Policy on the integration of principal adverse impacts on sustainability

Article 4 SFDR

LAST UPDATE - JULY 2024

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INTRODUCTION

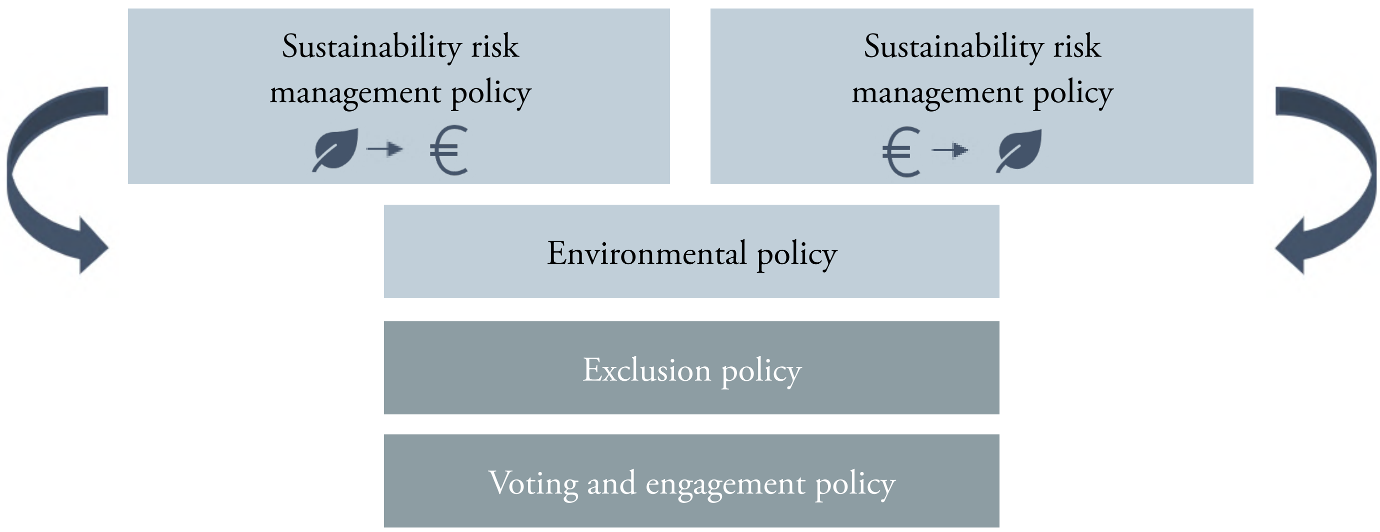
REGULATORY CONTEXT

The signing of the Paris Agreement in 2015 and the increasing prominence of environmental, social, and governance (ESG) issues have made it essential for states and public actors to define a structured framework aimed at better addressing the associated risks and opportunities. To harmonize regulation at the European level, the European Commission launched an action plan for sustainable finance in 2018.

As a long-term investor, Lazard Frères Gestion is resolutely committed to supporting the transition towards greener and more responsible finance. This document, in accordance with the requirements defined in Article 4 of Regulation EU No. 2019/2088 on sustainability-related disclosures in the financial services sector (SFDR - Sustainable Finance Disclosure Regulation), known as the "Disclosure Regulation," establishes the policy for managing principal adverse impacts on sustainability. This policy is coupled with a sustainability risk integration policy, as required by Article 3 of the SFDR regulation.

For more information, please refer to the document "Our ESG Approach" available on the website https://www.lazardfreresgestion.fr/FR/%20ESG-ISR_112.html or contact your sales representative.

Responsible investment policy



I/ Description of principal adverse impacts on sustainability

What are Principal Adverse Impacts (PAI)?

Negative impacts on sustainability are the overall negative effects of investment decisions on various sustainability factors (environment, society, governance, respect for human rights, and anti-corruption efforts).

Here are the 14 mandatory indicators as well as the additional indicators that we publish in our PAI reporting.

