Redwheel UK Value & Income Team

Stewardship Report 2021

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Foreword

Welcome to our second annual Stewardship Report for the Redwheel UK Value & Income Team. In this report we strive to deliver a clear picture of our stewardship activities for the past year, from our various corporate engagements and our voting record, to an insight into our collaborations with other investors. We also seek to illustrate the risks, exposures and challenges faced by the stocks we hold on your behalf and the material sustainability risks at a portfolio level.

New regulatory frameworks for disclosure and product labelling are going live, Sustainable Finance Disclosure Regulation (SFDR) in the EU is leading the way, while in the UK the FCA is expected to launch its own Sustainability Disclosure Requirements (SDR) by the end of 2022. While at the time of writing our SICAV strategies are not designated as Article 8, we are very much aware of the requirements of Article 8 and the sentiment behind the regulation. In this spirit, we produce our report to inform investors. We have made the argument many times that sustainability cannot be focused on divestment, sweeping exclusions, or about investing only in already highly rated stocks. With the communications from the FCA over the duration of 2021, particularly the Sustainability Disclosure Requirements and investment labels Discussion Paper which illustrate the room for 'transitioning' companies under the label of Sustainable, we take much comfort that our approach is on the right track.

Investment returns have been exceptionally strong for the Redwheel UK Value and Income range of funds over 2021. While COVID-19 very much remains with us- with the re-imposition of restrictions at the end of 2021- many companies recovered strongly both operationally and in terms of profitability. This was reflected in the recovery of dividend payments, in many cases exceeding expectations. The energy crisis has been one of the main talking points in the last quarter of the year, as energy prices spiked. It is hard to believe that in 2020 the energy crisis was about the price of oil going negative and the resultant pressure on energy companies as they shored up their balance sheets by slashing dividends and selling assets. The main drivers of positive absolute and relative performance were retailers including Marks & Spencer, Kingfisher and Currys; energy companies, such as BP, Shell and TotalEnergies; and individual companies like Royal Mail, NatWest, Centrica and Anglo American.

The number of engagements with companies increased further last year, having also increased in 2020 over 2019. The trend is driven by our desire to understand sustainability risks better, at the same time as companies wish to have the opportunity to explain their sustainability plans to us. Not all engagements are deep engagements, many are brief and simply consisting of us imparting what we think are crucial messages to management or boards. Other engagements continued from 2020 and will continue into 2022 and beyond. Where we think our message is not getting through, we will seek other ways to communicate the seriousness of our position. One such example was our vote against Shell's Energy Transition Strategy and with the Shareholder Resolution. We wrote to the Chair and publicly pre-declared our position to maximise the pressure on Shell to improve their transition plans.

One area that remains challenging is remuneration. We engage extensively with companies on remuneration policies, offering our views on how incentive structures should be set. We have developed a standalone Team policy and we share that policy with our investee companies. However, we tend to find companies engage in name rather than in spirit. We find that the proposal is rarely adjusted and the remuneration chair relays to us that most shareholders are happy with the original proposal. We are not alone with this experience; LGIM, which manages £1.3 trillion, were quoted in the Financial Times as saying, "Most companies don't act on the remuneration feedback we give them... Companies tend to do what's right for management rather than listening to us a shareholder." (Link). We have therefore reviewed our approach to remuneration engagements and will concentrate on companies where we are one of the top shareholders. We will be spending less time with other remuneration chairs, rather sharing our remuneration policy with them to clearly set expectations. Our experience tends towards hardening our voting stance at AGMs.

In 2021 we continued our work into understanding climate change risks and engaging with our portfolio companies on their emission reduction plans. This work will continue in 2022 as we dig deeper into areas such as carbon offsets and the development of a 'say on climate' vote at annual general meetings. In 2021 we did a thematic on water and the various ways our stocks are exposed to water related issues. We also did a deep dive into material stocks and their links to 'transition metals', highlighting that while materials are often a focus for sustainability risks, they also offer sustainability opportunities. Resource stocks have arguably heightened human rights risks, and this will be an area of focus for the coming year.

