

**For professional clients only**

## First State Stewart Sustainability Strategies

### Investment Strategy Overview

2014



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Since the launch of the Asia Pacific and Emerging Markets team's first product in 1988, sustainable investment has always been an integral part of the team's investment philosophy and stock-picking process. At the heart of this philosophy is the principle of stewardship.

We believe our job is to entrust our clients' capital to good quality companies with strong management teams and sound long-term growth prospects.

Each investment is a decision to purchase part of a real business with all the rights and responsibilities that go with this 'share' of the ownership of the company. We take these rights and responsibilities seriously. We also believe the way we behave as investment professionals and the role we play in the broader industry are important for our own sustainability.

All the First State Stewart investment strategies strive to integrate environmental, social and governance (ESG) considerations into every investment decision. Our sustainability strategies take this one step further by focusing on long-term sustainability themes as a key driver of the investment process. We manage investment strategies for clients through pooled funds, client mandates and a UK-based investment trust.

## History

Stewart Ivory & Company Limited was formed in 1985 by the merger of Stewart Fund Managers Limited and Ivory & Co. Stewart Fund Managers can trace its roots to the establishment of The Scottish American Investment Company plc, Edinburgh's oldest investment trust, in 1873.

In its more recent form, First State Stewart began when Angus Tulloch joined Stewart Ivory & Company in 1988 to set up the Asia Pacific and Global Emerging Markets (GEM) capability. Stewart Ivory & Company was bought by First State Investments/the Commonwealth Bank of Australia in 2000. The acquisition allowed the investment team to retain their independence and to effectively operate as a stand-alone boutique investment management business within Colonial First State Global Asset Management (CFSGAM).

Our first explicit sustainability strategy, the First State Asia Pacific Sustainability Fund was launched on 19 December 2005 under the guidance of David Gait. The Australian-domiciled Colonial First State Global Emerging Markets Sustainability Fund was launched on 16 February 2009 and the European-domiciled First State Global Emerging Markets Sustainability Fund was launched on 9 April 2009. In addition, the First State Indian Subcontinent Fund has been run with a particular emphasis on sustainable investment since July 2008. In November 2012 we launched our Worldwide Sustainability strategy with a vehicle domiciled in Australia and the UK. David Gait continues to lead the strategies.

# Sustainable investment aim and philosophy

## Sustainable investment aim

To generate attractive long-term, risk-adjusted returns for our clients by investing in the shares of those companies which are particularly well positioned to benefit from, and contribute to, the sustainable development of the countries in which they operate.

## Investment philosophy

We seek to invest only in good quality companies. Quality is measured through the lenses of quality of management, financials and the franchise. By analysing the sustainability performance and positioning of companies we can better measure less-tangible elements of quality and identify hidden risks.

We are long-term investors. We strive to make investment decisions with a minimum five-year time horizon.

We have an absolute return mind-set. That is, we define risk as losing money for our clients, rather than in terms of deviation from any benchmark index. We focus as much on the potential downside of our investment decisions as on the anticipated upside. The identification of long-term sustainability risks thus becomes an extremely important way of managing risk. In addition, our willingness to differ substantially from index weightings, both country and company, means we are not obliged to be invested anywhere where we have particular sustainability concerns.

We also recognise there is no such thing as a perfect company. We are active owners and stewards of the companies we own. While there is no formal negative screening, we do not anticipate that companies operating in high risk sectors will be natural candidates in terms of their long-term sustainability positioning. Examples of such sectors include gambling and tobacco.

## Definition of sustainable investment

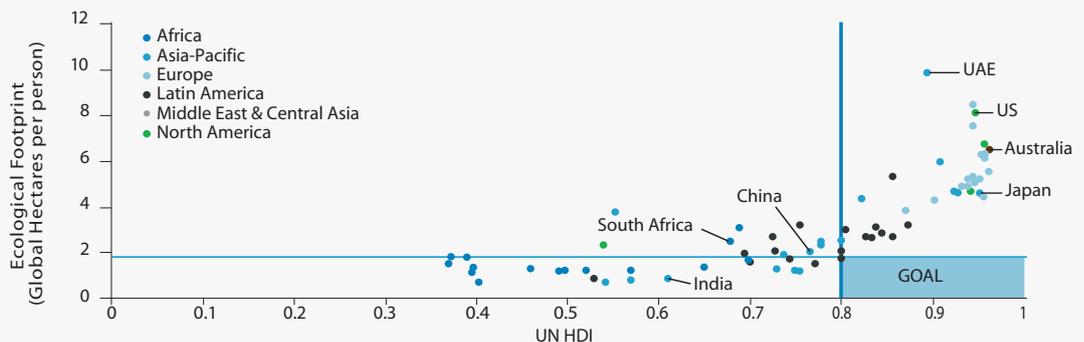
We invest in those companies we believe are particularly well positioned to deliver long-term returns in the face of the huge development challenges facing all countries today. Our emphasis is on sustainable development and not 'green', 'clean tech' or 'ethical' investing.

The root causes of these development challenges are numerous and complex. They include population pressure, land and water scarcity and degradation, resource constraints, income inequality, ethnic and gender inequalities and extreme levels of poverty. It is becoming increasingly clear that in order to tackle these development challenges, both developed and developing countries will be required to reinvent their development trajectories and shift away from the current resource intensive, consumption intensive, overly debt-dependent development models towards a more genuinely sustainable path of economic development.

Figure 1 illustrates the direction countries need to head towards in order to follow a sustainable development path. The diagram shows the Human Development Index (HDI) and ecological footprint of different countries. The X-axis shows the HDI (a composite measure of average incomes, health and education standards by country). The higher the HDI, the more 'developed' the country. A figure of 0.8 or higher is considered to be 'high human development'. While potentially a better measure than GDP, the HDI still has its limitations. Most notably it ignores environmental factors. This is reflected on the Y-axis which shows the average ecological footprint by country. An ecological footprint of 1.8 global hectares per person is defined as the current maximum sustainable level, above which a country's resource demands are too high to be provided for at a global average.

