SITRA'S CLIMATE STRATEGY FOR INVESTMENTS

9 March 2021

SITRA

SITRA

Contents

1. Introduction

Awareness of the impacts of climate change has greatly increased in recent years, and more and more companies and investors have set targets for reducing carbon emissions and even for carbon neutrality. The Paris Agreement's goal to limit global warming to 1.5 °C requires rapid emissions reductions. Investors can contribute to mitigating climate change by encouraging companies to engage in low-carbon business and by financing climate solutions.

Sitra will also develop its investment activities so that they support the achievement of the Paris Agreement goals. This is directly related to Sitra's strategic goal of adaptation to the earth's carrying capacity and the Sustainability solutions theme.

The purpose of Sitra's climate strategy for investments is to mitigate climate change, which is one of Sitra's primary sustainability goals for investment. The climate strategy is used for managing climate risks associated with investments and for trying to identify future profit opportunities.

As a signatory to the UN Principles for Responsible Investment (PRI), Sitra is committed in its climate reporting to complying with the Recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and its requirements.

The Climate strategy for investments also takes into account the recommendations and principles of some of the most significant international initiatives, including the UN-convened Net-Zero Asset Owner Alliance, the Institutional Investors Group on Climate Change (IIGCC) and the Science Based Targets initiative (SBTi).

Sitra's climate strategy for investments defines the climate-related targets for Sitra's investment portfolio and the measures for achieving these targets. The climate strategy will be updated regularly, and the targets will be reassessed in accordance with the latest research data and potential changes in the investment environment.

2. Decision-making and responsibilities

Sitra's climate strategy for investments forms part of the practical implementation of Sitra's responsible investment activities. Responsible investment is steered by the guidelines approved by the Board of Directors.

For Sitra, responsible investing means taking account not only of the return and risk but also of the environmental, social and governance (ESG) factors when making investment decisions. In relation to environmental factors, climate change mitigation is one of Sitra's most important corporate responsibility goals. Biodiversity has been identified as the next development target for responsible investment.

Climate change-related decisions are prepared and implemented in accordance with the same principles as any other matters related to responsible investment. Sitra's Board of Directors approves the responsible investment guidelines and the climate strategy for investments. Sitra's Vice president, Investments, is responsible for the organisation of responsible investment activities at Sitra. All individuals participating in Sitra's investment operations are responsible for the implementation of Sitra's ESG policy. Responsibility issues are regularly reviewed at the investment team's weekly meetings. Matters related to the Climate strategy are addressed in close collaboration with Sitra's experts.

Issues related to climate change are regularly reported to Sitra's Board of Directors. Sitra also reports annually to the PRI on its responsible investment practices. Climate reporting follows the TCFD framework. In future, Sitra will report on climate-related factors annually in accordance with this international disclosure framework.

3. Time horizon and coverage of the strategy (asset classes)

The global transition to carbon neutrality will take several decades, which means that the time horizon of the climate strategy for investments must also be long. In spite of the continuing increase in the reliability and coverage of science-based information, there is still a significant degree of uncertainty associated with the development paths. Therefore, the strategy is divided into milestones and specified as more information becomes available.

Initially, the monitoring and targets cover the listed equity funds, bond funds and real estate funds. The availability of information on them is moderate. In the coming years, the monitoring will expand to other asset classes as data coverage increases.

4. Climate risks, climate opportunities and risk management

According to the TCFD definition, the risks posed by climate change are divided into transition risks associated with the transition to a low-carbon economy and physical risks caused by global warming.

Transition risks can include those brought about by regulatory changes, technological development, market behaviour and reputation risk. Physical risks are divided into acute and chronic risks. The investment opportunities brought about by climate change can emerge from, for example, companies that develop technologies for climate change mitigation or that facilitate the transition to a low-carbon economy.

Climate risks and climate opportunities have financial implications, the identification of which may lead to changes in strategic allocation, the investment strategy, potential divestments and dialogue with asset managers and enterprises. The financial impacts of climate risks may include production and operational disruptions, supply chain disruptions, write-offs of balance sheet items, physical damage, increase in insurance premiums or changes in the costs of resources and production and in consumer behaviour. Figure 1 shows the risk framework in accordance with the TCFD model and the risk-management perspectives of Sitra's investments.