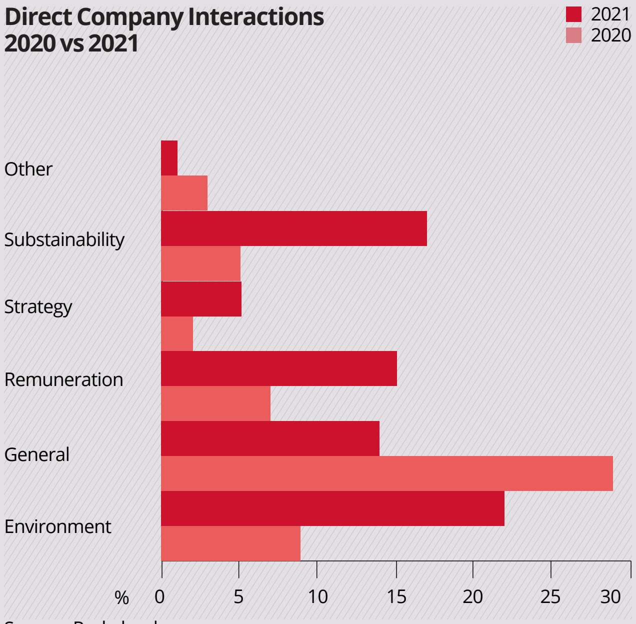
We commit to be that voice for sustainability and for responsible business behaviour, of holding our investee companies to the high standards deemed as best practice. This approach considers all stakeholders, and we believe it will also deliver the best outcome for long-term shareholders and help us deliver market beating returns for you, our investors.

Best wishes,
John Teahan, Ian Lance, Nick Purves

2021 in numbers

Here are some highlights of our engagement activity, top level characteristics at a portfolio level and individual company sustainability credentials from the past year (2020 with brackets). We endeavour, via our 'active owner' approach, to be a force for higher standards over time.

Direct Company Interactions 2020 vs 2021



Source: Redwheel.

11 out of 26 companies are Science Based Target initiative (SBTi) approved (7/29), 5 have committed to getting SBTi approval

14 out of 26 (14/29) companies set a target against at least one of the 17 Sustainable Development Goals

19 out of 26 (21/29) companies are signatories to the UN Global Compact

Marks & Spencer ranked 3rd out of 53 of the world's largest apparel companies, BP ranked 3rd out of 57 extractives companies

7 (9) companies, representing 27% (31%) of the portfolio, are members of the Dow Jones Sustainability World Index. The S&P Sustainability Yearbook contained 12 portfolio companies

BP moved to A- from F (the company did not previously make a CDP submission).

HP Inc, a holding, was deemed America's most responsible company for a second year in a row (Newsweek). Within mining Anglo American was ranked 2nd best by Sustainalytics on ESG risk out of 131 diversified metals companies

Kingfisher retained is AAA rating from MSCI

Sustainability at Redwheel – year in review, and looking ahead

Over the course of 2021, Redwheel has continued to deepen its resources dedicated to supporting sustainability initiatives.

The creation of a new centralised Sustainability function, independent of Redwheel investment teams, has helped to enhance the discourse within the business on sustainability matters, both in relation to investment activity and the business overall.

The creation of a Sustainability Forum now provides a monthly opportunity for all investment teams to come together in order to debate and discuss, from the investment perspective, the rapidly evolving expectations of clients and regulators, helping to enhance awareness and understanding of emerging requirements. Sessions during the year involved experts both from within the business and from outside and focussed on a range of different issues including materiality, the art of engagement, as well issues relating to the EU's Sustainable Finance Disclosure Regulation.

New oversight arrangements have also been introduced. The Redwheel Sustainability Committee has been set up to monitor and challenge Redwheel's investment teams on their individual approaches to integrating sustainability considerations within investment and stewardship, taking into account evolution in regulatory and client expectations.

