LGT Capital Partners
your partner for alternative investments

ESG Report 2016

Cover picture: Norsk Gjenvinning, waste recycling, Norway

Contents

Making an impact

We are pleased to present LGT Capital Partners' (LGT CP) ESG Report 2016, where we take up the theme "Making an impact" for our investors. For the past several years, our annual ESG report has focused on the findings of our annual ESG survey of our private equity and hedge fund managers, in which we rate them on how they integrate ESG factors into their investment processes, ownership policies and reporting practices. It provides investors with a useful "snapshot" of the state of ESG integration in their portfolios. Furthermore, when combined with comparable data from previous years' surveys, it shows how our managers are progressing on ESG over time.

This year we again feature the survey findings, but we have broadened our approach in order to provide a fuller picture of how incorporating ESG factors into investment decisions can make an impact for investors. For example, we explore how one of our portfolio companies, Norsk Gjenvinning, was transformed by a private equity manager, and at the same time helped to transform a troubled industry.

We have expanded the scope of our survey this year to include, in addition to our hedge fund managers, our long-only managers. With this year's survey results, we can again see how hedge fund managers are progressing on ESG, but we can also compare that to the work our long-only managers are doing. Furthermore, we have taken a closer look at the issues a hedge fund manager confronts when applying ESG criteria in its business practices through an interview with Matthew Beddall of Winton Capital Management.

In this edition of the report, we also show how our public equity and fixed income portfolios are making an ESG impact. Our approach to ESG assessment in these portfolios differs from that of our private equity and hedge fund managers, as the focus is on individual security selection, rather than managers. This gives us full control over the assets selected for investment. Furthermore, as the securities are publicly traded, we have the added benefit of considerably more information available for making an ESG assessment. Taken together, these two aspects of our public equity and fixed income portfolios have enabled us to develop a robust process for assessing the ESG risks and opportunities of each holding in these portfolios, which we are pleased to describe in this year's report. We focus on how we conduct ESG analysis for our Sustainability Funds, which include equity and bond funds launched in 2009 that are dedicated to investing according to ESG criteria. We also look at how the environmental footprints of select portfolios compare to the market as a whole.

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

LGT CP ESG Committee

Tycho Sneyers **Werner von Baum** **Robert Schlachter**

Marie Imbert **Jim Kosters**

Thomas Kristensen **Susanne Kundert** **Alexander Zanker**

ESG survey of managers – how we do it

Each year we conduct a survey of managers, which forms part of the firm's larger ESG due diligence, monitoring and manager engagement process. The survey 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, the survey facilitates our engagement with managers on ESG, highlighting excellence in implementation and flagging areas for improvement.

In the survey, 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 or committing to an industry initiative like PRI
- Investment process – the extent to which they have formally integrated ESG into their investment processes, using it as a framework for evaluating investments
- Ownership – the extent to which they have exhibited active ownership through activities like introducing ESG guidelines or key performance indicators for portfolio companies
- Reporting – the extent to which they have provided regular and relevant reporting on ESG

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 expected to improve over time.

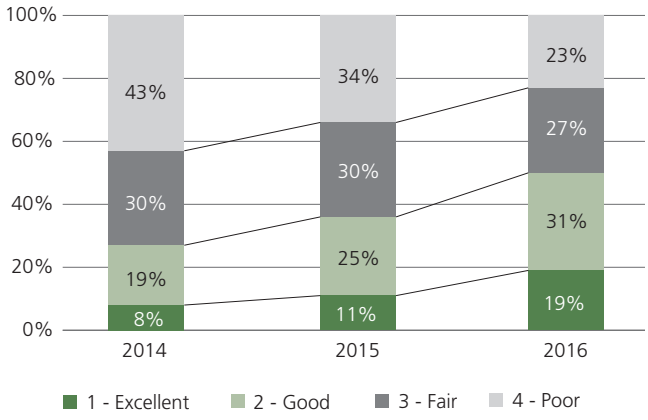
Rating	Description
1	**Excellent** – manager is genuinely committed to ESG, with institutional processes in place. Applies ESG criteria in investment decision-making, is an active owner and reports on ESG
2	**Good** – manager has taken steps to integrate ESG into firm approach and investment process. Process is institutionalized, but manager may not follow through on all levels (e.g. engagement and reporting)
3	**Fair** – manager demonstrates some commitment to ESG or has begun some initiatives, but effort seems half-hearted or marketing driven; lacks institutionalized processes
4	**Poor** – manager demonstrates little or no commitment to ESG

Private equity

Continued progress over the last three years

Looking at our global set of private equity managers over the last three years, we see that the positive change we observed in our report last year has continued over the past 12 months. As the chart shows, 50% of the 171 managers we have rated globally now have good or very good ESG practices in place, as indicated by their ratings of 1 or 2. This marks an increase of 14 percentage points over the last year, when 36% of managers held our top-two ratings. We also see that managers rated 4 have dropped to below 25% of the sample, whereas they made up more than one-third (34%) in 2015. So whether looking at the "top end" of our sample, or the "bottom end," we can see significant progress. Managers who already have ESG processes in place are continuing to enhance them, and those who have been doing little are now laying the foundations in their organizations for doing more in the future.

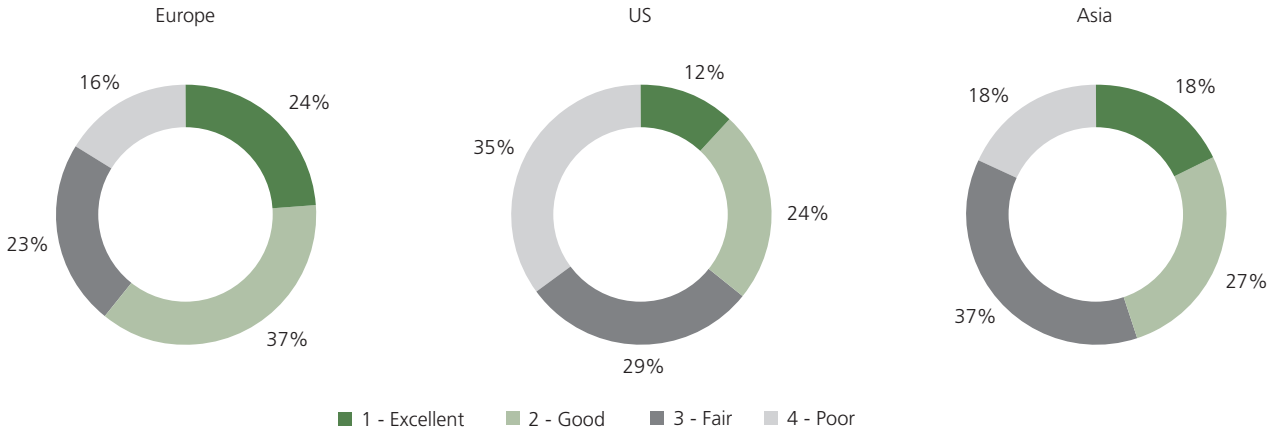
ESG ratings globally



How the regions compare

In 2016, we continue to see the regional divergences that we have observed over the last several years, with Europe the clear leader on ESG integration, followed by Asia and the US. In Europe, for example, the proportion of managers rated 1 is double that of the US, and Europe has a much smaller proportion of managers rated 4. As before, Asia lies somewhere between Europe and the US in terms of the rate of ESG uptake. Nevertheless, as we show in the pages that follow, progress is being made in all regions.

