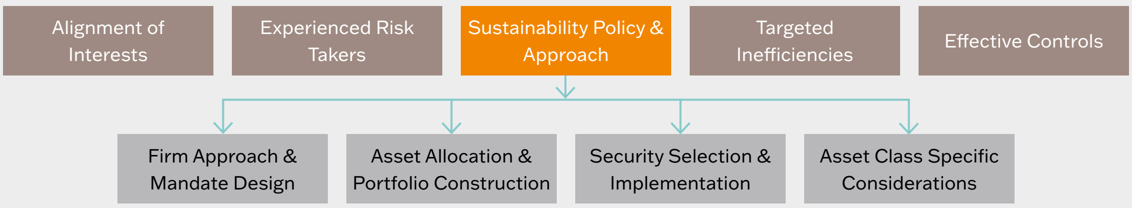
Integrating Sustainability Considerations in Alternative Solutions

Within the Alternative Solutions Team, our investment process is driven by an Impartial Implementation approach. This is our framework for selecting the most suitable implementation route (internally or externally managed, passive or active) for a particular idea, taking into account trade-offs between returns, risk, sustainability considerations and costs. Not only do we score each investment's sustainability characteristics using a proprietary system (see steps 2 and 3 of our investment process below for more detail), but we also adjust our return and risk assumptions based on our extensive due diligence. This process results in two key benefits:

- It prompts us to proactively seek out investment opportunities with positive scoring sustainability characteristics (e.g., clean energy and recycling companies, or third-party managers who themselves have strong sustainability characteristics)
- It provides a very clear audit trail for marginal decisions, where our sustainability scores can be very influential

To provide further context, below we outline the five stages of our investment process and how Sustainable Investing is considered at each stage:

1. **Strategic Asset Mix:** This sets out the baseline asset allocation framework that underpins our solutions and considers long-term secular trends, market size, investment efficiency and a range of other factors. It is at this stage where we may consider the potential sustainability of an asset class and debate whether the opportunity to invest remains attractive over the long term. We ask ourselves questions such as "Is there a future for the oil and gas industry within Natural Resources?"
2. **Dynamic Idea Generation:** For all potential investments, we develop views on the above five 'Key Ingredients for Competitive Advantage', which includes our primary decision-making tool for Sustainable Investment. We make a qualitative assessment based on the granular details of how an idea is designed, constructed, and implemented with sustainability in mind, and whether this could lead to improved risk-adjusted returns. An investment or manager's sustainability policy and approach is one of the key ingredients, assessed across four main areas, illustrated below:



Firm Approach & Mandate Design: This includes business firmwide commitment and investment in sustainability, culture and values, current and evolving credentials, approach to stewardship, participation in industry initiatives as well as the overall level of integration of sustainability considerations. We are also very interested to learn how and why a particular mandate has been designed the way it has, and we will explore in detail the specific business rationale for the launch of a particular product or solution.

Asset Allocation & Portfolio Construction: Broadly we focus on how sustainability considerations are factored into the investment process, from a qualitative (materiality assessments), quantitative (use of data in portfolio construction) and team culture perspective (knowledge, collaboration, leadership). We discuss adjustments that may be needed to capital market assumptions or climate-factored scenario analysis, which can in turn help us to make our own adjustments.

Security Selection & Implementation: We deep dive into the underlying holdings to understand their sustainability rationale i.e. through their due diligence process, credit or analyst notes. In particular we focus on engagement prioritisation and the range and depth of engagement tools used to engage on prioritised sustainability issues. We look at the overall engagement strategy, engagement tools e.g.: voting, collaborative engagements, letter writing, 1:1 meetings as well as outcome of engagements.