Further activity and internal debate has been facilitated via regular meetings of our "ESG Project". Featuring colleagues from across our business, these interactions have helped to ensure a solid understanding of the scope of emerging operational requirements, have enabled us to identify pragmatic solutions and, where appropriate, have catalysed an appropriate response from the core business.

Having become a signatory to the UN Principles for Responsible Investment in March 2020, we submitted on a voluntary basis our first response to the annual survey of PRI members. We continue to await our first assessment report, which we will in due course use to help us refine and further enhance our approach.

2021 also saw us publish - for the first time - a Stewardship Report presenting on a generalised basis the approach to stewardship followed by Redwheel's investment teams as well as aggregated statistics. It remains our aim that our stewardship report should meet the standards required by the Financial Reporting Council in order for Redwheel to be confirmed as a signatory to the UK Stewardship Code.

To this end, work across the latter part of the year was undertaken to comprehensively review all proxy voting arrangements, as well as to review and enhance formal policies and internal processes designed to support the delivery of responsible investment in practice. As well as a new policy approach to the identification of companies involved in the production of controversial weapons, the turn of the year saw publication of a revised Redwheel Stewardship Policy. This policy reflects the output of numerous conversations to agree and articulate how we as a business, and as a group of investors, are committed to acting as good stewards of clients' capital.

Expanding the team was also a major focus over the year, leading to two new hires who were brought on board in early 2022 to help take forward our work in relation to data and analytics on the one hand, as well as training and communications on the other. At the same time, we have expanded the number of organisations we are actively supporting in relation to responsible investment, including engagement initiatives like ClimateAction100+ and policy-focussed groups such as the Institutional Investors Group on Climate Change. We remain discriminating in our approach though; relevance of initiatives to the delivery of our clients' best interests, as well as resource availability, remain important factors to consider when evaluating whether or not to join further similar organisations.

At the corporate level, we have reinitiated our programmes on social enterprise, environment, and diversity which together we refer to as SEED. A SEED Steering Committee now has formal oversight of activities, with work in each area being driven by employee volunteers from right across our business. We have also committed to becoming net zero as a business by the end of 2022. In parallel, in order to further increase our impact, we have committed also to working with our investment teams and clients on the issue of investment portfolio "net zero" alignment.

Helping the business and investment teams navigate an evolving and uncertain regulatory landscape while ensuring our advice remains coherent is likely to be a major theme for the sustainability team in the year ahead. Making the best use of the data, tools and industry initiatives available to us to monitor portfolio positioning and approaches adopted by our investment teams will be critical. Equally important though will be to ensure that our teams are kept well appraised of developments in this fast moving field so that they can take into account new and emerging factors of significance within responsible investment and prioritise their stewardship work effectively whilst, simultaneously, we maintain coherence between the requests we make of the companies in which our teams invest and the standards we uphold as a business.

Chris Anker
Head of Sustainability

Our approach

"Over the last couple of decades, many asset managers have pushed CEOs to pursue shareholder value maximization policies and deliver results in the shortest possible time. We are fundamentally at odds with this mindset and instead believe that CEOs should run the company with long term sustainable value creation in mind." Redwheel UK Value & Income Team letter to the Chair, 2017

We are humbled by the trust placed in us by our investors to manage their capital and we are very clear in our fiduciary duty to protect and grow that capital over time. We believe that our stewardship role is wholly consistent with supporting companies to grow in a sustainable way, for executive teams and board members to run their companies for the long term and for the benefit of all stakeholders. We would venture further that companies not run in a sustainable manner, from lack of prudence on financial strength and recklessness in the pursuit of growth, at the expense of the environment and relations with other stakeholders, create enormous risks to shareholders' capital. Whereas companies run in a prudent, sustainable manner for all stakeholders are usually more successful, resilient, and financially rewarding for shareholders.

