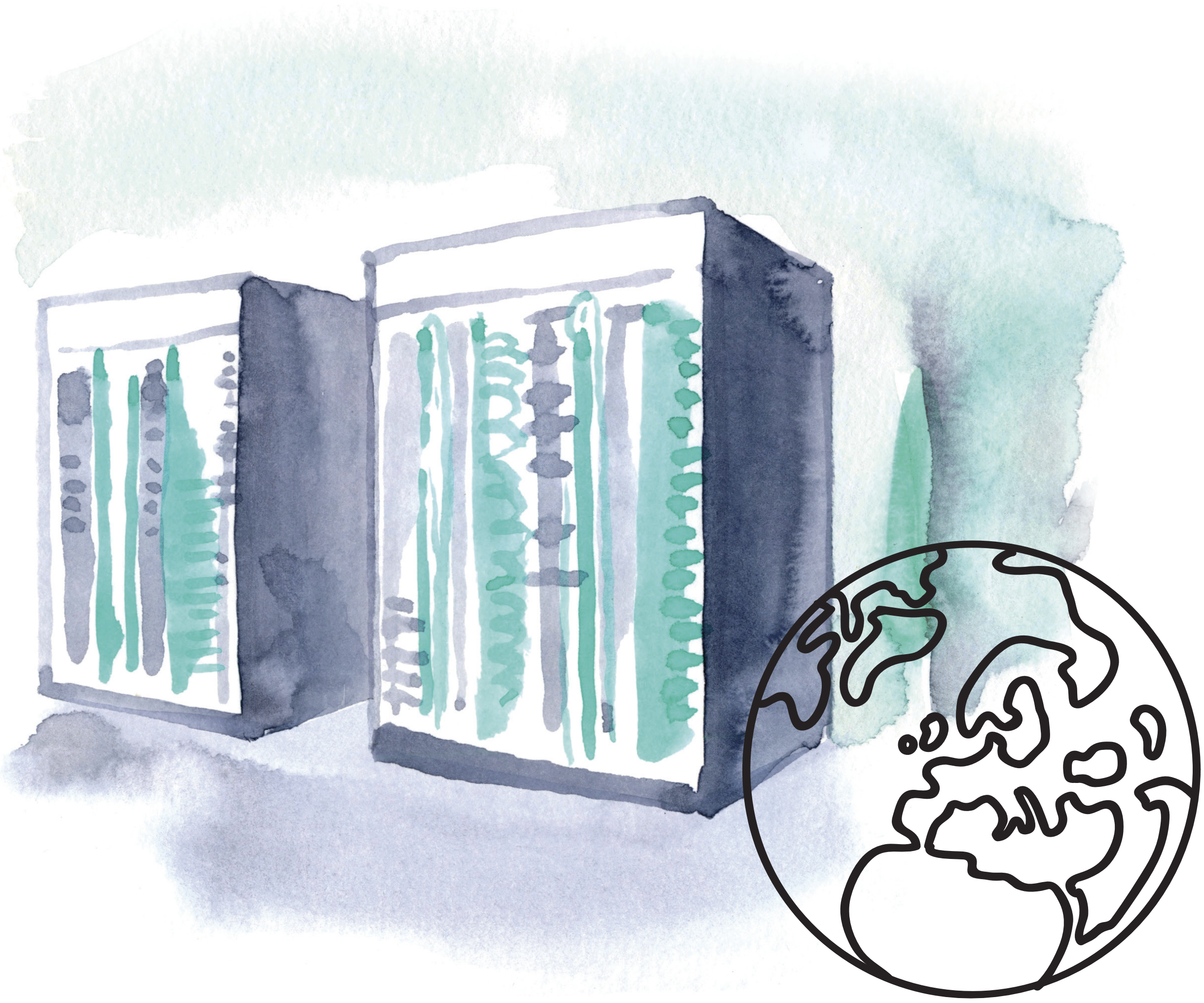
ESG Materiality Framework

September 2020



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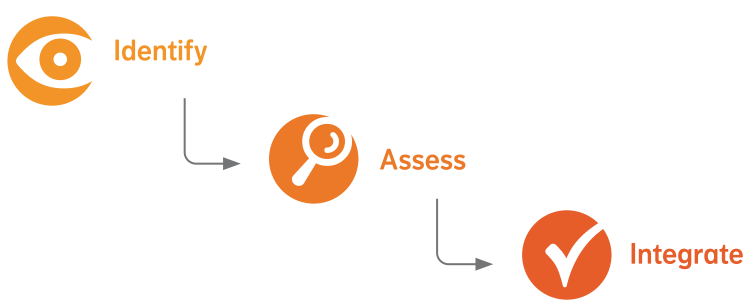
ESG Materiality Framework

The integration of environmental, social and governance (ESG) factors into our investment process is one of the core pillars of our responsible investing framework. It enables us to enhance our decision making by assessing the risks and opportunities that individual companies might face. In turn, we are better equipped to optimise both short- and long-term risk-adjusted returns. Our deep conviction that ESG integration improves performance is underpinned by our consistent and stringent integration of ESG factors into 71% of our assets under management,[1] up from 68% in 2019, coupled with our ambition to increase this figure to 80% by 2023.

As a responsible investor with a focus on sustainability, we are committed to integrating these elements throughout our investment process, from idea generation to analysis, portfolio construction, active ownership, voting and client reporting. This requires a critical and nuanced approach. Integrating ESG factors blindly, by taking ESG data from external providers, can lead to profound issues with data quality and availability.

We have therefore established a three-step process for ESG integration: identify material issues; assess a company's performance; and integrate our analysis into the investment case. This document explains the first part of this process, the identification of material issues, for which we have built our proprietary materiality framework. It also explores how this framework informs our thought processes and our engagement efforts, ultimately strengthening our capacity to generate financial outperformance.



[1]Figure as of August 2020

Introducing the Materiality Framework

