

Ardea Stewardship Policy

March 2021

1 Principle 1

Signatories' purpose, investment beliefs, strategy, and culture enable stewardship that creates long term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.

1.1 Context

We believe the following considerations are vital for ensuring Ardea continue providing long term value for clients and beneficiaries:

- A strong set of **values** which lead to a **culture** where inclusion and diversity are at the core of our operations rather than an afterthought.
- A tried and **tested relative value investment strategy and process** which considers all relevant risks and delivers volatility controlled returns which is lowly correlated with equity and bond markets (including equity and bond market drawdowns)
- Delivering value for clients over and above managing their assets. We do this via the **Research Team** which contributes to trade idea generation, is responsible for sustainability policy development and partners with clients to help them solve investment problems and other problems related to the industry

1.1.1 Purpose

Conventional fixed income strategies are based on accumulating bonds to harvest yield or trying to predict the direction of markets. We founded Ardea in 2008 having seen this approach can be unreliable and had therefore left a gap to fill. To this day we believe that gap is best filled by 'relative value' investing.

1.1.2 Business Model

While we are an asset manager, we aim to deliver value for clients over and above alpha. To that end, the recent establishment of the research team was driven by two goals:

- To assist with long term value creation for our clients through helping the portfolio managers to develop trade ideas.
- To bring extra value to our clients over and above the management of their assets via an advisory service

The research team therefore has **two functions**. The **first** is to help develop trade ideas for the portfolio managers and they do that by building quantitative tools which bring even more robustness and scale to the idea generation process. The team is also responsible for further developing the tools to support the integration part of our sustainability process and our reporting responsibilities under the evolving regulatory requirements. The **second function** undertakes research to help clients solve portfolio construction and asset allocation problems. To further boost the value we bring to our clients, we have formalised collaborations with academic institutions. Dr Laura Ryan is an associate professor (adjunct) at the University of Technology Sydney and is one of the leads on the [Ardea & UTS Academic program](#). As part of this program we are undertaking research with the UTS to investigate the impact climate change has on government bond markets (further discussed below).

1.1.3 Culture and Values

Leadership and shared values¹ determine the culture of an organisation. At Ardea, culture is just as important as performance. We are committed to fostering an inclusive and dynamic team working environment, where staff are supported and encouraged. The team have a shared set of values to protect their strong, positive culture which include:

- Succeeding together
- Having honesty & integrity
- Having a consistence of effort for work/life balance
- Valuing long-term relationships
- Practicing transparency to build trust
- Balancing support and accountability
- To continue to evolve and not stand still
- Remaining humble with success

1.1.4 Investment Beliefs & Strategy

At Ardea Investment Management, we believe sustainable investing is a necessity for long-term value creation. Conversely, we also believe that ignoring the impacts of sustainable risk factors on portfolios amounts to an intolerable risk to the funds we manage on behalf of our clients. It is therefore our fiduciary responsibility to integrate these considerations into our investment process.

Ardea adopts an alternative approach to fixed income investing that generates returns from 'relative value' (RV) strategies. This approach delivers reliable risk-adjusted returns that are independent of market direction and exhibit low correlation to broader fixed income and equity markets. RV mispricing is caused by market inefficiency and occurs when comparable securities that are closely related and have similar risk characteristics, are priced differently. Fixed income market inefficiency has proven to be persistent over time and across market cycles because the underlying drivers are structural in nature. This persistence makes market inefficiency a reliable source of returns around which a repeatable investment process can be built to capture a vast and diverse range of RV mispricing opportunities.

True RV strategies need the right risk management tools and strategies to isolate the mispricing being targeted from broader market movements in order to generate reliable returns. Doing this properly requires experience and expertise in using a wide range of derivative instruments and strategies, including during periods of extreme market stress. This is a barrier to entry that prevents conventional fixed income funds from adopting this type of strategy. What further differentiates Ardea is our focus delivering reliable risk-adjusted returns. We do this by constructing portfolios with a large and diverse range of RV positions, combined with 'risk-off' strategies that are specifically designed to profit in adverse market environments. We prioritise volatility control and capital preservation over chasing returns irrespective of risk.

Our portfolios are constructed to achieve risk diversification by combining many modestly sized and diverse RV trades, so that no single trade becomes a dominant driver of overall portfolio risk. These RV trades start with specific bonds (or other fixed income securities) that are mispriced relative to comparable securities, and then paired with risk management strategies to isolate that relative mispricing from interest rate movements and strip out other unwanted market risks.

As bond prices are less volatile and RV pricing relationships more constrained compared to stocks, these are low risk trades. Consequently, we may only make 0.05% on a single one. However, the portfolio will contain a large number of the positions at a given time. As the prices of these bonds are constantly moving, we can sell them to monetise a profit when the mispricing corrects and then rotate capital into another bond

¹ <https://www.willistowerswatson.com/en-AU/Insights/2018/10/measuring-culture-in-asset-managers>

that's undervalued. In this way, we can work capital harder to squeeze out more return, without taking more risk.

By continually repeating this process of buying the most undervalued bonds, selling them as they reprice higher and doing this over a very large and diverse universe of such opportunities, we can build up a stable return profile. This approach of rotating through many modestly sized and diverse RV positions delivers more reliable returns, with lower risk, compared to portfolios with large directional positions that can overwhelm their risk profile.

Additionally, our portfolios include 'risk-off' strategies, which are explicitly designed to profit during periods of market stress and therefore provide protection against market volatility and downside tail risks. This is an important aspect of portfolio construction that is always present, irrespective of the prevailing market environment.

So, returns are only part of the equation. Combining a large and diverse range of RV positions with 'risk-off' strategies provides the risk balance that enables our portfolios to deliver reliable risk-adjusted returns.

1.2 Activity

1.2.1 Business Model

From a fund manager's perspective, the literature and guiding bodies (e.g. UNPRI) are heavily focused on how sustainability risks should feature in the investment decision for equities, corporate bonds, private equity, real estate etc., with very little focus on Government bonds.

To fill this void and to provide additional value to our clients and stakeholders, we have been conducting our own research in [partnership with the University of Technology Sydney](#) on such risks, with a focus on climate change as this is a megatrend that we see as most relevant to the government bond market. To supplement this research we also consult with asset consultants, research houses and with our clients. And it is this research and client input that drives the evolution of our policies.

Our first area of focus is on climate change given that we see this as posing the greatest potential risk to our return profile. Other sustainability factors we can focus on in future include diversity among policymakers and key government decision makers, national-level pension and retirement sustainability, ageing, welfare outcomes, health outcomes, best practice at the government and bureaucracy level etc. All of these have a direct bearing on an issuer or government's expense line and thus their financial performance and sustainability.

We believe the research we are publishing in this area not only adds value to our portfolio construction process, but also adds value for our clients and the industry in general through an increasing knowledge base.

1.2.2 Culture and Values

With respect to Inclusion and Diversity, we are currently overhauling our corporate level Inclusion and Diversity policy. Dr Laura Ryan, our head of Research is currently investigating the pay and promotion rates of females and males in the Australian Finance Industry in conjunction with the CFA Institute and the Australian National University. Details can be found [here](#): This research will help us to understand some of the drivers of the lack of diversity in the finance industry and informs our diversity policy.

Currently our goals are focused on improving our hiring process. Our aim is to ensure the pipeline of talent for our firm is diverse. We have implemented changes to our hiring policy which include;

- expanding the disciplines and industries from which we recruit
- running our job descriptions through gender decoders so as to appeal to both genders
- ensuring that we have at least one woman on the interview panel
- engaging networking organisations such as "100 Women in Finance" to help us identify qualified females

- ensuring there are at least 25% women in the candidate pool
- the implementation of consistent technical questions across functions
- training staff (and in particular hiring managers) for unconscious bias

The Finance Industry suffers from a severe gender imbalance, particularly with respect to women occupying senior leadership, money management and technical roles. While we consider Ardea to be a diverse organisation relative to the industry, we acknowledge there is room for improvement. Currently we have two females in the portfolio management and dealing teams (2 out of 9) and three in the broader investment team (3 out of 11). Research suggests a minimum 30% is required before diversity benefits can be obtained. At Ardea our goal is to hire based on merit. Currently the research indicates that merit is not equally recognised or rewarded across genders². As such, we believe a hiring policy which acknowledges the institutionalised hurdles women face will help to level the playing field and will contribute to a more balanced gender ratio – of which we are targeting at least 30%.

