EVENLODE

INVESTMENTS FOR LIFE

Evenlode Investment Annual Responsible Investment Report 2018

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With a focus on long-term investments, we hold only the highest quality stocks that have a strong economic moat, reliable cash flow and a healthy balance sheet. However, we are not just investors, we also understand the influence we can have on the companies we invest in, on behalf of our clients. This is why we feel integrating environmental, social and governance factors in our investment process can help to sustain and improve returns for our clients, whilst also having the potential to create a positive social impact.

STEWARDSHIP & INVESTING – AN INTEGRATED APPROACH

By Ben Peters, Fund Manager

Stewardship of companies and analysis of ESG factors is often presented alongside investing as being an 'either/or' choice; either you focus on managing a portfolio of assets for financial return, or you look at the ESG and stewardship angles. We believe that this is a false choice. Financial returns will only come from positive long-term corporate performance. If there is any factor that may contribute to or impede that performance, then it should be considered as part of a rounded investment case.

Ben Peters, Fund Manager

With that in mind, we choose to integrate the consideration of ESG factors into our risk management framework. We score companies on a range of financial and non-financial risk factors. An analysis of a firm's governance frameworks, board makeup, management's approach to sustainability, and the social impact of the company's operations alongside its broader community work, can highlight both positives and negatives for any firm's overall investment prospects.

We do not believe that any individual firm will have everything arranged perfectly – this is an imperfect and uncertain world after all. In extremis, should we see a factor that we believe presents an existential risk to a firm we simply would not invest. However, most situations are not so clear cut. Observation of a negative, increased water usage at manufacturing sites for example, more likely presents an opportunity for engagement with a firm. We would prefer to have a seat at the table where we have the capability to effect change rather than divesting and not being part of the conversation.

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Equally, we do not believe that we ourselves have the perfect answer. That is why we engage with companies and with the investment industry to further our own thinking. We are building our stewardship and ESG analysis capabilities and expect our analysis and the quality of our engagements to evolve and improve through time. Being a fully integrated part of our investment process, alongside rigorous financial and business model analysis, gives us the most holistic route to furthering the quality of our stewardship.

EVENLODE'S STEWARDSHIP STORY

By Sawan Kumar, Stewardship Analyst

Evenlode is a signatory of the UK Stewardship Code which was first published by the Financial Reporting Council (FRC) in 2010. The code consists of seven guiding principles which aim to encourage engagement between institutional investors and company management and promote a greater level of transparency. It is applicable to those firms who manage assets on behalf of institutional shareholders, including pension funds, insurance companies, investment trusts and other collective investment vehicles and should be applied on a "comply-or-explain basis".

Sawan Kumar, Stewardship Analyst

In 2016, the FRC assessed signatories to the UK Stewardship Code based on how well they can articulate their application of the principles or explain the reason(s) behind non-compliance. There are nearly 300 signatories to the code, with more than 120 in Tier 1 which is defined as signatories that provide a good and transparent description of their approach to stewardship and explanations of an alternative approach, if that particular principle does not apply to their business. Evenlode Investment in 2018 when signing up to the code, was assessed as a Tier 1 signatory.

Evenlode is also a signatory to the United Nations Principles for Responsible Investment (UNPRI). The principles were developed in 2005 by an international group of investors who wanted to promote the increasing relevance of responsible investment. By becoming signatories, we have committed to implementing these principles and incorporating environmental, social and governance factors into our investment process to help enhance returns and better manage risks for our clients.

We believe that the consideration of ESG factors can both help to sustain and improve returns for our investors and have the potential to create a positive impact in the economy and society more broadly. Topics on which we engage may include, but are not limited to, long-term strategy, remuneration policies, attitude to capital structure, labour relations, climate change risk, shareholder rights, succession planning and company culture.

"ESG factors can both help to sustain and improve returns for our investors and have the potential to create a positive impact in the economy and society more broadly."

ENGAGEMENT THEMES

By Hugh Yarrow, Fund Manager

On behalf of our clients, we look to invest in good businesses over the long-term. In our view, one of the characteristics of a good long-term business is a strong culture. Specifically, we like teams of people who care about their customers and other stakeholders, want to invest consistently to develop and improve their products, and look to run a financially strong business to ensure both investment and dividends are sustainable through a wide range of economic conditions.

