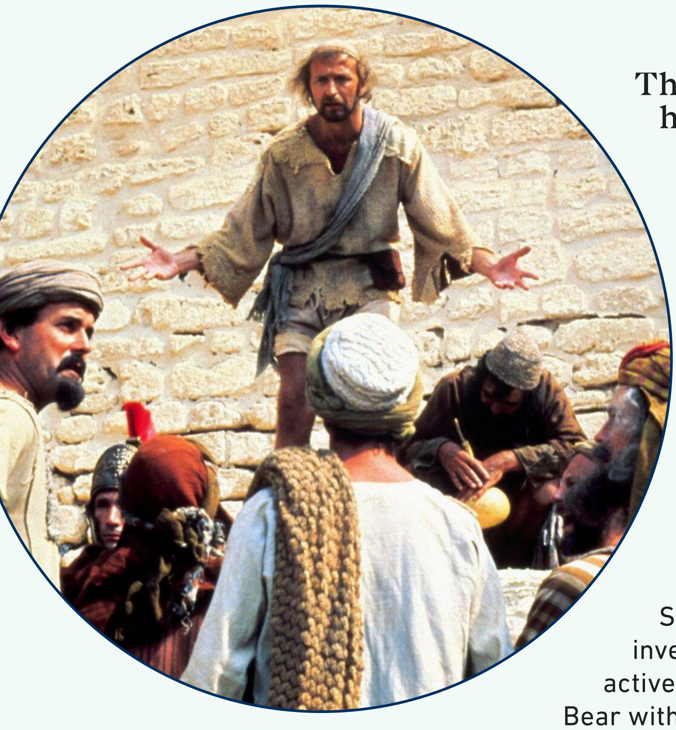
Pareto
Asset Management

Responsible investments

Report 2-2022

Contents

Brian's guide to sustainable investing



The Monty Python movie Life of Brian (1979) has a brilliant scene in which Brian reluctantly addresses a crowd of people believing he is the new Messiah:

BRIAN: Look. You've got it all wrong. You don't need to follow me. You don't need to follow anybody! You've got to think for yourselves. You're all individuals!
CROWD: Yes, we're all individuals!
BRIAN: You're all different!
CROWD: Yes, we are all different!
MAN IN THE CROWD: I'm not.
CROWD: Shh. Shhhh.
BRIAN: You've all got to work it out for yourselves!
CROWD: Yes! We've got to work it out for ourselves!

Strange choice of reference point in a report on responsible investing? There is in fact a logical link to our philosophy of active management. We believe in working it out for ourselves. Bear with me:

Much needed progress has been made on defining, classifying, and reporting on sustainability in European legislation. This is intended to help investors make better informed choices and of course to prevent greenwashing, thereby directing capital towards, and promoting, sustainable activities. I have yet to see anyone object to those goals.

As part of the European Economic Area, Norway regularly incorporates EU regulations into Norwegian law. A law combining the EU Taxonomy Regulation and the Sustainable Finance Disclosure Regulation was in fact passed in 2021. It is not expected to come into force until 2023, but all major asset management companies have long been working on adapting to this new legal and commercial environment. Pareto Asset Management is no exception.

We applaud this development and we do expect it to influence asset management outside Europe, as there is no other international body capable of chiseling out functioning cross-border legislation. We do, however, believe that such systems may act like kids' shape sorters; only pre-defined shapes pass the test.

In order to classify as a "green" or sustainable activity, a company must contribute to at least one of six environmental objectives while not significantly harming any of them:

• Climate change mitigation
• Climate change adaptation
• Sustainable use and protection of water and marine resources
• Transition to a circular economy
• Pollution prevention and control
• Protection and restoration of biodiversity and ecosystems

In addition, there are social impact and technical screening criteria. To keep companies from bending these definitions to their own benefit, delegated acts specify further which activities can be defined as sustainable according to this legislation.
Fish farming is not defined as sustainable according to this system. It is easy to see why: There may be pollution from excess nutrients, fecal discharge or leaked chemicals, while escaped fish may spread diseases or interbreed.

If you want to be on the right side of the EU taxonomy, you will not invest in fish farming. If you can find a functional index that excludes activities not defined as green (good luck with that!), you will not be invested in fish farming.

We are. Our Norwegian equity mandates have long been invested in fish farming, and to good effect – at least in terms of financial returns. Did we also contribute to unsustainable activities?

We don't believe so. While we recognise that there are negative consequences of fish farming, we honestly believe that they are far outweighed by the positive consequences.

First and foremost: Fish farming is a highly efficient way of producing animal proteins for human consumption. Whereas 100 kg feed produces 7 kg of edible cattle meat, 19 kg of pork and 39 kg of chicken meat, it yields as much as 56 kg of edible salmon.

This is not just a question of producing enough food for a growing global population. A critical issue is being able to produce the same amount food with a lower environmental footprint, from carbon emissions to requiring large tracts of land. Here, salmon farming reigns supreme.

Of course, we are attentive that fish farming is conducted in the best possible way. One such confirmation is the annual Coller FAIRR index of the world's most sustainable protein producers. For four years in a row (and soon, we hope, five) several Norwegian fish farming companies have come out on top of this ranking.

That's no definitive guide, though. We've got to work it out for ourselves. We keep in touch with our portfolio companies, raising various issues of environmental, social or guidance relevance, pushing for more information if we are not satisfied. This is a source of information we cannot do without.

And so, we have invested in an industry that is not classified as sustainable according to the EU taxonomy. We believe that it does indeed score well on several parameters of sustainability. It's just not on that list.

That's what active management is all about. We've got to work it out for ourselves. And we do. Rest assured those are not accidental investments.

Finn Øystein Bergh
Chief Economist & Strategist

Guidelines for responsible investments

1. BACKGROUND AND PURPOSE

Pareto Asset Management AS ("Pareto Asset Management") aims at contributing to sustainable development of markets and long-term value creation by investing in a responsible and ethical manner. We believe that responsible investments are important for achieving the best possible risk-adjusted return for our unitholders and customers. Sustainability and sound corporate governance give companies competitive advantages and contribute to long-term value creation.

This document sets out guidelines for responsible investments undertaken by Pareto Asset Management on behalf of our unitholders and individual asset owners. The purpose of the policy is to prevent Pareto Asset Management from contributing to the violation of human rights, labor rights, corruption, environmental damage or other unethical actions. Furthermore, we consider it important to integrate sustainability assessments into our investment processes, as this can also affect the long-term value of our investment.

We expect the companies that we invest in to comply with the same principles.

As part of our efforts to promote responsible investments, Pareto Asset Management has signed the UN Principles for Responsible Investment ("UN PRI")[1]. These guidelines are based on UN PRI, the UN Global Compact[2], the guidelines for the Norwegian Government Pension Fund Global, the Principles for the exercise of ownership rights in investment companies from the Norwegian Fund and Asset Management Association, as well as internationally recognised principles and conventions.