1.2.3 Investment Beliefs and Strategy

While the literature may not provide adequate research-based evidence on the magnitude of climate change risks for government bonds, from a fiduciary perspective we are still required to take action to counter the likely outcome of financial markets failing to adequately price climate risk. We cannot wait for the literature or the industry to provide the insights we need. Therefore, we have been working on two research pieces in conjunction with UTS which are helping us to identify how climate change risks are being priced by the government bond market. **The first** piece of research is complete and will be submitted to a high quality journal in 2021, we will also publish the findings on our website for our clients to access. The research focuses on how climate change has impacted yields historically.

This research is providing us with a robust and reliable way to identify sustainability risks that are relevant to the markets and securities that we invest in.

Alongside the climate change research, we also consider other risks as identified both internally by the research team as well as research houses and ratings agencies

1.3 Outcome

1.3.1 Business Model

The research we have undertaken in conjunction with UTS modelled Government bond yields as a function of control variables such as real GDP, inflation, the debt to GDP ratio and quality. We also model climate change vulnerability and resilience and we find both vulnerability and resilience are significant factors in determining yields. We hope that this research will bring to the attention of issuers and our clients the impact that climate change is already having on the government bond market. The results of the research are also informing the evolution of our integration policy in that the climate change risk factors that we find to be significant will be included in our sustainability monitoring process.

$$y_{it} = \beta_1 + \beta_2 y_{i,t-1} + \beta_3 vul_{i,t} + \beta_4 res_{i,t} + \beta_5 x_{i,t} + \gamma_i + \mu_t + \epsilon_{i,t}$$

Where: X are a set of control variables including the level and growth rate of Real GDP, Inflation, debt to GDP ratio, quality etc.
 γ_i are country specific effects. μ_t are common shocks that impact all markets $vul_{i,t}$ and $res_{i,t}$ are composite measures of climate change vulnerability and resilience

² <https://www.glassdoor.com/research/app/uploads/sites/2/2016/03/Glassdoor-Gender-Pay-Gap-Study-3.pdf> "The gender pay gap is real, both in the U.S. and around the world. Men earn more than women on average in every country we examined, both before and after adding statistical controls for personal characteristics, job title, company, industry and other factors designed to make an apples-to-apples comparison between workers."

High level, the results indicate that climate change has a long term impact on yields and valuations via both the resilience and vulnerability of an economy. Given these results, the next step for Ardea is to understand how this translates into short term pricing risks or opportunities (for example possible ratings changes, stranded assets, illiquidity, green bonds etc). Therefore **the second** piece of research we are currently working on (again with researchers at UTS) will examine how climate change news impacts government bond yields. We expect to publish this research in approximately 12 months.

We are yet to include climate change scenario modelling in our research and we see this as something of vital importance to understanding how credit ratings of the issuers we invest in.

1.3.2 Culture and Values

As a result of our changed hiring policy we have recruited an analyst who identifies as female into a technical portfolio management role. We plan to continue following the new improved hiring process given the success to date. We do however acknowledge that we have not achieved our target of 30%+ for technical roles across the firm.

1.3.3 Investment Beliefs and Strategy

Our investment strategy has delivered on its goals of delivering reliable risk-adjusted returns that are independent of market direction and exhibit low correlation to broader fixed income and equity markets since 2008. This return profile enables our clients to be confident about:

- the long term value we create for them
- the volatility and correlation profile of our products and therefore how they should fit into a multi asset portfolio

The independent research we have been conducting as mentioned above has informed the development of Sustainability Risk factor integration into our portfolio construction process. That is, we are directly utilising the results of the research which identified resilience and vulnerability as risk factors of importance to help drive our integration policy. We believe this will help to protect our clients from un-necessary risk, while also helping us to identify potential opportunities.

2 Principle 2

Signatories' governance, resources and incentives support stewardship.

2.1 Activity

2.1.1 Governance structure and rationale

The Ardea Stewardship Policy is part of the overall Governance, Risk and Compliance (GRC) Framework, managed by the Ardea Compliance Manager. The Compliance Manager is responsible for the implementation and day-to-day operation of the GRC Framework, with the support of the Fidante Compliance team's resources. All staff are provided with a copy of Ardea's GRC Framework and are required to sign the GRC Framework Acknowledgement to acknowledge that they have read and will abide by the policies and procedures contained within it. As the sustainability Policy forms part of this Framework the Compliance Manager is responsible for ensuring adherence with this Policy. We believe that stewardship should be a consideration which carries the same importance as the other risks Ardea must consider and in this way, it is appropriate for the GRC framework to encompass the stewardship policy.

2.1.2 Resourcing

2.1.2.1 Organisational Structure

Historically, our PMs/ investment analysts have been responsible for performing sustainability risk analysis and the development of policy. However responsibility now rests with the Research Team is now responsible

for carrying out this analysis. The research team works with the PMs to identify trade ideas, risks and opportunities through research and the development of technology. Sustainability is an integral part of the trade idea generation and risk management processes and we believe the Research Team possess the appropriate skills to not only analyse and assess sustainability risks but to also develop the appropriate frameworks for accounting for those risks.

Laura Ryan has recently joined Ardea as Head of Research and will be leading on future research projects in sustainable investing. Laura is an internationally published academic with papers appearing in 'The Journal of Portfolio Management' and 'The Journal of Forecasting', among others. Previously, Laura was Senior Vice President (Quantitative Research) and a member of the Australian senior management team at PIMCO. With 21 years investment experience, Laura's other roles include Manager of Quantitative Strategy at Commonwealth Bank, Quantitative Manager at AMP Capital and Lecturer in Statistics at the Australian National University (ANU). Laura holds a Ph.D. in Statistics from the ANU, a Master of Quantitative Finance from the University of Technology Sydney and an Honours degree in Actuarial Studies from the ANU.

Laura will be leading some of the current and future sustainability projects in conjunction with leading academic institutions. This will include the previously mentioned work on climate change, as well as looking at how best to approach the issue of engagement with sovereigns on issues of sustainability.

Tamar Hamlyn leads interest rate and macro strategies for Ardea and is responsible for strategic views on the economy and financial markets. Tamar co-founded Ardea, a specialist fixed income investment management firm, in 2008 and has since helped grow the firm to \$18bn of client assets under management (as at November 2020). Tamar's focus at Ardea includes the economic outlook and its impact on financial markets, and the implications for portfolios and investment strategies. He has a special interest in the policy actions of central banks and their impact on financial markets and the real economy, including inflation. Tamar focuses closely on both domestic and international developments, and he supports Ardea's client education initiatives, focusing on how innovative strategies can better achieve investment objectives. Prior to Ardea, Tamar was a portfolio manager in the fixed income team at Credit Suisse Asset Management. Tamar commenced his career at the Reserve Bank of Australia, where he worked from 1999 to 2007. He gained broad experience across a number of roles at the RBA including policy analyst, economist, financial analyst, and portfolio manager. Tamar is a graduate of the Australian Institute of Company Directors (AICD). He was awarded the CFA designation in 2004, and graduated with Honours in Economics from the University of Queensland.

Alex Stanley joined Ardea in July 2020 as a research analyst. Alex helps clients to solve investment problems with research and to understand Ardea's unique relative value investment strategy. Alex has 10 years of experience in financial markets research. Prior to Ardea, Alex was a Senior Interest Rate Strategist at National Australia Bank in Sydney and a Fixed Income Strategist at the Commonwealth Bank of Australia in Sydney and London. His research focused on high grade bond and interest rate derivative relative value analysis, strategic and tactical trade recommendations and broader fixed income and macroeconomic themes. Alex has contributed to strong research rankings in industry polls. He has supported a wide range of clients, including fixed income fund managers, hedge funds, central banks, corporate borrowers and bank balance sheets. Prior to working in markets research, Alex spent two years at Suncorp Bank, focusing mostly on treasury balance sheet management. Alex has a degree in Finance with first class honours from Queensland University of Technology.

Tracey Hunter. Tracey Hunter is the Chief Operating Officer (COO) at Ardea and is responsible for ensuring growth is undertaken in a measured and appropriate manner. Tracey joined Ardea in 2019 to support the boutiques strong growth. The COO position is a newly created role that will take on new responsibilities as well as a number of tasks that were previously shared by the rest of the team, allowing investment personnel to focus on investing. Tracey has oversight of portfolio and risk management systems development and continual improvement processes to ensure that, as technology improves, so do Ardea's systems and ability to manage risk and deliver consistent returns. In addition, Tracey is responsible for all operational requirements of the business which include monitoring and supporting day-to-day tasks to ensure the deliverables of the business are met. Prior to Ardea, Tracey spent nearly six years with Challenger Limited in various roles, including Head of Investment Operations Support and Derivatives for three years. Tracey holds a Bachelor's degree in Economics.

Finally, Ardea works closely with its minority shareholder and service provider Fidante Partners, who have a dedicated sustainability Specialists to continuously improve and develop Ardea's approach to and integration of sustainable investing practices.

