January 2023

# Approach to SFDR sustainable investment for Traditional Asset Classes
# AXA Investment Managers

## Document's objective

The objective of the document is to help our clients to understand how AXA IM defines "sustainable investment", as required by the EU Sustainable Finance Disclosure Regulation (SFDR) in its article 2 (17). The document presents the methodology used by AXA IM Core on traditional assets to qualify an issuer as sustainable under SFDR for Article 9 financial products that invest 100% of eligible assets in sustainable investments (eligible assets exclude investments used for hedging or related to cash held as ancillary liquidity), and for Article 8 financial products that can invest partially in sustainable investments.

Disclaimer: In a context of recent implementation of sustainable finance regulatory requirements in the EU which is expected to improve over the next years, the presented approach is subject to change.

# AXA IM's Approach to SFDR Sustainable Investment

## 1. SFDR Regulatory Definition of Sustainable investment

Regulatory definition of sustainable investment is mentioned in SFDR article 2 (17):

'Sustainable investment' means an investment in an economic activity that contributes to an environmental objective[1], as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective[2], in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance;

To qualify as a sustainable investment, an investment has to meet the following criteria:

1. Contribute to an environmental or social objective, *e.g., measured by indicators for use of energy, renewable energy, raw materials, water and land, the production of waste, and greenhouse gas emissions, or based on its impact on biodiversity and the circular economy; or a* ***social objective****, e.g., tackling inequality or fostering social cohesion, social integration, or labor relations, or in human capital or economically or socially disadvantaged communities*";
2. Do No Significant Harm: respect of "Do No Significant Harm" principle (DNSH) on other environmental or social sustainability factors is widely interpreted as requiring to adopt an approach to assess and take into account principal adverse impacts based on principal adverse impact (PAI) indicators[3] and whether the issuer adheres to the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights;
3. Good Governance: demonstrate that investee follows good governance practices, requiring to have a policy to assess good governance practices (sound management structures, employee relations, remuneration and tax compliance).

SFDR article 2 (17) provides a wide definition of what a sustainable investment is, leaving some room for interpretation and implementation. In the absence of clarity, market norms are developing to fill the gaps on the methodological approach to qualify investments as sustainable. AXA IM approach is detailed in the following sections.

In developing our own interpretation at AXA IM, aiming to highlight our RI convictions but also to facilitate comparability for our clients, we aim to:

[1] Financial products which have as an objective a positive impact on the environment and society (Preamble (21).

[2] Idem, but in relation a social thematic.

[3] Indicators from Table 1 of SFDR Regulatory Technical Standard (RTS) Annex I, and any additional relevant indicators from Table 2 and 3 of RTS Annex I.

- Follow the high-level principles of the "target" EU Taxonomy, based on related communications made by the European Commission. This includes creating agreed and shared criteria to assess whether activities are genuinely contributing to a future net-zero economy, applicable to corporates as well as financial market participants[4];
- Rely on existing and widely-acknowledged standards as an interim proxy, based on the contribution to United Nations Sustainable Development Goals (UN SDGs), the Science Based Targets initiative (SBTi) and the nature of issuance (for green, social and sustainability bonds, and sustainability-linked bonds).

# 2. Contribution to an environmental or social sustainable objective

AXA IM sustainable investment framework for Traditional Asset Classes is based on 2 dimensions:

i) Positive contribution to the UN SDGs; or
ii) Commitment to a decarbonization transition pathway illustrating issuers' strategy to align their activities with the Paris Agreement's goals

AXA IM sustainable investment framework also applies specific requirements for the DNSH and good governance criteria, presented in more details in the following sections.

Contribution to each sustainable objective (i) Contribution to UN SDG, (ii) Decarbonization is described as follows.

For Green, Social and Sustainable Bonds (GSSB) and Sustainabiliity Linked Bonds (SLB), the approach is detail in section 5.

## 2.1 Contribution to the Sustainable Development Goals of the United Nations

The UN SDGs have been developed in 2015 and span 17 sustainability environmental and social goals to be reached by 2030. They recognize that ending poverty and other deprivations must go hand-in-hand with strategies that improve health and education, reduce inequality, and spur economic growth – all while tackling climate change and working to preserve our oceans and forests.[5]

### *2.1.1 Quantitative approach*

AXA IM has developed a quantitative framework based on the assessment of investee companies' contribution to the achievement of UN SDGs. AXA IM uses ISS SDG Oekom data as an external data provider, that rates the extent to which companies are managing negative externalities in their operations across the entire value chain to minimize negative impacts, while at the same time making use of existing and emerging opportunities in their products and services to contribute to the achievement of the Sustainable Development Goals.

