

**Taskforce on Climate Related Financial Disclosure (TCFD)**

**Solaris Investment Management Inaugural Report**

**December 2020**

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## EXCERPT FROM SOLARIS ESG POLICY

*“Solaris recognises that climate change presents challenges to the valuation of stocks and also recognises that there is considerable conjecture surrounding the timing and depth of impact that will ultimately be borne by the companies in which we invest. Solaris also recognises that change is ever present in an evolving investment landscape and we seek to apply our rigorous analysis to the impacts of climate change in the same way we approach other uncertainties in the market. Solaris understands that limiting the increase in global temperatures to 1.5 to 2 degrees Celsius above pre-industrial levels requires significant changes in government policies and capital redirection to enable society to adapt to the physical impacts of climate change. The opportunities and risks presented by global warming are significant.”*

## Introduction

Solaris Investment Management (Solaris) is a mid-sized Australian Equity Fund Manager based in Brisbane, Queensland, Australia. Solaris employs eleven people with ten of the eleven having direct market responsibilities. Solaris manages between AUD8 – 9 bn for a range of wholesale and retail clients.

Solaris has long considered ESG factors as part of its investment process and maintains an extensive in-house database of ESG factors and associated impacts on company valuations. Solaris has considered itself an ESG integrator since the company’s inception in 2008 becoming a signatory to the PRI in 2009 and commencing carbon footprint calculations as part of the Montreal Carbon Pledge in 2015. Solaris has continued to expand its capabilities to monitor and analyse climate change implications. Solaris is also a Climate Action 100+ signatory.

In July 2019, Solaris signed the Statement of Support for the TCFD recommendations and completed a preliminary scenario analysis of the portfolios in December 2019. Support for the TCFD aligns with Solaris’ ESG Policy statement on Climate Change and our belief that climate change presents a strategic challenge to companies that has ramifications for long-term financial performance.

Solaris maintains an internal database of ESG factors (including Climate Change information) and calculates portfolio carbon exposure, carbon intensity and basic scenario analysis utilising third party data.



## Governance

Disclose the organization's governance around climate-related risks and opportunities.

### *Describe the board's oversight of climate-related risks and opportunities*

As a private company, Solaris is governed by a 5 person board of directors consisting of Solaris' Managing Director, Chief Investment Officer (Joint), a Solaris Analyst and 2 representatives from Pinnacle Investment Management. The Board is responsible for the governance of Solaris while day-to-day oversight of the investment activities is the responsibility of the joint Chief Investment Officers and the Managing Director. The Board gains visibility of material ESG and climate related impacts via input from the Chief Investment Officer (Joint), the Solaris Managing Director and the Solaris Analyst.

The Solaris Board is currently considering the inclusion of Climate Change and ESG factors in the Company's Investment Risk Register.



### *Describe management's role in assessing and managing risks and opportunities*

Solaris operates under a flat operating structure with each investment professional having responsibility for the analysis of the stocks allocated to them. The investment analysts are assisted in this task by the ESG Analyst who provides additional information as required. Stock analysts' roles involve the obligation to consider the material impacts of climate change and other ESG factors – both positive and negative. A deep understanding of a stock's transition pathway is integral to the valuation of each stock within Solaris' investment universe. This understanding is typically gained through analyst (stock and ESG analyst) meetings with company representatives and inhouse training on relevant factors. Solaris operates under the broad principle that companies cognisant of ESG principles (including Climate Change) may represent opportunities for outperformance and correspondingly those companies that do not may experience underperformance.

ESG factors (including Climate Change) and their related considerations are overseen by the Chief Investment Officers (Joint) who have responsibility for ensuring the consistent assessment of these factors in the Solaris company valuation process.

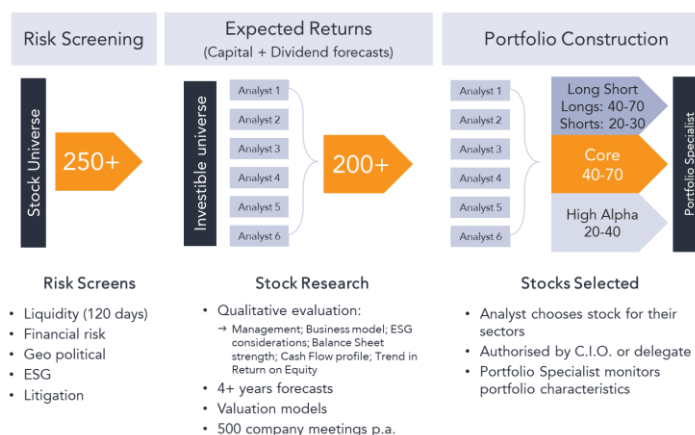
## Strategy

Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation’s businesses, strategy and financial planning where such information is material.

