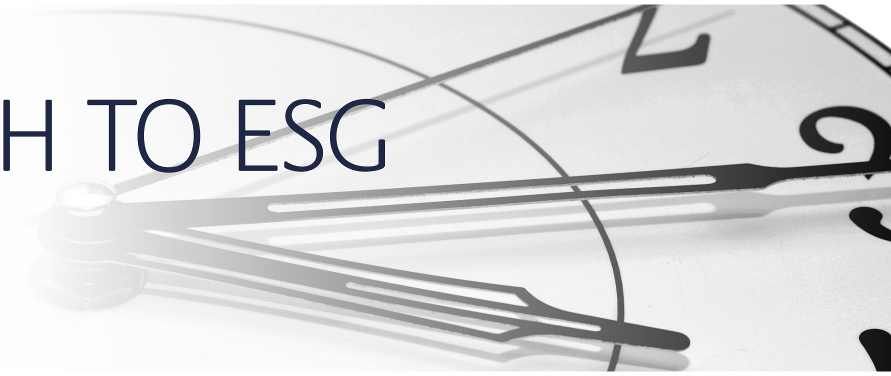

OUR APPROACH TO ESG

This letter forms the first in a series designed to introduce and explain our approach to sustainability, and the lessons learned so far. We hope that these reflections, drawing on the team's combined experience, will provide a useful insight.

At First State Stewart Asia (FSSA), we seek out quality companies defined by the strength of their management, financials and franchise. The pursuit of immediate gains through short-sighted strategy, reckless conduct, or the exploitation of labour, tax loopholes, legislative arbitrage or the environment runs contrary to this definition of 'quality'. We are long-term investors and measure success over years, not quarters. As a result, we look for managers that are well-aligned with minority investors and respect all stakeholders, both in good times and bad.

Stewardship, sustainability or responsible investment, call it what you will; having managed money for more than three decades, we believe that Environmental, Social and Governance (ESG) integration is vital, a natural extension of our investment process, and much more than a name or label or box to be ticked. That said, we recognise that there are many areas in which we can still improve. We do not claim to be experts in this field, but hope that this letter (and subsequent editions), clarifies our approach, highlights our weaknesses and strengths, provides evidence of our engagement with companies, and shows how we strive to do better.

Since the team's establishment in 1988, we have seen many terms for what is essentially, in spirit, the same thing. In the US, Socially Responsible Investors gathered for the inaugural SRI conference in the Rockies in 1989. In the wake of the Exxon Valdez oil spill, Green Funds increased in popularity and negatively-screened indices like the Domini 400 appeared. These joined an existing stock of ethical products constructed along similar lines, viewed sceptically by many industry practitioners.

In the late '90s, broader Sustainability Funds were launched as the correlation between good governance and financial returns was better recognised. In 2005, Kofi Annan, Secretary-General of the United Nations (UN), invited 20 of the world's largest investors to develop the Principles for Responsible Investment (PRI), an industry framework which launched the following year. It was around this time that the UN Environment Programme began pushing for the integration of ESG issues into institutional investment, reflected today in the industry's Stewardship Codes. In 2010, the ISO 26000 provided guidance on international standards for Corporate Social Responsibility (CSR). And in 2013, amidst preparation for the G8 summit, the British Prime Minister extolled the benefits of Impact Investing.

No matter the name, we believe the integration of sustainability factors into the investment process makes sense and is prudent risk management. To us, it is not just a label, but a set of values by which we operate. At FSSA, we do not have an ESG officer as we believe it is everyone's responsibility to think about these issues during daily decision-making and interactions with company management. It should not be outsourced, isolated in a silo or reduced to a box-ticking exercise. We are signatories of the UN Principles of Responsible Investment, but view it as a minimum standard and not something to be particularly proud of in isolation. You will not see our funds emblazoned with the next new slogan or categorisation as we believe all portfolios should be managed responsibly – and it is our fiduciary duty as asset managers to do so.

