Signatory of:
PRI Principles for Responsible Investment

Sparinvest

# Responsible investment review
November 2016

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## Supporting a Sustainable Financial System

> *We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole*

This is the PRI mission statement, a focal topic at September's PRI Annual Signatory Meeting in Singapore.

The dangers of greed, short-termism and opacity within the financial system were vividly demonstrated by the 2007-8 financial crisis. Following that crisis, it was evident to everyone that a 'back to basics' approach was needed. It was widely agreed that investing responsibly meant properly understanding the underlying risks involved and being as transparent as possible in conveying these to clients.

As 'dyed in the wool' long-term and prudent investors, Sparinvest endorses the desire to maintain a sustainable financial system. We do offer a range of investment products made up of shorter-term investments (such as corporate bonds or the momentum-investing element of our quant funds). But we are perhaps best known for our specialism in the field of active value investing - a strategy that requires a longer than average holding period to deliver what, historically, have been above average returns. The value strategy relies first on stock-picking and then on time and patience to see the full effect of companies purchased at deeply discounted levels reverting to fair value. Thus it is in our interests to promote a sustainable global financial system where long-term proven strategies like value investing can continue to work over complete economic cycles.

At Sparinvest, we have always had the mind-set that for our actively-managed value equity funds, we buy parts of real companies, and not just pieces of paper. We follow the simple idea that, most of the time, the investor is better rewarded if he forgets about the daily stock price, and focuses on the true value of the company, its assets, and its operations. To understand whether the compensation for investment is likely to be adequate, we need to assess the risks and opportunities that the company faces in its sphere of operations and whether these could impact the bottom line. It is only natural that this assessment includes the 'sustainability factors' – in other words, the environmental, social and governance (ESG) issues that we consider to be material to long-term value creation.

## Sparinvest Researches the ESG Factor

Those who are familiar with Sparinvest's Responsible Investment Policy will know that for most of our asset classes we do not seek out 'best-in-class' ESG investments. Instead, we seek to push for ESG improvement in our investee companies through our active ownership activities. The only exception to this is in our quant strategies where, at each portfolio rebalancing, all other factors being equal, we seek improvement of the combined ESG score of the total portfolio.

But, of course, ESG is an underlying consideration for all our active strategies, so it interests us to know whether there is any evidence that it pays to invest in companies with good/improving ESG credentials. We decided to conduct our own investigation - to see whether we could find any evidence of correlation between good ESG ratings and good investment performance.

MSCI issues 'Intangible Value Assessment' scores for several thousands of securities. Based on companies' risk profiles with regard to environmental, social and corporate governance matters, MSCI divides companies into seven ratings (from low to high): CCC, B, BB, BBB, A, AA and AAA.

Using performance data from Bloomberg, we looked at the performance of these categories over the past 5 years, rebalancing them on a monthly basis to capture rating changes.

This suggested that over the 5 years, the highest ESG categories achieved stronger returns. The best-rated companies (AAA) gave an annual return of 12.5 per cent, compared with the lowest-rated companies' (CCC) annual return of 6.4 per cent.

### Annualised % return since beginning 2011

| | CCC | B | BB | BBB | A | AA | AAA |
|---|---|---|---|---|---|---|---|
| ALL | 6.4 | 6.9 | 9.3 | 9.1 | 9.4 | 9.8 | 12.5 |

Source Sparinvest plus MSCI ESG Research

Zooming in a little more, there is also a clear advantage to investing in stocks with higher ESG ratings in emerging markets compared with the developed markets. Here we can see that the best-rated Emerging Markets companies gave a 23.8% annualized return.

### Developed versus Emerging Markets

### Annualised % return since beginning 2011

| | CCC | B | BB | BBB | A | AA | AAA |
|---|---|---|---|---|---|---|---|
| DM | 7.8 | 8.4 | 10 | 10.3 | 10.2 | 10.4 | 11.7 |
| EM | 4.5 | 2.6 | 4.3 | 4.9 | 4.1 | 8.0 | 23.8 |

Source Sparinvest plus MSCI ESG Research

We also divided the universe into cap sizes and, again, discovered that there was an effect here.

