CIP Asset Management (CIPAM) Fixed Income

Responsible Investment Statement

www.cipam.com.au/fixed-income/

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1. Introduction

CIP Asset Management Fixed Income (CIPAM FI) believes that incorporating material environmental, social and governance (ESG) factors in investment decisions can improve investment outcomes for clients by promoting more sustainable business practices and reducing the risk profile of investments.

CIPAM FI has a systematic approach to incorporating ESG considerations into its investment process, and its specialty in private lending markets provides a greater opportunity for active engagement. CIPAM FI manages investment portfolios taking into consideration ESG risks as part of a thorough and robust investment process. It regards these risks as being inherently linked to the sustainability of the businesses to which it lends, to their ability to refinance and ultimately the risk of default.

CIPAM FI believes that its approach to ESG integration not only benefits its clients but also can have a positive impact on society and the environment.

2. ESG philosophy

CIPAM FI's investment philosophy is heavily influenced by its heritage in private lending markets. For over a decade CIPAM FI has approached credit markets as a lender as well as an investor. As an investor CIPAM FI applies a relative value approach, integrating ESG risk factors into its pricing and valuation considerations. As a lender CIPAM FI prioritises direct engagement to mitigate ESG risk factors through incentivising more sustainable business practices.

CIPAM FI's approach is guided by these key principles:

CIPAM FI incentivises sustainable business practices by deliberately raising the cost of capital for businesses who do not engage in sustainable business practices and lowering the cost of capital for businesses who do.

To us responsible investing is about being responsible to clients to deliver long term predictable streams of income.

Over the long term CIPAM FI can only do this **by incentivising sustainable business practices** from the businesses it lends to. It does this by raising the cost of capital for businesses who do not engage in sustainable business practices and lowering the cost of capital for businesses who do.

CIPAM FI assesses ESG risk against exogenous factors.

There are only two ways that CIPAM FI can exit a position: either the cashflows of a business pay down CIPAM FI's debt or other investors refinance CIPAM FI's position. If the cash flows generated by the business are insufficient to pay CIPAM FI back, then CIPAM FI need to be comfortable that other investors will be prepared to lend to the borrower at the time of refinancing which could be 5 or more years into the future. CIPAM FI considers responsible investing to be gaining rapid attention from a broader investment group which will have an impact on long term investment outcomes and we believe this is something all investors should be mindful of, regardless of their investment philosophy.

Effective engagement drives positive performance by mitigating downside risk.

CIPAM FI believes effective engagement incentivises more sustainable business practices. For many years CIPAM FI has achieved this through a focus on structure and documentation as a means to manage risk, a prioritisation of direct due diligence with borrowers to gain transparency into business practices and by promoting better market practices on behalf of all market participants. CIPAM FI's long history in private lending markets informs its approach to effective engagement across both public and private strategies.

ESG risks are most pronounced when poor environmental or social practices are combined with poor governance.

Environmental and social risks are inherent in many businesses. Most have adapted to evolving standards around their business practices. However, CIPAM FI believes businesses with poor governance are most at risk of prioritising short term results over long term sustainability, greatly increasing their risk of default.

These principles inform the CIPAM FI approach across public and private lending strategies.

Assessing the sustainability of the businesses, pricing for the risks identified and engaging with borrowers to mitigate these risks has always been embedded in the CIPAM FI investment process.

3. ESG integration

3.1 The ESG rating process

CIPAM FI's investment universe comprises global developed market bonds and private lending in Australia and New Zealand with a focus on performing (as opposed to distressed) credits. CIPAM FI's approach is also to invest into shorter tenors than its peers. This has the effect of reducing correlations with other risky assets and allows CIPAM FI to invest where its predictive power is strongest.

This investment universe influences CIPAM FI's approach to ESG. For example, CIPAM FI has minimal exposure to political risks and long-term themes such as demographics.

The table below illustrates how ESG is considered at every stage of the investment process.

