

ESG concept in the investment business

July 2026

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Introduction

The ESG concept in the investment business of Zuger Kantonalbank (ZugerKB) describes the key aspects in relation to its responsible investments. It explains the investment principles as well as the concepts and processes based on which ESG (environmental, social and governance) criteria are systematically incorporated into investment decisions. The ESG concept in the investment business applies to all client assets managed by ZugerKB, unless explicitly stated otherwise. The aim of the ESG concept is to show in transparent terms how responsible investments are understood and implemented at ZugerKB.

ZugerKB's understanding of sustainability

Our understanding and concept of sustainability are enshrined in a harmonious interaction between business, society and the environment. These three factors are inextricably linked: Without a functioning economy, social and environmental goals cannot be achieved. In return, long-term economic success can only be achieved if the environment is intact and society is functioning well. Comprehensive sustainable development is therefore of fundamental importance if we are to leave future generations with a functioning society, an intact environment and the necessary economic resources. With our holistic management approach, we are committed to underpinning our business with ethical principles as well as social and environmental responsibilities, thereby fostering sustainable and beneficial development.

Responsible investments

In addition to risk and return considerations, ZugerKB consistently takes ESG factors into account in all areas of asset management and investment advice. This is based on our conviction that the use of ESG criteria in the investment selection process will contribute to a more sustainable global financial system. To that end, ZugerKB has issued this "ESG concept in the investment business", which governs its aspirations and actions in the context of responsible investments. For the management of our in-house investment funds and in the case of our asset management mandates, it has laid down the structured investment process on a binding basis and defined clear rules for the integration of ESG criteria.

Further information on sustainability and ESG at Zuger Kantonalbank:

www.zugerkb.ch/sustainability
www.zugerkb.ch/en/esg

Whereas with traditional investments only the metrics of classic financial analysis are applied, responsible investments offer the added possibility of steering portfolios in an environmentally and socially responsible way. Investing in accordance with ESG criteria means incorporating the corresponding opportunities and risks in these three areas when making investment decisions. Incorporating ESG criteria into the investment decision-making process is designed to reduce ESG risks in the portfolio and allow the corresponding opportunities to be exploited. Companies which incorporate ESG aspects tend to exhibit better long-term corporate quality and a superior ability to react to ESG risks and opportunities compared to those with a poor ESG rating.

ESG committee

The ESG committee consists of the ESG analyst (Chair), Chief Investment Officer, Head Fixed Income & Multi Asset, Head Equities, Head Investment Advisory and, as advisory members, the Head Sustainability as well as a representative of Investment Controlling and a representative of Product and Distribution Management. The ESG committee is responsible for developing the investment-specific aspects of sustainability. It supports the development and implementation of ZugerKB's ESG concept, which governs the bank's aspirations and actions in the context of responsible investments. The ESG committee is also responsible for assessing the application of ESG standards in individual cases.

ESG data providers

ZugerKB uses external ESG data to assess ESG-related opportunities and risks in the investment process. This data serves as the basis for investment decisions and the systematic consideration of ESG opportunities and risks. For this purpose, ZugerKB primarily uses ESG data from MSCI ESG Research LLC. Other data sources are only used if the data from MSCI ESG Research LLC are insufficient. As a result, consistent application of ESG criteria is assured right across the investment universe.

MSCI ESG Research LLC is a subsidiary of MSCI Inc. and is among the leading providers of data, analysis and ratings in relation to environmental, social and governance (ESG). The company offers in-depth ESG research and valuations designed to help investors identify long-term, financially relevant sustainable risks and opportunities.

ESG risks

ESG risks are events or conditions in relation to environment, social and governance factors that may, for example, adversely affect business efficiency, costs, reputation, and therefore the value of the company as well as the price of financial instruments, currently or in the future.

