

# Environmental, Social, and Governance (ESG) integration

## Overview and purpose

Our investment process integrates ESG considerations in a manner consistent with our fiduciary responsibilities. Managed appropriately, we believe ESG integration contributes to enhanced long-term returns and reduced risks.

We recognize ESG integration is distinct from prior concepts of socially responsible investing. The essence is integration and engagement, not exclusion screening, or even activism. Consistent with our overall investment philosophy, our ESG approach focuses on fundamental change. It is imbedded directly within our research process in assessing the fundamental attributes of companies. Our focus is not limited to companies that rate highly according to third-party ESG research providers, but rather companies that are demonstrating a commitment to improvement. In short, we encourage companies to always strive to be better versions of themselves. Our focus and commitment can therefore be summarized by our guiding purpose:

**By encouraging corporations to be leaders on sustainability through better long-term stewardship of human, natural and financial resources, we play an active role in the betterment of society.**

This commitment is well aligned with our responsibility to help clients protect and grow their capital through five key principles:

1. **Clients first** – we serve clients around the world of many different types, but our heritage and culture are centered on serving retirement plan investors. This is a substantial commitment that requires continual diligence to help ensure that our focus, interests and incentives are fully aligned with the interests of each client we serve, and the governing fiduciary standards of each jurisdiction in which we operate. This fiduciary mindset has long served as a key distinction of our culture, not only within Principal Global Equities, but for the overall Principal organization.
2. **Independent assessment** – we see third party ESG scoring metrics a bit like credit ratings. They provide useful background information but are often structurally flawed. The fact that the two main providers (MSCI ESG and FTSE Russell Sustainalytics), have vastly different ratings on many companies highlights this, as do their obvious structural preferences for large established companies, particularly those based in Europe. We must look beyond those biases, not blindly screen on ratings.
3. **Direction not level** – this reflects the most direct extension of our investment philosophy and the key source of alpha opportunities through ESG engagement. In our view, restricting opportunities to well rated ESG companies is not a long term viable alpha source. Rather, we are focused on identifying

companies with scope for improvement. For instance, limiting consideration to top ESG rankings explicitly disfavors emerging markets and smaller companies – the very opportunity set that affords the best scope for positive progress on ESG. Avoiding those strikes us not only as detrimental to performance, but also to the potential for favorable societal impacts. In the end, proponents of ESG should focus on change potential to identify the best opportunities to make a real difference.

4. **Alpha of risk reduction** - we believe the avoidance of “bad actors” or companies that knowingly exploit economic externalities at the expense of others is also an important source of enhanced returns, risk reduction and fiduciary responsibility. While we do not advocate overtly screening out entire industries, unless at the direction of clients, our selection criteria also embrace the importance of downside risk mitigation. This includes standards for financial stability and quality, corporate governance and ultimately, trust in the companies in which we invest. Companies lacking a strategic commitment to positive and sustainable fundamental change in our view will simply be avoided.
5. **Active Engagement** - our central focus on sustainable fundamental change and the related principles highlighted above provide a powerful framework for ESG integration. Our researchers engage directly with approximately 2,000 companies per year on average, through a variety of forums and methods. Such contact is only as useful as the quality of the discussions and questions posed. Rather than demanding specific actions, we take a more consultative approach, sharing our views and preferences on pertinent ESG priorities, and by beginning the process by simply asking “what is changing?” This tends to foster more constructive dialogue and can be further supplemented formally through proxy voting and other tactics, including the prompt disposition of shares as warranted.

A range of academic research and empirical data suggest that some ESG factors can have a material impact on the fundamental attributes and future prospects of companies. Therefore, we consider certain ESG issues to the extent they have material implications, consistent with our fiduciary duty to help clients achieve their investment objectives and help protect their economic interests. Simply put, our focus on “**businesses becoming better**” (e.g., companies demonstrating positive, sustainable fundamental change) is at the heart of everything we do as committed fiduciary investors.

## ESG Engagement priorities

The integration of ESG considerations is embedded within the fundamental research conducted by our analysts, as we feel they are best placed to determine the importance of such factors in relation to a specific company or industry. Our analysts provide the essential insights into industry trends and company-specific considerations including ESG issues. These insights are crucial to the evaluation of sustainable competitive advantages and risks at a company-specific and industry level. Our analysts have discretion to focus on the considerations and concerns they feel are most important and impactful to sustainable earnings, sentiment and relative valuation.

Specifically, we view Governance considerations as integral to our investment philosophy and process, and fully aligned with our fiduciary responsibility. Governance considerations are inherently related to shareholder value. Companies demonstrating strong shareholder protections and alignment policies naturally garner premium

valuations over peers with lesser standards. At the same time, improving governance policies and practices provide a basis for improved relative valuation, while governance dilution or deterioration represent an inherent source of risk and valuation compression. Similarly, albeit more nuanced, the evaluation of Environmental and Social considerations is an extension of our fundamental change focus and qualitative risk assessment.