Figure 1. Climate risks and risk management

	Climate risks	Managing risks as a fund investor
Transition risks	**Regulatory risk** is associated with tightening and more restrictive regulation– rising emission allowance prices, imposition of carbon tax or increasing reporting obligations, for instance **Technology risk** is associated with a technological transformation in certain sectors – for example, declining competitiveness, replacement of existing products and services with lower-emission options, unsuccessful investments in new technologies or the costs of transition to lower-emission technologies **Market risk** refers, among other things, to changes and uncertainty in market behaviour and increased cost of raw materials **Reputation risk** refers to shifts in consumer preferences, stigmatisation of certain sectors, increased stakeholder concern or negative stakeholder feedback	• Identification of the asset classes, sectors and companies that may turn out to be the biggest losers or winners as regulation is tightened • Assessment of the cost effects of taxes and/or sanctions • Identification of companies that are unable to renew their business models • Identification of future technologies and assessment of their impact on asset classes, lines of business and securities • Estimation of assets losing their value (fossil fuel reserves) • Evaluating and steering Sitra's investments so that Sitra reaches its carbon-neutrality targets in accordance with the targets set by the Finnish Government
Physical risks	**Acute physical risks** are associated with an increase in the frequency of extreme weather events, such as floods or hurricanes **Chronic physical risks** such as drought, rising mean temperatures and rising sea levels	• Special examination of real estate and forestry investments from the perspective of physical climate risks (these risks are the most important in these two asset classes) • Identification of geographical risk areas and their investment objects • Assessment of the insurance company holdings, as these risks increase when extreme weather phenomena become more common • Examination of risk management in supply chains

Risks can also be assessed by examining companies' climate targets. Based on the targets companies have set for themselves, it is possible to assess their resilience to climate change. In particular, companies that have set targets in accordance with the Science Based Targets initiative can be considered to be on a pathway following the Paris Climate Agreement. On the other hand, the lack of ambition in target setting may be interpreted as indicating an increase in long-term risks in particular.

5. Objectives and action plan

Sitra supports the global transition to carbon neutrality through investment selection and engagement. **The long-term objective is that all Sitra's investments are aligned with the Paris Agreement. Furthermore, Sitra aims to achieve a carbon-neutral investment portfolio by 2035** in accordance with Finland's national target, provided that the investment environment makes it possible. In accordance with the Act on Sitra, the investments are made in a secure and profitable manner. The transition to a low-carbon and, eventually, carbon-neutral investment portfolio is implemented in a controlled manner.

From the perspective of the real economy, the mitigation of climate change would require increasing the use of sustainable and renewable forms of energy and abandoning fossil fuels. Other tools for mitigating climate change include energy saving and energy efficiency, adopting the circular economy, the electrification of transport, halting deforestation, increasing natural carbon sinks, and sustainable food production and consumption.

For an investor, this means assessing the return on and risk characteristics of an investment from the perspective of climate risk and reducing the share of high-risk companies or sectors – even their potential exclusion from the investment universe – and increasing the share of climate-positive investments.

Sitra aims for a carbon-neutral investment portfolio without emissions compensation. In the real economy, contributions to emissions reductions are made at the company level, which is why, as an investor, Sitra has reservations about the use of compensation in investment activities. The compensation options are limited, and their use should be prioritised for activities where other methods of emissions reduction are not possible for technological or economic reasons.

Climate analysis of the investment portfolio requires access to high-quality data. With regard to climate data, Sitra has access to Investment Research Finland's ESG reports, which are based on MSCI data. Currently (in spring 2021), the carbon risk can be calculated for 60.7% of the value of Sitra's investment portfolio. **The aim is to increase the data coverage to 75% by 2025.** In addition, the aim is to expand the coverage of metrics and key figures in accordance with the TCFD framework. Sitra's investment portfolio is reviewed at least once a year, and the climate report is prepared based on this data.

The climate impacts and climate risk of Sitra's investments are measured using the carbon footprint. Sitra's long-term goal is to have a carbon-neutral investment portfolio. In the intermediate term, we will reduce the carbon intensity of the investment portfolio. This will be monitored in comparison to the benchmark index, where applicable. The carbon intensity of Sitra's investments must remain below the benchmark index.

