Diversified Growth Fund
Implementing Responsible Investment in a Multi Asset Portfolio

First Sentier Investors

Diversified Growth Fund | January 2019

For professional clients only

"That which is measured improves. That which is measured and reported improves exponentially."
– Karl Pearson

Introduction

First Sentier Investors was an early adopter of United Nations-supported Principles for Responsible Investment (PRI), and the first Australian domiciled investment manager to provide a detailed Responsible Investment Report.

For over a decade we have produced and distributed our formal governance, strategy, policies and implementation committees across our global business, recognising that the responsible approach of individual investment teams would be unique and develop at a different pace. Our approach is based on integrating Environemental, Social and Governance (ESG) factors into our investment practices to enhance the quality of our investment process and our understanding of risk and return.

This paper examines how responsible investment can be effectively implemented from the perspective of a top-down multi-asset investor.

Partnership approach

We partner with our clients to provide solutions that maximise the probability that they will achieve their stated investment objectives.

We engage our clients to determine their needs based on three key criteria:

Risk tolerance, time horizon and return ambition.

We work with clients to integrate ESG considerations into their portfolios which will meet their overall investment objectives of specific policies or interests.

Aligning interests

We utilise a range of tools to enable alignment with clients' specific ESG related policies and interests.

We have a fully integrated ESG approach which can be adapted for specific client sensitivities.

We vote all equity proxies where we have the ability to do so.

We will disclose our policies, actions and outcomes to the fullest degree possible.

We are continually working to enhance our understanding of how ESG risks can impact long-term performance.

Responsible investment can provide greater risk-adjusted returns

We believe responsible investment, which includes ESG issues, constitute sources of long term risk and return. By incorporating responsible investments directly into our investment practises, we seek to enhance the quality of our investment process. As a firm, we are a global industry leader in responsible investing, achieving the PRI minimum "A" score across all investment categories.

Our responsibilities are taken seriously – via ownership in listed companies and provision of debt to governments and corporation, we are active stewards of our investors' capital.

RISK FACTORS

This is a financial promotion for The First Sentier Diversified Growth Fund. This information is for professional clients only in the UK and EEA and elsewhere where lawful. Investing involves certain risks including:

- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- **Charges to capital risk:** The fees and expenses may be charged against the capital property. Deducting expenses from capital reduces the potential for capital growth.
- **Currency risk:** the Fund invests in assets which are denominated in other currencies; changes in exchange rates will affect the value of the Fund and could create losses. Currency control decisions made by governments could affect the value of the Fund's investments and could cause the Fund to defer or suspend redemptions of its shares.
- **Emerging market risk:** Emerging markets tend to be more sensitive to economic and political conditions than developed markets. Other factors include greater liquidity risk, restrictions on investment or transfer of assets, failed/delayed settlement and difficulties valuing securities.
- **Derivative risk:** derivatives are sensitive to changes in the value of the underlying asset(s) and/or the level of the rate(s) from which they derive their value. A small movement in the value of the assets or rates may result in gains or losses that are greater than the amount the Fund has invested in derivative transactions, which may have a significant impact on the value of the Fund.
- **Credit risk:** the issuers of bonds or similar investments that the Fund buys may get into financial difficulty and may not pay income or repay capital to the Fund when due.
- **Interest rate risk:** bond prices have an inverse relationship with interest rates such that when interest rates rise, bonds may fall in value. Rising interest rates may cause the value of your investment to fall.

For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document for each Fund.
If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

The literature

The finance literature as it relates to ESG has focused heavily on so called sin stocks, or equities in industries that are considered off-limits.[1] Until recently, scholars considered sin stocks to have a risk premium that results in higher historical returns.[2] This made sense in theory, as any exclusions lowers the investment universe and constrains the portfolio. We would expect a constrained portfolio to have worse risk-adjusted returns than an unconstrained one, all things being equal.

We would also expect higher returns for 'sin stocks' through the following mechanism:

Fewer investors in 'sin stocks' due to investor preferences for sustainable companies and higher risk (e.g. litigation) -> higher cost of capital for those firms -> higher expected returns.