[4] Please note that EU Taxonomy aligned investments are *de facto* deemed sustainable. However not all sustainable investments are EU Taxonomy aligned. For more details on EU Taxonomy aligned investments, please see to our Article 8 and Article 9 funds periodic reporting disclosures: Funds - AXA IM Global (axa-im.com)

[5] Source: sdg.un.org

Quantitative contribution to UN SDGs:

Most SDGs can be addressed through the economic activities operated by the investee companies, those are called “Products and Services based” SDGs.

A few SDGs are viewed as more appropriatly assessed through excellence of corporates’ business practices or operations (“Operation based SDGs”). Those SDGs that are predominantly Operations based are:

| | |
|---|---|
| SDG 5 | Gender equality |
| SDG 8 | Decent work |
| SDG 10 | Reduced inequalities |
| SDG 16 | Peace & Justice |

SDG 12 “Responsible production and consumption” can be addressed through the Products & Services or the way the investee company carries their activities (both a “Operation based SDG” and a “Products and Services based SDG”).

SDG 17 “Strengthen the means of implementation and revitalize the Global Partnership for Sustainable Development” is not taken into account in the quantitative framework.

Under the defined quantitative model, an issuer is considered to be contributing to a UN SDG provided that:

- The “Products and Services Overall Score” (PSS Score) offered by the issuer is equal or above a score of 0, and at least one of its “products and services” based SDG has a PSS Score equal or above 2, corresponding to at least 20% of their revenues being derived from a sustainable activity, or
- The issuer’s SDGs Overall score is above or equal to 0 and using a best in universe approach consisting of giving priority to the issuers best rated from a non-financial viewpoint irrespective of their sector of activity on the Operations score (Ops) [6]
    - At least one of its “Products and Services oriented” SDGs has an Ops score above the top 2.5% threshold, or
    - At least one of its “Operations oriented” SDGs has a Ops score above the top 5% threshold.

The assessment is done at the entity level and an investee company that satisfies the contribution to UN SDG criteria outlined above is fully considered as sustainable.

### *2.1.2 Qualitative approach*

Acknowledging the fact that SDG data and methodologies are still in the works, this quantitative approach is **supplemented by qualitative research** performed by AXA IM Core Impact Research.

The analysts assess the companies’ **positive contributions to environmental and social objectives** (and the corresponding UN SDGs). This research is notably guided by AXA IM's approach to impact investing in listed assets (https://www.axa-im.com/who-we-are/impact-investing) which highlights several key factors (intentionality, materiality, additionality, measurability and negative externalities). In-depth analysis allows to classify corporates into different categories: impact leaders, impact contributors, SDG-aligned companies, neutral companies and detractors. The methodological approach for this classification is detailed in Appendix 1. Impact leaders, impact contributors and SDG-aligned companies are deemed ‘sustainable’ under SFDR.

[6] Quantiles based on MSCI ACWI Index components SDGs Operations scores computed on equi-weighted basis and updated twive a year.

Neutral companies are not deemed 'sustainable' under SFDR only if they qualify as part of their commitment to transition towards decarbonization in order to reach the Paris Agreement's goals (see section 2.2) and provided none of their SDG score is strictly below -5. Detractors cannot be sustainable under SFDR.

This methodology may evolve in the future to take into account any improvements for example in data availability and reliability, or any developments of regulations or other external frameworks or initiatives -among others-.

### 2.2 Commitment to transition towards decarbonization in order to reach the Paris Agreement's goals

Corporates that are engaged in a decarbonization pathway are positively contributing to environmental sustainability in a way that is consistent with a 1.5°C net zero emissions future. At this stage, AXA IM is considering that corporates that have their carbon targets approved by the SBTi are sustainable provided they also meet DNSH, alignment to OECD Guidelines and UN Guiding Principles and good governance practices.

## 3. Do Not Significantly Harm (DNSH) other sustainability factors

The definition of Sustainable Investments requires that the 'Do No Significant Harm' (DNSH) principle is satisfied, *i.e.*, that indicators for adverse impacts on sustainability factors have been taken into account prior to making an investment.

AXA IM will ensure that the DNSH principle is considered through (i) the application of AXA IM's exclusion policies in respect of the most material sources of significant harm to sustainability objectives and (ii) a due diligence process for selecting prospective investments. Sustainability indicators can be taken into account through both approaches for the purpose of the DNSH assessment. No specific threshold or comparison with reference value has been defined within the DNSH approach itself: thresholds are applied through our exclusion policies and standards.