2. RESPONSIBLE INVESTMENTS

2.1 Priorities

We seek to invest in companies that have good quality of operations and management. The companies should have a clear focus on ethical issues in their attitudes and actions, as well as having a value base for the business that complies with the guidelines. The companies must exert good corporate governance, comply with national legislation as well as international conventions, and show an open and complementary information policy. This means we emphasise social conditions, the environment, sustainability and good corporate governance when considering a company.

Ethical risk assessments must be conducted before an investment can be made.

2.2 Exclusion of companies

Pareto Asset Management shall not be invested, on behalf of our funds and customers, in companies which themselves or through entities they control:

- Produce weapons that, in normal use, violate basic humanitarian principles
- Produce tobacco
- Sell weapons or military equipment to states subject to sanctions from the UN Security Council or other international measures directed at a particular country that Norway has supported (mandate for the management of the SPU section 3-1 second paragraph letter c)
- Mining companies and power producers that themselves or consolidated with controlled entities receive 30 per cent or more of their revenues from thermal coal, or base 30 per cent or more of their operations on thermal coal activity
- Produce pornography

[1] The contents of UNPRI can be found here: www.unpri.org/pri/an-introduction-to-responsible-investment.

[2] The UN Global Compact contains ten general principles derived from the Universal Declaration of Human Rights, the ILO Declaration of Fundamental Principles and Rights in Work and the Rio Declaration on Environment and Development.

Pareto Asset Management may decide to exclude a company if there is an unacceptable risk that the company contributes or is responsible for:

- Human rights violations, such as killing, torture, deprivation of liberty, forced labour and exploitation of children, including child labour[3]
- Violations of individuals' rights in war or conflict situations
- Breach of basic employee rights
- Severe environmental damage
- Actions or omissions that lead to greenhouse gas emissions at an aggregated company level
- Corruption
- Other repeated or significant violations of basic ethical norms

Pareto Asset Management shall exercise a precautionary principle in connection with investments in biotechnology companies, gambling and alcohol.

2.3 Exclusion decision

Companies listed on the exclusion list of the Norwegian Government Pension Fund Global after the decision of Norges Bank's Executive Board shall be automatically excluded from the investment universe of Pareto Asset Management.

If legitimate doubt arises as to whether an investment is in line with the guidelines, a separate ethical risk assessment shall be conducted. This assessment can be based on input from our customers and other stakeholders, as well as various publicly available sources. Pareto Asset Management will nevertheless always draw its own conclusions based on a specific assessment of objective, verifiable facts.

3. CORPORATE GOVERNANCE

Pareto Asset Management shall exercise active ownership in the portfolio companies in order to promote responsible business operations. This means that we will use our ownership rights and influence in the companies to help move the companies in a positive direction in terms of social relations, environmental issues, sustainability and good corporate governance.

When there is a specific reason to believe that a company violates our policy of responsible investments, we will consider addressing the issue with the company's management and encouraging the company to correct the circumstances. If necessary change is not implemented, Pareto Asset Management will normally sell all positions in the company.

[3] This includes "the worst forms of child labour" as defined in the ILO Convention (No. 182) Article 3.

Pareto Aksje Norge fund management team: Einar Løvoll (left), Besim Zekiri and Eirik Andresen.
To the right: Partner Monica Urnes, Direct sales

4. RESPONSIBILITY FOR MONITORING AND CHECKING THE GUIDELINES

Pareto Asset Management has established an ethics committee entrusted with the responsibility to ensure that the company's guidelines for responsible investments are up to date and appropriate, as well as assess and decide exclusion of companies in accordance with paragraph 2.3 of the guidelines. It will also assist portfolio managers with training, advice and sparring as needed. In particularly demanding cases, the Ethics Committee shall inform the CEO.

The Ethics Committee is headed by the company's Chief Economist & Strategist and consists, in addition, of representatives of different departments as required.

Twice a year, the Ethics Committee prepares a report on our guidelines for responsible investments and the practice of these. The report reviews specific topics we have worked with as well as relevant company assessments and dilemmas. It shall be available to our customers.

The chairman of the Ethics Committee shall annually provide the Board of Pareto Asset Management with an overview of the status of ongoing work for responsible investments in the company.

The Compliance Manager shall supervise compliance with our Guidelines for Responsible Investments, including the necessary exclusion of companies. In addition, the compliance officer will attend meetings of the Ethics Committee as an observer.

Background and facts

Behind the UNPRI principles is the UN Environment Program Finance Initiative (UNEP FI). UNEP FI is a global partnership between the United Nations Environment Program and the financial sector. Among the goals for the collaboration is to identify, promote and realize best environmental and sustainability practices in the financial industry. Central to this collaboration are ESG questions, derived from the English concepts environmental issues, social issues and corporate governance.

Through our signature, we committed ourselves to respond to ESG questions that may follow, to the best of both our customers in the long run and for society as a whole:

1. We will implement ESG issues in our investment analysis and decision-making processes
2. We will practice active ownership and implement ESG in our ownership policy and its exercise
3. We will work for satisfactory reporting on ESG topics from our portfolio companies
4. We will promote acceptance and implementation of the principles in the financial industry
5. We will work with other signatories to strengthen the effect of the principles and their implementation
6. We will report on our activities and our progress in implementing the principles

Our signature also includes a more general, implicit obligation to follow principles and standards anchored in the UN. These are voluntary, non-judicial recommendations that express expectations of good corporate governance, and which provide expectations for good corporate practices in dealing with environmental and social issues. In assessing our investments, these principles and standards will act as a reference framework and guide.

The UN Global Compact contains ten general principles derived from the Universal Declaration of Human Rights, the ILO Declaration of Fundamental Principles and Rights in Work and the Rio Declaration on Environment and Dvelopment. The principles are general and state, among other things, that companies must respect human rights and not be involved in violations of them, maintain freedom of association and collective bargaining rights, and eliminate all forms of forced labor, child labor and discrimination in working life.

Avoiding contributing to war

Earlier this year, sustainable investment got another layer of regulation: the sanctions against Russia. Whereas the bulk of the sanctions were directed at trade, every investor had an obligation to make sure they didn't contribute to breaching the sanctions. And this was about something far more serious than doing a bit more good. It was literally about life and death.

Not that sanctions were needed for the investment industry to take action. Pareto Asset Management – and, I hope, every other company in this business – had to make sure we did not contribute to assisting the aggressor in any way. Of course, subsequent revelations of war crimes have enforced the importance of this effort.

We had no direct investments in Russia (nor in Ukraine, for that matter), and hence no investments we were forced to offload. Our portfolio companies, however, could have been involved and affected in many different ways, so we had to analyse our portfolios with regard to their Russian exposure.

