

JUNE 2019



Your success. Our priority.

# SOCIAL INVESTMENT GUIDELINES THREADNEEDLE (LUX) EUROPEAN SOCIAL BOND FUND



# EXECUTIVE SUMMARY

## SOCIAL INVESTMENT THESIS

Our Fund unlocks the full potential of bonds to deliver both financial returns and positive social outcomes.

As public and private sectors look to improve social issues through financial markets, we see financial and social benefit as increasingly interlinked. This is particularly evident in Europe – our target area. Europe faces many social challenges – from persistent pockets of deprivation, to ageing populations, to the need to transition to a greener and more prosperous economic system. For instance:

- In recent years, we have seen poverty *increase* for those on lowest incomes in Europe.<sup>1</sup>
- By 2050 the number of people aged 85 or older will more than double, reaching an estimated 40 million.<sup>2</sup>
- Air pollution is estimated to cause around 450,000 deaths per year.<sup>3</sup>

But there are catalysts, and opportunities, for change. European institutions are, in fact, increasingly using the bond market to help implement such change – examples being the specific Social, Sustainability and Green<sup>4</sup> Bonds issued by the Council of Europe, the governments of France and Belgium, and the City of Madrid. Business solutions are also critical to social innovation, whether in increasing the provision of affordable housing and healthcare, or contributing to greener economic growth – and many of them turn to the bond market to help scale up such innovation.

This provides opportunities for investors to participate in, and benefit from, the targeting of social outcomes. Through our deep understanding of the European fixed income market, and our proven experience in investing for positive outcomes, we can enable clients to capture the twin reward of social and financial benefit.

## SOCIAL INVESTMENT GUIDELINES IN OUTLINE

How we action our social investment thesis throughout our investment process is highlighted below:

### TOP DOWN: SOCIAL UNIVERSE CREATION

How we shape a Social Universe of potential bonds, and exclude those with negative social characteristics.

### MINIMUM STANDARDS

How we systematically ensure no bond entering the Fund violates our standards.

### BOTTOM UP: POSITIVE INCLUSION

How we target, assess and scrutinise bonds contributing to positive social outcomes.

### ONGOING: GOVERNANCE, MONITORING, ENGAGEMENT & REPORTING

How our governance, monitoring, engagement and reporting enhance and evidence our social focus.

<sup>1</sup> European Investment Bank. From 2005-2015 lower deciles of the income lost the largest share of total equivalised disposable income [http://www.eib.org/attachments/efs/econ\\_inequality\\_in\\_europe\\_en.pdf](http://www.eib.org/attachments/efs/econ_inequality_in_europe_en.pdf) p 5

<sup>2</sup> WHO <http://www.euro.who.int/en/health-topics/Life-stages/healthy-ageing/data-and-statistics/demographic-trends,-statistics-and-data-on-ageing>

<sup>3</sup> 2016 WHO data <https://ourworldindata.org/air-pollution#death-rates-from-air-pollution>

<sup>4</sup> IMCA labelled bonds. <https://www.icmagroup.org/green-social-and-sustainability-bonds/>

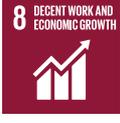
# TOP DOWN: SOCIAL UNIVERSE CREATION

## SHAPING A SOCIAL UNIVERSE

We start by shaping a Social Universe. This focuses on identifying categories of bonds with higher potential for delivering social outcomes, in line with our seven areas of social outcome. These draw on the social hierarchy of needs approach, whereby “primary” social needs such as housing are foundational and supercede more general social needs (see Appendix for further details). Alignment of related outcomes to the UN Sustainable Development Goals (SDGs), as the core global set of priorities for social and sustainable development, is also noted.

Some additional screening is also applied in certain categories. One example is in our Social Facilitation category. The additional screen ensures that only those financial services companies with higher social focus (eg, explicitly serving an important social group or run in the interest of their members as a “mutual”) are included in the universe.