- **Environmental risks** are commonly categorised as "physical risks" or "transition risks". "Physical risks" include damage and costs due to climate-related extreme weather events such as storms, floods or heatwaves that threaten or harm a company's business activities or its values. "Transition risks" include regulatory risks, changes in consumer habits as well as liability and lawsuit risks. The potential introduction of a carbon tax is one example of a transitory risk. Such a tax could negatively impact the profitability of a company and reduce its value.
- **Social risks** can arise due to a breach of labour standards, inadequate occupational health and safety, inadequate product safety, a poor approach to social issues, irregularities when dealing with employees, or a high rate of staff turnover.
- **Governance risks** can arise due to unequal treatment of shareholders, inadequate risk management, a lack of control mechanisms, inappropriate remuneration systems or rule breaches, e.g. corruption.

ESG risks can have differing impacts on individual asset classes, regions, economic sectors and/or individual companies. Thus events such as climate change and environmental destruction, as well as the need to evolve into a sustainable economy, may lead to changes in the real economy that can create new risk factors for investors. This means investors should always take account of ESG risks in terms of risk diversification.

In the context of asset management and investment advice, ESG risks and key features may be taken into account or monitored through various dynamically evolving ESG approaches. For investors, it is important to understand that these approaches have varied objectives and are not all geared towards achieving a measurable, positive impact on ESG factors, such as a reduction in the burden on the environment.

Greenwashing

From a regulatory perspective, the avoidance of greenwashing – a central pillar of responsible business conduct – is defined by the self-regulation guidelines of the Asset Management Association Switzerland (AMAS, Self-regulation on transparency and disclosure for sustainability-related collective assets, as currently in force) and the Swiss Bankers Association (SBA, Guidelines for the financial service providers on the integration of ESG preferences and ESG risks and the prevention of greenwashing in investment advice and portfolio management, as currently in force). ZugerKB is a member of the AMAS and of the SBA. It is therefore subject to both these bodies' self-regulation guidelines, which it implements as required.

AMAS self-regulation refers to sustainability-related collective assets, where it draws a distinction based on "alignment" with sustainability objectives or "contribution" to sustainability objectives. "Alignment" means investments are in line with a sustainability objective, for instance through investments in companies with sustainable products or a good ESG performance. A "contribution" goes beyond this and requires that the investment has a direct and positive, measurable impact on a sustainability objective. Based on the AMAS definition, ZugerKB's investment funds have an "alignment" objective.

On the other hand, the bank's (portfolio-based) investment advice and asset management are governed by the SBA self-regulation guidelines. These guidelines distinguish between "ESG investment solutions", where ESG factors are considered primarily for assessing opportunities and risks in the investment process, and "sustainable investment solutions", which pursue an explicit sustainability objective. ZugerKB's asset management mandates can be classified as "ESG investment solutions" as defined by the SBA.

The following criteria are applied to our investment funds and asset management mandates:

	Equity funds	Bond funds	Strategy funds	Mandates
ESG integration				
Exclusion criteria				
Best-in-class				
Positive screening/tilting				
Stewardship				
Climate focus				
Sustainability reporting				

Our structured process ensures that the defined sustainability requirements are implemented correctly. When implementing their investment decisions, our portfolio managers ensure that the specified sustainability policy is complied with. Investment Controlling monitors compliance with the processes on a regular basis.

Transparency is a key factor for the avoidance of greenwashing. ZugerKB's sustainability policy (basic principles, scope and implementation), this ESG concept, as well as other ESG-related information, are therefore publicly available on our website.

ESG integration

ESG integration is defined as the explicit and systematic incorporation of ESG aspects into investment analysis and investment decisions. This comprises the integration of ESG factors into various stages of the investment process through the linking of financial information with specific ESG-related aspects. In addition to risk and return considerations, ESG factors and the associated aspects are an important element and are also incorporated into the investment decisions. At ZugerKB, a portfolio is constructed via a two-stage selection process that combines responsible as well as traditional financial analysis factors. As the investment processes differ based on investment class, investment strategy and availability of ESG data, ZugerKB defines the specific measures for implementing ESG integration for each ESG subfund.

