Responsible Investment Review
November 2018

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A look at Sustainability Ratings

At Sparinvest, our responsible investment approach is built on our conviction that environmental, social and governance opportunities and risks can have a major impact on long-term returns, and that it is therefore an essential part of our duty to clients to consider ESG issues in our investment processes.

With EU legislation set to ensure that ESG considerations are introduced into all parts of the financial system, interest in the area of responsible investment is growing significantly, and we now receive notably more enquiries about our approach. At the same time, we also receive enquiries about how we score in externally assessed ratings. Again, we believe that EU plans will likely put more focus on such ratings. This is why we want to take a look at the pros and cons of the types of sustainability-focused rating systems currently available. At the most basic level, they fall into two groups: those that focus on manager processes and those that focus solely on fund holdings.

The fund manager process-focused ratings (of which the PRI Assessments are the best-known example) consider how asset managers tackle ESG opportunities and risks in their investment processes, and how they work with investee companies - through voting and engagement – to help them to exploit their ESG opportunities and mitigate risks, with the aim of creating long term value for investors. PRI ratings are based on a process of self-declaration via the annual signatory transparency reporting exercise. Self-reporting is obviously not ideal, but PRI is planning to address this in future through increased focus on assuring responses, highlighting examples of best practice and delisting signatories whose responses are inadequate.

Fund level rating systems (of which the Morningstar sustainability globes are the best-known example) ignore the fund managers' processes. Instead they focus on fund content, giving each holding in a portfolio an ESG score, and then amalgamating those scores to give a 'fund ESG score'. We discuss both below, but generally find that Morningstar Globes and other holdings-based rating systems, whilst offering the allure of simplicity, are ultimately too simplistic. Their methodology can create scoring biases.

PRI Assessment

Launched in 2005, PRI is the world's leading organization for promoting responsible investment and is supported by 2,000 signatories representing AUM of over US$ 70 trn.

PRI Assessment Scores 2018

PRI Scoring Modules	Sparinvest 2018	Median Score 2018	Sparinvest 2017
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	B
Fixed Income Corporates	A	B	B
Fixed Income Corporates	A	B	B
Fixed Income Securitized	A	C	C

Source Sparinvest: The 2018 PRI Assessment scores shown are extracts from the full UN PRI Assessment Report 2017-78 for Sparinvest Group which, available at Sparinvest.lu.

Annual transparency reporting is a requirement of PRI signatories and is achieved by completion of an in-depth questionnaire, divided into standardized modules which enable asset managers to describe how they invest responsibly across different asset classes. This, in turn, enables PRI to compare responses and deliver peer-based assessments.

In July 2017, PRI established its 'Data Portal' - an industry resource where all signatory reports are available to view online. This is increasingly becoming the 'go to' place for asset owners to conduct asset manager searches and monitoring.

Whilst acknowledging that PRI reporting is based on self-declaration, asset managers are encouraged to give concrete examples of how ESG issues have affected investment decisions and of how they have used active ownership – proxy voting and engagement to encourage greater awareness of ESG issues at investee companies.

Naturally, we are delighted to maintain a solid track record in our PRI assessment scoring, particularly because the PRI ratings are among the few that are based on an in-depth consideration of exactly what asset managers do to invest responsibly. As can be seen from the table above, Sparinvest's overall RI approach (which is reported in the Strategy and Governance module) has been assessed with top marks from PRI – actually for the fourth year in a row. (A+ is the top mark available.) We scored a similar A+ for ESG integration and Fixed Income SSA, with straight A's across all other modules.

One thing which is evident at a glance is the improvement in our fixed income scores since last year. This is due to an increased focus on ESG integration and engagement in this asset class, backed up by strong policies and regular reporting. Over the past couple of years of engagement by our credit team, it has been encouraging to see that portfolio companies have shown themselves responsive to the concerns of creditors.

Morningstar Sustainability Globes

As mentioned above, we are also increasingly asked how our funds perform in terms of the Morningstar Sustainability Ratings. Here we want to sound a warning note to investors.

