Signatory of:

PRI Principles for Responsible Investment

Sparinvest

Sparinvest Responsible Investment Review

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In this edition:

Dear Investor,

Responsible ≠ 'Best in Class ESG'

Our primary aim as asset managers is to fulfil our fiduciary duty and deliver robust, strategy-driven, long-term investment performance for clients. That is why we need to consider all factors that can represent a risk to a company's business model. ESG megatrends such as climate change, natural resource scarcity, and shifting demographics all present financial risks - and opportunities.

No investment is free from ESG risk. Our aim is to understand these risks, gauge their materiality, and question whether a security's valuation gives sufficient compensation for them. It is not the aim of our RI Policy to deliver portfolios that are 'best in class' on ESG metrics. We do exclude some securities. For example, controversial weapons are excluded from all our funds, while our ethically screened funds exclude companies involved in certain industries or in breach of international norms. However, investing in 'less than perfect' companies characteristically goes with the territory of value investment. Not being 'best in class' means room for improvement – potentially in a number of areas – that can positively influence share price over time.

Morningstar ESG Ratings – an Incomplete Picture?

Later this quarter, we expect Morningstar to introduce its new ESG ratings – probably resulting in a fanfare of publicity for those funds revealed as 'most ethical' because they are 'best in class' on ESG data. However, the Morningstar ESG rating per fund is based only on the ESG scores of underlying fund holdings, and not on the processes of the investment manager. Therefore, it does not paint the full picture of what is going on behind the scenes. In fact, it ignores one of the core principles of responsible investment - the requirement to be an active owner and exert influence on investee companies.

At Sparinvest, it is not just our value mind-set that enables us to be comfortable with funds that may not be 'best-in-class' on ESG metrics, it is also the knowledge that we are active owners of the securities we invest in. We make judicious use of stewardship (voting and engagement) to help companies to navigate towards better corporate behaviour. In cases where we see a real opportunity to influence a company towards an improvement in corporate behaviour, we may decide to add them to our engagement programme.

Engagement at Sparinvest

Naturally, as part of our investment analysis and monitoring, our investment teams frequently communicate with companies to bolster their understanding. The ideal is constructive, two-way dialogue with our holdings, with freedom to exchange views on key issues, whether short or long-term, 'ESG' or otherwise.

However, we classify as 'engagements' those dialogues with a specific goal. We take a practical and materiality-based approach, focussed on cases where we see potential for meaningful impact on corporate value and sustainability. Triggers for engagement, and the methods used, can differ on a case-by-case basis and often they overlap.

Engagements are monitored by the Responsible Investment Committee. The RI Committee and members of the investment teams attend a quarterly Stewardship Meeting on voting and engagement.

Methods of Engagement:

Engagements with companies are typically either direct, collaborative, or by service providers. We often find a combination of these to be powerful. Generally, we aim to act as constructive partners to our investee companies, and this means we may also bring third parties into the dialogue – for example, liaising between the company and an NGO regarding best practice on a specific issue.

Direct Engagement

Members of our investment teams implement direct engagements. Our portfolio managers and analysts run the dialogue on ESG (and other) issues, as they well placed to contextualise the specific issue within the overall investment case and corporate value. It also sends a clear message to the investee company that ESG issues run to the heart of investment decisions. Triggers for direct engagement include:

- **Specific ESG Risks or Opportunities**
  Various ESG risks and opportunities are identified in analysis and monitoring of potential and existing holdings. Issues are selected for engagement based on materiality and the potential for meaningful change.
- **Voting-related:**
  Votes are blunt tools, which we believe are more powerfully exercised in conjunction with dialogue. We seek to engage with companies where agenda items breach our voting policy or are contentious for other reasons. Where time permits, this happens before the ballot. Outcomes can include the company amending the agenda to our satisfaction, a change in our voting decision based on new information from the company, or a vote against the item followed by further dialogue.
- **Breach of International Norms:**
  This links with our service provider engagements – covered below.

Collaborative Engagement

Collaboration with other institutional investors provides and efficient and powerful avenue for engagement. Our involvement ranges from acting as lead investors (running the dialogue on behalf of a wider group of investors) to acting as supporting investors. The appropriate level of involvement is determined by assessing our specific relationship with the target company and our available resources. We typically become involved in collaborative engagements via industry bodies such as the PRI Clearinghouse.

Service Provider Engagement

We make use of service providers for engagement where their specialist insight may inform a more constructive dialogue. We use ISS-Ethix to screen for companies that are alleged or confirmed to have breached international conventions such as the UN Global Compact or the UN Guiding Principles on Human Rights. Where this screen identifies confirmed or alleged breaches, we participate in collaborative engagement along with other institutional investors, led by the service provider ISS-Ethix. The aim is to seek deeper understanding and, if appropriate, to suggest possible remedial actions and policy improvements. Alongside this, we directly engage with our affected holdings to highlight the issue, encourage them to respond comprehensively to the collaborative engagement, and address any issues of specific concern to us.