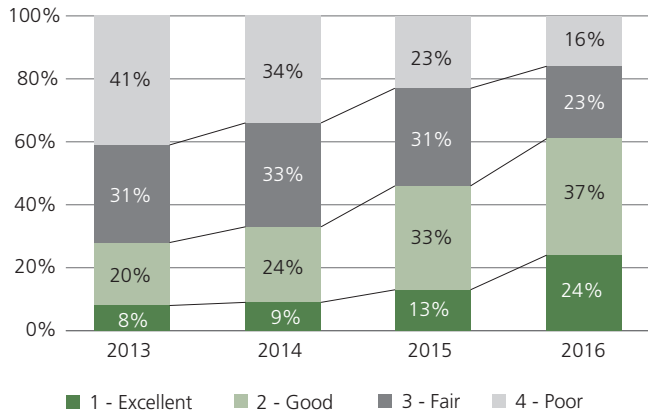
ESG ratings by region in 2016



Europe continues to drive improvement on ESG

We now have four years of survey data available in Europe, which shows the pace of ESG change over a relatively long period of time. We can see in the chart below that the last 12 months saw further increases in the proportion of managers rated excellent or good (1 or 2) on ESG. Furthermore, the rate of change is largely in line with, or even faster, than in the previous years. This is most evident from the increase in managers rated 1, who have comprehensive systems in place for analyzing ESG, implementing it in their ownership policies and reporting on it. This group of managers has increased by 11 percentage points over the last year, from 13% to 24%, compared to annual gains of 1 and 4 percentage points, respectively, in 2014 and 2015.

ESG ratings in Europe



We also see that a significant majority of European managers, 61%, are now rated 1 or 2, indicating that they have well-developed systems in place for identifying and managing ESG factors. Furthermore, managers doing little on ESG – those rated 4 – now represent a relatively small group, just 16% of European managers.

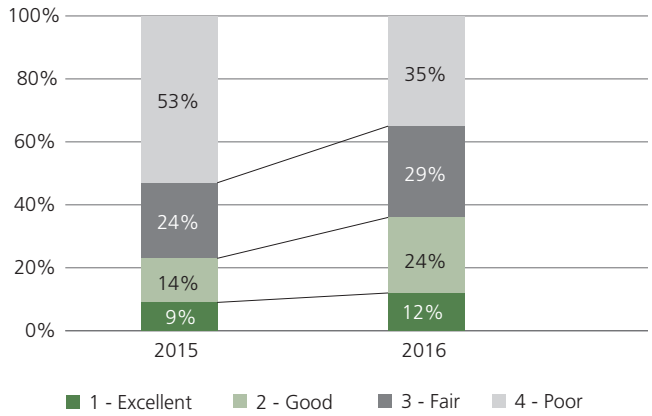
While the pace of change in Europe has been impressive, it may be difficult to maintain in the future. Many managers have now adopted key ESG practices. Further improvement may require significant additional investment of resources (e.g. setting up reporting systems) to get to the next level. Our European sample also includes a large proportion of managers with whom we have been engaging on ESG over a period of four years now. The process of surveying managers, holding discussions on ESG expectations and providing guidance on future next steps has likely played a role in encouraging managers on the topic. However, we cannot expect each additional round of engagement to inspire the same amount of progress year after year.

US and Asian managers have also made impressive progress

United States

In previous reports, we had expressed concern about the rate of ESG uptake by managers in the US, especially relative to their European peers. However, looking at the survey results of our US managers, we see significant progress since last year's survey. The proportion of managers rated 1 or 2 (which have well-developed ESG systems in place), has increased by 13 percentage points over the last year, from 23% to 36%.

ESG ratings in the US



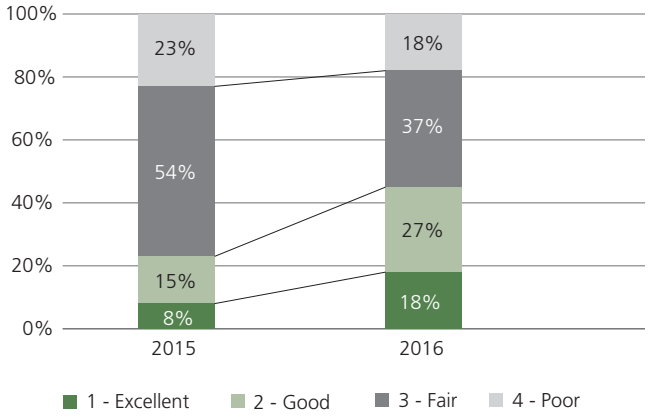
We also see a significant drop in the proportion of managers rated 4, from 53% in 2015 to 35% in 2016. Like with our global sample, we take this as an encouraging sign, because improving from a rating of 4 signals that a manager is now moving forward on ESG and is likely to continue progressing in the years ahead.

The improvement we see in ESG ratings matches with our own sense that interest in ESG is growing in the US, based on our engagement with managers there. They have told us that limited partners (LPs) have expressed ever greater interest in ESG over the last few years, which has encouraged them to further develop their ESG capabilities. The engagement process has also helped them clarify expectations and identify steps that can be taken.

Asia

We see a similar rate of ESG progress in Asia as in the US, but our Asian managers start from a higher base than their US peers, as a much higher proportion of them had already made an initial commitment to ESG as of last year (as indicated by their ratings of 1, 2 or 3). There was a significant increase in the percentage of managers with our highest ESG ratings, 1 or 2, over the last 12 months. Last year this group accounted for 23% of all Asian managers, but this year they account for 45%. We also see a corresponding decrease in the proportion of managers rated 3, from 54% in 2015 to 37% in 2016. This suggests that many managers are crossing an important threshold (from 3 to 2), where a basic commitment to ESG is developing into institutionalized processes for managing ESG factors.

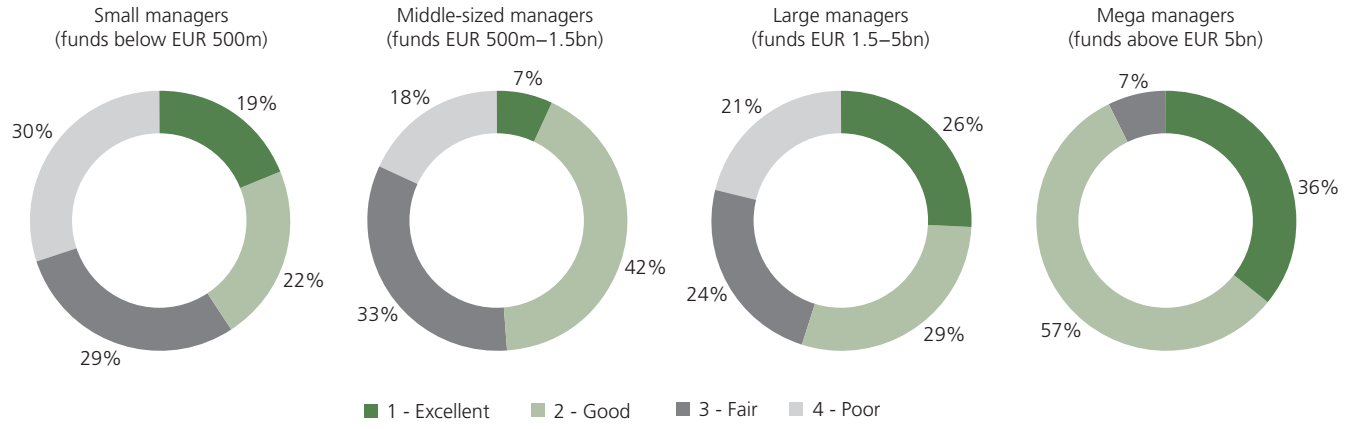
ESG ratings in Asia



Fund size is still a major factor in ESG uptake

As seen in previous years, larger managers tend to have better ESG processes in place than smaller ones, resulting from their greater economies of scale for maintaining dedicated ESG practices are now a prerequisite for managers wishing to raise a substantial pool of capital from a global institutional investor base.