Figure 1: Sustainable development: 1980 - 2007

### HDI and Ecological Footprint of Nations



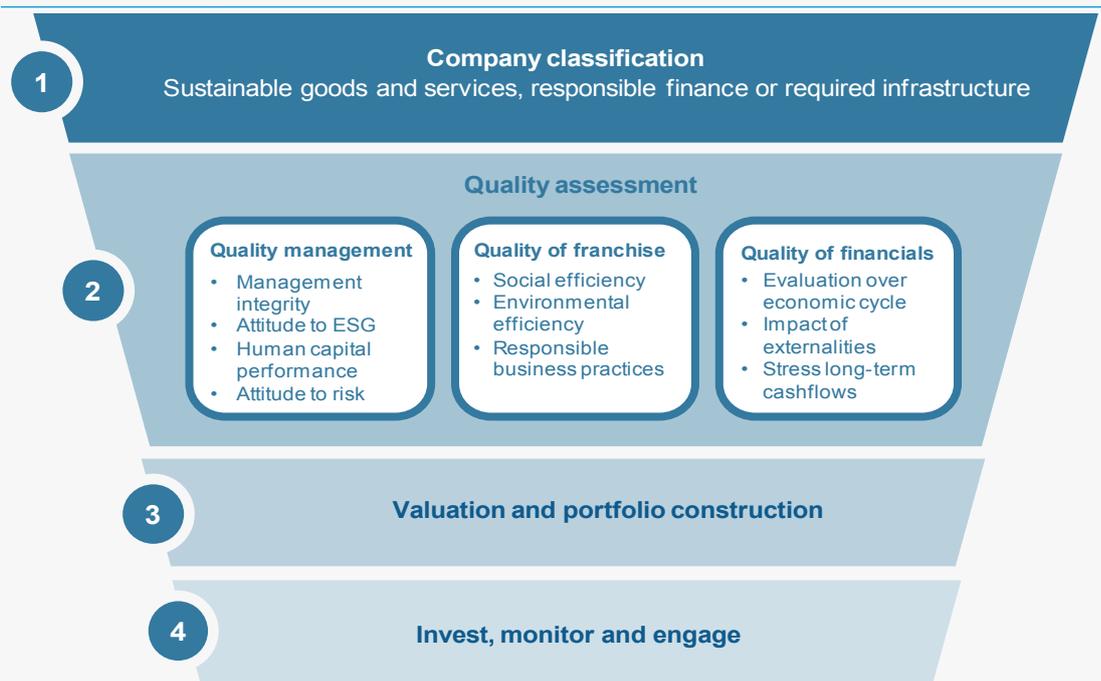
Source: [http://www.footprintnetwork.org/en/index.php/GFN/page/fighting\\_poverty\\_our\\_human\\_development\\_initiative/](http://www.footprintnetwork.org/en/index.php/GFN/page/fighting_poverty_our_human_development_initiative/)

At current aggregate levels, humanity is using up natural resources at a 35% faster rate than nature can regenerate. The challenge for all countries is to shift their development paths towards the bottom right quadrant in Figure 1 – that is, high HDI, low ecological footprint.

When we say that sustainability is a driver of our investment philosophy we mean we are actively seeking out companies that are assisting the global move towards the bottom right hand quadrant. For us, sustainable investment is about allocating capital to well-managed companies that are positioned to benefit from, and contribute to, the movement of countries towards this goal. It is these companies which, we believe, are best placed to deliver long-term growth in earnings and cashflows over time.

We have no proprietary models or ‘black boxes’ for assessing long-term sustainability positioning. There are no magic formulae we can rely on. Instead, we analyse as broad a range of quantitative and qualitative factors as possible.

Figure 2: Investment process



## Step 1: Company classification

The first part of our investment process could be described as starting with a blank sheet of paper and trying to find the best possible companies in which to invest. The best possible companies are framed by our thinking on the sustainable development challenge outlined above. We are not looking to ‘cover’ the 60-odd thousand companies in our investment universe, rather just looking to find the best 30-60 for our clients’ portfolios. We don’t have sector analysts or country analysts, we are all generalists and we are all charged with identifying possible companies to invest in.

To help analyse companies, we find it useful as a first step to classify potential investment opportunities into one of the three following ‘sustainability sectors’:

1. Sustainable goods and services,
2. Responsible finance, or
3. Required infrastructure.

These sectors are not designed to be a formal screen, rather to help us think more clearly about the long-term sustainability positioning of different types of businesses. Virtually all companies will fall into one of these sectors

but we categorise them to assist in determining the critical sustainability issues to apply to our fundamental analysis. There are about 300 companies across these quality lists at any point in time, and the list is continually changing and evolving as we refine our views on companies and build conviction.

### Sustainable goods and services

Companies that fall into the Sustainable Goods and Services sector are companies that provide products and services that have a positive impact on society and the environment. We seek out companies that are:

- selling and producing their products through efficient means with minimal environmental or social impacts.
- set to benefit as environmental externalities are internalised.
- producing products that are positive for human health.

Examples of such companies include Marico (India: healthier foods addressing diabetes risk), SGS (Switzerland: industrial safety and environmental verification), Shimano (Japan: bicycle equipment), and Unilever (UK: consumer staples).

### **Responsible finance**

The finance sector plays a vital role in a sustainable future. As well as serving the individual through savings, loans and investment for the future, the sector provides businesses with access to capital and enables prudent business activity. Accurately priced and equitable insurance is also critical to manage risk relating to uncertainty and property ownership. We seek out responsible finance companies that operate with trust and understand their licence to operate. Specifically we look for traditional savings and loans banks which focus on patiently gathering deposits and prudently lending them back to customers.