Our analysts identify and formally comment on the most relevant “ESG Engagement Priorities” within their thesis documentation for each company. They specifically focus on how pertinent ESG priorities shape our overall views on sustainable fundamental change for each company. To promote greater consistency and repeatability across the firm, our research teams have identified specific ESG pillars for each major market sector. Across all sectors, leadership and governance are a key dimension, but other dimensions will differ. For instance, within the technology sector, cybersecurity and privacy protection are key pillars. By contrast, among industrial companies, key dimensions include waste and emissions management, risk mitigation and operating protocols. Most importantly, these issues are considered within the context of their impact on the sustainability of company’s fundamentals which ultimately will drive the timing, amount and certainty of future earnings and cash flows.

By aligning our ESG Engagement Priorities with our analysts’ focus on fundamental change, we’re further strengthening our conviction of each investment thesis and related risk considerations.

For each of our holdings and prospective investments, we require our team members to assess the sustainability culture and risks and engage with management to encourage and facilitate further progress.

- Sustainability Risk Level – Our analysts assign each holding with a sustainability risk level of either low, medium, or high. In arriving at this designation, we evaluate the company’s relationships with each of its stakeholders – shareholders, customers, employees, suppliers and their supply chains, their communities, and the environment – and identify those key risks that could undermine the company’s existence and the positive change we are seeking. Our analysts collaborate across teams with their industry colleagues to identify best practices and identify emerging issues of concern. We partner with third-party data providers to help provide consistent data across our investment universe.
- Sustainability Risk Trend – Our analysts also assign each holding with a sustainability risk trend of either improving, stable or deteriorating. This risk trend designation provides important context to the risk level and informs our tolerance for that risk. Consistent with our investment philosophy we have a strong preference for positive change. We find that improving trends in sustainability risk can also be an important source of alpha for our clients.
- Engagement – Our analysts meet with senior executives of our holdings to discuss a range of topics relevant to our investment theses. From our assessment of sustainability risk level and trend we incorporate discussion on the ESG issues of greatest importance to us. From management, we both look for and ask for actions and plans that fit a SMART framework: Specific, Measurable, Attainable, Relevant and Time-bounded. Following our engagement with management, we then re-assess our sustainability risks – a circular process that continues.

To supplement our independent assessments, we have integrated MSCI ESG analytics in our process and monitoring tools at the company specific level and portfolio level. This equips our analysts and portfolio managers with company-specific ESG scores, but more importantly with trends in the scores and underlying measures over time, as well as notification of potential controversies and other notable ESG risk considerations. Each company has an overall ESG score, along with the underlying scores of Environmental, Social and Governance which we have integrated directly on our central research dashboard. Additionally, links to a full

ESG tear sheets from MSCI provide more transparency into these scores with qualitative insights as researched by the MSCI specialists.

Consistent with our focus on fundamental change identification, we place greater emphasis on trends in ESG metrics rather than current levels and scores. Indeed, we caution investors to recognize that mainstream ESG scoring metrics incorporate significant structural biases. Most notably, they tend to systematically favor large capitalization companies over smaller ones and developed market nations over their emerging markets counterparts. In some regards, this can run counter to the aspirational aims of ESG engagement, as companies with below average scores may offer greater opportunities for positive change, and vice versa.

## Engagement policy

Principal Global Equities began incorporating custom exclusionary screening criteria on behalf of clients in the early 1990's, and we currently support a wide range of mandates with such criteria. Additionally, Principal Global Investors has been a signatory to Principles for Responsible Investment ("The PRI") since 2010, highlighting the firm's dedication to Environmental Social and Governance (ESG) issues. The PRI works to provide a sustainable global financial system by encouraging adoption of six principles and collaboration on their implementation, fostering good governance, integrity and accountability, and addressing obstacles to a sustainable financial system within market practices, structures and regulation. Over the years, our processes have grown to include engagement with companies on ESG issues and we believe that direct communication between investors and companies on ESG matters is an important element of the portfolio management services provided to clients. Engagement may lead us to make decisions that favor actions intended to maximize a company's shareholder value and contribute to our overall research to develop a holistic fundamental view of the company. We take seriously our commitment to our community and society. We believe that we must take responsibility for educating others and ourselves by addressing a range of ESG issues that influence the wellbeing of our community and society and may enhance shareholder value. As a result, we commit to:

- Engage and collaborate with the companies we invest in using our shareholder advantage to encourage responsible ESG practices by the company when aligned with of our investment thesis of the company.
- Encourage greater transparency by the companies on their ESG practices.
- Encourage companies to manage risks related to ESG factors and react swiftly to achieve a competitive advantage relative to peers regarding remuneration, boards/directors, audit issues, regulations, litigations, and other market factors that could impact a company.
- Encourage companies to disclose through public reporting relevant ESG metrics and how it may fit into the company's overall business activities considering such importance will vary significantly depending upon industry and geography.
- Seek out ESG research that will further our overall knowledge on a company.
- Keep records or notes on relevant engagement activities.