Agnieszka Cochrane. Agnieszka has a background in sustainability integration in investment products, having previously worked at Newton Investment Management in the UK (Newton is a London-Based global investment management firm with a strong focus on sustainability Integration). Agnieszka consults with all investment teams to review and update existing sustainability policies and help them to clearly define and articulate their sustainability beliefs; and provide support to managers to integrate their sustainability beliefs into an investment process within the relevant asset class.

Charlotte O'Meara. Charlotte has a background in risk management across funds management having previously worked in Challenger Funds Management enterprise risk management function and for Pandal Group. Prior to this Charlotte was a risk management consultant for EY Financial Services Risk Management. Charlotte consults to boutiques on sustainability integration, in particular the management of sustainability risks across their investment portfolios, articulating their sustainability beliefs and processes and asset class specific guidance on sustainability integration.

Lisa Jordan. Lisa joined Ardea in 2020 as a Relative Value Research Analyst, reporting into the Head of Research. In her current role, she is developing infrastructure for Ardea's idea generation process in order to create investment ideas using quantitative analysis. Prior to Ardea, Lisa worked as an Execution Trader for the American hedge fund Point72 Asset Management in London, where she traded Global Macro products with a focus on Relative Value. She started her career as a Trader at HSBC on their Graduate Program in London, where she worked on the G10 FX Forwards Trading, Rates Sales and Emerging Markets Rates Trading desks. Lisa holds a Bachelor of Science degree in Business Administration with a specialization in Finance from the Frankfurt School of Finance and Management.

2.1.2.2 *Third Party Data Providers*

In terms of third party data providers we have recently re-subscribed to a vendor who will provide us with sustainability country risk ratings. We will use these ratings alongside the risk factors we have identified as important from our research with UTS.

Product: Country Risk Ratings

Methodology: measuring the risks to a country's long term prosperity and economic development by assessing its wealth and its ability to manage its wealth in a sustainable manner

1. utilizes wealth data provided by the World Bank and groups a country's assets (or National Wealth) into three categories: Natural & Produced Capital, Human Capital and Institutional Capital
2. A country's ability to utilize and manage its wealth in an effective and sustainable manner is determined by: sustainability Performance, sustainability Trends and sustainability Events
3. By incorporating more than 30 indicators across the two steps, the resulting Country Risk Ratings provide a comprehensive rating for each country

Indicators: 31

Coverage: 172 countries

Historical data: 5 years of rating and 8 years of indicator data

Delivery: Updated quarterly. Onscreen, Excel/csv or data feed, Country PDF report.

2.2 Outcome

2.2.1 Governance

Accountability for effective stewardship is well defined at Ardea. That is, stewardship research, integration and reporting is the responsibility of the research team with ultimate sign off and approval by the Ardea Compliance Manager. As such, we believe this has led to the development of clear expectations regarding

the incorporation of sustainability risks into the portfolio construction process and across the business in general. We believe our engagement policy is also well defined with clear lines of accountability with respect to our engagement responsibilities and reporting of those responsibilities.

Please see [Section 4, Principle 4](#) for a detailed explanation of our integration and engagement policies.

Improvements could be made in the way that Ardea has incentivised employees to integrate stewardship and investment decision making. Currently there are no explicit incentives.

2.2.2 Resourcing

We believe we are appropriately resourced for supporting stewardship. Our resourcing includes the research team, ESG specialists, the Chief Operating Officer, Portfolio Managers and academic researchers. This covers a wide breadth of perspectives and ensures our policy benefits from diversity in knowledge and expertise.

3 Principle 3

Signatories manage conflicts of interest to put the best interests of clients and beneficiaries first.

3.1.1 Context

In accordance with regulatory requirements, Ardea maintains a conflict of interest policy to ensure that any actual, potential and/or perceived conflict of interest that may arise both between itself and its clients, a staff member and a client and between clients are identified, prevented or managed and disclosed in the best interests of clients. This Policy sits within our Governance Risk and Compliance (GRC) Framework and the Ardea Compliance Manager is responsible for ensuring adherence with this conflicts policy.

This commitment to the way we conduct our business is intended to ensure that we provide high quality services which create long term value and minimise adverse impacts to our clients and key stakeholders of the business

3.1.2 Activity

As part of the GRC framework, we maintain a conflicts register. Some examples of notable potential conflicts include:

- A staff member has part ownership in an electronic trading platform which facilitates the trade execution process from price discovery to settlement and the calculation of transaction costs Ardea are currently users of this platform
- Internal trading

3.1.3 Outcome

All Ardea staff are required to complete annual conflicts of interest training to ensure they have the appropriate understanding to identify and report conflicts of interest which can then be prevented or managed pursuant to its conflicts of interest framework.

With respect to the part ownership of the electronic trading platform the following actions took place after sign off from Ardea's board.

- Full analysis of conflict and risk mitigants as below
- Any development work, including conversations could only be carried out outside of working hours and must not interfere with the performance of their duties at Ardea
- Staff member was not part of the overall business decision to use the trading platform
- The impacted staff member was instructed not to discuss or promote the relative merits of the trading platform with other Ardea employees, unless asked
- Ardea had to be notified immediately of any change in duties of the staff member in relation to the

platform

With respect to personal trading we have implemented the following rules:

- Put the interest of our clients before your own interests
- Check if the transaction you wish to undertake requires pre-authorisation
- Obtain pre-authorisation on applicable securities from the Compliance Manager or a Director
- Undertake trading within the correct timeframe
- If you miss the timeframe window, re-obtain pre-authorisation before trading;
- Keep a record of all trades, including contract notes;

4 Principle 4

Signatories identify and respond to market-wide and systemic risks to promote a well-functioning financial system

4.1.1 Activity

4.1.1.1 *Market Wide and Systemic Risks*

Our strategy invests in high grade and very liquid government bonds and their associated derivatives. We hedge all currency exposure and the nature of the strategy is such that there is negligible exposure to the level and direction of interest rates. Further, given that the return profile is driven by mispricing between securities and the portfolio construction process ensures diversification across a large number of liquid high quality markets, exposure to risks such as geopolitical issues is not seen as material.

To further combat exposure to market wide and systemic risks, we stress the portfolio for both forward looking and backward looking scenarios on a daily basis to understand which macroeconomic and market environments may impact the portfolio negatively and positively. Further, our portfolios include 'risk-off' strategies, which are explicitly designed to profit during periods of market stress and therefore provide protection against market volatility and downside tail risks. This is an important aspect of portfolio construction that is always present, irrespective of the prevailing market environment.

Regarding climate change, the research collaboration we have with UTS is investigating the role climate change has on the markets we invest in.

4.1.1.2 *Working with Stakeholders and Participation in Industry Initiatives (Engagement)*

"As stewards of savers' money, responsible sovereign bondholders have a fiduciary duty not only to yield returns for their beneficiaries but to pursue them by promoting sustainable economic, societal and environmental outcomes." (UNPRI, 2020).

Engagement seeks to move beyond demonstrating the impact of sustainability factors for investment returns, and beyond the inclusion of sustainability factors as a part of the investment process. We view engagement with stakeholders including clients, media, debt management offices, academia and issuers as the most efficient and logical way to promote sustainable outcomes generally, not just within our industry or asset class. Engagement also broadens the scope to include a wider discussion on sustainability issues with the key entities that produce the supply of a large part of the fixed income universe, namely governments.

Engagement with governments is important because they form the benchmark curve in markets and are used as inputs to the pricing of many other assets. So all assets incorporate in their valuations the extent to which sustainability risks are managed by governments. Improvements therefore lower risks not just to investors in government bonds, but potentially to other asset classes priced off the government curve.

Engagement also addresses the concern that selectively purchasing only sustainability-favourable assets as part of the integration process can be perceived as leaving so-called "brown" assets to become someone else's problem. Effective engagement can provide a roadmap for improving the entire funding stack, including debt through to equity. A further focus of engagement is to ensure that capital, once allocated, continues to be deployed in assets that are well managed (The Economist, 2020).

A key emphasis within our engagement process is to engage in a way that benefits both sides of the table, such that both issuers and investors stand to gain, and are thus appropriately incentivised to respond. For

this reason, although engagement provides a crucial mechanism to convey downside risks and concerns and seek to have these mitigated or resolved with the issuer, engagement also provides an opportunity to support and encourage issuers to take steps that rely on the support of the investor base. This might include new instruments such as green bonds, but also initiatives that involve an upfront cost and potentially a hit to issuer finances. Support from the investor base can ensure that issuers, even government ones, have the confidence to make costly decisions that have material long term benefits in mitigating future sustainability risks.