ESG ratings by size of funds in 2016 (EURm)

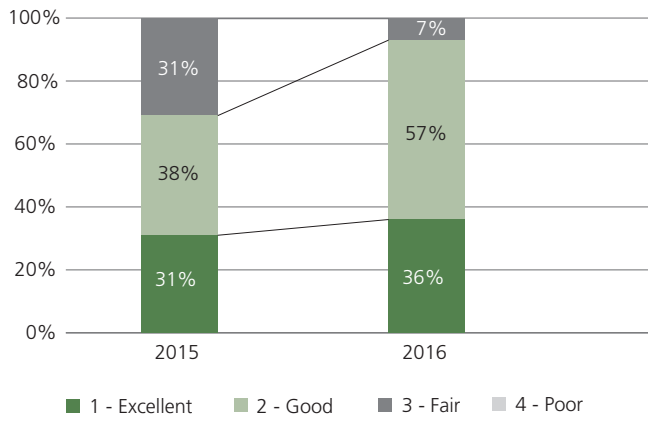


resources. These managers also tend to have global LP bases, including European investors who are increasingly pushing for ESG standards. This year we observe the same dynamic, but we are encouraged by improvements made by managers of all sizes.

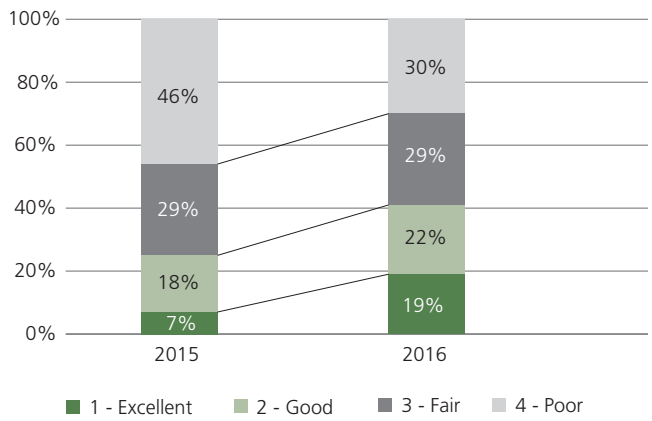
One development that stands out is the progress made by our mega managers (funds above EUR 5 billion), which last year were roughly evenly split between 1's, 2's and 3's, with no manager having a rating of 4. This year nearly all managers in this group, 93%, now have ESG ratings of 1 or 2, indicating excellent or good processes in place. It suggests that sound ESG

While our largest managers still lead the way on ESG, small firms are also enhancing their processes, as indicated by the improvement in ratings. The proportion of small managers (funds below EUR 500 million) rated 1 more than doubled over the last 12 months, jumping up to 19% from 7% last year. At the same time, the proportion of small managers rated 4 decreased significantly to 30%, down from 46% last year. This shows a growing awareness among our smallest managers that they need to take their first steps on ESG. It also illustrates that even managers with limited economies of scale find it worthwhile to invest in ESG capabilities.

ESG ratings of mega managers (funds above EUR 5bn)



ESG ratings of small managers (funds below EUR 500m)



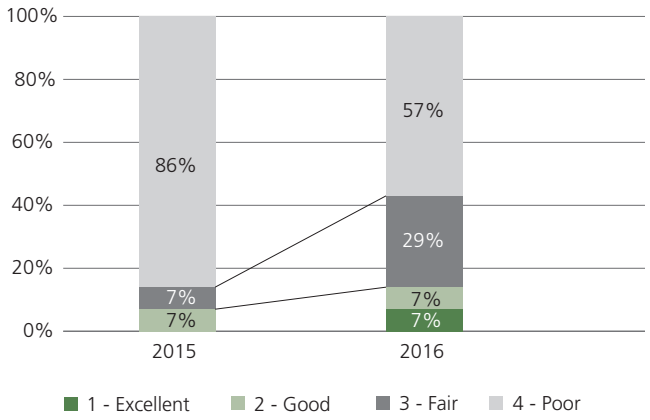
Progress among US small and middle-sized managers

We expressed the most concern last year about US small and middle-sized managers, among whom there had been relatively little uptake of ESG, as over half of them had ESG ratings of 4. While they are still far behind their European peers, we do see reassuring signs of progress this year.

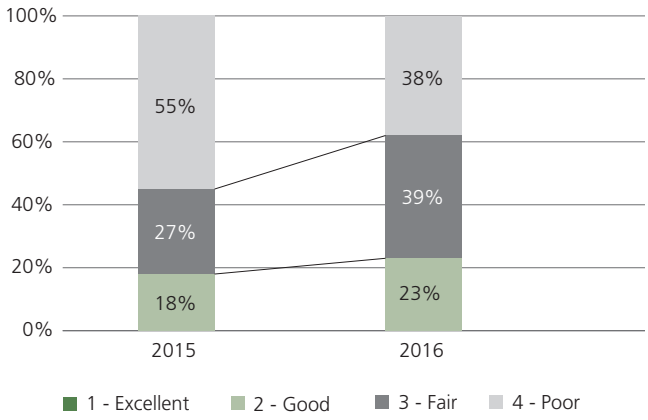
One positive development is the fact that our first-ever US small manager achieved a rating of 1, whereas last year no small or middle-sized firm had received our top rating. This particular team impressively jumped three rating categories in a year, from 4 to 1. The manager made significant investments in their ESG capabilities, which included hiring a full-time, dedicated ESG officer, setting up an external ESG advisory board, fully integrating ESG analysis into their investment practices and publishing an annual dedicated ESG report. While such rapid progress is unusual, it illustrates what can be achieved by a highly motivated manager in a relatively short period of time.

The big change we see among US small and middle-sized managers is in the proportion of those rated 3 rather than 4. This is an important move for a manager, as it indicates the transition from no ESG commitment to an initial commitment and likelihood of future ESG uptake. The proportion of small managers rated 3 has increased by 22 percentage points to 29%, and for middle-sized managers this proportion has jumped 12 percentage points to 39%. The corresponding decrease in the proportion of small managers rated 4 is particularly striking, as last year this group represented 86% of all small US managers. As of 2016, however, this proportion has dropped to 57%.

