For professional clients only

First State Stewart Sustainability Strategies

Client Forum Summary Paper

20-21 May, 2014

INTRODUCTION

"What would Alice say?"

The forum opened with an introduction to the problem of short-termism in the financial services industry through the lens of Alice in Financeland (see paper attached).

Short-termism has long been a problem in the finance industry. While awareness of the risks it poses and the undesirable behaviours it causes has grown since the financial crisis of 2008 there is little evidence that the problem is getting any better.

One issue which encapsulates a lot of what's wrong with Financeland in its present state is the shadowy practice of high frequency trading (HFT). HFTs essentially make money by front-running big investors, as documented in Michael Lewis' book 'Flash Boys'. As the book explains, this dubious practice is legal and is actively enabled by stock exchanges motivated by short-term profit targets.

It's a stark illustration of what seems to be a lack of ethics and values in the finance industry and in particular the lack of attention the industry gives to the need to fulfil its social licence to operate. Long-term active investment managers and responsible asset owners must be at the forefront of the effort to address this.

A FINANCIAL SYSTEM FOR THE LONG-TERM

"Where am I in the room?" Michael Lewis, Flash Boys

"Is co-location ethical?", we asked the CFO of the listed stock exchange.

"I've never thought of it that way. So long as it's legal, we've got quarterly earnings to make."

The first task for the forum was the small matter of redesigning the financial system and maybe bringing Financeland back in touch with reality. Three discussion groups were formed with each one assigned a topic: Stock Exchanges, System Design or Alignment, and the aim to formulate action points.

Based on the NYSE index data, in 1940 the mean duration of holding period by US investors was seven years. This stayed the same for the next 35 years. By the 1987 crash the average holding period had fallen to under two years. By the turn of the century it had fallen to below one year. It was around seven months by 2007.

By 2010 high-frequency trading accounted for over 70% of equity trades taking place in the US and was rapidly growing in popularity in Europe and Asia. According to research by wealth management firm SCM Private, excessive trading is adding more than £3 billion a year of hidden charges for UK schemes. SCM found that UK pension funds had an average portfolio turnover of 128% each year – adding 0.7% in undisclosed costs. The cumulative effect of this over 20 years, it said, would be to shrink retirement pots by up to 15%[1].

Then there are dark pools. Nearly 40% of US equity trades take place away from public exchanges in dark pools or through 'internalization'. While they may have started as a way to minimise market impacts with large trades, the lack of transparency means none of us really know what's going on.

On 20-21 May 2014, the Sustainable Funds Team of the First State Stewart business hosted their first ever client forum in Edinburgh. The objective of the forum was to give our clients the opportunity to meet each other and debate the challenges of the industry, agree some steps to improve it and broadly to challenge the way we do things. We tackled a range of issues including:

- **Stock exchanges:** what would they look like if we started again?
- **System design:** is investing in average companies the best that we can do?
- **Alignment:** what are the principles that should determine the incentive structures across our investment supply chain to achieve the greatest alignment with clients? What do we most urgently need to change and how can we influence this?
- **Sustainable investing:** what are we really trying to achieve and how do we reclaim the concept to be one about delivering the best possible investment returns?
- **Company engagement:** what should we be working towards as an industry and how do we encourage industry collaboration?

The forum was conducted under the Chatham House Rule so there was much debate and free flowing conversation.

This paper summarises the topics covered and some of the main thoughts and ideas from the day.

1 http://www.scmprivate.com/recent-articles.php

STOCK EXCHANGES

So the forum, starting with a blank sheet of paper, set about building a new stock exchange model, one fit for purpose in the twenty-first century and designed specifically for long-term investors and companies who want genuinely long-term investors. The ensuing discussion brought out some particularly audacious ideas. Questions posed included:

- Who would own stock exchanges?
- Who would regulate them?
- How regularly should trading be permitted?
- What is a fair commission to pay for buying or selling a share?
- Does best execution matter?

It was agreed the kind of characteristics such an exchange would need would be unappealing to many people in that it would need to be slow and expensive to deter short-term speculative trading: "You pay more because it stands for something." One participant drew a comparison with the slow food movement. Trading would need to be limited to as little as once a day for individual stocks, there would be a minimum holding period, front-end fees or relatively high trading costs would be charged, and derivatives, hedge funds and short selling banned.