Exclusion criteria (negative screening)

Through the application of various ESG exclusion criteria, ZugerKB systematically reduces the risks that can arise due to controversial business activities and additionally concentrates on companies with greater resistance to long-term, sector-relevant ESG risks. Issuers who fail to comply with defined standards or values closely related to the aims of sustainability are thus excluded.

Exclusion criteria	Direct investments	Investment funds
Norms-Based		
UN Global Compact	Result = «fail»	Fund share ≥ 3%
ESG controversies	Result = «red»	Fund share ≥ 3%
Controversial weapons	Sales share > 0%	Fund share ≥ 3%
Nuclear weapons	Sales share > 0%	Fund share ≥ 3%
Values-Based		
Conventional weapons	Sales share ≥ 5%	Fund share ≥ 8%
Thermal coal	Sales share ≥ 5%	Fund share ≥ 8%
Unconventional oil & gas	Sales share ≥ 5%	
Nuclear energy	Sales share ≥ 5%	Fund share ≥ 8%
Adult entertainment	Sales share ≥ 5%	Fund share ≥ 8%
Tobacco	Sales share ≥ 5%	Fund share ≥ 8%
Gambling	Sales share ≥ 5%	Fund share ≥ 8%
ESG rating	«B» or «CCC»	«B» or «CCC»
Country-Based		
UN sanctions	Result = «yes»	
Government ESG rating	«B» or «CCC»	

We distinguish between norms-based exclusions (exclusion of companies that violate internationally recognised norms and standards), values-based exclusions (exclusion of companies whose business activities are deemed inadmissible for an investor) and country-based exclusions (countries that systematically breach international standards). If necessary, these exclusion criteria or controversial business areas and turnover thresholds can be adjusted within the sustainability concept on the basis of a more detailed breakdown.

Investment Controlling checks on a weekly basis that these requirements applicable to investment products are being complied with. In this way, possible breaches of ESG investment restrictions can be identified at an early stage. Positions in breach of ESG requirements must be rectified within the six-month deadline (see also the section “Monitoring” on page 6).

Best-in-class (laggards-out approach)

Implementation of best-in-class with a laggards-out approach prevents investments (direct investments as well as investment funds) classified as “laggards” by MSCI from being included in ZugerKB’s responsible investment universe. These are companies that have been given an ESG rating of “B” or “CCC” by MSCI ESG Research. This avoids investments being made in companies that have a high sustainability risk.

The MSCI ESG rating measures a company’s dependency on and resilience to long-term ESG risks of relevance to its sector. Whereas the leading companies (rated “AAA” and “AA”) have their ESG risks and opportunities under control and are there-

fore less exposed to potential risks, the laggards (rated “B” and “CCC”) do not have such management processes in place. Laggards can suffer from regulatory pressure, reputation loss or financial sanctions over the long term.

Positive screening/tilting

Positive screening/tilting describes a sustainable investment approach where companies, sectors or issuers with above-average ESG characteristics are systematically preferred. Selection is made based on clearly defined qualitative and quantitative criteria (e.g. ESG ratings or ESG scores), the aim being to give greater consideration to investments that have a better sustainability profile than their peers.

The resilience of securities or portfolios to long-term, sector-related ESG risks is characterised by an MSCI ESG score of between 0 and a maximum of 10. At the same time, the ESG score is assigned a rating code of “CCC” up to a maximum of “AAA”.

- **Equity and bond funds** each have a core investment universe. When constructing an ESG subfund’s portfolio, the portfolio manager uses an optimisation approach to exceed the ESG score of the respective core investment universe, resulting in an improvement in the ESG score of the ESG subfund versus the respective benchmark index.
- **Strategy funds** do not have a core investment universe. When constructing the subfund’s portfolio, the weighting of all securities within the fund’s assets with an ESG score lower than “BBB” must not amount to more than 20 percent in overall terms.