Consideration of ESG issues (including Climate Change) is embedded in the Solaris investment process. ESG assessments are performed at:

- **The Initial Risk Screening Stage** – Analysts consider Liquidity, Geopolitical, Litigation, Financial and ESG risks. A stock may be excluded from the Solaris’ investable universe if any of these factors are assessed to pose too great a risk.
- **The Qualitative Evaluation Stage** – ESG evaluation is one of the qualitative assessments that Solaris analysts use to arrive at a target price for the valuation of their companies. Solaris endeavours to be aware of potential ESG issues that may not be currently affecting a company’s valuation, but may at some point in the future. The qualitative criteria that analysts use are:
  - Management
  - Business Model
  - ESG assessment
  - Balance Sheet
  - Cash Flow profile
  - Trend in Return on Equity

The conclusions drawn by our analysts from their qualitative assessment feeds into the appropriate rating applied to each company’s valuation. For one of the most commonly used valuation technique: DCF, this involves adjusting the beta to incorporate positive or negative factors discovered in the qualitative assessment. Accordingly, conclusions drawn from the assessment of a company’s ESG activities may affect that company’s rating and its valuation. The main portfolio construction technique that Solaris use is based on expected return. Simply put, if a company has a high expected return that company will, prima facie, be included in the portfolio and equally a low expected return (or negative excess return) will see a company excluded from Solaris portfolios. ESG evaluations may affect a company’s valuation positively or negatively, thereby impacting the company’s chances of being included in portfolios.



*Describe the climate-related risks and opportunities the organization has identified over the short, medium, and long term*

Solaris assesses Climate related factors at both the Initial Risk Screening stage and the Qualitative Evaluation Stage of our investment process. At the Initial Risk Screening stage a stock may be excluded, for example, due to a high degree of uncertainty regarding the ongoing viability of its products under a decarbonising pathway. If a stock’s outlook is sufficiently uncertain due to climate related impacts (to the extent that the analyst is unable to gain any clarity in the stock valuation) the stock may be deemed uninvestable and will be excluded from the Solaris portfolios. The following table details some of the considerations Solaris takes into account when assessing Climate Risk.

Climate Related Risks and Opportunities and Potential Financial Impacts		
Type	Climate Related Risks	Potential Financial Impacts
Transition Risks	<b>Policy and Legal Implications</b>	
	<ul style="list-style-type: none"> <li>• More widespread adoption of carbon pricing;</li> <li>• Greater requirements for emissions reporting;</li> <li>• Increasingly regulated products and services;</li> <li>• Exposure to litigation</li> </ul>	<ul style="list-style-type: none"> <li>• Impact on asset valuations;</li> <li>• Increased cost of capital;</li> <li>• Potential for lower capital returns;</li> <li>• Potentially stranded assets;</li> <li>• Costs associated with more onerous reporting regimes;</li> <li>• Some products and services no longer able to be offered in a decarbonising world;</li> <li>• Costs associated with legal appeals and management time consumed</li> </ul>
	<b>Technology</b>	
	<ul style="list-style-type: none"> <li>• Existing products and services replaced by lower emission options</li> <li>• Failed investments in new technology</li> </ul>	<ul style="list-style-type: none"> <li>• Stock write-offs and losses associated with that.</li> <li>• “Old” products and services cease to be saleable</li> <li>• Increased investment in research and development</li> <li>• Implementation costs of new practices and processes</li> </ul>
	<b>Market</b>	
<ul style="list-style-type: none"> <li>• Changed consumer preferences</li> <li>• Availability and costs of materials change rapidly</li> <li>• Input costs increase</li> </ul>	<ul style="list-style-type: none"> <li>• Market for products changes due to consumer preferences and societal “norms” shifting</li> <li>• Unable to produce products due to lack of materials.</li> <li>• Increased cost of production due to raw materials scarcity and increasing input costs</li> <li>• Asset revaluations</li> </ul>	
<b>Reputation</b>		
<ul style="list-style-type: none"> <li>• Changed consumer preferences</li> <li>• Sector perceived as irrelevant in the future</li> <li>• Stakeholders no longer support the company or product</li> </ul>	<ul style="list-style-type: none"> <li>• Impact on revenue due to decreasing demand, inability to attract and retain staff and inability to attract sufficient capital.</li> </ul>	