Unless the client has requested a custom approach on a segregated account, products classified as Article 8 and Article 9 under SFDR apply AXA IM's exclusion policies and standards such as Controversial Weapons, Climate risks, Soft Commodities and Ecosystem Protection & Deforestation. They also apply the AXA IM's Environmental, Social and Governance standards policy ("ESG Standards") integrating the ESG Standards in the investment process by applying specific sectorial exclusions on corporates with a low ESG score (see below) and such as tobacco and white phosphorus weapons and by excluding investments in securities issued by companies in violation of international norms and standards such as the United Nations Global Compact Principles or the OECD guidelines for Multinational Enterprises; as well as investments in companies which are involved in severe ESG-related incidents:

- AXA IM ESG Standards Policy
- AXA IM Climate Risks Policy
- AXA IM Ecosystem Protection and Deforestation Policy
- AXA IM Controversial Weapons Policy
- AXA IM Soft Commodities Derivatives Policy

More details on those policies and their respective criteria is available on: Policies and reports | AXA IM Corporate (axa-im.com)

In addition to elements abovementioned, for traditional assets, the application of the DNSH for the sustainable investments a Financial Product also intends to make means that the following investee companies cannot qualify as sustainable:

- The issuer should not have a CCC (or below 1.43) ESG score according to AXA IM's $Q^2$ scoring methodology[7];
- The issuer should not be causing harm along any SDG (meaning no SDG score strictly below –5 based on a quantitative database from external provider on a scale ranging from + 10 to - 10 – unless this score is overridden by a qualitative analysis or qualifying for its commitment to transition towards decarbonization in order to reach the Paris Agreement's goals).

For some of the products, Stewardship policies may also be an additional risk mitigation on principal adverse impacts through direct dialogue with companies on sustainability and governance issues. Through engagement activities, AXA IM uses its influence as investors to encourage companies to mitigate environmental and social risks relevant to their sectors. Voting at general meetings is an important element of our dialogue with investee companies in order to foster sustainably long-term value of the companies in which AXA IM invest and mitigate adverse impacts.

# 4. Ensuring investee companies' good governance practices

For Article 8 and Article 9 financial products with minimum sustainable investments, SFDR article 2(17) requires that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance. Those 4 pillars are addressed through exclusion of companies which cause, contribute or are linked to violations of international norms and standards in a material manner. Those standards focus on Human Rights, Society, Labor and Environment, and as such, provide a methodology to help assess the appropriate governance of investee companies in general, and more specifically help to ensure that we avoid investments in investee companies where poor management structure lead to corruption or money-laundering as examples, and where very poor practices in terms of management of human capital, which can include employee relation or remuneration of staff are observed. AXA IM relies on an external provider's screening framework and excludes any companies that have been assessed as "non-compliant" to UN's Global Compact Principles, International Labor Organization's (ILO) Conventions, OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights (UNGPs).

In addition, for some financial product ensuring good governance practices may also be addressed by the engagement policies. AXA IM implemented a comprehensive active ownership strategy – engagement and voting – where AXA IM acts as stewards of investments made on the clients' behalf. AXA IM views engagement as a means for investors to influence, shape and shift investee company policies and practices to mitigate risks and secure long-term value. Governance practices of companies are engaged at first level by the portfolio managers and dedicated ESG analysts when meeting companies' management team. It is through the long-term investor status and in-depth knowledge of the investment targets that AXA IM feels legitimate to engage in a constructive but demanding dialogue with them. More details on AXA IM Corporate Governance & Voting policy are available on: Policies and reports | AXA IM Corporate (axa-im.com)

[7] Since November 2021, AXA IM is using the $Q^2$ scoring methodology, an internal methodology using MSCI ESG scoring model as a starting point, and completed by fundamental ESG analysis provided by AXA IM ESG analysts (when MSCI doesn't provide a rating for an issuer) which is turned into a quantitative ESG score following MSCI scoring normalization (from 0 to 10).

# 5. Sustainable investment approach for specific financial instruments contributing to an environmental or social sustainable objective

This section details the specific AXA IM Core financial instruments that can qualify as sustainable under SFDR (*i.e.*, for all criteria: contribution to an environmental or social objective, DNSH and good governance practices) for both corporates and sovereign issuers provided those are not in AXA IM Sectorial and ESG Standards ban lists nor have a CCC (below 1.43) ESG score.

### Sustainability approach for Green, Social, Sustainability bonds and Sustainability Linked bonds

Green, Social and Sustainability Bonds (GSSB) are instruments which aim to contribute to sustainable objectives by nature. The market is considered as mature with large application of Standards or Principles relating to GSSB (*e.g.*, Green Bond Principles, Climate Bonds Standards, EU Green Bond Standard, etc.). As such, investments in bonds that have been identified as green bonds, social bonds or sustainability bonds in Bloomberg database (*i.e.* that follow the abovemnetionned standards of pricinples) are considered *de facto* as sustainable under SFDR in our framework.

