Signatory of:

PRI Principles for Responsible Investment

Sparinvest

Sparinvest Responsible Investment Review

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Sparinvest's Latest PRI Assessment Report

Every year, we complete a UN PRI 'Transparency Report' on our progress in implementing responsible investment principles across our asset classes. The PRI reviews our responses, compares us to peers, and publishes an 'Assessment Report'. We publish both reports in the Responsible Investment area of our website.

For the second year in a row, the PRI Assessment Report gave Sparinvest an A+ score for our overarching approach to responsible investment. We understand that only 15% of PRI signatories achieved this score.

We are also pleased to note solid scores, ahead of peer groups, in all categories. That said, our focus when shaping our RI policy and practice is what makes sense for our funds and clients – not what gets us high scores. So, for example, in our engagement policy we place more emphasis on quality than on quantity. We aim for impact through a small number of carefully selected and constructive dialogues.

We regularly examine how we can improve our processes and practices, and in coming months will focus this particularly on fixed income, including opportunities for engagement in that asset class.

Sparinvest 'Score Card' from UN PRI Assessment Report 2016

PRI Scoring Modules	Sparinvest 2015	Sparinvest 2016	Peer Grp 2016
Overarching Approach	A+	A+	B
Listed Equity Incorporation	A+	A+	A
Listed Equity Active Ownership	A	A	B
Fixed Income Corporates	A+	B	C
Fixed Income Gov't Bonds	A+	B	C
Property (Indirect SAM)	A+	A+	B

Source Sparinvest: The 2016 PRI Assessment scores shown above are extracted from the full UN PRI Assessment Report 2016 for Sparinvest Group and are based on Sparinvest's Transparency Report for the year 2015 both reports available at sparinvest.eu.

A 'Value' Approach to Responsible Investment

For a responsible investor, the essential thing is to recognize that environmental, social and governance factors create fundamental risks and opportunities for companies – that can, and do, affect their long-term returns.

In brief, Sparinvest's approach to Responsible Investment is a combination of excluding some companies from investment, and integrating ESG in our investment processes. This helps us build an understanding of the ESG risks and opportunities we face and, where appropriate, to encourage companies to mitigate risks and exploit opportunities.

What do we exclude? For **all funds**, we exclude illegal weapons (e.g. cluster munitions and landmines) and securities in breach of EU sanctions. For our ethical range of funds, we have developed broader exclusions in response to client needs, so these funds go further and exclude companies in breach of international norms, or operating in certain sectors.

But what about the companies which are not excluded? Clearly, all companies face some form of ESG risks and opportunities. Our thinking about this derives from a long history of value investment, where we frequently see that deliverable returns can be higher when you participate in a company as it makes changes for the better. So, in addition to our exclusions, we do often choose not to invest in companies with elevated ESG risk, where we think it compromises long-term value. However, we do not take a 'best-in-class' approach, buying only those companies with leading ESG track records.

Some asset managers do take that 'best-in-class' approach, and it can make their funds 'look good' in terms of ESG ratings. But we think our willingness to invest in some companies where there is greater room for behavioural improvement might be an even better way to maximise returns – both from a societal and financial perspective.

This is where ESG integration is important. We work to understand the ESG issues faced by a company, and assess the implications for long-term corporate value. We use our stewardship programmes – both voting and engagement – to encourage some of our holdings towards improved levels of sustainability: to mitigate ESG risks, and seize ESG opportunities.

ESG in the decision-making process

Investors often ask for concrete illustrations of what ESG integration actually means. So here are some examples from the past year of how ESG issues formed part of investment case discussions within our Value Equities team:

In Example 1, one company was preferred over another because of governance and social issues. In Example 2, before investing, the team dug into NGO allegations that touched on the company. In Example 3, the team contacted the company to request further disclosure regarding carbon risk mitigation

EXAMPLE 1 – Governance & Social: CEO Pay and Labour Relations

In early 2015, we were considering investment in the US retail sector, and our potential targets included clothing retailers 'Company A' and 'Company G'.

At Company A, we noted both social issues (labour management practices) and governance issues (concerns centred on the then CEO, who subsequently left the company).

The company had very low approval ratios in 'Say-on-Pay' - whereby shareholders vote on executive remuneration. The departing CEO's remuneration was both high, and included large non-performance based elements. He had also allegedly made ill-judged comments about the company's products only being suitable for the better-looking segments of the population.

