Fixed Income ESG Integration Policy

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In executing our fiduciary mandate, we at Matrix Fund Managers believe we have a responsibility to support the highest standards of corporate governance and accountability. Our objectives are to ensure sustainable returns and to protect value for all our stakeholders. As such, our investment processes need to include due regard to corporate governance as well as factors that may result in adverse environmental and social effects.

1. Fixed Income and ESG Considerations

In general, the fixed income space has lagged equities in terms of embracing ESG incorporation in their investment analysis. This has been largely due to a larger universe of securities, a lack of ESG data on non-listed firms and the relative inability of bondholders to influence company policy. More recently, a growing body of research has shown that ESG factors represent material credit risk for fixed income investors, supporting the incorporation of ESG into credit risk analysis.

2. Our Approach to ESG Integration

At Matrix, our approach to fixed income investing entails focusing on liquid assets within the broader investment universe in South Africa. Our fixed-income investment universe typically consists of:

- Debt issued or guaranteed by the National Treasury of South Africa, for example government fixed-rate bonds, floating-rate bonds, inflation-linked bonds and treasury bills.
- Senior debt issued by systemically important banks in South Africa.
- Various derivative instruments such as SWAPs, FRAs and other OTC products related to the aforementioned issuers.
- Credit Linked Notes to repackage SA government debt. For example, generating floating rate exposure linked to the credit of a nominal government bond.

a. General Principles

From a general perspective, we are particularly interested in the relationship between ESG factors and their impact on the issuer's credit risk (debt issuance and debt service sustainability). As such, we view ESG factors in relation to issuers from two perspectives:

- Firstly, how ESG risk factors impact the ability of the issuer to repay its lenders and / or issue more debt. This reflects the risks posed to the sustainability and profitability of the issuer.
- Secondly, the way the issuer conducts its business in the context of the natural environment, socio-economic situation, and governance landscape.

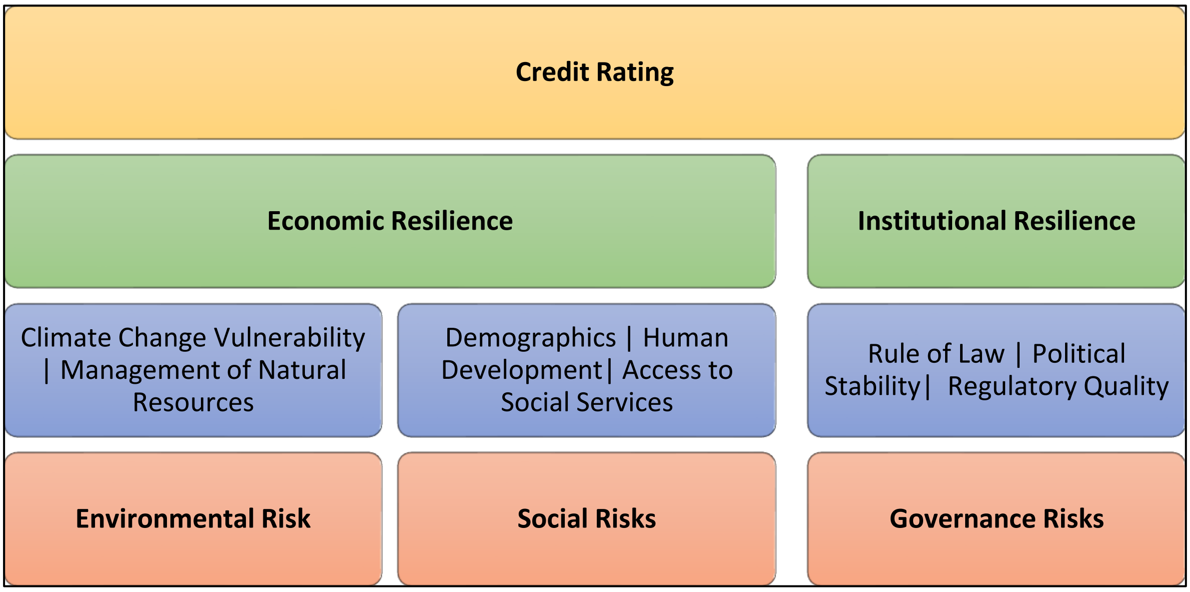
b. Sovereign Debt Assessment

In considering ESG factors for sovereign bonds, we look at how ESG risk factors can impact the overall credit rating of a sovereign through the economic and institutional resilience channels:

- Economic Resilience:
  - Considers the ability of the sovereign to sustain long-term economic performance.
  - This includes the consideration of how the environmental and social risk factors can have a material impact on the fiscal and economic performance of a country.
  - Environmental considerations include the country's management of its natural resources, its vulnerability to physical and transitional risks borne by climate change risks, and the management of its waste and pollution.
  - Social considerations relate to demographic trends, level of its skilled labour force, access and quality of basic services and other socio-economic metrics such as inequality and the pervasiveness of poverty and unemployment in the country.

- Institutional Resilience:
  - Considers the strength of governance institutions of the sovereign.
  - The strength of the country's institutions can meaningfully impact the ability and willingness of the sovereign to honour its debt obligations.
  - Governance risk factors would include the consideration of the quality of the regulatory framework and ability to enforce the rule of law in a just and equitable manner.
  - Other considerations include political stability, protection of human rights and ability to deal with corruption.