Examples of such companies include Chubb Insurance (US), Commercial International Bank (Egypt), Daegu Financial Holdings (South Korea), Public Bank (Malaysia), Gruh Finance (India), GT Bank (Nigeria) and Handelsbanken (Sweden).

### **Required infrastructure**

We also seek out companies that provide the required infrastructure necessary to support long-term sustainable development. Such companies may be aligned to the provision of water, energy, waste, and housing services, using innovation and technologies that grow these services within the limitations of our ecosystem. These limitations are driving growth in areas such as the lower carbon and energy efficiency sectors, the provision and management of fit-for-purpose water and sanitation and the reduction and re-use of waste. Energy efficiency and low carbon energy sources provide the same services and growth profile as traditional suppliers without facing the same environmental constraints. Mining, metals and industrial companies that operate efficiently, can demonstrate they have earned their license to operate from local communities and provide an essential input also fit within this sector.

Examples of such companies include Manila Water (Philippines), Wartsila (Finland), SMA Solar (Germany), Tomra Systems (Norway), American States Water and Xylem (US).

We are not setting out to invest in every clean technology, water or microfinance company we come across, nor will we invest in a company simply because it appears to be a leader in sustainability.

## Step 2: Quality assessment

Many companies which appear to be well positioned in terms of their sustainability positioning are likely to struggle to fulfil this potential over time because they are fundamentally poor quality businesses run by poor quality management teams.

Perhaps the single most important step in our sustainable investment research process is to assess the overall quality of a company. In doing so we hope to be able to identify and invest in those companies most likely to fulfil their long-term sustainability potential and avoid those companies most likely to fall by the wayside over time. Fortunately we can afford to be choosy. Our investment universe runs into the thousands, while we are only looking to identify 40-60 good quality companies to which we can allocate our clients' and our own capital for the long-term.

We break our quality assessment down into three distinct parts and analyse both qualitative and quantitative factors to help us build up an overall picture of the quality of a company.

1. Quality of management
2. Quality of franchise
3. Quality of financials

### Quality of management

We place particular emphasis on the quality of the management team to whom we are entrusting our clients' capital. We spend a great deal of time focusing on issues such as management integrity and corporate governance, attitude to ESG issues and the ability to develop and execute successful long-term strategies. We also look for evidence of innovation.

The existence of long-term alignment between company management and minority shareholders is highly significant. We have a preference for simple remuneration structures, recognising that the very best managers often perform out of a sense of purpose, or as our favourite Indian companies refer to it, 'dharma'.<sup>1</sup> Many modern management teams appear to have lost all sense of purpose or dharma in their search for short-term returns. We look for evidence of dharma as a key long-term competitive advantage.

Human capital performance is also critical and indicators such as employee compensation, employee turnover rates and safety performance can be particularly revealing.

1 Dharma: the Sanskrit word often translated as 'purpose'.

### Quality of franchise

To analyse the quality of a company's franchise we consider factors such as the brand and market share, pricing power and competitive advantage. In our sustainability assessment we also seek to answer three key questions:

1. Is the franchise socially useful?
2. Is the franchise environmentally efficient?
3. Does the company have responsible business practices?

### Social usefulness

We analyse social usefulness because those companies that have a high percentage of products or services that are actually needed by society are more likely to provide less volatility in returns and will face fewer risks to their license to operate over time.

For example, it is possible to argue that consumer companies whose sales are dominated by products containing high levels of sugar, salt and fat have a weaker quality of franchise when looked at through this social usefulness lens. Such products when consumed in excess have negative externalities for society through increased health costs. This in theory should dampen demand in the longer term but more significantly attract significant negative attention from regulators, politicians and concerned stakeholder groups. In short, such companies are likely to face increasing headwinds from advertising controls and regulatory scrutiny to potentially damaging community campaigns.

On the other hand, consumer companies which focus on selling healthier foods or consumer staples such as toothpaste, soap and shampoos tend to have a stronger quality of franchise when viewed through this social usefulness lens.

Social usefulness is important not only for consumer companies. For example, we spend a significant amount of time assessing the social usefulness of banks. We seek to avoid banks that generate a significant part of their profits from proprietary trading and listed stock exchanges which regard their high frequency trading strategies as a key growth driver.

In many markets greater prudential regulation is needed to rebalance the finance sector. Companies which recognise the requirements of their implicit social contract will not face these headwinds. Those companies most

likely to benefit from tailwinds will be traditional savings and loans banks. In addition, access to equitable finance for all in society is critical to escape poverty and those organisations able to serve the bottom of the pyramid with responsibility are also well placed to generate long-term shareholder value.

The assessment is obviously one that is based on subjective measures and there is significant debate within the team about the social usefulness of the franchises we look at. Our aim is not to screen out companies with particular product or service. Nor is it to be self-righteous or judgemental, but rather to try and gain a better understanding of the overall quality of a company's business franchise.

#### Environmental efficiency

A company's quality of franchise is also impacted by its operational efficiency and the environmental outcomes provided by its products. We are seeing a slow but steady internalisation of environmental externalities across sectors and countries. A company that, everything else being equal, can generate higher economic returns per unit of 'environmental resource' will be better positioned over time. With the increasing availability of energy, water and waste data at a company level, we are now better able to compare and contrast companies on metrics such as return on energy, return on waste and return on water.

While we still need to monitor a company's environmental performance from an operational perspective, by looking at issues such as water and air contamination and what we observe at site visits, these environmental metrics help us to build up a more complete picture of the long-term sustainability positioning of each company we analyse.

Environmental efficiency is also about opportunities. For example, from a product and service perspective, companies can present an investment opportunity by providing technologies that improve environmental outcomes for their customers.

