Signatory of:

PRI Principles for Responsible Investment

Sparinvest

Responsible Investment Review
Edition 2 2019

Content

PRI Report 2019 – 5 years of top grades…and improving

PRI Scoring Modules	Sparinvest 2019	Median 2019	Sparinvest 2018
Strategy & Governance	A+	A	A+
Listed Equity Incorporation	A+	B	A+
Listed Equity Active Ownership	A	B	A
Fixed Income SSA (Gov Bonds)	A+	B	A+
Fixed Income Corp (non-Financial)	A	B	A
Fixed Income Corporates (Financial)	A+	B	A
Fixed Income Securitized	A	C	A

Source Sparinvest: The 2019 PRI Assessment scores shown are extracts from the full UN PRI Assessment Report 2018-19 for Sparinvest Group which, available at Sparinvest.lu.

We are pleased to report that, for the fifth consecutive year, Sparinvest has received the top assessment score of A+ from PRI for its overall responsible investment approach. (Strategy & Governance.) In addition, we have maintained strong scores of A or A+ for our implementation processes in each of the asset classes that we manage, with an improvement in the score for Fixed Income (non-financial) corporate bonds from A to A+.

We believe that the PRI Transparency reporting system offers the most comprehensive insight into different management groups' responsible investment policies and activities.

Shareholder Rights and Stewardship

Amendments to the EU Shareholder Rights Directive now require asset managers to publish their policies on active ownership (engagement and voting). Sparinvest's Stewardship Policy is available on our websites. It describes our processes for: monitoring investments, deciding which companies to engage with, escalation, voting, managing conflicts of interest, collaborating with others and reporting to clients on active ownership outcomes. Our website also provides full transparency on our voting activities.

Compliance with a national stewardship code is also a strong indication that an asset manager takes its active ownership duties seriously. Sparinvest complies with the Danish Stewardship Code.

Sparinvest's RI Toolkit

It is perhaps worth spending a little time examining the key characteristics of an approach to responsible investment that has achieved A+ scores from PRI since scoring began. Sparinvest principally uses three tools to implement responsible investment – ESG integration, Stewardship and Exclusions. These are used with slight variations across the asset classes we manage, and we explain this in our Responsible Investment Policy. The asset classes where our RI toolkit is deployed most rigorously in pursuit of sustainable returns for clients are our active, fundamental equity and bond funds. Here, we consider ESG issues throughout the investment cycle – from idea generation & security selection, analysis, valuation, portfolio construction, and day to day monitoring of portfolios and risk – until the day we sell.

Focus on ESG Integration

Our long-term investment philosophy and focus on fundamental analysis to understand the drivers of each investment case, means that environmental, social and governance factors naturally feature significantly in our investment processes for actively managed funds. Indeed, we see the integration of ESG issues in our investment process, along with our stewardship programme (both voting and engagement), as being part of our fiduciary duty to deliver strong returns for investors.

This means looking at ESG-related risks and opportunities at the individual security level, and also considering the impact of broader themes which may impact on values across an entire sector, country, or the portfolio. We work to understand the ESG issues faced by a company, and assess the implications for corporate value and whether risks are adequately compensated. We consider how stewardship can be used to nurture corporate value and to encourage improvements in sustainability.

The ways in which ESG risks can affect investment decisions for active funds include: a decision not to invest, a decision to invest at reduced weightings or a recalculation of fair value - the target price readjusted in the light of the investment risk.

Below, we give some examples of some of the different ESG issues that we have considered during 2018, and how these have affected investment decision-making. We begin with a couple of examples of companies rejected for investment on ESG grounds, and continue with examples of companies where we recognise significant long term ESG opportunities.

