

MARCH 2020

BUILDING STRONGER CLIENT RELATIONSHIPS WITH ESG INVESTING



FRANKLIN
TEMPLETON





INTRODUCTION

RESPONSIBLE INVESTING HITS MAIN STREET

Responsible investing is on the rise. The Global Sustainable Investment Alliance¹ (GSIA), a prominent industry body, estimates responsible investing assets stood at \$30.7 trillion at the start of 2018, a 34% increase in two years. Responsible investment now commands a sizable share of professionally managed assets in all major economies, ranging from 18% in Japan to 63% in Australia and New Zealand, according to the GSIA. Clearly, responsible investing constitutes a major force across global financial markets.

As individuals, we are increasingly aware of the impact that our day-to-day choices have on the environment and on communities both far away and close to home – from the clothes and food we buy to how we travel. It was only a question of time before those concerns spilled over into how we save and invest. As a result, a fast-growing number of retail investors now expect their savings to make a positive contribution to society and the planet.

This growing interest in responsible investing is an opportunity for financial advisers to build closer relationships with retail clients. But navigating the sea of products that all wear the Environmental, Social and Governance (ESG) tag can be tricky. As an adviser, it is more important than ever to understand the long-term goals of clients, the differences between ESG investment products, and how regulators are working on better metrics to bestow more transparency and rigor to this new investment class.

The European Commission's Sustainable Finance initiative, adopted in May 2018, aims to encourage responsible investing by, among other things, developing a classification of economic activities measured by their ESG impact. Meanwhile central banks, including those in France and the Netherlands, are increasingly committing to ESG integration, seeking to lead by example.

1. Source: 2018 Global Sustainable Investment Review.



KEY FINDINGS

Franklin Templeton has conducted a global survey among advisers to learn more about their views and experiences on responsible investing. These are the main findings of the survey:

1

Clients increasingly seek investments with **positive ESG impacts**. Climate change and related issues drive concern.

2

Responsible investing leads to outperformance.

3

Advisers are **increasingly embracing** ESG-integrated products.

4

Advisers want **more ESG** investment products.

Responsible investing has existed for decades in a variety of forms. The first portfolio screens were developed in the 1960s to allow investors to link their personal values to investment principles – for example, requesting that investment portfolios specifically excluded certain industries or companies such as firearms or tobacco. The practice has since moved well beyond simple screening mechanisms. Investors can now select products with ESG variables integrated into the investment process; they can also choose investments with specific sustainability goals (for example, a bond to fund the development of solar power generation) – a concept known as impact investing.

Franklin Templeton itself has long been committed to responsible investing and the application of ESG criteria in its investment processes. ESG analysis is not just about identifying and measuring risk; it is also about identifying investment opportunities. We at Franklin Templeton consider ESG factors alongside traditional financial measurements to provide a comprehensive view of an investment and help identify those that have the potential to deliver sustainable returns.

At Franklin Templeton we use responsible investing as an umbrella term for the following categories of investing:

Socially responsible investing (SRI) – which screens out controversial investments that do not satisfy investor-designated environmental and/or social beliefs and values.

ESG integration – which considers material ESG factors alongside traditional financial and economic measures, to promote a more comprehensive view of the value, risk and return potential of an investment.

Impact investing – investing with the explicit intention to generate positive and measurable social and environmental outcomes alongside financial returns.

ESG-tilted – invests in issuers with leading ESG practices, or issuers that have been improving ESG standards.

Thematic – focuses on issuers with products or services that address social or environmental challenges.

SURVEY METHODOLOGY

Franklin Templeton partnered with NMG Consulting to undertake a comprehensive study. NMG examined the attitudes of financial advisers and intermediaries towards responsible investing in 10 major markets across the globe, in EMEA, APAC (Japan and Australia) and North America. The survey was conducted online with 824 adviser respondents, including 388 across Europe in Denmark, France, Germany, Italy, the Netherlands, Norway, Sweden, Switzerland and the UK. Fieldwork took place between April and June 2019.

Respondents were selected based on job titles and typically held the position of ‘financial adviser,’ although some variation was introduced based on region. Respondents were required to have existing clients with responsible investment allocations, with screening and trap questions used to exclude ineligible participants.



THEME 1

BUSINESS OPPORTUNITY

CLIENTS INCREASINGLY SEEK INVESTMENTS WITH POSITIVE ESG IMPACTS

Climate change and related environmental issues drive concern:

- 87% of advisers see the incorporation of ESG considerations as a profoundly meaningful way to evaluate investments.
- 90% of advisers see responsible investing as a business growth opportunity and a way of forging closer ties with their clients.
- 71% of advisers introduced the subject of responsible investing to their clients.

Whether they are experienced in the field of responsible investing or have had little to do with it in the past, all the financial advisers who responded to our survey detect a growing interest from clients in investment products with positive ESG impacts. This is almost certainly a response to growing public concern about environmental issues and climate change, brought to the fore by the actions of climate protest groups such as Extinction Rebellion and the advocacy of youth leaders, including Greta Thunberg.