<b>Physical Risks</b>	<ul style="list-style-type: none"> <li>• Impact of extreme weather events – severity and occurrence increases</li> <li>• Increasing temperatures – droughts, fire</li> <li>• Increasing sea levels</li> <li>• Increasing migration due to climate stress</li> </ul>	<ul style="list-style-type: none"> <li>• Revenue impacted due to production interruption and supply chain disruption</li> <li>• Relocation and/or fortification of physical assets</li> <li>• Inability to insure at risk assets, or increases in insurance premiums</li> <li>• Costs associated with increased heating/ cooling requirements</li> <li>• Increased cost of water procurement</li> <li>• Increased risk to agricultural crops associated with pests, drought, fire, flooding</li> <li>• Infrastructure damage</li> </ul>
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Not all of these risks may eventuate and there are undoubtedly additional risks that will emerge over time. Solaris notes however that many of these impacts are already being experienced (particularly in the Australian context). Australian companies are already grappling with many of the physical impacts of climate change – most notably temperature increases, extreme weather events, water scarcity, flooding and bushfires. The risks for our companies are being observed in the Transition category with many of the most carbon exposed Australian companies already making progress along their transition pathways. However, Solaris believe that many of the less exposed companies have considerable work to do and whilst they may argue that the risks are “less” for their operations many of the climate related risks will still apply and should be considered.

Companies are rewarded where there appears to be opportunities for improved financial performance due to climate related impacts. There are many areas where opportunities may be found – new products and services; more efficient and less costly operations may be developed; utilisation of renewable energy sources; adaptation strategies utilising new technologies that encourage consumer buy-in and potentially new customers; staff retention and engagement improvements; potential government subsidies for certain sectors to encourage uptake of technologies. Solaris assesses companies on a case by case bottom-up basis and examines the factors that are material and relevant to the company being analysed.

*Describe the impact of climate-related risks and opportunities on the organization’s businesses, strategy, and financial planning*

A stock’s climate-related risks or opportunities are incorporated into analyst valuations of the stocks we invest in where these factors are material. The impact of climate related risks or opportunities on the strategy and financial planning are described in the table above. The rapidly changing operating environment makes adaptation and transition even more important for our investee companies. The rate of change appears to be increasing as the imperative to address climate change in a meaningful manner finally is recognized.

This assessment of climate impacts is carried out for all products managed by Solaris. Some of Solaris’ clients have made the decision to exclude thermal coal producers from the investable universe for their portfolios (in conjunction with other exclusions). To date Solaris does not have specific mandate requirements from clients regarding decarbonising their portfolios, however the level of monitoring and understanding the drivers of portfolio climate intensity has increased. Solaris anticipates a natural progression away from carbon intensive companies or companies that are not demonstrating a



commitment towards net zero targets and robust transition plans. Simply put, companies that are failing to respond to their operating environments will not be valued as highly as others and may start to experience discounts to valuations to reflect the analyst's concerns over their ability to operate into the future.

*Describe the resilience of the organisation's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.*

Solaris has completed preliminary assessments of the investment portfolios currently managed and has ascertained that the portfolios will perform slightly better than the market (represented by the S&P/ASX200 Index) under the PRI Inevitable Policy Response documents. Solaris is currently building out further capabilities to analyse additional scenarios to provide further information regarding the risks that the portfolios may face. Solaris has also constructed an in-house database that will cater for these scenarios. This is a work in progress.

## Risk Management

Disclose how the organisation identifies, assesses, and manages climate-related risks.

*Describe the organization's processes for identifying and assessing climate-related risks.*

Climate Change is assessed at two points in the Solaris Investment Process – the Initial Risk Screening Stage and the Qualitative Evaluation stage. Solaris is a fundamental, style neutral, bottom-up stock picker and assesses each stock individually. Materiality is ascertained through the stock analyst's extensive knowledge of the company's operations coupled with the ESG Analyst's input regarding the likely extent of climate impacts on the company, the sector, geographic location, transition risk, and potential physical impacts.

