Signatory of:

PRI Principles for Responsible Investment

Sparinvest

Sparinvest Responsible Investment Review

January 2014

Sparinvest signed UN PRI in December 2009.

ESG risk analysis is now fully integrated into the investment process for all Sparinvest strategies.

Portfolio managers own the process of assessing overall company quality in the light of all potential risks.

We believe that this is consistent with our long-standing focus on fundamental risk and part of our fiduciary duty to clients.

Jacob Nordby Christensen is Sparinvest's Responsible Investment Director.

Dear Investor

Fixed Income - Sparinvest Ahead of the Curve

I would like to start this Review by looking at Fixed Income which has been a dominant industry theme during 2013. Sparinvest is a company with a Danish heritage and Denmark has a long-standing preference for bond investment. Perhaps this is why it seemed natural and obvious to us that if ESG analysis added value to the equity investment process, it could do the same for our Fixed Income strategies. Indeed, ESG risk analysis has now been embedded in our actively-managed corporate bond strategies since 2010, and in all our sovereign bond strategies for nearly two years.

From this perspective, it has been puzzling to watch the Responsible Investment community struggle with the problem of how to apply the UN Principles and ESG integration to the world's biggest asset class.

The UN Principles promote the idea of beneficial influence through active ownership of assets. Therefore, one could be forgiven – on first reading – for assuming the Principles are aimed at equity investors rather than bond holders. There is also the question of relevancy. Fiduciary duty and fixed time horizons dictate that a bond strategy should focus first and foremost on a company or nation's ability to honour its debts rather than any thought of influencing longer term policies.

But on closer reading, it is obvious that the PRI are intended to cover all asset classes, and rightfully so. We have only to look at the Greek Debt Crisis (more or less ongoing since October 2009), the Cypriot banking crisis of last year or the BP Mexican Gulf oil spill of April 2010 to realise that ESG risk events can happen to both nations and companies unannounced and with surprising speed, causing their bonds to lose value almost overnight.

And such risk events are not confined. There is often a ripple effect (the entire Eurozone in the case of Greece or Cyprus the entire energy sector in the case of BP.) Thus it is not only relevant but extremely important for investors that asset managers should consider ESG risks within Fixed Income – both for sovereigns and for corporates – to ensure that portfolio positioning has anticipated such risks.

ESG Integration in Corporate Bonds

When it comes to corporate bonds, we are typically looking at a relatively short time horizon of only 3-5 years, during which time it is difficult – but not impossible – to influence a company towards changing its behaviour. Our Value Bonds process often leads us to invest in smaller, non-benchmark companies. This is territory often unchartered by others, which means we sometimes find ourselves in a position of influence with companies that we have invested in previously when they come to issue new bonds and approach us for financing. For example, in the Energy sector, where we like to insist on a pledge of assets, we can require the pledge to be against new equipment rather than old. This has the dual effect of ensuring that the bond's asset-backing maintains value and encouraging the company to keep its equipment up to standard, resulting in a better E score.

The main reason why we find it very important to conduct an ESG assessment before handing over any money is the governance aspect. Experience has taught us that this is extremely important. We dedicate a considerable amount of time to looking deeply into corporate governance and ownership structures as well as the investor protection provided by bond documentation. We avoid investments in companies where we find any of these aspects to be opaque.

ESG Integration in Sovereigns

When you get into sovereigns territory, it is difficult to know where to draw the line because it's almost always possible to find a worrying issue at state level. For example, more than 50% of nations in the world (by population) still endorse the death penalty and in many of them, this has been mandated through democratic process. So, where sovereign investment decisions are values-driven, huge swathes of the global investment universe can quickly become off-limits.

With sovereigns our strategy is pragmatic. Our fund managers begin by analysing quantitative sovereign ESG risk data but they have the freedom to override risk warnings and invest if, based on a subjective analysis of the opportunity or newly available information, the risk is worth taking (well compensated) or has diminished. What is obvious from the quantitative data, however, is that where we see high ESG risks at state level – such as instability, UN Norm violation, or lack of a free and fair judiciary system or of free speech – we see a higher risk premium in that nation's bonds and our Portfolio Managers operate with this in mind.

For actively-managed sovereign strategies, there are no exclusions per se, but the Portfolio Manager will analyse ESG event risk systematically with every investment. Where such risk is potentially undercompensated, we are more likely to flip to a state with fewer issues. This pragmatism reflected well on Sparinvest recently when the Danish Press highlighted the issue of so-called 'blood bonds', issued by African States with poor democratic records and poor rule of law. On inspection, we found that, despite our 'no exclusions' policy, our Portfolio Managers had nonetheless avoided all investment in such bonds. No doubt this was in large part because of their poor compensation for high risk.

Further down the road, if a critical mass of sovereign bond managers were to adopt the same attitude to the importance of ESG risks, it would certainly create impact at state level, by making a poor ESG record an expensive burden for states wishing to borrow money.

Danish Mortgage Bonds

Sparinvest specializes in Danish mortgage bonds - an asset class with unique attractions for Fixed Income investors. However, this asset class is often not readily understood outside Denmark. So, when seeking to make all of our strategies compliant with the UN Principles, Sparinvest was instrumental in educating the UN PRI Secretariat about Denmark's unique mortgage financing system.

We argued that Demark offers one of the best-run and most robust mortgage markets in the world. It has operated for over 200 years without a single default. It is completely transparent to all and, without promoting sub-prime lending, makes home-ownership relatively easy for anyone in Denmark. The market is effectively run by only a handful of institutions whose principle role is to achieve wholesale financing for home-buyers by issuing bonds backed by those homes. The terms of the loan to the borrower are matched almost precisely with the terms of the bond for the lender.

