Signatory of:

PRI Principles for Responsible Investment

Sparinvest

Sparinvest Responsible Investment Review

February 2015

Sparinvest signed UN PRI in 2009.

In becoming a PRI signatory, Sparinvest committed to becoming an active owner of the securities it invests in; to incorporate ESG issues into its ownership policies and practices; and to seek appropriate disclosure on ESG issues by the entities in which it invests.

In the past two RI Investment Reviews, we have looked at ESG integration in the investment process for different asset classes.

In this edition, Nichola Marshall, Sparinvest's Head of Responsible Investment, describes Sparinvest's Active Ownership Policy.

Dear Investor

After signing the UN PRI, Sparinvest's Responsible Investment Committee began to look at who would undertake the practical aspects of active ownership - such as voting and engagement. However, in the process, we quickly realised that this additional 'non-financial' risk information could be of significant value to the investment process – not only by identifying potential risks but also by giving new insights on how companies might mitigate them.

It also became apparent that, whilst proxy voting (under instruction), could sensibly be delegated operationally, it was not logical **at all** for us to outsource company dialogue. A well-orchestrated, respectful dialogue with company management can change risks for the better and consequently impact directly on the calculation of discount to intrinsic value. Given that our portfolio management teams already had such dialogues with companies about fundamentals, it made sense to add any ESG concerns to such discussions. Such dialogue is potentially a fundamental value generator and therefore – in our view – is something that can only be undertaken by our own investment teams as an integral part of the full process.

Active Ownership – with a focus on corporate value – an essential part of Fiduciary Duty.

There are two distinct strands to Sparinvest's Responsible Investment approach. First, we have the overarching RI policy that we apply to our entire fund range. This prioritises fiduciary duty and is, above all, about nurturing long-term corporate value in our holdings by looking at all potential risks including those that are environmental, social and governance-related.

Our ethical investment approach, on the other hand, is all about prioritising the investor's values – even if this means partially restricting the investment universe through negative ethical screening. This ethical approach applies only to a range of clearly-labelled funds and mandates.

The main way in which these two strands differ is in the active ownership approach that applies to each. Active ownership is all about trying to exert influence with companies to get them to act in the best long-term interests of shareholders in particular and society in general.

There are a number of 'tools' in the active owner's armoury. These include: exclusion/divestment; engagement – which can mean both individual and collaborative dialogue – and voting.

Exclusion - the 'withdrawal of funding' approach.

Exclusion is designed to rob companies of the 'oxygen' of their financing from share- and bond-holders. Asset managers will usually seek to select investments from as broad and unconstrained a universe as possible. But there are some situations where matters of humanitarian principle or legislation demand exclusions. The price for the asset manager of not complying can be high – loss of performance, reputational damage or legal penalties. That is why, across all portfolios, Sparinvest excludes all companies involved with illegal weapons production and those prohibited for investment by EU sanctions (for instance the sanctions, which are currently in place for securities issued by certain Russian financial Institutions after August 1st. 2014)

When it comes to ethical mandates, the bar for exclusion can be set as high or low as the investor wishes it to be. For our ethical fund range, however, we use a standard exclusion formula agreed with our ethical screening service provider – Ethix SRI Investors. Thus, each of the ethical funds begins with a portfolio which has already had consideration of ESG risk factors built into its investment process. We then add to this Portfolio the overlay of ethical exclusions of companies violating pre-specified Norms or operating in certain controversial sectors. UN norms-based screening means zero tolerance of breaches of human rights, environment, labour conditions or anti-corruption norms. Sector-based screening means zero tolerance for production (and maximum 5% tolerance for distribution) of alcohol, gambling, tobacco, pornography and arms/weapons.

It is important to recognise that the result of exclusion/divestment is non-ownership of shares – meaning no further power to influence the future behaviour of a company from within. That is why the distinction between responsible and ethical investment follows through to Sparinvest's engagement policy. Ethical investment requires exclusion whereas Sparinvest's overarching RI policy advocates inclusion with dialogue.

What triggers engagement on ESG matters?

In addition to dialogue with company management regarding business fundamentals or strategy, there can be a number of reasons why we might also decide to engage with them on ESG issues. For example:

- An indication from Sparinvest's ethical screening provider (Ethix SRI Advisors) of a controversial issue related to the company
- New ESG research information
- Company AGM/EGM Voting resolutions that are controversial/contrary to shareholder interest.

If a position in a Sparinvest ethical portfolio receives a controversial issue alert from Ethix, it is indicative of a serious normative issue or critical sector activity and so triggers immediate divestment from the ethical portfolios.