How we invest – Private Credit mentality applied across all markets

Geography / Macro	Sector / Industry	Company / Issuer	Deal Structure	Liquidity
• Avoid situations where macro themes are the key valuation drivers as market shifts can be unpredictable and binary.	• Target sectors that have ongoing financing needs rather than opportunistic issuers. • Assess event risk within the sector? How does the company rank relative to peers?	• Focus on refinancing risk, cash flows, debt distribution, financing costs, covenants etc. • Engage with management team: key man risk, track record, stability.	• Active engagement with issuers in both public and private markets. • Ensure structure aligns economic incentives of the issuer with our clients. • Preference for structures that incentivise deleveraging to aid refinancing.	• Explicit modelling of liquidity premia. • Underweight issuers with high levels of perceived vs actual liquidity. • Focus on shorter tenors when lending in private markets.
Environmental, Social and Governance Considerations				
• Avoid countries/ regions which have heightened ESG risks.	• Evaluate the key environmental and social risk factors inherent in the sector.	• Rank the issuer relative to peers in terms of ESG. What is the history and trajectory?	• Seek to mitigate ESG risks or incentivise positive action by engaging on structure.	• Assess the ability of the business to withstand an ESG risk event which limits access to markets.

Materiality of ESG factors

CIPAM FI incorporates material ESG factors into the fundamental analysis of each issuer it includes, or is considering for inclusion in, its portfolio.

CIPAM FI determines materiality by considering which ESG risks and opportunities the industry is most exposed to as well as any ESG risks and opportunities specific to the issuer itself. A material ESG risk is one which, if not well managed, can have a significant impact on the ability of the borrower to repay the loan.

Within the private lending platform CIPAM FI have developed a proprietary framework to assign a rating for environmental, social and governance risk factors on each potential investment. This assessment forms a key part of the investment process.

The investment and credit teams jointly determine these ratings as part of CIPAM FI's due diligence process. Each investment is assigned one of the following four ratings for each E, S and G risk factor:

CIPAM FI's internal ESG ratings

ESG+	the factor **actively reduces** the credit risk of the investment
Low	the factor **does not meaningfully affect** credit risk of the investment
Medium	the factor **does meaningfully affect** the credit risk of the investment but this risk **could be mitigated** by engagement with the borrower or valuation
High	the factor **does meaningfully affect** the credit risk of the investment and engagement with the borrower or valuation considerations **does not mitigate this risk**

The ratings feed into the investment process as follows:

- If any factor is **High**, the investment will be avoided as it is difficult to mitigate the risk through engagement or ascertain fair value;
- If any factor is **Medium**, the investment can only proceed if one of two conditions are met: 1- the relative value of the investment justifies the medium risk, or 2- the risk can be mitigated through engagement; and
- The return hurdle for an **ESG+** investment will reflect the lower risk profile.

Risk layering

Layering of risks is of particular focus. CIPAM FI will be more inclined to avoid investments where a medium environmental or social risk is combined with a medium governance risk.

Interaction of ESG rating and value

	ESG +	Low	Medium	High
Undervalued	Add	Add	Add/Engage	Avoid
Fair value	Add	Add	Avoid/Engage	Avoid
Overvalued	Avoid	Avoid	Avoid	Avoid

The ESG ratings CIPAM FI assigns are tracked on a system which monitors CIPAM FI's deal pipeline.

Where practical, the same process is followed for public transactions. External ESG ratings are utilised in a similar manner to external credit ratings. They form a part of the overall ESG risk assessment but do not replace it.

Every investment memorandum is required to include a section that explains how these ESG ratings have been determined. Portfolio managers and/or investment committees are responsible for ensuring that an appropriate level of ESG analysis has been conducted and evidenced prior to approving any new exposure.

Case study: Layering of environmental risk with governance risk

In 2017 CIPAM FI avoided the refinance of a coal terminal. Whilst many investors simply screened out the investment based on perceived environmental risks, CIPAM FI was just as concerned with the lack of transparency and poor governance of the owner of the terminal. In 2015 and 2016, the investment and credit teams held several calls with the CFO of the coal terminal, advocating increased engagement and transparency from the firm with investors, regulators and the wider community.