Principal Adverse Impacts on Sustainability Factors (PAI - Principal Adverse Impacts)		
PAI	Indicator of Adverse Impacts on Sustainability	Measurement Element
Climate and Environmental Indicators		
PAI 1	Greenhouse Gas Emissions	Scope 1 / Scope 2 / Scope 3 / Total greenhouse gas emissions
PAI 2	Carbon Footprint	Carbon footprint
PAI 3	Greenhouse Gas Intensity of Investee Companies	Greenhouse gas intensity of investee companies
PAI 4	Exposure to Companies Active in the Fossil Fuel Sector	Share of investment in companies active in the fossil fuel sector
PAI 5	Share of Non-Renewable Energy Consumption and Production	Share of energy consumption and production of investee companies from non-renewable energy sources compared to renewable energy sources, expressed as a percentage of total energy sources
PAI 6	Energy Consumption Intensity per High Climate Impact Sector	Energy consumption in GWh per million euros of revenue of investee companies, by high climate impact sector
PAI 7	Activities Negatively Affecting Biodiversity-Sensitive Areas	Share of investments in companies with sites/operations located in or near biodiversity-sensitive areas, if those companies' activities negatively affect those areas
PAI 8	Water Emissions	Tonnes of water emissions from investee companies, per million euros invested, weighted average
PAI 9	Hazardous and Radioactive Waste Ratio	Tonnes of hazardous and radioactive waste produced by investee companies, per million euros invested, weighted average
Social, Employee, and Human Rights Indicators		
PAI 10	Violations of UN Global Compact Principles and OECD Guidelines for Multinational Enterprises	Share of investment in companies involved in violations of the UN Global Compact principles or the OECD Guidelines for Multinational Enterprises
PAI 11	Lack of Processes and Compliance Mechanisms to Monitor Adherence to UN Global Compact Principles and OECD Guidelines for Multinational Enterprises	Share of investment in companies that do not have a policy to monitor adherence to the UN Global Compact principles or the OECD Guidelines for Multinational Enterprises, nor mechanisms to handle complaints or disputes to address such violations
PAI 12	Unadjusted Gender Pay Gap	Average unadjusted gender pay gap within investee companies

Principal Adverse Impacts on Sustainability Factors (PAI - Principal Adverse Impacts)		
PAI	Indicator of Adverse Impacts on Sustainability	Measurement Element
Social, Employee, and Human Rights Indicators		
PAI 13	Gender Diversity in Governance Bodies	Average ratio of women to men in the governance bodies of the investee companies, as a percentage of the total number of members
PAI 14	Exposure to Controversial Weapons (anti-personnel mines, cluster munitions, chemical weapons, or biological weapons)	Share of investment in companies involved in the manufacture or sale of controversial weapons
Indicators Applicable to Investments in Sovereign or Supranational Issuers		
PAI 15	GHG Intensity	GHG intensity of the countries of investment
PAI 16	Countries of Investment with Social Norm Violations	Number of countries of investment with social norm violations (in absolute numbers and as a proportion of the total number of investee countries), as defined by international treaties and conventions, UN principles, or, where applicable, national law.

Additional Indicators Related to Principal Adverse Impacts on Sustainability Factors		
PAI	Indicator of Adverse Impacts on Sustainability	Measurement Element
Additional Climate and Environmental Indicators		
PAI 7	Investments in Companies Without Water Management Policies	Share of investment in companies without a water management policy
Additional Social, Employee, and Human Rights Indicators		
PAI 1	Investments in Companies Without Workplace Accident Prevention Policies	Share of investment in companies without workplace accident prevention policies
PAI 6	Insufficient Protection for Whistleblowers	Share of investment in entities that have not defined a whistleblower protection policy
PAI 9	Lack of Human Rights Policy	Share of investment in entities without a human rights policy
PAI 15	Lack of Anti-Corruption and Anti-Bribery Policy	Share of investment in entities without an anti-corruption and anti-bribery policy in line with the United Nations Convention against Corruption.
Additional indicators applicable to investments in sovereigns and supranationals		
PAI 18	Average income inequality score	Distribution of income and economic inequality among the participants in a particular economy
PAI 19	Average freedom of expression score	Extent to which political and civil society organisations can operate freely
PAI 20	Average human rights performance	Average human right performance of investee countries
PAI 21	Average corruption score	Perceived level of public sector corruption
PAI 22	Non-cooperative tax jurisdictions	Investments in jurisdictions on the EU list of non-cooperative jurisdictions for tax purposes
PAI 23	Average political stability score	Likelihood that the current regime will be overthrown by the use of force
PAI 24	Average rule of law score	Level of corruption, lack of fundamental rights, and the deficiencies in civil and criminal justice

• What is sustainability risk?

