

# Responsible Investing

## Annex to Sustainability Preferences Questionnaire

2022




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# ANNEX TO THE ESG PRACTICAL GUIDE TO THE SUSTAINABILITY PREFERENCES QUESTIONNAIRE

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## 1. What is ESG Investing?

ESG Investing means taking Environmental, Social, and Governance factors (ESG Factors) into account when selecting investments to better understand their exposure to sustainability risks or opportunities. This process usually focuses on the assessment of the aspects that are more relevant for the specific investment, selecting them across the E, S, and G categories, such as:

- **Environment:** Emissions of greenhouse gases, energy consumption, exploitation of resources, waste and water management, impact on ecosystem and biodiversity;
- **Social:** Human rights and human capital standards; Diversity, Supply chain labour standards; Health and safety risks; Privacy and data protection; Demographic risks; Social commitments in the company's local community; Responsible marketing; Access to basic goods and services;
- **Governance:** Overall governance factors of a company for decision-making such as Business Code of Conduct and Values; Business integrity, principles, and responsibilities to meet and align the interests of internal and external stakeholders; Risk management and security measures; Governance rules against bribery and corruption; fair and transparent remuneration policies; General disclosure and transparency standards.

To put ESG factors into more concrete terms:

- **The “E”** is about the way a company interacts with the external environment and the world's natural resources. There are three important perspectives to consider which are included in the “E”. First, the negative impact that a company's activities can have on the natural environment (for example, intensive or inefficient resource management, pollution, energy use). Second, the impact on the same company's activities and business model resulting from physical environmental risks, such as climate change (increased temperatures, floods, droughts, natural disasters). Third, the impact of transition risks that might emerge from stricter regulations or different consumer behavior. The aim of the assessment is to capture the company's ability and preparedness to make the necessary transition to a more environmentally friendly business model (for example, how easily can a company transition to a less carbon-intensive footprint). E factors are usually more relevant for companies belonging to sectors with significant environmental impact, such as Mining, Energy, and Agriculture.

- **The “S”** is about the way a company affects society and its various stakeholders, such as its employees, its consumers, its suppliers or contractors, and the wider communities in which it operates or sells products or services. There are typically two main predominant themes in this category. The first theme concerns how a company promotes good employment conditions to attract talent and how effectively manages the social rights of its workers, such as health and safety, protection from discriminatory practices, and employment safeguards, but also how it monitors its supply chain under similar considerations. The second theme considers the impacts of its products and services on consumers and the wider society, and to what extent the company seeks to transition away from those products or services that create harm or other negative externalities. S factors are usually more prominent for sectors requiring high intellectual capital or producing products for personal consumption, such as financials, pharmaceuticals, or food producers.

- **The “G”** relates to corporate governance and business integrity, and how a company manages its business through internal policies and controls to comply with applicable norms and to effectively prevent and manage corruption or bribery risks to which it could be exposed. Governance aspects are transversal to all sectors.

In summary, using exposure to climate change and greenhouse gases as an example, an ESG assessment would seek to capture three main aspects:

- How is a company negatively or positively impacting Climate Change?
- What are the financial and regulatory risks or the opportunities that might arise because of the above?
- What is the company doing to mitigate its negative impacts or to strengthen its competitive position?

The outcome of the ESG assessment is usually determined with a directional rating expressed in numbers or letters. Companies which are highly rated from an ESG standpoint are those which actively contribute to reducing their negative impact or which are considered to positively contribute to sustainability aspects, measured with the different indicators across the E, S, and G categories.

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## 2 Can you provide me more information on the EU Taxonomy?

The Taxonomy is a central regulatory initiative at the heart of the EU Sustainable Finance Action Plan<sup>1</sup>. One of the objectives of the Taxonomy is to create a common language across companies, investors, financial market participants, and policymakers, as to what sustainability means. To this end, it aims to increase, in an objective and measurable way, how entities report on the sustainability features of their economic activities. This helps investors who are interested in ESG investing to have a clear, objective, and comparable framework to consider the ESG features of a company.

Under the Taxonomy, the Non-Financial Reporting Directive<sup>2</sup> and the related and upcoming Corporate Social Reporting Directive<sup>3</sup>, companies subject to those regulations will be required to perform a due diligence to evaluate which of their activities can be considered as “Taxonomy-aligned”.

This will require that these activities meet the four conditions of the Taxonomy: “contributing substantially” to one or more of the environmental objectives; meeting technical screening criteria; not doing any significant harm to any of the environmental objectives; and complying with minimal Social and Governance safeguards<sup>4</sup>.