We pride ourselves on being long-term investors. The very core of our investment strategy is that short-term sentiment amongst many market participants causes them to overreact to news which has little or no impact on the long run value of a business. Our long-term value strategy allows us to take advantage of such market dislocations, which provide an opportunity to purchase shares at less than their true value. This long-term approach also allows us to develop a deep understanding of the companies in which we invest, allows us to get to know the executive teams and board members, and to develop a deep understanding of their business strategies. We believe this approach enables better engagement with our investee companies, particularly when circumstance necessitates heightened levels of engagement.

Sustainability issues can have a material financial impact on the value of a company along with their social licence to operate and, therefore, on the value of our investors' capital. The following summarises our approach:

Environment

The potential for climate issues to cause a material financial impact on the value of individual companies and sectors has increased dramatically in the past decade. Climate change risks, both physical and transitional, are top of the list. Pressures on natural resources, such as water scarcity and biodiversity loss along with pollution and waste are further prominent risks. As value managers, our companies tend to be old economy stocks and, on balance, more exposed to environmental related issues. Energy, materials, food retailers are all exposed in their own way. Few sectors, particularly in manufacturing, are without their exposure to such risks. However, services providers, for example banks providing credit and insurance companies providing property cover, are also exposed.

We believe that the answer to environmental problems is not as simple as divesting from challenged sectors. By actively engaging with companies, by supporting them in the transition to a sustainable business model, we believe the outcome can be better for the environment and support economic prosperity.

Social

The financial impact from social issues can be substantial as we further set out in our 2017 Letter to the Chair:

"We believe companies should act in the interests of all stakeholders. Putting pressure on employees, customers and suppliers may enrich shareholders in the short term but can damage the long run sustainability of the business. Too often, investors seem to believe you are either a champion of the shareholder or of the other stakeholders but in our view, they are not mutually exclusive. There should never be any inherent tension between creating value and serving the interests of employees, suppliers and customers."

Companies treating their employees, customers, or suppliers badly store up future problems for the business in terms of human capital (lower productivity, disruption to production, staff turnover), brand value (dissatisfied customers, litigation) and reputation (supply chain issues, health and safety). Local communities are also important to consider, particularly in extractive industries. Exposure to conflict regions is monitored as an elevated risk of human rights abuses.

Cyber security is a notable risk for many companies, particularly for those holding customer information, sensitive sectors such as banks or utilities or where intellectual property is the basis of the value of a company.

Governance

Governance has always been at the heart of our process as we believe it sets the basis for the culture of a firm, supporting positive environmental and social outcomes. We want management to run the business as owners, thinking long-term and about customers, employees, suppliers, and community, which ultimately benefits shareholders. To ensure this outcome, we believe in the importance of a strong board, with non-executive directors possessing the requisite skills, experience, and independence to counter the impact of a powerful or dominant CEO. Diversity can support this aim and helps to counter 'group think' and incorporate better the views of all stakeholders. We also observe the growing demands on non-executive directors (NEDs), and how those demands can surge at times of crisis. We therefore believe that NEDs may be over stretched and need to consider devoting more time to their roles.

Corporate behaviour

Governance in a sustainability context must go further than traditional boundaries. We look for responsibility for sustainability issues at a board level, ideally sitting with an independent director with relevant experience, who can challenge management on related sustainability issues.

We encourage companies to commit to both global and industry level principles and codes that support high levels of sustainability practices. By committing to such codes, we can hold management to account should they fail to uphold the standards they have set for themselves. This is supportive of 'soft law' such as the UN Global Compact Ten Principles and shared values and the OECD Guidelines for Multinational Enterprises; in requesting companies commit to such values, they set the standards investors should expect of them, it is then our role to monitor subsequent behaviour and to sanction for breaches.