While issuers remain a key component of engagement, Ardea's approach encompasses more than the issuer and the debt management office (e.g. AOFM). For example we engage with:

- Our clients to understand what their expectations are
- The media to help increase information provided to the market on sustainability matters
- Research houses to understand risks and opportunities and to highlight the need for targeted research on sovereign bond sustainability matters
- Academia so that we can highlight the need for additional research on sustainability outside of equities, corporate debt and property. Indeed, we are partnering with the UTS on joint research projects to fill this void.
- Other key participants within financial markets such as clearing houses and exchanges, which have the potential to perform new and innovative functions with respect to sustainability
- Policy makers and regulators, whose interests are often aligned with sustainability-aware investors due to taking a longer-term focus than private financial market participants
- Investment bank capital market desks and dealer panels, who through their market-making role can advise sovereigns on sustainability issues that might be material to pricing and would increase the attractiveness of their bonds.

4.1.1.3 *Ardea's Commitment to Engagement*

As part of our commitment to the PRI we seek to be active owners³⁴. Ardea's active ownership and engagement goals include:

- To help sovereigns better understand the increasing sustainability demands of investors
- To convey expectations and concerns on behalf of our clients
- To promote discussions between investors, sovereign issuers and other stakeholders
- To increase the information provided to the market on sustainability matters
- To extract sustainability information important for our analysis
- To encourage sustainability data transparency

We believe indirect engagement is as valuable as direct engagement with issuers. For example, the research we have been conducting in conjunction with UTS demonstrates that climate change risks are being priced into yields by market participants. By publishing in high quality journals and bringing that research to the attention of the media, our clients and other fund managers, we will be assisting other market participants to influence issuers in a way which is informed by high quality and defensible research outcomes.

4.1.1.4 *Engagement challenges unique to the Sovereign bond asset class*

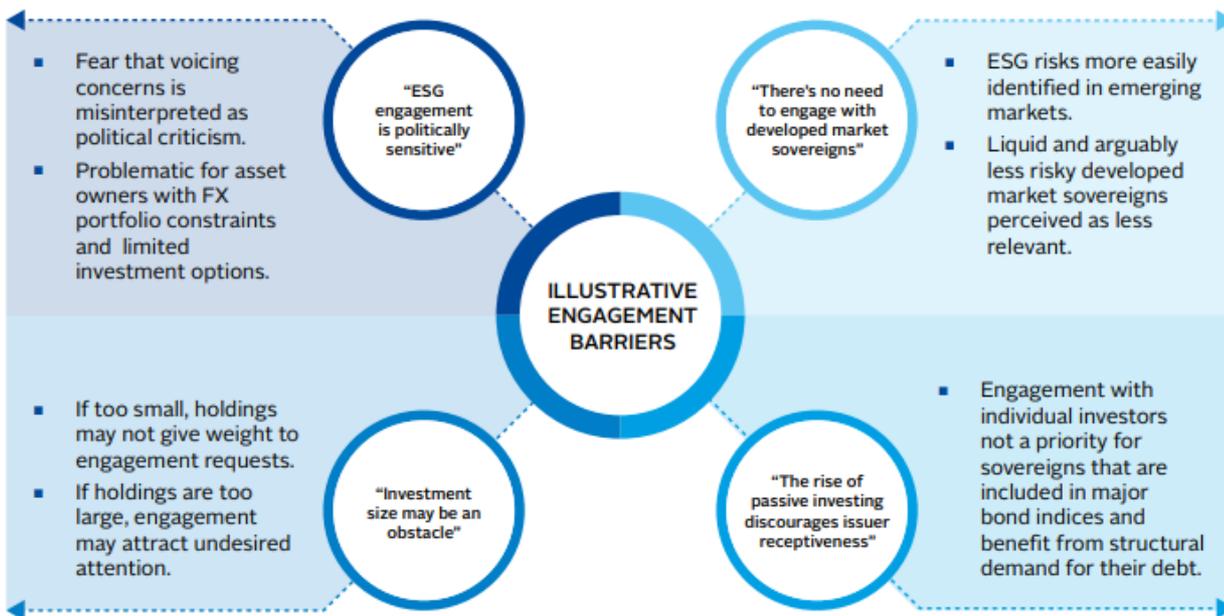
UNPRI recognizes the engagement challenges posed for fund managers operating in the fixed income markets, but also highlights the necessity to differentiate engagement from lobbying:

"It comes with challenges though. In particular, the terms active ownership and stewardship – at the core of Principle 2 of the six Principles for Responsible Investment and typically associated with equity investing – are not particularly appropriate in a sovereign debt context, as investor engagement can be misinterpreted as lobbying, advocacy or an attempt to interfere in governments' policy choices. Direct engagement between

³ <https://www.unpri.org/defining-objectives-and-measuring-the-effectiveness-of-engagement-in-fixed-income/2926.article>

⁴ <https://www.unpri.org/sovereign-debt/esg-engagement-for-sovereign-debt-investors/6687.article>

sovereign bondholders and government officials should not be confused with advocacy or lobbying.”⁵



Source: PRI <https://www.unpri.org/sovereign-debt/sustainability-engagement-for-sovereign-debt-investors/6687.article>

From our perspective, engagement with governments also creates a number of other unique challenges. These include the inability of the investor to divest, or to withhold capital. This can arise because the investor is required to hold government bonds, for regulatory or prudential reasons, and so the threat of divestment carries less weight than it does for other assets such as corporate bonds or equities. This is particularly relevant for the investor’s own home-country government bonds.

A further challenge of engaging with government issuers is that issuing agencies generally don’t have the discretion to set policies and take decisions with respect to mitigating sustainability risks. These decisions are usually reserved for the government itself. That said, engagement and feedback through the appropriate channels is important in shaping the advice that is provided to governments.

Our approach to engagement is to utilise our long-standing communication channels with government issuers to raise sustainability issues that are deemed of importance by asset owners and fund managers. We also believe it is important to receive feedback and communication from government issuers as to the challenges and constraints they are facing, with a view to raising awareness within the investor base.

This frank and open approach has worked well for many years in terms of investor communications more generally and has resulted in government issuers maintaining strong relationships with the market and a very strong focus on investor outcomes. We see the sustainability engagement process as highly consistent with existing practice.

4.1.1.5 How Ardea engages

Engagement is undertaken by the portfolio managers/analysts and the newly created Research team that will provide a support role for engagement.

4.1.1.6 How Ardea prioritises engagement activities

Ardea prioritises engagement with issuers of all bonds held in investment portfolios, and all elements of our engagement framework apply to all portfolios we manage. All elements of the Engagement framework are applicable to all Ardea portfolio managers/analysts. Mandatory engagement activities include:

- discussing sustainability considerations as part of a client’s periodic portfolio review
- discussing sustainability in some form at all meetings with issuers (this can take many forms – for example raising concerns on behalf of clients, asking about sustainability initiatives, advice

⁵ PRI <https://www.unpri.org/sovereign-debt/esg-engagement-for-sovereign-debt-investors/6687.article>

regarding TCFD reporting)

Activities are prioritised as a function of:

- Relevance to our strategy
- The degree to which we think we will have impact
- Relevance to our clients

4.1.1.7 How Ardea undertakes engagement activities

Direct engagement with Sovereign issuers comes with a different set of challenges and constraints when compared to engagement with corporations issuing debt or equity. It is important that our engagement activities do not appear to be lobbying or attempting to interfere in government policy. Whilst engagement with issuers may be somewhat constrained when compared to other asset classes there are still many ways for Ardea to engage. The first is to recognize that engaging with issuers and alerting them to the expectations of our clients with respect to sustainability is not lobbying. Second, direct conversations which seek out an understanding of an issuer's sustainability policy is a very clear message that sustainability is of importance to not only the fund manager but the asset owner. Third, engagement with issuers can help provide insight regarding attitude toward and likelihood of green bond issuance. Engagement is facilitated through one-on-one investor feedback sessions with all issuers of bonds in our portfolios. Given our focus as a primarily government-only investor the universe of issuers is manageable, and engagement can occur frequently enough to develop a dialogue and influence outcomes.

And finally, there are many avenues for engagement outside of direct engagement with issuers which have a material and direct impact with respect to promoting acceptance and implementation of the Principles within the investment industry. These alternative engagement paths include:

- Engagement with the media about sustainability risks and aspirations. An example is found [here](#).
- Working with academic organisations such as the University of Technology so as to contribute to the sustainability industry knowledge base and academic literature. For example: <https://www.fssustainability.com.au/ardea-uts-partnership-to-bring-ai-to-fixed-income-analysis>
- Engagement with research houses which specialise in fixed income research

4.1.1.8 Monitoring and escalation process for engagement activities

Engagement activities are logged in a dedicated tracker and file notes prepared summarising each engagement activity. This ensures that engagement activities can be tracked, and progress assessed. Reporting on the results of engagement activities, and escalation, occurs through the formal inclusion of sustainability as part of Ardea's weekly risk and strategy meetings.