For us, ESG integration starts with identifying the issues that matter to the companies in which we are invested – in other words, the material, long-term issues and opportunities that each company might face. For example, the transition to green energy sources may threaten the ability of traditional energy providers to create value for investors unless they adapt to focus on new forms of power generation. Similarly, banks and insurance companies face significant ongoing risks from the threat of data breaches and other IT security issues.

By identifying material factors like these and carefully assessing how companies are adapting in response to them, we can both sharpen the focus of our responsible investing efforts and strengthen our capacity for financial outperformance. Material ESG issues are central to a company's business model and financial success, as they affect its short-, medium- and long-term competitiveness. The core question we ask ourselves is: how sustainable is a company's value creation? This is also important to our clients, who want to ensure that their capital is being put to work in the most impactful way possible, without hurting financial returns.

NN IP is among the first asset managers to have developed its own approach to materiality in the form of our proprietary materiality framework, which optimises how we identify and interpret corporate ESG factors on an industry level. This approach unlocks potential value by identifying the associated risks and opportunities. It captures how ESG issues impact firms in terms of their inputs, throughput, outputs and outcomes. It also builds focus in our ESG investment analysis, underpins other ESG integration tools, provides a link with our engagement efforts, and offers a starting point for discussion topics in our dialogues with companies. Above all, it guides our thinking and investment actions across all our investment teams.

Creation of the Materiality Framework

In order to create our materiality framework, we first determined what counts as a "material" factor. While relevant ESG issues are those issues that are currently important, material ESG issues are those issues that affect the financial stability of a company, or are a core part of the company's business.