When Russia invaded Ukraine, we needed first of all to ascertain our exposure to Russia and Ukraine. We had no direct investments in these countries, primarily for reasons of corporate governance, but we knew that the situation might be different for our portfolio companies.

We found that a total of 1-1.5 per cent of the revenues in our equity holdings went to companies in Russia and Ukraine. It could have been higher: Earlier sanctions and reverse sanctions, instituted after Russia's invasion and subsequent unlawful annexation of Crimea, had already led to an embargo of salmon exports to Russia – a pertinent reminder that the trade potential was larger than existing trade figures revealed.

With new and much tougher sanctions, we also needed to understand the direct and indirect exposure to Russia, Ukraine and Russian ally Belarus in our portfolios. The managers of our major Norwegian equity mandate thus arranged meetings with all their portfolio companies. The purpose of the meetings was to understand how they safeguarded their employees and how they complied with the sanctions imposed on Russia and Belarus.

Furthermore, we wanted to quantify the aggregate financial impact on their revenues and their balance sheet exposure.

We were pleased, if not surprised, by our findings. The compliance level within these 27 portfolio companies was generally high. Where relevant, they also had the safety of their employees high on the agenda through dedicated task force teams. Many of them had little or no exposure to the region.

Lerøy Seafood Group had no personnel in these countries, but exports (or rather exported) seafood – primarily salmon – for more than NOK 800 million to Belarus and Ukraine. Seafood technology supplier **AKVA Group** discontinued all sales to Russian companies after the invasion.

Our investments in Norwegian industrial and material companies were more affected by the war. **Elopak** had the largest exposure to Russia and Ukraine. The company had 180 employees in Russia (St. Petersburg) and another 150 employees in Ukraine (Kiev – Fastiv). Management set up a task force to ensure the safeguard of their employees. The financial impact is through one leased factory in Russia and a wholly owned factory in Ukraine. Operating profit was estimated to be reduced by almost 9 million euros.

Yara had few employees in Ukraine and these employees were safeguarded. However, the company was a large customer of Belarus Kali, which they decided to cut from their supply chain before the war. This is an issue that we raised and discussed with the company on previous occasions. Yara was also a customer of Uralkali, a Russian producer, that now would be excluded. We had engaged with the company on the sourcing matter.

We do realise that this is a significant ethical dilemma. On the one hand, lower food production and possibly famine as a consequence; on the other hand, compliance with sanctions in both fact and spirit. To the extent that this balance is dictated by the war and related sanctions, we may add that neither Yara nor other portfolio companies reveal any signs of attempted circumvention.

In other portfolio companies, there was little or no significant exposure. **Orkla** had some third-party production in Russia which is now discontinued. There was also an indirect exposure through Orkla's 40 per cent ownership in Jotun, which had a factory in St. Petersburg that is now discontinued.

Wilh. Wilhelmsen had some ship agency offices through third parties in Russia with limited impact on personnel and profits. Wallenius Wilhelmsen uses third party agents and had two sales offices in Russia, located in Moscow and St. Petersburg.

For many companies, the war turned business as usual into unwanted business, requiring their urgent attention and the gathering of more information. This is a novel, but sad reminder that truly responsible investment requires thorough knowledge of your investee companies. The Russian invasion simply expanded the field of knowledge necessary.

”This is a novel, but sad reminder that truly responsible investment requires thorough knowledge of your investee companies. ”

Product-based exclusion criteria

Weapons and ammunition

A variety of types of weapons, ammunition and warfare methods are prohibited under international law, such as the Geneva Convention.

Both **Saab** and **Kongsberg Gruppen** are currently excluded from the company's investment universe as a precautionary principle. In a previous report's section on company assessments, we also showed how we worked to clarify whether the American company **Heico** is involved in weapons production. The company was and still is excluded from our investment universe.

Tobacco

Tobacco is a legal stimulant, which according to WHO is causing several million deaths in the world each year.

Coal

Pareto Asset Management follows the Norwegian Government Pension Fund in its assessment of coal producing companies.

Pornography

Pareto Asset Management does not invest in companies producing pornography.

Product-based precautionary principles

Biotechnology
Modern biotechnology touches life's big questions and has an impact on what we think about human worth. It is therefore relevant to the whole global population, and not just doctors and researchers who carry out in vitro fertilisation, map genes and research stem cells. Investments in biotechnology may involve a risk of violation of fundamental ethical norms.

Alcohol
We have considered whether there should also be an absolute ban on investments in alcohol but has concluded that it is neither desirable nor manageable in an ethically consistent and sound manner.

Alcohol as a food additive is generally considered to have many positive aspects. Furthermore, alcoholic beverages are embedded in most societies, with many businesses indirectly profiting from alcohol consumption. Breweries, wineries and distilleries stand out as obvious examples, but also wholesalers, hotels, restaurants, airlines, shipping companies, railways and especially grocery chains may have a significant portion of their profits from the sale or delivery of alcohol. The same applies, of course, to real estate companies with revenue-based rent, such as the listed company Olav Thon Eiendomsselskap (OSE).

An absolute ban on investments in companies with interests in alcohol will therefore likely be perceived as a case of double standards, and insurmountably complicated. In consideration of the significant social and health problems relating to alcohol abuse, the company will nevertheless apply a precautionary principle with investments in alcohol.

Gambling
We have considered whether there should be a ban on investments in gambling. At this point, our assessment is that a general ban is problematic for several reasons.

Gambling has a relatively wide definition, covering everything from games that primarily fills an entertainment function, to more economically active activities where the outcome is largely due to chance and luck.

For the purpose of these guidelines, it's the possible harmful effects that are of importance. The consequences of gambling can be summarised in two words: gambling addiction.

Pareto Asset Management does not want to act in a way that contributes to increasing and more harmful gambling addiction. As part of the investment process we must therefore always raise the question of whether the company in question has a way of business that it is likely to create gambling addiction.

In our opinion, a general ban will not contribute to better achievement. An important element is that a significant part of the gambling business largely, or wholly, fills an entertainment function. Although the gains are in the form of money, unlike the teddy bear in the amusement park, the stakes are normally such that participation is for fun, excitement and surprise, not because it nourishes some presumption of getting rich.

Furthermore, gambling, like alcohol, has such an extent that it can be difficult to draw sharp limits. One might imagine a kiosk chain with deployed slot machines of a type approved by the relevant authority, where the kiosks get a lease while the profits are due to a third party. The chain then has no benefit of increased gaming on the vending machines, and their own activity can be claimed to be limited to the letting of floor space.

Similarly, gambling is offered on most cruise ships and passenger ferries, as well as at some hotels. In addition, there are companies producing the game machines used without this being considered gambling. For these reasons, we have concluded that there should be no general ban on gambling. On the other hand, it seems obvious that it should apply a precautionary principle when investing in companies that offer gambling.

Conduct etc.