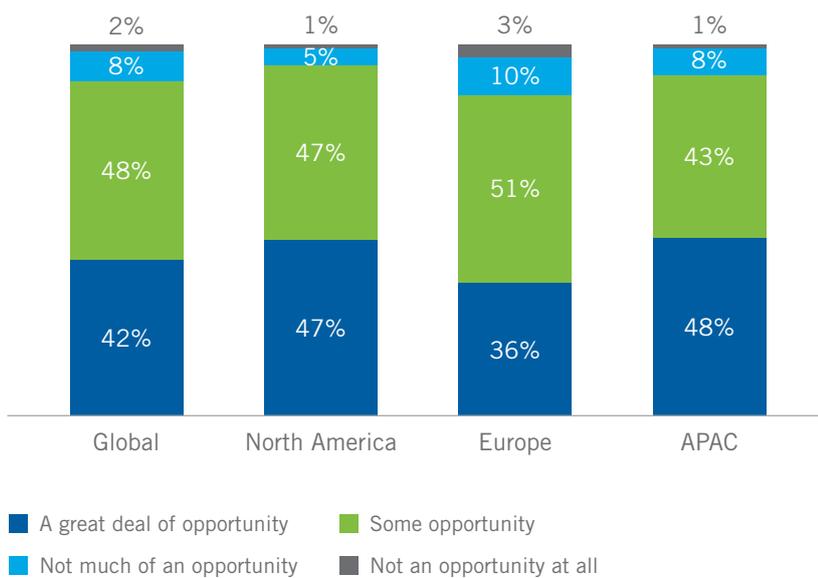
Advisers increasingly accept the value of including ESG criteria in making investment decisions. In our survey, 87% of respondents saw it as a “profoundly meaningful way” to evaluate investments. Once a niche approach, ESG considerations are now standard for all asset

classes. This trend – already well established across institutional asset owners – is taking root with financial advisers and their retail clients.

Advisers with responsible investing expertise say it is good for business: some 90% of respondents see responsible investing as a business opportunity for their practice, including 42% who see it as a “great opportunity” (Figure 1.1). A familiarity with responsible investing helps advisers prepare for future investment trends. It also deepens relationships with clients by enabling new conversations around the fundamental purpose of investing and the client’s investment mission. Ultimately, responsible investing ought to keep clients more engaged with their investments, as these come to reflect their personal values as much as their financial goals.

FIGURE 1.1

90% of Advisers Consider Responsible Investing as a Business Opportunity



To what extent do you see selling ESG, responsible, sustainable or impact investments as a business and investment opportunity? Sample size = 824

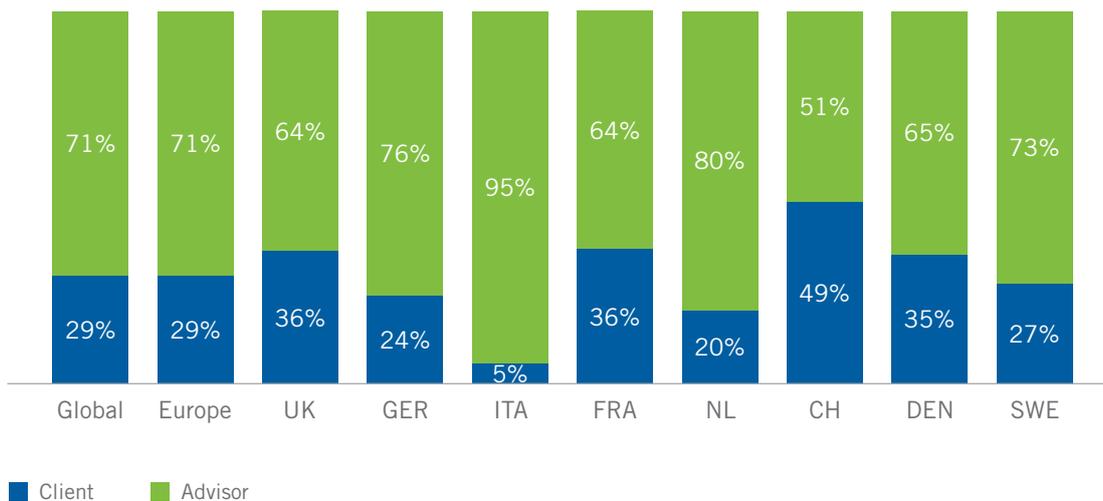
Source: NMG Consulting, June 2019.

As retail investors become more interested in responsible investing, advisers are not standing idle; indeed it is often advisers who broach the subject first with their clients. On average, 71% of advisers (both globally and in Europe) reported initiating the conversation around responsible investing strategies and products. However, there are big differences between countries. In Italy, advisers led over 90% of the time, while in Switzerland, the subject was equally likely to be introduced by the adviser or the client (Figure 1.2).

What is clear is that the level of understanding about responsible investing varies widely. While many retail clients may be attracted to the idea of investing in a more responsible way, most need some education around options and implications. Such conversations are generally driven by a combination of the client’s ESG priorities and their return and performance goals. However, a sizable minority of clients continue to focus on one over the other (Figure 2.2). Balancing these client objectives (and understanding where on this spectrum a client sits) is an important skill for an adviser to have.

FIGURE 1.2

Advisers Initiate Most Responsible Investing Conversations



Who typically initiates the conversation about ESG, responsible, sustainable or impact investing? Sample size = 824