ESG ratings of US small managers (funds below EUR 500m)



ESG ratings of US mid-sized managers (funds EUR 500m–1.5bn)



Strong level of ESG commitment across the four themes

In looking at the ESG scores of our global set of managers by the four core themes we assess – manager commitment, investment process, ownership and reporting – we get a better insight into the specific areas of ESG improvement. One of the clearest positive changes is the significant increase in the proportion of managers rated 1 on each of the four themes, with changes ranging from 7 to 12 percentage points since the last survey. Given the general improvement in global ESG ratings noted above, we would expect improvement in individual theme scores as well. However, the consistent improvement across all four themes suggests that managers are improving their ratings by implementing substantive changes across all aspects of their ESG processes, they are not confining their work to achieving only the "easy wins."

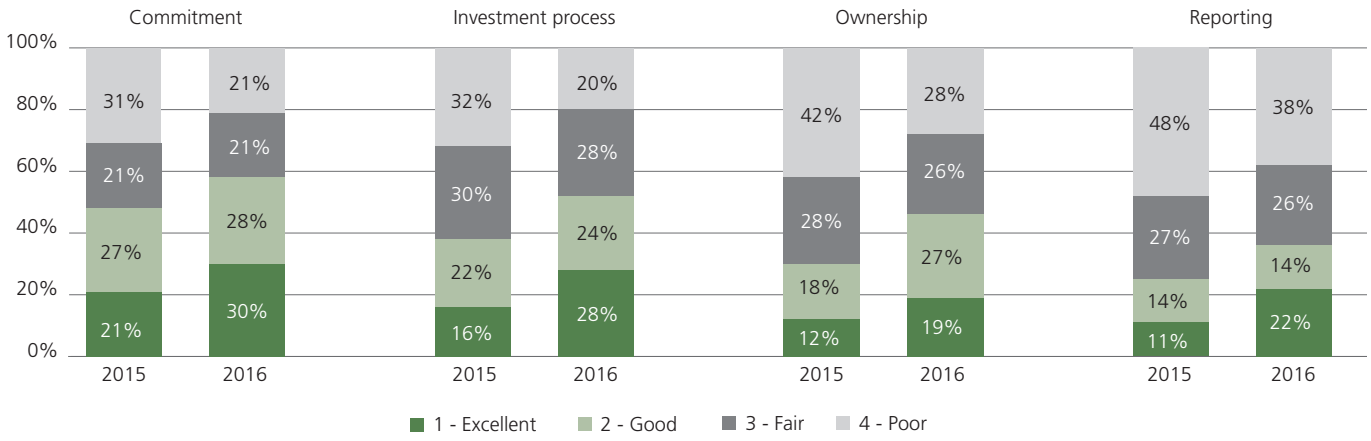
Overall, we still see that providing dedicated ESG reporting is the last component of the framework to be implemented by managers, as the majority have not yet developed comprehensive processes for reporting on ESG. But even here, it is encouraging that 22% of managers now have excellent systems in place for ESG reporting, as indicated by their 1 rating.

Private equity conclusions

Our 2016 ESG survey has shown that our global group of private equity managers – which currently includes 171 firms – has made significant progress over the last year, as 50% have now achieved our top ratings of 1 or 2. Global improvement continues to be driven by European managers. We also see progress in the US and Asia, where the proportion of managers doing little on ESG has shrunk considerably over the year. Many have now made their first steps in integrating ESG factors into their investment practices.

This improvement has taken place in the wider context of rising expectations for ESG among LPs and increasing conviction by managers that sound ESG practices add value to their investments. Given this dynamic, we will continue to engage with our managers on the topic and share the insights we have gained from working with our global set of managers.

Manager assessment by ESG theme



Private equity case study: Cleaning up the Norwegian waste management industry

This year's focus on making a measureable ESG impact for investors has led us to the example of Norsk Gjenvinning, a Norwegian waste-management company owned by Altor, a Nordic private equity manager. Norsk Gjenvinning is an instructive example because it shows how allocating capital to a manager with a strong commitment to ESG can result in the dramatic transformation of a company, laying the foundation for sustainable growth and facilitating the transformation of an entire industry in Norway.

A promising company with many challenges to overcome

In 2011, Altor acquired Norsk Gjenvinning, Norway's largest waste management company, which today has approximately 1,400 employees, 40,000 customers and EUR 490 million in revenue. The company Altor acquired, however, was far from the Norsk Gjenvinning of today, and it was operating in an industry where irresponsible handling of hazardous waste and illegal waste exports was not uncommon. Furthermore, it was an industry with many examples of financial fraud and anti-competitive behavior, and where regulatory requirements were frequently ignored. The Altor team was generally aware of these industry practices when choosing to invest in Norsk Gjenvinning, and they saw it as an opportunity for executing a turnaround, something they had done successfully with previous portfolio companies.

New management team paves the way for transformation

Altor's commitment to transforming Norsk Gjenvinning entailed a significant change in the leadership team: replacing 44% of its top 70 leaders over an 18-month period, including a number of major revenue generators. The new leadership led a dramatic turnaround of the company. Starting in 2013, they began executing their plan for change, focusing on the key areas of illegal exports, corruption and anti-competitive behavior. They established a new code of conduct for the company, which all employees were required to sign, and put in place a general amnesty for any prior wrongdoing. Subsequent to the new code, management instituted a "zero tolerance" policy for breaches.

Robust control systems and training requirements were complemented with "softer" approaches, such as establishing an individual feedback process, new incentives, and building a new company culture. Altor supported the new management throughout, which was essential, as the changes entailed significant short-term costs during the transition phase. Norsk Gjenvinning incurred EUR 12–18 million in compliance costs and suffered a short-term loss of business to competitors with different standards.