It is difficult for shareholders to anticipate events and often to identify corporate governance weaknesses. However corporate structures aligned to the high standards of the UK Corporate Governance Code, reinforced by commitments to international codes and principles and demonstrated by a company's day to day behaviour towards other stakeholders and the way they run the business, gives a strong indication of corporate culture and future behaviour.

Engagement and collaboration

Engagement is central in communicating with our investee companies on areas of concern or where we want to express an opinion on strategy, with a long-term investment horizon and a concentrated portfolio we can build meaningful engagements. The engagement process is led and carried out by us, the portfolio managers, supported by the central Redwheel Sustainability function. Engagements are an extension of monitoring, and it is important to add that we feel management time should be protected from excessive demands from shareholders, so we will typically focus on annual meetings with management where a company is operating as expected. A record of our engagements is included in this report.

While directly engaging with management is our preferred approach, collaborative engagements are a useful tool for shareholders to further specific objectives. We are open to engagement with other individual shareholders in common holdings and have done so this past year and in previous years. Our main approach to collaborative engagement is via the Investor Forum, ClimateAction100+, the Investment Association, and the UN PRI Collaboration Platform.

We seek to join and to initiate engagement with other shareholders on issues that are important to us and where we feel a bigger voice will increase the chances of success. It may also be necessary where management or a board is refusing to engage on specific issues, or where our shareholding is not significant enough to get the attention of management.

Voting policy

We recognise our responsibility to actively exercise our voting rights and the opportunity voting affords us to convey a message to a company in the strongest terms, outside of divestment. It is therefore our policy to vote all shares at all meetings, except where there are onerous restrictions, such as share-blocking (where we must surrender our right to dispose of the shares for a period). We do not lend stock.

As an independent investment team within Redwheel we set our own voting policy, however, we draw on the support of the central Redwheel Sustainability function in developing the policy. Our policy is to vote in the best interests of our clients and in line with the high standards of corporate governance as set out in the UK Corporate Governance Code 2018. Our voting is shaped by our fundamental research, by our engagements with our investee companies and by Institutional Shareholder Services (ISS), the proxy voting service. ISS follows best corporate governance practice in each market, based on local norms, codes and regulations. In the UK ISS policy is rooted in the voting guidelines of the Pensions and Lifetime Savings Association (the PLSA - formerly the National Association of Pension Funds, or NAPF) and follows the guidance provided by the Financial Reporting Council in the UK Corporate Governance Code. The PLSA and the UK Governance Code 2018 set a high standard globally on governance matters, along with reference to the ICGN Global Governance Principles, we use these standards as a benchmark on votes outside the UK, and where appropriate we will override local ISS policy for the higher standard.

In 2021 the proxy recommendations were based on the ISS Benchmark Policy; this will change in 2022 when we will refer to the ISS Climate Voting Policy. The move reflects our own evolving views on governance and climate risk. As previously we will, however, diverge from the recommendations when our own research or engagements leads us to an alternative view on what is in the best interests of our clients.

Remuneration

Remuneration is an area of controversy, with management pay ratcheting higher, often without consequence for failure or poor performance. Compensation packages must be tied to long-term drivers of sustainable value, rather than a function of financial engineering. The time frame for executive evaluations should be extended and there should also be a downside risk by requiring management to put significant 'skin in the game'. We have set out our views in our Remuneration Policy, which we share with our investors and with our investee companies. We contribute to the industry discussion on remuneration via the Investment Association, the Investor Forum, and other investors where we have common shareholdings. Please refer to the extended remuneration section in this report for a longer discussion on this topic.

Conclusion

We see our role as stewards of our investors' capital as wholly consistent with investing responsibly and encouraging our investee companies to act sustainably. Sustainability and our long-term investment horizon go hand-in-hand. Furthermore, as value investors, we believe we can have an outsized impact on sustainability issues, as these are often of greater importance to older economy companies that typically fall into our value universe, particularly on environmental issues.