Yet our bigger concern was labour management – a key issue in labour-intensive retail operations. The consolidation of retail operations in the US led to store closures and layoffs – a challenge for many industry players. But the company's management of these issues appeared to be only average. It employed tens of thousands of people, mostly on part-time contracts and apparently without any consistent incentive programmes. We feared that, relative to competitors, it could face weakening labour relations, hiring difficulties, weakened staff morale and, consequently, a worse retail experience (even for good-looking customers).

Meanwhile, industry peer, 'Company G' was also a significant employer, with over 100,000 employees, so it faced many similar risks. In contrast to Company A, however, it had shown the ability to lead positive change in social conditions in the industry. For example, it made a public commitment to raise its minimum wage *before* the US federal requirement to do so. Other retailers followed suit. The company also offered certain benefits to part-time workers. We felt this positive stance could help them to hire and retain skilled employees, enjoy a more motivated workforce and offer a more positive in-store experience for customers.

Impact of ESG Integration on Investment Decision

Both companies had suffered share price declines, which made their shares nominally attractive from a valuation perspective. However, after considering the above-mentioned concerns, alongside other fundamental factors, we chose to invest in Company G – with its future-friendly approach to labour management.

EXAMPLE 2 – Social: Responding to Norms-based Allegations

In mid-2015 we considered investing in one of the world's leading manufacturers of prestige cosmetics. The service provider we use to screen for breaches of international norms flagged a 2014 NGO report regarding the alleged links between beauty companies, their supply chains, and illegal Indian mica mines. (Mica is a naturally occurring sparkling mineral dust that is a key ingredient in makeup and car paints. It is mined throughout the world, but in India its extraction has been linked to the illegal use of child labour.)

The NGO report found child labour to be widespread in illegal mines in the states of Jharkhand and Bihar. It also appeared to establish that certain major cosmetics brands did have links to such mines via a complex chain of local traders, exporters and two wholesale/chemistry companies. However, regarding the company we were analysing, the NGO report was unable to establish any evidence of supply chain contamination.

We take child labour extremely seriously and were anxious to obtain as much clarity as possible. Our service provider concluded that the allegations against the company were fragmentary and unsubstantiated. Their view was that there was no ongoing or systematic violation of international norms.

Moreover, they noted that the company was one of very few that had actually responded to the NGO's original report, with a robust explanation that – far from condoning child labour in the Indian mica industry, it was actively working to end it. It collaborates with – and helps to fund – the Indian children's rights organisation Bachpan Bachao Andolan (BBA). It works to develop 'child-friendly villages' with clean drinking water, toilets, and other infrastructure improvements, and to get children into education – partly by working to raise adult income. The company noted that it consciously continues to buy mica from India because it sees a chance to improve conditions in mica mining communities.

Impact of ESG Integration on Investment Decision

Our further investigations suggested that this company was proactively working to protect human rights and was one of the industry leaders in addressing these crucial issues. As a result, we did not exclude the company. We consider ongoing engagement appropriate to reiterate our desire to see a continued robust approach against child labour.

EXAMPLE 3 – Environment: Carbon emissions

We analysed a South African food retailer. The company had a broad range of private label goods, which entailed significant indirect carbon emissions related to the upstream production of raw materials and goods.

This upstream production is vulnerable to rising energy costs, and specifically to the potential pricing of externalities: South Africa is exploring the idea of introducing a carbon tax from 2016 as it attempts to meet its commitment to reduce GHG emissions by 34% by 2020, and by 42% by 2025. The cost of this carbon tax would likely be passed on by power generation companies in the form of increased tariffs, which could lead to cost increases for this company.

Impact of ESG Integration on Investment Decision

While this issue did not prevent us from investing, we decided to contact the company to enquire further about their efforts to understand and manage their carbon footprint. The company appears to be working to control its more direct carbon footprint (such as via store operations and product transportation) but, as we continue dialogue with them, we wish to build our understanding of the risk and potential mitigating steps that can be taken regarding their upstream production and supply chain.

Engagement News

Our Engagement Policy can be found on our website. (For those reading an e-version of this Review, link here). Below is an update on some of our collaborative and supra-company engagements.

Collaborative Engagement: Social: Human Rights in the Extractive Industries

Sparinvest is now part of a PRI-coordinated engagement with a focus on the social issue of 'Human Rights in the Extractive Industries'.

Extractive industries are those that remove resources from the earth: oil and gas extraction, mining, dredging and quarrying, and so on. The nature of this industry has high potential for impacting human rights: for workers, for the communities located near their operations, and the people living in the operating country. Often, operations are located in countries with security issues or weak governance and regulatory structures, increasing the risk that human rights are overlooked or abused. It is important that companies operating in these areas have a robust approach to human right protection.