Analysing how companies provide, or embrace, new 'essential' technologies over time can be another useful way of building up a picture of the quality of the franchise and the management. For example, good management teams are usually much quicker to use and adapt new technologies such as smart meters, LED lighting, smart grids and cloud computing, co/tri-generation, distributed solar, drip irrigation and rainwater harvesting.

#### Responsible business practices

We also seek out companies with defensible barriers to entry. We have a preference for balanced franchises and are nervous about business franchises that appear too strong or lopsided. Over time, they tend to attract the attention of competition regulators, politicians, non-governmental organisations and new capital.

Companies that are too aggressive or pursue irresponsible business practices with their suppliers, employees or customers provide easy pickings for new entrants. As a very quick and crude check for franchise balance, we ask ourselves whether all customers, suppliers and employees are being treated fairly and we look at metrics such as days payable as proxy.

#### Quality of financials

We analyse a number of factors to try and build up an overall picture of the quality of the financials.

Firstly, we want to understand how the company has performed over the economic cycle. As long-term investors, we look for business franchises that can stand the test of time. We place little trust in short-term extrapolations of current profitability. Instead, we try and look back as far as we can in time to see how the company has performed during times of stormy economic weather.

We are not value investors in the often understood sense of that term. We strive to invest in companies able to grow their cashflows over the long-term as they contribute to, and benefit from a shift in the economic development trajectory. However, we have a strong preference for predictability over speed of growth. Companies that try to grow too fast tend to end up falling over or cutting environmental, social and governance corners. We prefer the marathon runners to the sprinters.

Importantly, we also try to ensure we understand the potential impact if externalities are internalised into the financial accounts. Typically, most environmental and social liabilities and costs are currently omitted from balance sheets and income statements. Examples include the long-term environmental liabilities of many chemical companies, or the anticipated legal liabilities facing those tobacco companies that continue with less responsible marketing and sales practices in emerging markets.

Other factors we analyse when looking at the quality of financials include working capital trends and requirements, tax rates, the reputation of the audit firm, non-audit fees to audit fees, change in audit firms, unusual changes in financial year ends, currency mismatches, aggressive accounting and hedging policies.

#### Step 3: Valuation

We simply try to analyse as broad a range of valuation metrics as possible to come up with a sensible estimate of what a share is worth over time to us as long-term investors. Where ESG issues arise, they will be factored into the overall assessments of quality and growth. These in turn drive our valuation methodology in terms of earnings forecasts and the price we are prepared to pay for any given stream of cashflows. We undertake a range of different valuation techniques based on

earnings, cashflows, book value, replacement cost and physical metrics.

As stockpickers, the most difficult challenge for us lies not in identifying what a share is worth, but rather in making the emotional decision to sell our favourite companies if they reach our fair market value. Given the volatility of stockmarkets, we face this challenge more often than we would like.

For many companies, there is no price at which we are prepared to allocate our clients' capital. No matter how cheap a company's stock is, the downside is always one hundred per cent. For companies facing stiff sustainability headwinds, or specific ESG challenges, earnings and cashflows can disappear very quickly.

For those companies that pass our quality criteria, we set our own fair market values based on both qualitative and quantitative analysis. We have no proprietary valuation methodologies.

Once we purchase a share in a business on behalf of our clients (which often will include our team members as they are unitholders of some of the funds that we manage), we spend a significant amount of time engaging with the management team.

#### **Step 4: Invest, monitor and engage**

##### **Portfolio construction**

We aim to invest in sensibly priced, high quality companies that can deliver sustainable earnings per share growth. We believe selecting companies that display these features is the most important factor in producing consistent, above-average long-term performance for our investors.

As our portfolios are constructed with a bottom-up approach, we expect the majority of our value-added performance to come from stock selection. With the exception of the limitations imposed by our portfolio construction parameters, the country, currency and sector allocation is largely a residual of our underlying stock selection process.

As we manage conviction-based portfolios, we strive to ensure that the top ten investments generally account for 40% of the portfolio. The stock weighting reflects the relative risk/reward profile of each of our companies, subject to liquidity and risk control constraints.

And finally, our portfolios are constructed with the long-term in mind.

##### **External portfolio verification**

Every six months, our Sustainability Product will be screened by our external Sustainable and Responsible Investment (SRI) advisor, Ethix of Sweden ([www.ethix.se](http://www.ethix.se)) to ensure that each company within the portfolio meets the 'global norms' for best business practices. These 'global

norms' are a series of internationally agreed standards for business, including the UN Human Rights Norms for Businesses and the UN Global Compact Principles. Companies are flagged using a traffic light system – green, amber (monitor/potential issue) and red (engage/exit).

Given our rigorous investment process with its emphasis on quality, and our positive screening approach described above, we would be extremely disappointed if more than a very small number of stocks within the portfolio were ever flagged amber or red.

##### **Engagement**

We engage on a wide range of issues including strategy, governance alignment of interests and reputation. We engage for two reasons.

First, we believe that the purchase of a share in a business comes with both rights and responsibilities. Should one of our companies fail to meet international best practices on the environment, human rights or social issues, we believe we have a responsibility, as part owners of the business, to engage with senior management to persuade them to address the issue, rather than to walk away from the problem.

Second, we see ESG issues as investment issues. Positive engagement on ESG issues becomes a powerful tool in driving shareholder value and protecting and enhancing the value of our portfolios.

Our engagement takes many different forms, from face-to-face meetings to informal emails to formal written correspondence. We find it much more productive to engage with management teams with whom we already have a good relationship. As a result, perhaps the most important part of our engagement process is to establish rapport with management teams ahead of any engagement. One of the best ways we have found of doing this is to write thank you letters after our meetings, reiterating our appreciation for the meeting and reminding management of our long-term approach and expectations as shareholders. Fundamentally, the engagement always needs to be two-way. It's critical that we listen to companies and truly understand the challenges they are facing, as well as effectively communicating our expectations as investors.