We believe in free market capitalism. However, we believe that the agency problem, short-termism, and a sole focus on shareholders, undermines the system in the long-term. A fairer, more socially responsible free market benefits business over the long term and benefits shareholders, as well as other stakeholders. We will lend our voice to raise concerns and push for change where we think necessary, and where we have influence.

We would encourage those thinking of investing with us to keep in mind our long-term focus. On both financial metrics and sustainability issues, companies need time to deliver on their sustainable value potential.

Our ESG approach is documented in full in our Team ESG Policy, and we encourage our investors to read that policy for a full description of our approach and framework. ESG investing is a fast-developing area, we will endeavour to develop our policies in line with industry best practice and raise the bar where we can. We commit to keeping you, our clients, fully informed and work with you to achieve your objectives.

Materiality discussion

Companies have reported on material ESG issues for a long time now. One of our largest holdings, Anglo American, have discussed material ESG issues separate from the annual report's 'Other Risk Factors' since the introduction of their Report to Society in 2004. In that report they said, "We believe that our key material risks and impacts are covered: those that measure our economic contribution; the effects our operations have on the natural environment and how these are managed and mitigated; the safety, health and development of our people; and the role we play in contributing to the long-term quality of life of society." However, ESG materiality reporting has increased significantly since then. TCFD have pushed companies since 2017 to disclose more on climate related materiality risk issues, while on the investment side, UN PRI are encouraging the integration of ESG factors, which incorporates a materiality assessment of ESG risks. We therefore feel it may be useful to share our thoughts on the issue and the ESG materiality risks in our portfolios for the benefit of our investors.

A paper by Harvard Business School, 'How ESG Issues Become Financially Material to Corporations and Their Investors' (link), gives an interesting perspective on the dynamism of this subject. Companies and society may be misaligned, but either due to lack of awareness or lack of information, such misalignment is accepted. This may not persist if society becomes aware of the misalignment or if a company pushes the misalignment further in the pursuit of greater profits or if society itself moves in its own definition of acceptable practice. The paper offers interesting examples of how individual issues became material over time; the pharma industry was drawn into a political battle over drug pricing as a few miscreants, including Mylan, Valeant and Marathon Pharmaceuticals, went well beyond what was previously accepted in drug price increases. Valeant's approach of using large amounts of debt to buy other companies and then raise drug prices "for such diseases as diabetes, acid reflux and serious heart conditions" caused outrage. Drug pricing became a material issue for the entire pharmaceutical industry. We experienced this pressure on pharma share prices in the portfolio in 2015 and 2016, before a recovery in 2017 and 2018.

We have witnessed a similar dynamic as regards to climate risks since the Paris Agreement was signed in 2015. While it has been a subject of debate for decades, the Paris Agreement seems to have been a watershed moment in terms of moving society from awareness to a broad demand for action, coupled by investors becoming increasingly active in demanding change and discussing divestment. Successive Intergovernmental Panel on Climate Change (IPCC) reports have increasingly raised the alarm on climate change, the sixth IPCC report in 2021, a 'Code red for humanity', highlighted in no uncertain terms the crisis we face. This development in turn has forced major strategic changes among energy companies. In September 2020, BP group announced a 40% cut to hydrocarbon production by 2030, not so long-ago, long reserve life was a big positive, now it signals the potential for stranded assets. Shell, Total and BP have moved to net zero emission targets by 2050. The European majors have reacted fastest to the changing zeitgeist, US majors like Exxon Mobile have been much slower. Events in 2021 highlighted the pace of change, a small hedge fund, Engine No. 1, managed to get three of its candidates elected to the board of Exxon Mobile, while on the same day a Dutch court ruled against Shell, demanding it cut emissions faster.

In terms of assessing materiality, we rely on our long, combined experience as a team looking at companies to understand material risks. We also look at how companies rate their own material ESG risks, along with other independent sources such as the Sustainability Accounting Standards Board (SASB) Materiality Map.