**Table 1: Universe Construction by Social Hierarchy of Needs & SDGs<sup>5</sup>**

Social Outcome Category	Primary SDG	Opportunity & Mapped Bond	Specific Additional Screen
Primary Social Needs	 11 SUSTAINABLE CITIES AND COMMUNITIES	Affordable Housing eg, Social bonds (housing focus)	
Basic Social Needs	 3 GOOD HEALTH AND WELL-BEING	Health & Welfare eg, Health Services	Lowest opportunities in health & nutrition & access to healthcare eliminated
Social Enabling	 4 QUALITY EDUCATION	Education & Training eg, Printing & Publishing	
Social Empowerment	 8 DECENT WORK AND ECONOMIC GROWTH	Employment eg, Retail	Enhanced labour standards screen conducted
Social Enhancement	 11 SUSTAINABLE CITIES AND COMMUNITIES	Community eg, Social bonds (community focus)	
Social Facilitation	 10 REDUCED INEQUALITIES	Access to services eg, Financial services (socially focused)	Lowest opportunities in access to communications and non-mutual or socially focused banks eliminated
Societal Development	 9 INDUSTRY, INNOVATION AND INFRASTRUCTURE	Economic Regeneration & Development eg, Green Bonds	Heightened ESG controversy screen implemented Coal and nuclear power exposure (over 10% by revenue) eliminated

<sup>5</sup>Note: Further additive and contextual SDGs are often relevant across outcomes, e.g. the link of an outcomes intensity in addressing social exclusion and deprivation and the Poverty SDG). The strategy itself and work around it links to SDG 17: Partnership for the Goals.

## UNIVERSE EXCLUSIONS

The consequence of our positive social focus is that some categories of bond are excluded, such as those originating from industries or issuers which we consider offer minimal social or sustainability benefits, or which represent a high risk of adverse impacts. Where possible we go down to the bond level. For instance, whilst sovereign bonds are excluded, equivalent labelled Green, Social or Sustainability bonds would remain eligible.

**Table 2: Sectors excluded from Universe Creation**

Minimal or unusual social benefit <sup>6</sup>	High risk of adverse social and sustainability impacts
Advertising	Aerospace/Defense
Beverage	Air Transportation
Brokerage	Auto Loans
Cable & Satellite TV	Auto Parts & Equipment
Insurance Brokerage	Automakers
Investments & Misc Financial Services	Energy – Exploration & Production
Packaging	Foreign Sovereign (if general use of proceeds for central gov)
Media Content	Gaming
Media – Diversified	Government Guaranteed (if general use of proceeds for central gov)
Machinery	Integrated Energy
Monoline Insurance	Metals/Mining Excluding Steel
Multi-Line Insurance	Oil Refining & Marketing
Recreation & Travel	Oil Field Equipment & Services
Reinsurance	Steel Producers/Products
Software/Services	Tobacco
Sovereign	
Tech Hardware & Equipment	
Non-European issuers (excluding international or social bonds)	

In addition, we conduct a number of exclusions in line with our minimum standards (see overleaf).

Whilst some of these can be implemented as part of Universe creation, others are effected through the enhanced research we undertake upon consideration of specific bonds for the Fund.

# MINIMUM STANDARDS<sup>7</sup>

1. **Norm Adherence:** we exclude on evidence of violation of key norms and standards such as the UN Global Compact.<sup>8</sup>
2. **Sustainable Energy Focus:** we avoid those with material revenue from nuclear energy and coal generation or mining, as well as oil and gas (conventional and unconventional) extraction and generation.<sup>9</sup> In the case of a Green, Social or Sustainability Bond from a utilities issuer usually excluded for these reasons, we may invest where we see efforts to support the transition to a low carbon economy. In any case we will not invest in utilities whose emissions pathways do not comply, based on credible analysis, with a below two-degree scenario.<sup>10</sup> All utilities will be subject to our Climate & Energy Transition Engagement process (see Engagement below).
3. **Health Enhancement:** we have minimal tolerance for tobacco or alcohol production.<sup>11</sup>
4. **Social Cohesion:** we exclude those with material revenue from adult entertainment or gambling.<sup>12</sup> In addition, we expect all firms to recognise the importance of tax management, approached prudently and legally, to both societal contribution and responsible management of their affairs. We thus monitor all firms within the Fund for tax-related controversies, with severe issues triggering review of eligibility.<sup>13</sup>
5. **Weapon Avoidance:** we avoid weapons and firearms, with zero tolerance for controversial weapons.<sup>14</sup>
6. **Severe Environmental Impact Avoidance:** in addition to seeking investment opportunities which enhance natural capital, we avoid companies with severe controversies related to water or biodiversity and land use.<sup>15</sup>
7. **Controversial regimes.** We will not invest in countries with the death penalty,<sup>16</sup> subject to EU sanctions,<sup>17</sup> taking minimal collaborative action on Climate Change,<sup>18</sup> or which are oppressing freedoms or taking action which would violate principles of the UN Global Compact.<sup>19</sup> This applies also to wholly state-owned companies. For clarity, where we do invest in government debt this is only via Green, Social or Sustainability bonds.