Asset Class Specific Considerations: Finally, we consider factors specific to the particular asset class (discussed later in the paper). We also use this to normalise between asset classes. This is particularly important for two reasons: 1. Certain asset class are more susceptible to climate risks and can also benefit from climate opportunities. 2. The degree of engagement (and thus real world impact) is dependent on the asset class. This should be factored in our scoring process. Example: A manager might have stellar sustainability credentials amongst their peers but the nature of their asset class e.g.: futures would limit the impact that they could have. This should be factored into our overall portfolio score (therefore, influencing our asset allocation choice).

Each of the aspects above is scores on a scale of 1-4 (1 represents poor and 4 represents a leading score) and aggregated to form an overall Sustainability view on any given idea in our research pipeline.

3. **Portfolio Construction:** It is here that we apply our Impartial Implementation approach, and we do this by applying 'Four Key Factors' to enable holistic investment decision-making. All potential investments are scored across these four factors, and this enables us to assess the relative trade-offs between ideas, as illustrated below.

   When it comes to adjusting our return and risk assumptions, based on sustainability considerations, we apply caution and are conservative with any adjustments given the difficulties inherent in measuring the impact of sustainability factors in a quantitative manner. Any adjustments are based on a combination of statistical analysis and academic research. This step also allows us to have the option to veto any investments we may feel uncomfortable about, for example those investments with a low Sustainability, thereby enabling the Sustainability score to be a powerful tool for tie-break decisions. Going forward we have decided to no longer invest in managers with an overall sustainability score of 1.

Four Key Factors	Description
Target Net Return	Long term house asset class assumptions for major markets Return boost from strong fundamental/behavioural traffic lights
Diversity Factors	Holistic risk assessment including target volatility, factor exposures, geographical exposure Target volatility informed by house assumptions and nature of investment idea
Sustainability	We evaluate company, mandate, investment process and asset class components of an investment opportunity to arrive at an aggregate score for ESG policy and approach. Each is scored 1-4: 1 represents a poor score and 4 represents a leading score. In addition to impacting return and volatility assumptions, ESG scores influence marginal decisions
Implementation Considerations	Assess implementation costs Scrutinise idea and portfolio level liquidity

Idea	Sub- Strategy	Target Net Return	Diversity Factors		Sustainability	Terms and Conditions	
			Target Volatility	Geography	Aggregate Score	Total Fees	Min Market Cap/ ADV
Theme Basket 1	Clean Energy	6%	15%	Global	4	0bps	$1bn/$5mn
Theme Basket 2	Residential REITS	5.5%	12%	US and Germany	2	0bps	$1bn/$5mn
Manager 1	Securitised Credit	5%	5%	Global	3	59bps	Daily
Objectives	**15-20**	**Inflation + 4%**	**8-12%**	**Diverse**	**Aim to improve average scores over time**	**Meet overall cost limits. Highly liquid**	

4. **Engagement:** We believe this is critical in achieving a positive outcome for those involved, and therefore we do not automatically rule out a poor scoring direct investment or third-party manager, particularly if we can identify the right steps are being taken to innovate and improve. This is done primarily through the creation and subsequent communication of our short and mid-term engagement goals with our managers.

   The reason we have chosen to create bespoke engagement plans is due to the inherent comparability challenge faced by a multi-asset portfolio. We are mindful that focusing purely on improving our sustainability scores and lowering our carbon intensity figure can be reductive. Therefore, a hybrid approach where we layer qualitative engagement with these two data points allows us to challenge and learn from our managers on their sustainability considerations. The area of engagement that we focus on with external managers depends on the extent to which sustainability integration is effective in their business and investment processes. For example, we have engaged with small hedge fund managers who are very new to sustainability, and we have also dealt with much larger, more established asset managers. We understand and appreciate that the level of maturity varies and therefore have curated short and mid-term engagement plans unique to each manager to ensure an effective discussion.

We hold annual engagement meetings (at the minimum) with all our underlying managers where we assess their progress against the engagement plans. We use the meetings to perform deep dive on their portfolios from a sustainability perspective. This allows us to not only measure their progress against the engagement plans but also review their overall sustainability score as part of our internal annual review.