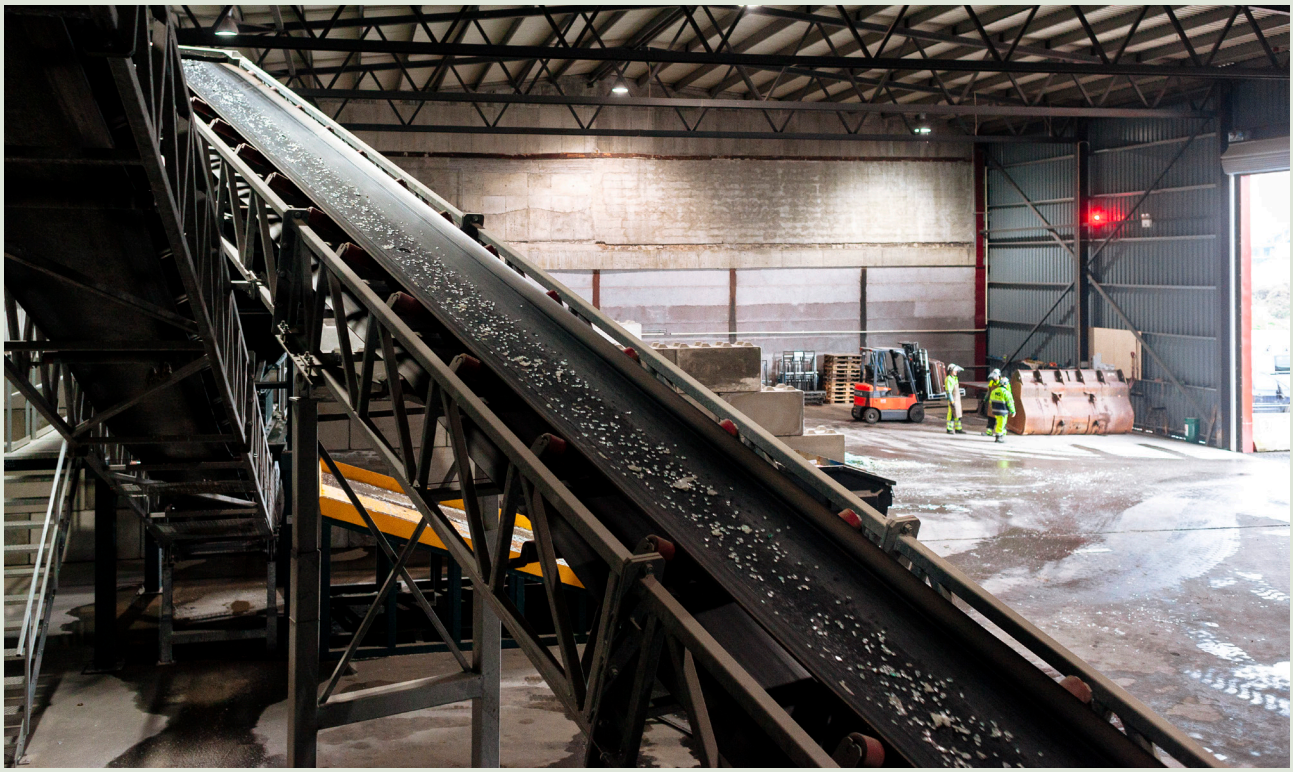
Engaging with the public to cement commitment

The final step of Altor's transformation plan for Norsk Gjenvinning focused on engagement with the wider public and the waste industry. The owners and the management team committed themselves publicly to cleaning up the company and raising standards in the industry through a media campaign. They also engaged with the industry to establish a code of conduct, aimed at eliminating illegal dumping, anti-competitive activities and other practices and worked with authorities in setting up industry-wide training aimed at raising standards.

Signs of success

Altor's far-reaching efforts at transforming Norsk Gjenvinning have started to bear fruits on many different levels. Management has observed a significant increase in employee pride and productivity, as employees now feel that they are part of a business with a positive agenda. This in turn has manifested itself in a substantial improvement in service quality and customer loyalty. The company is now winning new business, especially among customers who value its commitment to high ethical standards and sustainable waste management practices. Management has also dramatically reduced the company's legal and regulatory risk by implementing best practice compliance systems, and it has taken measures to significantly lower the company's commodity price risk. Finally, Norsk Gjenvinning has been rewarded in the financial markets, completing a EUR 280 million refinancing in 2014.

Overall, Altor has laid a successful foundation for Norsk Gjenvinning to grow in an industry where sustainable waste management practices are expected to become the standard. Investors will share in this growth and will benefit from exposure to a company that is on track to become a profitable investment. It is a compelling example of how judicious allocation decisions can result in an investor "doing well by doing good."



Norsk Gjenvinning, waste recycling, Norway

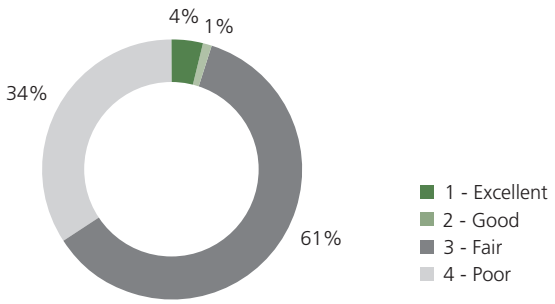
Hedge fund and long-only managers

Continued improvement in ESG ratings of hedge fund managers

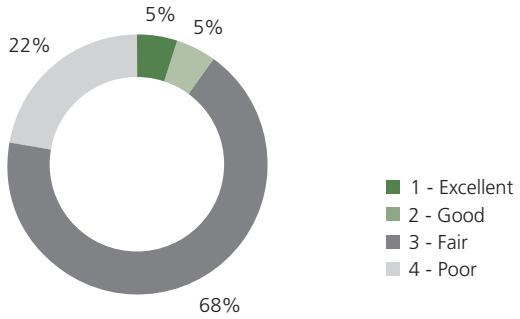
The gradual improvement in the ESG ratings of hedge fund managers that we have seen over the last few years in our portfolios has continued. The number of top-rated managers (rated 1 or 2) further increased during the year, and they now comprise 10% of all managers, with two new managers having achieved our top ratings. At the same time, the proportion of managers with our lowest ESG rating decreased by 12 percentage points to 22% of all managers this year. The significant decrease in the proportion of low-rated managers is mainly due to the fact that we removed a number of firms with low ESG ratings from our list of approved managers. Poor governance and inadequate transparency were two of the key reasons for the removals.

We also note that two of our managers became signatories to the Principles for Responsible Investment (PRI) during the last year. While they still only make up a small proportion of the total, the direction of travel is positive. Furthermore, our own involvement in PRI, through the Hedge Funds Workstream, allows us to engage with our peers in this space and to help shape ESG expectations for hedge funds. Our interview with Matthew Beddall, CIO of Winton Capital Management, in the next section of this report provides some insights into how managers are already addressing ESG.

Hedge fund ESG ratings 2015



Hedge fund ESG ratings 2016



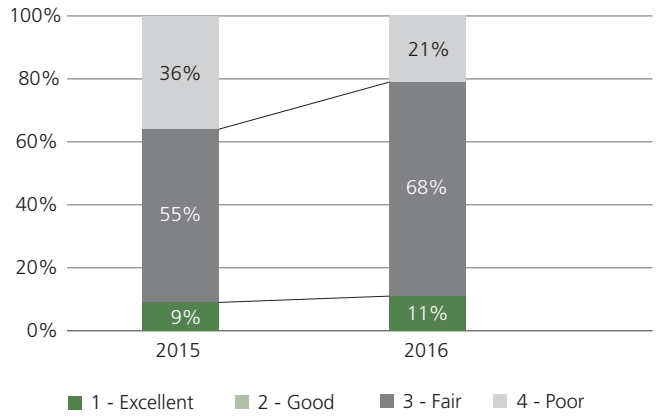
ESG ratings by hedge fund style

The improvement in ESG ratings for our full group of hedge fund managers is also evident across the various style groups, especially among our equity long/short and event driven managers. The former have established a reputation as ESG "early adopters," as many maintain well-designed proxy voting policies for ESG and manage their investments through liquid and transparent managed accounts. Managed accounts are considered ESG best practice according to guidance from PRI (see "Responsible investment and hedge funds: a discussion paper"), as they allow for direct access, liquidity, transparency as well as the exclusion of specific companies, sectors or other exposures. 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 difficult to implement. Equity long/short managers have also led the pack in their use of scoring models and other ESG analysis when defining their investment exposure. Our engagement in the hedge fund ESG space has brought us in contact with a growing number of hedge fund managers that are researching ESG scoring methodologies for equity-related strategies, and we hope to be able to show the positive results of such efforts in future ESG reports.