Human rights violations
Gross or systematic violations of human rights such as killing, torture, deprivation of liberty, forced labour, the worst forms of child labour. In our reviews, we have not found any circumstances that indicate that any of our portfolio companies contribute to such human rights violations.

Serious environmental damage
Serious environmental damages can be said to include severe climate impact in the form of relatively high greenhouse gas emissions, which is also in line with Norway's international commitments and the government's climate report.

Based on this review, we are not aware of circumstances that indicate that any of our portfolio companies contribute to serious environmental damage. However, we have previously spent a lot of time assessing the situation for **Norsk Hydro**'s operations in Brazil, where heavy rain in February 2018 led to flooding and environmental damage. The company is no longer on our watch list.

Greenhouse gas emissions
The section on climate risk goes into further detail on our assessments in this area. Suffice it to say that we have no company-wide, principled objections to fossil fuel as such, but we do care that the companies in question work to limit emissions and other side effects of their business. Two of our funds have a stated policy of not investing in fossil fuels.

Gross corruption
In August 2017, **Samsung** heir and Group Vice Chairman Lee Jae-yong (50) was sentenced to five years in prison for corruption, he has now served his term.

Jae-yong was found guilty of enabling bribes to organisations where he expected reciprocal support from former President Park. Pareto Total holds shares in Samsung.

We have had instances of corruption also in partly government-owned companies in Norway. As a general rule, we don't necessarily sell our holdings simply because something unacceptable has happened. We will have to evaluate the risk of the problem repeating itself, whether it was a singular case or a consequence of a permeating problem, and of course what is being done in order to get their house in order.

Other particularly gross violations of basic norms
We have not identified other gross violations of basic norms.

Corporate governance

Engagement policy

Pareto Asset Management conducts meetings with the management and board members in many of the portfolio companies, as well as shareholders, on a regular basis. This dialogue is the most important instrument we use in our work as an active owner.

Grounds for initiating engagement activities may be breach of ESG criteria, substantial investment in the company or a need for more information on critical ESG damage that has already occurred.

Requests from clients can also be grounds for engagement.

Proxy voting

Pareto Asset Management has established its own voting guidelines. These are based on the Norwegian Code of Practice for Corporate Governance.

Active ownership

Stating the obvious, our portfolio companies are not perfect. If we decide to invest in a company, there is most often a lot we wouldn't mind being able to change. That leaves us two options.

There is a phrase called "voting with your feet", which means leaving something or someone you disagree with, rather than trying to change them. In our industry, we might say that we vote with our wallets. We do this when we sell something we do not want to own – or, conversely, seek particularly promising investments.

But we do more than that. We also try to influence the companies we own. We vote at annual general assemblies, we have direct dialogue with management or try to work with other committed shareholders. And we do believe that, sometimes, we can push the development in the desired direction.

Our Norwegian equity portfolios consist of companies we know well, in many cases after years of ownership and a number of opportunities for dialogue with management. In the fund Pareto Aksje Norge, which has a relatively low turnover rate, we have engaged in dialogue with practically all the companies in the portfolio on corporate governance, environment and (to a lesser extent) social conditions over the past few years. These are companies we know well, with direct lines to top management.

We also have discretionary management of Norwegian equities. These mandates all hold the same companies as Pareto Aksje Norge, which simplifies engagement. The combined portfolio is our largest in the equities space, representing the major part of our Norwegian stock investments.

These are some of the topics that our portfolio managers have raised in discussions with portfolio companies in the past year:

Multiconsult: Discussions with the board of directors and the largest owner (Multiconsult foundation) on how the management incentive scheme is designed to align interests.

Lumi Gruppen: Discussions regarding listing on the main Euronext list and aligning reporting to comply with the NUES guidelines. Discussions with management regarding how employees are treated during the downsizing of physical schools (layoffs).

Akva Group: Discussions regarding the new strategic owner (Israel Corporation, 18%) and reporting quality of both financial and non-financial information.

Veidekke: Environmental ambitions for the asphalt business and degree of recycling of cement in new projects. Discussions on capital structure and capital allocation.

Elkem: Governance aspects of Chinese-based Bluestar being the majority shareholder. Employee rights and environmental targets set by the company.

Borregaard: Discussions on emission -targets and pathway to reach the targets.

Odfjell: Management incentive programme and aligning interests with shareholders to a larger extent.

TGS: Dialogue on the management compensation scheme.

Given our relative size in the Norwegian stock market and the long-standing relations with most of our portfolio companies, we do believe that our views hold some weight and provide useful input to these companies about investor concerns. In addition, such dialogues produce important information about key risk factors in the companies in which we have part ownership.

We have, however, concluded that we are not going to vote just for the sake of voting. While some asset managers make a point of their having voted at so and so many general assemblies, we will prioritise issues where the outcome is of significance and importance to our unitholders. This enables tighter control with the exercising of voting rights, which ultimately rests with the Board of directors. And, in many instances, the resources can be better spent on materially relevant issues – e.g. through discussions with company management.

Of course, many of our foreign positions are in significantly larger companies with a somewhat longer distance to top management. It's not likely to be easy to get in personal contact with the management of Microsoft or Alphabet, which owns Google. But we have the same digital presence as all other investors, our input is recorded at one level or another, and we get the same information as everyone else.

As for bond funds, active ownership takes on a different meaning. Per definition, we have no voting rights with these funds. However, we have observed that it is generally easier for fixed income investors to reach companies seeking for capital on the debt market. Our bond issuers are often unlisted and can be out of the regulatory scope. This is the reason why we believe that fixed income fund managers have an important role to play in positively influencing bond issuers in the right direction. As responsible investors, we consider engagement activity a key component of active ownership.

Of course, influencing potential bond terms may also have financial benefits. Again, we see that there is no inherent contradiction between responsible investment and profitable investment. On the contrary, we keep getting confirmation that responsible investment also contributes to good risk-adjusted returns.

Active ownership in practice:
- Would you please improve your reporting?

Last year, we reviewed the ESG reporting of the companies in the Pareto Nordic Equity portfolio. The aim was to identify to which extent the 14 ESG indicators made mandatory by next year under the EU Sustainable Finance Disclosure Regulation (SFDR) were already disclosed. For this task, we had the assistance of bright summer interns.

Overall, we were satisfied with the current level of reporting. Two companies were identified as laggards: Nordhealth and CSAM Health, which both recently completed their Initial Public Offerings.

To initiate a constructive dialogue, we forwarded our summary of the findings to the respective companies. Both companies appreciated our input and we agreed to work with them to reach a satisfactory level of reporting.

Climate risk in our portfolios

In our analysis, we strive to find companies with a favourable relationship between potential upside and downside. Finding companies with a good margin of safety is an important part of risk management. For an active manager, therefore, climate risk is included as a natural part of our company analyses.