We note that the ability to escalate issues has limitations given that as government bond holders, there are political sensitivities that need to be accounted for. As such, our role revolves around advocacy rather than lobbying.

4.1.1.9 key issues on which Ardea engages with sovereign bond issuers and examples

There are key sustainability factors on which we engage with sovereign bond issuers, of which are outlined below.

Green Bonds

An example of engagement is apparent for an investor considering owning a government issuer's green bonds. The integration process may conclude that green bonds represent a better balance of risk/reward than the issuer's other securities, and as such a decision to invest in green bonds may be made.

While this represents an optimal outcome from the perspective of the investor's own return, it ignores the still-large pool of the issuer's outstanding conventional bonds. sustainability engagement is about changing the issuer's approach to their entire asset base and not cherry-picking individual assets to the potential benefit of the investor, but perhaps with broader detrimental externalities that might otherwise run unchecked.

In this respect sustainability is consistent with focusing on social outcomes rather than pure investment ones,

though ultimately improvements in social outcomes of course support investment ones.

Other practical examples that arise during engagement discussions relate to difficulties in sourcing enough green investment programs to underpin the issuance of green bonds. Not all issuers function as large investors or asset owners in their own name, and so issuance of green bonds may be constrained in practice, thus improvements in other areas may take greater focus.

Further considerations involve liquidity constraints and the tendency of many investors to buy and hold green bonds, consistent with strong demand for the asset class. While this is an excellent outcome from a funding perspective, it is a poor outcome from a liquidity perspective. Investors may be better served therefore by engaging with the government issuer to ensure that their practices in all areas are lifted, such that sustainability risks are reduced across all existing lines, thus resulting in better sustainability outcomes, but without coming at the cost of a bifurcated market or reduced liquidity for certain lines.

We expect further nuances and considerations will arise as the engagement process continues.

Climate Change

Our engagement with issuers with respect to climate change is intended to span the wide range of negative risk factors that issuers face, and positive steps that can be taken to mitigate these. Key components of this engagement include:

- Focusing on helping sovereigns better understand the increasing sustainability demands of investors and to convey expectations and concerns on behalf of our clients, particularly with respect to physical and transition risks
- Conveying any specific sustainability risks identified through our integration process that require mitigation.
- Informing issuers of industry developments and innovation that have support from the investor base, and which therefore represent an opportunity for issuers.
- Seeking to extract sustainability information from issuers that is important for our analysis but that would otherwise be unavailable.

Modern Slavery

Ardea strongly opposes modern slavery in all forms, from first principles and with respect to specific risks proscribed by regulation. Ardea takes steps to actively counter modern slavery practices throughout its business, in its client and supplier relationships, and in its engagement with the industry and with issuers.

Measures that Ardea is actively undertaking include:

- Reviewing the modern slavery statements for Australian states and territories under the Modern Slavery Act 2018. These are due in March 2021.
- Engaging with the AOFM, which is the issuer of Australian government bonds, to understand their perspectives on modern slavery. We will document these engagements as part of our reporting policy. Given our limited exposure to modern slavery risks, we believe Engagement on these matters is the best avenue via which to signal its importance to issuers on behalf of our clients.
- Participating in a review of practices by a key supplier, Challenger Limited. Challenger Limited is covered under the federal Modern Slavery Act and is currently reviewing its processes and procedures to reduce the risk of modern slavery throughout its operations and supply chain. This involves continuous monitoring and actions which will be put in place as risks are identified. Challenger will publish a Modern Slavery Statement in accordance with the requirements of the Modern Slavery Act.
- Inclusion of specific disclosure criteria and other criteria to address Modern Slavery risks in our agreements with clients and suppliers.
- Engagement on specific Modern Slavery risks with issuers, as part of our broader sustainability engagement process.
- Consideration of Modern Slavery specific criteria in the know-your-customer (KYC) processes performed on our behalf by Fidante Partners, a wholly owned subsidiary of Challenger Limited.

Steps already taken to counter modern slavery practices arising in Ardea's business, clients, suppliers, and

investments include:

- A low level of complexity in our business, with no reliance on offshore suppliers or opaque external supply chains.
- The modest size of our business: our headcount ensures that there is complete visibility of management through to all areas of the organization.
- The narrow focus of our investment universe on highly-rated government bonds from countries meeting high standards of governance, and high investment grade credit. This is not to say that no modern slavery risks arise within these investments, but that oversight and monitoring is well established, and thus the risk of egregious practices escaping undetected is low.

In addition to active measures being taken to counter modern slavery, Ardea also ensures that all regulatory requirements relating to Modern Slavery are met, specifically:

- Our consolidated revenue falls below the threshold where regulation requires companies in the Commonwealth and in New South Wales to report, so we are considering these initiatives for best practice reasons given that we are not currently required to comply with the Act.

As noted above, our key supplier Fidante Partners is a wholly owned subsidiary of Challenger Limited, who is required to report under the Modern Slavery Act.

4.1.1.10 Collaborative industry initiatives that could increase impact

As reflected above, Ardea views issuers as only a single component of a wider engagement process. Engagement with a broad range of industry stakeholders (refer section 3) is in our view most likely to deliver collaborative initiatives that improve sustainability outcomes. Collaborative initiatives could include:

- Being a signatory to the Global Investor Statement to Governments on Climate Change⁶
- Advocating alongside other industry stakeholders for the issuance of green bonds by the Commonwealth of Australia
- Supporting and encouraging direct ownership of, and initiation of, national-level sovereign infrastructure projects that produce green assets owned by the Commonwealth. If ownership is retained, these assets can provide a hedge to other brown assets that mitigate the Commonwealth's overall sustainability risk profile
- Supporting initiatives of the State issuers in Australia to increase the creation of green assets through infrastructure investment programs
- At an international level, contributing through our research activities to structural and longer-term findings that strengthen the underpinnings of global sustainability initiatives
- Considering specific initiatives to introduce sustainability-positive issuance in new sectors such as restoration bonds, to sit alongside other social outcome linked instruments.

4.1.1.11 Investment Alignment (Integration)

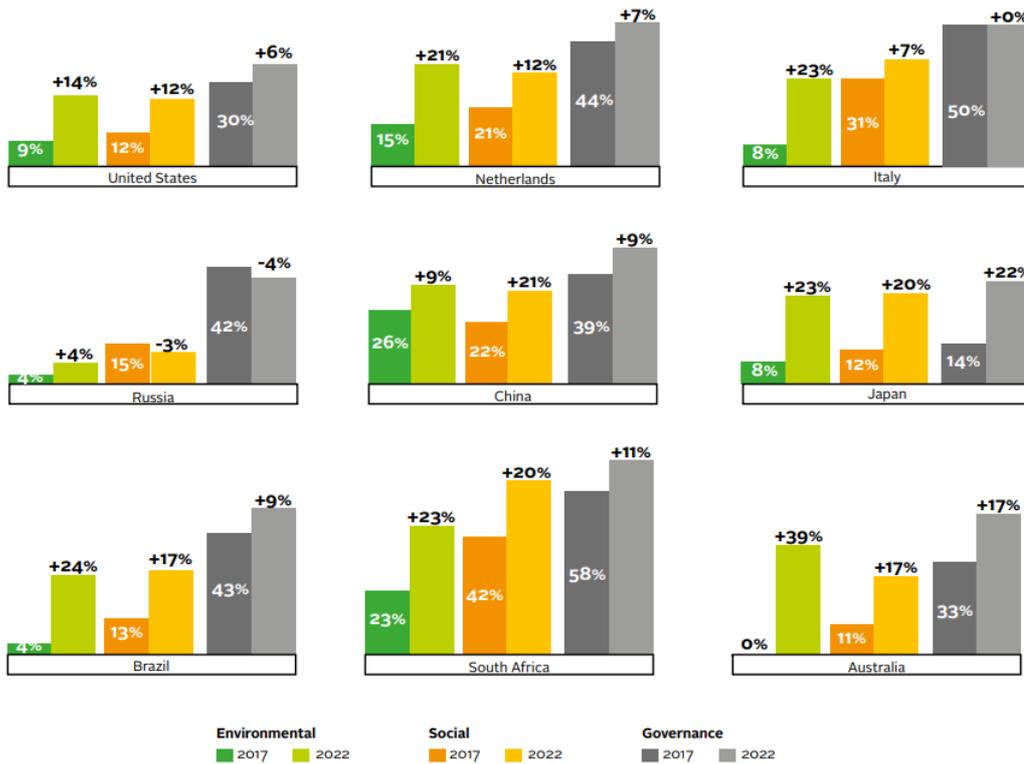
Given the nature of our portfolios and specifically our focus on a pure relative value investing style, the integration of sustainability factors as a material source of risk or value-add is not as clear cut as it would be for corporate-only investment styles, or for fundamentally-driven investors. Traditional bond portfolio construction methods harvest yield via exposure to currency, default, interest rate and liquidity risk. In contrast, our strategy seeks out exposure to mis pricing between securities which are exposed to the same risks. This mispricing is driven by demand and supply dynamics in interest rate markets and is independent of the premiums associated with interest rates, credit and liquidity risk. sustainability risks, and how the market prices these risks via the premiums attached to duration exposure, default and illiquidity factors is therefore likely to operate independently of our strategy. sustainability factors are likely to play out over both long and indeed short horizons as risks come to the fore and are realised in market pricing, but this process

⁶ <https://theinvestoragenda.org/focus-areas/policy-advocacy/>

can coexist with relative value investment styles. Other strategies such as long-term buy and hold strategies are more likely to be in direct opposition to sustainability integration and sustainability risk factors.