<sup>7</sup>These apply to all bonds, unless specific exceptions apply e.g. for Green, Social or Sustainability bonds.

<sup>8</sup>The UN Global Compact; ILO Core Conventions; Child Labour; Bribery and Fraud; Severe Environmental Controversies (see also Severe Environmental Impact Avoidance below). Assessment informed by MSCI ESG Research: their assessment of a 'Fail' or worst score results in exclusion.

<sup>9</sup>Over 10% revenue related to: thermal coal generation, mining sales, nuclear energy generation, conventional oil and gas extraction, unconventional oil and gas extraction. Assessment informed by MSCI ESG Research, internal research, Bloomberg and other sources.

<sup>10</sup>Where possible we use the Transition Pathway Initiative <http://www.lse.ac.uk/GranthamInstitute/tpi/the-toolkit/>. Gaps may be supplemented with MSCI data (CO2 per electricity generation output). These are both tested against International Energy Agency (2017) below two-degree scenario (see 'Energy Technology Perspectives 2017', OECD/IEA, Paris, Figure 6.7).

<sup>11</sup>Tobacco production over 1% sales; alcohol production over 5% sales. Our Universe creation also excludes those classified as tobacco or alcohol producers. Assessment informed by MSCI ESG Research.

<sup>12</sup>Adult entertainment or gambling exposure over 5% sales. Assessment informed by MSCI ESG Research.

<sup>13</sup>Our approach in this connection aligns with that in our Responsible Investment Corporate Governance and Proxy Voting Principles, available on our RI website. Assessment of tax related controversies is informed by MSCI ESG research on taxes and subsidies.

<sup>14</sup>Production of conventional weapons or firearms for military or civilian markets over 1% sales; all related sales and services over 5% revenue; any material linkage to controversial or nuclear weapons: landmines; biological, chemical & nuclear depleted uranium. This is a more stringent extension our firm-wide Controversial Weapons policy, which can be found in our core Responsible Investment policy. Assessment informed by MSCI ESG Research.

<sup>15</sup>Assessment informed by MSCI ESG research on severe controversies related to Biodiversity & Land Use, and Water.

<sup>16</sup>Publicly available information, for instance on [https://en.wikipedia.org/wiki/Capital\\_punishment\\_by\\_country](https://en.wikipedia.org/wiki/Capital_punishment_by_country)

<sup>17</sup>Found at <https://sanctionsmap.eu/#/main>

<sup>18</sup>Such as those withdrawing from COP21, not reporting to the United Nations Framework Convention on Climate Change through National Communications and Biennial Reports <https://unfccc.int/national-communications-and-biennial-reports>

<sup>19</sup>We thus avoid those assessed by Freedom House as 'Unfree' States [https://freedomhouse.org/report/countries-world-freedom-2019?order=field\\_fiw\\_status&sort=asc](https://freedomhouse.org/report/countries-world-freedom-2019?order=field_fiw_status&sort=asc), and those ranking lowest on Transparency International's Corruption Perceptions Index, (darkest red) <https://www.transparency.org/cpi2018>. Other issues informed by MSCI ESG Research. This does not apply to development banks or agencies which are unrelated to controversial activities, and have played a huge role in developing the market for Green, Social and Sustainability Bonds – e.g. KfW, EIB.

# BOTTOM UP: POSITIVE INCLUSION

Our bottom-up social assessment process further ensures that our strong positive inclusion focus is maintained.