ESG Integration Examples – Equity Funds

Use of plastics in the circular economy

From an ESG point of view, the plastic industry is a target for a lot of scrutiny - especially due to the environmental impact of single-use plastics. Clearly, there are opportunities for companies that really focus on the circular economy – helping to ensure that materials are used as long as possible, and maximum value is extracted from them. Certain uses of plastic can even be beneficial to the environment. For example, in the automotive industry, plastics can have a clean tech application. Plastic components can reduce vehicle weight, and thereby lower conventional vehicle emissions or extend the travel range from a single battery charge for electric vehicles. At the same time, there are risks for companies that do not recognise where sustainability trends are taking us; the increasing amount of legislation – especially in Europe – seeking to ban or limit plastic packaging and single use products as well as the significant shift in consumer awareness about the plastics issue leading to a preference for minimal packaging.

So, when we analysed a Chinese company that manufactures machinery for the production of plastics, we naturally wanted to understand which underlying industries it was supplying and whether the changing environment presented them with opportunities, or challenges. In our initial analysis, we noted that the company had exposure to both the automotive industry and to the plastic packaging industry. We therefore sought dialogue with them to better understand their awareness of how sustainability trends could affect the different parts of their business – whether their machinery could be adaptable to more biodegradable alternatives, and what strategy they would adopt to respond to new legislation and shifts in consumer behaviour.

Impact on investment decision

Based on our dialogue with the company, we were able to estimate that about 25% of their sales went towards the automotive industry to make auto parts, and 25% went into the home appliances industry. The remaining 50% was mixed between medical products, packaging, toys etc.

Our conclusion was that the risk associated with the company was too high, both from a regulatory and an environmental point of view, given the large portion of their revenue potentially exposed towards single-use plastics. In the end, we decided not to invest in the company on the back of our ESG-related concerns.

Joint venture exposure to controversial weapons

We looked at a French auto components manufacturer as a potential investment. The company specialized in products for emissions reduction and the use of plastics for making vehicles lighter. Because of this product exposure, we initially looked at the company positively from an ESG point of view.

However, during the final stages of our investment analysis we learned that the company was engaged in a joint venture to produce fuel cells for passenger vehicles. The partner company in this joint venture partner turned out to be a weapons manufacturer that had recently acquired a company that produces cluster munitions.

Impact on investment decision

We have a zero tolerance for investing in companies that are engaged in controversial weapons, such as cluster munitions.

After our initial discovery, we consulted with one of our ESG-focused service providers to get their opinion on the matter.

From our analysis, it was clear that our target company was only connected to the weapons manufacturer through their joint venture, and our service provider found no evidence of other business relations that would expose the company to the manufacturing of weapons.

However, due to the financial link through the joint venture, we decided not to invest in the company due to what we considered to be its close proximity to a weapons manufacturer with cluster munition products.

ESG Opportunities - Green Energy

ESG integration means looking at both risks and opportunities to see how these might impact on an investment case over the longer term. For example, when looking at the energy sector, we consider risks like stranded assets, high carbon emissions, and failure to adapt for climate change. On the positive, we consider opportunities in the energy sector created by new legislation and market demand.

The transformation to green energy is high on the political agenda in many countries in order to reach energy decarbonisation and climate transition goals set out in the Paris Accord. This is especially the case in Europe where the EU's 2030 Climate and Energy Framework sets a target of at least a 32% market share for renewable energy by 2030. That equates to around 55% of electricity production coming from renewables by 2030. At present, wind energy accounts for 12% of Europe's electricity. In future, however, thanks to its cost-competitiveness and scalability, wind is uniquely placed to play an increasingly important role in Europe's green energy transition.

Another company that we considered for investment for its value characteristics during 2018 was an Italian company which is one of Europe's market leaders in installing offshore wind farms and supplying the electrical cabling to connect them to national grid networks, thereby enabling the transition away from fossil fuels.

On behalf of its customers, this company facilitates the connection of the windmills to the grid in a cost effective manner and offers high technology solutions to help reduce the capex cost of renewable energy projects.

Impact on investment decision

It is estimated that 15-20% of the company's order backlog for energy projects during 2010-2015 came from windmill projects and hence this is a significant business for the company.