We are in a unique position where we have a bird-eye view of the industry and work together with our specialist managers on sustainability issues. Be in guidance on thought leadership or better use of data, if done well, we believe this can have a multiplier effect on the industry.

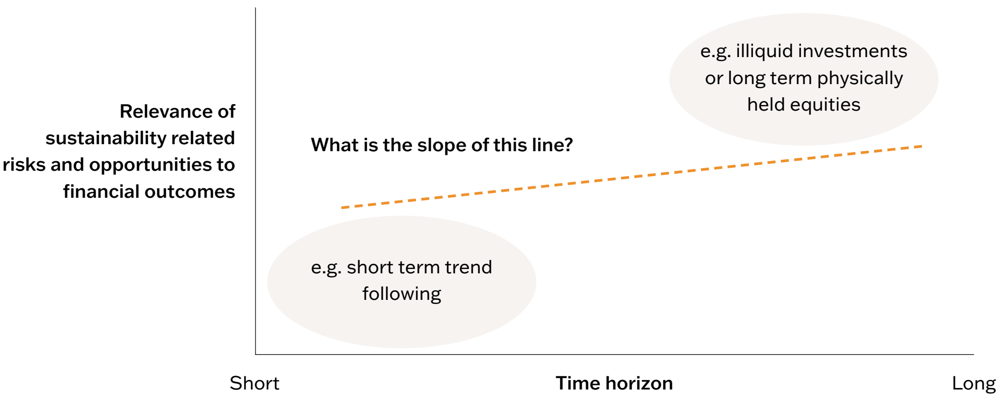
5. **Annual Reviews and Reporting:** Transparency is at the heart of our sustainable investment approach. It holds us accountable and allows us to monitor our progress in a disciplined manner. This includes annual Weight Average Carbon Intensity (WACI) calculations, in line with our net zero ambitions as part of the Net Zero Asset Manager Initiative.[1] It also includes our Annual Sustainability Report and quarterly sustainability updates to our clients. We also publicly disclose our voting statistics at a firmwide level.[2]

A. Asset Class Considerations for a Liquid portfolio

In a previous thought piece[3], we highlighted the challenges of integrating sustainability considerations in a multi-asset portfolio. Sustainability related integration is more mature within certain sectors such as real assets due to clearly defined risks e.g.: physical risk of climate change impacting infrastructure in low-laying areas and opportunities e.g.: opportunities within clean energy. Certain asset classes benefit from defined guidance on integrating and engaging on sustainability issues such as equities where voting is a powerful engagement tool and finally time horizon is a key determinant on if and to what extent should sustainability factors be material.

While this is an evolving space, our instinct when investing in different asset classes/strategies with different time horizons is that the shorter the time horizon, the less relevance sustainability related risks and opportunities have (see below illustration).

Conceptual framework for sustainability related integration across time



1 Please find our ambition here: https://www.netzeroassetmanagers.org/signatories/fulcrum-asset-management/
2 Please find our voting statistics here: https://viewpoint.glasslewis.com/wd/?siteId=Fulcrum
3 Please find our thought piece here: https://www.fulcrumasset.com/inst/uk/en/fulcrum-blog/sustainability-now-never-or-when/

When we apply this concept to our underlying managers, two things become clear:

1. The importance of understanding materiality and nuances of the underlying strategies when engaging with managers. This allows us to be viewed as collaborators and therefore provide guidance. We need to stay abreast with current regulations, dynamics of the asset class and industry best practices. Therefore, we have an integrated sustainability approach, where portfolio managers work hand in hand with the sustainability specialist on manager selection, due diligence, annual reviews and engagements.

2. The need to prioritise our engagement efforts based on relevance of sustainability risks and opportunities to financial outcomes without overlooking potential innovation in harder strategies. Finding this balance is one of the most challenging aspects of our sustainability strategy. While we develop engagement plans for all our underlying managers (as we believe regardless of strategy or time horizon, more can and has to be done to embed sustainability considerations), the nature of these plans varies based on the relevance of sustainability risks and opportunities.