On the environmental front, CIPAM FI conducted on site due diligence in 2014, visiting the terminal to examine the environmental impact of the existing infrastructure which it found to be comparable to other coal terminals operated by respected global infrastructure firms. Despite medium environmental risks ultimately it was the poor governance and stranded asset risks that led to CIPAM FI avoiding this transaction.

3.2 Asset class specific approaches to assessing ESG risks

The breadth of CIPAM FI's investment universe means that there is no one size fits all approach to assessing the ESG risk of a potential investment.

CIPAM FI employs various asset class level approaches to assessing ESG risks. Examples of typical considerations are outlined below.

The team's aim is to apply, where possible, consistent and comparable ESG analysis across the fixed income portfolio.

Given the broad scope of fixed income instruments, the ESG analysis is tailored where needed for different types of issuers and transactions.

Recognising that the nature of fixed income is that the potential downside outweighs the potential upside of an investment, the focus of ESG analysis is largely to identify and protect against significant event risk that can impact issuer / originator creditworthiness and that of asset cover pools.

Non-financial corporate credit

Assess the strategy of the borrower.

- Does their business entail any environmental or social risks? Examples may include:
  - labour practices (i.e. use of child labour, workplace health & safety),
  - product risk (i.e. tobacco/alcohol),
  - environmental risks (does the business have a direct or indirect negative impact of CO2 emissions),
  - stranded asset risk (is there a risk that the business is overtaken/replaced by a more "responsible" alternative business)?
- What does climate change mean for the business?

Assess the governance risks of the business.

- Does the board have sufficient independence?
- Does the board have diversity and experience to provide proper oversight of management?
- Is management/ ownership transparent and ethical (including with respect to relevant ESG data i.e. CO2 emissions data)?
- What is the track record of management/ sponsors in working with bondholders/ lenders?
- Is the financial reporting transparent and clear?

Financial credit

What is the business strategy of the financial institution?

- What are their key products and how are they distributed?
- What is the financial institutions approach to lending (do they consider ESG factors and if so how)?
- Where do they operate?

What are the governance risks of the business?

- Does the board have sufficient independence, diversity and experience to provide proper oversight of management?
- Is management/ownership transparent and trustworthy?
- What is the relationship of management/board with regulators?

Asset backed securities

Assess the lending strategy of the originator.

- What is the lending product?
- Does it have deleterious effects on society or the environment (e.g. payday lending)?
- How is the product originated?
- What are the credit policies of the originator (do they consider ESG risk in their decisions) Are there risks of mis-selling to borrower?
- What levels of disclosure are there around the product?
- Is the lending regulated or unregulated?

Assess the governance risks surrounding the structure.

- Is there proper segregation of cash?
- Is there an independent trustee?
- What is the organisational structure of the originator (e.g. are credit underwriters paid on volumes or performance)?
- Are collections outsourced?

Real estate lending

Assess the environmental risks of the property being lent against.

- What is the NABERS/Green Star rating?
- Identity and risks associated with the tenants in the property (e.g. do they require certain NABERS ratings, are they in sensitive industries)?
- What were the prior uses of the site (e.g. potential contamination of development site)

Assess regulatory compliance of property being lent against.

- Assess regulatory compliance (e.g. use of combustible cladding)
- Safety and security of building (e.g. for student accomodation)

Assess the governance risks of the sponsor and property manager.

- Can they be identified including source of funds?
- Are audited financials available?
- What is the track record of management?
- How are assets valued (e.g. frequency/independance)?

3.3 ESG factors

ESG factors that may be taken into consideration by CIPAM FI in its investment process include, but are not limited to, those shown in the below Key Issues Matrix. CIPAM FI recognises that ESG issues are not necessarily static and are likely to change over time, therefore this matrix will be amended accordingly from time to time.