Companies will be required to also report a set of key performance indicators (Turnover, Operational expenditures, and Capital expenditures) further detailing the Taxonomy-alignment of these activities.

It is important to understand that the Taxonomy is, itself, a regulatory framework that will evolve in the coming years, which means that the reporting of companies’ activities against those requirements will progress as well. Below are a few additional explanations on this state of evolution.

- First, as of 13 July 2022, the technical screening criteria have only been issued for 2 of the 6 objectives

(for Climate Change Mitigation and Climate Change Adaptation). As a result, some companies may not be able to see some or all activities to the other environmental objectives of the Taxonomy.

- Secondly, the sectoral coverage of the Taxonomy currently covers 13 economic sectors<sup>5</sup>. This means that some companies’ activities may not have any or only partial coverage in the current Taxonomy. Also, the Taxonomy is itself subject to ongoing review: this means that new activities can be added, and that requirements (for example, the technical screening criteria) can change. This, in turn, can affect how companies’ activities are reported to be aligned with the Taxonomy.
- Thirdly, the scope of entities subject to the Taxonomy is evolving. Whilst a limited number of entities in Europe are already subject to some reporting under the Taxonomy, the upcoming Corporate Sustainability Reporting Directive (CSRD) aims to increase this reporting to a significantly larger number of entities. Still companies which are not established or active in Europe may not be required to report their Taxonomy-alignment, even if they might be subject to other similar regulatory regimes in other jurisdictions.
- Fourthly, reporting of Taxonomy-alignment by corporate entities will take off progressively between 2022 and 2024. It is important to note that, when entities report, they take a backward-looking view (looking at the past financial year for example), which may not necessarily be indicative of how their future Taxonomy-alignment reporting will be. During this period, it is expected that the reporting by companies of their Taxonomy-alignment (on a revenue base) will be initially very low but will increase as companies perform their due diligence, assess their activities, and possibly even transform some of their activities to be more Taxonomy-aligned.

- Fifthly, during the years 2022 and 2023, reporting on Taxonomy-alignment is also expected to be very low across corporate entities in scope, but expected to regularly increase.

- Finally, there is no “Social Taxonomy”. This is currently under consideration and development by the EU Authorities.

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1 For more information on the EU’s Sustainable Finance Initiatives, please visit the EU Commission’s website at: [https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/overview-sustainable-finance\\_en](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/overview-sustainable-finance_en)

2 Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups

3 See the Proposal for a Directive of the European Parliament and of the Council, amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting

4 These minimum safeguards are procedures that the company conducting an environmentally sustainable economic activity must follow and that must be aligned with the following international instruments: the International Bill of Human Rights (the Universal Declaration of Human Rights and the UN Covenants on Civil and Political Rights and on Economic, Social and Cultural Rights); the International Labour Organization Declaration on Fundamental Rights and Principles at Work; the UN Guiding Principles on Business and Human Rights; and the OECD guidelines for Multi-National Entities.

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5 As of 13 July 2022, the Taxonomy covers 13 sectors: Forestry; Environmental protection and restoration activities; Manufacturing; Energy; Water supply, sewerage, waste management and remediation; Transport; Construction and real estate; Information and communication; Professional, scientific, and technical activities; Financial and insurance activities; Education; Human health and social work activities; and Arts, entertainment, and recreation. Please note the Taxonomy applies only to sub-sectors and not all sectors of activities.

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All of this means that, as an investor, if you express a Sustainability Preference to have some Taxonomy-alignment in your Portfolio, this Preference will be subject to how companies in which you invest are subject to, and report on, their Taxonomy alignment. Reporting by companies on their Taxonomy-alignment will progressively increase and may also vary from year to year. In particular, if you are invested in a fund which commits to make “environmentally-sustainable investments” (i.e. Taxonomy-aligned) and which is subject to the SFDR, the fund will be expected to report on its commitments to making “environmentally sustainable investments” starting in 2023, and, in periodic reporting thereafter, on the actual Taxonomy-alignment of its holdings. We expect Taxonomy-alignment figures reported by such funds to start at relatively low levels in 2023 and steadily increase in time as data and corporate reporting develop further.