The SASB framework gives an alternative view of ESG materiality. SASB is an independent non-profit organization that sets standards to guide the disclosure of financially material sustainability information by companies to their investors. The SASB Materiality Map is a tool that identifies and compares disclosure topics across different industries and sectors. While the map is not a perfect fit for each stock, for example stocks will span across sub-industries and therefore across materiality risks, it does help to ensure individual issues are not totally overlooked and it gives a top-down view of the portfolio. These issues are unweighted, i.e. each issue is given equal importance and therefore the overall ranking reflects which ESG risks arise most often across all the holdings. For instance, it might be a surprise that data security ranks so highly within our portfolio of value stocks, whereas technology companies holding vast amounts of customer data, such as Facebook, or companies where intellectual rights underpin the value of the firm, such as Netflix, are well understood as being exposed to data security and cyber security threats. A high-profile example of a cyber security breach was the Sony hack in 2014. However, most companies now hold some level of customer data or have valuable trade secrets and thus data breaches and cyber threats are relevant for most sectors.

Data security

Data security is the most common material issue across the portfolio based on the SASB materiality map. Banks, insurers, retailers and telecommunications all hold sensitive data that were it lost, stolen or leaked would cost the respective business in terms of reputation and regulatory fines. For example, GDPR fines range from 2% to 4% of annual revenue, which would represent the annual profit for a food retailer.

As an example of a data security breach, and prior to becoming a portfolio holding, Currys PLC suffered a massive customer data breach for a period during 2017 and 2018. Subsequently, the company was fined £500,000 by the Information Commissioner's Office (ICO), for context company profits for 2018 equalled £166m. This illustrates that while the risk may be present, the monetary fine may not be material. The more difficult quantification to make is the damage to a company's brand and reputation due to a data breach. While the fine was relatively small, the company responded by investing to enhance its cyber security and cyber security became one of the most regular topics of discussion at Board meetings.

Banks are a much more serious target for cyber criminals and were individual banks, or the sector in general to suffer a large, successful raid, then the trust in the banking sector would be badly damaged and the financial consequences severe. NatWest Group identifies cyber threats as one of the main external risks that the bank faces. Each year it invests in additional capability and controls to defend against evolving and more sophisticated threats. It also focuses on staff and customer education and runs cyber resilience exercises to simulate such attacks on the bank.

Business ethics

Business ethics represents the second most common material issue based on the SASB analysis. Business ethics is important to all companies but for those in the extractive industries, such as mining and oil exploration and production, it is even more material due to the regions of their operations. Corruption increases reputational risks, political action, and regulatory fines. Business ethics is also high on the materiality list for banks. In 2021, NatWest Group received a criminal conviction and a fine of £264.8m by a London court. The bank pleaded guilty to failing to prevent a £365m money laundering scheme between 2012 and 2016. While NatWest's controls had obviously failed, it had invested £700m in anti-money laundering systems between 2010 and 2015. Since 2016 it has invested a further £700m in financial crime compliance. The episode illustrates both the cost when systems fail in terms of fines, and the cost in terms of investment to ensure systems are sufficiently robust to mitigate the risks. As portfolio managers, we must satisfy ourselves that the company is appropriately addressing the historical weaknesses, that the additional cost of fixing those weaknesses will not have an undue impact on profitability, and that the valuation and risk/return profile remains attractive. With NatWest Group we believe this to be the case.

Table 1 The table represents the materiality of each category, on an unweighted basis. The darker shaded categories represent risks that occur more frequently across holdings

General Issue Category	General Issue Category Portfolio	Portfolio
Environment	GHG Emissions	
	Air Quality	
	Energy Management	
	Water & Wastewater Management	
	Waste & Hazardous Materials Management	
	Ecological Impacts	
Social Capital	Human Rights & Community Relations	
	Customer Privacy	
	Data Security	
	Access & Affordability	
	Product Quality & Safety	
	Customer Welfare	
	Selling Practices & Product Labeling	
Human Capital	Labor Practices	
	Employee Health & Safety	
	Employee Engagement, Diversity & Inclusion	
Business Model & Innovation	Product Design & Lifecycle Management	
	Business Model Resilience	
	Supply Chain Management	
	Materials Sourcing & Efficiency	
	Physical Impacts of Climate Change	
Leadership & Governance	Business Ethics	
	Competitive Behavior	
	Management of the Legal & Regulatory Environment	
	Critical Incident Risk Management	
	Systemic Risk Management	