### Cap Sizes

### Annualised % return since beginning 2011

| | CCC | B | BB | BBB | A | AA | AAA |
|---|---|---|---|---|---|---|---|
| Large | 5.4 | 5.2 | 6.8 | 7.3 | 7.2 | 8.2 | 11.3 |
| Mid | 5.2 | 4.5 | 6.5 | 7.1 | 8.2 | 9.1 | 13.7 |
| Small | 13.2 | 11.8 | 12.3 | 14.8 | 15.8 | 17.1 | 15.1 |

Source Sparinvest plus MSCI ESG Research

While one cannot draw too many conclusions from this, it does suggest that over the past 5 years, investing with a focus on companies with strong or improving ESG credentials would likely not have detracted from returns. During this time, the responsible investment movement has gained momentum and ever larger volumes of AUM have been targeted at the companies at the top of the ratings spectrum. What's more, we have recently seen the introduction of Morningstar ESG ratings that favour the funds investing in these best-in-class companies – something that is likely to contribute further to the appeal of 'best-in-class' ESG investing.

However, it is worth remembering that over time, some companies will migrate up and down the ESG rating categories, and these companies likely have some impact on the performance. We strongly believe that improving fundamentals – including ESG considerations – can be a key share price driver. This is obviously part of the rationale behind our active ownership programme.

Within our actively-managed value funds, we view a company's ESG profile as just one of numerous considerations to be weighed as part of an investment decision which, ultimately, is all about long-term risk compensation. Investment cases can be invalidated by poor ESG credentials but good ESG credentials alone do not make an investment case.

When it comes to active ownership, however, our ongoing engagement efforts are designed to foster corporate value by improving ESG transparency and accountability in our investments. In this context, it is very encouraging that those companies who take these matters seriously have also seen share price improvement.

## A Sustainable Mortgage Market

We have already alluded to the pain of 2007-8 and the subprime-led global financial crisis. In its aftermath, one of the lessons learned by the shaken financial system, and its investors, was that the Danish Mortgage system has a great deal to recommend it. Having withstood many tests since it was brought into existence after the great fire of Copenhagen in 1795, the Danish system is perhaps the most sustainable method for financing property purchase that the financial system has yet invented.

### What is so special about the Danish system?

First, it is underpinned by rigorous regulatory requirements which must be met by any entity wishing to issue mortgages. Subject to meeting these requirements, it is an open system in which all mortgage issuers can participate on equal terms.

Second, the Danish system is properly incentivized to maintain a high standard of mortgage provision. The lesson learned from US-style mortgage securitization is that if the entities that originate, securitize and service mortgages are not the same as those that invest in mortgage securities, there are no incentives to issue sound mortgages and to service them well. In Denmark, mortgage issuers are required to retain all the credit risk on their own books *and* to perform the servicing functions.

Third, the Danish mortgage is funded not by complex and poorly understood capital structures but by the issuance of transparent, standardized bonds, creating a large and liquid market that offers considerable attractions for risk averse investors in search of decent returns. In more than two centuries of existence, there has never been a default on a Danish mortgage bond

Finally, and most importantly, the Danes have what they call the 'Balance Principle.' Every Danish mortgage is instantly converted into a security, valued at same amount, and the two remain interchangeable at all times. This is especially relevant for 30-year callable mortgage loans that homeowners can retire either by paying them off at par, or by buying an equivalent face amount of bonds at market price. Because the value of homes, and the associated mortgage bonds, tend to move in the same direction, homeowners have some protection of their equity. In other words, if home prices decline as a result of higher interest rates, the amount that a homeowner must spend to retire his mortgage decreases because he can buy the bonds at lower prices.

