2019

Stewardship Activities Report

SARACEN
share success

Contents

Introduction

Welcome to Saracen Fund Managers Ltd 2019 Responsible Investment Report.

Political uncertainty, ever-growing inequality, and complex trade barriers are all important influencers of economic growth. Investors, however, are increasingly sensitive to the broader needs of society and how companies may impact this. History would suggest that if corporate activity is not on sustainable terms for society, it will eventually cease to be financially viable.

With a focus on long-term investments, we hold only the highest quality value companies that have reliable cash flows and a healthy balance sheet. When investing for clients we always consider the sustainability of corporate activity. Integrating environmental, social and governance factors into our investment process can help to sustain and improve returns for our clients whilst also having the potential to create a positive social impact.

We recognise that governance and stewardship risks can be material to the performance and valuation of companies. Actively considering proxy votes for client holdings is therefore vital. Active engagement with companies on governance issues is an important adjunct to voting activities.

The Year in Review

Our highlights from the reporting year;

- Development of a gap analysis for our investment process.
- Sustainability is now a permanent agenda item for every Investment Meeting to deepen ESG insights and understanding.
- SFM is now a PRI signatory.
- SFM is now a signatory to the FSB Taskforce on Climate Related Financial Disclosure

Our focus for next year;

- Update our internal Stewardship Policy.
- Improve investment team subject knowledge through ongoing training and development.
- Continue to utilise quantitative research to better understand and embed ESG data into our investment process.
- Start the process to become a signatory of the UK Stewardship Code.

ESG is an integral part of our investment analysis

At Saracen, we invest with conviction for the long-term. Our investment process is disciplined, and research driven. Our research is bottom up and the process is understandable and repeatable. All our investments are subject to in-depth analysis prior to investing, with an emphasis on controlled risk.

We historically incorporated Corporate Governance and SRI factors in our investment research process as an additional risk overlay. They have always been an integral part of the research process. This could cover topics such as levels of emission and the cost attached to this, or the diversification of the board, or the sustainability of resources and the effect of this on the risk profile of a company for the next five years. We are fundamental investors and always try to reflect all possible risks in our proprietary templates. In our worst-case scenario, we would stretch these to a severe level. In short, looking at so called ESG factors is nothing new to us.

With the increased interest in ESG aspects from both clients and media, we are often asked how we changed our investment approach. While we have formalised our ESG assessment over the last year, the underlying approach has not changed much.

What has changed is that we have put it in a more formalised framework. In the past it was up to each analyst to incorporate the risks in their analysis and rate the corporate governance and SRI exposure on a scale of 1-5. Since summer 2019, we have implemented a new system that is based on specific ESG factors. Each company template will have a value for E, S, G and overall ESG. The scores are treated like any financial / risk aspect to investing in the company.

The values for E, S, G and ESG are derived from a very detailed ESG scorecard based on Bloomberg data which screens ESG factors for each investment. The factors are divided into 33 Environmental factors, 15 Social factors and 37 Governance factors. Depending on the industry a company is in, there are different weightings. E.g. for a Media company there are three Environmental factors (total CO2 Emissions, does the company have a climate change policy and water use). In the Oil, Gas & Coal sector there are 9 factors to consider when calculating and Environmental score (total CO2 Emission, does the company have a climate change policy, energy intensity per sale, water intensity per sale, waste generated per sale, % of water recycled, does the company have a biodiversity policy, SOx Emission per sale, NOx Emission per sale).

For policies, the score is a yes or a no and therefore a one or zero. For other factors we assign a value to each score, which is added up to an individual E, S or G score and they are then equal weighted to generate an overall ESG score.

We have an overall score for the portfolio which is also monitored. It is a weighted average of the underlying holdings' ranks. For the whole portfolio, we would expect the overall risk to decline as we try to either avoid or minimise exposure to negative ESG factors.

All templates are presented and debated at the weekly "Investment Research Meeting" which is chaired by the Head of Research and attended by all investment staff. ESG aspects are addressed during the discussion of a company in these meetings. This includes a detailed discussion of the ranks compared to the peer group.

At the conclusion of the debate, the company will be given a Buy, Hold or Sell recommendation. If individual or the overall ESG ratings score too low, the company will not receive a Buy recommendation.

Following the investment meeting, the Fund Managers will then discuss the appropriateness of the company for inclusion in the fund, taking into account the portfolio objective and risk characteristics, incl. the portfolio overall ESG score.

We will only invest once we are satisfied that the company fulfil our value and ESG criteria.

If the ranking is acceptable but elevated it will have an influence on position size, just like any other risk outcome of the research meeting. We might therefore have a smaller position in a company with higher ESG risk.

By adopting Bloomberg data based on publicly available information from annual accounts, we believe we can take as much subjectivity out of the process as possible. It also gives us the opportunity to regularly check the data and update it. Furthermore, if we believe a score to not be correct, we have a clear starting point from which to find out why this is the case and if the company in the meantime has started an improvement process.