It was agreed that it would need to be structured almost as a members' club and that it ought not to be privately-owned given that at present, exchanges that are run in the interests of shareholders are not serving the interests of the people who use them. The answer arrived at then, was public ownership. So the forum agreed on a publically owned, expensive, slow, stock exchange governed by a set of simple but stringent rules. While this may seem absurd, the fact remains the current system is rather absurd as well!

SYSTEM DESIGN

Following this, the System Design discussion group looked to address the challenge of "investing in the average". Passive investing has clearly become the dominant form of asset allocation over the last few years. Not only that, almost 70% of the passive industry is controlled by the big three: Blackrock, State Street and Vanguard.

In defining risks as a deviation from the benchmark and rewarding investors on performance against it, we have incentivised index hugging behaviour and find ourselves paying/charging fees when money is lost in absolute terms.

The System Design discussion group concluded that benchmarks should be abolished, or at least declared not fit for purpose. More absolute return oriented benchmarks based on cash or inflation would be more appropriate to the long-term needs of pension funds and savers. Under the new system market capitalisation weighted benchmarks would be ditched in favour of indices incorporating governance or sustainable best practice performance (though it was suggested that the Dow Jones Sustainability Index and others like it are not appropriately delivering on this purpose). For example indices could be devised based on calculating companies' social dividend, which could reflect things like job creation. The social dividend could then be bundled up at the portfolio level so fund managers would have clear metrics on the social impact of their funds, in turn enabling long-term institutional asset allocators to make more informed investment decisions.

The option of switching to alternative benchmarks or even no benchmark at all was again a call for a change in mind-set. One suggestion was "all else being equal, do the right thing". That means being brave enough to not invest in companies that are very poor on governance and sustainability and a large part of the benchmark because they can still go to zero.

To address the problem of "closet indexers" a 'long-term' kite mark certification was proposed, with hard requirements on things like total expense ratio (the overall running costs of an investment fund), portfolio turnover and retention.

It was also highlighted that perhaps there is a problem with wrong language being used – "tracking error" suggests it's an "error" to deviate away from the benchmark but deviating is precisely what active managers should be doing. As one participant pointed out, the active share of a manager's top 10 holdings is a powerful indicator.

"Starting with a blank piece of paper, the forum set about designing a new stock exchange designed specifically for long-term investors. It was agreed it would need to be a publically owned, expensive, slow, stock exchange governed by a set of simple but stringent rules."

ALIGNMENT

The third working group looked to address the challenges of alignment. We highlighted to the group that too often we are told “every day” when we ask a CEO how often they check the share price. Fund managers obsess over daily attribution. Firm risk leads asset consultants to fear recommending anything more than passive funds. Pension Funds with liabilities over 30 years want live unit pricing!

It’s like watching a marathon in 100m intervals.

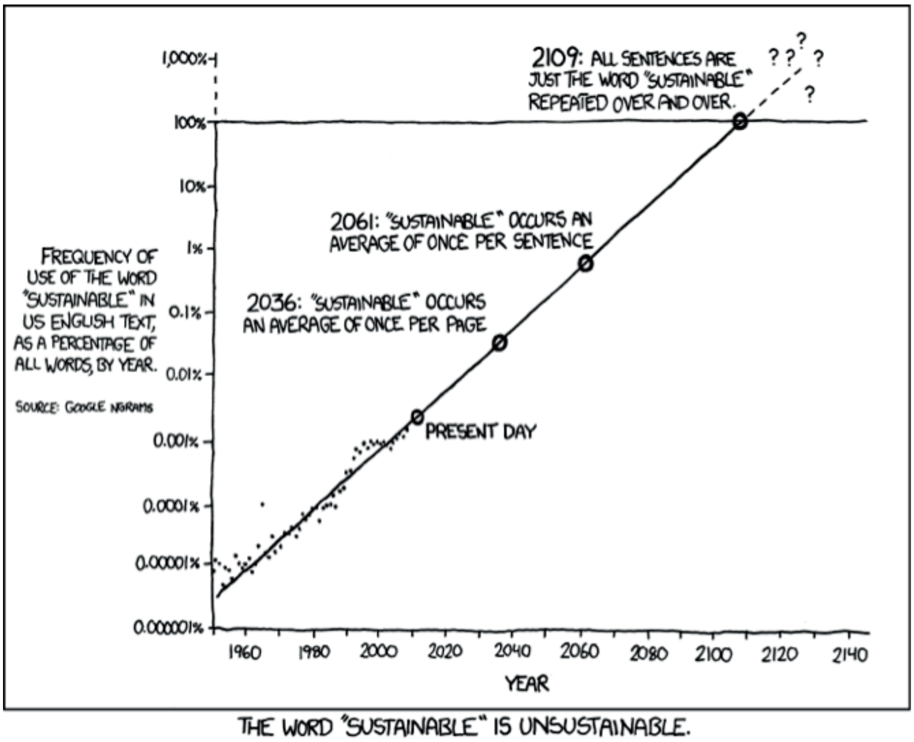
It was agreed that the area of financial incentives and executive remuneration is in need of an overhaul. Research from the London School of Economics has found that financial incentives are ineffective in achieving outcomes yet they continue to be given enormous importance by the financial sector. So our starting point was simple: why are financial incentives needed at all, particularly short-term ones? And why do finance professionals lack the intrinsic motivation of teachers, doctors or nurses?