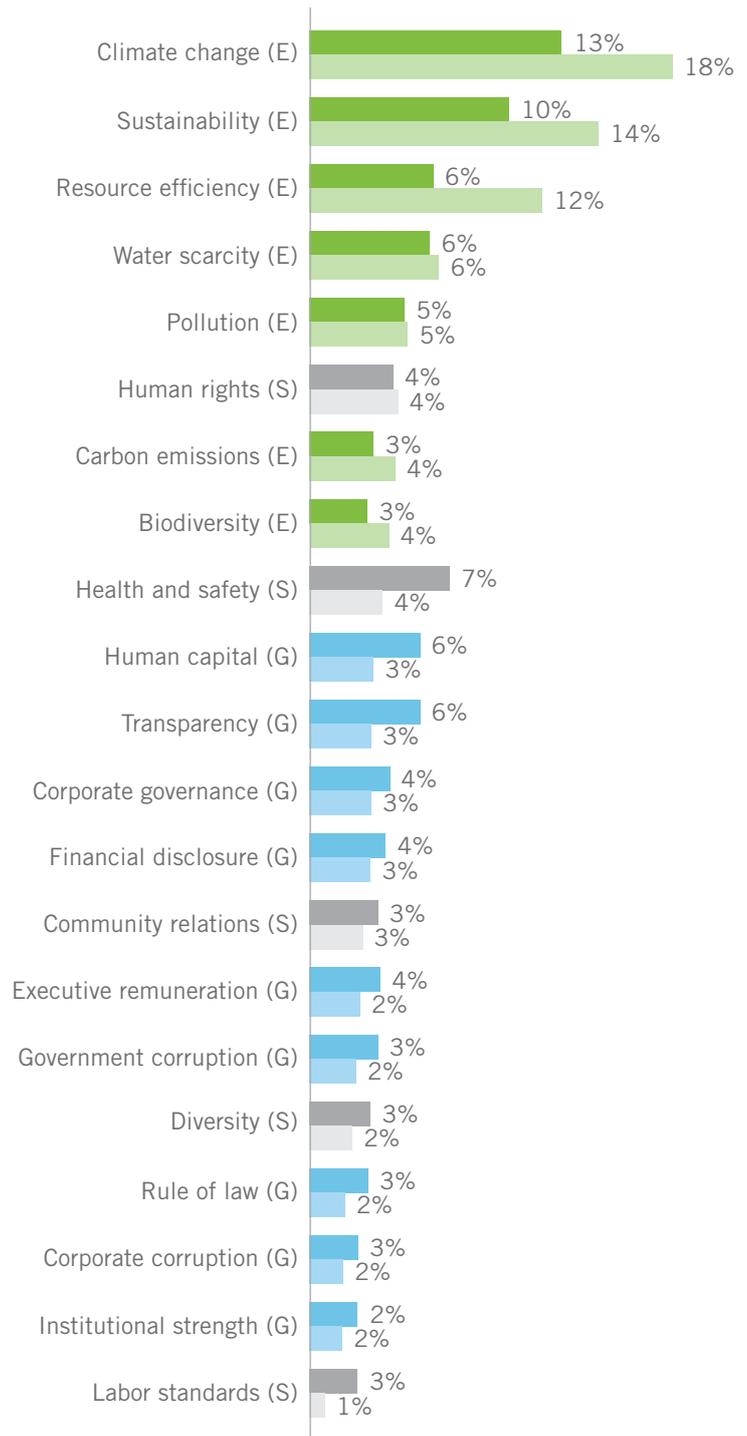
Source: NMG Consulting, June 2019.

ENVIRONMENTAL ISSUES DRIVE CLIENT INTEREST IN RESPONSIBLE INVESTING

How will responsible investing products be developed for retail channels? In large part, they are likely to reflect the priorities of individual clients. At a macro level, nearly half (46%) of advisers believe that “E” – the environmental factors – are the most important for their clients, with “G” – governance factors – cited by 34% and “S” – social factors – cited by 20%. Over the longer term, advisers expect environmental factors to crowd out other responsible investing issues because of the growing concern about climate change, environmental sustainability and resource efficiency (Figure 1.3 and 1.4).

FIGURE 1.3

ESG Themes Most Likely to Change How People Invest

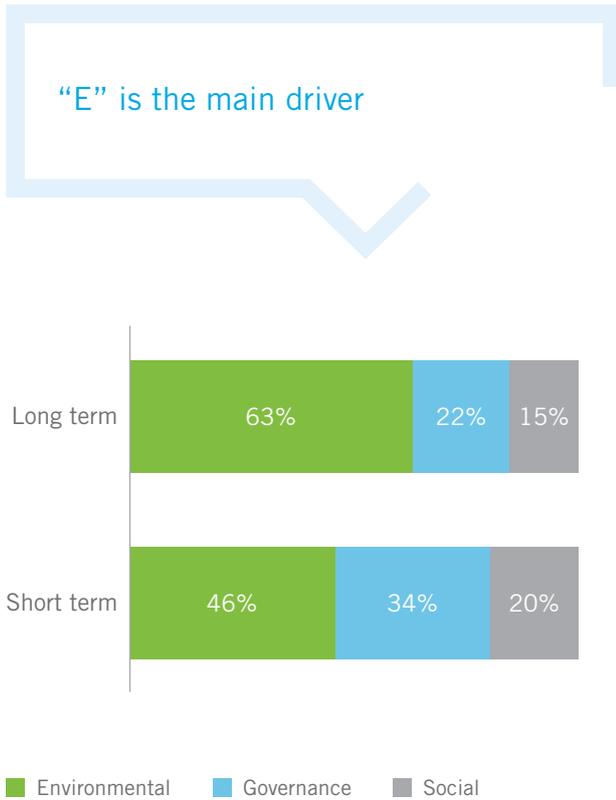


■ ■ ■ Short term ■ ■ ■ Long term

Which ESG issues do you believe are likely to change how people invest in the short term/long term? Sample size = 824

Source: NMG Consulting, June 2019.

FIGURE 1.4



Which ESG issues do you believe are likely to change how people invest in the short/long term? Note: timeframe not specific but typically short term = 1–3 years, long term = 5+ years. Sample size = 824

Source: NMG Consulting, June 2019.



Dr. Michael Hasenstab
 Templeton Global Macro, Portfolio Manager Templeton Global Bond Fund*

We have re-weighted the E, S and G in our strategies. E is now weighted with 33%. Previously the E factor was at 20% (with S and G each at 40%), given our view that environmental factors typically develop over relatively longer time periods. However, we have revised that assessment given that environmental factors have, in our view, recently had increasingly acute effects on a growing number of sovereigns. Part of the drive to equal weight the scores is in recognition that environmental factors are becoming urgent concerns in major emerging countries like India and Brazil.