The UN PRI Secretariat agreed with Sparinvest's view that ESG risk factors did not really exist in this asset class. Indeed, it could be argued that Danish Mortgage Bonds could be considered a very high-scoring responsible investment.

Sparinvest's UN PRI Journey – A Retrospective

Four years ago, prompted by increasing client interest and demand, Sparinvest began an investigation into the United Nations Principles for Responsible Investment to determine whether or not to sign up to them. We were immediately reassured to find that the Principles were built on pragmatism – on an acceptance that investment should be about the long term and with fiduciary duty as the asset manager's overriding concern. The Principles' intention was not to restrict investment universes by excluding 'misbehaving' companies but rather to encourage asset owners to focus on, and use their influence to reduce ESG risk. As value investors, we have long been focused on risk in all its forms. Thus we felt that we could sign up to the principles without compromising our fiduciary duty to clients. We signed in late 2009.

The process of implementation began with our equity investment team. We wanted to involve portfolio managers in decisions about who should provide our ESG research information (as well as the operational aspects of active ownership – a topic that we will look at in a future Review.) In choosing between external suppliers of ESG research, we were presented for the first time with samples of the types of 'non-financial' risk information that they focus on. Sparinvest's Portfolio Managers immediately saw the potential added value. Hunger for new information is part of the DNA of a Value investor. Therefore any information that sheds light on the potential risk involved with a long-term investment is of interest to them. ESG factors had often come under scrutiny in past investment decisions but now it became obvious that a more systematic focus on ESG risks in all holdings would add information and thus create value.

Being involved in decisions about how to implement Responsible Investment helped our equities team to see the potential benefits of integrating ESG risk analysis into their investment process. It was a natural fit – more of an extension of their existing process than a radical new departure.

This made it easier to accept ESG integration and easier to roll it out to other asset classes. By February 2012, we were able to declare our entire range of offerings – including corporate bonds, sovereigns, property and indexed strategies to be compliant with the UN PRI.

Process Embedded with the Portfolio Managers

Sparinvest has approached responsible investment with our fiduciary duty uppermost in our minds. For us, ESG risk analysis is not an exclusion exercise, nor is it a deliberate attempt to 'reward' high ESG scores. What we undertake since signing UN PRI is an important and useful event risk mitigation exercise. We strongly believe that the input from our ESG providers and our own ESG research questionnaires results in better investment decisions. This explains why the investment management teams have bought into the idea of ESG analysis so readily as a natural part of their process.

When I look at where we are with responsible investment today in Sparinvest, this is the fact that I am proudest of. We do not have a separately staffed RI department because I believe that where such entities exist, they exert very little influence over investment team decision-making. Instead we have a meaningful and consistent investment process.

- It is consistent with fiduciary duty because we maintain the broadest possible 'mainstream' investment universe.
- It is consistent with our UN PRI commitment because we take ESG factors into account alongside financial risk factors.
- It is consistent with our Value expertise because we assess the materiality of all risks before reaching a qualitative decision on overall company quality relative to price.
- It is consistent with our desire to create value for investors because it puts new and relevant information in front of the Portfolio Managers before they make investment decisions.

For ESG risk analysis to be fully integrated in the investment process, it can only make sense for the Portfolio Managers to take the lead role. In Sparinvest, we find that the same applies to active ownership, but that's a topic for a future Review.

Exclusion = Ethical

For Sparinvest, there is a clear distinction between responsible and ethical investment. Responsible investment puts fiduciary duty first, meaning all risks are assessed but no options are off the table for the portfolio manager if those risks are adequately compensated. However, we also recognise that, for many clients, it is important for their investments to be in line with their own values. Achieving profit is, for them, less important than remaining true to a personal moral code. That's why we also offer ethical options. As an ethical client, you can access our core strategies with the addition of an ethical screening. Our highly experienced partners in this area are Ethix SRI Investors of Sweden. Their ethical overlay is a negative screen based on fixed normative and sector criteria. The bar for exclusion can be set higher or lower so that you can align your portfolio with your personal beliefs. Sparinvest offers a range of (currently) three ethical funds with an exclusion overlay from Ethix.

They are:

- **Sparinvest – Ethical Emerging Markets Value**

  Emerging Markets equities selected for their value characteristics and cleared for ethical investment by Ethix' screening

- **Sparinvest – Ethical Global Value**

  Global equities selected for their value characteristics and cleared for ethical investment by Ethix' screening

- **Sparinvest – Ethical High Yield Value Bonds**

  Global corporate bonds selected for their value characteristics and cleared for ethical investment by Ethix' screening

Focus on the 'G'

Now that the responsibility for ESG analysis and the tools for active ownership are clearly owned by our investment teams, we expect the next stage of Sparinvest's responsible investment journey to be one of refinement. As part of this process, we also intend to keep up the pressure on our external research providers to increase their coverage of the SME territory which, as value investors, we often inhabit.

Within Sparinvest, we have already agreed that our RI focus for 2014 will be on governance. It is our experience to date that where a company has good G policies, it is more likely to have good policies for E and S as well. This does not mean that we will lose sight of environmental or social risks because we also believe that the converse is true: that where a company has visibly poor E and S policies – or policies that look good on paper/web site but don't stand up to inspection – it is often an indication of poor governance. Thus the better we become at getting the G risk analysis right, the better we can become at judging whether E and S policies are there just for show or whether they are likely to be enforced.

Sparinvest has a strong in-house competence on corporate structures and how to recognize good governance. This is something that we seek to exploit and share knowledge on internally. I look forward to reporting to you on our progress.

In our next RI Review, I hope to be able to demonstrate how ESG integration sheds new light on risk with case studies from both equity and fixed income strategies.

Yours faithfully

Jacob Nordby Christensen

Responsible Investment Director