As long-term shareholders, we are active owners of the companies in which we invest; we aim to vote on all resolutions at annual and extraordinary general meetings. The majority of resolutions we vote against relate to management remuneration, minority shareholder rights and board directorships. We rarely see environmental or social issues appear on the ballot papers.

# Strategy summaries

We have broadly four strategies operating under the Sustainability Investment team (managed through funds based in the UK and Australia, individual mandates and a UK-based Investment Trust). Combined, these strategies represented USD2.2 billion in assets under management as of 30 December 2013.

## First State Asia Pacific Sustainability

Launched: December 2005  
Global FUM: USD572m

The strategy invests in equities in the Asia Pacific region (excluding Japan, including Australasia). As it became increasingly clear that Asian countries would no longer be able to follow the traditional development path of their Western counterparts, we became keen to run an explicit sustainability strategy which focused on investing in those companies best positioned for this development shift.

Examples of long-term investments of the strategy include Manila Water (Philippines) and Public Bank (Malaysia).

Manila Water has a wonderful track record of delivering affordable, clean water to low income households living in East Manila. Since taking over the East Manila franchise in 1997, the Company has cut leakage rates from over 50% to less than 12%, while increasing coverage from less than 50% to over 99% of households today. This operating success was primarily achieved by working closely with local communities within the concession area, instead of making top-down executive decisions from the executive floor. Having earned its social license to operate in Manila, the Company is now well positioned to replicate its success in other municipalities, elsewhere in the Philippines and overseas. The Company is controlled by the Ayala family who have a strong approach to corporate governance.

Public Bank in Malaysia is a conservative, and truly long-term focused traditional bank that even goes as far as to question the role of banks in society. In a recent meeting with them they referenced the lessons of 1997 five times. The founder is still involved in the Company and there is a strong culture. Incentive structures are robust. Even at the branch manager level, people are measured over the long-term and tied to loan performance (not just volume). Public Bank has an impressive approach to human capital demonstrated by them measuring metrics across divisions (e.g. staff turn-over). They are also the one bank that is completely independent of Government in Malaysia.

**Note: The First State Asia Pacific Sustainability strategy is now closed to new investors.**

## Pacific Assets Strategy

Launched: August 1989  
Global FUM: USD318m

Since 1st July 2010, First State Stewart has been the Investment Manager of Pacific Assets Strategy, on behalf of the UK listed Pacific Assets Investment Trust. As with our other strategies, the Pacific Assets Strategy is managed with an explicit sustainable investment focus. In terms of portfolio positioning, this strategy is similar to the First State Asia Pacific Sustainability strategy but with two main differences. Firstly, Pacific Assets Strategy excludes Australia and New Zealand from the investible universe of companies; we also have the opportunity to invest in small, illiquid companies in the region, where appropriate.

## Global Emerging Markets Sustainability

Operating since: February 2009

Global FUM: USD672m

The strategy invests in shares of companies based in, or having significant operations in, emerging markets. We started the Global Emerging Markets Sustainability strategy because by 2009 we felt we had a deep enough understanding of the sustainable development challenges across emerging markets and could identify companies that were managing and benefiting from them.

Examples of long-term investments of the strategy include Marico (India) and Tech Mahindra (India). Marico is a particularly well-managed Indian consumer company. The Company's core product is 'Parachute', a coconut oil that can be used for both cooking and as a hair oil. Cashflows from this business have been used to slowly build up a broad-based portfolio of consumer products with a particular emphasis on health and well-being. Products range from low GI rice and low cholesterol cooking oil to massala porridge. According to some estimates, India now has the largest number of type-2 diabetics globally, and obesity has become one of the most important public health challenges facing the country. Given Marico's strong emphasis on healthy products, the Company appears well placed to contribute to, and benefit from, a move to healthier consumer choices.

Tech Mahindra is part of the Mahindra family who are renowned for their integrity and high levels of corporate governance. Tech Mahindra expanded its IT portfolio in 2009 by acquiring the leading global business and IT services company, Mahindra Satyam (earlier known as Satyam Computer Services), becoming a technology services powerhouse. It is the fifth largest service provider with 84,000+ employees and revenues of US\$2.7bn. Both Satyam and Tech Mahindra were working behind the scenes prior to the merger developing initiatives, which will enable them to continue pioneering the IT industry. Mr Gurnani (CEO) is incredibly knowledgeable in the IT industry, having spent most of his career there; he has a Mahindra background and a good relationship with Mr. Mahindra, helping to align Tech Mahindra with the parent. He is also a cautious man who runs the business in terms of managing the people and is likely to succeed under the Mahindra backing.

**Note: The Global Emerging Markets Sustainability strategy is closed to new investors.**

## Indian Subcontinent

Operating since: November 2006

Global FUM: USD342m

While not labelled explicitly as a sustainability strategy, since the change of lead manager in July 2008, the strategy is run with a strong sustainable investment focus, alongside our other sustainable investment strategies. The strategy invests in shares of companies based in, or having significant operations in, India, Pakistan, Sri Lanka or Bangladesh.

Examples of long-term investments of the strategy include Dabur and Tube Investments.

Established in 1884 to produce and dispense Ayurvedic medicines, Dabur has evolved into a professionally run broad-based consumer company with a particular focus on Ayurveda based products. Their core product is 'Chyawanprash', a brown, sticky paste containing herbs, spices and other natural ingredients and based on ancient ayurvedic recipes. It can be eaten directly or mixed with water or milk and is believed to have wide-ranging health benefits. The Company has taken cashflows from this product and built a broad-based, diversified consumer company covering hair care, skin care, digestives, health care and food. The ayurvedic heritage of the Company underpins many of their products and guides their long-term strategy and positioning. As such, the Company is particularly well positioned for shifting consumer preferences towards healthier, more environmentally friendly consumer choices. Management are professional and family members are still present on the board.