When examining the carbon footprint and carbon intensity, account will be taken of the direct emissions generated by an enterprise's own operations (Scope 1) and the indirect emissions caused by the use of purchased energy (Scope 2). Later, as the calculation and data evolve, the goal is to also take into account all indirect emissions (Scope 3).

Climate risk can be reduced by focusing on companies or sectors with low carbon footprints or carbon intensity compared to the rest of the sector. The proportion of these companies and sectors of Sitra's investments will be analysed and the change will be monitored.

Climate risk is also reduced by promoting positive development by means such as investing in renewable energy or other environmentally beneficial business. The proportion of these climate-positive investments that support the transition will be analysed.

Sitra has excluded from its investment universe any companies with more than 30 per cent of turnover linked to the production or use of coal in power generation without a clear strategy to reduce the use of coal. It is monitoring the development of other potential carbon risk concentrations.

The amount of fossil fuel reserves in the portfolio will be assessed and monitored. The aim is to keep the share of such reserves low.

For investors, the pledges made by companies to reduce emissions in relation to the targets of international climate agreements are also an indication that development is going in the right direction. The first step is to examine how well Sitra's current investment portfolio complies with the global warming targets of the Paris Agreement based on the calculations provided by the International Energy Agency (IEA), built upon different climate scenarios. Based on the analysis, the current level of emissions can be compared to a sector-specific emission pathway in line with the global warming target of under 1.5 °C. The alignment of the investment portfolio with the goals of the Paris Agreement will be examined fund by fund, changes will be monitored, and the targets will be discussed with asset managers.

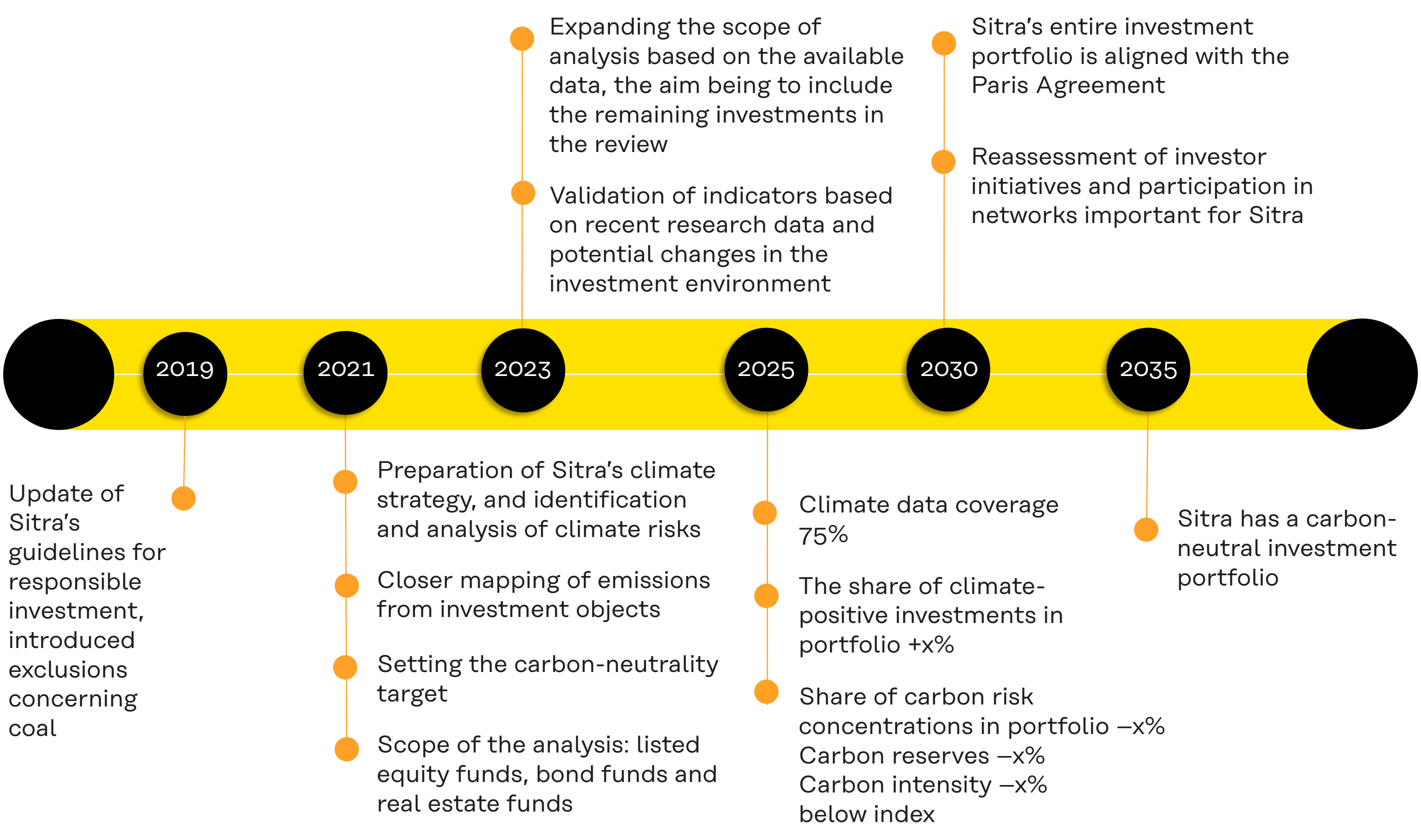
Investors may also seek ways to influence companies and asset managers. Major investors in particular have influence, with institutional investors in an especially strong position to make responsible investment more common. By building networks, smaller investors can also exert their influence on a wider scope of investment assets.