Summary of Engagements during 2015

	Companies Engaged in 2015
Individual/Internal staff engagements	93
Collaborative engagements	62
Service Provider engagements	45

Supra-Company Engagement

In addition, to the above, we also engage at a supra-company level. We are active members of the Sustainable Investment Forums Eurosif and Dansif, as well as the Association of the Luxembourg Funds Industry (ALFI) - bodies that work to develop RI industry standards. This year, for example, Eurosif has been lobbying to ensure that SRI considerations are included in European legislation related to the Capital Markets Union. Via its subsidiary, LuxFLAG, ALFI is working to promote recognition of responsibly invested funds by use of labelling.

Results of PRI-Led Collaborative Engagement on Anti-Bribery and Corruption

From August 2013 to June 2015, Sparinvest became one of 34 investors (with collective AUM of USD 2.7 trillion) that participated in a PRI-coordinated collaborative engagement to improve anti-corruption standards.

The anti-corruption-campaigning NGO, Transparency International (TI) used 18 indicators to give a baseline evaluation of 32 companies' policies and disclosure relating to anti-corruption and bribery. At the end of the engagement, the lead investors used the same 18 indicators to measure improvement.

The PRI has now published the results of this engagement, the highlights of which are as follows:

- 30/32 companies responded to contact
- 29/32 companies acknowledged issues
- 28/32 companies improved their overall performance against the indicators

- The companies' average score increased from 8.8 to 12.7 out of 18 (from 49% to 71%)
- Sparinvest's engagement partner, NTT, improved dramatically from 4.5 to 14.5 out of 18 (from 25% to 81%).

Sparinvest and NTT – a Closer Look

For each target company in the abovementioned 2-year engagement, there was a lead investor running the dialogue. Sparinvest took on the role of lead investor with Japan's NTT, one of the world's largest telecoms companies.

Our aim was to encourage improvement in both the substantive content and the transparency of its anti-corruption strategies, policies and systems. NTT has expanded its footprint around the world, and it is important that its risk policies are appropriate to the scale, diversity and complexity of its operations. Through in-depth meetings and sustained communication, Sparinvest encouraged NTT to improve in a number of indicators, including:

- Bolder anti-corruption statements from top management
- Greater disclosure around whistle-blower policies and incidents
- The application of anti-corruption policies to contractors, subcontractors and suppliers, and
- Internal risk assessments, training, and regular monitoring of the internal anti-corruption programme across the companies' global operations.

During the engagement period, the company issued its first integrated Annual Report, and issued its first Anti-Bribery Handbook for its increasingly global workforce, covering risks such as facilitation payments. Most significantly, the company issued a clear statement of zero tolerance towards corruption.

At the beginning of engagement in 2013, Transparency International gave NTT a baseline score of only 4.5 out of 18 (25%). After engagement, the company had achieved a revised score of 14.4 out of 18 (81%) – a three-fold increase, denoting significant improvement in anti-corruption and bribery. Encouragingly, the company has publicly acknowledged that such developments have a positive impact on corporate value.

Obviously, this engagement was satisfying in many respects, but above all, we are pleased with the improved risk awareness and disclosure at our investment. A knock-on benefit for our entire investment team is the fresh insight gained into ways to judge a company's anti-corruption and bribery policies, and into current best practice. We continue to see such thematic, collaborative engagements as an important tool in our engagement toolbox, and have entered a new PRI-coordinated engagement on Human Rights in Extractive Industries.

Promotion of Responsible Investment

One of our ambitions during 2015 was to take positive steps to promote acceptance and implementation of responsible investment and the PRI within the investment industry. Within Sparinvest, we added an RI module to our induction programme for new recruits, thereby ensuring that, from day one, our new employees understand how central these issues are to our investment process.

We also presented at a number of industry conferences:

- TBLI Nordics Conference in Copenhagen on 15-16 June on the subject of engagement.
- 'PRI in Person' in London on 8-10 September – a case study of an engagement.
- Fifth Annual Africa ESG Forum in Cape Town on 13-14 October on global trends in responsible investment.

Climate Change

Towards the tail end of 2015, two events focused the world on the materiality of carbon-related market and regulatory risks:

- In September, Volkswagen AG lost almost a quarter of its market value in the emissions scandal after it admitted the use of 'defeat devices'.
- In December, the Paris COP21 talks resulted in a global agreement to limit temperature rises by transitioning away from fossil fuels. Coal stocks suffered in the aftermath, whereas businesses linked to renewables benefited.

