event driven), this year does not reveal any noteworthy surprises. The assessment results are largely driven by a reduction in the number of managers, some with low ESG ratings and others with high ratings. Overall, we observe a continuation of last years' development, with managers improving their rating by moving to our managed account platform. For example, we now see that 84% of long/short managers have a rating of 3, compared to 82% last year and 68% in 2016. Furthermore, managers rated 4 now account for 8% of the cohort, down from 12% last year and 21% in 2016. This is an encouraging result over the three-year time horizon.

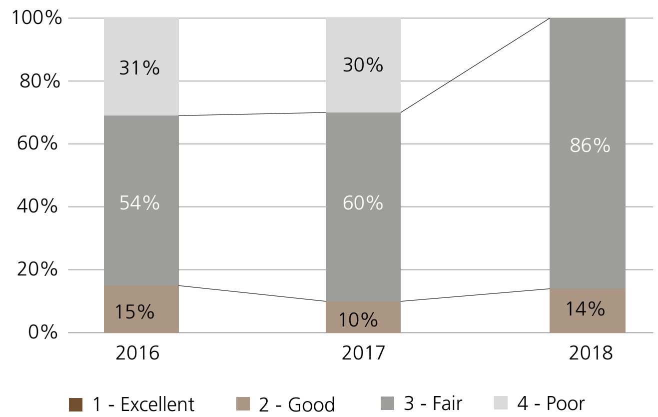
We see a similar development among event driven managers, with very little change on a like-for-like basis. Managers rated 3 now account for 86% of the cohort, up from 60% in 2017 and 54% in 2016. None of the event driven managers changed their ESG ratings during the reporting period, but several that were rated 4 last year have since been disapproved.

ESG ratings of equity long/short managers



Source: LGT Capital Partners

ESG ratings of event driven managers

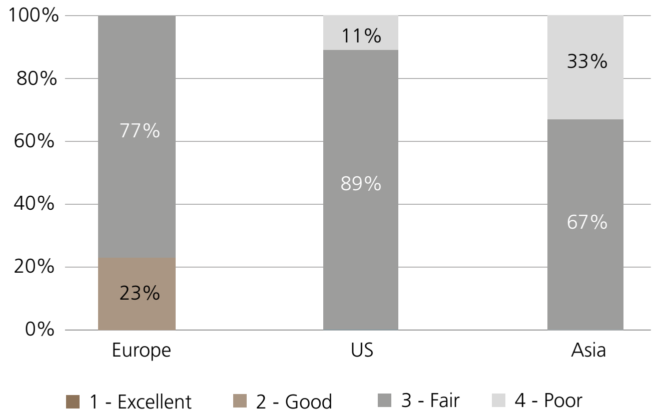


Source: LGT Capital Partners

Regional considerations

Similar to the analysis we carry out on the ESG practices of private equity managers, we wanted to better understand the regional differences in ESG uptake among hedge fund managers. The data shows a similar result to private equity, with Europe well ahead on ESG, followed by Asia, with the US lagging behind. We see that 23% of managers in Europe have good ESG practices, and none of them ignore the topic altogether. By contrast, most of the managers in the US and Asia (89% and 67% respectively) have taken only basic steps in integrating ESG, typically by agreeing to have their portfolios on our separate account platform to ensure best practice in transparency and to enable us to implement our exclusion of companies involved in controversial weapons.

ESG ratings by region



Source: LGT Capital Partners

The importance of data in ESG integration and the challenges ahead

An important topic at hedge fund conferences over the past year was the question of ESG integration into the investment process. The PRI is also taking up this issue in its hedge fund work stream, where they are focusing on several key questions:

- Is it appropriate for typically short-term oriented hedge funds to apply the same criteria as a long-only equity fund?
- Will the degrees of freedom and the alpha expectations of investors be severely impacted if strict exclusion lists are implemented?
- How should you look at the short exposure of hedge funds?
- Is it possible for a hedge fund to improve the ESG rating of its portfolio by shorting stocks with a low ESG rating?

These questions reveal that implementing ESG into a hedge fund investment strategy is much more complicated than for long-only strategies.

The key to answering these questions lies in the availability of data and the quality and depth of such data. This includes transparency on positions and transactions within a manager's portfolio, as well as access to consistent ESG data that can be mapped to the underlying positions.