This collaborative engagement, which is likely to continue well into 2017, targets various prominent companies within extractive sectors, with the aim of improving human rights policies, practices and performance. Key background resources to inform the engagement are the UN Guiding Principles on Business and Human Rights, and the UNGC/PRI Guidance on Responsible Business in High-Risk and Conflict-Affected Areas.

Sparinvest is working closely with two other institutional investors to lead the dialogue with a Japanese oil and gas company. The company has a long history of participating in projects as a non-operating partner, but in recent years has started to operate projects directly, particularly in the LNG space. While their human rights track record is relatively strong, we think this is a good time to push for even stronger policies and practices. Although it is still early days, we are encouraged by the company's willingness to engage in dialogue.

We have previously mentioned Sparinvest's involvement in a 2-year PRI-coordinated collaborative engagement with 32 companies on Anti-Bribery and Corruption (ABC) which ended last year. The PRI has now published their insights in a 'Guide for Engaging on Anti-bribery and Corruption', available from the Collaboration Platform area of their website.

Supra-Company Engagements

In previous Reviews, we have touched on how Sparinvest's direct, collaborative and service-provider engagements target individual companies. This time, we wanted to give an insight our engagement work conducted at a supra-company level.

Here, we work with policy makers, industry standard setters and opinion leaders to help shape the future of Responsible Investing through industry guidance and legislation. This includes initiative such as:

- Carbon Footprinting – As mentioned in previous reviews, as carbon footprinting develops, we are in discussions with data providers, asset owners and industry bodies to advocate a focus on carbon intensity as the key measure. This measures a company's emissions relative to its output or revenue, so we feel it's the most appropriate measure to use – whether the aim is to encourage companies, and society, towards higher carbon efficiency, or to understand the potential cost of carbon for a company relative to its earnings power.

- Sustainable Stock Exchanges Initiative – Sparinvest has been a long-standing member of the SSE Investor Working Group. The aim of this UN-endorsed initiative is to encourage the world's stock exchanges to issue guidance to listed companies on how to disclose material ESG information to investors – where possible alongside their financial reports – on a comply or explain basis. During 2016, numerous stock exchanges have joined the initiative, including those from Denmark and Luxembourg.

- EuroSIF is an industry association that (amongst other things) lobbies for the introduction of European regulation and legislation supporting the development of responsible investment. As an individual member, Sparinvest has supported EuroSIF's lobbying activities focused on the need to incorporate sustainability (mandatory ESG disclosure and risk analysis) as central concepts in both Capital Markets Union legislation and the IORPS Directive on Occupational Pension Schemes

- The Association of the Luxembourg Funds Industry (ALFI). Sparinvest is a member of ALFI's Responsible Investment Committee, which aims to promote growth and awareness of Responsible Investment within Luxembourg's fund industry. Sparinvest was also instrumental in the development of LuxFLAG, an initiative that recognizes funds with strong ESG, microfinance or climate financing credentials.

- NGOs. Sparinvest has also worked closely in recent years with the Anti-Bribery and Corruption NGO, Transparency International (TI). Indeed, we were invited to speak at TI's 'Workshop on Business Integrity' at their Annual chapter meeting in Berlin in March this year to give an investment manager's perspective on constructive engagement with companies on ABC matters.

- The PRI Statement on ESG in Credit Ratings marks the launch of a 2-year programme to raise awareness of the links between ESG and creditworthiness. Sparinvest has signed this statement, and supports the project, which asks credit rating agencies to integrate ESG considerations in their rating analysis.

2016 Voting Season

With the 2016 voting season virtually complete, we are pleased to have achieved a very high level of voting on our active funds.

Total meetings	200	100%
Of which voted	198	99%
Total items	2587	100%
Of which voted	2560	99%
Of which voted against Mgmt	260	10.2%
Total shareholder proposals	83	100%
Of which supported	39	47%

Our voting policy [link here] requires us to prioritise the long-term interests of shareholders. Although we use a service provider for voting-related research and for the act of voting, the decisions about how to vote are directed by our portfolio managers.

Occasionally we take the view that proposals put forward by company management are not in shareholders' best interests. Of the issues that caused us to vote against Management this season, the main three were:

- Board Composition/Independence (116 items = 45% of the votes we cast against Management proposals)

- Capital structure/Restructuring of the company (58 items = 22% of the votes we cast against Management)

- Executive/Board Remuneration (38 items = 15% of the votes we cast against Management proposals)

We aim to write to all companies where we have voted against Management proposals to explain our reasons for doing so and, hopefully, encourage a dialogue regarding shareholders' best interests.

Sparinvest Responsible Investment Committee