Figure 1: Matrix Sovereign ESG Fixed Income Assessment:



To support ongoing monitoring of the above-mentioned ESG considerations, we have a framework to track the performance of the underlying metrics over time.

c. Corporate Debt Assessment

We use our Corporate ESG Scorecard to assess ESG risks of corporate issuers, which is an important ESG integration tool that is used across our fixed income and equity portfolios.

The scorecard reflects and tracks ESG risk factors that we believe can have a material impact on the company's financial and non-financial metrics and its overall credit worthiness. The combination of these risk factors are used to build an overall ESG score for each corporate across the broader investment universe.

An annual review of the ESG scorecard is conducted to ensure that the elements and the metrics which are considered remain in line with international best practices and the continuously improving sustainability reporting environment. Key themes which are captured in our scorecard are highlighted below:

- Environmental Themes:
    - Environmental indicators which are considered in our scorecard look to capture broad thematic issues such as pollution, climate change and biodiversity loss. Key metrics include disclosure of environmental targets, GHG intensity, energy and water usage.

- Social Themes:
    - Social factors which are considered in our scorecard include themes related to employee safety and tenure, the amount of spending in relation to social and community related initiatives and the levels of black ownership in the company. Key metrics include levels of employee turnover, staff training costs, social spending to revenue and the percentage of broad-based black ownership.

- Governance Themes:
    - Governance factors which are incorporated in our scorecard include themes related to board composition and overall independence of the board, composition of the remuneration committee and complexity of the shareholder structure. Key indicators include the percentage of independent directors on the board, whether the chairperson of the board is independent and if there are multiple classes of shares in issue.

3. Integration of ESG across the fixed income investment process

a. Sovereign Debt:

Throughout our investment process, we have systematically integrated ESG analysis across the different investment phases:

- Research Phase:
    - In the research phase of our investment process, along with credit and financial assessments, we overlay our research with environmental, social and governance considerations which have a bearing on the credit worthiness of the sovereign.
    - We monitor and analyse socio-economic metrics such as employment levels, demographic patterns, social welfare structures and levels of poverty and inequality.
    - Other indicators we monitor relate to issues such as water security, climate-related vulnerability as well as the regulatory, governance and the political environment.

- Valuation Phase:
    - In this phase of the investment process, we analyse how the ESG factors we monitor in the previous phase, affect the valuation of the sovereign fixed income assets we invest in.
    - ESG risk factors would feed directly into two subcomponents of valuation - one observable through the credit spread and credit rating of the sovereign debt, while another factor is less observable in the risk premium investors require to hold government debt. For example, during periods of increased political instability, the credit spread will widen to reflect the increase in credit risk.
    - Another area where ESG consideration would impact valuation is through the term premium - the compensation to an investor for holding longer maturity instruments. In instances where government policies are viewed unfavourably and eventually lead to increases in government issuance, yields would increase as less buyers participate in weekly auctions at less competitive levels.

- Portfolio Management Phase:
    - This phase of the investment process incorporates ESG analysis in the overall portfolio construction and risk management process.
    - Duration management is a portfolio management tool that is utilised in the management of portfolio risk. In instances of increased risk (including ESG risks), this may result in a yield offered that does not adequately compensate for risk taken. Portfolio duration would be decreased, or the asset may be sold to reduce risk in the overall portfolio.
    - Other considerations in the risk management of a portfolio would be the level and direction of the inflation rate and monetary policy rate cycles. This would affect asset allocation decisions based on short-dated vs long-dated instruments or inflation-linked vs nominal fixed income instruments. For instance, during higher inflationary episodes, inflation-linked bonds provide protection against rising inflation which is not obtained from nominal bonds – hence their value increases as coupon payments are directly linked to inflation index levels.

b. Corporate Debt (including Credit Liked Notes):

- We apply our corporate ESG scoring framework to listed bank issuers where the instrument meets our internal minimum credit criteria for investing in financial credit instruments.
- Additionally, we engage with the issuer on various platforms and review any listing-related documents in detail.

c. Fixed Income Derivatives:

- Derivatives are financial instruments that derive their value from underlying assets – in this case listed fixed income assets. Conventional derivatives do not reflect ESG risk exposure, as exposure to an issuer is indirect.
- Derivatives lack the direct actions of a management team or board of directors and are not single operated assets and fall outside the conventional framework of ESG analysis. Given the nature of derivative instruments, we would reference the actual underlying asset in applying stewardship activities and integrating ESG analysis into our investment process.

We monitor ESG factors in portfolio exposures on an ongoing basis and will address issues via issuer engagements, valuation adjustments or exiting a position, subject to liquidity and pricing conditions given the requirement to put clients' interests first.

4. Fixed Income Engagements

There are several avenues where we pursue engagements across the different asset classes:

- Through the various sell-side (brokers and trading banks) facilitations, we engage with many of state entities such as National Treasury, SOEs, government-led forums as well as other stakeholders such as labour unions and research institutions.
- Through the SARB Investor post Monetary Policy Committee forum, we engage closely with the SARB's MPC members on matters related to Monetary Policy setting.
- Through our membership of industry bodies, we participate in various working groups to support policy development initiatives within our industry.

All our fixed-income related engagements are recorded in our Fixed Income ESG Engagement Register.