Abolishing short-term incentives proved slightly contentious, with some arguing they do have a purpose in recognising the importance of day-to-day management. But it was agreed that the link between remuneration and share price should be weakened and that remuneration should be weighted towards long-term performance. Interestingly, and slightly against our own thinking, there was a view that it might not be good for directors to have large share holdings as this can give some individuals more influence (our own view has tended to be that directors who own shares will be more aligned with us), also that they should have to keep shares for five years after key decisions, while there should be some directors who hold no shares to guard against decisions being made solely with the share price in mind.

IN SUMMARY

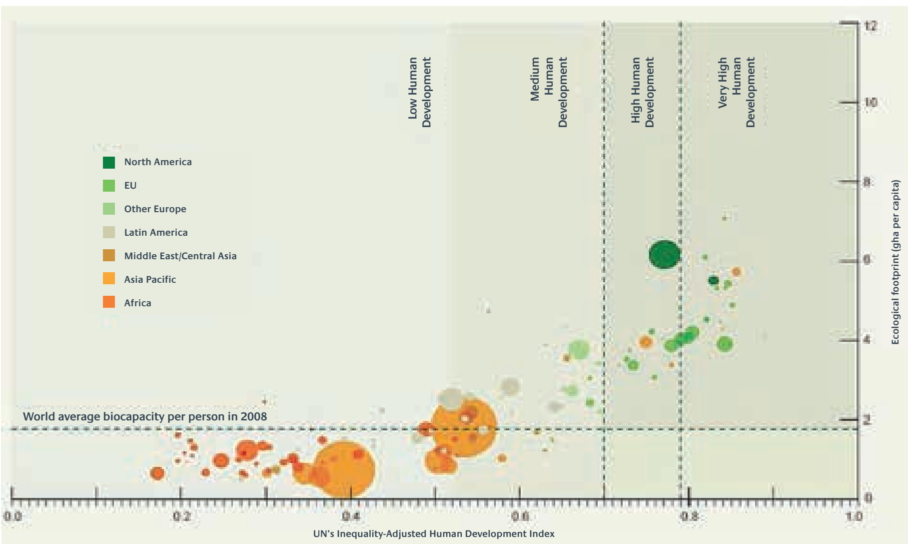
To address the problems in the financial system we must take away the emphasis on short-term performance and profit or at least redesign the system so that it is genuinely for the benefit of the end user. To this end, our conclusion was that we could redesign stock exchanges in such a way that the ‘disruptive’ short-term influences are removed. Linking to this we could consider redesigning benchmarks so that they relate more meaningfully to long-term objectives particularly by incorporating a social impact dimension. Lastly, as an industry we must try and break the obsession with financial incentives, particularly short-term incentives, and base remuneration structures on straightforward measures of long-term performance.

REDEFINING ‘SUSTAINABILITY’



One of our core concerns is that ‘sustainability’ has become an overused term. For this reason we began the session on defining sustainability with a show-of-hands poll on whether the term is redundant – the forum was unanimous that it is not! The discussion then addressed sustainable development, what a sustainable company looks like and what sustainability means in an investment context.