Hugh Yarrow, Fund Manager

We are long-term investors, and where a company's culture is strong our engagement process tends to be relatively straightforward (i.e. a collegiate exchange of ideas and information) as well managed companies will tend to formulate long-term plans and AGM proposals that are well aligned to the interests of long-term stakeholders. However, sometimes we feel it is appropriate to question certain elements of strategy, particularly if we believe they are unlikely to support the cultural qualities we have a preference for.

Over the last year, there have been two main themes that have tended to trigger engagement with companies. The first category relates to our preference for companies to make consistent organic investment over time. We much prefer this approach to investment compared to an approach that looks to cut back on long-term investment in pursuit of higher but unsustainable short-term results.

The second is balance sheet strength. There has been a trend across the global corporate sector of weakening balance sheets over recent years, as companies have used debt to make acquisitions and buy-back shares. This has been tempting as the cost of borrowing has been low, and the use of debt to make acquisitions and buy-back shares has therefore been effective at artificially boosting short-term earnings growth. A weakened capital structure raises a company's risk profile for the long-term shareholder. We therefore always prefer the safety and optionality of a strong and healthy balance sheet.

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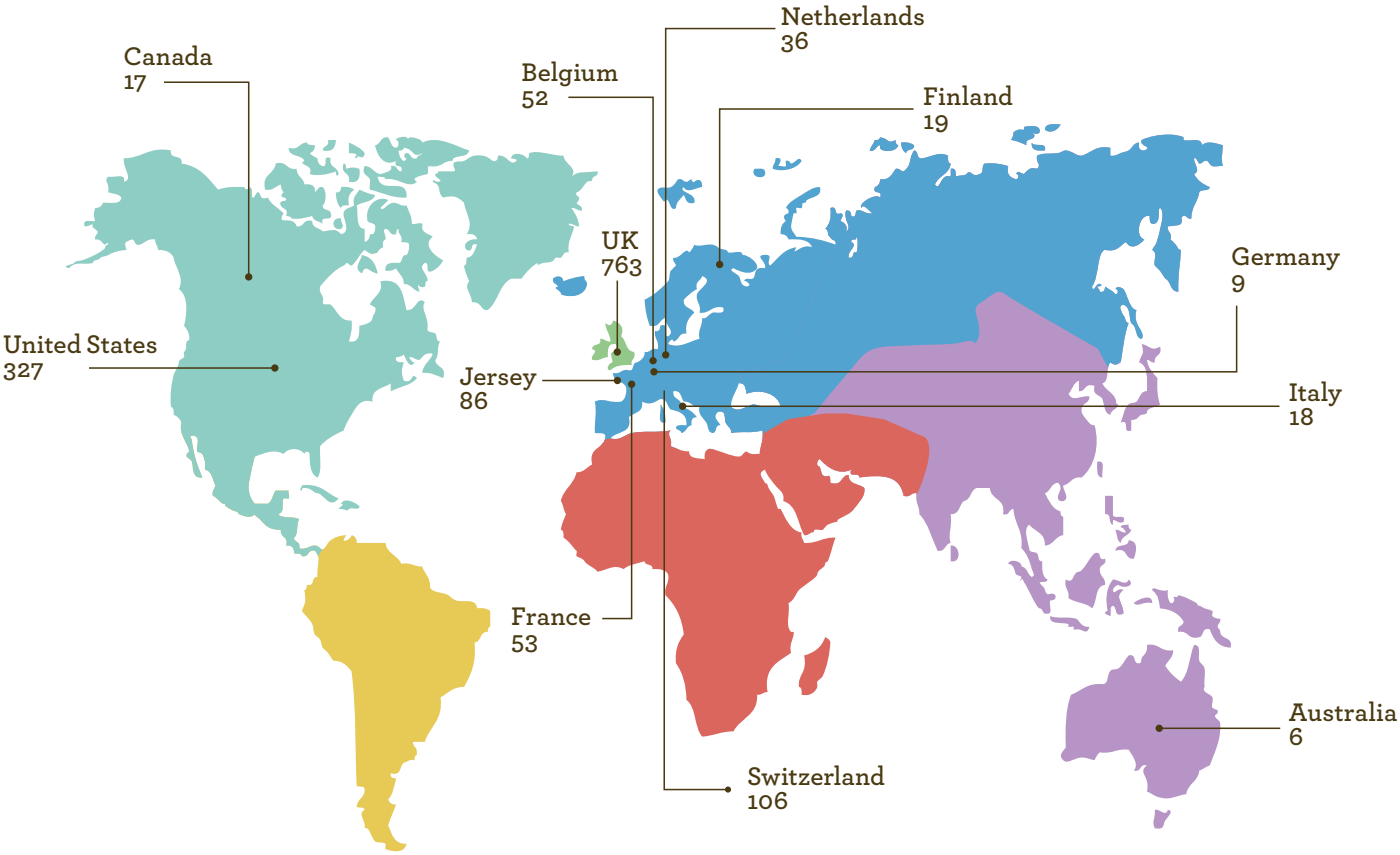
Often our engagements have been focused on management remuneration schemes, particularly where we believe they utilise metrics that can be too easily met by either cutting back on investment, deploying debt, or both. In particular, the use of Earnings Per Share (EPS) as the sole or major metric has this shortcoming. We generally prefer to see a broader range of targets used, perhaps including cash conversion, return on capital, organic revenue growth, customer satisfaction or other relevant strategic measures which better complement the company's long-term strategy and take into consideration the wider community of stakeholders.