Electrification overall is the driver for the company's core business, which is also in line with achieving the green energy transformation. We saw ESG opportunities in the fact that the company is positively exposed to renewable energy and electrification weighted positively in our investment conclusion, which was to invest.

More opportunities in the green energy service industry

Another company that appeared on our value radar was a Belgian marine engineering company. Over the years, the company has evolved from offering low value-added contracting services to offering higher value-added activities in marine engineering, especially in the installation of offshore wind farms. During our analysis, we concluded that the growth prospects for offshore wind farms are above 10% per annum for the next decade, with high barriers to entry. We therefore, liked the exposure to this industry.

Looking at the company specifically, we also found the competitive positioning strong. The company had, at an early stage, shifted away from oil and gas projects towards offshore wind farms, through upgrading of its fleet. Its relatively young fleet, not only enables the company to take on projects that are more attractive, it also gives them a competitive advantage because of energy efficiency.

Impact on investment decision

During a peer comparison, we decided to invest in this company instead of some of its peers. The main reason being the relatively higher exposure of its order book to the attractive offshore wind industry. This also gave the company a relatively stronger earnings and cash flow outlook than its peers.

We were also attracted to its relatively long track record with some of the leading players, which gave us confidence in the downside scenarios, as the offshore wind market remains a relative young and rapidly-developing industry.

ESG Integration Examples – Bond Funds

When we talk about ESG integration in the investment process, we refer to the entire process from pre-investment to sale. This means that in monitoring our holdings, we are continuously alert for any deterioration in the investment case that may occur as a result of the appearance of new and material ESG risks. In the two examples below, we look at the investment decisions taken when ESG controversies affected two companies in our bond funds.

Health & safety breaches in the food industry

In 2018 we were monitoring one of our portfolio companies operating in the food industry, which had been flagged for social risks related to potential labour rights violations. In the country where it operates, the company has been cited by the national Occupational Safety and Health Administration regulator for several alleged serious occupational health and safety breaches at its food production units.

The company has provided details of a plan to improve safety performance. However, new allegations against the company keep arising. We had previously divested from the company in our ethical strategies because we considered the risk for labour right norm violations was high, and we kept monitoring the engagement of our service provider on our behalf.

While the company has been responsive to the engagement, the information it has provided does not yet seem to indicate substantial evidence of meaningful changes and transparency over their improvement plan and its efficacy.

Impact on investment decision
We decided to divest our holdings in all remaining bonds of the company as the norm violation risk still exists and the ESG profile of the company is weakened due to its weak response to high social risks and the apparently insufficient and ineffective measures taken to address serious allegations.

Potential involvement in large tax scandal

In the fourth quarter of 2018, allegations were made about a financial corporate issuer that we were invested in for several of our bond funds. The allegations implied the company might be involved in a very large tax fraud scandal. The allegations were not verified, and the complexity of the case was high, which meant that further investigation and a fact-finding analysis was warranted.

We contacted our screening service provider, asking them to review the company in light of the new information and to provide an updated screening assessment in relation to our ethical criteria. Internally, we were not convinced that the allegations against the company would ultimately be verified. We also viewed the risk of tax fraud unlikely. However, even a low likelihood of the risk materializing contributed negatively to our assessment of the fair value of the issuer's bonds because we viewed the potential impact as significant.

Impact on investment decision
Having adjusted our risk/reward profile of the company with the new information, we viewed the fair value as being impaired, and decided to divest our investments. We continue to monitor the case and wait for an answer from our service provider to clarify if the allegations are supported by facts.

Stewardship Report YTD

With the 2019 voting season largely over, we can provide an indication of results for our actively-managed funds.