Visualising Sustainable Development



Source: WWF / African Development Bank / Global Footprint Network.

To introduce the challenge, we outlined the definition we tend to use on the First State Stewart team, which is essentially captured in the visual conception of ‘sustainable development’ in the above chart.

The horizontal axis shows the UN's Inequality-Adjusted Human Development Index – a proxy for broad-based societal development based on median values around literacy, income and life expectancy, while the vertical axis shows ecological footprint per capita – a measure of the environmental impacts that societies have on the planet. The bottom right hand corner is the zone in which a society achieves 'very high' human development at or below 1.8 hectares/person – roughly the volume of natural resources available to us as a planet. This is sustainable development. No country, unfortunately, comes close.

According to the New Economics Foundation, in 1961 the Earth could have supported everyone living a UK lifestyle. However, today it would take at least three planets to support the current UK lifestyle. Even at a global level, including all the low-income countries, the world is now living well beyond its means.

Unfair as it seems, it is becoming increasingly clear that most low-income countries will be unable to follow the resource-intensive, carbon-intensive, environmentally destructive development path pursued by industrialised countries. A scarcity of key natural resources such as arable land and freshwater, the unpredictable, serious consequences of a changing climate and unprecedented population levels have all combined to block the traditional route for most low-income countries.

At the same time, there remain huge challenges around human development. These include the need to lift the world's bottom billion out of abject poverty, but also some in more 'advanced' societies; this is the first generation of Americans, for instance, with shorter life expectancies than their parents due to the prevalence of chronic lifestyle diseases.

The presentations and table discussions agreed on a broad definition in terms of "needs and limits", "meeting the demands of today without using up the resources of tomorrow" and "doing more with less". We had a presentation from the CEO of an automated sensor-based sorting solutions company whose technology has improved energy efficiency in the mining sector and helped improve food yields and is used in collecting and processing recycling. One idea taking hold is the circular economy, where resources are used (and reused) rather than consumed. Perhaps this company is an early example of this...

Talk of things like responsible resource management seems for some to conjure images of "tree huggers" and to cloud people's idea of sustainable investment. But it is not just about green energy companies. Nor should it be confused with ethical investing. We sought to address these misconceptions by discussing what a sustainable company looks like. As the above mentioned CEO put it, a sustainable business requires holistic thinking – which means investing for the long-term in the well-being of employees, in building 'partnerships' with suppliers, and in intellectual property. It also means being attuned to society by listening to customers, monitoring public opinion and collaborating with public institutions.

Another one of our favourite companies is an Indian consumer goods company operating in the product categories of hair care, skin care, health foods and grooming. We heard the Founder at the forum talk about how the company has over the past two decades built a culture based on a flat structure within the organisation and values of openness, trust and transparency. The company has tasked itself with making a difference to all stakeholders and society. This it seeks to accomplish directly through the quality of its products. For example, India has high rates of heart disease and the company's edible oils can improve cardio vascular health. The company has also created a Healthy Heart Foundation, which has begun initiatives such as providing free health and cholesterol checks and educating the population on the issue of cardio vascular disease.

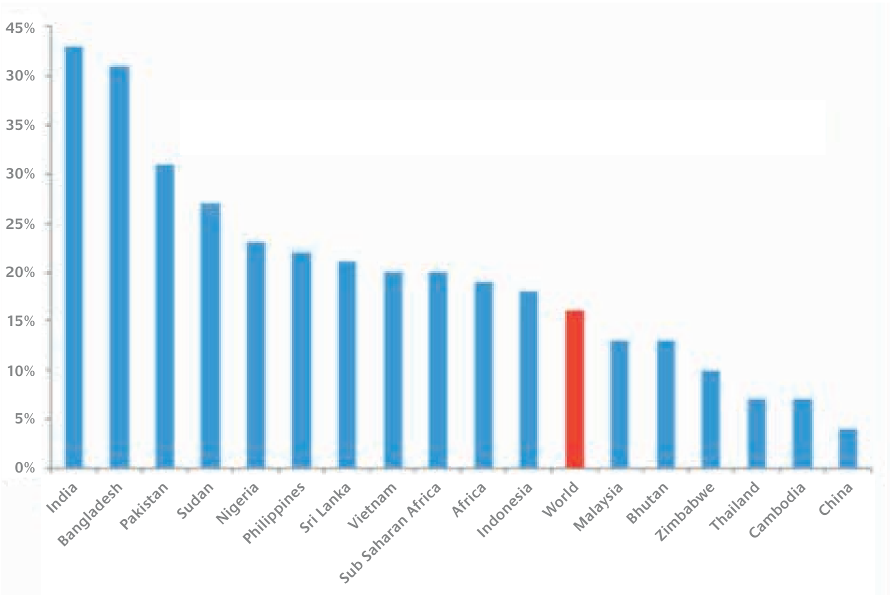
Another misconception is that to be a sustainable investor or company means compromising returns. The companies at the forum would certainly not agree. The CEO of the sorting solutions company observed that being truly sustainable can sometimes mean compromising on short-term returns, but not long-term performance. The company has consistently grown its top-line and consistently achieved a gross margin of over 40%. China with its fast expanding middle class is gearing up for huge investment in waste treatment facilities – a substantial long-term opportunity. "We want to be labelled as a profitable green company."