As Asness (2017) says, this is exactly what we would want, as it discourages undesirable firms and industries, and promotes sustainable companies via lower cost of funding for them. However, recent research (Adamsson and Hoepher 2015; Blitz and Fabozzi 2018) found that the 'sin stock anomaly' – disappears when controlling for Fama and French (2015) factors: size, value, momentum, profitability and investments. Lobe and Walkshäusl (2016) also found that sin stocks did not outperform a portfolio of socially responsible stocks (which included nuclear energy stocks.) Firms with good ESG scores elicit lower stock volatility on dividend announcements, as they're already transparent and committed to higher ethical standards with fewer agency problems (Kim et al. 2014; Glegg et al. 2018). Finally, reversing the literature's earlier consensus, Owen and Temasvary (2018) found that more women on bank boards is value-enhancing – an example of the mispricing of diversity.

The newest financial literature align with our world view; ESG factors can help generate superior risk-adjusted returns over the long-run, as we believe ESG risks and externalities are mispriced in the market. As such, the academic literature has moved on from the idea of giving up on returns for a more sustainable portfolio.

Our philosophy

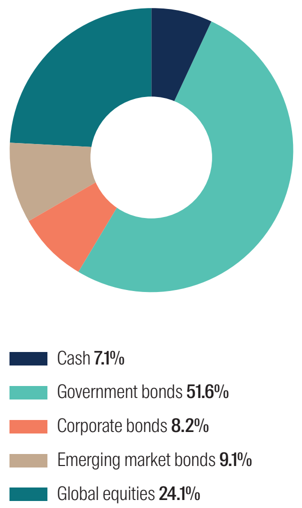
Our philosophy	Our beliefs
In the long run, fundamental valuations will assert themselves and be the most important driver of returns. In the short-term, markets are not completely and globally efficient due to a variety of investor behaviours, providing an opportunity to enhance and protect returns. Desicions should be made with respect to the portfolio's objectives.	We believe the ESG issues comprise sources of long-term risk and returns and that systematic analysis leads to better informed investment decisions. Assets with well managed ESG risks will produce higher risk adjusted returns over the long-term. ESG issues and externalities are mispriced. Blending quantitative analysis with qualitative judgement and expertise is a competitive advantage to the benefit of our clients interests.

As global multi-asset investors, we have a stake in the effective operation and sustainability of the broader economy, society, the integrity and transparency of markets, good governance and business conduct. Given the size, geographical coverage, (multi) asset class mix, and variety of client mandates, we need to be flexible in the way we approach responsible investment and the integration of material ESG factors.[3]

[1] The exact defninitions differ, but usually include weapons manufacturers, gambling, tobacco, alcohol, and sex-related industries.

[2] E.g. Salaber (2007); Fabozzi et al. (2008); Hong and Kacperczyk (2009); Statman and Glushkov (2009).

[3] Most research so far has focused on equities, although there are notable exceptions, e.g. Desclée et al. (2016)



Cash
Margin accounts, collateral and custodian holdings

Government bonds
Direct holdings, futures and swaps

Inflation-linked bonds
Direct holdings, futures and swaps

Corporate bonds
Direct holdings, futures, swaps and options

Emerging market bonds
Direct holdings and swaps

Global equities
Direct holdings, futures and options

Commodities
Exchange-traded funds

Transparency of holdings and exposures through:

Direct holdings:
- Proxy voting (Glass Lewis)
- ESG insights
- Climate risk & exposure
- Corporate governance
- Tailored exposures

Derivatives (equity, bond, currency: futures and options)
- Counterparty evaluation
- Collateral management
- Reference index exposure

Exchange-traded funds (ETFs)
- Exposure management (cash, synthetic)
- Securities lending

Source: First Sentier Diversified Growth Fund asset allocation as at 31 December 2018.

We employ a top-down investment process to efficiently allocate to broad asset classes. We utilise direct access to ESG ratings and data, which provides us with a comprehensive database of ESG scores for global companies. This allows us to directly replicate equity and bond market exposures. If deemed necessary, this allows us to remove poorly rated ESG companies within their sector classifications. Over time this is expected to add value to the portfolio by avoiding negative investment outcomes.