Stewardship

ZugerKB has decided to implement stewardship (consisting of proxy voting and engagement) in relation to its in-house investment funds, largely within the framework of the Swiss Stewardship Code and according to the Principles for Responsible Investment (PRI). The Swiss Stewardship Code is applied on a voluntary basis and serves as a recommendation. For practical implementation, we have delegated stewardship to our fund management company, which in turn works with Columbia Threadneedle Management Limited, London (CTML).

- **Proxy voting:** The exercising of membership rights includes the exercising of voting rights. As proxy, CTML has been mandated to exercise voting rights at all general meetings relating to the relevant subfunds (equity funds) independently and exclusively in the interests of the investors. Upon request, investors may receive information from the fund management company on the exercise of membership rights.

- **Engagement:** Engagement is defined as a constructive dialogue with issuers about ESG risks that could have a material negative impact on their business. For ZugerKB, engagement refers to financial performance, sustainability-related risks and opportunities as well as other factors, divided into core themes such as climate change, human rights and governance, and into a series of sub-themes. CTML conducts a dialogue with selected companies in which the relevant subfunds (equity and bond funds) are invested. The aim of this dialogue is to encourage companies to move towards best practice in key ESG areas.
- **Escalation:** Fundamentally, the aim is to have a constructive dialogue with the selected companies that leads to the desired result for all parties involved. However, CTML may consider escalating if the companies do not show any progress on matters deemed to be in clients' best long-term financial interests. Escalation activities take place in cooperation with other investment companies. Various options through to partial or complete divestment are available and send a clear signal to the companies concerned.
- **Reporting:** ZugerKB publishes a summary Stewardship Report on its website on a quarterly basis. This discloses the voting rights and engagement activities performed on behalf of ZugerKB based on the aggregated holdings of the relevant subfunds.

Climate focus for equity funds

Based on emissions data for 2022, a –35 percent reduction pathway for carbon intensity by 2030 was formulated for each of our in-house equity funds. This takes account of Scope 1 + 2 emissions data. The data for the calculations was obtained from MSCI ESG Research LLC. The reference values (starting points) for the reduction pathways are based on the carbon intensities (Scope 1 + 2) of the respective benchmark indices at the end of 2022.

The respective subfund is constructed by the portfolio manager in such a way that it shows a weighted average carbon intensity that is below a reduction value which is reduced by 5.24 percent annually versus the respective reference value as at 31 December 2022. Thus the aim is for the respective subfund to have a carbon intensity that is 35 percent lower than the reference value by the end of 2030. ZugerKB calculates the weighted average carbon intensity of the fund assets concerned annually as at 31 December and discloses this in the ZugerKB Sustainability Report. The carbon intensity of a subfund may also increase between these reference dates and may be above the relevant target reduction pathway.

Selection of target funds

Similar ESG criteria are used for investments in target funds, though without specifying the data providers and data sources or the precise operationalisation of the criteria. Target funds are admitted to the sustainable investment universe if, in addition to exclusion criteria, they show additional ESG characteristics and have a defined sustainability policy. The investments and exclusions contained in the target funds do not necessarily have to match ZugerKB's ESG approach.

Investments in target funds that do not meet these requirements, or for which there is no adequate ESG data coverage, and in target funds that exclusively use "exclusions" as their sustainability approach, can only be made following approval by the ESG committee and only subject to the limits stated in the following section. ZugerKB requests the required information from the target funds twice a year in order to ascertain whether the products used correspond to the ESG conditions set out in the fund prospectus.

Investments with insufficient ESG coverage

In addition, a maximum of 10 percent of the subfund assets in the case of equity funds and 20 percent of the subfund assets in the case of bond and strategy funds may be invested in securities that do not correspond to the requirements of the sustainability approaches specified above. This is mainly because the tactical asset allocation, liquidity management and hedging may be carried out through index futures which do not have a sustainability rating.