Our sustainability integration framework does not implement screens. This is because, by default, much of the governance and social risks are eliminated due to the fact that we restrict our investible universe to countries without major credit risks. However, environmental risks are not currently adequately addressed by credit ratings. Further, we believe, as does the market, that environmental risks will become increasingly important over time. See Figure 1 below. As such, we see this as a key area of focus for not only our research efforts, but our integration process as well.

Figure 1: The impact of sustainability issues on sovereign debt prices: market participants' view in a selection of capital markets.



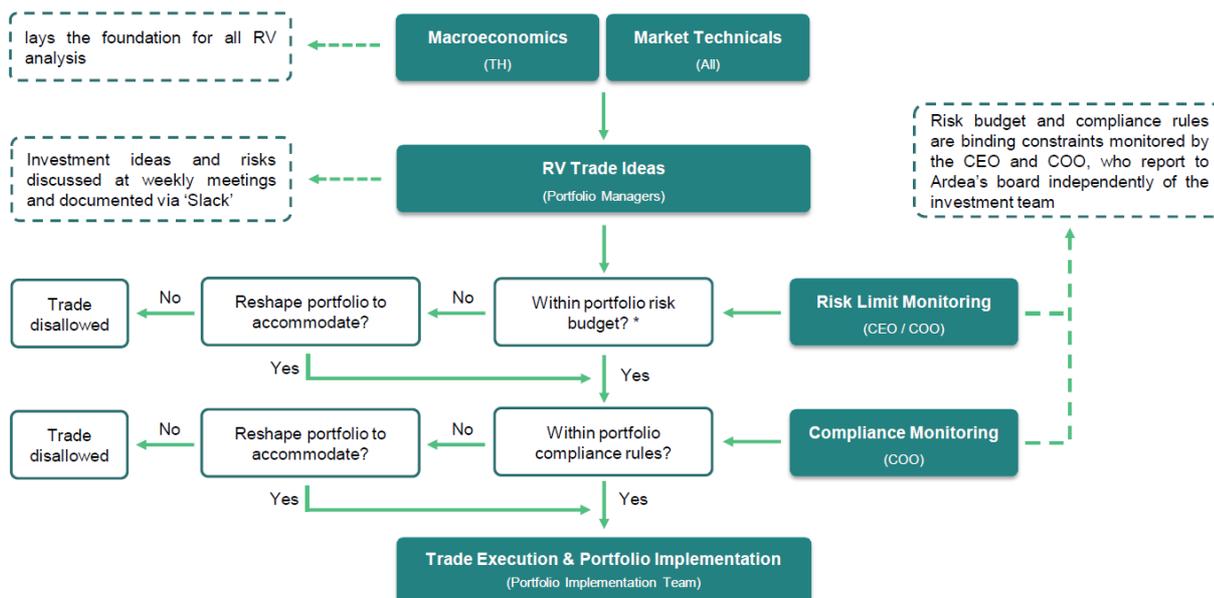
Source: PRI <https://www.unpri.org/fixed-income/a-practical-guide-to-sustainability-integration-in-sovereign-debt/4781.article>

4.1.1.12 Integration: Our process

Risks and opportunities are identified via research (in house, in conjunction with academic institutions, the literature, research houses and ratings agencies). Investment ideas and risks are discussed at our weekly risk and strategy meetings.

Figure 2: Ardea's Investment Process

Every investment decision goes through a rigorous screening process



Below we discuss examples of how research regarding risks and opportunities are incorporated into our investment process.

4.1.1.13 Integration Examples: Risks

There is very little in the academic literature regarding climate change risks may impact the government bond market, nor has the industry seen this as a risk worthy of research:

While some investors have managed to factor climate change into stocks and corporate bonds, the long-term effects of global warming and other factors on an entire economy make it difficult to apply the same models to government debt.”

“We don’t have enough data to price the risk on a macro level over a long-term horizon,” said Shaun Roache, Asia-Pacific chief economist at S&P Global Ratings. “We don’t know the magnitude of the next shock, or how big the next bushfire will be or its impact on the economy,” said Roache, who was formerly a macro strategist at Singapore sovereign wealth fund Temasek Holdings. “When markets find it difficult to price the risk, they just don’t price it at all.” (Bloomberg, 2020)

Despite the lack of evidence-based literature on financial market impacts, there is nonetheless a consensus among the scientific community and among policy makers that climate change risks are material. At the same time, there is also a tendency well established in the literature for financial markets to focus almost exclusively on short-term outcomes (short-sightedness or myopia (Kvaløy & Eriksen, n.d.)).

Further, investors are discounting the near term impacts of risks like climate change on investments. Jeremy Grantham, Co-founder and Chief Investment Strategist, GMO and Lucas White, Portfolio Manager, GMO as part of their introduction at the 2017 Social Enterprise Leadership Forum to discuss the near-term impacts of climate change on investors stated:

“We believe the problems and risks associated with climate change are much worse than the average investor or business person realizes. Failing to understand the investment implications of climate science exposes professional investors to risks that must be understood in order to maintain fiduciary duty.

Climate change is already impacting the world, and it will continue to get worse, regardless of how quickly we move to address it. Scientists, investors, and policymakers must work together to address the impacts of climate change, most notably the implications for our food and water supplies. Agricultural productivity is

expected to suffer greatly as temperatures continue to rise, leading to more extremely hot days, droughts, floods, and heavy downpours that lead to soil erosion. Water supplies will also be threatened by changing precipitation patterns and distribution; enhancing water infrastructure will be critical. Addressing these challenges will largely determine the shape of society itself in the decades to come” (The Tamer Center for Social Enterprise at Columbia Business School, 2017):

These factors together suggest that it is highly likely that financial markets will fail to adequately incorporate the likelihood and magnitude of sustainability risks into investment decisions.

An example is provided below:

4.1.1.14 Integration Examples: Risks

Sustainability Risk Description

In January 2020, Moody’s published a report highlighting the long term risks to Australian federal and state government finances from more frequent natural disasters. No ratings action was flagged, and the research was published within a sector comment.

Sustainability Impact on Investment Decision:

The risks to the rating were deemed to be very long term and highly uncertain. However, there is little research by rating agencies and in the literature with respect to the market impact of climate change. It is, therefore conceivable that climate risks could eventually lead to adverse ratings action, bonds to underperform, issuance to rise and curves to steepen. But it was deemed that this risk is not material in the foreseeable future relative to the wide range of other much bigger drivers of the market. This report did not warrant any change in investment strategy. We do however acknowledge that our conclusion may have changed if there was more credible research on which to rely. In which case, we are conducting our own research into the risks of climate change on markets.

4.1.1.15 Integration Examples: Opportunities

Sustainability Opportunity Description

While sustainability considerations do present risks, they also present opportunities. Over the last few years, there has been significant growth in global green bond issuance volumes. The market has risen to be over US \$1tn of outstanding debt. In 2020 over \$200bn of green bonds have been issued globally, one of the largest on record. Europe has committed to fund around 30% of its COVID joint fiscal response with green bonds, amounting to around €225bn (source: Commonwealth Bank Research and the Climate Bonds Initiative). Supranational and regional issuers have been more active than individual sovereign issuers. However, this trend could be shifting. For instance, the German federal government issued its first green bond alongside its regular funding program in August 2020.

There is significant variation in issuance volumes across the world. Australia, for example, has not yet issued a green bond at the federal level. But global SSA issuers have been active in AUD and the Australian semi-government issuers have provided more than one third of the total supply of AUD green bonds in 2019. QTC, for example, is now a “programmatically issuer” of Climate Bonds Initiative-certified green bonds. The state was recognised by the Climate Bonds Initiative for the largest Subnational Green Bond Deal of 2019, with the issue of a \$1.7bn green bond in 2019. QTC and NSWTC have issued green bonds in 2020.