Climate risk can be categorised as follows:

- Physical risk: Physical damage caused by climate change
- Transition risk: Financial risk from regulations, technology, consumer behaviour and political actions when transitioning to a sustainable society
- Liability risk: Claims for damages due to actions that can be linked to climate policy and climate change

In such a framework, it is especially the transitional risk that will create tomorrow's winners and losers in the stock market. If we find that a company has significant physical or liability risk, it is typically a company we stay away from anyway. For banks and insurance companies, we nevertheless consider the possible effect on loan provisions and claims payments.

The concept of climate risk naturally leads to evaluating fossil energy, especially in Norway. Concepts such as peak oil and the need to reduce greenhouse gases make the transition risk well visible to oil and oil service companies.

Two of our funds, Pareto Nordic Cross Credit and Pareto Global, exclude fossil energy producers. This is basically well justified financially, as Norwegian investors are directly or indirectly highly exposed to the oil industry. Global funds without the same exposure thus provide a better risk balance overall.

The same absence of fossil energy can also be found in the fund Pareto ESG Global Corporate Bond. There it has a further function, since the fund has attained the Nordic Swan Ecolabelling – as the first fixed income fund in Norway and Sweden. This fund also has a dedicated ESG analyst working on sustainability issues. For the time being, this is our only article 9 fund.

However, Pareto Asset Management has no principled objection to fossil energy. Oil and gas are central, integrated elements in all modern societies, and in many cases, they can replace significantly more polluting coal. At the same time, the work to limit climate change is one of humanity's biggest challenges, and CO2 emissions from fossil fuels contribute significantly to such emissions. Thus, it is clear that the industry has a considerable social responsibility. We must consider whether we believe the companies we invest in take this responsibility seriously.

The oil sector, which is dominant in the Norwegian economy, is well represented in other of our funds, both in equities and in fixed income. In particular, we do believe that oil and gas are good substitutes for coal in the slightly shorter term, and we also see that Norwegian companies are often among the best at reducing emissions from the extraction itself. In this way, this sector is definitely part of the solution and not just part of the problem.

Note that climate risk is about much more than the ethical perspective. For example, companies with low greenhouse gas emissions will have a significant competitive advantage in the face of new regulation and changed consumer behaviour. It is likely that they will also have an edge in attracting investors, which may affect the future price trend in our favour.

Similar arguments can be made for Alfa Laval, in which both Pareto Nordic Equity, Pareto Nordic Alpha and Pareto Nordic Omega hold shares. The company produces heat exchangers and other environmentally friendly products, and it announced in its latest quarterly report that they will increase investments in production capacity to meet strong demand. Alfa Laval is thus a good example of how the ongoing transition also creates many winners.

An industry with an obvious climate risk is aviation. Pareto Investment Fund holds stock in Norse Atlantic, we have previously owned shares in both Norwegian Air Shuttle and Ryanair, and we have not imposed any ban on such investments. But the concept of flight shame is a reminder that there is a significant transition risk associated with such investments (in addition, of course, to the fact that the emissions themselves are a negative element). It is also not unlikely that airlines will face higher environmental taxes, which we must take into account in our analyses.

Relevant factors when investing in airlines include the age of the aircraft fleet and the load factor, which together are decisive for CO2 emissions. We then aim to uncover the relative climate risk, to find out which companies will do best.

In practice, it is demanding, not to mention difficult, to assess climate risk in our portfolio companies. Reporting on climate risk and other sustainability issues is little regulated, and the quality varies considerably. Many companies lack a systematic approach to reporting on sustainability, which the Governance Group has concluded in its analyses of the 100 largest companies on Oslo Børs (the Oslo stock exchange). However, they have also found that many companies have improved their reporting on sustainability.

Hence, we believe that by exercising active ownership and dialogue with the companies, we can help sharpen the focus on sustainability. Either way, we note that many companies are stepping up their sustainability efforts and thereby also work towards reducing climate risk. From the Pareto Global portfolio, we can cite the following examples:

BASF

BASF is the world's largest chemical company, emitting 22 million tonnes of CO2 a year. But BASF itself has high ambitions for CO2 cuts and the company will be an important part of the EU's green deal. It cut CO2 emissions by more than 45 per cent from 1990 to 2018, through optimisation of energy production and integration of chemical processes. The next goal is to cut emissions by 25 per cent by 2030, just as the company fires up a new production plant in China. To manage this, it must invest in new environmentally friendly technology.

BASF is building the world's first electrified steam cracker that can produce basic chemicals without CO2 emissions. Another current technology is methane pyrolysis, which is used to produce hydrogen from natural gas without CO2 emissions. This technology has only 1/5 of the power consumption of conventional electrolysis. A pilot reactor is already in operation. The company's long-term ambition is to be CO2 neutral by 2050. Going forward, BASF will stamp all its products with the CO2 footprint.

Microsoft

Invests heavily in reducing emissions and contributing to a sustainable future. Has been carbon neutral in its global operations since 2012, but only through paying others for cuts. Will be carbon negative by 2030 and will have compensated for all historical emissions by 2050.

Prudential

A life insurance company where managing climate risk and opportunities is a strategic priority; management's remuneration is linked to achieving this. The company has a goal of cutting the portfolio's emissions by 25 per cent by 2025 and being a carbon-neutral asset manager by 2050.

Climate risk in practice: Carbon tax?

Last year, to picture the effects of a global carbon tax, we conducted an exercise, a stress test if you will, on the Pareto Aksje Norge portfolio. The conclusions were somewhat different from what you might expect.

We mainly looked at two aspects: taxation of direct emissions (so-called scope 1) and value chain effects (scope 2 and 3). Looking at the companies' prospective tax bills is not enough. The key is their relative position in their industry and, of course, the industry's own vulnerability.

Norsk Hydro operates in a carbon-intensive industry. The product, aluminium, is a light and strong metal, widely used and recyclable, and demand is expected to increase. But production requires a lot of energy, and a global carbon tax will significantly affect the supply side. The industry will incur higher taxes/costs, in addition to having to invest heavily to reduce emissions. Higher costs will push up aluminium prices, benefitting companies with lower carbon intensity. Norsk Hydro is one of the world's cleanest producers, using a lot of renewable energy. Some of the largest competitors are 3 to 8 times as carbon intensive. Consequently, a global carbon tax will significantly strengthen Norsk Hydro's competitiveness.

The Paris Agreement

In 2015, the Paris Agreement was signed by 195 countries. The goal was to keep the global temperature increase below 1.5 degrees, or at worst below 2.0 degrees. A pivotal measure to reduce emissions and achieve these goals is the pricing of carbon emissions.

Norway is to cut its emissions by 55 per cent by 2030 and has reported a planned increase in the carbon tax to 2,000 kroner per tonne. More countries are expected to follow suit, as a global tax will have a significantly greater effect. In addition, it will be fairer, as companies in all countries will be subject to the same conditions. This will highlight companies that are relatively better and provide additional incentives to become greener.