Prior to any investment, the Responsible Investment team considers the bond in question and gives a preliminary view of eligibility for the Fund. Where there is minimal social or socio-economic benefit or failure to meet the minimum requirements, or where we see material ESG or reputational issues which risk negating positive social outcomes, an indication of ineligibility may be assigned.

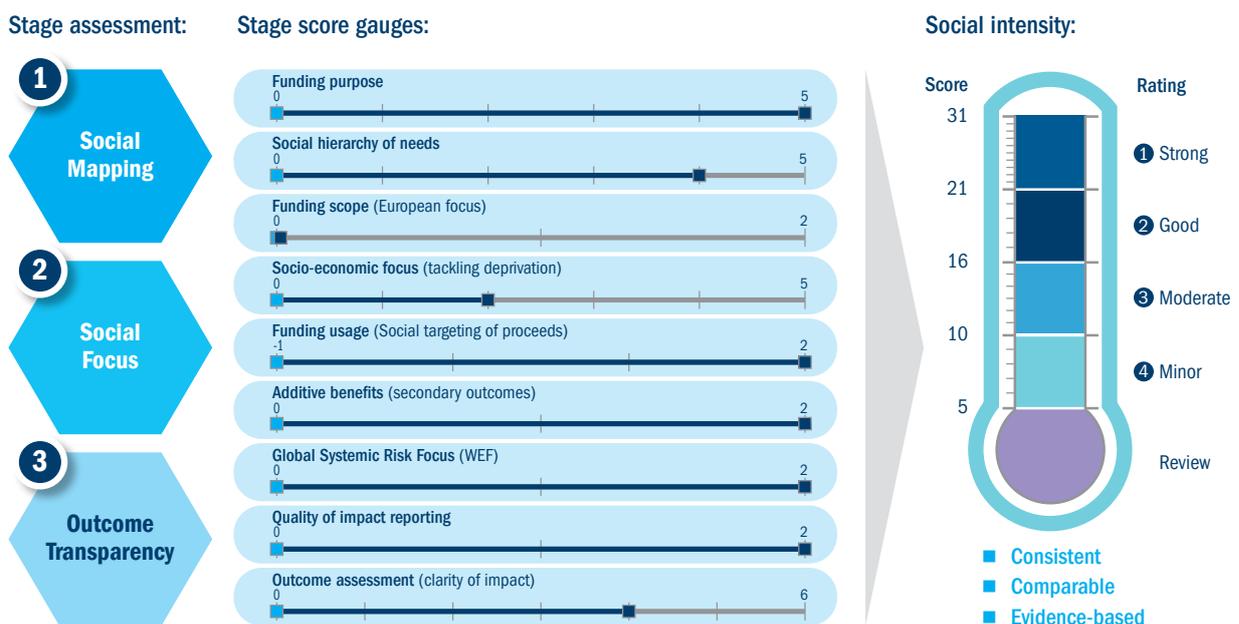
A full social assessment is undertaken post-investment, moving through initial social mapping to the social focus and the outcome. Where possible we seek to engage with issuers at this stage. Although opportunities for engagement in fixed income are rare in comparison with equity, we seek to pursue this as a source of information and encouragement of best-practice.

The social assessment also requires analysts to outline any ESG or reputational risks which might impact the social credentials of the investment and to consider whether it merits inclusion in the Fund. In this connection we make our own assessments

but draw on data provided by MSCI ESG Research, as well as the materiality framework of the Sustainability Accounting Standards Board (SASB).<sup>20</sup> The direct activities of the entity in question will be assessed but, in the case of controversies, there may be instances where the broader value chain is material. For example, demonstrable failure of an entity to exercise leverage in reducing human rights abuses committed by a supplier may provide grounds for avoidance.<sup>21</sup> We also assess whether Green, Social or Sustainability bonds are subject to a Second Party Opinion, Climate Bond Certification, audit or similar; this is a requirement for corporates, although we do make exceptions for some issuers such as development banks, given their related experience, standards and internal controls.

The social assessment process is primarily undertaken by the Responsible Investment team, but is also reviewed by our social partner INCO. INCO advise on the overall research, and have final input into the outcome assessment. Overall, the process generates a discrete social score which can be used to compare bonds addressing different social needs, and monitor the degree of the portfolio's social intensity over time.