Top 10: Countries/territories of number of people with diabetes (20-79), 2011 and 2030

	Country/territory	2011 Millions		Country/territory	2030 Millions
1	China	90.0	1	China	129.7
2	India	61.3	2	India	101.2
3	United States of America	23.7	3	United States of America	29.6
4	Russian Federation	12.6	4	Brazil	19.6
5	Brazil	12.4	5	Bangladesh	16.8
6	Japan	10.7	6	Mexico	16.4
7	Mexico	10.3	7	Russian Federation	14.1
8	Bangladesh	8.4	8	Egypt	12.4
9	Egypt	7.3	9	Indonesia	11.8
10	Indonesia	7.3	10	Pakistan	11.4

Source: International Diabetes Federation.

Percentage of malnourished children under the age of 5



Source: Unicef 2006-2010

We also spent some time discussing our definition of Sustainable investment.

The observation was made that the function of capital markets as allocators of society's capital to productive and socially useful enterprises often gets lost. The pressure on asset allocators for short-term relative performance versus a benchmark pushes investors to ignore the principle that long-term returns are inexorably linked to the sustainability positioning of the underlying companies.

There remains a widespread perception that sustainability as an investment philosophy is in some way a compromise – that investors have to 'give up' some return in order to invest according to the principles underpinning sustainability. For mainstream investors with 20 year timeframes, for whom even a marginal difference in annual returns compounds to very meaningful eventual outcomes, this idea can be extremely difficult to overcome.

These ideas stem roughly from perfect market theory and more specifically the idea that you should not be able to outperform in the long-term if you reduce the scope of the investable universe. It was argued that viewing some companies that are very poorly positioned for sustainability challenges as, in practice, uninvestable is no different to a quality approach which refuses to buy companies below a certain quality threshold, regardless of price. Indeed, one is very much an extension of the other.

There is no one 'sustainability investment process'; each manager will have slightly and sometimes radically different ideas on how things ought to be done. The central challenge remains to prove that sustainability can be the driver of returns rather than a compromise, and that funds managed in this way ought to be considered alongside more 'mainstream' funds without any assumption that returns should be any lower.

The principles underlying our new and improved financial system also apply to defining sustainability; it is about taking a patient, long-term, "holistic" view. Resource efficiency is part of the solution, but in the sense that resources are used, and reused, responsibly and not in the Financeland sense of driving down costs. For developing countries, sustainability will need to be at the heart of economic development so that growth is inclusive: the unequal, 'clean-up' approach of the West will not work. To this end we need better GDP accounting which doesn't just measure traditional output but also social and environmental impacts.

COMPANY ENGAGEMENT: CAN WE BE MORE EFFECTIVE?

Engagement with companies is central to our process, from the moment analysis of a company begins to the point an investment is made and for as long as it is owned. In preparation for the forum we went back to some of the letters we had written up to ten years ago encouraging companies to change governance or sustainability behaviours. It was disappointing to note that often very little had changed. One of the objectives of the session was to solicit feedback directly from company leaders and senior management, and our clients, on how we and the industry might be more effective.

The forum heard from the Global Head of Investor Relations from a company whose approach to sustainable development we greatly admire. One of the most concerning things we heard was that they had met with ten investors the day before our forum but only one had asked about a sustainability related matter and it was the last question of the day! The other startling observation was that the business had in the past implemented only one operational change following engagement, and it was from engagement by a non-governmental organisation (NGO). Nothing has changed as a result of engagement from an investor. Key take away: we have a long way to go!