Tube Investments is part of the Murugappa Group of companies, headquartered in Chennai. The Murugappa family stand out for their stewardship, which has resulted in an excellent attitude to risk, fair treatment of minority shareholders and an excellent approach to evolving the sustainability positioning of their businesses. Tube Investments is the largest manufacturer of bicycles in India. Rapid urbanisation, the rise of 'mega' cities with populations over ten million people and the growing focus on healthy lifestyles have all combined to create strong sustainability tailwinds for the bicycle industry.

## Worldwide Sustainability

Operating since: November 2012

Global FUM: USD312m

The Worldwide Sustainability strategy is an unconstrained investment strategy and can invest in companies across the world. We launched the Worldwide Sustainability strategy because we believe we need to understand all companies in a global context to be good emerging markets investors, and because we believe emerging markets are currently very fully valued.

Two of the companies in which we have the strongest conviction are Xylem (US) and Dia (Spain). Spun-out from ITT in 2011, Xylem is the world's largest wastewater and dewatering pumps provider, the largest in the membrane market doing filtration and disinfection of water, and second largest in water testing. The Company's focus on water technology leadership leaves them well placed to help tackle the immediate sustainable development challenges around water scarcity and water pollution, both in developed and developing countries. As the Company itself notes, 'There is a direct line of sight from our work to the sustainable health of our planet.'

DIA is a Spanish-based retailer and grocer that spun-out from Carrefour in 2011. The creation of a new stand-alone company has empowered DIA's impressive local management team to focus on steadily growing their international operations in Argentina and Brazil, using the strong cashflows generated from their Portuguese and Spanish store networks. The Company's new DIA Fresh store formats and the neighbourhood locations they occupy leaves the Company well positioned to benefit from shifting consumer preferences away from big-box over-consumption towards more local-based provision of daily consumer 'necessities'. We also appreciate how open they have been to our engagement on sustainability – an area they themselves would like to improve on.

# First State Stewart Sustainable Investment Team

The First State Stewart team consists of 32 analysts located in Edinburgh, Singapore and Hong Kong. All of the investment strategies and funds managed within the First State Stewart business draw on the ideas and expertise of the whole team. David Gait, Amanda McCluskey, Nick Edgerton, Sashi Reddy and Jack McGinn have a particular focus on the Sustainability Funds.

## **David Gait**

David Gait is a Senior Portfolio Manager within the First State Stewart team, having joined the company in 1997. David is the lead portfolio manager of the Asia, Emerging Markets and Worldwide Sustainability Funds.

David holds a Master of Arts with Honours in Economics from Cambridge University, and holds a Master of Science in Investment Analysis from Stirling University.

## **Amanda McCluskey**

Amanda McCluskey is a Senior Investment Manager at First State Stewart. Amanda is responsible for leading the Sustainable Funds team and supporting the investment strategy and research process.

Previously Amanda was Head of Responsible Investment at Colonial First State Global Asset Management and has had fund management experience at Portfolio Partners and BT Financial Group. Amanda was the founding Deputy Chair of the Investor Group on Climate Change and is a non-executive director of the Great Barrier Reef Foundation and the Banking and Finance Oath.

Amanda holds a Bachelor of Economics with Honours in International Relations from the University of Sydney.

## **Sashi Reddy**

Sashi Reddy joined the First State Stewart team in July 2008. Sashi is the lead Portfolio Manager of the First State Indian Subcontinent OEIC.

Before joining First State, Sashi worked at Irevna Research, an outsourced Indian equities research house from 2005 to 2007. As an analyst covering the small and mid-cap European market at Irevna, he was seconded to Credit Suisse First Boston as an associate. Sashi brings with him six years of industry experience, one year of which was gained at First State in a contract role.

Sashi has an Engineering degree from the National Institute of Technology, Trichy and a Master of Business Administration from the Schulich School of Business, York University in Toronto.

## **Nick Edgerton**

Nick is responsible for generating investment ideas for the First State Stewart Sustainability Funds across all sectors in the emerging and developed markets. He joined the team in April 2012, following two years in the First State Investments group. He previously worked as an analyst with the Sustainability funds at AMP Capital Investors, and has experience as a consultant, public servant, and an academic in sustainability and economics.

Nick holds a Bachelor of Economics from Macquarie University, and a Master of Science with Distinction in Ecological Economics from the University of Edinburgh.

## **Jack McGinn**

Jack is responsible for generating investment ideas for the First State Stewart Sustainability Funds across all sectors in the emerging and developed markets. Jack joined First State Stewart in September 2011 upon graduation from university.

Jack holds a first class Bachelor of Arts with Honours in Politics, Philosophy and Economics from Queen's College, Oxford.

## **Jennifer Stephen**

Jennifer joined the First State Stewart team in October 2012 and is responsible for supporting the team and driving the corporate engagement process. Prior to joining First State Stewart, Jennifer worked in communications within the automotive industry.

Jennifer holds a first class Bachelor of Arts with Honours in Marketing Management from Newcastle Business School, Northumbria University in Newcastle.

# Questions and answers

## **1. Why is the First State Stewart (FSS) team interested in sustainability investing?**

We have a strong conviction that the sustainability positioning of companies is playing an increasingly important role in determining long-term shareholder returns for all companies in both developed and developing markets. By launching dedicated sustainability funds we are able to offer investors an investment product with an explicit focus on this theme. In addition, we hope that the existence of a dedicated sustainability product will help us to strengthen our expertise in this area for the benefit of all of the FSS team strategies.