Morningstar's globe system, introduced in 2016 was heralded by them as: "A reliable, objective way to evaluate how investments are meeting environment, social, and governance challenges." But the jury is still out on how useful this independent measure actually is in terms of evaluating sustainability outcomes. For sure, the Globes create focus on sustainability. They take a 'holding based approach' and provide a weighted average of portfolios' ESG scores – as supplied by a single research provider – Sustainalytics – whose methodology awards higher points to companies with better ESG profiles and deducts points for involvement in ESG controversies. Thus funds investing in companies with good ESG profiles (as judged by Sustainalytics), and avoidance of controversies, will get a higher number of globes. One key issue here is that other research providers may reach different conclusions to Sustainalytics about the ESG profile of a given company or about the extent of its involvement in a given controversy. Another issue is whether a fund should be rewarded with a higher sustainability score if it divests in reaction to a controversy rather than engaging with company management to try and mitigate future risks – an equally valid, and responsible reaction, and often the preferred response of long term and impact-seeking investors.

A number of criticisms have been levelled at the Sustainability Globes system, with the result that Morningstar have recently announced changes to their methodology. One lingering criticism is that small cap companies, even if they have an excellent record on environment, can often receive lower governance scores due to limited resources, making their overall ESG score unduly low.

From Sparinvest's viewpoint, however, the main criticism is that the holdings-based approach says nothing about the Fund Manager's process in implementing responsible investment. Morningstar has said that if they can't get independent proof that engagement is happening, and effective, they can't put it into an indicator. Therefore Fund Managers get no credit for the degree of active ownership that they exercise to encourage improvement in companies with poorer ESG profiles. Nor is their sophistication, commitment, culture and investment strategy recognised. Therefore investors who seek to have impact with investments do not get the information that they need from these ratings in isolation. For this reason, we would encourage clients to talk to their asset managers, and question them about their engagement practices – to build a real understanding of what they do.

LuxFLAG and LGX

As a member of the Responsible Investment Committee of the Association of the Luxembourg Fund Industry (ALFI), Sparinvest was instrumental in helping to develop the LuxFLAG ESG label. This label is designed to reassure investors that any Investment Fund bearing it actually incorporates ESG (Environmental, Social, Governance) considerations throughout the entire investment process. The eligibility criteria for the LuxFLAG ESG Label require applicant funds to screen 100% of their invested portfolio accord-ing to one of the ESG strategies and standards recognised by LuxFLAG. Each year, the label must be renewed and the fund portfolio is subject to a stringent review process which also considers whether ESG issues are being addressed through engagement.

One measure of the increasing recognition of the LuxFLAG label is that it is one of the approved labels required by the Luxembourg Green Exchange before a fund can be listed in the ESG window of the Luxembourg Green exchange. Thus, in October, our Sparinvest SICAV - Value Bonds - Global Ethical High Yield became the first fund investing in mainstream high yield corporates to be listed on the LGX

Some Examples of ESG Integration

In past editions of this newsletter, we have given examples of how we integrate ESG analysis into our investment decision making. Below, we look at two recent examples where product quality (classed as a social issue) was an important consideration in our stock analysis. We also give an example of ESG integration in credit analysis.

Decision not to invest for Social reasons

We were considering investment in a tyre manufacturing company which appeared to have a generally good profile from an ESG point-of-view. However, in the business of tyre manufacturing, we are aware that the need for product quality is an absolute must. Tyres that do not meet industry quality standards can potentially result in vehicle accidents that can be fatal for passengers as well as bystanders.

It became evident during our investment analysis of the tyre manufacturer, that they had had some product quality issues in the past. We became aware of this through both reading the financial statements of the company and through the ESG re-search performed by our service provider, MSCI. Besides that, during the analysis phase of our investment process, the company was also involved in lawsuits regarding accidents involving vehicles using their tyres.

In total, we estimated that the potential cost of lawsuits and warranty payments, due to insufficient product quality, could have a financial impact worth several million USD. Eventually, we opted not to invest in the company, not solely because of ESG issues, but with these concerns factored into the overall decision-making process.