In addition to ESG considerations, hedge fund managers need to take into account a large variety of factors in order to achieve low correlation of returns, and some of those factors will potentially conflict with ESG considerations. Only in-depth data analysis can help to differentiate the contribution of various factors to risk and return. Such analysis can also provide evidence on the extent to which applying ESG criteria really leads to changes in the portfolio and the investment style.

In our own portfolios, we aim for full transparency on positions and transactions, and we have developed our managed account platform to achieve robust tagging along many different dimensions. We can also draw on the capabilities of our sustainable bond and equity offering, which enable us to map companies to consistent, robust ESG assessments. On the next pages, we describe some of the key assumptions and our approach for establishing a hedge fund long /short portfolio with an enhanced ESG profile.

Conclusions

The hedge fund community is finally waking up to the need for ESG considerations in investment decision-making. Pushed by asset owners and the PRI, some managers are now making serious efforts to address ESG issues, rather than simply making vague commitments on the topic. We also see that large institutional investors are increasingly considering ESG criteria in their allocation decisions.

Currently, the industry and hedge fund investors seem to collect ESG data mainly for reporting reasons, but in the future, they will need to further strengthen the process of challenging and educating hedge fund managers. They will be assisted in this by PRI initiatives aimed at enhancing ESG analysis in the investment process.

While the momentum is there, concrete actions are still required and the more difficult questions of implementation are now being discussed. Based on what has been achieved so far, as well as the increase in resources dedicated to the topic, we are optimistic that further progress will be made.

A different way of looking at ESG and hedge funds

In addition to rating managers on their overall approach to ESG, we can also look through their portfolios into the individual securities they hold. This full position-level transparency is a key benefit of our managed account platform. It also enables us to match individual company positions in our portfolios with the ESG scoring we do on listed companies, using our proprietary ESG Cockpit. It assesses the ESG performance of companies using a variety of KPIs, leveraging data sourced from specialist providers. For our hedge fund portfolios, we can assign an ESG score for every single holding and then aggregate them into a total portfolio score. Scoring can be applied to a wide range of ESG factors, including carbon emissions, health and safety, diversity and others.

One complication, however, relates to the treatment of short positions in portfolios, as the industry has not yet agreed on a single way of calculating "net" ESG results. In our initial work in this area, we are taking the view that short positions in companies with low ESG scores should be treated similar to long positions in companies with high ESG scores. Simply put, a short position in a company with a low ESG score should enhance the portfolio's overall ESG rating, just as a long position in a company with a high score would. This is premised on the idea that providing capital to companies that are strong on ESG is beneficial to them, as it lowers their cost of capital. Similarly, taking away capital from companies with a poor ESG profile should have the opposite effect, which could encourage the companies to reassess ESG practices.

Integrating long and short ESG positions into a portfolio

Figure 1 illustrates how the ESG profile of a portfolio can be improved, taking into account both long and short positions in companies. In this example, the original portfolio (with no ESG tilt) consists of 80 long position and 80 short positions, which have an aggregate portfolio ESG rating of 45 (on a scale of 0 to 100, where any score above 50 is considered good from an ESG perspective). In this hypothetical portfolio, the long positions have an aggregate ESG score of 45, which is below average, while the short positions have a score of 55, which is above average. Improving the portfolio from an ESG perspective would entail raising the score of the long positions and lowering the score of the short positions, effectively rewarding companies with attractive ESG profiles and "penalizing" those with less attractive ESG profiles.