*A sub-fund of Franklin Templeton Investment Funds, a Luxembourg-registered SICAV (“FTIF”).



THEME 2

PERFORMANCE

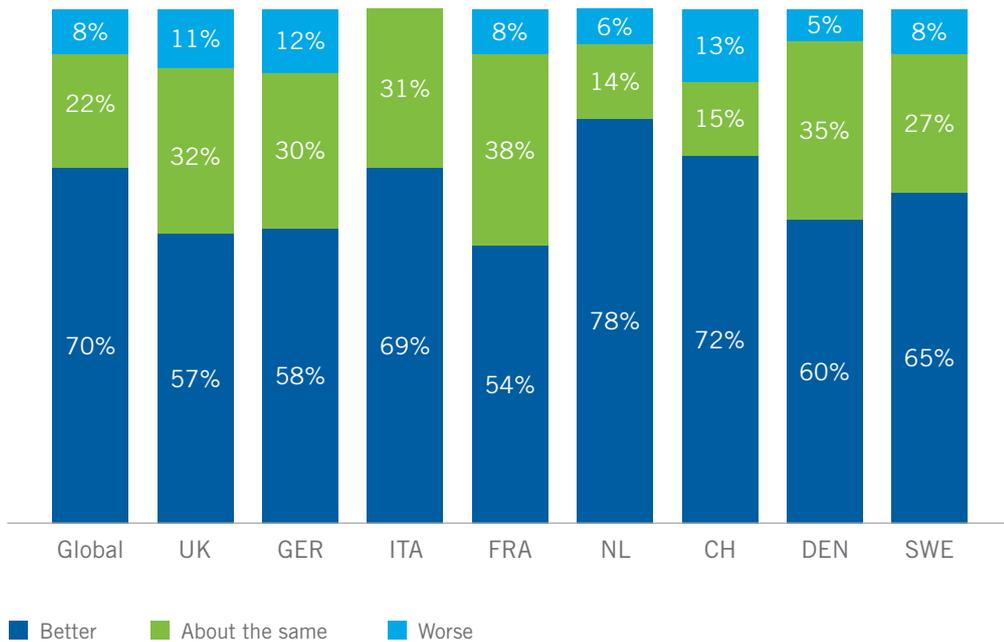
RESPONSIBLE INVESTING LEADS TO OUTPERFORMANCE

- 70% of advisers report that their clients' allocations to responsible investing strategies have outperformed.
- 80% of advisers believe that their clients are at least partly motivated by the returns case when considering responsible investing.
- 77% expect their clients to increase their allocation to responsible investing funds over the next two years.

Rising adviser engagement with responsible investing is not just about client demand. It is also because responsible investment products have delivered superior returns. Some 70% of advisers report that their clients' allocations to responsible investing funds have outperformed their other investments, with only 8% reporting inferior performance (Figure 2.1).

FIGURE 2.1

Responsible Investing Allocations Deliver Superior Returns



As far as you know, since investing in ESG, responsible, sustainable or impact assets, how do their returns compare to those of other investments? Sample size = 824

Source: NMG Consulting, June 2019.

This is a broadly consistent view across European countries. While there are some especially receptive adviser communities in Italy, Netherlands, and Switzerland, in no country is belief in the superior performance of responsible investing below 50%.

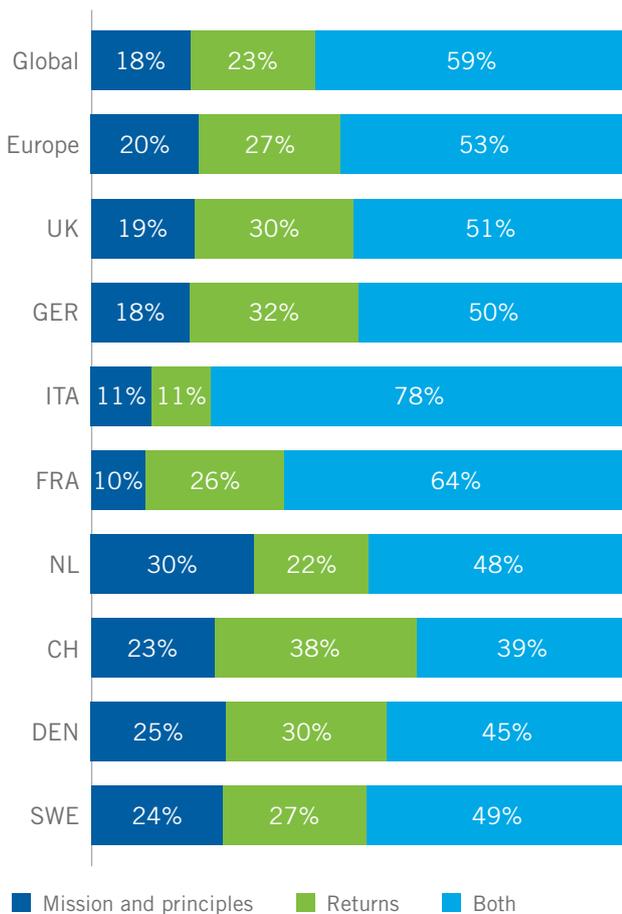
The superior performance of responsible investing products is important because the majority of advisers believe their clients are

unwilling to sacrifice investment returns for the sake of other values such as sustainability (Figure 2.2). So far, it has been a win-win situation.

There are still some perceptions of higher volatility. While two-thirds see responsible investing allocations as being less or similarly volatile to other investments, a third of advisers associate responsible investing with higher levels of volatility (Figure 2.3).