Similar effects apply to **Yara International**. A growing global population needs food. The challenge is to produce enough food, fast enough, in a small enough area. Yara's quality fertiliser solutions contribute to increased food production, while reducing space requirements and consequently deforestation.

Then again, fertiliser production requires ammonia, which in turn requires hydrogen, which is now mainly produced from natural gas. This emits a lot of carbon dioxide. But Yara's relative position is strong, and a global tax will put significantly higher pressure on competitors. Increased industry costs will increase fertiliser prices. Yara will then improve its margins, have more room to invest in emission-friendly technologies, and thus strengthen its competitive advantage. In addition, Yara is far ahead in the production of green ammonia, a preferred solution in the development towards emission-free shipping.

Of course, a carbon tax will also impact oil and gas producers. Here, the indirect effects are clearly stronger than the direct ones, as consumption accounts for the larger part of the emissions. In the short run, the world is dependent on fossil energy sources, and oil and gas will remain an important source of energy and energy storage. Demand for gas will probably even increase because of reduced coal-based energy, a clear climate "worstie".

In a longer-term perspective, however, demand will be negatively affected by the shift towards renewable energy sources. In addition, the industry will be hit by increased direct taxes (albeit to varying degrees) and increased input prices. The companies that will prevail are those with the lowest carbon footprint. Equinor stands out as one of the world's cleanest producers and will (and should) be one of the last to halt production, provided they maintain their competitive advantage.

These are not isolated cases. We see several such companies in the portfolio. For instance, salmon has a much lower carbon footprint than other protein sources and Elopak produces their cartons with a fraction of the emissions from plastic substitutes. Overall, the portfolio has a strong relative position. We expect a global carbon tax to strengthen this position significantly.

Our study thus provides renewed confirmation of the complementary nature of sustainability and long-term value creation. And of the value of active asset management.

Company assessments

Avaya

Avaya is an American technology company headquartered in North Carolina. At the end of July, Avaya suddenly announced that they expected to miss the earnings forecast by 60% and decided to eject their CEO. The audit committee at Avaya had opened internal investigations into financials results and a whistleblower letter. The company announced "substantial doubt about the Company's ability to continue as a going concern".

At that time, Pareto ESG Global Corporate Bond held bonds in the company. Disappointed by the governance, transparency and accountability of the company, with little hope of contributing to bring these up to the required quality, the fund management team decided to sell its position in Avaya.

Rockwool – cloudy on coal

The Danish company Rockwool has not been mentioned here before. It is probably best known for rock wool for insulating houses, but also produces, among other things, facade panels and roof panel systems intended to reduce noise and fire hazards. Most are products that provide a factual basis for the company's unrelenting emphasis on sustainability and the circular economy. For example, rock wool makes a good contribution to reducing energy needs in homes and offices.

The problem is that the production of these products consumes a lot of energy. And Rockwool bases part of its production on coal. How much?

Well, that's information that the company will not divulge. – Due to the competitive nature of our industry we do not disclose this information, the company replies. For Pareto Asset Management, this is a problem, as our policy does not allow companies that base 30 per cent or more of their business on thermal coal.

We have not taken the step of excluding the share, letting three arguments decide. Firstly, management is very clear that they are going to reduce the use of coal. There are concrete, credible plans to shift to cleaner energy sources.

Secondly, the share is not on the exclusion list of the Norwegian Government Pension Fund Global. The Petroleum Fund, as it is informally called, has the same restriction on coal use, which indicates that the share is within the limit (or that the Council on Ethics in Norges Bank has also granted the company the benefit of the doubt).

And third, the products are obviously sustainable. This is not just about focusing inquisitorially on the problems. Sustainability is about opportunities, and here they are good. Rockwool itself believes that the products they sold in 2021 will save 100 times the energy consumed during their lifetime. We therefore think that Rockwool is a good company to own, which we do in the funds Pareto Nordic Equity, Pareto Nordic Alpha and Pareto Nordic Omega.

We will still work to gain more insight into the company's energy use. This is also about the value that we place on transparency in the companies we own. At Rockwool it is a little too opaque.

This is not just about focusing inquisitorially on the problems. Sustainability is about opportunities.

Stora Enso and UPM Kymmene – a cartel?

In September 2021, EU officials raided several wood pulp producers on suspicion of these companies forming a wood pulp cartel. Among these companies were Stora Enso, which we own in Pareto Nordic Equity, Pareto Nordic Alpha and Pareto Nordic Omega, and UPM Kymmene, which we have sold short in the latter two funds.

Unannounced inspections are an initial step in investigating possible anti-competitive practices and usually the first major step in a cartel investigation. Officials will then look for documents revealing that the companies have worked with competitors to set prices or allocate sales. According to the EU Commission, the fact that they carry out such inspections does not mean that the companies are guilty of anti-competitive behavior, nor does it prejudge the outcome of the investigation itself.

Wood pulp is a global commodity, so it will be challenging to prove illegal anti-competitive behaviour. According to normal practice, the companies are under strict confidentiality rules.

We have no independent basis for suspecting anything illegal and have not changed our positions in the two companies.

Danske Bank – the cleanup that was not over

In May 2018, the Danish FSA announced that it would impose fines on Danske Bank as a penalty for several years of money laundering in Estonia. The culpable department was shut down in 2015, the bank was conducting an audit of its Estonian branch, and we thus figured that we invested in a bank fully engaged in clean-up and self-questioning.

The bank submitted its internal review in September 2018, revealing much more comprehensive money laundering than we had assumed. Worse yet, the report exposed a pervasive culture of unacceptable attitudes in the bank, in the sense that top management and the Board should have acted several years ago. For a long time, the bank trusted the reporting from the Estonian branch and the group's overall money laundering routines. The reporting later turned out to have been deficient and misleading, and group routines failed.

The first internal whistleblowing came late in 2013. It put the case on the agenda for both group management and the Board. Measures taken in 2014 proved to be insufficient. Towards the end of 2014, there came a highly critical report from the Estonian supervisory authority, and the business was finally shut down in 2015.

In Norway, the bank has paid day fines to Finanstilsynet for breaches of the Anti-Money Laundering Act. This could be small change in relation to possible fines from the US authorities, an issue that remains unresolved. To top it all off, it turns out that, for a number of years, the bank has demanded too high overdue fees, a case they are now working to rectify and compensate customers for.

In later years, the bank has hired many people in compliance and IT services to prevent money laundering. A lot has been invested in IT systems related to this. All of the bank's employees have undergone training to both prevent money laundering and correct errors in a proper manner. In addition, the Board has appointed a separate sub-committee for Conduct & Compliance.

If these problems have been more extensive and fundamental than we thought three years ago, our assessment now is that the bank has developed into one of the best in its class. There may still be more bad news coming, but we consider it less likely that the next banking sector issue will originate from Danske Bank.