The Key Issues Matrix summarises CIPAM FI's perspective on the key issues across environmental, social and governance risks which are most relevant to CIPAM FI's portfolios. These issues are a combination of issues identified by CIPAM FI and those highlighted by MSCI in their ESG ratings methodology.

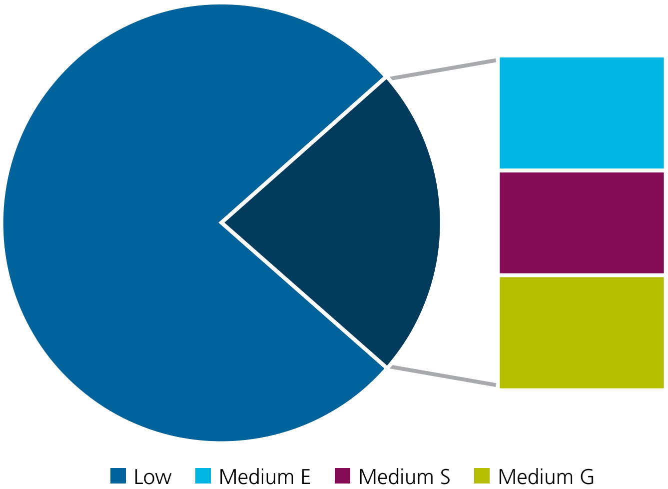
CIPAM FI Key ESG Issues Matrix

	Environmental				Social				Governance	
	Climate change	Natural resources	Pollution & waste	Environmental opportunities	Human Capital	Product liability	Stakeholder opposition	Social opportunities	Corporate governance	Corporate behaviour
Critical	Stranded Assets	Raw Material Sourcing	Toxic Emissions & Waste		Labour Mgmt	Privacy & Data Security			Accounting Standards	Lack of Disclosure
	Mining Carbon Emissions	Fossil Fuel Dependance			Health & Safety	Product Safety & Quality			Risk Management & Internal Controls	Business Ethics – Sponsor Conduct
	ILS – Climate Change				Trade Finance Receivables – ABS	ABS – Responsible Lending			Ownership	Anti-Competitive practices
					Supply Chain Labour Standards – ABS				Board	
Moderate	Redundancy (Cap Ex)	Product Design	Toxic Emissions & Waste		Labour Standards – RE EBAs	Health to Demographic	Product Sourcing	Access to Healthcare	Diversity of Management & Board	Tax Transparency
	Vulnerability to Climate Change	Aircraft – Energy Use/ Efficiency	Aircraft – Emissions / Noise Pollution			Financial Product Safety				Corruption & Instability
		Energy Use/ Efficiency								
Relevant	Product Carbon Footprint	Water Stress	Toxic Emissions / UST Asbestos	Opportunities in Renewable Energy	Human Capital Development	Chemical Safety		Nutrition & Health	Remuneration	Financial System Instability
		Biodiversity & Land Use	Packaging Material & Waste	ABS – Green Building				Access to Finance – ABS		
			Electronic Waste	Opportunities in Clean Tech				Access to Communications		

3.4 Portfolio construction & monitoring of ESG risks

ESG ratings are also used within the portfolio construction process to check that there is no concentration of environmental, social and governance risk factors within portfolios. These are monitored and discussed at portfolio construction meetings.

Sample ESG ratings distribution



Within the sample fund, all ESG factors are assigned as Low for 77% of the portfolio. The remaining 23% have only 1 factor rated as Medium (8% had a Medium score for Environmental, 7% for Social and 8% for Governance). There is no layering of Medium risks in any individual investment.

In terms of impact, CIPAM FI measures impact through investment performance, most particularly lower default experience through more explicit consideration of ESG risks and more effective engagement to mitigate these risks. Where practical, CIPAM FI will include details on ESG ratings for client portfolios.

3.5 Exclusions

We do not explicitly screen out any sectors as our ESG integration goals are to enhance and supplement our evaluation of the risk-return profile of investments. We believe that we must assess all investment opportunities under the same systematic process in order to deliver on our objective of achieving superior investment returns for our clients.