Our understanding of sustainability has improved over time, but we realise it is an incredibly complex subject. There is no single, correct path to prescribe to investors or companies – rather, it is the direction of travel that is more important. That said, there is not a price for everything and there are families, organisations and sectors in which we do not invest because of ethical conflicts (tobacco, gambling, defence), past conduct or culture. There is no obligation for us to invest in them, as we are bottom-up investors and entirely benchmark agnostic.

We have always integrated ESG factors into our investment process, but our approach in the past was shaped by an emphasis on stewardship and the belief that quality managers and good governance should, in itself, ensure that environmental and social concerns are rightfully addressed. Investing in young markets, where disclosure levels and transparency were still developing, meant that it was a necessity to invest alongside good people with whom our interests were aligned. This is as true today as it was in the late '80s.

Indeed, it is often in hard times that business owners and managers show their true colours; how they react under pressure is a good insight to understanding their values, priorities and principles. As an example of this, we have tended to avoid families who abused stakeholders in the 1997 Asian Crisis, a litmus test of corporate governance. Sadly, not all investors have memories as long and it is cruelly ironic that the very same clans that destroyed so much value some two decades ago have since managed to raise similar foreign currency loans.

"Worst Asian default forgiven as Indonesia billionaire sells debt"

Source: Straits Times, April 2015

Is it unfair to recall mistakes made so long ago? The above headline was taken from a newspaper in 2015 regarding Indonesian tycoon families' return to the USD bond markets following prior catastrophic defaults. Though they did not fare well in the crisis, they were able to return with the help of public and private funds. For the sake of argument, let us focus on one of these groups and track its evolution since. The second generation offered change, as perhaps – if we were to be generous – it was the first cohort's approach to business that led to the family's undoing during the Asian Crisis. This hope was shattered in 2001 when the founder's son paid the largest fine in US campaign finance history, pleading guilty on behalf of himself and one of their banks for violating federal election law. After some years went by and further succession, an anti-corruption probe was launched against the group in October 2018. Details subsequently emerged of disputes over a USD50m loan from an Austrian bank. While we sincerely hope governance standards here improve, we trust our investors can see why we have avoided these people.

Admittedly, we were focused on governance far more than environmental or social aspects in our earlier years. It was perceived then that, in general, the greatest risks to client capital were rooted in poor management and inadequate or conflicted board oversight. Though still very important, it has become increasingly clear that additional factors are just as relevant and a more holistic approach is necessary. For example, if a garment or textile manufacturer condones the exploitation of its workforce, what prevents the board from taking a similarly dim view of minority shareholders? If injury rates are on the rise, are managers' incentives misaligned and is adequate investment being made to maintain their licence to operate? If an industrial company relies on low environmental standards, what does this say about the strength of the franchise and its long-term prospects? Our evolution with respect to ESG is not a reaction to tighter regulation or public demand – which is very welcome – but a recognition that we cannot ignore our impact on society and the environment – and good governance is the foundation on which great companies can be built.

Aware of our shortcomings, we have made efforts in recent years to improve our awareness and understanding of ESG issues more broadly, especially those material to our portfolio holdings. We have done this through internal reflection – dedicating more time and resources to the subject with valuable help from colleagues within the broader First State Investments umbrella, as well as likeminded corporates and sustainability consultants. With this knowledge, we aim to continue to improve the quality of our research, strengthen our relationships with management and increase the efficacy and impact of our engagements. It should, we hope, help us to create and defend value.

Whilst we often say that there is no such thing as a perfect company, this is not an excuse to stop pushing for progress or step down the quality curve. To encourage development, we now engage with companies in a more structured way. Controversies and areas of concern are recorded in a central log which is reviewed weekly with specific actions (meetings, calls or letters) to be undertaken by relevant members of the team. Our progress on each engagement issue is monitored, logged and escalated if need be. Issues flagged range from absent board directors, raised during proxy voting exercises, to much broader queries following annual report reviews. For example, a recent letter written to a power tools company resulted in a meeting with the CEO, in which he addressed our concerns around gender inequality, low tax, environmental fines, business strategy, competition and more.