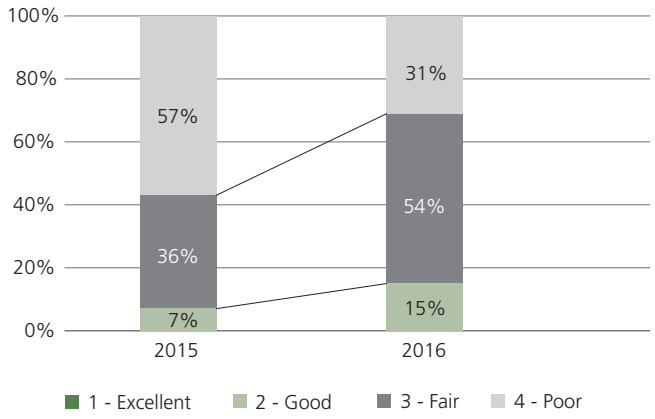
By contrast, event driven managers have traditionally been reluctant to share information on their investments and exposures. Given the nature of their strategies, their investment returns could be severely damaged if information regarding their investment targets and implementation of trades were to be published too early. This opaqueness has tended to translate into low scores on ESG. Nevertheless, our continuous engagement has led a number of our event driven managers to enhance their ESG practices by implementing managed accounts. As part of this transition, these managers had to start screening for and excluding companies involved in the production and proliferation of controversial weapons, which is one of LGT CP's requirements for managers to be eligible for inclusion on the managed account platform.

Improved ESG practices by both equity long/short and event driven managers have resulted in a significant decline in the proportion of managers with our lowest rating. For equity long/short managers, this proportion dropped to 21% in 2016, down from 36% last year, while for event driven managers the proportion fell even further to 31% over the same time period, down from 57%. We believe that these positive developments signal a shift among managers towards more ESG thinking.

ESG ratings of equity long/short managers



ESG ratings of event driven managers

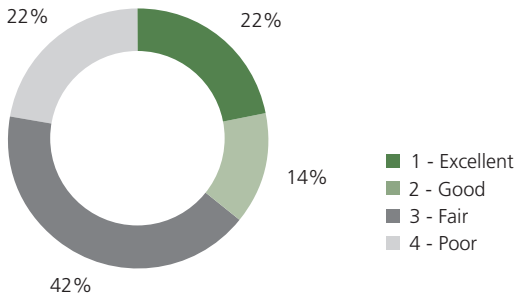


ESG practices of our long-only managers

Following the consolidation of LGT's traditional multi-manager asset management unit with LGT CP's alternative business, we have extended our ESG-scoring methodology to our long-only multi-manager business. This means that our ESG framework now covers hedge funds, traditional equity and fixed income managers, as well as insurance-linked strategies (ILS), commodity and REIT managers. Together, they comprise 115 firms with USD 10.8 billion in assets under management. This gives us the opportunity to analyze the ESG practices of the full spectrum of our liquid multi-manager portfolios.

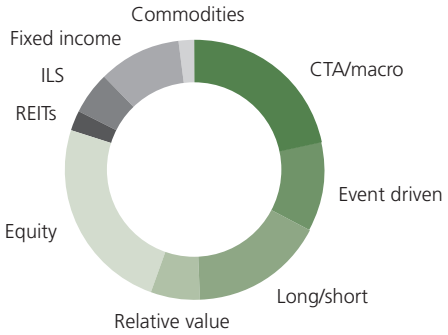
In looking at the survey data for our full set of long-only managers, we see significantly higher uptake of ESG considerations than among our hedge fund managers. A full 36% of our long-only managers have achieved our top ESG ratings of 1 or 2, while only 10% of hedge fund managers have. We get a similar picture of the differences between the two types of managers when looking at the proportion PRI signatories: 36% of our long-only managers have signed on to PRI while only 8% hedge fund managers have done so.

ESG ratings of long-only managers

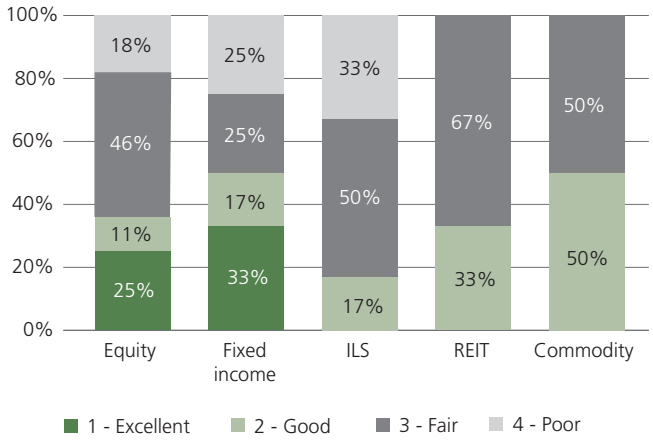


We believe that these pronounced differences stem from the fact that long-only managers have found it much easier to adopt ESG considerations in their fund operations. Such managers have the advantage of less complex investment strategies, which lend themselves more readily to ESG screening and filtering techniques, especially for equity and fixed income. With a number of reputable organizations now offering credible ESG screening solutions, long-only managers have had many options for integrating ESG factors into their investment processes, which has had the added benefit of differentiating their offerings in a crowded competitive landscape. With the global equity and fixed income asset management industry dominated by large, institutional firms, the organizational and operational costs of implementing ESG screening and filtering techniques were easily born. As a result, managers like LGT CP have had greater scope for selecting ESG-oriented managers in the long-only space than in the hedge fund universe.

Breakdown of our multi-manager portfolios



ESG ratings of long-only managers by asset class



Conclusions on hedge fund and long-only managers

While our hedge fund managers have continued to make gradual progress on ESG, the analysis of our long-only managers shows that there is a significant gap between the ESG practices of the two groups. We do not expect this gap to close any time soon, but we do know that pressure for further ESG integration is likely to increase in the years ahead. The "buy side" is dominated by the global pension fund community, which strongly encourages these managers to take ESG factors into account in their investment process. This was a view clearly expressed by institutional asset owners in a study LGT CP released in March 2015, "Global insights on ESG in alternative investing" (conducted jointly with Mercer), which showed that such investors have rising expectations for managers on ESG. This suggests that ESG is likely to keep spreading, even to those who have been the slowest in adopting it.

Interview: Matthew Beddall, CIO of Winton Capital Management, on ESG in hedge fund investing

Applying ESG criteria in hedge fund investing is an area that is still very much in development across the industry, with limited guidance from industry bodies. Even so, some managers are forging ahead based on the conviction that ESG principles are important for hedge fund investing. One of our managers, Matthew Beddall, CIO of Winton Capital Management, shared his views on the topic.

LGT CP: Winton Capital Management is one of the few hedge funds to have become a signatory to PRI. Could you elaborate on some of the reasons for joining?

Beddall: There is more than just one reason why we became a PRI signatory. For one, Winton has longstanding relationships with public and private pension funds around the world. For many, ESG is an issue which is becoming increasingly important and, as a company, we feel this is a trend that we cannot ignore. It is also worth noting that our active ownership activities – that is, proxy voting eligible equity holdings – predates our signing of the PRI by several years. In a way, becoming a signatory was already a good fit for us on the governance side. Lastly, we launched our long-only equity program seven years ago, and this meant we entered a space where ESG issues are more actively considered by investors. You could say we have widened our perspective from the one of a "hedge fund" to one of a global quantitative investment manager.