An internal framework was developed to assess the robustness of Sustainability Linked Bonds (SLB). On this basis, only SLB that have a positive or neutral opinion based on the qualitative analysis from our internal RI analysts are considered *de facto* as sustainable under SFDR. As the frameworks are newer leading to heterogeneous practices from issuers sustainability linked bonds flagged in Bloomberg which have not been reviewed through our qualitative framework are not considered as sustainable under SFDR. This internal analysis framework draws on the International Capital Market Association (ICMA) guidelines with a stringent proprietary approach based on the following defined criteria: (i) issuer's sustainability strategy and key performance indicators relevance and materiality, (ii) sustainability performance target's ambition, (iii) bond characteristics and (iv) sustainability performance target's monitoring & reporting. All investments in SLB comply with AXA IM's internal framework. We have designed our framework to be compliant with Green Bonds Principles and Social Bond Principles, adding more stringent criteria on some aspects.

Those methodologies may evolve in the future to take into account any improvements for example in data availability and reliability, or any developments of, but not limited to, regulations or other external frameworks or initiatives.

# 6. Implementation

This framework is implemented on a best-effort basis, taking into account the best interests of both the client and the fund, with a technical implementation period of maximum 15 days, after the validation in the relevant governance (*i.e.*, dedicated committees), for the funds/mandates in scope, and following period revisions of the sustainable investment universe. If the application of this framework dictates divestments, portfolio managers shall disinvest at their discretion as soon as possible within this transition period taking into account the portfolio impacts based on market conditions, liquidity and portfolio construction constraints. In practice, some targeted instruments could remain in the funds or mandates for a period if deemed in the best interest of their clients and provided that it is compliant with the applicable Laws; however, those holdings cannot be increased[8].

[8] Such tolerance could be applied, for example in relation to strategies with accounting objectives, or for concentrated strategies with appropriate validation from oversight functions.

This framework relies on external data providers, and although qualitative review is performed, AXA IM is therefore not responsible for the accuracy of this data.

# Appendices

## 1. Appendix 1: Qualitative approach to assess the companies' positive contributions to environmental and social objectives

AXA IM approach to assess the companies' positive contributions to environmental and social objectives (and the corresponding UN SDGs) is guided by AXA IM's approach to impact investing in listed assets (https://www.axa-im.com/who-we-are/impact-investing) which highlights several key factors (intentionality, materiality, additionality, measurability and negative externalities). In-depth analysis allows to classify corporates into different categories:

- impact leaders,
- impact contributors,
- SDG-aligned,
- neutral, and
- detractors.

*Impact leaders*

These companies are the highest rated in terms of sustainably generating positive societal impact:

- Products and services (P&S) Impact Leaders sell goods and services that are of critical value, and generate significant additionality by leveraging technology, scale and innovation to make their P&S accessible and commercially viable in potentially underserved markets;
- Operational Impact Leaders drive positive change in their industry through best-in-class corporate practices, ambitious targets, vocally highlighting issues and pioneering solutions affecting numerous beneficiaries (in the supply chain for example).

*Impact contributors*

These companies generate significant positive societal impact but have not obtained the Impact Leader status due to considerations regarding impact theme alignment purity (*e.g.* only a limited portion of revenue may contribute to the SDGs while the rest of the business is largely neutral), the severity of the issue being addressed, a lack of corroborating disclosures, or negative externalities.

*SDG-aligned*

These companies contribute positively to environmental or social objectives, and do not significantly harm environmental or social objectives, but their net positive contribution is deemed insufficient to warrant Impact Leader or Impact Contributor status.

*Neutral*

This category includes companies with limited positive and negative contributions to environmental or social objectives, OR companies with materially positive and negative contributions to environmental or social objectives.

*Detractors*

These companies significantly harm environmental or social objectives and do not bring significant positive contributions to environmental or social objectives.

Disclaimer

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

Due to its simplification, this document is partial and opinions, estimates and forecasts herein are subjective and subject to change without notice. There is no guarantee forecasts made will come to pass. Data, figures, declarations, analysis, predictions and other information in this document is provided based on our state of knowledge at the time of creation of this document. Whilst every care is taken, no representation or warranty (including liability towards third parties), express or implied, is made as to the accuracy, reliability or completeness of the information contained herein. Reliance upon information in this material is at the sole discretion of the recipient. This material does not contain sufficient information to support an investment decision.

Issued by AXA INVESTMENT MANAGERS PARIS, a company incorporated under the laws of France, having its registered office located at Tour Majunga, 6 place de la Pyramide, 92800 Puteaux, registered with the Nanterre Trade and Companies Register under number 353 534 506, and a Portfolio Management Company, holder of AMF approval no. GP 92-08, issued on 7 April 1992.

In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.