## **2. Are these sustainability strategies a marketing gimmick to raise more assets under management?**

Absolutely not. Over recent years, we have probably turned down existing business in our mainstream funds which, taken together, would represent multiples of the funds we intend to raise over time with our sustainability strategies. We have also resisted the pressure to launch new, potentially very lucrative investment strategies such as hedge funds and BRIC funds because we did not have conviction in the integrity of the investment strategies.

## **3. Is the FSS team restricting the investment universe which will lead to lower returns?**

We would view it the other way around. Our investment philosophy, focusing on management quality, strong franchises and sound financials, and long-term sustainability positioning, allows us to invest in the part of the investment universe, which we think will deliver superior returns over time.

## **4. How do FSS's sustainability strategies differ from other 'mainstream' strategies managed by the same team?**

For the existing sustainability strategies there is a approximately 50% overlap between the two strategies in terms of company names. The main difference is that the sustainability funds have a specific mandate to dig deeper and pull out from our list of favourite companies those with the very best long-term sustainability positioning.

As a result, there are a number of companies in the mainstream funds which are not held in the sustainability funds. For example, well-managed Coca-Cola bottling companies (e.g. Andina, Hellenic Bottling) may be good investments but they do not naturally make it into the sustainability funds.

## **5. Does the FSS team undertake any negative screening?**

There is no formal negative screening. However, we do not anticipate that companies operating in high risk sectors will be natural candidates in terms of their long-term sustainability positioning. Examples of such sectors include gambling and tobacco.

## **6. The first sustainability product was launched in 2005. What was the reason behind this?**

Our oldest product dates back to 1988. In the early years we took the decision to focus on evolving the sustainable investment features of all our 'mainstream' strategies. As sustainability trends started to accelerate, and we saw more evidence of the impact these trends were having at a stock level, we decided to launch a dedicated sustainability strategy. At the same time, an existing client indicated their interest in a focused sustainability product, so we took the opportunity to seed the new sustainability strategy.

## **7. Are the sustainability investment strategies the same as ethical investment funds?**

No, not in the traditional sense. We do not look to screen out particular companies or sectors on moral or ethical grounds. However, we are not afraid of the word ethics. We think the finance sector as a whole does not spend enough time talking about ethics. We spend much time as a team reflecting on our role as stewards and have, more recently, introduced a Financial Hippocratic Oath which each member of the FSS investment team has signed.

## **8. Are the sustainability strategies the same as clean tech or green funds?**

No. The remit is much broader. They are 'sustainable development' funds.

## **9. Does that mean FSS's other investment strategies and funds are not sustainable?**

No. The opposite is true. It is only because we already have a strong sustainability bent within our existing investment philosophy that we are able to extend this approach to a dedicated sustainability strategy focusing in on particularly well positioned sustainability leaders.

## 10. Why have the FSS team now launched a new Worldwide Sustainability strategy?

For two related investment reasons. First, it is becoming increasingly clear that both developing and developed countries face significant sustainability challenges that are creating new risks and new opportunities for companies wherever they are based. By expanding our investment universe, we are able to invest in a wider range of companies which are well positioned to benefit from, and contribute to, long-term sustainable development. In addition, we are able to benefit from valuation differentials that open up from time-to-time between developed and emerging markets companies offering similar risk-adjusted return characteristics. As a result, we are excited about the long-term investment potential of an unconstrained Worldwide Sustainability portfolio.

Second, we are convinced that by improving our knowledge and understanding of developed market companies, we will become better emerging markets investors. The geographic distinction between emerging and developed companies is becoming increasingly blurred. Many developed market companies now have significant economic activities in developing countries. The reverse is also true. As a result, for some time now we have felt compelled to analyse the developed market competitors of our favourite emerging market companies in order to gain a better understanding of the long-term prospects of those companies. For example, to understand the long-term positioning of Indian software consultancy companies such as Infosys and Wipro, we need to spend time understanding US-based competitors such as Accenture and IBM. Likewise, to analyse Tata Motors, an Indian car manufacturer, we also need to understand the long-term strategies of global car companies such as BMW, Hyundai and Toyota. Five years ago, less than 10% of Tata Motor's profits were outside India. Today, over 80% of profits are outside India, primarily generated from European sales of its recently acquired Land Rover and Jaguar models.

Not only do developed and emerging markets companies compete globally in terms of customers but also in terms of recruiting and retaining management teams and directors. For example, the CEO of Coca-Cola in the US was formerly the CEO of one of our favourite Turkish companies. The founders of two of our favourite Indian companies, Bharti and Infosys, have both recently been directors of Unilever PLC in the UK. Similarly, there are a growing number of developed country managers and directors sitting on boards of emerging markets companies. In summary, it is becoming increasingly difficult to tell whether a company is a developed or an emerging markets company.

## 11. What capacity does the FSS team have in the Worldwide Sustainability strategy?

We regard all our sustainable investment strategies as a journey – without end! Our focus is not on gathering assets, but rather on making sure we evolve, adapt and continually strengthen our investment process to ensure we can deliver attractive, long term, risk-adjusted returns for investors. As such, we are initially looking to identify a small number of like-minded investors who are prepared to embark on this journey with us.

We will approach capacity in this strategy in the same way as all our other team strategies. We are not able to provide an open-ended commitment. At the same time, it is very difficult for us to provide absolute figures and the rate of growth is likely to be a key driver in any capacity decisions.