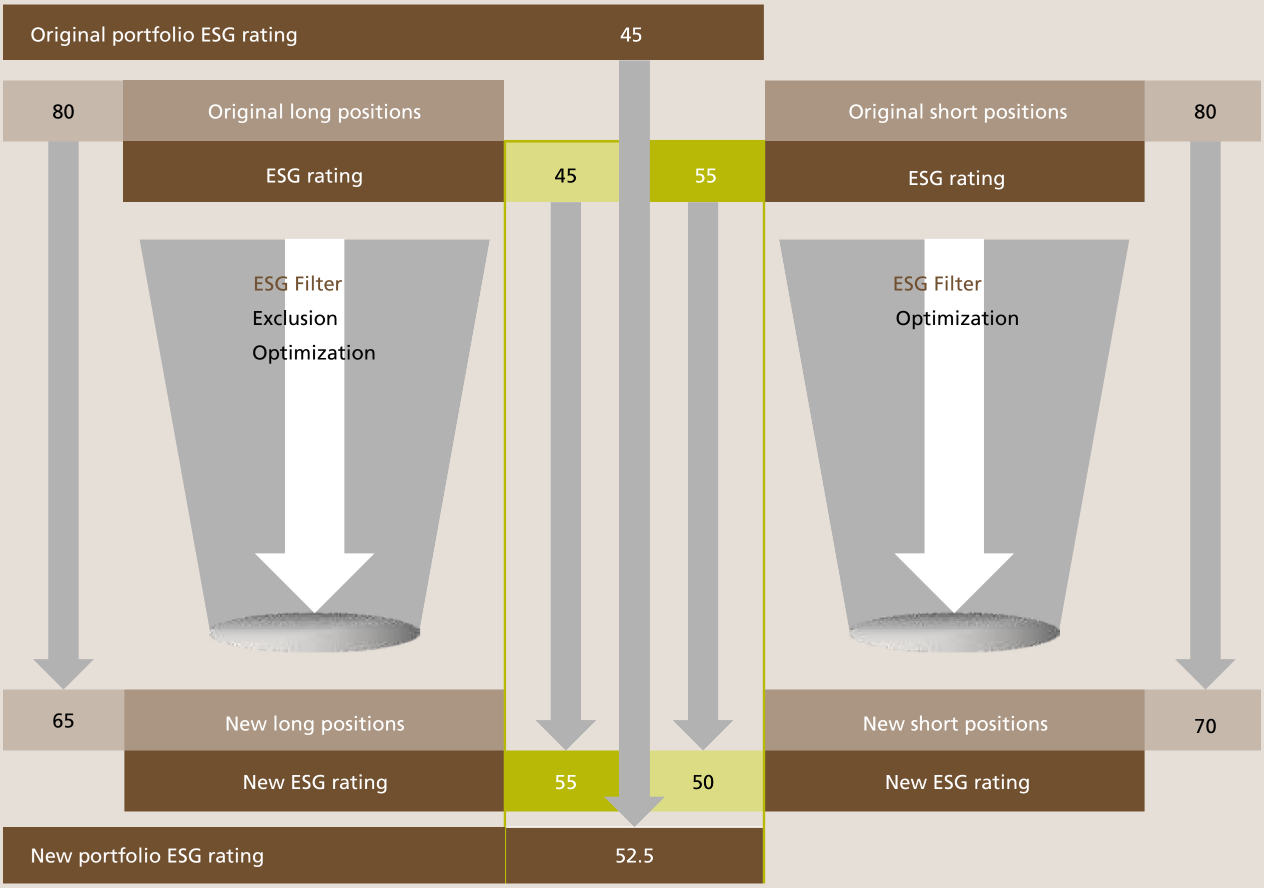
In the example, we apply an ESG filter to the long and short positions, where we seek to overweight long positions in companies with a high ESG score, while also overweighting short positions in companies with a low score. On the long side, this is achieved by excluding companies with the lowest ESG scores and positively selecting for those with higher scores. On the short side, we exclude some of the better scoring companies on ESG and "positively select" companies with lower scores. The result is a slightly more concentrated portfolio, with 65 long and 70 short positions. The long positions now have an aggregate ESG score of 55 (up from 45) and the short positions have a score 50 (down from 55). Again, we want to lower the ESG score of the short positions because it imposes a small penalty on companies with unattractive ESG profiles.

Using our proprietary portfolio weighting system, we calculate a new ESG score for the portfolio, where the new long and short positions result in an improved overall portfolio score of 52.5, up from the original score of 45.

LGT CP is currently working to develop such a portfolio, and we are in the process of seeking buy-in from our managers. The approach is considered "quantamental," in that the holdings will be based on a normal long/short multi-manager portfolio, where the investment process is fundamental. The ESG portfolio will then select single stock holdings through a quantitative process, with an emphasis on ESG criteria and ratings.

It will be important to ensure, however, that the return drivers do not change too dramatically from the original portfolio. In essence, the approach needs to be calibrated in a way that fairly balances ESG and performance goals.