Voting Statistics As at 31st July 2019 (Actively managed fundamental equities)		
Total Votable Meetings	162	
Of which voted	162	100.0%
Proportion with votes against Management.	96	59.3%
Proportion with votes against ISS standard benchmark recommendations	42	25.9%
Proportion with votes against ISS customized recommendations	19	11.7%
Total Agenda Items	2,087	
Of which voted	2,087	100%
Proportion with votes against Management.	238	11.4%
Proportion with votes against ISS standard benchmark recommendations	66	3.2%
Proportion with votes against ISS customized recommendations	43	2.1%
Shareholder Proposals	80	3.8%
Of which voted	80	100%
Of which supported	41	51.35%

Whilst we aim to vote 100% of our actively managed portfolios, our ability to do so is partially dependent upon market rules regarding Power of Attorneys, and timely communication from our service provider and custodians.

The table below gives an indication of the types of issue where we most commonly voted against management.

Issue	% of votes against Mgmt
Reorganisation/Mergers	2.1%
Routine/Business	9.2%
Capitalization	14.3%
Directors Related	47.5%
Non-Salary Compensation	13.0%
Anti-takeover Related	1.7%
Shareholder Proposals	12.2%
Total	**100.0%**

Collaboration with others

Two of the six Principles for Responsible Investment encourage collaboration with others.

- **Principle 4**: We will promote acceptance and implementation of the Principles within the investment industry.
- **Principle 5**: We will work together to enhance our effective-ness in implementing the Principles.

Collaboration can take numerous forms. Examples include our longstanding supra company engagement with the Sustainable Stock Exchanges initiative, or more recently, our involvement in an engagement aiming to strip out controversial weapons manufacturers from all mainstream indices.

Collaboration can mean participating in industry working groups and Sustainable Investment Forums. It can mean working with NGOs to improve understanding and with reporting standards companies to improve ESG disclosure. Of course it can also mean speaking at – or hosting - industry events, something we do regularly.

In June, Sparinvest's Credit team hosted a very interesting event in Copenhagen to consider the unique and complex ESG challenges faced by one of the world's largest oil and gas companies in a post-Paris investment environment.

Industry Event with Rosneft

Having previously been in contact with Rosneft to enquire about certain ESG issues, Sparinvest had found the company to be very open and forthcoming. Rosneft's management has, in recent years, focused strongly on improving the company's ESG performance and reporting. It was Sparinvest's assessment that Rosneft's higher degree of transparency and openness had not reached the market. We felt it would be beneficial for investors to hear more on this subject. So we invited Rosneft to address investors in Denmark at an event that included ESG rating agencies. It was an opportunity for Rosneft to give some concrete information and examples of how they had handled past ESG issues, and to report on their development and future goals. The aim was to facilitate an exchange of views about ESG risks and issues in the oil and gas sector generally between a producer, institutional investors and ESG rating agencies.

As previously noted, The Paris Agreement and the global focus on the threat of climate change have resulted in urgent efforts by policy makers to direct investment flows towards the green energy sector. In turn, they have also had a major impact on the way investors' perceive ESG risks in the traditional oil and gas industry.

Increasingly, the public debate focuses on the exclusion of oil and gas companies from investment portfolios. However, the Paris Accord also recognizes that there must be a 'just transition' towards achieving climate change goals, and that the process will take time. Meanwhile, we remain reliant on traditional oil and gas companies to meet the global growth in energy demand.

Sparinvest continues to engage with Rosneft on environmental matters and prefers to maintain a respectful confidentiality while engagements are ongoing. Therefore, no specific details on this engagement case will be given until it is concluded.

Regarding this individual event, however, we are satisfied that it was successful in raising awareness of how investors can use active ownership to encourage companies to work with ESG issues to improve sustainability. We felt that the knowledge shared reduced the gap between perception and reality regarding the challenges faced by producers in the oil & gas industry.

CSR Policy

Sparinvest's updated CSR Policy (available in the About us/Governance section of our websites) describes our philosophy and values, our governance structures and policies, our attitude to sustainability and to our stakeholders and our contribution to society in general. In short, it describes our culture and how we work together with shared values.

Yours sincerely

Responsible Investment Committee