### 3. Why could investors be interested in applying ESG factors in their investment approach?

The main reasons usually considered by investors are one or more of the following, which are not mutually exclusive:

- **Positive contribution:** investors could be interested because they think that they can collectively push companies to improve. While this can be sometimes difficult to measure, this can happen because companies benchmark themselves against their peers which may be more “ESG-advanced” and decide to improve their ESG profile to collect more investments or to strengthen their competitive position. This can also happen as from engagement activities performed individually or collectively by asset managers or by voting at the company’s annual general meetings.
- **Alignment with their personal values:** investors can decide that they don’t want to finance companies or sectors they think are not aligned with their values or where they see risk of contradicting some principles they subscribe to. They might for example, wish to be invested avoiding certain sectors such as fossil fuels, arms, tobacco, and alcohol, or in companies subject to controversies or litigation relating to certain business or labour malpractices or negative environmental impact. Alternatively, they may wish to reinforce certain sectors, companies, or activities that aim to have a positive contribution to sustainability factors that more closely resonate with their beliefs.
- **To improve risk-adjusted returns:** investors can think that capturing additional information on companies can lead to better risk control or improved performance. Companies with a stronger focus on the management of risks related to environmental, social, or governance factors can exhibit lower levels of risks, such as

operational and reputational ones. By focusing on those companies with better ESG practices, investors aim to reduce the overall risk of their portfolio, thereby improving their risk-adjusted performance. The focus of those investors is therefore usually not to massively exclude companies or sectors, but to better understand if the price of an investment correctly reflects all the available financial and extra-financial information.

### 4. What are the main approaches to considering ESG factors in investing?

**There are two main approaches. They are not mutually exclusive and can coexist or be mixed together.**

The **first approach** is more “activity-based” or thematic. It consists of making investments in companies which have measurable activities, products, or objectives aiming to positively contribute to either environmental or social goals. This strategy is well known to investors who invest in companies, funds or ETFs which are active in specific sectors such as water, clean energy, or microfinance which are deemed to have activities influencing sustainability topics, and the financial performance of which is expected to be strengthened by the sustainability trend that should drive additional investments and inflows into the companies concerned.

These investments are often focused on one or more of the following activities:

On the environmental front:

- Climate protection
- Adaptation to climate change
- The sustainable use and protection of water and marine resources
- The transition to a circular economy
- Pollution prevention and reduction
- The protection and restoration of biodiversity and ecosystems

On the social front:

- Combating inequalities and promoting social cohesion
- Supporting economically or socially disadvantaged segments of the population

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In some cases, the sustainable activities of companies are assessed under the framework of regulations such as the Taxonomy which provide for strict guidelines – for example, a solar panel producer producing panels which must respect technical specifications. In other cases, companies have a comparable contribution to environmental or social objectives, even if the measurability of their approach is less precise than the first group of companies – for example, a pharmaceutical company having implemented a program to facilitate access to medicine in poor countries.

The **second approach** is more “behavior based” and consists of making investments in companies which demonstrate a positive attitude and consideration of ESG factors, and which seek to strengthen their role by minimizing negative externalities on the way they do business and by better serving stakeholders’ needs. For example, companies can aim to reduce their carbon emissions or optimize their waste management processes, and, by doing so, they reduce

the negative impact that their activities can cause on the environment or society in general. This second investment approach can also consider additional ethical screening and remove companies involved in controversial activities.

The approach doesn’t usually have specific bias against sectors or against the main reference benchmarks, even if controversial activities or sectors (weapons, coal, fossil fuels, gambling etc.) are very often under-represented or even absent. This second approach which aims to promote better social or environmental practices can apply different strategies, illustrated more in details further below.

## 5. What are the main strategies to implement ESG investing?

There is no one size-fits-all strategy to ESG Investing, and the related regulatory standards and product offerings, are in a state of constant evolution. The below illustration provides you a description of the main strategies developed on the market.

Pre-investment decision				Pre-investment decision		Pre-investment decision	
Exclusions	Norms-Based Screening	Best-in-Class	ESG Integration	Exclusions	Norms-Based Screening	Best-in-Class	ESG Integration
Mainly ethical decision, alignment of investments with personal / company values	Mitigation of sustainability risks (but also includes potential opportunity costs)	Portfolio optimized for financial and sustainability performance.	Active voting and engagement to motivate companies to improve their financial and sustainability profiles	Invest to have impact			
Examples: <ul style="list-style-type: none"> <li>• Exclusion of controversial weapons producers</li> <li>• Exclusion of companies in breach of UNGC*</li> <li>• Exclusions of Tobacco / alcohol / gambling etc.</li> <li>• .....</li> </ul>	No sector exclusions, but invest only in best ESG companies across every sectors	The approach balances ESG considerations with financial data => better assessment of how ESG risk / opportunities are discounted by financial markets.	The approach exploits the ownership rights embedded in equity ownership to vote at AGMs or discuss with management to promote better ESG practices.	Invest to have impact financing companies or projects with a strong sustainability focus e.g. solar panels, plant based meat, regenerative agriculture, microfinance, timber.			