Decision to invest with conservative valuation

We analysed an Indian maker of generic pharmaceuticals, for potential investment. Among the various ESG issues we considered, product and facility safety dominated. Within pharmaceuticals, product safety is a paramount consideration, and particularly within the generic space, issues of manufacturing quality and product safety can have significant impacts on companies' reputation, revenues, and corporate value - both in the short, medium and long-term. The Indian generic sector overall has significant revenue exposure to the US, and as such the makers' facilities are subject to FDA inspections. This includes both regular inspections, and inspections related to the filing of new ANDA applications. In recent years, the sector has experienced some issues with these inspections; while many inspections may lead to minor issues being flagged, they can also lead to more serious warning letters and plant closures. We therefore spent considerable time analysing these issues, and the specific company's track record. We did this using written sources, but also in discussion with the company itself, and other analysts.

The company had in fact been among the first companies in the sector to receive FDA warning letters, in 2010-11, when it remained a relatively small company. This experience triggered a robust response from the company, which has since taken a stubborn approach to quality. It was noted that in 2016 and 2017 the company has received significant numbers of ANDA approvals, both in absolute terms and relative to peers, which may be considered one sign of strong facility compliance. We found it reassuring that the company's robust approach to compliance was leading to increased new drug approvals, which in turn provided stronger revenue opportunities. However, we recognised that is a sector which - due to the crucial importance of product safety and the ongoing scrutiny of the FDA - will always face the risk of disappointing inspection results. That, and the fact that the company had previously experienced issues - albeit responding very well to those issues - were among the factors we considered in our valuation calculations, and led us to apply discount rates and valuation multiples towards the more conservative end of the considered range.

ESG Considerations in Corporate Bonds

In late 2017 we participated in a new issue for an agricultural company from Asia Pacific. If not properly managed, the company's business operations have the potential to pose significant environmental risks at a sector level and could affect its products, services and brand reputation.

Our analysis revealed that the company is taking important steps in managing its environmental risks and is doing so relatively better than peers. From a fundamental perspective, the risk/reward profile of the investment was attractive. However, there were certain gaps in the company's environmental risk management policies and processes that – once integrated in the analysis – led to a lower recommended exposure to the company. There are still certain standards that the company has not adhered to in terms of environmental risk management and third party verifications. To get a better understanding of the company's plans to strengthen its policies and potential adherence to certain industry and client standards we decided to engage with the company. The (ongoing) engagement will aim to bring more information about the environmental policies and lead to a more thorough review of the company's risks.

Developing our Voting Approach

The three pillars of our approach to responsible investment are the integration of ESG considerations into our investment processes, stewardship, and using exclusions (to a greater or lesser extent in different strategies) to avoid certain investments. Stewardship consists of our voting and engagement programmes. We believe that using active ownership to encourage companies towards stronger mitigation of ESG risks and more active exploitation of ESG opportunities, can augment long-term investment returns.

We continually look to develop our practices further, and recently bolstered our approach to voting, in two ways. Firstly, we have updated our voting principles – which you can find in our Stewardship Policy. Secondly, based on our voting principles, we have implemented a new custom voting policy at proxy voting service provider, ISS. This means that when ISS provide us with research on upcoming corporate AGMs, their input is based on our independent criteria. This input is used to inform voting in our quant and index funds. As always, in our value equity funds (which are actively managed, fundamental stock picking funds), our investment team reviews all voting agendas, as well as the input from ISS, and then the team makes voting decisions based on our voting principles and in the interest of long-term corporate value. This means that across our equity fund range, from active to index funds, we take an informed but independent approach to voting, aligned with the long-term interests of our investors.

Voting on Board Effectiveness and Diversity

A key focus for us has always been corporate governance, and proposals related to board composition and independence. The aim is not to micro-manage companies, but to help develop strong corporate governance and help build corporate value over the long-term.

The board's role includes providing guidance, review, oversight, and monitoring, and also setting high corporate and ethical standards. Our aim is to have well-functioning boards which work in the best long-term interests of the company - for the benefit of shareholders, but also considering other relevant stake-holders, such as creditors, employees, and so on.