As part of our stewardship responsibilities, we exclude specific companies involved in munitions and armaments across all of our portfolios, as well as applying screens to exclude tobacco and other ESG "red flag" companies for certain clients. In addition, we believe that voting on company resolutions is an important client asset and we vote on all company resolutions using the advice provided by the services of CGI Glass Lewis. The team's full proxy voting record and statistics is available online at: ri.firstsentierinvestors.com/multi-asset

A responsible investment sensitive process

In our **expected return** framework, which looks at long-term drivers of the economy, ESG factors are considered:

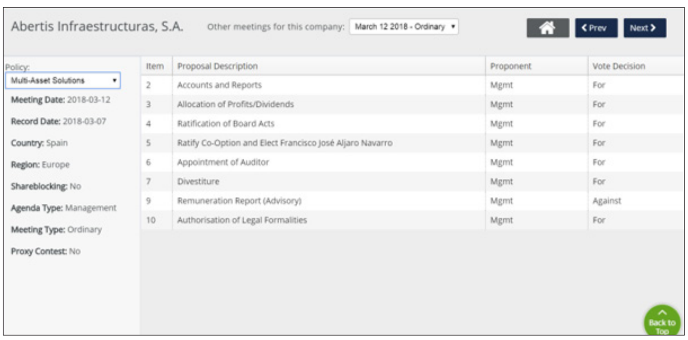
- Is the economy overly reliant on polluting, resource extraction, or at high risk of losing out from climate change (politically, economically, geographically)
- How sustainable is the economic growth, and are there policies in place to deal with certain risks: Demographic, inequality, institutions, legal frameworks, etc.
- Good governance has historically been one of the strongest predictors of inclusive, robust, sustainable growth.

At a portfolio level, we have integrated responsible investing throughout our investment process:

1. Carbon footprint monitoring
2. ESG scores (Bloomberg, Sustainalytics) incorporated as part of portfolio construction[4]
3. Proxy voting
4. All of our counterparties are assessed for their ESG commitments; including polices such as anti-bribery and corruption, whistleblowing, anti-money laundering, and credit standards and supplier vetting.

Stewardship

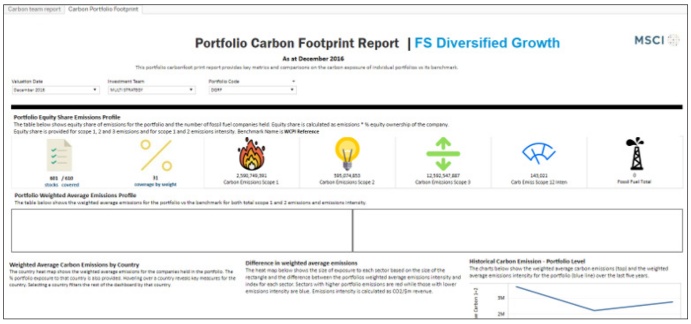
Proxy voting rights are an important asset for investors. Exercising these rights are a core part of our stewardship responsibilities, voting on all possible resolutions at company meetings and disclose all 'real-time' decisions publicly.

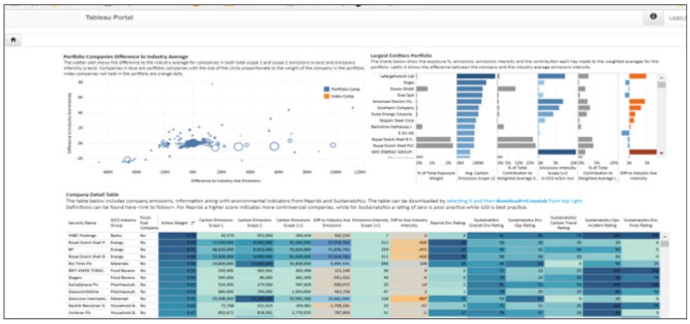


[4] The quality of ESG-data has been continuously improving, as has the ability to integrate that data into portfolio management systems via direct data-pipes and application programming interface (APIs), ensuring increased systematic use.