Solaris identifies climate-related risks through in-house research which involves:

- direct discussions with our investee companies,
- assessing company publications,
- producing detailed financial models,
- gaining a detailed understanding of the current science available,
- participation in various industry bodies
- engagement - both directly with the company and via collaborative groups,
- the Annual General Meeting proxy voting process provides an avenue of discussion and feedback regarding climate-related resolutions.

In discussions with companies, Solaris may raise issues relating to the climate change disclosure and practices exhibited by the company. Numerous discussions have been held with Board members and company executives in an effort to encourage greater disclosure, robust target setting and inclusion of climate related metrics in executive remuneration. These are ongoing conversations, but Solaris has witnessed some significant shifts in the last two years.

The conclusions drawn by our analysts from their qualitative assessment of both the risks and the opportunities presented by climate-change feed into the appropriate rating applied to each company's



valuation. For one of the most commonly used valuation techniques: DCF, this involves adjusting the beta to incorporate positive or negative factors discovered in the qualitative assessment. Accordingly, conclusions drawn from the assessment of these factors may affect that company's rating and its valuation. The main portfolio construction technique that Solaris use is based on expected return. Simply put, if a company has a high expected return that company will, prima facie, be included in the portfolio and equally a low expected return (or negative excess return) will see a company excluded from Solaris portfolios.

ESG evaluations may affect a company's valuation positively or negatively, thereby impacting the company's chances of being included in portfolios. Solaris anticipates that as the economy moves further along the decarbonising pathway, more companies will begin to exhibit the impacts of these changes. Some of the impacts will be positive and some will be negative. The Solaris analysts assess these factors and reflect the assessment in their valuations. This leads to (as we have already witnessed) the exclusion of some stocks from the investable universe and a higher valuation for those stocks that are managing the transition and grasping opportunities

*Describe the organization's processes for managing climate-related risks.*

Solaris is in the early stages of formulating the best method of assessing portfolio wide climate-related risk. At this stage Solaris has the ability to track a portfolio's carbon emissions and intensity versus the relevant index over the last 5 years on a monthly basis. This assessment gives an indication of the direction of the carbon exposure for each portfolio. These metrics are reported internally on a monthly basis. Additionally Solaris produces metrics on the major contributors to a portfolio's carbon emissions or intensity to ensure that the investment team is cognisant of the current exposures.

*Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organization's overall risk management.*

The Solaris Board is currently assessing the inclusion of Climate Change and ESG factors in the Company's Investment Risk Register.