Furthermore, investments may be made in securities that do not correspond to the requirements of the sustainability approaches specified above, in particular due to minimal or non-existent ESG data coverage for individual investments (e.g. no ESG rating or no data for assessing the sustainability profile) or due to the lack of any opportunity to incorporate ESG factors in the case of certain investment classes. However, this is only possible after prior, formal approval by the ESG committee.

Investments with inadequate ESG data coverage that do not meet ZugerKB's ESG criteria in terms of quality cannot be acquired.

ESG preferences

Establishing our clients' ESG preferences in line with the Swiss Bankers Association's binding guidelines enables us to ensure that the investment decisions meet clients' ESG needs and are taken into account in the investments. ZugerKB differentiates between the following four profiles, although we reserve the right to adjust the parameters for implementing these profiles if required.

- **No consideration of ESG factors:** ESG criteria are not relevant for the client and are therefore not taken into account when choosing investments. However, ZugerKB is free to offer its clients financial products with ESG features if these products match client requirements from a financial viewpoint.
- **Neutral:** The focus is on financial interests, while the client has a neutral stance on the topic of ESG. ZugerKB is free to offer its clients financial products with ESG features if these products match client requirements from a financial viewpoint.
- **Consideration of ESG factors:** ESG criteria are important to the client and are to be taken into account in the composition of the portfolio. Accordingly, only investments from the responsible investment universe are recommended.
- **Consideration of ESG and climate factors:** Climate aspects as well as ESG are important to the client. Investments from the responsible investment universe are recommended. In addition, a reduced Implied Temperature Rise is targeted at portfolio level. This involves a significant restriction on the investment universe.

Collection of carbon data in the investment business

In the context of the carbon footprint for the bank as a whole and the calculation of carbon reduction targets for banking operations, we measure various carbon-related data for assets under management on an annual basis. Based on Scope 1–3, these are essentially the absolute carbon emissions (t CO₂e), carbon intensity (t CO₂e/USDm sales) and carbon footprint (t CO₂e/USDm enterprise value including cash). In terms of indirect greenhouse gas emissions from assets under management, the methodology of the Partnership Carbon Accounting of Financials (PCAF) initiative is used. ZugerKB is a member of PCAF.

Monitoring

The structured process, where various areas of the Investment Office are involved, ensures organisational implementation of the sustainability requirements defined in the strategy. The correct operation of these processes and implementation of the decisions are assured by Investment Controlling. When implementing their investment decisions, our portfolio managers ensure that the specified sustainability policy is complied with.

On a weekly basis, Investment Controlling checks compliance with the ESG-related requirements as well as other rules that need to be taken into account by the portfolio managers. This involves screening the entire universe based on raw ESG data. In this way, possible breaches of ESG investment restrictions can be identified at an early stage. All checks and events are carefully documented and archived to ensure full transparency and verification of our monitoring measures at all times. Positions that breach requirements must be adjusted on a timely basis.

Reporting

ZugerKB's reports provide our investors with transparent information in relation to sustainability and ESG and are supplemented by other publications on our website.

- **The bank's Sustainability Report:** ZugerKB prepares its Sustainability Report in accordance with the Standards of the Global Reporting Initiative (GRI) and the content requirements specified in Art. 964 CO on non-financial reporting. The CO article is aimed at creating transparency regarding the bank's business model and its impacts on society and the environment. In the Sustainability Report, the bank provides detailed and transparent information about its objectives, potential for improvement and milestones on the way to becoming a sustainable bank.
- **Sustainability reporting for our investment funds:** As a member of AMAS, we are required to prepare a sustainability report for each in-house investment fund at least once a year. This report describes the sustainability approaches used, by comparing the key ratings, metrics and other relevant information with the respective benchmarks, where relevant.
- **Stewardship:** ZugerKB publishes a summary report on a quarterly basis. This discloses the voting rights and engagement activities performed on behalf of ZugerKB based on the aggregated holdings of the relevant subfunds.

We are signatories to or members of the following organisations

Signatory of:



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