Monitoring climate risk

We believe that focusing on carbon emissions is an important factor for evaluating ESG and sustainability-related factors. As part of this focus, we monitor and manage our portfolios carbon vs. relevant capital market benchmarks. Carbon intensity is the most commonly-used metric for assessing the carbon footprint of a portfolio. The figure allows for a more accurate measure of a portfolio's efficiency because it evaluates a company's based on size rather than absolute carbon output.





ESG quality

We monitor investment in listed companies' equity and debt against ESG scores; both on an absolute level and against various capital market benchmarks.

DGRF vs MSCI WORLD by GICS Sectors in GBP
Date Trend

Name	Delta Adj Wgt Port	UD-ESGRANK Port	UD-ERANK Port	UD-SRANK Port
DGRF	32.67	69.23	64.22	69.24
Bonds	53.62			
Cash	4.51			
Consumer Discret...	4.03	69.49	56.93	66.85
Consumer Staples	3.68	69.50	57.52	81.54
Currency Forwards	0.00			
Energy	3.05			
Financials	6.90	79.18	87.23	75.78
Funds	5.62			
Futures	-67.33			
Health Care	3.71	82.80	83.06	78.29
Industrials	2.60	52.55	29.61	60.51
Information Tech...	7.43	61.00	58.23	50.79
Materials	1.93	65.10	40.27	71.85
Real Estate	0.55	59.14	60.41	48.09
Swaps	0.00			
Telecommunicati...	1.48			

Source: Bloomberg.

Evaluating counterparties

As part of our stewardship responsibilities, we manage the risks associated with derivative transactions through counterparty selection and collateralisation management, among other processes.

As part of this process we evaluate our counterparties across a range of criteria which includes alignment with First Sentier Investors' beliefs on responsible investment commitments. Before transacting we survey and conduct ongoing monitoring, of the counterparty's credit worthiness, business strategies and firm wide policies and procedures.

COUNTERPARTY	CREDIT & LOAN STANDARDS	SUPPLIER STANDARDS	ANTI-BRIBERY & CORRUPTION	WHISTLEBLOWING	ANTI-MONEY LAUNDERING	POLITICALLY EXPOSED PERSONS & SANCTIONS	Pass/Fail
A	N/A	No policy	Yes: policy which defines the concepts, forbids bribes and outlines processes: does not include guidelines, examples and does not define or forbid facilitation payments	No policy	Yes: fulfils all elements, SF6 Compliance conduct annual training	N/A : does not handle these types of people	PASS
B	N/A: is a prop trading firm i.e. no customers	No policy	Somewhat: AML policy does not permit a counterparty to use bribery, coercion, undue influence to induce	Yes : widely communicated, trained, code of conduct, website etc.	Yes: describes measures in place to identify clients and beneficial owners through AML	N/A: no customer accounts	PASS
C	N/A: is broker/dealer so does not facilitate credit	No policy	Yes: policy defines and forbids, with guidelines and examples. Does not define or set out process for conflicts of interest or define or forbid facilitation payments	Yes: is available to stakeholders, reports can be anonymous and has a non-retaliation clause. Does not widely communicate or have a hotline	Yes: and provides statement to us - ticks all boxes	Yes: risk based due diligence program to scrutinise accounts	PASS
D	Yes: anticipate and manage potential sector or environmental risks, website link for more	Yes: has updated and issued Ethical and environmental code of conduct for suppliers, w/ website link	Yes: zero tolerance towards bribery and corruption, w/ website link	Yes: clear policies and processes	Yes: single global standards committed to	Yes: committed to complying with sanctions etc.	PASS

Challenges await within Multi-Asset: what is best practice?

As the investment approaches and beliefs vary across diversified growth funds many investment managers have taken a very different approach to responsible investment. Derivatives and ETFs that do not provide ownership and voting rights pose challenges for investors that want to engage with companies.

At First Sentier Investors we acknowledge that different asset types require an integrated approach. Within a multi-asset universe we need to align our approach to responsible investment with our firm's beliefs and policies. This is a continual treadmill of research, and whilst we don't have all the answers, we are making constant efforts to ensure sustainable outcomes. This is within the overall governance process and underlying investments, to enhance the quality of our investment process and our understanding of risk and return.

We welcome all industry, investor and academic research in this area as we are committed to improvement.

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