FIGURE 2.2

Objectives of Investors

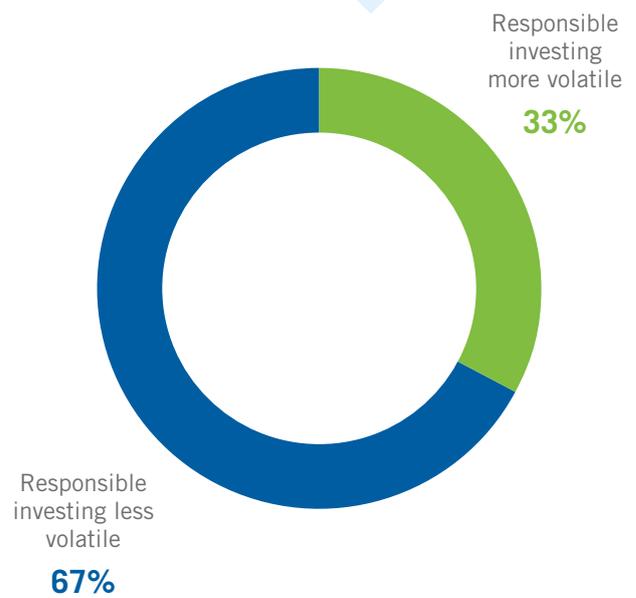


Do investors selecting ESG, responsible, sustainable or impact funds do so primarily because they believe in the mission and principles of the fund or primarily because it can achieve market rate returns? Sample size = 824

Source: NMG Consulting, June 2019.

FIGURE 2.3

Perceived Volatility of Responsible Investing



As far as you know, since investing in ESG, responsible, sustainable or impact assets, how does the volatility of their returns compare to that of other investments? Sample size = 824

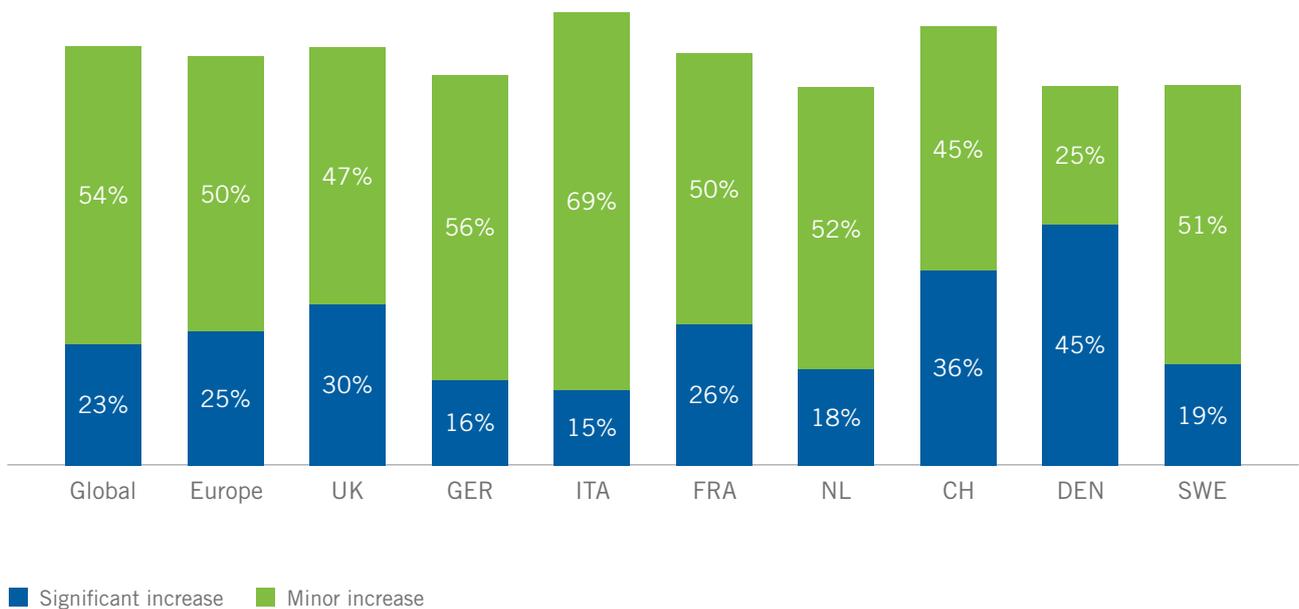
Source: NMG Consulting, June 2019.

This is an important change in how advisers framed the trade-offs involved in responsible investing. The traditional view was that a more constrained investment universe typically associated with responsible investing (see Theme 3) must result in lower performance because of the reduced set of opportunities. But the outperformance of responsible investing products has turned this view on its head.

Rising client demand and a positive investment experience is a powerful combination in terms of influencing adviser allocation intentions. Nearly 80% of advisers said they expected to increase allocations to ESG strategies over the next two years, including nearly a quarter planning significant increases (Figure 2.4).

FIGURE 2.4

Client Assets Allocated to Responsible Investing Strategies to Increase over Next Two Years



Over the next two years, how do you expect total client assets allocated to ESG funds as a proportion of total assets to change? Sample size = 824

Source: NMG Consulting, June 2019.



**Preyesh Patel and
Fionnuala O'Grady**
ESG Analysts,
Franklin Templeton

A CONSIDERABLE BODY OF RESEARCH SUPPORTS THE VIEW THAT ESG ANALYSIS ADDS VALUE

From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance (2015),² a review of sustainability based on more than 200 academic studies, industry reports, newspaper articles and books, paints a positive story of how sustainability practices can support better fundamentals and stock performance.