As previously mentioned, for most of our asset classes, Sparinvest does not have a best-in-class approach to ESG integration, but our funds investing in Danish covered bonds are perhaps an exception. This is because the investment universe for this asset class is, by its nature 'best-in-class', consisting of mortgage and shipping bonds issued by a small number of banks with top credit ratings, as well as bonds issued by the Government of the Faroe Islands and the Kingdom of Denmark which, according to World Bank Governance Indicators, had the following profile in 2015.

## WGIs for Denmark 2015

| | |
|---|---|
| Voice and accountability | 97.54% |
| Political stability and absence of terror | 76.19% |
| Government effectiveness | 97.60% |
| Regulatory quality | 94.71% |
| Rule of law | 99.04% |
| Control of corruption | 98.08% |

In conclusion, we believe that Sparinvest's Danish bond funds offer a best-in-class ESG approach to securitized debt investment.

## LuxFLAG ESG Labels

Sparinvest is delighted to have been successful in renewing its LuxFLAG ESG Label for the fund Sparinvest SICAV – Ethical Global Value and in getting approval on first application for an ESG Label for Sparinvest SICAV – Ethical Emerging Markets Value, one of the first Emerging Markets funds to obtain such a label.

We think that obtaining the LuxFLAG ESG label for our funds provides reassurance to our clients that we are happy to be transparent about what we are investing in (and how we do it), and happy to have this held up to scrutiny by an Eligibility Board made up of senior figures from the European ESG research industry. We think this reassurance is perhaps particularly valuable to investors with an ethical approach when investing in Emerging Markets.

In a process that is rigorous but at the same time quite user-friendly (and not prohibitively expensive), any fund applying for the LuxFLAG ESG label not only has to be approved by the Eligibility Board, it also has to undergo an independent annual control underpinned by an external audit firm review to ensure that it retains the high standards of ESG integration expected of it. We find this a very credible approach, providing smaller investors with the same kind of level of due diligence that institutional investors get by employing consultants, and at the same time impressing institutional investors when they see it.

## Eurosif Transparency Code Label

Sparinvest is also delighted to have obtained a EuroSIF Transparency Label for the following four funds from our Luxembourg SICAV:

- Sparinvest - Global Value
- Sparinvest - European Value
- Sparinvest - Ethical Global Value
- Sparinvest - Ethical Emerging Markets Value

Tracing its roots to the European Transparency Guidelines unveiled in 2004, the European SRI Transparency Code (the Code), first launched in May 2008, primarily aims at increasing accountability and clarity of SRI practices for European investors.

The principle driving the Code is that asset manager signatories should be open and honest, and disclose accurate, adequate and timely information to enable stakeholders, in particular retail investors, to understand the policies and practices of a given SRI fund. The Code focuses on SRI funds distributed publicly in Europe and has been designed to cover a range of asset classes. We will now begin work on adopting the Eurosif Transparency code on behalf of our entire range of funds, especially those domiciled in Denmark which are aimed at retail investors.

## Japanese Interest in Engagement

Finally, looking to Japan, it is with interest that we note the continuing impact of the governmental reform agenda on corporate behavior and, in particular, a heightened interest in the concept of ESG issues and shareholder engagement.

In recent years, Japanese companies have been asked to adopt a clear Corporate Governance Code. This highlights the importance of long-term value creation and healthy dialogue with their shareholders. On the shareholder side of the equation, Japan has introduced a Stewardship Code designed to encourage institutional investors to 'promote sustainable growth of companies through investment and dialogue'. The growing number of national stewardship codes is just one more example of how the Responsible Investment movement is gaining traction and encouraging increasing numbers of investors to engage with investee companies on ESG issues.

In this developing environment, Japan's financial news platform Quick explored the topic of engagement by interviewing Sparinvest's senior portfolio manager, David Orr. Sparinvest was lead investor in a UN PRI co-ordinated engagement on the subject of anti-bribery and corruption with Japan's leading telecoms company, NTT.

Read Quick ESG's interview with Sparinvest's David Orr here:

http://sustainablejapan.jp/quickesg/2016/10/05/sparinvest-in-english/23853

Yours faithfully,

Sparinvest Responsible Investment Committee