This might suggest doubts about the idea that capital, or financial stakeholders, can have values. At any rate, it seems we aren't being as effective as NGOs. Collaborating with these organisations might be one remedy as might greater collaboration among investors.

Another Founder/CEO said that investor engagement had been particularly influential, especially in relation to Governance but that the company certainly didn't listen to everything fund managers said (thankfully).

There is no such thing as a perfect company. The easiest decisions are probably on companies we would never own: the coal company which had 50 deaths last year and has no independent directors, the power generation company whose owners have been banned from the stock exchange for share price manipulation or the bank which has accumulated fines of $28 billion and counting since the financial crisis. But there are a lot of companies we like that have one or two sustainability issues. For example there is one we are currently backing which we think is overpaying its CEO, but which has impressed us with its openness during a recent bribery scandal. Engagement is an ongoing and dynamic process.

In order to bring out some of these grey areas, two of our colleagues from the First State Stewart team came to the forum and, playing the roles of trustee and asset owner, cross-examined us on our process and sustainability credentials. They were only too happy to ask about our "dirty secrets" corner, a list of companies with no obvious sustainability credentials which we have held in the past, for example an Australian mining company. There are mining companies which would be eligible for investment where safety standards are high, which have a responsible approach to environmental impact and where we think there is an opportunity for engagement.

Unfortunately, in this instance, after a considerable amount of engagement we felt the necessary changes were not being executed in a timely enough manner and, as a result we were not comfortable investing our clients' capital. Despite this we continue to meet and engage with this company on a regular basis.

They were also keen to ask: "In what way is the investment process of the other First State Stewart teams (Global Emerging Markets and Worldwide; and Asia) not sustainable?" The answer is that it is of course sustainable and it is only because our traditional funds have such a strong focus on sustainable investment that we are in a position to manage explicit sustainability strategies. We are just fortunate enough in the sustainable funds team to have been given the explicit mandate by our clients to go one step further and identify those companies that are driving sustainable development outcomes in some way. Our investment philosophy and what we look for in a company is exactly the same.

The session on engagement was enlightening. The companies in the room said they welcome investor engagement, but clear questions emerged around the efficacy of engagement. Generally investors have to accept that they are unlikely to be able to direct outcomes, but they can influence behaviour and culture through long-term engagement. It is a process which involves taking a case by case approach: there are those companies which will always treat shareholders with disdain and may not even care if the shares are sold. Others are more open and willing to engage.

CALL TO ACTION

The aims of the forum were to redesign the financial system, redefine sustainability and undertake a frank examination of the efficacy of engagement. Through a series of discussion and roundtable groups we formulated a number of key action points as follows:

- Create a stock exchange designed solely for long-term investors – a publically owned, slow (ultra-low frequency), expensive, members' club stock exchange – no hedge funds allowed!
- Abolish benchmarks, or at least redesign them based on more absolute measures such as cash or inflation
- Create indices that reflect social impacts like job creation, or "social dividends", and create new measures of economic growth to reflect social issues and the cost of resource consumption
- Implement an industry 'long-term' kite mark based on measures including total expense ratio and portfolio turnover
- Engage companies on incentive schemes, in particular, lessening the emphasis on short-term incentives and broadly pushing for far simpler remuneration structures
- Emphasising social alignment as much as financial alignment (we need to find a way to do this as an industry)
- Take a more multi-faceted approach to engagement through more collaboration with NGOs and other investors
- "Just give us a bill!" – Improve transparency of fees in the financial industry and continue to push sell-side brokers for transparency on costs
- Most important of all, turn off CNBC and Bloomberg!

The quality and openness of the debate, the level of interaction and the boldness of ideas at the Sustainability Forum were extremely gratifying to see, not to mention highly enjoyable! If collaboration is among the best ways to address the challenges we face as sustainable investors in a flawed financial system, then the forum argued well for the possibility of positive change in the future. Thank you for your attendance and contributions and as ever if you have any feedback, thoughts or suggestions please get in touch.

Regards,

Amanda, David, Jack, Jen, Nick, Ollie, Ruth and Sashi.

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