Pareto Nordic Corporate Bond holds bonds in the company.

Swedbank – shorting a scandal

In earlier reports, we have highlighted the lack of sufficient routines to uncover possible money laundering in Swedbank. The bank is still being investigated in both Estonia and the US.

Pareto Nordic Omega has held on to its short position in Swedbank. We do not object to shorting companies with a lousy ESG record, which we know is a point of discussion in the investment community. This short position was initiated before the scandal became public, so it has been a profitable position for the fund.

Wells Fargo – remains of a culture problem?

In 2016, it was revealed that bank accounts in Wells Fargo were created without the approval of the clients. The audit firm PwC was engaged by Wells Fargo to uncover the scope. Their review documented that this involved up to 3.5 million deposit accounts and 565,000 credit card accounts. It was further revealed that this had been going on from 2011 to the end of 2015. The review pointed all the way to top management.

For a more detailed walk-through of the issue, please see our previous RI report.

Even as these sales practices are history and the company has made a complete revamp of senior management and more than 80 per cent of the board, the US Federal Reserve has not lifted the asset cap it imposed, limiting the bank's balance sheet to just under $2 trillion. Timing of the removal is still uncertain, but there have been several positive signals that this process is moving forward.

We believe that this process has been constructive for Wells Fargo. Major changes have been made in the management of the company and, we believe, its culture. Furthermore, all else being equal, the asset cap has probably been productive in elevating the quality of Wells Fargo's balance sheet at a time when the economy was running at full capacity.

Wells Fargo shares have performed much better than the S&P 500 over the past couple of years. While there may be many factors driving this performance, we also take it to signify that the company is gaining increased trust from the market.

Pareto Total holds shares in Wells Fargo.

Previous mentions

SKF AB

The war being fought in Ukraine has put a spotlight on Western companies that would potentially profit from doing business with Russia. SKF is one of several Swedish industrial companies suspected of potential breaches of trade restrictions relating to military use.

Claims arose in the Swedish press that wheel-bearings from SKF in some instances had been sold to Russian producers of nuclear weapons. A total of 16 customers defined by the press as producers of nuclear weapons were supposed to be involved in procurement for SKF products in the 2013 to 2022 timeframe.

SKF has been manufacturing wheel bearings locally in Russia for sale through Russian distributors. The structure is based on distribution agreements limiting sales to customers according to Swedish export control measures.

Pareto Asset Management addressed the issues in dialogue with SKF. The company stated that the issues were investigated internally as possible breaches of distribution agreements and has publicly denied any wrongdoings.

Pareto Total, Pareto Nordic Equity, Pareto Nordic Alpha and Pareto Nordic Omega held stock in SKF. All funds have now sold their holdings and we have made no further inquiries in the matter.

Third-party data no magic bullet

During the traditionally slower summer months, the Pareto Global fund managers made an effort to increase the transparency of how they integrate ESG in the fund.

As a signatory to UNPRI since 2014, we have committed ourselves to integrating sustainability concerns into our investment processes. This means that we include all relevant ESG aspects in our company analysis and selection, spanning everything from company market opportunities to financial costs. In order to be able to do this in a structured and transparent way, a lot of ESG data is needed, which is supposed to be used in conjunction with more traditional financial data.

Furthermore, as most of our funds are classified as Article 8 funds and, in one case, Article 9, steadily more data is needed for external documentation according to the SFDR regulation, which has already come into force in the EU and is expected to be incorporated into Norwegian law in 2023.

Not surprisingly, the ESG data market has been booming, with third-party data providers collecting and re-selling company ESG data to financial market participants, our own fund management sector included. For many smaller Nordic companies, there is still a dearth of relevant data, but for larger global companies, there is an abundance of third-party data.

For an actively managed fund like Pareto Global, however, it's not just a matter of helping themselves to these data sets. For one thing, various ESG data providers have attempted to create their own interpretation of "good ESG" by scoring and rating companies along various dimensions. In addition, these ratings are often very dispersed, due to the highly objective nature of what "good ESG" means and the framework surrounding it.

The increased availability of third-party ESG data also highlights another challenge: in order to truly be able to utilise data in financial decision-making, a high degree of attention to detail is required. The underlying reported company data often comes with assumptions and disclaimers, making direct comparison difficult, across companies but also across time.

How is the management level defined in Company A's gender pay gap reporting? Is the emissions data reported by Company B organised by market or by location, and has this changed since last year? What about all the data Company C does not reveal and report on, can this give us as investors a clue about the quality of ESG integration within the company?

”Like in most walks of life, there are no shortcuts to valuable insights and success.”

Like in most walks of life, there are no shortcuts to valuable insights and success. As active investors with a concentrated portfolio, the Pareto Global fund managers know their companies very well. And they don't need a third-party data provider to collect ESG data on their 25 to 30 positions. In fact, they probably wouldn't benefit from doing so.

This is not just about fulfilling a reporting requirement. We believe that handling more data collection as part of the fund management may provide improved risk management. Better insight into the nature and background of the data makes it easier to avoid investing in companies where the potential financial gains might be neutralised by increased market scrutiny. It provides an opportunity to positively discriminate on ESG quality by simply not holding the laggards in the space.

During the traditionally slower summer months, the Pareto Global fund managers made an effort to increase the transparency of how they integrate ESG in the fund. By systematically collecting and categorising company ESG data, they developed a framework for Principle Adverse Impact (PAI) reporting, while mapping their companies' efforts to align with the United Nations' Sustainable Development Goals (SDG's).

By building a better data structure, they also made it easier to store and update such data, leading to better progress-tracking possibilities.

And, while the fund managers were convinced that all the portfolio companies have superior ESG characteristics along all PAI dimensions required by the SFDR framework – or else they'd picked other companies – they now have the relevant figures to back it up.

We think of this as a nice side effect. The main point is that by not just relying on third-party data providers, they have ascertained that these figures are also relevant for the investment process. In this way, the growth of responsible investing has brought to light another defining characteristic of truly active fund management.

Pareto Global fund management team: Andreas Kamvissis (left) and Andreas Sørbye

Common acronyms in ESG investment and regulations

The emergence of ESG investing and related regulations has spawned a myriad new acronyms. If you don't work in this field, you probably don't know all of them. Here is a short overview that may come in handy:

- **CDP:** CDP (the Carbon Disclosure Project) is a non-governmental organization (NGO) that runs a global disclosure system to manage the environmental impact for private and public institutions. Nearly 10,000 of companies, cities, and governmental institutions report on their risks and opportunities related to climate change.

- **CSRD:** The Corporate Sustainability Reporting Directive. In order to help the financial industry to better assess company extra-financial aspects, the EU Commission requires large public-interest companies with more than 500 employees to report information on how they manage environmental, social and governance issues in their business operations. Companies that fall under the scope of CSRD will have to disclose EU Taxonomy-related information.