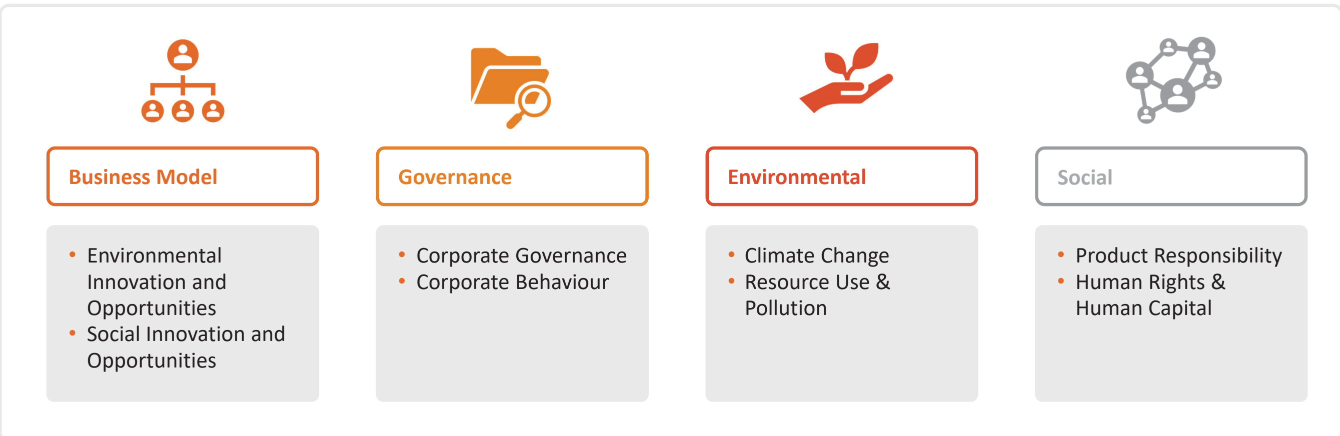
We did this by applying our internal quantitative and qualitative assessment of the investor relevance of material ESG issues, based on our long history of incorporating ESG issues into our investment process. We overlaid this with the best-of-breed characteristics of the materiality frameworks of ESG benchmark and standard setters, and ESG data providers.

The below four-step approach offers a thorough breakdown of the process:

- **Standard setters: We analysed and quantified material issues identified by organisations such as the Sustainability Accounting Standards Board (SASB), Sustainalytics and MSCI ESG.**
- **Industry group level: We mapped the separate inputs along the 24 industry groups (GICS).**
- **Investor relevance: We aligned the differing taxonomies and regrouped material issues in line with what matters most to us and our clients, based on the investor relevance of material issues. We involved our analysts and portfolio managers to get their perspective and incorporate their feedback into our framework.**
- **Momentum: Material ESG issues may change over time in terms of their relevance and impact. This calls for a regular and iterative approach at the industry group level to determine whether the identified material ESG issuers are indeed still material.**

After determining our material factors, we began building the framework itself, starting with four pillars: Business Model, Governance, Environmental, and Social. By identifying Business Model as the first pillar alongside environmental, social and governance factors, we emphasise the need for companies to capture environmental and social innovation in their ways of doing business. This pillar focuses on the potential opportunities that can be uncovered by a materiality-based approach, rather than the risks. The four pillars are further divided into two themes apiece, as shown in the below infographic.

We have identified a central question at the core of each theme, which helps us focus our thinking and assess the real-world impact of companies. For example, for the



Social Innovation and Opportunities theme, we ask “Is the firm actively pursuing social innovation and related opportunities?” For the Resource Use & Pollution theme, we ask “What is the firm's dependency upon natural resources and what does it do to manage its impact?” By asking these questions, we can better determine not just where a company stands now, but also where it is likely to stand in the future.

The four overarching pillars are weighted for each sector, using a combination of external input (SASB, Sustainalytics and MSCI ESG) and our proprietary view provided by in-house analysts. We then further subdivide our selected pillars and themes into 16 material factors. For example, the Resource Use & Pollution theme is subdivided into three material factors: **Materials Sourcing; Water Management, Biodiversity & Land Use;** and **Pollution & Waste.**

We assess the materiality of these 16 factors to each of the 24 industry groups where ESG factors play a role. Issues pertaining to climate change, for instance, would have a different weighting for a software developer than for an energy company, whereas resource use and pollution – highly material for energy firms – is not considered material for real estate companies. In this, we do not differentiate between equity and credit, as we believe that the material factors for an industry group are the same regardless of asset class.