**Figure 1: Full Social Assessment Process**



<sup>20</sup>The SASB materiality map provides useful indicators of topics to consider. <https://www.sasb.org/standards-overview/materiality-map/>

<sup>21</sup>The UN Guiding Principle on Business and Human Rights specifically outline the importance of this type of leverage.

# ONGOING: GOVERNANCE, MONITORING, ENGAGEMENT & REPORTING

Governance structures, monitoring mechanisms and reporting commitments are in place to evidence and ensure our ongoing social focus.

## GOVERNANCE & MONITORING

The Social Advisory Panel plays a vital role in reviewing, challenging, advising and monitoring the Fund. Ongoing monitoring checks are undertaken by both the Portfolio Compliance and Responsible Investment teams.

Key issues and assessments are discussed, on a quarterly basis at the Social Advisory Panel, comprising members nominated by our social partner, INCO, and the fund manager and chaired by an INCO-nominated member.

In advance of each Social Advisory Panel, the Responsible Investment team undertake portfolio screening to ensure that minimum requirements continue to be met. Any non-compliance or high risk of non-compliance is highlighted to the Panel.

The Panel has right of referral on the final assessment. Should a bond be considered ineligible or no longer eligible for the Fund, the fund manager will draw up and implement an action plan comprising an exit strategy in the best interest of the underlying investors.

The Mandate Monitoring team also have a role in safeguarding the social monitoring of the Fund. Pre-investment, the Responsible Investment team gives a preliminary opinion to the Mandate Monitoring team, outlining the social credentials at a high level. On the request of the Mandate Monitoring team we also provide regular overviews of all our holdings and their social ratings. The team is particularly focused on whether there are any holdings no longer aligned with the Fund's social objective.

## ENGAGEMENT

We seek opportunities to engage with issuers to better understand and positively influence their social value. We actively encourage issuance of Green, Social and Sustainability bonds both individually and collectively eg, as members of the International Capital Markets Association (ICMA) Social Bond Working Group.

Another specific example of our engagement approach relates to the issue of Climate & Energy Transition. For utility issuers we systematically seek engagement on an annual basis covering the following:

1. Transparent and informative reporting (eg, regarding disclosure to CDP, aligned with TCFD)<sup>22</sup>
2. Assessment of scenarios, including alignment with a below two-degree scenario
3. Concrete targets to prepare for and facilitate Transition
4. Carbon intensity per unit of electricity generation and plans to reduce this<sup>23</sup>
5. Plans for expansion/reduction of potentially unsustainable vs sustainable energy generation (thermal coal, conventional and unconventional oil & gas, nuclear energy vs renewable energy)

Where we consider a firm is not making effective plans to support transition to a low carbon economy we will review the eligibility of related bonds for the Fund.

Should a firm whose bonds are held in the Fund indicate that it is planning to build new coal or nuclear plants, the fund manager will draw up and implement an action plan comprising an exit strategy in the best interest of the underlying investors. Exceptions can be made for Green, Social or Sustainability Bonds where there is a second-or third-party assessment. Along with clarity that, in conformity with the Green Bond Principles, these will in no way facilitate development of nuclear or coal-related energy.

<sup>22</sup> We are a signatory to CDP programmes. TCFD refers to the Task Force on Climate-related Financial Disclosures.

<sup>23</sup> Items 4 and 5 apply only to those with generation capabilities.

## RI DERIVATIVES & CASH POLICY

Our social focus also applies to our consideration of the small proportion of our Fund which is not invested in bonds, namely derivatives and cash.

We maintain a list containing financially approved counterparties, with the ESG credentials of the counterparty reviewed every six months. We exclude those deemed to violate the UN Global Compact and related core standards; in addition, we monitor factors such as recent accounting investigations and qualified audit opinions.<sup>24</sup>

Consistent with the Fund's social focus, we do not take any derivative position where the underlying security would be ineligible for investment – eg, no tobacco, weapons or coal position, whether long or short. The one exception is for government instruments, where we only buy Green, Social or Sustainability bonds from eligible governments, but we can short general government securities to manage the duration of the Fund.