Figure 1: Improving the ESG profile of a portfolio through long and short positions[3]



Source: LGT Capital Partners

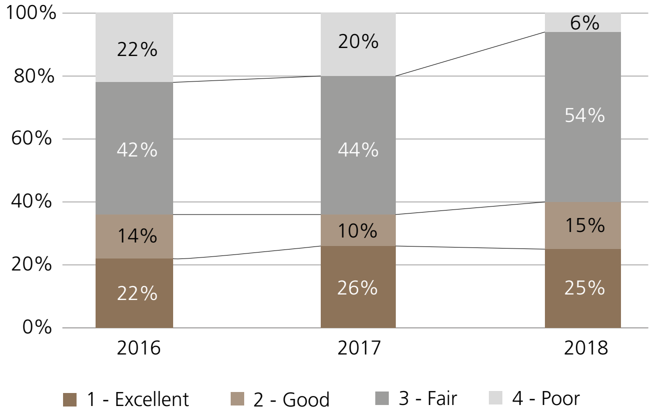
[3]This example is for illustrative purposes only. The portfolio rating takes into account the exposure long and short. For the ESG contribution of the short exposure the inverse ESG rating is used. A weaker ESG rating of the short book will therefore benefit the portfolio ESG rating

Multi-manager long only

Increased focus on ESG by long-only managers

The trend towards increased ESG integration remains strong in our multi-manager long-only portfolios (equity, REIT, insurance-linked strategies, high-yield and commodities). Managers rated 1 and 2 now account for 40% of long-only managers, up from 36% for the last two years. At the same time, the proportion of managers with our lowest rating, 4, has dropped to 6%, down from 20% last year and 22% in 2016.

Improvement in ESG ratings globally

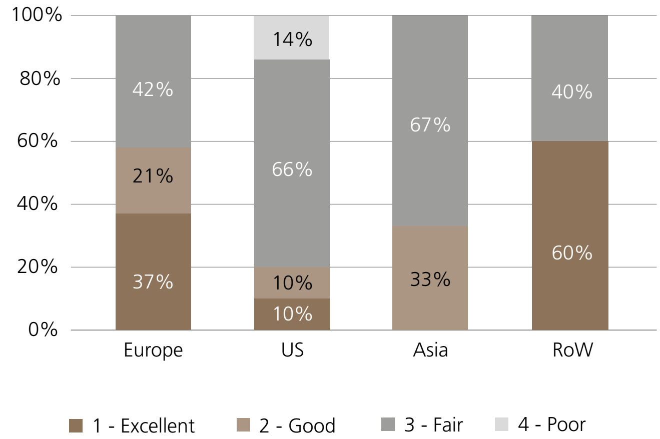


Source: LGT Capital Partners

Regional considerations

In looking at the regional breakdown of our long-only managers, we see a similar picture to both private equity and hedge funds. Europe is the most advanced on ESG, followed by Asia, with the US trailing behind both. In Europe, 58% of managers have excellent or good ESG practices, and none of them ignore the topic altogether. By contrast, only a small proportion of managers in the US and Asia (20% and 33% respectively) have institutionalized processes for managing ESG issues. Most take the minimal step required to achieve a rating of 3, typically by agreeing to have their portfolios on our managed account platform. The "Rest of the World" category includes a number of Australian managers with very strong approaches to ESG, which serves to tilt the distribution towards top ratings.

ESG ratings by region



Source: LGT Capital Partners

Public equity and fixed income

Including controversies data in our ESG rating

Up until now, the ESG scores generated by our ESG Cockpit have been mainly based on data reported by companies themselves. We have also been monitoring our portfolios for ESG controversies, using the services of RepRisk (please see page15), but so far, the result has not influenced the rating. Now we are quantitatively scoring the controversies data, so that it has much more systematic impact on our investment decision-making.

Including controversies data in our ESG scoring gives us a fuller picture of the relevant issues, by drawing on a variety of external information sources, such as media outlets, public sources, non-governmental organizations (NGOs) and think tanks. Monitoring them can flag controversial ESG issues, ranging from allegations of environmental or social harm caused by the company to claims of corruption or other governance issues. This information can provide real-time insights on the ESG issues in a company's day-to-day operations.

RepRisk provides regular updates on ESG controversies along various themes, as shown in the chart below, which we then map to the ESG Cockpit for quantitative scoring.