Certain factors have more of a widespread impact than others. This is why Corporate Behaviour and Corporate Governance are material factors in all industry groups. They are overarching elements that are equally important for all industries, as they determine how companies are run and how they interact with stakeholders.

Using the framework in our investment processes

Our materiality framework reflects our views on material factors on an industry level, but this is only the starting point for our analysis of individual companies. We do not use the framework blindly in our investment processes; rather, it serves as a foundation for building a case for investment (or not) in a specific company. This is primarily carried out by individual investment teams, with ongoing support from our responsible investing team.
Within the investment process, our investment teams primarily use the materiality framework to analyse investment opportunities and risks, including potential positive and negative impacts. For example, one of our 16 material factors is environmental innovation and opportunities, a material factor for the household and personal product industry. When analysing a company in this industry group, our investment experts look into how the company is actively pursuing environmental innovation and related opportunities. Are any of its product lines designed to have positive environmental effects, and has it set explicit targets for this? Is it committed to reducing its waste impact by introducing alternatives to plastic, such as recyclable, reusable and compostable packaging solutions? By asking these questions, we can gain a better understanding of the ESG risks and opportunities that are most material to a company, and in turn link these material factors to its (future) financial performance.

The framework is also a valuable tool for focusing our thinking and our engagement efforts. When building an investment case, we continually ask ourselves whether the company has the necessary awareness, ability, and willingness to improve its scores on its material issues. We also maintain an active dialogue with the company in order to best gauge how it is addressing these issues. To aid in this, we have created an internal ESG dialogue guide based on the materiality framework, which offers clear and detailed guidance for engaging with companies in each industry group. Regular company dialogues and engagements are essential to improving (long-term) business performance on material issues. Portfolio managers, investment analysts and the responsible investing team are all involved in this process.

Our materiality assessment does not end once we have established a materiality score for a company. Our investment teams reassess their materiality scores for individual companies on an ongoing basis, supported by our responsible investing team and aided by regular engagement and dialogue with the companies in question. Ultimately, we are committed to better understanding how well a company is prepared for change and the impact this may have on its value creation.

The NN IP Corporate ESG Indicator

The implementation of the materiality framework within the investment decision-making process is anchored by its inclusion in our proprietary Corporate ESG Indicator – a tool that incorporates multiple external data sources combined with the materiality framework. For each of the eight themes in our materiality framework, we assess a

Materiality of sovereign ESG factors

While the materiality framework is very well suited to analysing companies, our approach for sovereigns is different, since ESG-related factors are equally important to all countries. Examples include the quality and availability of education and healthcare, political stability, and the energy sources a country relies on. We therefore score all countries using the same factors to determine how they compare with each other from an ESG point of view. This analysis also enables us to identify issues that might cause us to refrain from investing in a specific country.

number of data points using input from a variety of data providers. For example, for the human rights and human capital theme, we look at factors such as employee engagement and gender diversity in management. These inputs are bolstered by the in-house expertise of our investment professionals, who provide detailed feedback to enhance and refine our ESG scores. The output of the Corporate ESG Indicator is therefore a comprehensive score that provides information on a company's ESG performance and guides our investment decision-making.

Looking to the future

Material ESG issues may change over time in terms of their relevance and impact, as can be clearly seen from the Covid-19 pandemic and from the ongoing climate crisis. Therefore, although our materiality framework is complete and is actively being used in our investment processes, it is not static and is subject to change. We carefully assess on an ongoing basis whether we need to make alterations to the framework, in terms of weightings and individual factors, taking into account large- and small-scale developments.

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