However CIPAM FI is not invested in sectors such as tobacco and munitions – our view is that the risk of these sectors places them outside of our mandates.

4. Key issues

4.1 Climate change risks and opportunities

CIPAM FI acknowledges that climate change and its associated risks, both from a physical and transition perspective, have become an increasingly important consideration in investment analysis and are a significant factor in the investment process for many of our clients. CIPAM FI's approach to climate risk is two-fold, looking at the long term and short term implications of climate change.

CIPAM FI's investment process favours shorter term lending decisions where it has the ability to assess, price and manage credit risks. Climate change is an example of a risk that CIPAM FI believes is difficult to assess, price and manage, especially over a longer term time horizon. CIPAM FI tends to avoid those climate change sensitive sectors which require it to make long term predictions with high degrees of uncertainty. Examples of this are avoiding long term lending to auto manufacturers.

CIPAM FI also incorporates the evolving views of the wider investment community into its investment process. For example, while the long term utilisation levels of non-renewable energy sources is uncertain it is clear that these sectors will be increasingly difficult to refinance in the coming years regardless of where utilisation levels are. This has led us to limit our exposure to these sectors, to those investments where we are comfortable that we can be repaid out of underlying cashflows, rather than through a refinance.

CIPAM FI's approach to climate risk is two-fold, looking at the long term and short term implications of climate change.

Over the short term horizon, CIPAM FI's assessment of climate change risks mainly focusses on the near term implications such as extreme weather events e.g. droughts, wildfires and floods. Sectors such as agriculture, insurance linked securities, power generation, water infrastructure are all considered through this lens. CIPAM FI also considers the impact of transition risks associated with potential regulatory changes imposed by governments in the effort to move to a low carbon economy, such as the introduction of a carbon price or costs associated with transitioning away from carbon dependence

4.2 Modern slavery risks

CIPAM FI considers the risks of modern slavery to be potentially material contributors to credit risk. When companies are found to engage in deliberately exploitative labour practices, serious questions should be raised about the governance of the company, the potential for large scale litigation is elevated and lastly, they risk significant brand damage and loss of social license. All of these could ultimately lead to defaults.

As a result of the focus on developed markets, CIPAM FI has assessed the direct risk of modern slavery in its portfolio as relatively lower than peers that directly lend into emerging markets. As a result, CIP's main area of focus in due diligence, when considering modern slavery risks, is in the supply chains of borrowers as for many, these supply chains are based in emerging markets. In assessing supply chains, CIPAM FI will consider the following questions:

- Does the borrower have an ownership stake in offshore supply chains?
- How are their supply chains audited/overseen?
- What is the track record of their suppliers with respect to labour practices?

Even where the responses to these questions suggest that the risks of exploitative labour practices are low, CIPAM FI will further assess what structural features it may include in transactions so that the risks remain low, and if they increase, CIPAM FI has recourse. These features may include:

- a requirement for regular external audits from bodies like Sedex; or
- specific representations and undertakings that the borrower is required to make around their compliance either as a condition precedent to funding or on an ongoing basis.

If the borrower has no exposure to emerging markets either directly or indirectly via supply chains, CIP will still assess the risks of modern slavery in their business. This assessment will be focussed on the governance of the borrower as the Modern Slavery risks will pertain to compliance with law ("is the company paying staff wages in line with award levels?") and societal expectations ("is the company engaging in exploitative practices that may negatively impact it's credit risk?").

Lastly, as an organisation incorporated in Australia with more than $100 million in revenues, Challenger Group will be required to report on steps taken to respond to the risk of modern slavery in its operations and supply chains. This reporting requirement extends to Challenger Group, and by virtue of this, CIPAM FI's investment activities described above.

5. Resources

As many CIPAM FI portfolio investments are not ESG rated by third party institutions (being private loans to unlisted companies, securitised credit exposures or loans secured by commercial real estate), the determination of ESG scores for many client portfolios is driven by internal teams.