## 12. Where does the FSS team get the ESG input from? Does the team use external experts?

The emphasis is very much on our own team of analysts to identify and analyse key ESG issues. The primary source of ESG related information is one-on-one meetings with senior management. We undertake approximately 2,000 such meetings each year. We are particularly interested in companies which embrace the underlying spirit of ESG, rather than simply taking a compliance driven, box-ticking approach. Assessing the attitude of senior management is therefore crucial. While a growing number of our companies produce Sustainability Reports they rarely tell the whole picture. We sometimes refer to the 'Kodak Count' – typically the greater the number of pictures of smiling children in a report, the greater the ESG problems lurking beneath! That said, some of the data relating to the Global Reporting Initiative can be useful for peer group comparisons.

We augment internal research with the use of external ESG research, where appropriate. We have built up relationships with a number of independent ESG research houses, including Ethix SRI advisors, Sustanalytics, Trucost and RepRisk, and occasionally commission bespoke ESG research from the best analysts amongst the mainstream investment banks.

Finally, we also strive to identify key ESG contacts in our markets, including company, government and NGO representatives. For example, as part of our India research trips, we make a point of visiting the excellent Centre for Science and the Environment in Delhi. This visionary organisation is able to provide us with a local perspective both on key ESG trends and how Indian companies are reacting to these changes. Our most important source of training is the companies themselves. Many of the management teams we meet have spent decades in their chosen industry and are uniquely placed to explain the key ESG issues.

In addition, we frequently commission outside, independent experts (NGOs, industry consultants, government officials and academics) to come and speak to us. Recent examples include wind, wave and solar power, synthetic biology, nuclear, green buildings and carbon pricing.

### 13. What about voting?

We have a comprehensive proxy voting policy, which is available upon request. In principle we prefer to engage companies outside the AGM season and if our engagement is effective we should not have to vote against companies. However, no company is perfect, so from time-to-time we will vote against. The types of things we find ourselves voting against most frequently include:

- executive remuneration packages, where there is a lack of alignment or the incentives are too short-term.
- directors elections when we do not think the candidate has the right charter or skills for the board, or they have not been turning up to Board meetings!
- resolutions that give the Board totally unfettered rights.

While we may vote against specific resolutions at Company meetings, we are particularly active in terms of positive engagement with company management teams. For us, ESG issues are investment issues. Positive engagement on such issues therefore becomes a powerful tool in driving shareholder value and protecting and enhancing the value of our portfolios. Engagement primarily takes place during company meetings. However, we also enter into correspondence with companies where necessary.

### 14. When a company fails to address ESG issues, why not just sell it?

The purchase of a share comes with both rights and responsibilities. Should one of our companies fail to meet international best practices on the environment, human rights or social issues, we believe we have a responsibility, as part owners of the business, to engage with senior management to persuade them to address the issue, rather than to immediately walk away from the problem.

### 15. What about industry collaboration?

We are always happy to collaborate with other investors and are active signatories to the Principles for Responsible Investment and other industry forums on Responsible Investment.

### 16. How are you incentivised?

There are three elements to the compensation of each member of the investment team, comprising a salary paid in line with industry peer group average, an investment

bonus paid in cash and calculated on the three and five-year performance of a composite of funds managed by the team, and most significantly participation in a long-term profit share scheme. Under this scheme, a percentage of the team's profits each year are allocated to individual team members and then reinvested back into the funds we run for a further three years. We believe this scheme is well designed in terms of alignment.

However, we believe that it is a combination of our team culture, sense of purpose and long-term investment approach that is key to attracting, motivating and retaining team members.

### 17. How do you manage and measure risk?

We invest with an absolute return mindset. That is, we define risk as losing money for our clients, rather than in terms of deviation from any benchmark index. We focus as much on the potential downside of our investment decisions as on the anticipated upside. The identification of long-term sustainability risks thus becomes an extremely important way of managing risk. In addition, our willingness to differ substantially from index weightings, both country and company, means we are not obliged to be invested anywhere where we have particular sustainability concerns.

We are often asked about tracking error. We measure tracking error but do not deliberately seek to limit it. We consider the benchmark index to be a poor representation of the investment opportunities available. We are aware of the country, sector and major company weightings in the benchmark index. However, we use this knowledge to challenge – rather than dictate – how our portfolios are constructed. Therefore, we do not have a targeted tracking error. The annualised ex-post tracking error over a rolling three-year period tends to range between 4% and 9%. While we do not 'target' a predetermined tracking error we do monitor it to ensure that we fully understand the risk/return characteristics exhibited by our portfolios.

Individual portfolio managers have the responsibility for ensuring that portfolios under their control adhere to the relevant Portfolio Construction Parameters. Every portfolio has an assigned portfolio manager which ensures that responsibility for adhering to parameters is clearly defined. The Risk Management & Compliance team maintains a final check from outside the investment team to ensure compliance with all parameters, whether they are imposed by regulation, client agreements, or ourselves. They monitor the issues raised by the front office system on a daily basis and alerts the Investment Operations Team of any action required.

## **18. What market conditions are most likely to result in outperformance/underperformance?**

Given our emphasis on fundamental company research, we tend to outperform in market conditions where due recognition is given to companies with quality management teams, good long-term growth prospects and sound balance sheets. The downside in falling markets should also be limited by our risk-aware approach in matters such as valuation criteria.

Our investment style is inherently conservative, focusing on capital preservation as well as capital growth. Companies that we invest in typically exhibit lower levels of gearing, stronger cash flows and lower earnings volatility than the peer group. There are times when solid fundamental analysis does not equate to performance, such as during momentum-led markets. While our prudent style may lag in very strong liquidity-driven or momentum-led markets, this approach produces consistent long-term outperformance.

As a result of our prudent investment style and emphasis on investment risk (i.e. we focus as much on the downside risk as the upside potential of every investment decision), we have experienced (and will continue to experience) periods of relative underperformance in strong liquidity-driven or momentum-led markets, but have always managed to compensate very quickly once such bubbles burst. Our experience and record in this volatile asset class has clearly demonstrated the merits of focusing on controlling investment as opposed to benchmark risk.

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