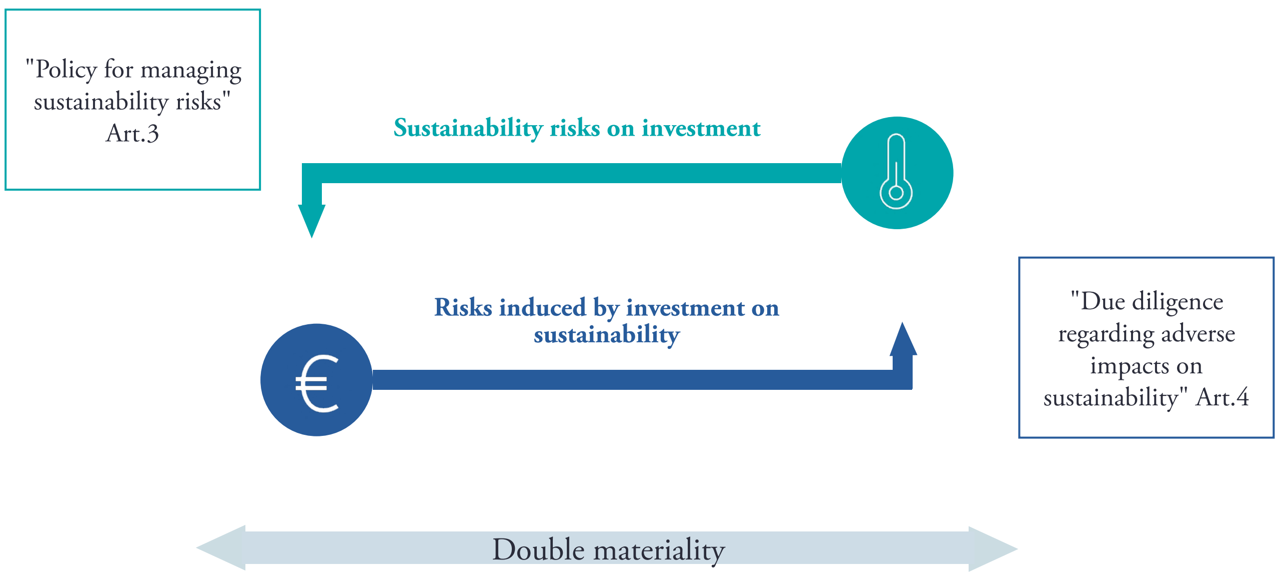
L Sustainability risk is defined as "an environmental, social, or governance event or condition that, if it occurs, could cause a significant negative impact, real or potential, on the value of the investment."

For companies, sustainability risk can take various forms. Based on the recommendations of the TCFD (Task Force on Climate-related Financial Disclosures), Lazard Frères Gestion has established a table of the different risks that companies may face (see Annex I). All these considerations are taken into account by the analyst-managers and the Risk team on a daily basis through proprietary extra-financial analysis.

• What is double materiality?

On one hand, the materiality related to sustainability risks concerns investors insofar as climate, environmental, social, and governance factors exert pressures on the sustainability of companies. On the other hand, the materiality related to adverse impacts focuses on the impact of investments on society and the environment as a whole.

To ensure that neither aspect is neglected, the European Commission introduced the notion of "double materiality." Thus, the Commission indicates that non-financial information can have a financial impact and, conversely, that finance can have consequences on the environment and/or society.



[1] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (view)
[2] SFDR, Article 2 (22)
[3] DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directives 2013/34/EU, 2004/109/EC, and 2006/43/EC as well as Regulation (EU) No 537/2014 regarding the disclosure of sustainability information by companies (view)

• What is SFDR classification?

The SFDR regulation defines three categories of financial products classified according to their integration of sustainability risks, their consideration of ESG criteria, and Principal Adverse Impacts (PAI):

"Article 6" products

All financial products that are not eligible under Article 8 or Article 9.

No consideration of ESG criteria is required for these products.

However, they must meet the transparency duty regarding the integration of sustainability risks.

"Article 8" products

These products promote environmental or social characteristics.