LGT CP: We understand that you are applying ESG criteria in the modeling of some of your equity programs. Could you share some of your insights on this?

Beddall: We have always focused on highly liquid exchange-traded instruments, which means that we were already at a good starting point from an ESG perspective. In addition, we have always had a formal committee that approves changes to our investible universe, and ESG criteria have therefore been introduced as an additional check for some investment programs. Winton's approach is fully systematic, and models are being developed through rigorous statistical research, which involves very long and consistent data series that are cleaned by our data team. On the big question of "alpha," we have to say that we haven't fully tackled the question of whether ESG impacts a stock's risk and return. This will require much more research time. Our initial focus is to create a database on governance-related factors, in the hope that we can find empirical evidence of a link between good governance and share price performance.

LGT CP: ESG involvement also includes important steps to be taken on the corporate level (i.e. good corporate governance). What did this entail for Winton and was this difficult to implement?

Beddall: Winton is a regulated company and – as a matter of fact – always has been. Our investment approach is very process- and protocol-oriented as well, which is perhaps different from what the public might expect of a "hedge fund." For us, it was a normal evolution to have our corporate and governance structure reflect best global practice. The implementation of a separate executive committee and a board for the management company follows this evolution. These currently consist of an independent chairman (the recently appointed Sir David Walker) and non-executive directors from a variety of backgrounds.

Within the organization, key decisions are channeled through formal committees with clear responsibilities and minuted meetings. Ultimately, it reflects common sense to clearly separate out lines of responsibility and have formal committees in place to ensure an audit trail. As mentioned before, all of this is compatible with our investment process and company culture.

LGT CP: Do you see a general movement in the hedge fund space for greater adoption of ESG and do you anticipate greater demand from investors?

Beddall: It is perhaps too early to tell and we might also not necessarily be best placed to make any predictions, but we have seen a lot of focus on governance from our investors in the last few years. That said, we felt our approach to communicating the risks inherent in our strategy and investment style to investors have been well received. This fits well with the PRI guidelines for hedge funds.

Public equity and fixed income

LGT CP has a long-established framework in place, dating back to 2009, for assessing ESG risks and opportunities in public equity and fixed income portfolios. It is built around a process aimed at excluding ethically controversial activities, while identifying and selecting securities of companies with high ESG standards. Our aim is to provide investors with exposure to companies or entities that contribute to a sustainable improvement in human well-being and create long-term financial value. The process drives the investment decision-making of our dedicated Sustainable Equity and Bond Funds.

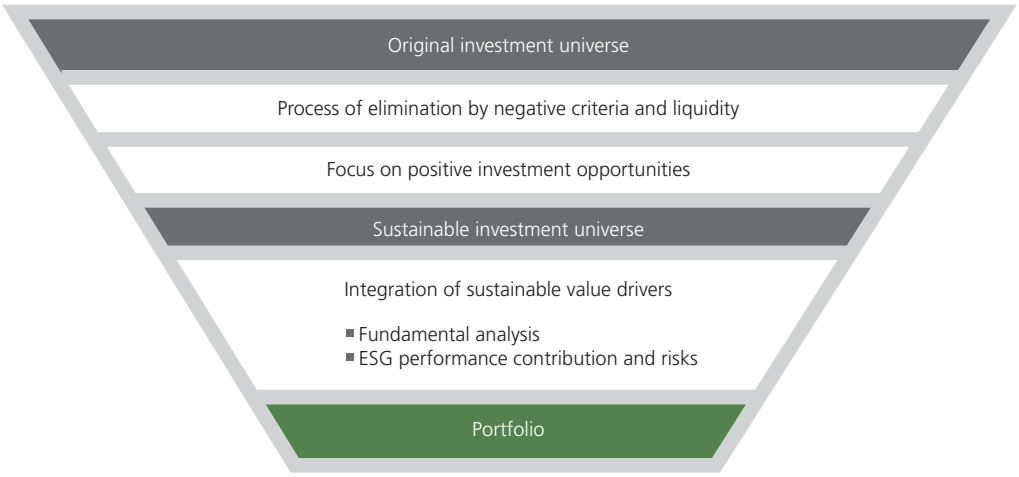
Our ESG selection process begins with eliminating issuers of securities that are involved in controversial business activities or fail to meet certain minimum standards. We exclude companies that generate significant earnings from tobacco, gambling, arms, pornography, nuclear energy, or which are involved in child labor. For government bonds, we eliminate countries that exhibit significant shortfalls with respect to human rights, rule of law and democracy, tolerate high levels of corruption or have not signed international conventions on controversial weapons. We also use an ESG indicator set to identify attractive investment opportunities, focusing on companies with business models that can benefit from climate change, social development or improving governance standards. The resulting company selection forms the basis for our sustainable investment universe. As a final step, we integrate ESG value drivers into classical financial analysis to select individual securities for the portfolio.

ESG Cockpit drives the analysis

The engine of our sustainability selection process is LGT CP's proprietary analysis tool known as the "ESG Cockpit." This tool draws on publicly available ESG data from a variety of well-established information providers, such as Thomson Reuters and Inrate, to generate ESG scores for individual securities. For example, our company analysis focuses on factors for which information is sufficiently widely reported to allow for meaningful comparison between companies. In doing so, we examine approximately 50 key performance indicators (KPIs) per company across the three themes of environmental, social and governance. The majority of these KPIs are the same across all companies, which allows for consistent scoring across the investment universe. However, some are sector specific, such as "R&D investment in eco-designed products and services" in the industrial sector. This enables us to fine-tune the analysis for specific sectors where certain KPIs offer keener insights on the ESG characteristics of the company.

Each KPI is assigned a score between 0 and 100 based on LGT CP's proprietary scoring algorithm. The performance is assessed in most cases against all other companies in our universe, but also against the closest industry peers for specific KPIs. The ESG indicator score is then aggregated into overall scores for each of the E, S and G themes. These are then combined for an overall ESG score for the company. The decision to exclude or positively select a company is based on this overall score. Scoring provides a consistent, quantitative approach for defining a universe of possible companies for our portfolio managers, who then select individual assets based on further in-depth analysis of ESG and financial criteria. Overall, the approach combines quantitative analysis with the sound judgment of an experienced investment professional to develop a well-diversified portfolio with robust return drivers.

Security selection process according to ESG criteria



Environmental impact

A key aspect of ESG analysis of companies is the environmental impact of their operations. This is especially true today for the most challenging environmental topics humanity faces: climate change and greenhouse gas emissions. To assist investors with understanding the environmental impact of their portfolios, we have measured the carbon footprint of our investment portfolios together with other key environmental impact data. We have also compared this with the results of global benchmarks, so our investors can better understand the environmental impact of their investment decisions.

LGT CP portfolio and the benchmark by industrial sector in Table 2. It shows the contribution of each industry sector to the total. We have further decomposed the portfolio's overall emission reduction versus the benchmark into a sector allocation effect (the effect of our sector weightings versus the benchmark) and a stock selection effect, which results from picking individual stocks within the different sectors.