Sitra makes its investments through funds, and therefore the engagement discussions are conducted with asset managers. In addition, Sitra participates in investor initiatives as a part of its engagement process. One example of these is the Climate Action 100+ initiative, which encourages companies to achieve emission reduction targets under the Paris Agreement and to report on the climate change risks to their business activities.

Figure 2 shows Sitra's investment activity road map to carbon neutrality. At this stage, the milestones set for the period 2023-2030 are indicative, and, as the knowledge base improves, their content and schedules will be specified further. The carbon-neutrality target will contribute to the development of the investment portfolio from 2021 onwards.

For 15 years, Sitra has been making climate-friendly investments in, for example, thematic equity funds and private equity funds, renewable energy infrastructure funds, the energy efficiency of real estate and growth companies that develop climate-friendly technologies. Thus, in practice, measures to build a more climate-friendly investment portfolio had already been initiated well before this climate strategy was prepared.

Figure 2. Sitra's road map to carbon neutrality



6. Risk analysis of strategy implementation

The climate strategy must be built upon an uncertain future, and under the prevailing circumstances it is not possible to plan its implementation in great detail.

The definitions related to climate indicators and carbon neutrality remain ambiguous, and they may change significantly in the future. It is not yet known exactly which emissions will be taken into account in the calculations and how they will be allocated to different stakeholders.

The coverage of climate data is still relatively low, and there is uncertainty associated with the reliability of data as a result of the estimates used, for example. So far, the focus has also been too much on the carbon footprint, with the carbon handprint attracting much less attention.

International studies emphasise the reduction of global emissions in the real economy, whereas the Finnish investment field – inspired by the national strategy – places an emphasis on the carbon-neutrality targets of individual investment portfolios. These different targets may lead to partial optimisation and exclusion of transition companies that are on the right development path. As a rule, actual emission reductions should be given priority in investment activities.

Only a small proportion of the activities of Sitra's investment objects take place in Finland and are consequently included in the national carbon-neutrality target. However, most of the global carbon-neutrality targets have been set for much later (between 2040 and 2060) or have not yet been set at all. By 2035, the selection of investment opportunities is still likely to remain limited, and some sectors that are essential for the functioning of society may be excluded from Sitra's investment universe.

As a fund investor, Sitra cannot influence the selection of underlying fund holdings. The investment strategies of most investment funds are unlikely to fully meet Sitra's climate strategy for investments, leading to a risk that targets that are incompatible with the climate strategy end up in the investment portfolio. Because of delays in reporting, Sitra does not have up-to-date information of its fund holdings.

Reducing a carbon footprint too suddenly may lead to increased investment risks that might emerge, for example, from reduced diversification or simply poor timing, if investments are over-concentrated on companies and sectors with already low carbon footprints or the technology risk taken with investments is too high.