Examples: embedding controversies into our ESG assessment

ESG controversies	LGT CP's ESG Cockpit KPIs
▪ Forced labor ▪ Child labor ▪ Freedom of association and collective bargaining ▪ Poor employment conditions	▪ Labor Conditions
▪ Occupational health and safety issues	▪ Health & Safety
▪ Discrimination in employment	▪ Diversity

Source: LGT Capital Partners

The tables below show how this works in practice. For example, we use the ESG Cockpit to assess whether the company complies with the human rights convention of the International Labor Organization or supports the human rights declaration of the United Nations. We also check whether the company has specific processes in place to avoid the use of child or forced labor and to ensure the freedom of association. Assessing just this company-reported information would result in a score of 100 on "labor conditions", as shown in Figure 2, because the company appears to fulfill all of the requirements of this ESG metric.

The picture gets more complicated when we complement company-reported information with data on controversies related to labor conditions, as shown in Figure 3. Various data sources show that the company has been involved in a number of controversies related to its labor practices. The ESG Cockpit enables us to assess these data points in a rule-based framework, which takes into account the materiality of the controversy and the quality of the information sources.

It places more weight on relevant news items from long-established, original sources and less weight on those that simply repackage existing content or pursue political agendas.

In the case of our example company, the large number of controversies related to its labor practices results in a "penalty" of -35 on labor conditions. The original score of 100 is added to the penalty score of -35, resulting in a final score 65 for this KPI. Taking into account controversies makes the company much less attractive on this particular ESG metric.

Systematically taking controversies into account results in an enhanced ESG framework, which can make timely adjustments to ESG scores in response to major incidents. We are convinced that our enhanced ESG score enables us to have a more holistic and realistic view on the underlying ESG performance and to make more informed investment decisions.

Figure 2

Labor conditions – assessment of company policies	
Does the company claim to comply with the fundamental human rights convention of the ILO or support the UN declaration of human rights?	Yes
Does the company describe, claim to have or mention processes in place to avoid the use of child labor?	Yes
Does the company describe, claim to have or mention processes in place to avoid the use of forced labor?	Yes
Does the company describe, claim to have or mention the processes in place to ensure the freedom of association of its employees?	Yes
Preliminary score	**100**

Figure 3

Labor conditions – assessment of company's controversies

Date	**Source**	**Severity**	**Title**
12.02.2018	Business Wire (US; businesswire.com)	very severe	… sued in the US for alleged link to child labor in supply chain in Ivory Coast
07.02.2018	Osservatorio Diritti (osservatori-odiritti.it)	severe	… accused of subjecting workers to poor conditions at plantations in Sumatra, Indonesia (Italian)
30.01.2018	20 Minuten (20min.ch; Switzerland, German Edition)	less severe	Fraud and labor issues of …, …, … and other companies reiterated (German)
23.01.2018	Web Economia (webeconomia.it)	less severe	…and …criticized for past controversies surrounding their products (Italian)
19.01.2018	Nueva Tribuna (nuevatribuna.es)	less severe	Multinationals, including …, …, and …, linked to environmental, social, and human rights violations (Spanish)
05.01.2018	ABC News (Australia; abc.net.au)	severe	… investigation reveals alleged slavery and human rights abuses in its supply chain in Thailand
Penalty score			**-35**
Final score			**65**