## Metrics and Targets

Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material

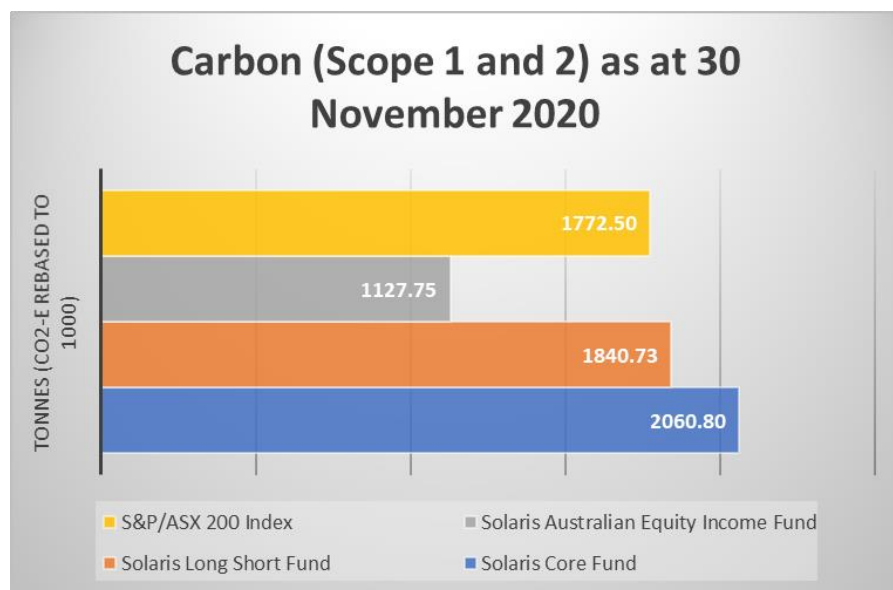
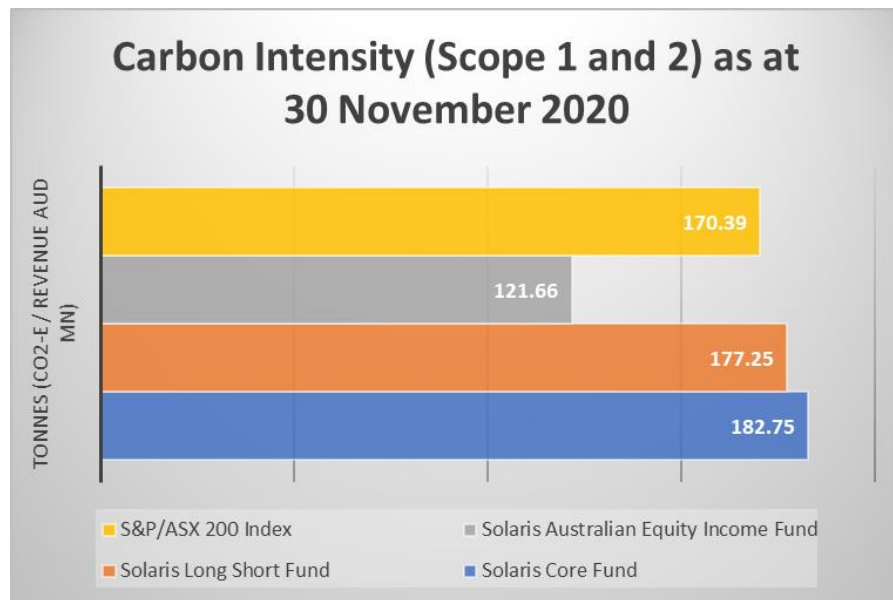
*Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process.*

Solaris ensures that we are fully cognisant of the carbon footprint and emissions intensity metrics of our portfolios. These metrics are assessed as standalone numbers and relative to the relevant benchmark index. Solaris also ensures that we monitor the stocks within our portfolio that have the highest level of carbon exposure. These are the companies that we are particularly engaged with to ensure transition plans, metrics and targets are being set and pursued. A particular area of discussion has involved ensuring that current management teams have robust de-carbonising pathways that will ensure the long-term viability and prosperity of the company. We are wary of management teams' promises that are

made with little “skin in the game” in the future ie making promises now that they will not have to deliver on.

*Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks.*

Solaris has been measuring the carbon footprint of managed portfolios since 2015 and has automated this process to enable individual portfolio analysis on either a weighted average carbon intensity basis or a physical carbon assessment. In addition, Solaris is able to drill down on a portfolio basis to determine individual stock contributions to a portfolio’s score.



*Describe the targets used by the organization to manage climate-related risks and opportunities and performance against targets.*

At this stage, Solaris does not have specific targets related to climate-related risks and opportunities. However portfolio carbon intensity measurement is now included in monthly reporting and trends are reviewed and an understanding of the contributors gained.

Table A1

## TCFD Recommendations and Supporting Recommended Disclosures

Governance	Strategy	Risk Management	Metrics and Targets
Disclose the company's governance around climate-related risks and opportunities.	Disclose the actual and potential impacts of climate-related risks and opportunities on the company's businesses, strategy, and financial planning where such information is material.	Disclose how the company identifies, assesses, and manages climate-related risks.	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.
a) Describe the board's oversight of climate-related risks and opportunities.	a) Describe the climate-related risks and opportunities the company has identified over the short, medium, and long term.	a) Describe the company's processes for identifying and assessing climate-related risks.	a) Disclose the metrics used by the company to assess climate-related risks and opportunities in line with its strategy and risk management process.
b) Describe management's role in assessing and managing climate-related risks and opportunities.	b) Describe the impact of climate-related risks and opportunities on the company's businesses, strategy, and financial planning.	b) Describe the company's processes for managing climate-related risks.	b) Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks.
	c) Describe the resilience of the company's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.	c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the company's overall risk management.	c) Describe the targets used by the company to manage climate-related risks and opportunities and performance against targets.