The table below highlights some specific considerations we review for each asset class in our liquid alternative opportunity set keeping these two elements in check:

Asset Class	Key Sustainability Considerations: Key Ingredient Assessment and Development of Engagement Plans	Relevance of sustainability risks[4]
Real Estate	• Assessing GRESB scores, a leading benchmark for sustainability related performance in real estate. • Consideration of certifications in real estate industry such as LEED and BREEAM. • Assessing TCFD reporting including emissions metrics and scenario modelling (to assess physical risks of climate change). • Assessment of Biodiversity assessments and appraisals e.g.: Biodiversity Net Gain in the UK. • Focus on active ownership: proxy voting, engagement, tenant management. (including community management, safety, human rights adherence)	High: Physical risk of climate change and inclusion of social consideration. Moderate: Biodiversity loss.
Infrastructure	• Assessing climate scenario analysis to assess impact of physical and transition risk to the portfolio, including events such as El Nino and La Nina. • Understanding macro view and mega trends alignment/divergence. • Understanding how impact of regulatory environment impacts investment decisions e.g.: Inflation Reduction Act in US. • Assessing GRESB, TCFD/TNFD reporting.	High: Physical and transition risk of climate change, biodiversity loss and inclusion of social consideration.
Natural Resources	• Assessing supply chain risks, with a deep focus on social considerations such as modern slavery, human rights, child labour health & safety, incident monitoring. • Assessment of Biodiversity assessments and appraisals e.g.: Biodiversity Net Gain in the UK. • Assessing climate modelling to understand physical and transition risk of climate change. • Encouraging working with indigenous communities.	High: Physical and transition risk of climate change, biodiversity loss and inclusion of social consideration.
High Yield	• In lieu of voting, engagement is still possible and should be prioritised by credit managers (direct and collaborative). The global credit market provides the bulk of financing to companies and should exercise their stewardship responsibilities. • Consideration of a range of sustainability issues when modelling default risks such as health & safety, governance issues, climate risks. • Incorporation of sustainability considerations during due diligence and conversations with management. • Encourage support for initiatives seeking to improve data for high yield investors (including carbon data).	High: Inclusion of social considerations. Moderate: Physical and transition risk of climate change. Low: Biodiversity loss.

4 Based on nature of asset class, time horizon and sectoral considerations. This illustrates how we prioritse our engagements with underlying managers.

Asset Class	Key Sustainability Considerations: Key Ingredient Assessment and Development of Engagement Plans	Relevance of sustainability risks[4]
Emerging Market	• Assessing integration of Just Transition considerations in issuer due diligence and engagement. • Encourage working with industry initiatives and local bodies for context specific engagement. • Support innovation and market development such as green bonds, sustainability linked bonds and engagement during the price discovery phase of new bond issues. • Understanding integration of sustainability considerations and local context in sovereign risk models such as dynamic peer group modelling. • Assessing human analysis of big data impacting risk and credit rating.	High: Just Transition. High/Moderate: Physical and transition risk of climate change and biodiversity loss.
Securitised	• The assessment of lending and mortgage serving standards to reduce the prevalence of predatory lending practices. • Encourage support for initiatives seeking to improve data and transparency in the industry. • Understand exclusion policies to define scope e.g.: exclusion on predatory lending.	High: Inclusion of social considerations. Moderate: Physical and transition risk of climate change. Low: Biodiversity loss.
Convertibles	• Integrating sustainability consideration into assessment and bond selection process. • In absence of voting rights, understanding where a manager is reviewing a new issue, engagement on bond terms to encourage greater transparency and improving practices (especially where they are made private). • Encourage support for initiatives seeking to improve data and transparency in the industry.	Moderate: Inclusion of social considerations, physical and transition risk of climate change. Low: Biodiversity loss.
Quant Hedge Funds	• Encourage support for initiatives seeking to improve data and transparency in the industry (as data availability and reliability are common issues) • Understanding key KPIs used to measure sustainability impact quantitatively	Moderate/Low: Inclusion of social considerations, biodiversity loss, physical and transition risk of climate change.
Fundamental Hedge Funds	• Understanding the due diligence and reasoning behind the decision to short a stock vs to engage is key in assessing the sustainability of returns over the long term. • Understanding carbon accounting methodology i.e. role of shorts as an offset vs a signal. • Understanding thematic alignment and divergence on macro sustainability trends impacting portfolio construction and position sizing.	Moderate/Low: Inclusion of social considerations, biodiversity loss, physical and transition risk of climate change.
Event Driven Hedge Funds	• Assessing transaction announcement threshold to understanding minimum sustainability thresholds in place that could initiate a position and possibly lead to improved risk-adjusted returns.	Moderate/Low: Inclusion of social considerations, biodiversity loss, physical and transition risk of climate change.