The findings include:

- **26 out of 29 studies (90%)** on the subject find a relationship that points to superior sustainability practices reducing the cost of capital.
- **45 out of 51 studies (88%)** show a positive correlation between sustainability and operational performance.
- **33 out of 41 studies (80%)** document a positive correlation between good sustainability practices and superior financial markets performance.

2. Source: Arabesque Partners and Oxford University, From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance, 2015. Most recent data available. Data based on multiple studies.



THEME 3

RESPONSIBLE INVESTMENT APPROACHES

ADVISERS ARE INCREASINGLY EMBRACING ESG-INTEGRATED PRODUCTS

- Advisers are familiar with responsible investing; most understand terms such as ESG, SRI and impact investing.
- 86% have already allocated to ESG products, compared with 62% allocating to SRI funds and 57% to impact investing funds.
- European advisers may benefit from European Commission programs to standardize and regulate ESG definitions and practice.

The different approaches to responsible investing all aim to achieve a similar goal: to bring investing into alignment with the personal views or mission of the investor. An adviser recommending a responsible investing product or strategy usually has three different approaches to choose from:

- **Socially responsible investing (SRI)** – a first-generation approach implemented by screening out controversial investments that fail to satisfy investor-designated non-economic environmental and/or social beliefs and values.
- **ESG integration** – now the dominant approach with advisers, featuring the incorporation of ESG-related inputs into the analysis of securities and the investment process, resulting in a unified but fundamentally different approach to asset selection and allocation.
- **Impact investing** – a more assertive niche approach, in which targeted investments are tied to advancing specific outcomes (for example, micro-finance initiatives in the developing world).

The first generation of products typically existed as socially responsible investing or “SRI” products. These featured portfolios (usually equities) with a negative screen that removed offending “sin” stocks in sectors such as tobacco, alcohol, gambling and munitions.

Many advisers continue to use these first-generation SRI products (62% globally), which to some extent continue to shape perceptions of responsible investing.

From the late 1990s onwards, newer generations of responsible investing products have typically incorporated ESG metrics into the analysis of securities. This is part of a more integrated investment process which seeks to consider responsible investing objectives alongside financial objectives. For example, when pricing a security, analysts using ESG metrics now consider the risks associated with the effects of climate change and related regulatory change.



David Zahn
Head of European
Fixed Income, Portfolio
Manager Franklin
European Total Return
Fund*

An important part of our investment process is the integration of ESG criteria. Each issuer is evaluated on how strongly it is exposed to ESG risks and factors and how it manages these risks. In addition, we are in dialogue with companies regarding their approach to CO2 and waste management. The integration of these factors can help to reduce risks and increase returns in the long term.

*A Sub-fund of Franklin Templeton Investment Funds, a Luxembourg-registered SICAV (“FTIF”).

Some sectors, such as oil and gas, power generation and coal mining, carry the risk of holding “stranded” or devalued assets if they were to come under stricter environmental legislation in a climate-constrained world. ESG metrics also seek to put a value on a corporation’s social license to operate – and the risks of losing it, such as when a bank is fined for misconduct.

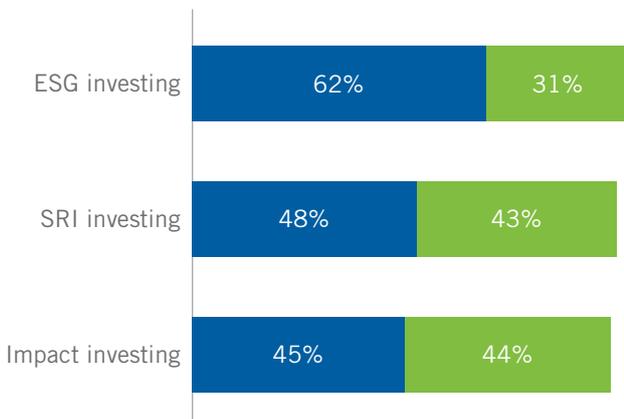
Impact funds emerged in the late 2000s to seek investment returns in lock-step with advancing specific non-financial benefits. Impact investing includes more focused investments in asset classes such as equities, bonds, and alternatives (particularly infrastructure) which generate environmental, social, or governance benefits as well as a satisfactory investment return.

This category can also include investment in specific instruments such as green bonds, blue bonds, sustainable bonds, and other similarly structured investments. These securities typically provide a return which is linked to specific responsible investing outcomes.



FIGURE 3.1

Adviser Awareness of Responsible Investing Approaches



Advisers are generally aware of the range of responsible investing approaches available to them – 93% of respondent advisers were aware of ESG investing, 91% were aware of socially responsible investing, and 89% were familiar with impact investing (Figure 3.1). The first category – ESG Investing – best reflects current product usage for client portfolios.