Sustainability Impact on Investment Decision:

Semi government issuers proactive stance on green bond issuance is unlikely to be impacting the performance of its bonds, in-and-of-itself. However, sustainability bonds attract a more diverse investor base and support the funding of historically large issuance programs. The use of sustainability funding programs could support the performance of semi-government issuers over the long run.

Periodic variations in investor interest in green bonds relative to the size of the green issues (and underlying pool of eligible assets) could impact relative value on semi curves in the future, so investor and issuer activity in this space needs to be monitored.

4.1.2 Outcome

4.1.2.1 *Effectiveness in identifying and responding to market-wide and systemic risks and promoting well-functioning financial markets.*

We believe the low performance volatility and strong long term performance demonstrates our effectiveness in identifying and responding to market-wide and systemic risks. We are yet to understand how our engagement activities and climate change research will contribute to the promotion of well functioning financial markets. We are hoping that the publication and promotion of our research findings with respect to climate change and how this impacts government bond markets will contribute to the narrative and knowledge base with respect to how it impacts rates markets.

5 Principle 5

Signatories review their policies, assure their processes and assess the effectiveness of their activities.

5.1.1 Activity

5.1.1.1 *Review, assurances and reporting*

The purpose of our GRC Framework is to identify our principal regulatory obligations and explain how we ensure compliance with them. The GRC Framework sets out our policies as well as the broad procedural controls, monitoring and reporting that is in place to ensure compliance with these obligations. This GRC Framework will be reviewed and amended as necessary, such as if the nature of our business changes or any applicable regulations change. In addition, the policies within the GRC Framework are subject to periodic review.

The Board must approve all material amendments to the GRC Framework. When material changes are made to the GRC Framework, these must be communicated to impacted Staff etc.

The Company consists of a single corporate entity, incorporated in Australia, and registered with ASIC as a proprietary company. The Company is owned primarily by the principals, along with an interest held by a related entity of the Administrator.

The Company is governed by the Board, which consists of both Executive Directors and Non-Executive Directors. The Company Secretary appointed to the Company is provided by the Company Secretarial team at the Administrator.

The Board sets the risk appetite of the Company and approves the GRC Framework to address the risks and compliance obligations faced by the Company. The Board has appointed a senior member of staff to be the nominated Compliance Manager with responsibilities across both risk and compliance. The Compliance Manager is responsible for the implementation and day-to-day operation of the GRC Framework. The Board meets regularly and receives regular reports from the Compliance Manager as to the operation and ongoing effectiveness of the GRC Framework. In addition, the Compliance Manager has ongoing, direct access to the Board as needed.

Due to the size, nature and complexity of our business, the Board has not delegated any of its responsibilities to any committees.

With respect to assurances and the quality of our reporting, we utilise our ESG specialists as provided to us by a related entity of the Administrator. We believe having a dedicated specialist who sits outside of the research team provides a “sense” check for the policy development at Ardea. These ESG specialists have oversight across a large number of boutique fund managers and this brings us the benefit of diversity.

We also seek review from our CEO and Portfolio Managers to ensure that our reporting obligations and our activities are aligned.

5.1.2 Outcome

5.1.2.1 *Continuous improvement outcomes*

Reviews from the board, our Portfolio Managers, our COO, our CEO and our ESG specialists have ensured a constantly evolving process for accounting for sustainability risks. This review process has meant that we are now in the process of significantly overhauling the way we integrate sustainability risks into our portfolio construction process.

The business also undertakes an annual strategic business review which functions as part of an annual strategic workshop conducted by all staff.

The business's flat culture also facilitates ongoing review and improvement among the respective teams, consistent with segregation of duties. This typically takes the form of the dealing team or investment team identifying a potential improvement in relation to workflow or investment analytics, with the risk team implementing and delivering the process improvement or change.

6 Principle 6

Signatories take account of client and beneficiary needs and communicate the activities and outcomes of their stewardship and investment to them.

6.1.1 Context

As part of regular updates to clients and other stakeholders such as the board, the business discloses the composition of the client base including across sectors and locations, and the composition of assets under management.

As we believe that the most productive business relationships benefit from a long-term focus, the business also ensures during the onboarding process that clients select strategies that are appropriate for their needs and investment horizons. We do this qualitatively and quantitatively, by being explicit about the tracking error targets of each product, and the expected distribution of returns.

6.1.2 Activity

To evolve into a more scalable institution we needed an efficient and robust way to monitor the growing number of portfolios we are managing. The ultimate aim is to ensure we consistently manage every portfolio in a way that is consistent with client expectations. We periodically (at least annually) consult with clients to confirm our understanding of their investment objectives and the role that we play as part of their broader portfolio as part of our portfolio monitoring initiative.

The portfolio monitoring database systematically documents key parameters for every portfolio and makes this information easily accessible to everyone in the firm. This information is used by the investment team to ensure portfolios are constructed and managed appropriately and by the broader team to understand our obligations with regards to other stewardship considerations such as engagement and reporting on emissions.

Currently our communications as part of this process have focused more on gathering client's investment expectations and communicating investment outcomes to clients.

Our portfolio monitoring database includes the following investment questions for our client:

- Bucket the strategy sits in (e.g. defensive, cash alternative)
- Expectations (e.g. low volatility returns independent of market environment; portfolio diversification from uncorrelated returns; potential for higher returns from risk-off strategies when equities or credit sell off; inflation protection when needed)
- Client downside tolerance (e.g. performance volatility < 2% over rolling 2 year horizon; few months < -0.5%; no months < -1.5%; no downside correlation with equities or credit)
- Historical issues (e.g. has volatility been greater or less than expectations)
- Satisfaction with performance and role in portfolio
- Level of support preferred
- Review frequency
- Moving to insourcing?
- Compliance errors
- Operational errors

- Reliance on consultant?
- External factors impacting
- Research interests
- Client work outstanding

6.1.3 Outcomes

Following on from our most recent round of client feedback, we are looking to add additional stewardship risks to the portfolio monitoring database. Items to include are:

- reporting on climate change exposure for the relative value strategy in general and for their portfolio specifically
- emissions exposure specific to their portfolio
- engagement activities (e.g. issuers, academia, media, collaborations)
- changes to our integration policy

7 Principle 7

Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities.

7.1.1 Context

We invest predominantly in government bonds and derivative instruments, where there has historically been less scope for stakeholder engagement than has been the case in other asset classes, such as corporate bonds and equities. Additionally, the literature provide little guidance as to how investors in government bond markets should incorporate the principles into their investment process (integration). However, it is becoming increasingly clear that sustainability megatrends like climate change is, and will be impacting the yield on Government bonds either through investors penalising governments who are not seen to be doing their part (Johnson, 2019) or through the impact climate change will have on an economy directly (Debelle, 2019) (American, 2020) (University of Melbourne, 2020) or indirectly through carbon tariffs (Fowler, 2020) (Holden, 2020). The UNPRI states:

“Despite its size and importance, the sovereign debt market has been the subject of less systematic environmental, social and governance (sustainability) consideration than other investment asset classes. However, appetite for sustainability integration is growing among investors, with a rising number appreciating that sustainability factors can and do affect sovereign debt valuations.” (UNPRI, 2020)

And in an IMF working paper they state:

“Climate change is already a systemic risk to the global economy. While there is a large body of literature documenting potential economic consequences, there is scarce research on the link between climate change and sovereign risk. This paper therefore investigates the impact of climate change vulnerability and resilience on sovereign bond yields and spreads in 98 advanced and developing countries over the period 1995–2017. We find that the vulnerability and resilience to climate change have a significant impact on the cost of government borrowing, after controlling for conventional determinants of sovereign risk.” (Serhan & Jalles, 2020)

Please see [Section 4, Principle 4](#) for a detailed explanation of our integration and engagement policies

8 Principle 8

Signatories monitor and hold to account managers and/or service providers.

8.1.1 Activity

We have recently reviewed the major ESG data and research providers in the market to understand what the latest offerings are and to benchmark the service providers. We also wanted to understand what offerings

were in the pipeline given the evolving reporting environment.

After reviewing the options, we are re-engaging a service provider to help us to further identify ESG risks at a sovereign bond issuer level. Note that previously the data we required to do this was not available via our existing data subscription, and this resulted in us ending the subscription. Having done a more recent market review, it is clear that the offerings have improved. The offerings are still inadequate for state level issuers of which are a large exposure for Ardea.