STEWARDSHIP IN PRACTICE

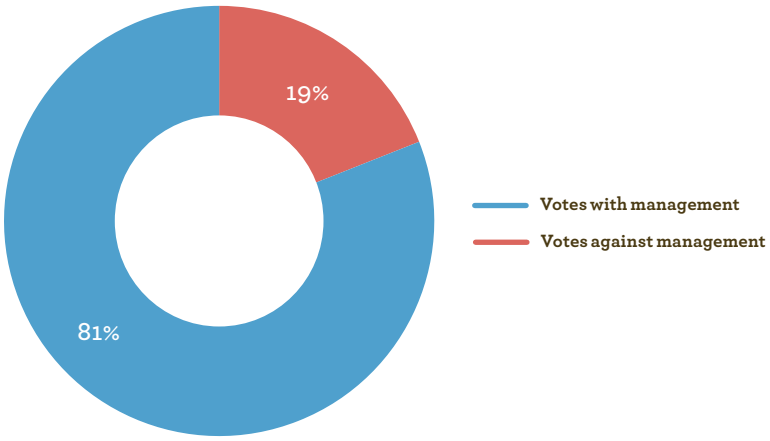
NO. OF RESOLUTIONS VOTED



VOTING TABLE SUMMARY (2018)

Meetings	70
Resolutions	1492
For	1368
Against	42
Against Mgmt	13
Abstain	1
Non-Voting	81

VOTES AGAINST MANAGEMENT (PER MEETING):



STEWARDSHIP IN PRACTICE

In 2018, we voted a total of 70 meetings, voting against management 19% of the time on at least one resolution. Below are some examples of when we have felt necessary to engage with companies after voting at their AGM, (with company names removed).

ONE

We wrote to Company A to express our views on the make-up of their board. We did not oppose any resolutions but wanted to initiate dialogue on the topic of over-boarding. We noticed a couple of non-executives, as well as sitting on approximately six or seven outside boards, also had various other commitments which we didn't feel at the time, allowed them to fulfil their fiduciary duties. We had no doubt the level of expertise and knowledge they brought to the board however, non-executive/executive roles are becoming increasingly complex and demand a greater level of attention. We appreciate that some directors have the capability to juggle multiple different roles but, in that instance, we thought the board would benefit from directors who don't have such significant levels of directorships.

TWO

We chose to vote against Company B's remuneration policy for the year. Although the company's remuneration practices were not excessive, the performance metrics for the annual bonus and share-based incentive plans had not been disclosed. We feel that shareholders should have the ability to gauge whether executives' interests are in alignment with their own and are being challenged appropriately.

THREE

We chose to vote against the Company C's remuneration report for 2018. We have been long-term investors in the business and hence have been supportive of the company's long-term strategy. However, in regard to incentivising management for the year, a large proportion of the company's long-term incentive plan (LTIP) was based on earnings per share (EPS) and share price appreciation, both of which, we felt, were not very effective metrics to measure long-term company performance. Despite its extensive use, EPS has some drawbacks if used alone.

In particular it may discourage organic investment and does not measure both the degree to which earnings are converted to cash flow and how much capital has been required to generate earnings growth. We prefer to see additional measures such as organic revenue growth, return on capital, operating cash conversion or stated strategic objectives, which would help to give a more rounded picture of the company's broader financial progress. We also felt uncomfortable with the company choosing to adjust its EPS figures to exclude the legal and compliance costs when calculating compensation for senior executives (see 'Warts and All section on next page).