■ Very familiar ■ Somewhat familiar

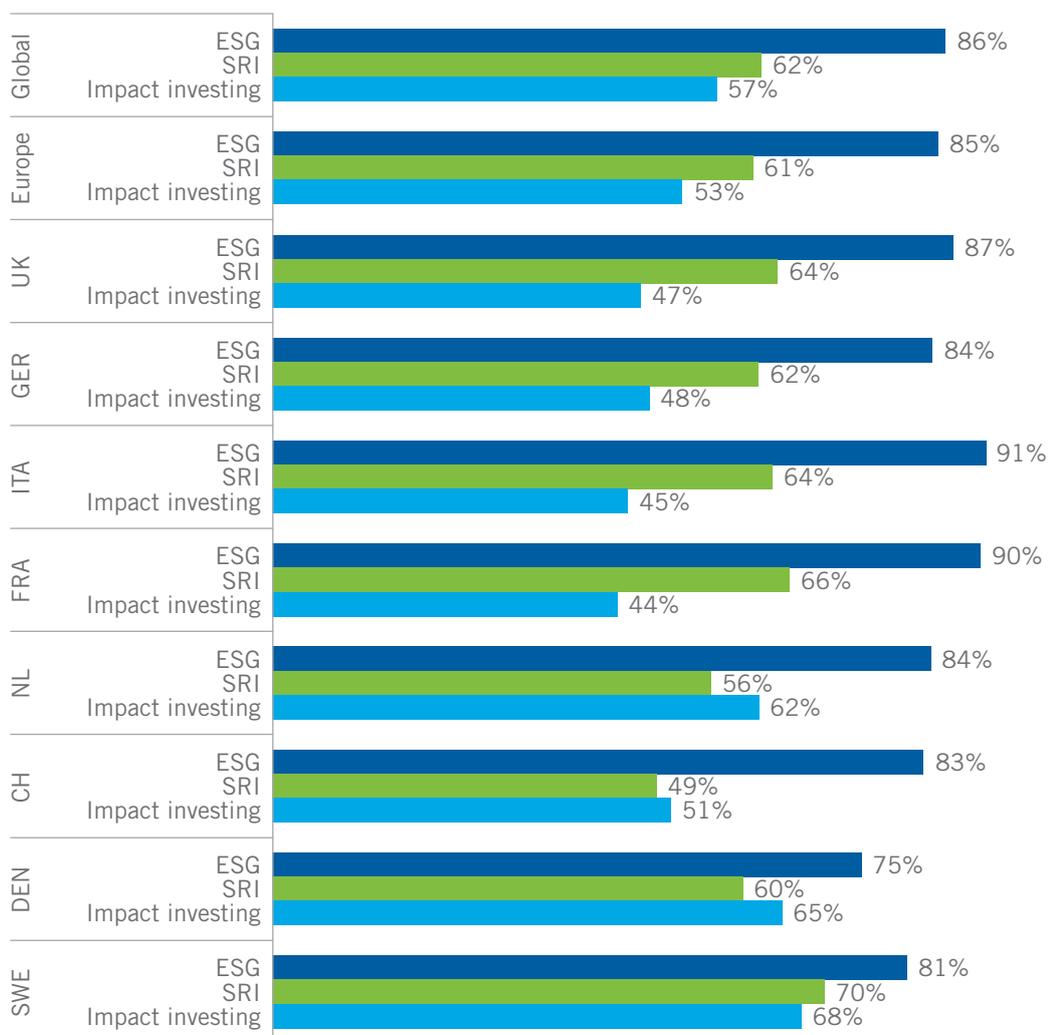
Indicate the extent of your agreement or disagreement with each statement below when it comes to ESG, responsible, sustainable or impact funds. Sample size = 824

Source: NMG Consulting, June 2019.

This can be seen in terms of adoption. Some 86% of respondent advisers have allocated to ESG products, compared with 62% allocating to SRI products and 57% to impact products (Figure 3.2). Impact investing products are most commonly used in Sweden, Denmark and the Netherlands, and have overtaken SRI product usage in the latter two countries, reflecting the more advanced stage of adoption in these markets.

FIGURE 3.2

Responsible Investing Products Used by Investors



In which of the following types of responsible funds, if any, do you currently have clients invested? Sample size = 824

Source: NMG Consulting, June 2019.



In an effort to provide more consistent and transparent definitions and support the adoption of responsible investing, regulatory authorities across the world are looking to develop more consistent terminology. The European Commission, for example, is moving to enforce an industry standard taxonomy when it comes to sustainable finance.

It is likely that the formalization of this new taxonomy will help advisers understand the reach of different responsible investing approaches, while also helping investors identify and understand investment opportunities. By the end of 2020, companies will be required to disclose their approach to the integration of some ESG factors, and will have to explain what they have done to mitigate those risks – and why, if they have not done so. Greater transparency regarding ESG risks will not only better educate investors, but also frame the investment case for responsible investment.



Julie Moret
Global Head of ESG,
Franklin Templeton

ESG factors are a set of performance indicators that provide a measure of sustainability to assess the future preparedness of issuers to manage longer-term strategic risks. Strong ESG performers will be better placed to reshape competitive advantage and, ultimately, create long-term value for investors.



THEME 4

MORE ESG PRODUCTS WANTED

ADVISERS WANT MORE ESG INVESTMENT PRODUCTS

- Advisers are relatively well served with responsible investment products, but would like more options.
- Within product categories, there is preference for active management over passive, and domestic over global, partly reflecting the desire to present clients with compelling responsible investing narratives.

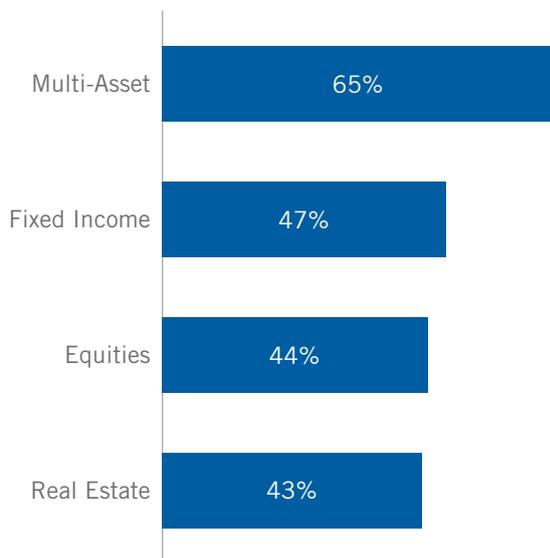
Advisers are not short of responsible investment products to choose from, but there is a significant gap in terms of satisfaction. Nearly half of all respondents (Figure 4.1) see the need for better products in all key categories.

Advisers are keen to see responsible investing values incorporated into the full suite of asset classes and for a full product range to be available. Advisers want to be armed with credible products across the full range of asset classes to meet client demand.