In addition to our monitoring of investment services providers, the business also ensures that service providers that support business operations are also within scope. In this aspect we receive considerable support from our operations provider Fidante, but nonetheless both Ardea management and the board can and have raised issues in this area, most commonly in relation to sustainability aspects of building and facilities, and service providers such as contract cleaners.

8.1.2 Outcomes

8.1.2.1 Monitoring data and research providers

Main reasons for re-engaging the service provider

- The provider is not just looking at a potential impact to credit rating like many rating agencies do for their offering.
- Data released on a quarterly basis whereas other providers are usually less frequent.

However, there is no perfect offering currently. For example:

- ESG data on a state level is not available.
- Shortcomings on carbon/emissions and climate risk data.

Recommendations:

- Supplement the service providers data on emissions and climate risk as desired/required for analysis/reporting with other data sources (reporting requirements should be discussed from Compliance/Regulations perspective). For obtaining additional data, we will need to commit resources to the gathering of relevant data, as there are issues around availability and comparability (e.g. state level emissions data for both domestic and international issuers is difficult to gather).
- Stay in the loop on updates to other vendors' offerings. Other providers have a climate offering and warming potential data under development.
- Full review of data options again next year due to fast changing ESG landscape.

9 Principle 9

Signatories engage with issuers to maintain or enhance the value of assets.

9.1.1 Activity

9.1.1.1 How we select and prioritise engagement:

As an advanced-economy government bond fund manager, the universe of issuers we engage with is much narrower than for corporate bond fund managers. Corporate issuers number in their hundreds for investment grade, and even more for sub-investment grade and emerging markets. In contrast each advanced economy market contains only a handful of government-related issuers.

Given this concentration, we can target ESG outcomes that span the majority of our investable universe by engaging with only a handful of issuers, and undertaking highly concentrated and targeted engagement, at a much deeper level than possible with corporate issuers.

Our primary guiding consideration in selecting issuers for engagement is our "seat at the table": do we have a long-term well-functioning relationship with the issuer that allows for the candid exchange of feedback, constructive initiatives and traction, and tangible metrics with which to assess progress.

9.1.1.2 How we develop well informed and precise objectives for engagement

The nature of engagement with respect to government bond issuers emphasises objectives that are long-term in nature, consistent with the primarily long maturities of the asset class.

That said, we focus on objectives that are incremental in nature and thus conducive to assessing progress over shorter time frames.

These objectives include scope and frequency of climate-related disclosures, extent of usage of bonds earmarked as green bonds (or absence of this), and the context of wider government policies e.g. signatories to global initiatives. While these measures are not in and of themselves sufficient, we believe they are useful indicators of progress.

9.1.1.3 What methods of engagement do we use and to what extent

When engaging directly with issuers we focus on whatever methods we believe best advance the issues we are seeking to address. These include direct communication with the issuer by emails, phone calls, and meetings, with all of these taking place with senior leadership of the issuer i.e. CEO level or equivalent.

Engagement with other stakeholders including the research community, consultants, asset owners, and other fund managers occurs via bilateral communications and open research forums and conferences.

All of the methods discussed above have been used to date.

9.1.1.4 Reasons for our chosen approach

Our approach to ESG is pragmatic and results-oriented, and in our view the methods of engagement we have chosen are what we deem to be most effective in progressing the issues of concern, and naturally vary by case and context.

9.1.1.5 How does engagement differ for funds, assets or geographies

Engagement activities are identical across all funds. This is because our engagement functions as an integrated component in our investment process, and this is applied in a uniform manner across all funds and portfolios that we manage. Engagement also occurs at the issuer level and not the security level so the natural fit for engagement is across our business, rather than specific to funds or portfolios.

Engagement is the same for all assets we manage. As a fixed income manager all our efforts are focused on engagement of issuers and we do not differentiate between different asset classes.

Engagement varies across geographies, consistent with the approach outlined above of identifying where we can best deploy our engagement efforts and based on where we can best facilitate concrete and incremental progress. In practice this means that we tend to focus our efforts on those government issuers where our relationships are strongest and thus where our engagement is most likely to move the needle. We engage with other issuers as well but believe it is consistent with our fiduciary obligations to deploy our efforts in areas where they will achieve the largest progress and change.

9.1.2 Outcome

Engagement to date has focused heavily on the AOFM, which is the issuing agency for Australian government bonds.

Our focus on AOFM reflects the fact that their issuance amounts to 68 per cent of the Australian government universe and 56 per cent of the Australian fixed income universe.

Moreover, all other Australian fixed income instruments are priced off the Australian government curve, so engagement with the Australian government affects not just government bond outcomes themselves, but also outcomes for all other instruments priced off the government curve. It follows that engagement with this issuer carries much broader benefits.

Engagement with AOFM to date has consisted of communications by email, phone calls, and meetings, emphasising the rising importance and expectations that our clients place on ESG outcomes. Feedback

during meetings has been candid and direct and has occurred at the CIO/CEO level. This feedback has been incorporated by the AOFM into the briefing they provide to the Treasury and to the Government, who are the ultimate decision-makers with respect to ESG policy. It is our understanding that with rising awareness because of our engagement, key decision-makers are more inclined to take these factors into account in setting current and future policies. This is expected to affect a broad set of outcomes including climate-related disclosures at the national level with respect to conventional bond issuance, plus specific green bond financing programs in future.

10 Principle 10

Signatories, where necessary, participate in collaborative engagement to influence issuers.

10.1.1 Activity

10.1.1.1 Collaborative Engagement

Given the lack of guidance with respect to both the literature and guiding bodies such as PRI, we have sought to develop our own research led framework. We have partnered with the [University of Technology of Sydney \(UTS\)](#) to investigate the role that climate change has had and will have on the pricing of Government bonds. We are currently jointly researching three topics:

1. The role of climate change on government bonds yields historically
2. Event studies to understand how climate change news may impact yields
3. A framework for understanding how climate risks in the future may impact the pricing of sovereign bonds (scenario analysis)

We will also be hosting an industry workshop at the end of 2021 to understand the perspectives of other fund managers, clients, academics, issuers and consultants with respect to climate change and government bond investing. The goal of the workshop is to first identify the difficulties and issues that need to be considered for sovereign bond investors. These considerations will then inform the development of a framework to guide sovereign bond fund managers. We look forward to sharing the results of our research and integrating these into our investment process.

Finally, we believe it is our duty to act responsibly and sustainably with respect to our own carbon footprint and our actions as global citizens. As such, we:

- support the Paris Agreement and its goals of limiting global warming to 1.5 degrees Celsius compared to industrial levels via economic and social transformation based on the best available science ⁷
- will be signing the [Global Investor Statement to Governments on Climate Change](#)⁸ which calls on world governments to:
 - Achieve the Paris Agreement's goals
 - Accelerate private sector investment into the net-zero transition
 - Commit to improve climate-related financial reporting
- support and will be implementing the recommendations of the Task Force on Climate Related Financial Disclosures⁹. The TCFD seeks to help investors make better informed capital allocation decisions with respect to climate related risks

Please see [Section 4, Principle 4](#) for a more detailed explanation of our integration and engagement policies.

10.1.2 Outcomes

Our desired outcomes are yet to be achieved/measurable. We hope to have more of an impact on the

⁷ <https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement>

⁸ <https://theinvestoragenda.org/focus-areas/policy-advocacy/>

⁹ <https://www.fsb-tcfd.org>

narrative around issues such as climate change and government bond investing after our research is published and following on from the workshop.

11 Principle 11

Signatories, where necessary, escalate stewardship activities to influence issuers.

11.1.1 Activity

11.1.1.1 Monitoring and escalation process for engagement activities

Engagement activities are logged in a dedicated tracker and file notes prepared summarising each engagement activity. This ensures that engagement activities can be tracked, and progress assessed. Reporting on the results of engagement activities, and escalation, occurs through the formal inclusion of sustainability as part of Ardea's weekly risk and strategy meetings.

We note that the ability to escalate issues has limitations given that as government bond holders, there are political sensitivities that need to be accounted for. As such, our role revolves around advocacy rather than lobbying.

Please see [Section 4, Principle 4](#) for more detail regarding our integration and engagement policies.

11.1.2 Outcomes

We are yet to escalate any issues. However, given the increasing legal risks to both our clients and to issuers themselves, we believe there will be more frequent discussions regarding how sustainability risks are accounted for and reported on by issuers.

12 Principle 12

Signatories actively exercise their rights and responsibilities.

12.1.1 Context

We are not in a position to exercise rights as would be the case if we were shareholders. As government bond investors we are faced with unique challenges and limited rights and responsibilities as compared to other asset classes.

Please see [Section 4, Principle 4](#) for more detail regarding our integration and engagement policies.

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