This means we want companies to develop boards that are able to provide independent views and counterbalances, and one of our key focusses is on the appointment of independent, outside directors – and we will vote against companies that fail to meet our thresholds. We want boards to be effective, so we will also vote against board members with poor attendance records, and against board members who serve on too many boards to be able to give enough attention to their role. We want boards to analyse their own effectiveness, and work to improve it.

We also think that it benefits boards to have membership with a diverse mix of relevant knowledge, industry experience, skills, and diversity of perspective, because this can help the board provide more effective challenge, discussion, and stronger, more objective decision making. We think in order to get a wealth of different perspectives, it is important to have directors with diverse (but relevant) professional experience – but it also helps for a board to consider its diversity in terms of age, gender, ethnicity, and so on.

There is then a practical question, of how to make this desire for diversity operational in terms of voting. It is important to have easily available underlying data, and one such area is gender diversity - it is easy to see the number of women appointed to boards. Here, as a first step, if a company fails to appoint at least one woman to the board, we will typically vote against the chair of the nominations committee, or if they are not up for election, the chair of the board – but we will seek dialogue on the issue. We think gender diversity is beneficial, but the point is not to focus excessively on one aspect of diversity. If a board hasn't managed to appoint a single woman, then this may be an indication that this board doesn't consider diversity seriously. The goal is overall diversity, and this is one tool to achieve that.

We would also add that we see voting on its own as a fairly blunt instrument. Our aim is discuss these issues with the companies, and work with them, hopefully to boost long-term corporate value.

Carbon and Climate Engagement

Investors in our ethical funds will be aware that we have been measuring their carbon footprints since signing them up to the Montreal Carbon Pledge in 2015 and the trend has, pleasingly, been downwards since we began measuring. However, the funds' sector exposure can change quite significantly over time and evidently some sectors are more emissions-heavy than others. For this reason, Sparinvest does not have a quantified CO_2 reduction target. Instead, we have promised to focus our efforts on understanding carbon and climate risks at individual holdings with a view to engaging to drive improvement.

We are therefore pleased to report that we have now begun a significant carbon-themed direct engagement with all holdings in our ethical portfolios (both equities and bonds). The short term goal of our thematic engagement is a better understanding of companies' awareness and attention to climate risks and opportunities and the governance structures involved in managing these risks. Over the medium and long term we strive to impact corporate value and the portfolio carbon footprint whilst recognising that this will always be influenced by sector exposure and whether we find value in sectors that are carbon-heavy or carbon-light.

Climate Action 100+

The Climate Action 100+ initiative is underway. This global collaborative engagement will now target 161 companies identified as being the world's highest greenhouse gas emitters and there-fore least likely to be compliant with the Paris Agreement goal of limiting global average temperature increase to well below 2oCelsius above pre-industrial levels.

Climate Action 100+ should really pack a punch, given that it is backed by 280 institutional investors representing combined AUM of $30 trillion. The companies targeted have significant opportunities to drive the clean energy transition and help achieve the goals of the Paris Agreement. A website dedicated to the initiative has been set up at http://www.climateaction100.org/. Here you can find a list of the companies being targeted and a list of the participating investors. As and when target companies make new commitments to taking positive climate action, these will be uploaded to the website. We are not allowed to reveal which company/ies Sparinvest will be engaging with until the end of the process.

Supra-Company Engagement

At a supra-company level, Sparinvest is proud to have contributed to the production of the a new report from the United Nations Sustainable Stock Exchanges (SSE) initiative which sets out a five-point action plan for regulators to support the Sustainable Development Goals by:

- **Strengthening disclosure** of ESG information (with the sustainable development goals being viewed as an ESG+ framework)
- **Facilitating investment flows** towards achieving the SDGs via financial products
- **Clarifying investor duties** regarding ESG integration
- Strengthening governance by promoting board level responsibility for E and S factors
- **Builiding capacity** by training market participants on sustainability topics

Read the full report here

Yours sincerely

Responsible Investment Committee