In addition to this, we have been conducting a wider review to identify the most significant ESG concerns for each of our investees. Through meetings, calls and emails we assess their greatest threats and opportunities, ascertaining who in the business drives sustainability strategy and to what extent the board and management are involved. This exercise has already provided valuable insights into companies' general approach to risk and allowed us to see how expectations and education levels vary from country to country. For instance, some of the banks we hold in high regard have yet to integrate or formalise environmental and social risk policy; in other words, we look not only at their loan book exposure to sensitive industries (questionable thermal projects, tobacco, etc) but at how they can use their influence and scale to effect positive change (in terms of certifications from the Forest Stewardship Council, the International Labour Organisation or the Roundtable on Sustainable Palm Oil, and others).

This does not mean that they are inferior franchises or culturally suspect. Far from it, they are local and regional leaders. However, it opens up opportunities for us to engage in a helpful, if not meaningful, manner. Examples of this include providing feedback on financial and non-financial disclosure, encouraging alignment with the Global Reporting Initiative (GRI) framework and the Taskforce for Climate-related Financial Disclosure (TCFD) recommendations. We have also provided introductions to Tobacco Free Portfolios, an organisation promoting tobacco-free finance. We volunteer ourselves in a similar manner to all our investees, providing assistance and constructive criticism wherever we can. For us, 'engagement' is neither negative nor a reactive term.

As alluded to above, while everyone on the team includes sustainability factors in their daily analysis and interaction with companies, we have not quantified these responsibilities or demanded a quota of letters or calls each year. Rather, we have kept it intentionally personal, allowing individuals with a passion in certain areas – industry, country or company-specific – to realise this in their engagement and related research. From packaging (learning about the pros and cons of biodegradable plastics and introducing companies to innovators in this field) to engaging with regulators and industry bodies to bring about improvements in corporate disclosure, fund categorisation and stewardship codes. This high degree of personal empowerment matches our flat team structure and fundamental investment approach.

Having laid out our approach, we now provide some working examples which touch on one or two of our portfolio holdings and key sustainability themes. Many more will be provided in subsequent notes.

A Hong Kong soy-based beverages company

By 1940, Hong Kong had received waves of refugees from Mainland China, starving and penniless, fleeing Japanese forces and an appalling Civil War. It was in this year that this company was launched, offering a nutritious, low-cost alternative to milk to address the malnutrition rife in immigrant camps. After a few faltering years, the soy-based drink was soon second in popularity only to Coca Cola. In fact, if Coke is the international brand ambassador for the US, then this company is most certainly Hong Kong's. It is interesting to ponder which product, after eighty years and much improved health awareness, will do better in future.

We have owned this company for decades. It has done well; growing profits by more than five times in twenty years, and building a China business – two thirds of revenue today – from nothing. However, it has not always been smooth sailing. In 1996, the company's financial and brand value was severely impacted by a manufacturing flaw which turned its soymilk sour. Management recalled more than 30 million cartons, but retained staff, corrected the process and rode out the incident reasonably well. More recently, they resolved over-diversification through the divestiture of their North American business in 2016, allowing them to focus entirely on booming Asian markets.

The company's evolution and approach to sustainability are similar to our own. It starts with the search for good managers and people. Just as we seek the right families and owners to back, they too attracted high-calibre professionals to grow and strengthen their business. What is remarkable about this company is that despite its size (it made less than USD80 million profit last year), it has been led by multinational CEOs from the likes of Nestlé and Coca Cola for over a decade. In part, this reflects the family's willingness to professionalise. Though often a difficult decision for devoted family managers, such practice should ensure that the brand and the business thrives well beyond the proverbial third generation. They published their first standalone sustainability report in 2015, but it is clear they considered these factors much earlier, harking back to the founder's original inspiration. In subsequent years they improved disclosure and set consistently more ambitious targets with respect to packaging; nutritional, sugar and fat content; and energy, water and waste. They have refrained from issuing bold, unrealistic statements and instead delivered gradual improvements throughout.