However, Sparinvest's RI policy permits Portfolio Managers to continue to hold 'red alert' companies in the portfolios outside of the ethical fund range. In these cases a red alert will systematically trigger a review and engagement assessment of the holding which will most likely result in either individual or collaborative dialogue.

The challenge for a boutique asset manager such as Sparinvest is that teams are small and resources are not infinite. So, when it comes to dialogue (which can be quite time-consuming) we have to take a decision on which situations merit intervention with detailed ongoing dialogue, which merit more limited communication, and which might be more appropriately conducted as collaborative engagements.

Our Portfolio Managers choose to enter dialogue directly with holding companies, selecting on a case by case basis – only where they feel it likely that they can have impact on ESG or other fundamental issues. We call this 'dialogue with impact'.

Ethix, SRI Investors, on the other hand, undertakes collaborative engagement on behalf of numerous ethical investors with companies that fail its screening on grounds of normative issues.

Although our ESG research service providers continuously monitor for ESG concerns, major risk events can happen at any time and can't be predicted, only assessed as they arise.

Dialogue by Portfolio Managers

As long-term investors, it makes sense to us that the different RI strategic elements – consideration of ESG risks, engagement and voting – are all carried out by the investment management teams.

Ultimately, whether dialogue is about balance sheet structures, deeds of covenant or ESG issues, it's essentially about the corporate holistic risk environment, the long-term corporate value and investment returns. So to us it doesn't make sense to separate out dialogue on 'fundamentals' and dialogue on 'ESG' and allocate them to different teams within the same company. Given that our fund managers are those who know the long-term investment rationale behind each holding, they are best positioned to make decisions and carry out dialogue in a way consistent with the focus on long-term value. A useful added benefit is that such dialogue also helps to improve communication between our investment teams and the holdings and serves as a reminder to company management that they are being monitored for their attitude towards ESG risks.

Proprietary ESG Questionnaire

Sparinvest has developed its own questionnaire to give an insight into the ESG status of smaller companies where issues are not always as transparent or as well-monitored as they are with larger companies. The data received can prove useful but perhaps the biggest impact of the questionnaire is as a tool to show management that these issues matter to investors, because they potentially impact corporate value.

Our PMs often use the questionnaire as a starting point in any subsequent dialogue with company management. Even where we receive no response, we view it as useful information nonetheless – perhaps indicative of the company's attitude to governance and transparency. (It's also interesting that we get a lower response rate from companies in emerging than developed markets.)

Voting and stewardship

The voting behaviour of institutions and asset managers is increasingly coming under the scrutiny as the concept of 'stewardship' gains influence.

The concept of a 'stewardship code' originated in the UK. After the 2008 financial crisis, when people raked over the coals to see who was to blame, they realised that part of the responsibility for bad corporate behaviour lay with shareholders who hadn't exercised their votes properly. So, in 2010, a UK Stewardship Code was introduced to promote responsible voting as part of fiduciary duty.

Japan's Stewardship Code, introduced in May 2014, is central to the Abe government's corporate governance reform. As part of the broader growth policy, which is the third arrow of Abenomics, this is considered essential to increase the return on equity (ROE) of Japanese companies, which has historically lagged behind US and its European counterparts.

The European Commission's Shareholder Rights Directive, expected to become law during 2015, is designed to improve the corporate governance for companies listed on Europe's stock exchanges. The goal is to 'improve competitiveness and address the short-termism which damages European companies and the economy.' The current draft is designed to:

- Increase the level of voting and engagement on corporate governance by institutional investors and asset managers
- Create a better link between directors' pay and company performance
- Give shareholders more oversight over related party transactions (RPTs) which can result in the expropriation of value away from minority shareholders.
- Improve the transparency of the proxy voting industry and
- Improve the quality of corporate governance information.

In future this means that all institutional investors will have to:

- Disclose engagement and voting policy
- Make available their ex-post voting records
- Be transparent

We view this move as a complete vindication of everything that Sparinvest is already doing. Since 2011, our voting policy and ex-post voting records have been clearly visible on our website. Thus, in due course, we envisage no problem signing up to the Stewardship codes.

Responsible voting

Voting on the resolutions put forward on a holding company's AGM or EGM agenda is fully integrated in our active ownership process. Last year, we voted on around 90% of company resolutions. We use a Proxy Voting Service Provider (ISS) who help us analyse the resolutions, but we do not blindly follow the voting recommendation from ISS. We vote actively and deliberately and based on our own analysis. Where this analysis suggests we should vote for rather than against a resolution, (or vice versa) we will do so. We are not 'tick box voters.'