In terms of where investments are made, more than 40% of responsible investing assets are placed in domestically focused products; 29% are allocated to regional products; while another 27% are in global products (Figure 4.2). This is broadly consistent with traditional home-market preferences of advisers.

FIGURE 4.1

Extent of Responsible Investing Product Availability

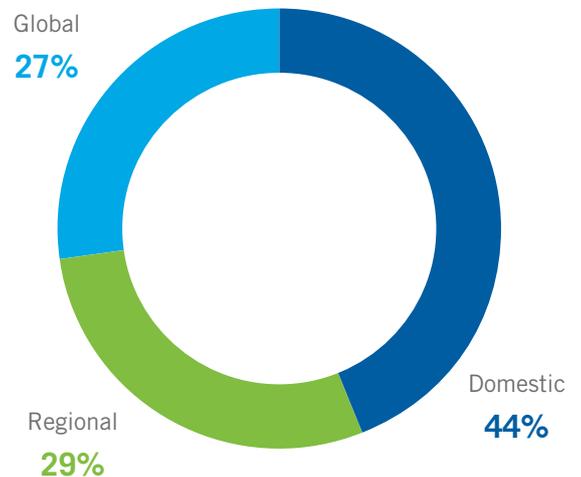


Please indicate how extensive or limited you feel the ESG, responsible, sustainable or impact investment options are that are currently available for each of the following asset classes? Ideally, which asset classes would you like to see better represented when it comes to ESG, responsible, sustainable or impact funds? Sample size = 824

Source: NMG Consulting, June 2019.

FIGURE 4.2

Allocations to Responsible Investing Funds by Geography (Average % of Assets)



■ Domestic ■ Regional ■ Global

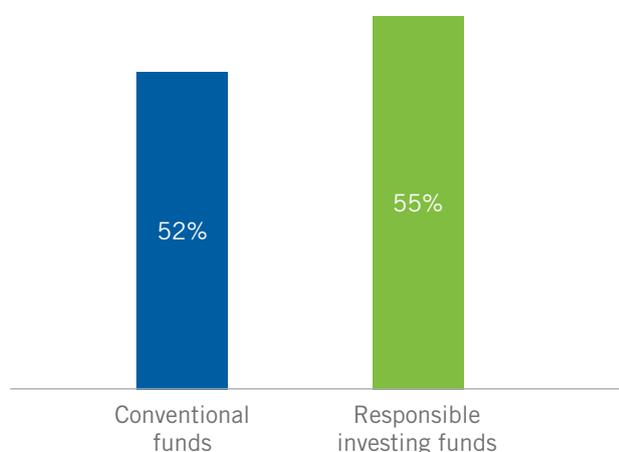
How are your ESG, responsible, sustainable or impact funds allocated by geography? Sample size = 824

Source: NMG Consulting, June 2019.

In terms of management style, 55% of responsible investing assets are actively managed, slightly higher than the 52% of assets which are actively managed in conventional products (Figure 4.3). This supports a developing view within the market that active management can add value as part of a sophisticated strategy for ESG integration. These preferences partly reflect typical underlying allocations of many advised retail portfolios, but also the desire of advisers to present clients with compelling narratives and stories.

FIGURE 4.3

**Allocation to Active Management
(Average % of Assets)**



Thinking about your total client assets invested to ESG, responsible, sustainable or impact funds, what percentage of these assets are actively managed? Sample size = 824

Source: NMG Consulting, June 2019.



Maarten Bloemen
Portfolio Manager
Templeton Global
Climate Change
Fund*

We think companies actively trying to meet realistic emission-reduction targets that are grounded in science could create potential opportunities for value investors like us. Especially companies that are transitioning to a lower-carbon economy. We favor three types of companies that we think hold climate change and value opportunities:

- **Climate-change solutions** – solar panels and wind-turbine manufacturers, which provide clean and renewable energy.
- **Companies in transition** – energy companies reducing their contribution to global warming by switching from non-renewable to renewable energy sources.
- **Transition-resilient** – companies with low carbon intensity, or little exposure to carbon-intensive sectors, such as retailers, bio-pharmaceuticals and telecommunications firms.

*A sub-fund of Franklin Templeton Investment Funds, a Luxembourg-registered SICAV ("FTIF").



CONCLUSION

RESPONSIBLE INVESTING IS RAPIDLY GAINING TRACTION WITH ADVISERS AND RETAIL CLIENTS

As ESG issues enter the public domain, people are responding by changing their behavior and consumer patterns, and by extension, to the way they invest. This trend will likely accelerate as new regulation favoring responsible investing is introduced by governments and adopted by the financial services industry.

The influence of this new generation of clients will grow as they accumulate wealth. Advisers cannot be indifferent to this trend. Those who best serve their clients in this area will be best placed to capitalize on the opportunity offered by responsible investing. To do so, advisers will need to build up their expertise and learn to link their clients' motivations and values to their investment goals.

Responsible investing is an opportunity to engage clients with their long-term savings goals and build stronger adviser-client relationships. It could even be an effective driver of investment

flows, with engaged clients who believe their investments are invested in a responsible way potentially more motivated to make further investment contributions.

Responsible investing products are becoming more prominent in the adviser toolkit and experiences to date have been positive, with many advisers reporting that their responsible investments have delivered superior performance. So far, product availability has not been a major obstacle to adoption. However, as responsible investing goes mainstream, advisers are looking for a wider range of products to satisfy the needs of a broader set of clients.

With advisers no longer seeing responsible investing as a niche market, their main wish is for a broader selection of products that integrate outstanding investment capability, with ESG considerations across a full range of asset classes and investment strategies.

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