B. Considerations for an Illiquid portfolio

Illiquid assets present a wonderful opportunity for an enhanced level of engagement as a consequence of the increased level of control and influence. At Fulcrum, we have developed a 'panel of illiquid specialists' across the full range of illiquid alternatives: Real Estate, Infrastructure, Natural Resources, Alternative Credit and Private Equity/ Venture Capital. We develop bespoke relationships with each underlying manager on the panel and work with them to create vehicles just for Fulcrum's clients. The underlying managers will conduct the detailed, deal level due diligence and in most cases, Fulcrum will retain a right of refusal.

We maintain engagement plans with each manager and ESG improvement plans for each asset. The improvement plans will be tailored to the asset and discussed with the underlying manager. In each case, there will be discrete (e.g. installing solar panels) and continuous (e.g. monitor WACI over time) objectives.

Our illiquid strategy enables us to focus on sustainability considerations in three new ways:

1. **Long-term ownership of asset:** The long-term investment horizon enables thoughtful sustainability objectives to be realized and reflected in the financial value of the business. Additionally, the control-oriented model will provide us with the ability to drive change in a way that is more challenging in listed markets.

2. **Deal level decarbonisation strategy:** This allows us the opportunity for greater and more targeted engagement by placing value creation derived from sustainability considerations at the heart of our deals.

   We believe this will complement and strengthen our existing manager level engagement. On an asset class level, this would include aspects such as:

   a. Real estate: Improving energy efficiency, building solar panels & EV charging ports on our real estate assets to improve environmental credentials while minimising social and biodiversity risks through thoughtful sourcing and implementation of improvement strategies.
   b. Infrastructure: Funding projects required for a net zero future, such as wind farms, solar parks and energy storage facilities.
   c. Natural Resources: Active ownership and funding of natural resource projects that mitigate biodiversity loss, while providing environmental solutions to mainstream practices such as biofuels and vertical farms. In the case of timberland, this may involve upgrading the certification of the forest or conducting environmental restoration projects.
   d. Alternative Credit: Building sustainability ratchets, both positive and negative in their private loan and direct lending practice. While still nascent, we are working with managers to explore how and when this mechanism can be most effectively employed when deploying capital.
   e. Private Equity & Venture Capital: Deploying capital focusing on social and environmental challenges including funding climate tech solutions to address the climate crisis.

3. **Allocating to sustainability solutions:** In our recent thought piece 'Buying is Good, Building is Better', we discuss that real-world change can be created through our investments by funding the creation or improvement of sustainable assets and companies instead of just passively owning existing ones. A key tenet to our private markets allocations is the idea that to reach net zero and meet the world's sustainability goals we collectively need to deploy fresh capital to solve these problems. We need to build new renewable power generation facilities, new battery storage sites, install new home heating systems and improve the efficiency of our buildings at a much faster rate. We look forward to actively support solutions that address key issues such as climate change and biodiversity loss.

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