Source : Swiss Sustainable Finance, EFGAM. \*UNGC: United Nation Global Compact principles

These strategies can be described as follows:

→ **Exclusions:** Strategies applying Sector/Norm-based exclusions, which will exclude from their selection process certain sectors, companies or countries based on certain criteria that can be based on product categories (e.g. weapons, tobacco), company practices (e.g. animal testing, violation of human rights, corruption) or controversies;

→ **Norms-Based Screening:** Strategies excluding from their screening process companies (or government securities) failing to meet internationally accepted norms relevant to sustainability, such as the Kyoto Protocol or the UN Declaration of Human Rights, United Nation Global Compact or OECD Guidelines for Multinational Enterprises.

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- **Best in Class:** Strategies setting positive screening techniques to select companies or countries with the best practices in specific sustainability areas.
- **ESG Integration:** Strategies including sustainability information alongside financial information in their investment selection process.
- **Stewardship (voting or engagement):** Strategies seeking to use shareholder or investor power to influence corporate behaviour (for example, through communications with the management, or in shareholder voting);
- **Thematic investing:** Strategies investing in companies because belonging to sectors that positively contribute to the advancement of an environmental or social objective;
- **Impact investing:** Strategies investing to achieve positive social and environmental impacts with measurable indicators.

## 6. What are the asset classes that can be used for ESG Investing?

With respect to investable asset classes, ESG investing can be achieved across a wide number of asset classes such as equities or bonds, both listed and unlisted. Investors can make direct investments into companies or government debt, or they can choose to go through investment funds or portfolio management mandates.

## 7. Is there a positive link between investment performance and the management of sustainability risks?

It is difficult to find a clear and definitive answer to the question given how many existing variables need to be considered, such as different rating systems using multiple datapoints with different weights, different approaches or strategies applied to various market conditions and in different timeframes, and with varying financial factors driving financial performance.

If you want to find supporting elements to this question, please be aware that the academic and financial world has invested significant time and efforts to better understand

the links, if any, between ESG factors and financial performance, and multiple studies or meta-studies are available. A research paper on the relationship between ESG factors and financial performance was published in August 2021 by the New York University Stern Center for Sustainable Business in collaboration with the Rockefeller Asset Management examined more than 1,000 research papers from 2015 – 2020<sup>6</sup>, and found a correlation between ESG factors and financial performance. This was applicable to both thematic or activity-based strategies and to behavior-based ones.

## 8. How do I know if my ESG Investments have made a positive contribution to the environment, society, or governance factors in the world?

The assessment of the positive contribution of ESG Investments to the real world is difficult to demonstrate. In some cases, particularly when the ESG Investment strategy consists in an exclusion strategy, the positive contribution is hardly demonstrable. It can become slightly more measurable when engagement or voting strategies are applied to the strategy.

A 2020 research paper from the Center for Sustainable Finance and Private Wealth of the University of Zurich<sup>7</sup> concluded that the positive impact of shareholder engagement is well supported in the literature, the impact of capital allocation only partially, and indirect impacts (such as stigmatization or endorsement) lack clearly measurable outcome but still help spread good business practices.

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6 See Tensie Whelan, Ulrich Atz and Casey Clark, "ESG and Financial Performance: Uncovering the Relationship by Aggregative Evidence from 1'000 Plus Studies Published between 2015-2020", available at: [https://www.stern.nyu.edu/sites/default/files/assets/documents/NYU-RAM\\_ESG-Paper\\_2021.pdf](https://www.stern.nyu.edu/sites/default/files/assets/documents/NYU-RAM_ESG-Paper_2021.pdf)

7 See Julian F. Kölbel, Florian Heeb, Falko Paetzold, Timo Busch, "Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact", June 2020, available at: <https://www.csp.uzh.ch/dam/jcr:d1d7a28e-10de-40d1-99e2-344fe60709ac/Can%20Sustainable%20Investing%20Save%20the%20World%20-%20%20Organization%20and%20Environment.pdf>

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