All derivatives are used with regard to the daily liquidity requirements of the Fund, and for efficient portfolio management only: these are not used for speculation. We are not involved in any commodities derivatives of any sort. Moreover, we do not assign any positive social impact to cash or derivatives.

## REPORTING

Finally, transparency of outcomes and impact is a core part of our commitment.

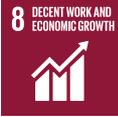
We commit to reporting on the impact of our Fund on an annual basis through an independent report undertaken by our social partner, INCO.

In addition, we undertake quarterly reporting on the Fund, including updates on the social rationale for new purchases and core ESG and/or engagement issues. We produce regular content related to the Fund on our website, through our Responsible Investment Quarterly Reports, Thought Leadership and through third-party sources.

At an organisational level we are committed signatories to the UN Principles for Responsible Investment (PRI), and are annually assessed by them on our approach to Responsible Investment.

# APPENDIX: FULL SOCIAL HIERARCHY OF NEEDS & SDG ALIGNMENT

Additive/contextual SDGs are often relevant across outcomes, eg, the link of an outcome's intensity in addressing social exclusion and deprivation and the Poverty SDG. The Fund's strategy itself, as well as work around it, links to SDG 17: Partnership for the Goals.

Social Outcome Category	Outcome Matrix	Primary SDG Alignment	Additive/Contextual SDGs
<b>Primary Social Needs</b>	<b>Affordable Housing</b> <ul style="list-style-type: none"> <li>■ Social housing</li> <li>■ Key worker housing</li> <li>■ Independent living housing</li> <li>■ Care homes</li> </ul>		
<b>Basic Social Needs</b>	<b>Health &amp; Welfare</b> <ul style="list-style-type: none"> <li>■ Physical Health</li> <li>■ Mental Health</li> <li>■ Healthy Living</li> <li>■ Rehabilitation &amp; support</li> </ul>		
<b>Social Enabling</b>	<b>Education &amp; Training</b> <ul style="list-style-type: none"> <li>■ Primary &amp; Secondary</li> <li>■ Vocational training &amp; apprenticeships</li> <li>■ Further &amp; Adult education</li> </ul>		
<b>Social Empowerment</b>	<b>Employment</b> <ul style="list-style-type: none"> <li>■ Creation of jobs in deprived areas</li> <li>■ Good employment standards</li> </ul>		  
<b>Social Enhancement</b>	<b>Community</b> <ul style="list-style-type: none"> <li>■ Local amenities, services &amp; environment</li> <li>■ Care services</li> <li>■ Personal (e.g. elderly)</li> <li>■ Other community services</li> </ul>		  
<b>Social Facilitation</b>	<b>Access to services</b> <ul style="list-style-type: none"> <li>■ Affordable financial products</li> <li>■ First time mortgages</li> <li>■ Professional services</li> <li>■ Communication &amp; broadcast services</li> </ul>		
<b>Societal Developments</b>	<b>Economic Regeneration &amp; Development</b> <ul style="list-style-type: none"> <li>■ Sustainable development</li> <li>■ Public &amp; community transport</li> <li>■ Urban &amp; community regeneration</li> <li>■ Infrastructure &amp; utility development</li> <li>■ Environment &amp; agriculture</li> </ul>		  

Source: Columbia Threadneedle Investments, 2019.





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## Key Risks

The value of investments can fall as well as rise and investors might not get back the sum originally invested. Where investments are in assets that are denominated in multiple currencies, or currencies other than your own, changes in exchange rates may affect the value of the investments. The Fund invests in securities whose value would be significantly affected if the issuer refused, was unable to or was perceived to be unable to pay. The Fund holds assets which could prove difficult to sell. The Fund may have to lower the selling price, sell other investments or forego more appealing investment opportunities. Most bond and cash funds offer limited capital growth potential and an income that is not linked to inflation. Inflation is likely to affect the value of capital and income over time. Changes in interest rates are likely to affect the Fund's value. In general, as interest rates rise, the price of a fixed rate bond will fall, and vice versa. The Fund's assets may sometimes be difficult to value objectively and the actual value may not be recognised until assets are sold. The investment policy of the fund allows it to invest in derivatives for the purposes of reducing risk or minimising the cost of transactions. The fund may exhibit significant price volatility.



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