Source: LGT Capital Partners

Zeroing in on carbon emissions

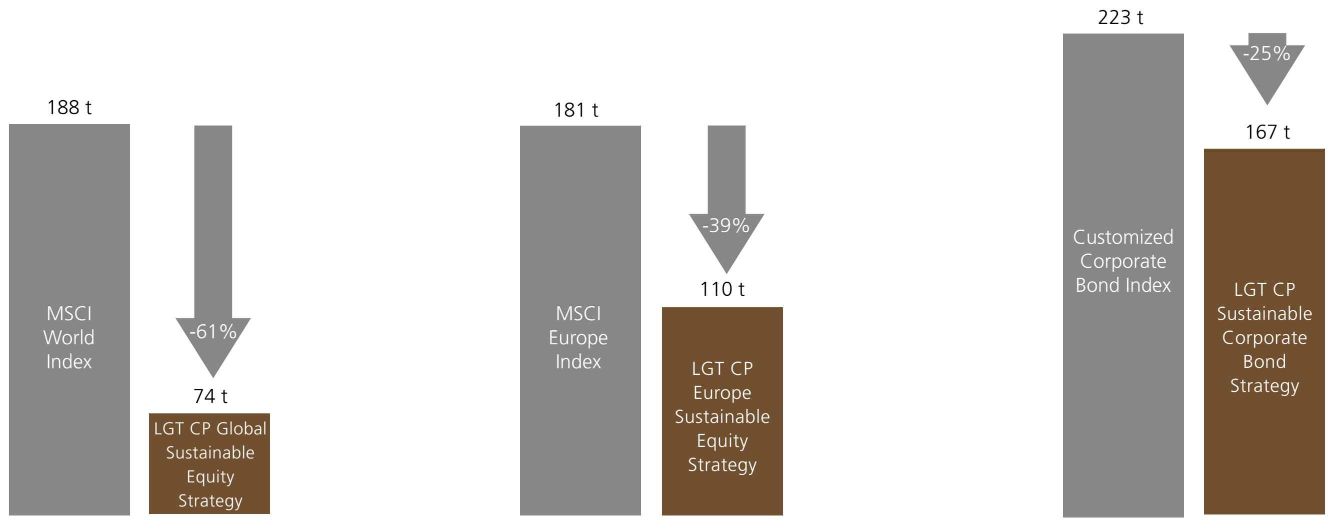
While the addition of controversies data will help to enhance the scope of our ESG assessment, many investors' first concern is with tracking carbon emissions in their portfolios. Pressure from stakeholders and regulators has made carbon footprint one of the most requested and discussed aspects of investor reporting. To assist them with understanding the environmental impact of their portfolios, we have measured the carbon footprint of three sustainable investment strategies, comparing them with the footprint of the respective benchmark indices, so our investors can better understand the environmental impact of our investment decisions.

The chart shows the aggregated normalized greenhouse gas emissions for three different strategies: Global and European Sustainable Equities, compared to the MSCI World Index, and our Sustainable Corporate Bond Strategy, measured against a customized Corporate Bond Index. All strategies are well diversified by industry sector and market capitalization, so they enable investors to gain exposure to a broad set of risk drivers while at the same time reducing the carbon impact of their investment decisions by 25%–61%.

As the chart shows, corporate bond benchmarks tend to have larger carbon emissions than listed equity benchmarks. This is because the two indices have different industry weights, so it is important to compare the emissions from a corporate bond portfolio to the respective fixed income benchmark, and not to a broad equity benchmark.

Carbon footprints of three LGT CP sustainable investment strategies vs. public markets

metric tons CO_2 equiv./USDm



Source: Asset 4, ThomsonReuters, LGT Capital Partners. All data in metric tons CO_2 equiv./USD 1 million company sales per calendar year. Data as of 28 February 2018

Overweighting companies with lower carbon emissions

As greenhouse gas emissions vary widely across different industries, reductions in emissions can be achieved either by avoiding investments in carbon intensive industries, or by focusing on companies with lower emissions across industries. As we strive to offer well-diversified portfolios, we deliberately implement the latter approach. This gives us considerable leeway in implementing industry allocations that deviate from the respective benchmark, and it enables us to significantly reduce the overall carbon emission level of the portfolio compared to the benchmark.

For example, the chart on page 29 shows that our Global Sustainable Equity Strategy generates 74 metric tons of carbon, while the benchmark produces 188 metric tons, a difference of 114. Roughly half of this difference results from the utilities allocation, which is achieved by overweighting companies focused on renewable energy and underweighting those that generate power from fossil fuels. Another 50 metric tons carbon are saved through our stock selection decisions in two other critical industries, materials and energy. In these industries, we currently focus on a specialty chemical manufacturer, a metal producer and an energy company, all of which exhibit very low levels of carbon emissions compared to their peers.

Our approach illustrates that it is possible for investors to maintain reasonably diversified with respect to industry exposure and at the same time significantly reduces the carbon emissions from their portfolio. Importantly, the improvement in carbon footprint over the benchmark does not come at a cost to returns. For example, our Global Sustainable Equity Strategy has outperformed its MSCI World (EUR) (NR) benchmark by a significant margin over both a 3- and 5-year period, with a 3-year return of 9.3% per annum and a 5-year returns of 15.8% per annum.[4] It shows that a well-diversified portfolio with a smaller-than-average carbon footprint is also compatible with attractive long-term returns.

[4]Source: LGT Capital Partners, Datastream
Data as of 28 February 2018, in EUR gross of fees.
Past performance is not a guarantee, nor an indication of current or future performance.