In 2018, we engaged with the company to formalise a packaging policy that included plastics (less than 20% of their volumes but still significant) and enquired about board independence, succession planning and an anomalous audit fee. Reassurances were gained around the former issues, while the higher than normal charge reflected a promising company-wide digitalisation program planned and assessed by their auditor. This expenditure was overseen by the audit committee and the chairman in a transparent process involving multiple tenders. We corresponded by letter and over email before meeting the management to discuss these matters and broader business concerns in person. Later in the year, we provided ESG-related feedback during the formulation of new KPIs[1] and policy, to be announced in July 2019.

A consumer goods company in the Philippines

From Hong Kong soymilk, we turn to coffee and crisps in the Philippines. Firstly, few companies' origin stories are clean and simple, and even fewer avoid crisis throughout their lives. What is required is a respect for minority shareholders' rights and protection of their interests, no matter the circumstances. Where controversy occurs, our benchmark agnosticism means that we need not involve ourselves at all. However, at what point does a company become investible, if there is mounting evidence of positive change and a recognition and rectification of past wrongs? The question of 'original sin' is a difficult one – but surprisingly common.

Three years after the first carton of the aforementioned soymilk drink rolled off the production line in Hong Kong, a young entrepreneur began trading consumer goods between his native island of Cebu and the Philippine capital, Manila. He was the sole provider for his family having lost his father aged 15. He had enjoyed a wealthy upbringing but was forced to send his five siblings to China amidst Civil War to save on living costs. The entrepreneurial determination he showed then – in trading, and rebuilding his family and their fortune – was replicated in snack foods manufacturing in 1954, beverages in 1961 and a host of other businesses since, stretching from property to petrochemicals. It is through this graft and risk-taking that one of the leading conglomerate groups in the Philippines was formed. Within the Group, and the subject matter of this section, was a consumer company at its heart, with leading brands in crisps, coffee, chocolate, noodles and ready-to-drink tea.

In 1997, as Asian asset bubbles popped, the Philippine peso devalued from 26 to the US dollar to more than 40. By the end of the year, the Group's long-term foreign borrowings had risen 2.5x to over PHP45 billion (or USD1.1 billion). Leverage, measured by net debt to equity, tripled to around 150%. To escape from this perilous situation, the family sold assets – banking stakes and a cement plant in Cebu, for example – and moved cash around the group to make good their creditors. Though their intentions were respectable, cash from the consumer goods company was taken in exchange for equity in the Group's real estate company. Minorities lost a potential dividend and became unwitting realtors. It was certainly not the worst incident to have occurred during the Asian Crisis, but neither was it a shining example of good corporate governance; and it shook our confidence in the group.

It has taken years to rebuild it. To be fair, our scepticism and caution was perhaps taken to extremes; though we admit investing late into the Group's turnaround, we were more interested in protecting client funds and ensuring the family's actions and intent were consistent and genuine. What we have witnessed since is a sweeping change in culture, management style and investment discipline, prompted by succession within the family. The founder deserves credit for his entrepreneurialism and tenacity in building a multi-billion dollar group, surviving coups and crises. However, his only son is managing an equally impressive feat by professionalising and restructuring the business, upgrading their systems and ensuring the group operates responsibly and in a sustainable manner.

Recent missteps at the consumer goods company – losing share in coffee, suffering a product recall in Vietnam, overpaying for an acquisition in New Zealand – have prompted much reflection and it is here that reforms are being tested before being rolled out across the entire Group network. The founder's son, who was stretched thin across the group, is now chairman and has more time to coordinate change from the top. He is being helped by a 30-year Procter & Gamble veteran, who took over as CEO in the middle of last year.