'WARTS & ALL' – INCENTIVISATION

By Chris Elliott, Fund Manager

Incentivisation of management is a key tool in aligning the interests of those that govern the business with those of the long-term investor. However, the wide range of metrics that are chosen to achieve this only illustrates the complexity facing boards and remuneration committees.

Chris Elliott, Fund Manager

It is therefore disappointing to see further adjustments made for the sake of "smoothing results" over time, especially when applied to earnings per share. These are often generalised adjustments, such as amortization of acquired intangibles or exclusion of legal fees and litigation expenses. While the actions that caused the costs occurred before the management team took control, this does not prevent them from affecting the return to investors.

When we analyse a company as part of the Evenlode investment process, we do not make adjustments for these exceptional items unless a detailed and well evidenced explanation can be provided for why they will not recur. We prefer to see a "warts and all" view of the company with the volatility in earnings included, as that will be the return profile that our investor will receive over time. A company that makes acquisitions as part of the growth strategy will likely always have an acquired intangible to amortise. Ignoring amortisation of these would inflate earnings (though not our preferred cash flows metrics) every year and cause the company to artificially look more profitable. Similarly, many large pharmaceutical or medical device companies face ongoing legal costs, which will recur even if related to different drugs or medical products. Excluding these provides management no incentive to prevent future legal costs for investors. We would therefore urge boards and remuneration committees to carefully consider whether such adjustments really align management incentives with shareholders.

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BOARD OVERSIGHT – MAINTAINING DIRECTOR FOCUS

By Bethan Rose, Investment Analyst

The term 'over boarding' has been a topical issue not just for the companies in our portfolio but for the general UK market in 2018. The 2018 AGM season saw an increasing trend of shareholders voting against non-executives for sitting on too many outside boards. It is safe to say the issue is becoming progressively prevalent and the role of non-executives is becoming increasingly complex.

Bethan Rose, Investment Analyst

We do understand that having several non-executives serving on many different outside boards can be helpful in providing a stronger level of both knowledge and expertise. However, it does bring into question the principle of effectiveness and the ability for these non-executives to allocate sufficient time to each company. We tend to invest in businesses for the long-term, hence we don't necessarily have a hard-line number which would prompt a vote against, but this would be a chance for us to initiate an engagement in trying to understand how that director is adding value to the business and the conversations had around the boardroom table. It's important to understand that over boarding is not just based on how many outside directorships the non-executive has but also on the size and the complexity of the businesses it is linked with.

> "It's important to understand that over boarding is not just based on how many outside directorships the non-executive has but also on the size and the complexity of the businesses it is linked with."

Directors have a fiduciary duty to shareholders and the companies they are associated with. Therefore we would encourage boards to take into account each non-executive' commitments to ensure that boards are made up of directors who are not overburdened and can perform each of their given duties effectively. We will continue to address this issue with boards through our engagement framework, as and when we feel necessary.

LOOKING AHEAD

Ultimately a company's approach to its capital allocation strategy, remuneration policies and board profile can highlight its culture within. Hence, we look to prioritise these topics of engagement with the companies in our portfolio and investable universe. We feel providing an investors' point of view is very important and consider stewardship, engagement and our voting activities to play a vital part in our investment process. Engagement provides us with the opportunity to discuss a company's long-term investment strategy, and other key governance issues, not least the long-term purpose of the company.

We have created an annual general meeting analysis framework, which helps us highlight the best in class companies in our portfolios from a stewardship perspective. In the coming years, we will further incorporate our environmental and social analysis into our investment process to better sustain returns for our clients whilst also creating a positive social impact. We understand the need for all stakeholders to work together to address the imperfections in the global economy. It is not just up to companies but also us as individuals and investors to ensure that we are all working together to tackle the risks we face as shareholders and citizens of the world.

We hope this report has given you a sense of how we consider responsible investment at Evenlode, and the actions we have taken on behalf of our clients during 2018. We look forward to updating you on our progress during 2019.

Should you wish to learn more in the meantime, please feel free to contact our Stewardship Analyst, Sawan Kumar sawan.kumar@evenlodeinvestment.com

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FURTHER INFORMATION

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