Cambridge Pre-school, early education, Singapore

Engagement

Joining the PRI board

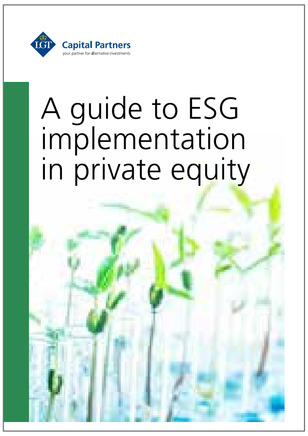
The PRI is the world's leading proponent of responsible investment, with a focus on promoting and defining standards on ESG issues. With more than 1,900 signatories from around the world, who manage total assets of USD 68 trillion, it is a significant voice in shaping the global ESG agenda.[5] In 2017, the PRI held an election for several seats on its board of directors, which provides strategic direction for the global body at a time of rapid growth. Prior to the election, it called on candidates with private assets experience to consider running for the PRI board, as the board wished to increase its know-how in this area.

With this in mind, LGT CP put forward as a candidate Tycho Sneyers, the managing partner who has chaired our ESG Committee since its inception. Voting took place over several weeks starting in October, and it concluded with Tycho being elected to the Board. We look forward to helping shape priorities for the PRI, especially in the areas of alternative investments, over the course of the three-year board term.

Providing guidance to private equity managers on ESG best practice

We have been engaging on ESG with our private equity managers for many years now. This year, as part of our engagement, we published "A guide to ESG implementation in private equity," which we sent to the 202 managers we assessed. In the guide, we highlight ESG best practices of 10 of our managers through a collection of 12 case studies in the areas of ESG commitment, investment process, ownership and reporting. Each case study describes what the manager does in a particular area, and then we provide commentary on why we believe it is an effective approach.

The guide is not meant to be prescriptive to managers, as each will have their own approach to ESG, but rather it is intended to give them concrete ideas on how they can integrate ESG considerations into their portfolios. We believe it helps answer the question we often get from managers on the topic of ESG, "what do you expect from us?" With the guide, they get very clear direction. It is all part of our larger goal of helping to embed ESG thinking more deeply into managers' working practices to meet investors' rising expectations on ESG in private equity.



[5] Source: PRI

Embracing the SDGs

By now, most investors have at least heard of the Sustainable Development Goals (SDGs), and many others are already looking at ways to embed them into their ESG frameworks. The collection of 17 global Goals was put forward by the United Nations and approved by 193 countries in September 2015. They address topics like poverty, hunger, health, education, climate change, gender equality, water, sanitation, energy, environment and social justice. Together, they make up the 2030 Agenda for Sustainable Development. The Goals include 169 underlying targets, measured by 230 individual indicators, which will require involvement by governments, NGOs and the private sector. Estimates suggest that realizing the Goals will require investment of USD 90 trillion over the next 15 years, with 80 percent coming from private capital.[6] It is truly an ambitious agenda.

Making the SDGs investable will require investors to look carefully at each Goal and its underlying targets to determine where and how the investor make an impact. They will need to commit team resources to understanding the links between the many targets and actual investable themes. LGT CP, for its part, has already begun engaging on this topic, with a project aimed at mapping relevant targets to its ESG Cockpit, our proprietary tool for assessing listed securities on ESG. Over the coming months, we will be making the links, with the goal of making the SDGs an integral part of our ESG analysis. It will also serve as template for linking the SDGs to the ESG processes of our other asset classes in turn.

[6] Source: UN Sustainable Development Goals, PRI

Embedding ESG into our business

LGT CP has a long-held commitment to incorporating ESG considerations into its client programs and its business overall. Since 2003, many of our programs have a responsible investment clause written into their governing documents, authorizing us to exclude investments that are substantially exposed to arms-related activities, violations of human rights, irresponsible treatment of the natural environment or other non-ethical conduct of business. Furthermore, the firm was among the first alternative investment managers to set up client programs as regulated structures in Ireland and Luxembourg, which have high standards of corporate governance. In 2009, LGT CP launched its dedicated sustainable bond and equity offerings. In addition, the firm has been a signatory to the PRI since 2008, and it participates in CDP and Eurosif. The firm became a signatory to the Montreal Carbon Pledge in 2016.

LGT CP's commitment to ESG is a reflection of our core corporate values as a large, global asset manager. Among these is the belief that being a good corporate citizen entails investing responsibly, which we strive to do through the ESG practices described in this report.

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