"Article 9" products

These so-called "Article 9" products aim for sustainable investment, meaning they invest in economic activities that contribute to an environmental and/or social objective.

For "Article 8" and "Article 9" products, the transparency and disclosure requirements are higher. Thus, just like market risk, credit risk, or liquidity risk, sustainability risk must be taken into account in the decision-making process when making an investment.

II/ Policy for considering principal adverse impacts

A/ Prioritization of principal adverse impacts

At Lazard Frères Gestion, adverse impacts are taken into account in ESG analysis. We have defined two levels of consideration within the asset management company: exclusions, on the one hand, to limit risks, and ESG analysis, on the other hand, to enable the integration of best practices.

Furthermore, aware of the importance of intra-sector comparisons and a good understanding of the operational, geographical, and regulatory environment in which companies operate, we pay particular attention in our analysis methodology to the materiality of ESG risks and opportunities. A differentiated consideration of criteria according to sectors, countries, or even specific characteristics seems necessary to adequately reflect the ESG performance unique to each company.

Starting in 2020, Lazard Frères Gestion has defined several sectoral and normative exclusion policies. These exclusions help to limit principal adverse impacts by not investing in companies with high exposure to sustainability risks.

SECTORAL EXCLUSIONS

- Tobacco
- Thermal coal (disengagement by 2030)

NORMATIVE EXCLUSIONS

- Controversial weapons (regulatory exclusions)
- Severe Violations of the United Nations Global Impact

For more information, please refer to Our ESG Approach.

B Internal ESG analysis

ESG ANALYSIS PROCESS

The construction of analyses involves an in-depth, informed, forward-looking, and, if necessary, critical study of all available environmental, social, and governance data. ESG analyses are conducted directly by our analyst-managers in accordance with our commitment to rejecting a "siloed" ESG approach.

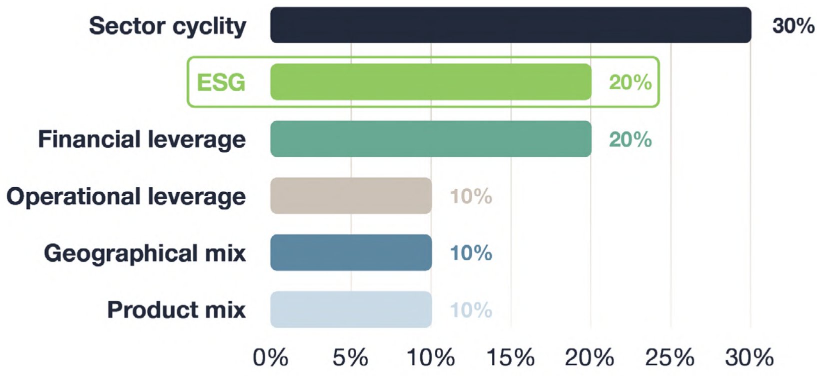
INTERNAL ANALYSIS GRID

Information related to each company is summarized in an internal grid common to all analyst-managers. Sector analysts, responsible for monitoring each stock, establish an internal ESG score based on both a quantitative and qualitative approach: for each E, S, and G pillar, around fifteen key indicators are tracked and then aggregated into a composite score. Among these indicators, we have included all the principal adverse impacts listed in Table 1 of Annex I of the Delegated Regulation (EU) 2022/1288 of April 6, 2022 (known as the "Disclosure" Regulation) to incorporate these considerations into the internal ESG score.

Each pillar is scored out of 5, and the company's overall ESG score synthesizes the E, S, and G scores according to the following weighting: 30% for Environment, 30% for Social/Societal, and 40% for Governance, which has always been a crucial element and therefore deserves, in our view, slightly more weight. The overall ESG score ranges from 1 to 5 (with 5 being the best score). Designed with a focus on combining granularity and efficiency, this score allows management teams to integrate ESG elements into their analysis that may have an underestimated influence in the future.

INTEGRATION INTO MANAGEMENT

Within the framework of equity management, analyst-managers take into account the internal ESG score in the analysis and calculation of the cost of capital of the companies they follow through the calculation of Beta. This calculation provides a measure of the overall risks of the company. We consider financial and extra-financial criteria according to the following weighting:



Within the framework of bond management, analyst-managers exclude issuers from the investment universe whose internal ratings are deemed weak (≤ 2/5). Additionally, for Investment Grade issues, the share of issuers rated between 2/5 and 3/5 is limited to 30% of portfolio holdings. For High Yield portfolios, which are more exposed to smaller issuers and traditionally have lower ratings, this share is limited to 50% of the portfolios (see opposite).