Although attention is building, climate change has long been an investment issue and long-term investors need to recognise that the various risks involved affect more companies than just those fossil fuel producers with high levels of stranded assets and no 'Plan B'.

Early Adopters of Coal Exclusion from Ethical Funds

During the summer of 2015, Sparinvest gave careful consideration to whether certain fossil fuels should be screened out of its ethical portfolios. The Ethical funds have screening criteria based on client values rather than pure value. For this reason, we took the decision permanently to exclude thermal coal and oil sands – deemed the worst environmental offenders amongst the fossil fuels – from our ethical funds.

Whilst this exclusionary decision applies only to the ethical portfolios, it is worth noting that our broader range of equity funds did not have any companies focussed on thermal coal production either, which in part reflects the integration of ESG into our investment analysis and selection.

Carbon Footprinting

As signatories of the Montreal Carbon Pledge, we publicised the carbon footprints of our two ethical equity funds on December 1st and these are now available to view on our websites.

However, we would like to use this opportunity to draw attention to the different carbon footprinting metrics, and how we view their relative usefulness. In this developing area of fund reporting, it is important to be aware of potential pitfalls.

1. **Carbon Intensity**
   We have chosen to lead with this measure, which shows how much carbon is emitted by our portfolio holdings, relative to their economic output, which is measured by revenues. We believe investors should care about how efficiently a company generates carbon relative to its productivity. This measure could also be thought of as one of environmental harm relative to economic good.

2. **Weighted Average Carbon Intensity**
   With this measure, the calculation is based not on ownership, but on portfolio weights. We find this useful from a portfolio risk perspective, because it gives an idea of the risk faced by the portfolio in the event of the introduction of carbon pricing, for example.

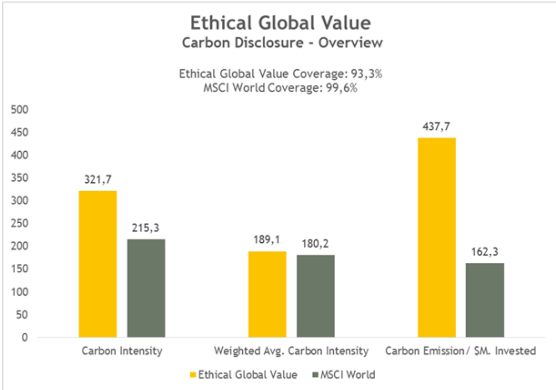
3. **Carbon Footprint (Carbon Emissions per 1$m. Invested)**
   This figure shows how many tonnes of carbon are emitted per $1 million invested in the fund. It is based on the fund's ownership stake in each holding. It is a simple measure, which on the surface appears to allow easy comparison. However, we think it is rather misleading because it does not consider how carbon efficient the holdings are.

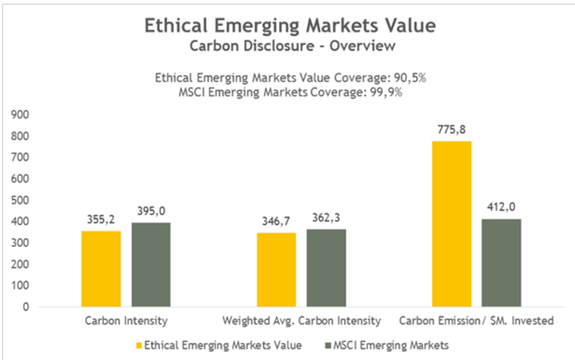
The problem with metric 3. is that it based purely on the fund's ownership stake in a company, which means it is inherently influenced by the price paid for each holding. It penalises investment strategies where a low price is paid for shares.

Imagine two companies selling the same amount of the same product, receiving the same revenues, and emitting the same amount of carbon. They are equally efficient. But now imagine that one company's shares are much cheaper than the other. If you pay 0.5x Price-to-Sales for Company A, and 1.0x for Company B, then for every dollar invested in Company A you will 'own' 2x the emissions. But in reality, both companies are equally carbon efficient. Our Ethical Emerging Markets Value fund is a good example: the portfolio is more carbon efficient than the benchmark, but because it is a value fund, paying a low price for its holdings, the 'emissions per $ million invested' is higher than benchmark. We don't see much logic in a metric which penalises investors who buy stocks at good prices, but we disclose it because it is commonly used.

Carbon Footprints Ethical Equity Funds

(Full reports available at sparinvest.lu)





This is the first carbon footprint measured for these funds. It gives a baseline from which carbon emissions and risk can be monitored over time. It also – particularly as one drills down into more detailed data – forms a useful part of the information available to our fund managers, as they manage portfolios, consider new investments, and consider engagement plans with existing investments.

Yours faithfully

Nichola Marshall
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