CIPAM FI believes that ESG integration is strongest when portfolio managers and analysts are deeply involved in the process. CIPAM FI utilises a wide selection of external sources, where available, to assess its portfolio. These include:

- Specialist research and insights on individual issuers and sectors from MSCI ESG Research;
- Broker research from a broad range of sell-side institutions and ESG service providers;
- Credit rating agency research (primarily Standard & Poor's and Moody's);
- Publicly available financial information regarding individual companies;
- Insights from Challenger Group's ESG Specialist within its Funds Management division; and
- Research from industry bodies, regulatory bodies or multi-lateral organisations such as the PRI, investment consultants, World Bank, ASIC and others.

Third party research is stored on the CIPAM FI ESG intranet page and discussed at monthly ESG meetings, which form part of Portfolio Construction meetings and which are chaired by the Head of Investment Strategy (who is the CIPAM FI ESG representative at the Challenger Group level), alongside the ESG Specialist within Funds Management.

CIPAM FI believes that ESG integration is strongest when portfolio managers and analysts are deeply involved in the process.

The meetings are attended by the CIPAM FI investment team as well as the independent Group Credit team. These meetings include a review of recent ESG scores to maintain a consistent approach, recent engagements (which are tracked via an Engagement Log) as well as a discussion of relevant recent issues in the market.

The CIPAM FI team works closely with the broader Challenger Group on ESG related initiatives. Challenger is a signatory to the PRI and CIPAM FI reports on its ESG activities and progress each year in Challenger's annual PRI submission.

6. Engagement on ESG

CIPAM FI seeks to engage with borrowers in two main ways. First, the investment team engages with the management of borrowers directly to understand the relevant E, S and G factors affecting the issuer and to advocate for changes to improve the overall sustainability of a borrower's business model. Additionally, the investment team engages with borrowers (and arrangers) to effect changes in structures to protect its interests as a lender.

CIPAM FI considers engagement a significant opportunity, particularly in its private lending activities, where it has more ability to engage directly with borrowers and to effect real change in either business models or deal structures (e.g. through bespoke covenant design).

CIPAM FI's heritage in private lending markets drives the overall investment approach, meaning the public markets investment team is expected to actively engage with borrowers, arrangers and other market participants. Furthermore, in public markets, CIPAM FI recognises there is greater opportunity for public engagement and advocacy designed to influence other investors to follow CIPAM FI's position (e.g. at investor roadshows).

Clients are provided with regular updates on recent engagements which are relevant to their portfolios.

Case study: Social risk considerations – engagement in private lending

In 2018, CIPAM FI met with a non-bank lender who was introducing a commercial lending product. The product did not fall under the National Consumer Protection Credit Protection (NCCP) Act. As part of providing a mezzanine loan, CIPAM FI negotiated several changes to the lender's credit policies intended to improve the degree to which the lender would consider the needs or circumstances of the underlying borrowers (effectively "responsible lending"). Whilst not required under ASIC regulation for commercial loans, CIPAM FI considered the changes necessary to ensure the loans were responsible and consequently, lower risk.

7. Responsibility for ESG integration

CIPAM FI believes that ESG integration is strongest when portfolio managers and analysts are deeply involved. As such, all portfolio managers and analysts are responsible for assessing, discussing and incorporating ESG factors in investment decisions, in accordance with this policy and process.

The Head of Investment Strategy – Fixed Income is responsible for the ESG investment process and has oversight of how individual portfolio managers and analysts are integrating ESG into their investment decisions.

8. Scope

This Responsible Investment Statement applies to all relevant employees of Challenger Investment Partners Fixed Income team responsible for making active investment decisions.

9. Oversight

The Responsible Investment Statement is reviewed annually by the Head of Investment Strategy – Fixed Income and ESG Specialist, Fidante. The statement is ultimately authorised by the Chief Executive of Funds Management, Challenger.

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