One important objective with the vote is to initiate and to influence dialogue with the company in question. Our experience is that companies are alert to the voting-decisions from their institutional investors, and very responsive to the invitation to enter a dialogue on the subject. I.e. proxy voting is a door opener to company management which is very efficient.

Voting can also be used tactically. For example, one thing that we are particularly keen to look at is anything relating to capital structure (which comes under Governance in our world). So, if there is a possibility of using voting to help the negotiations on capital allocation – we may try to do that.

Most company resolutions relate to Governance factors and it is relatively rare for Environmental and Social issues to be reflected in voting agendas. Where they are, it is often shareholder initiated, either in the form of a shareholder proposal, or in the form of a protest vote against board member appointments.

Luxembourg focuses on RI and introduces LuxFLAG ESG label

This year's ALFI fund industry conference in Luxembourg compared the Responsible Investment movement to a train which left the station a while ago, is gathering pace and has now become 'unstoppable'. According to Conference, the movement began in the Nordic nations and is now on a southerly migration, with Luxembourg and Germany now focusing increasingly on it.

Sparinvest has always clearly differentiated between its overarching Responsible Investment approach – which applies to its entire range of funds – and its smaller ethical fund range which applies an ESG exclusion screening to portfolios.

On 1st October, **Sparinvest Ethical Global Value** became one of the first Luxembourg funds to be awarded the brand new LuxFLAG ESG label which can be used by clients as an identifier of funds with an ethical investment policy.

Only three out of more than 13,000 Luxembourg-domiciled funds currently hold the brand new LuxFLAG label but many more can be expected to apply for it in future in order to service institutional clients with an ethical mandate.

Top scores in UN PRI Assessment Report

Since our last RI Review, Sparinvest has received very positive feedback from UN PRI regarding our progress, relative to peers in implementing the six UN Principles. We are delighted that our UN PRI Pilot Assessment report clearly shows Sparinvest to be an industry leader in terms of its RI policies and practices.

In our peer group of 800 Investment Manager signatories, Sparinvest received a top 'A' grade for its overarching approach to RI.

'A' grades were also awarded for Sparinvest's progress in implementing the Principles within its three main asset classes: Listed Equities, Fixed Income Corporates and Fixed Income Government Bonds. A further 'A' grade was awarded for Proxy Voting.

Noteworthy features of the Report are the maximum score of 15/15 points for ESG integration in the Equity decision-making process and the stark contrast between Sparinvest's 'A' grade in Fixed Income compared with the Peer Group Median grade of 'D' indicating that we are well ahead of the rest of the industry with regard to our RI policy for this Asset Class.

Sparinvest joins UN Global Compact Anti-Corruption Campaign

Within the UN PRI, Sparinvest forms part of the Anti-corruption Group which participates in collaborative engagement on anti-corruption and transparency issues. As such, Sparinvest has pledged its support to the UN Global Compact "Call to Action" campaign which will urge governments to fight corruption.

The "Call to Action" is an appeal from the private sector urging governments around the world to promote efficient and effective anti-corruption measures and to implement robust policies that will foster good governance.

The collective "Call to Action" letter from the PRI investment community will be forwarded to UN Secretary General Ban Ki-Moon to underscore the importance of integrating anti-corruption and good governance into the UN's post-2015 development agenda.

Changes to Sparinvest's RI Committee

The principal architect and project manager for Sparinvest's Responsible Investment Policy over the past 5 years has been Jacob Nordby Christensen.

Jacob has now taken on new responsibilities as Sparinvest's Executive Vice President in charge of international distribution. As a result of this, we have formed a new Responsible Investment Committee in which Jacob will continue to play an important advisory role. The Committee comprises:

- Nichola Marshall (Chair)
- Jacob Nordby Christensen (Executive Vice President, Sparinvest Group)
- Christian Bache Vognbjerg (RI Analyst)
- David Orr (Senior Portfolio Manager and representative of Equities team)
- Anders Christensen (Analyst and representative of Fixed Income team)

The make-up of the Committee reflects the fact that there is a robust framework already in place within Sparinvest so that ESG risk integration and active ownership are fully embedded with the Portfolio Management teams.

Looking at the six UN Principles, it could be argued that whilst the essential Principles 1-3 are integral to the investment process, and best achieved by investment professionals, the skills set required for implementing Principles 4-6 is somewhat different. These principles are more concerned with raising awareness within the industry, communicating and reporting on progress. As someone with a strong background in communications, as well as a deep conviction that ESG integration will ultimately improve both long term returns and corporate behaviour, I look forward to this challenge.

Yours faithfully

Nichola Marshall
Head of Responsible Investment