The interaction of the sector allocation and stock selection effects can be seen most clearly, for example, in the utilities sector. LGT CP's portfolio construction overweights this sector, with an emphasis on companies focused on renewable energy. At the same time, power production from fossil fuels, especially coal, is underweighted. As a result, the utility stocks in the LGT CP portfolio emit considerably less greenhouse gas than the benchmark: an average of 383 metric tons versus 2,315 metric tons for the benchmark (on an unweighted basis). The same effect can be seen in most of the other sectors, resulting in the total emission reduction for the LGT CP portfolio of 44% versus the benchmark.

Table 1: Environmental footprint of LGT Sustainable Equity Strategy vs. MSCI World Index[1]

	Greenhouse gas emissions	Energy consumption	Water consumption
Unit / year	metric tons CO_2 equiv./USDm	MWh/USDm	m^3/USDm
LGT CP portfolio	92	272	2,978
MSCI World	165	530	14,658
Reduction	73 (44%)	258 (49%)	11,680 (80%)

Table 1 shows aggregated values for the environmental metrics of both the LGT CP portfolio and the benchmark. All numbers are normalized by company sales to make the data comparable. The figures show that the LGT CP portfolio has an environmental footprint that is 44–80% lower than the benchmark, depending on the metric analyzed.

To provide a deeper insight on how this reduction is achieved, we have broken down the greenhouse gas emissions of the

Table 2: Decomposition of greenhouse gas emissions of LGT Sustainable Equity Strategy vs. MSCI World Index

	Greenhouse gas emissions (metric tons CO_2 equiv./USDm)				
	LGT CP portfolio	Benchmark	Sector allocation effect	Stock selection effect	Total emission reduction
Utilities	383	2,315	12.8	-66.1	-53.3
Materials	351	715	7.7	-17.8	-10.1
Energy	296	389	2.4	-6.2	-3.8
Industrials	91	128	-3.0	-1.7	-4.7
Consumer staples	63	59	9.4	0.6	10.0
Consumer discretionary	32	57	-4.0	-2.0	-6.0
Telecommunication services	61	45	1.7	1.7	3.4
Information technology	12	26	-1.9	-1.2	-3.1
Health care	18	29	0.4	-1.5	-1.1
Financials	16	19	-3.3	-0.6	-3.9
Total	**92**	**165**	**22**	**-95**	**-73**

[1] Per USD million of sales. Source: Thomson Reuters

Significantly better ESG score than the benchmark

Our ESG scoring system enables us to analyze entire portfolios to see how they compare with a benchmark portfolio of securities that have not had the benefit of ESG analysis. As Table 3 shows, the LGT Sustainable Equity Strategy outperforms its MSCI World benchmark on each of the E, S and G themes, ranging from 5% (governance) to 25% (environmental), with an overall ESG outperformance of 13% across the three factors. These higher scores indicate that, on the whole, the companies in the LGT CP portfolio have better processes for managing environmental, social and governance issues across their businesses, which should result in lower long-term risks for investors and additional return opportunities.

Conclusions on public equity and fixed income

At LGT CP, we are convinced that subjecting investments to rigorous ESG assessment helps to enhance their long-term risk and return profile. The performance of LGT CP's dedicated sustainability offering bears this out. In comparing LGT CP's sustainability funds with a broad market benchmark (including both other sustainable funds and traditional funds), the LGT CP funds place in the first or second quartile of their respective peer groups over different time horizons.[2]

Table 3: Overall ESG footprint of LGT Sustainable Equity Strategy vs. MSCI World Index

	Overall ESG score	Environmental	Social	Governance
LGT CP portfolio	71	71	77	68
MSCI World	63	57	67	65
Improvement	8 (13%)	14 (25%)	10 (15%)	3 (5%)

[2] Source: Morningstar. Data as of 29 February 2016, net of all fees. Universe: Registered funds in Austria, Germany, Switzerland and Liechtenstein. Peer group for LGT Sustainable Equity Strategy: global large-cap blend equity. Peer group for LGT Sustainable Bond Strategy: global bonds. Past performance is not a guarantee, nor an indication of current or future performance.

Green bond investing

What is a green bond?

Green bonds have the same characteristics as regular bonds, but they are used to finance climate-related or environmental projects. The bonds have the same credit risk as the issuer's other bonds with the same rating, and investors are exposed to the credit risk of the issuer, but not to the risk of the underlying project. Maturity, coupon and pricing are in line with those of ordinary bonds and are not linked to the duration or characteristics of the underlying projects. Issuance sizes have often been relatively small for green bonds, but these have been increasing over the past years in order to provide market liquidity for investors. The performance of underlying projects does not directly affect the creditworthiness or redemption of the green bond.

Example: renewable energy project Iberdrola (EUR 750m, maturity: October 2022, coupon: 2.5%)

Iberdrola is a Spanish energy supplier serving the UK, the US, Mexico, Brazil and Spain. The firm is issuing a green bond to refinance previous investments in projects related to renewable energy, transmission, distribution and smart grids. This infrastructure will contribute to the transition to a low-carbon and climate-resilient economy, in line with the firm's sustainable development commitments. (Source: Vigeo; second party opinion)

LGT CP and green bonds

LGT CP has invested in green bonds for a selection of our fixed income funds in order to incorporate ESG themes into our investments. The proceeds of green bonds are 100% directed to various types of green projects. Since the investor can maximize the green impact without being exposed to related project risks, LGT CP views investments in green bonds as a low-risk but high-impact alternative in the fixed income space.

LGT CP's sustainable fixed income funds currently hold a significant share in green bonds issued by corporates such as Iberdrola and Engie as well as by development banks and agencies such as EIB, KFW or IBRD. Green bonds are subject to close scrutiny prior to investment in order to ensure that they comply with commonly accepted green bond principles. LGT CP also considers second-party ESG opinions on the project and requires the issuer to confirm that they follow ESG best practice.

LGT Bank, solar system, Liechtenstein

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 investment 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 United Nations Principles for Responsible Investment (UN PRI) since 2008, as well as a member of the Asian Corporate Governance Association (ACGA) since 2010. LGT CP also participates in CDP and Eurosif.

LGT CP's commitment to ESG are 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. Furthermore, in line with the expectations we place on our underlying managers, we embed ESG principles in our organization through various initiatives, as shown below.

Environment

- Have reduced LGT´s carbon footprint by 30% since 2010, when the firm became carbon neutral. Offset emissions by supporting a small-scale hydropower project in Honduras
- Committed to reducing its carbon footprint further with energy efficiency measures and the purchase of renewable energy
- Procurement of materials produced in an environmentally and socially responsible manner using LGT´s systematic supplier risk management framework

Social

Support for LGT Venture Philanthropy

- Initiative aimed at improving the quality of life of less advantaged people around the world
- Applies the tools and processes of venture capital to fund and provide expertise to social enterprises in the developing world
- Supports an active portfolio consisting of 32 social organizations in 19 countries, focusing on health and sanitation, education, renewable energy, nutrition, forestry, and information and communications technology

LGT Employee Volunteering Program

- Supports employees who wish to volunteer their time to help less advantaged people in their own communities

Governance

- Although privately held, LGT Group is committed to transparency and makes its audited accounts publicly available through an annual report
- Employees are bound by a written code of conduct that puts client interests first and ensures high ethical standards
- Well-defined separation of powers is built into the governance structure, with appropriate checks and balances between the Board of Trustees and various company management boards

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