> "It's now imperative for us to take our business to the next level by embedding a sustainability program that ensures continued growth, and strengthens our competitive advantage as a premier multinational company in Asia and Oceania."

The consumer goods company's 2016 Sustainability Report

Unsurprisingly, our interactions with the company were initially focused on governance, the extent to which the new leader was in control and how he was changing things. Although the company understands the need to address health and nutrition and are adjusting their product portfolio accordingly, we have yet to see a formalised policy or performance figures regarding these factors, or others such as packaging. While they lack these tangible materials, we have been encouraged by their comments on sustainability and their intention to incorporate ESG into managers' key performance indicators. Their 2030 sustainability commitments, aligned with the UN Sustainable Development Goals, will be issued at the end of this month. We have been assured that all will be revealed in their next standalone sustainability report, to be published in the second half of this year. Their first, in 2016, was useful in providing a general introduction and anecdotal evidence of their awareness and strategy, but lacked quantitative targets and a broad range of performance figures. We look forward to seeing more of these, supporting the management's statements, in the next edition. On the business side, it is heartening to note a recent venture to bring the same soy-based drink mentioned earlier to the Philippines. The joint venture is not yet material, but is an encouraging sign; you have to start with good people, after all.

In closing, let us touch on topics of increasing importance, which we will discuss in greater detail at a later date. In 2018, First State Investments together with Kepler-Cheuvreux conducted a research project to survey the views of millennials on sustainable investment. The results confirmed that the majority of this cohort are more at ease with ESG concepts than the previous generation and are keen to invest in responsible products; in fact, an asset manager's sustainability expertise would influence 78% of respondents' investment decisions.

[1] Key performance indicators

While it is encouraging to see this interest and support, which aligns with our longstanding approach (as well as new guidelines and regulation), we fear it will be seen by many as a marketing opportunity. Greenwashing represents a growing threat to the reputation of our industry and is as much a problem for our clients as ourselves.

As bottom-up investors with Scottish roots, perhaps scepticism and caution comes too easily. We believe investors should share a little of this sentiment and look beyond a chairperson's letters or labels to ascertain whether their words are embraced in spirit and action. For example, is it possible for an organisation to sell truly sustainable funds if ESG is not integrated into its values, management incentives and the broader business? Maybe, but we would certainly need convincing. Returning to the Indonesian group discussed earlier, what evidence would be required to believe claims that stewardship is among their core principles? After all, they say all the right things and have a venerable foundation which supports thousands of students, but..?

As mentioned, we are focused on absolute returns, not relative performance against a benchmark. We would urge some caution around sustainability indices as they are subject to a market cap skew, which is biased towards larger but not necessarily better companies. The latter have the budget to produce impressive ESG reports which tick rating agencies' boxes, but their inclusion and weighting does not necessarily reflect quality, impact or improvement. For instance, should a controversial oil and gas company reside in the top ten holdings of an emerging markets ESG index? Or a semiconductor manufacturer whose chairman was jailed for embezzling more than USD40 million, pardoned by a president who herself was recently incarcerated on corruption charges? Surely, there are better candidates?

The ratings on which these indices are built offer but a glimpse into a company's culture and sustainability credentials. There are clear pitfalls in using them as an absolute measure, given discrepancies in methodology, a lack of publicly available data, the risk of oversight, and their retrospective nature. Instead, we use the underlying data and any significant changes in rating as a starting point for further research, internal debate and engagement. In one instance, where we felt an agency's review was unfair, we verified the rating with the company itself and introduced them to the team at Sustainalytics to set the record straight and improve future disclosure.

Finally, we wish to emphasise that we are by no means any sort of experts in sustainability. We strive for improvement and our efforts in sustainable investment are in keeping with our team values. We hope the insights provided in this letter have been useful and look forward to penning our next, having learned more about sustainability and our companies in the meantime.