- **EU Taxonomy:** The EU Taxonomy regulation, which entered into force in the EU in January 2022, has established a classification system of environmentally sustainable activities that translates the EU's climate and environmental objectives into criteria or specific economic activities purposes. The EU Taxonomy recognizes 'environmentally sustainable' economic activities that make a substantial contribution to at least one of the EU's climate and environmental objectives:
  - Climate change mitigation
  - Climate change adaptation
  - The sustainable use and protection of water and marine resources
  - Transition to a circular economy
  - Pollution prevention and control
  - The protection and restoration of biodiversity and ecosystems

  In addition, the investment must respect the do no significant harm criteria and be in line with the minimum safeguard.

- **GHG:** Greenhouse gases (GHG) are gases that absorb and emit radiant energy within the thermal infrared range, causing the greenhouse effect. Greenhouse gases shall be calculated according to the GhG protocol or similar official standard.

- **GRI:** The Global Reporting Initiative publishes GRI Standards, which provide guidance on disclosure across environmental, social and economic factors for all stakeholders including investors. These standards are used by organizations worldwide.

- **PAI:** According to SFDR, Principal Adverse Impacts (PAI) are impacts of investment decisions or advice with material, negative effects on sustainability factors. Sustainability factors mean environmental, social and employee matters, respect for human rights, anti-corruption, and anti-bribery matters.

- **PRI:** Principles for Responsible Investment is an international network of investors/signatories working together with a common ambition to foster ESG ownership decisions in investment. With 7,000 corporate signatories in 135 countries, it is the world's largest voluntary corporate sustainability initiative.

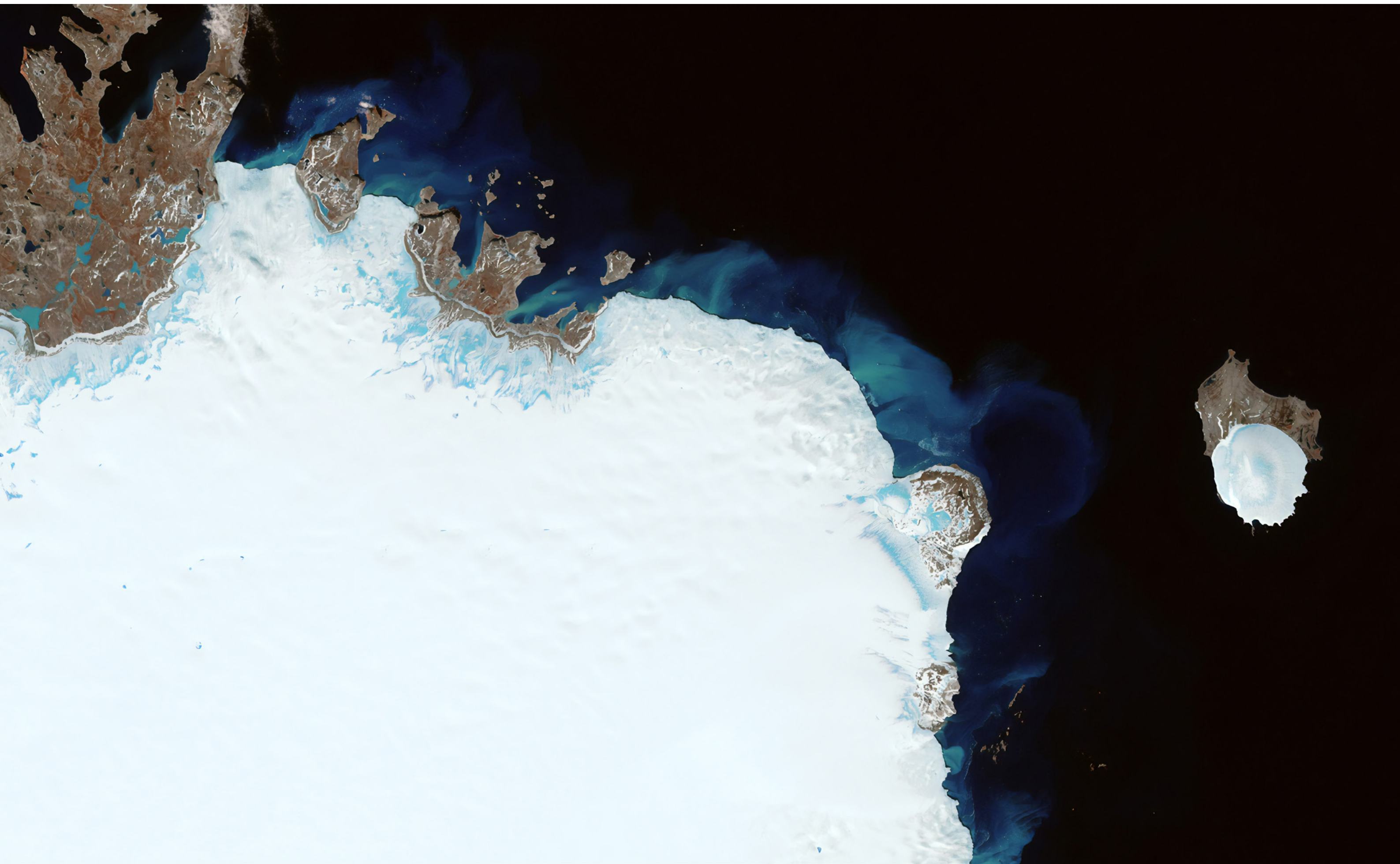
- **RTS:** Regulatory Technical Standards are a set of technical compliance standards that, once endorsed by the European Commission, need to be met by all parties. Under the SFDR, RTS are the rules that financial market participants need to obey to comply with regulations.

- **SBTi:** The Science Based Targets initiative ("SBTi") is an alliance created between CDP, the United Nations Global Compact, the World Resources Institute (WRI) and the World Wide Fund for Nature (WWF). The initiative ensures that companies' net-zero targets are consistent, by assessing the robustness of climate action plan via science-based methodologies.

- **SFDR:** The Sustainable Finance Disclosure Regulation (SFDR), applied in the EU from March 2021, is a European regulation introduced to improve transparency in the market for sustainable investment products, to prevent greenwashing and to increase transparency around sustainability claims made by financial market participants. SFDR sets different kinds of disclosure requirements for three types of funds or other financial products within the scope of the regulation:

    - Article 6: Funds that do not integrate a sustainability focus into the investment process.
    - Article 8: Funds that promote environmental and or social characteristics, referred to as "Light Green" funds.
    - Article 9: Funds that have 'sustainable investment' as their objective, referred to as "Dark Green" funds.

- **TCFD:** Task force on Climate-related Financial Disclosures is a market-driven initiative developed to establish and recommend a general framework for identifying, assessing and reporting climate-related financial disclosures. TCFD focuses on four key areas: governance, strategy, risk management, and metrics and targets.



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