As with most things in life, big processes don't change overnight. We are pragmatic. If we see a low score but know that a company is making considerable effort to improve its ranking, we would see this as a positive and would want to support this.

Voting Summary

<u>Proxy voting policy</u>

In order to execute our responsibilities under the PRI we closely examine companies' corporate governance policies. We actively encourage boards to:

- Adopt clear values and standards in business dealings throughout the organisation
- Develop a culture of transparency and accountability
- Focus on strategic issues and the quality of the business rather than simply short-term performance
- Develop appropriate checks and balances to deal with conflicts of interest
- Maintain effective systems of internal control and risk management
- Operate fair remuneration structures that reward the achievement of business objectives at all levels
- Recognise and responsibly manage the impact of the business on all stakeholders

We believe that boards should demonstrate the following key features:

- Be led by an independent chairperson
- The chairperson and the CEO roles should be separate and not exercised by the same individual
- The Board and its committees should retain the requisite balance of skills, experience, knowledge and independence, including an adequate level of gender diversity
- Develop clear and fair remuneration arrangements which incentivise shared value creation
- For larger companies, at least half of the board should be composed of non-executive directors considered to be independent

Engagement

Engagement with the companies in which we can invest takes a number of forms, including (but not limited to):

- regular and ad hoc face-to-face meetings with management
- teleconferences with senior management
- formal written correspondence
- informal written correspondence

Engagement may cover a wide range of issues from executive pay, board diversity to ESG policies.

Case studies for engagement

1. We engaged with company A on their priorities of use of cash. We prefer companies with strong balance sheets and an optionality on their use of cash. In this case, while the company's investments for the long term have picked up and are being better deployed than in the past, the strategy for use of additional free cash flow after capex has not been very consistent. It has moved from almost purely share buy backs to a high dividend pay-out ratios with minimal share buy back and partly back again. We applaud companies who buy back shares when their share price is depressed. We see it as a value enhancing exercise. However, we also would like to see a progressive dividend policy. We try to avoid holding companies in the portfolio where we expect a dividend cut. In the case of company A, the shift between share buy backs and changes in the dividend policy from one year to the next did not send a clear message to the market. As a consequence, the shareholder base kept rotating and the share price underperforming. We have engaged with management to find a sustainable level for both aspects of returning money to shareholders. We are pleased with the outcome as management have now given clear guidance on their return of capital policies which should attract a more stable base of shareholders.

2. As mentioned above, we prefer companies with low leverage and optionality for investment which results in increased organic growth. Often this can be augmented by acquisitions and/or mergers, which drive growth in the short term but are not necessarily sustainable in the long term. We would want the management of our investment companies to have a long-term outlook with a view to create shareholder value in the long run. We are not interested in short term, unsustainable gain. In the case of company B, management proposed to merge with a quasi-competitor, which would expand its footprint into a new geography. Although in the short term the reported earnings might have looked better as 1 + 1 = 2+, after synergies there were many red flags for the long-term performance of the company. The new geography would have added a new – and much more stringent – regulatory environment, which was rapidly changing. It was unclear, how the long-term growth

prospects of B could have improved with the add on of a lower growth, lower profitability and higher risk jurisdiction. We were advocating to discontinue merger talks at once and for B to stick to its knitting, which it is very good at, without changing its risk/return profile to the worse. We were not alone in our thinking. Many other investors and the media questioned the rationale behind the proposed merger. In the end, it was called off. We applaud management for their openness and for listening to their shareholders (and us). We continue to support them with our investment.

3. Company C is a healthcare company which owns a luxury hotel and vineyard in the Mediterranean. This was often used for management conferences and for private holidays by senior management. This raised many questions on our behalf with regards to Corporate Governance. What is the rationale in the first place to own the hotel? Why would management conference be held at this expensive, “far” away place when they could easily be staged for much less cost closer to home. What indirect benefits did managers receive from booking holidays at the hotel? We raised all these aspects with the management of C. While they appreciated our dialogue, they unfortunately could not concur with our concerns. There was no willingness in providing us with detailed financial information as answer to our questions. Equally, there was no willingness to either run the hotel at arm’s length or dispose of it. After careful consideration of these Governance issues and other risk aspects, we decided to sell our investment in company C.

Conclusion

Ultimately a firm's approach to its stock allocation strategy, remuneration policy and Board profile should highlight its inherent culture. Hence, we look to prioritise these topics of engagement with the companies in our portfolio and future potential opportunities. Considering an investors' point of view is very important and we consider stewardship, engagement and our voting activities to play a vital part in our investment process. Engagement provides us with the opportunity to discuss a company's long-term investment strategy, and other key governance issues, not least the long-term purpose of the company.

In the forthcoming months, we will further incorporate our environmental and social analysis into our investment process to better sustain returns for our clients whilst also creating a positive social impact.

We hope this report has given you a sense of how we consider responsible investment at Saracen Fund Managers, and the actions we have taken on behalf of our clients during 2019.

Should you wish to learn more in the meantime, please feel free to contact our ESG/Stewardship Analyst, Bettina Edmondston – bettina@saracenfundmanagers.com.