Type of issuer	Internal rating	Exclusion	Exposure limit
All issuers	Rating ≤ 2/5	Yes	-
Investment Grade	2 < Rating ≤ 3	-	Max 30%
High Yield	2 < Rating ≤ 3	-	Max 50%

The diversified management team defines the tactical allocation according to the cycle and markets, and delegates the management of equity and fixed income pockets to specialized management teams.

C/ Governance

All the activities of the asset management company, both for institutional and private clients, are now concerned with environmental, social, and governance (ESG) issues. The principles of responsible investment are now embedded in the discussions and practices of all key functions: internal governance, research and analysis, portfolio management, risk control and reporting, compliance, and client relations.

Thus, Lazard Frères Gestion has implemented a governance structure that allows for effective decision-making on ESG issues while facilitating dialogue among all departments. This governance is organized around four committees: the Executive Committee, the ESG Committee, the ESG Risk Committee, and the monthly ESG Meeting. Finally, Lazard Frères Gestion seeks to develop its ESG expertise within a specialized team. Composed of the Head of ESG, six ESG specialists, and ESG analyst interns, this team reports directly to François-Marc Durand, President of Lazard Frères Gestion.

For more information regarding the ESG governance of Lazard Frères Gestion, please refer to our ESG approach.

D Data sources

To support our analyses, we use various data providers. In a spirit of vigilance, their respective offerings are reviewed annually to ensure that we benefit from the most suitable services for our management needs.

Lazard Frères Gestion uses MSCI as the provider for data concerning principal adverse impacts.

MSCI

- **MSCI** : our partnership with MSCI allows us to assess physical and transition risks. Notably, we are able to calculate a portfolio "temperature," in other words, to evaluate its ability to meet the 2°C alignment stipulated in the Paris Agreement. Additionally, we use the PAI data provided by MSCI as part of our sustainable investment methodology under the SFDR Regulation.

E Engagement and voting policies

Lazard Frères Gestion places particular importance on meetings with the management of the companies it follows. The objective is to encourage these companies to continuously and constructively improve their overall ESG practices: transparency, integration of sustainable development issues, SDGs (Sustainable Development Goals), good governance practices, etc. During regular meetings, analyst-managers discuss numerous ESG topics with the company management. Drawing on their expertise, they determine the key points to address during these meetings. Thus, principal adverse impacts can be relevant indicators for suggesting areas of improvement to companies.

Lazard Frères Gestion also supports active ownership, which allows shareholders to influence the ESG strategies and practices of companies. We apply our own Voting Policy when voting at the General Meetings of issuers within the defined scope. The number and reasons for dissenting votes are recorded in a tool and are an integral part of the annual voting report.

III/ International standards and degree of alignment with the Paris Agreement III

A/ References to international standards

Lazard Frères Gestion relies on a range of international conventions and standards to consider adverse impacts. These conventions include:

- The Ten Principles of the United Nations Global Compact,
- The OECD Principles of Corporate Governance,
- The OECD Guidelines for Multinational Enterprises,
- The Universal Declaration of Human Rights,
- The United Nations Guiding Principles on Business and Human Rights,
- The Children's Rights and Business Principles,
- The Fundamental Conventions of the International Labour Organization,
- The United Nations Declaration on Environment and Development,
- The United Nations Convention against Corruption,
- The Oslo and Ottawa Conventions on Cluster Munitions and Anti-Personnel Mines,
- The Paris Agreement on Climate Change,
- The 1992 Convention on Biological Diversity.

B/ Degree of alignment with the Paris Agreement

At COP 21 in 2015, 196 countries signed the Paris Agreement to limit global warming to well below 2°C, preferably to 1.5°C, above pre-industrial levels. To achieve this long-term temperature goal, countries aim to reach the global peak of greenhouse gas emissions as soon as possible to achieve a climate-neutral world by 2050. In France, Article 29 of the Energy-Climate Law articulates European law with national specificities. French market participants must therefore publish a strategy for alignment with the international climate goals set out in the Paris Agreement.