We have implemented this policy with the premise that portfolio management personnel base their determinations of whether to invest in a particular company on a variety of factors, which may include ESG factors, recognizing however, this will not supersede the primary considerations of risk and return, consistent

with our fiduciary obligations. As such, this policy is designed to guide Engagement and not necessarily proscribe specific criteria in making investment decisions.

## Proxy voting policy

Principal Global Investors has adopted and implemented written Proxy Voting Policies and Procedures that are designed to reasonably ensure that proxies are voted in the best interests of those advisory clients who have authorized us to address these matters on their behalf. Our guiding principles in performing proxy voting are to make decisions that:

- Favor proposals that have the potential to maximize a company's shareholder value, and
- Are not influenced by conflicts of interest.

Our Proxy Voting Policies and Procedures (Proxy Voting Policy) is designed to guide us in voting proxies, not necessarily in making investment decisions; Our portfolio management teams base their investment decisions on a variety of factors. Principal Global Equities has adopted and implemented written Proxy Voting Policies and Procedures that are designed to reasonably ensure that proxies are voted in the best interests of those advisory clients who have authorized us to address these matters on their behalf. Our guiding principles in performing proxy voting are to make decisions that:

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Principal Global Investors creates their own set of proxy voting guidelines which is updated and approved no less than annually by our Proxy Voting Committee. The Proxy Voting Committee utilizes Institutional Shareholder Services, Inc. (ISS) and other external and internal inputs in creating the annual guidelines. In addition to the Principal Global Investor Voting Guidelines (Guidelines), we have implemented sustainable voting guidelines, or other custom guidelines (Custom Guidelines), for certain strategies based on the product type, client preference or desired investment outcome. There may also be voting themes or particular ballots where a portfolio management team decides to diverge from the Guidelines or Custom Guidelines. In such a case, certain procedures and documentation are executed and maintained. In the event that a proxy ballot is received, the relevant Portfolio Manager is responsible for voting the ballot.

A client may authorize Principal Global Investors to vote proxies and may obtain a summary report relating to their account by contacting their relationship manager. A client may also obtain a copy of our complete proxy voting policies, which also contains the Guidelines, and procedures upon request.

ISS is utilized for the administration of all proxy ballots and other record keeping. Principal Global Investors Operations Team works closely with ISS in the execution of these responsibilities. We disclose our voting results via our website and results are updated quarterly.

If an issue is identified which is inconsistent with the interests of our clients, we take the appropriate warranted action in mitigating our exposure to such company and/or as it relates to issues to be voted on by company shareholders, we would vote accordingly. In some cases, this will mean overriding the PGI Guidelines and in conjunction with our Proxy Voting Policy will vote an exception. We may also engage and always reserve the option to exit our shareholding. We manage our relationships with investee companies in such a way that it is not made an “insider” and as such seek to avoid being made an “insider” in any discussion with a company or its advisors, in order that we can continue to act in our clients’ best interest. As part of our engagement policy, we keep records or notes on relevant engagement activities.



### Risk considerations

Investing involves risk, including possible loss of principal. Past performance does not guarantee future results. Equity investment options involve greater risk, including heightened volatility, than fixed-income investment options. Equity stocks of small and mid-cap companies carry greater risks including that they may be more volatile and less liquid than equity stocks of larger, more established companies.

Neither this document, nor the ESG considerations contained therein, relate to a specific investment strategy/product managed by Principal Global Investors, LLC (or its affiliates) nor their classification under the Sustainable Finance Disclosure Regulation (EU) No. 2019/2088. More information on Principal Global Investors responsible investment policy can be found at <https://www.principalglobal.com/about-us>

Environmental, social and governance responsible investing (ESG) is qualitative and subjective by nature, and there is not guarantee that the criteria utilized, or judgment exercised, will reflect the beliefs or values of any one particular investor. Information regarding responsible practices is obtained through voluntary or third-party reporting, which may or may not be accurate or complete, and such information is used to evaluate a company's commitment to, or implementation of, responsible practices. Socially responsible norms differ by region. ESG criteria may present additional advantages or risks and does not protect against market risks or volatility. You should not make any investment assumptions based solely on the information contained herein. There is no assurance that the socially responsible investing strategy and techniques employed will be successful.

### Important information

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