In addition to the principal adverse impacts that we regularly monitor, we assess the alignment of our investments with the Paris Agreement by measuring the implied temperature rise (ITR) of our investments at the asset management company level. The measurement of the implied temperature rise is based on the methodology and data from our provider MSCI and provides an indication of how companies and investment portfolios align with global climate goals.

For more information, please refer to our Article 29 Report.

APPENDIX

Sustainability risk		Example	Effect	Probability	Horizon	Impact	Type	Type of intake
Environment								
Physical and climatic risks	Acute	Extreme weather events such as storms, hurricanes or floods	. Direct impact: damage to assets . Indirect impact: supply chain disruption	High	Short term	High	Current Exogenous	ESG analysis > Comment E
	Chronic	· Changes in precipitation and extreme volatility in weather patterns · Rising temperatures and chronic heat waves · Rising sea levels		High	Medium term	High	Current Exogenous	· ESG analysis > CO2 intensity, sector temperature (°C), climate change policy · Implied Temperature Rise
Climate transition risks	Political and legal	· Tighter regulation of existing products and services · Tougher requirements on GHG emissions reporting · Litigation	· Increased costs · Direct financial impact: litigation · Risk of stranded asset / depreciation	High	Short term	High	Emerging Endoge-nous	ESG analysis > climate change policy
	Technology	· Substitution of existing products and services towards less GHG emitting alternatives · Cost of transition to low-carbon technologies · Insufficient investment in new technologies	Technological lag that can lead to a loss of competitiveness	High	Medium term	Me-dium	Current Exogenous	ESG analysis > Patents, Low Carbon Patents
	Market	· High cost of raw materials · Market uncertainty	Rising raw material and energy costs	Medium	Medium term	Me-dium	Current Exogenous	ESG analysis > Sector
	Reputational	· Growing concern or negative reaction from stakeholders · Changing consumer preferences	Risk of market loss	Medium	Short term	Me-dium	Emerging Endoge-nous	ESG analysis > Comment E
Biodiversity risks	Loss of biodiversity	Pollution and destruction of ecosystems: deforestation, water pollution, etc.	Impact on companies and business activities dependent on ecosystems	High	Strong term	Me-dium	Current Exogenous	· ESG analysis > Water management policy, water consumption intensity, waste generation intensity · Biodiversity score
Risks of controversy	Legal	Environmental controversy	Direct financial repercussions: lawsuits	Medium	Medium term	Me-dium	Current Exogenous	Controversy management process

Sustainability risk		Example	Effect	Probability	Horizon	Impact	Type	Type of intake
Social								
Internal risks	Human capital management	· Inadequate human resources · Lack of training, loss of employee motivation · Deterioration in well-being at work · Staff turnover	Loss of productivity and responsiveness to customer needs	Low	Short term	Medium	Current Endogenous	ESG analysis > staff turnover, total incident rate, health and safety policy...
	Legal	Violation of human rights	Direct financial repercussions: lawsuit	Low	Short term	High	Current Endogenous	ESG analysis > Human rights policy
External risks	Reputational	· Professional inequalities · Difficulties in attracting talent · Diversity	Loss of competitiveness	Medium	Medium term	Medium	Emerging Endogenous	ESG analysis > % women in workforce, equal opportunities policy, fair pay policy
Risks of controversy	Legal	Social controversy	· Direct financial repercussions: lawsuit · Loss of competitiveness	Medium	Short term	Medium	Current Endogenous	Controversy management process
Governance								
Internal risks	Governance	· Excessive concentration of power · Lack of involvement and skills of directors	Poor decision-making leading to financial loss	Medium	Short term	High	Current Endogenous	ESG analysis > combining the roles of CEO and Chairman, % of independents on the board, % of non-executive members on the board, attendance at board meetings
	Corruption	Corruption, lack of integrity, tax evasion	Direct financial repercussions: lawsuits	Medium	Short term	High	Current Endogenous	ESG analysis > Comment G

POLICY ON THE INTEGRATION OF PRINCIPAL ADVERSE IMPACTS ON SUSTAINABILITY

LAZARD FRÈRES GESTION

LAZARD
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