Our own assessment of material sustainability risks led us to give specific focus to carbon emissions and coal exposure in 2020, we therefore deal with these risks in greater detail in the following sections.

Carbon footprint and climate risks

Carbon emissions and climate change are material risks for the portfolio. The two are very much interrelated, carbon emissions driving planetary warming and thus climate change, but the risks arising from the two are both linked and somewhat independent. The risks include transition risks, physical risks, and the risk that society will turn against individual companies and sectors, forcing heavy regulation and forcing investor divestment. All these risks have the potential for material financial consequences for shareholders. The risks remain real whether society makes a successful transition to a low carbon economy or if it fails to do so.

Can our investee companies make a successful transition to a low carbon world, whilst keeping their profitability and balance sheets intact? This is a transition risk. This risk is particularly important for our integrated oil companies and energy intensive companies in the mining sector. How will these oil companies look in the future as they move from being integrated oil companies to integrated energy companies? Will they generate attractive returns for shareholders, or will cash flows be consumed by the transition to clean energy and carbon taxes, will their equity be severely impaired due to stranded assets? Will they remain aligned with all stakeholders and thus retain the support of the wider society?

There are physical risks associated with climate change. Changing weather patterns and rising sea levels brings the risk of damage to property and plant, or curtailed production. Seventy-five percent of Anglo American sites currently fall within water-stressed areas based on World Resources Institute's Aqueduct tool. How will the company manage these risks if the climate gets warmer and water scarcer still?

We track both carbon intensity and absolute carbon emissions for the portfolio. By doing so we can see how carbon intensive our individual companies are and how exposed they are to carbon risks, such as carbon pricing or carbon tax. Interestingly, on an absolute basis oil companies exhibit the highest level of emissions, because of their size, while on an intensity basis mining companies score worst. We also measure our portfolio versus the benchmark and include the comparison in this report.

There are challenges in this process. Here are some of the issues investors need to be familiar with:

- Net zero on absolute Scope 1 and Scope 2 emissions is achievable because it is based on the companies' direct and indirect energy consumption, where that energy is generated by fossil fuels. This will be the energy used in drilling, transport etc, with some of the energy (Scope 1) sourced from their own production and some energy (Scope 2) sourced from other companies (electricity provider). BP, Shell and TotalEnergies have all committed to net zero by 2050 or sooner on S1 and S2. This is what most companies are judged on, but the integrated oil companies (IOCs) are held to the higher hurdle of Scope 3.

- Carbon intensity is carbon emissions versus some other unit, the energy companies focus on carbon versus unit of energy consumed by the end customer (grams of CO2 equivalent per megajoule), whereas most references to carbon intensity refer to CO2e versus revenue, market capitalisation or enterprise value. The latter approaches cause carbon metrics to be volatile at a portfolio level, as relative stock weights move due to share price performance and revenues change with commodity prices.

- With regards to the IOCs' approach on intensity, they can decrease the intensity by changing the mix of coal, oil and gas. They can also reduce intensity whilst keeping hydrocarbon production stable or even growing once renewables or other low carbon businesses grow faster.

- BP have committed to net zero on S1, S2 and S3, in 2020 the S3 ambition was defined narrowly as the emissions from their own production, not arising from products bought from other energy companies that they subsequently sell on. BP upgraded this ambition in early 2022 to include all the products it sells.

- Shell also raised their S3 ambition, from 65% reduction in intensity by 2050 to 100% reduction.

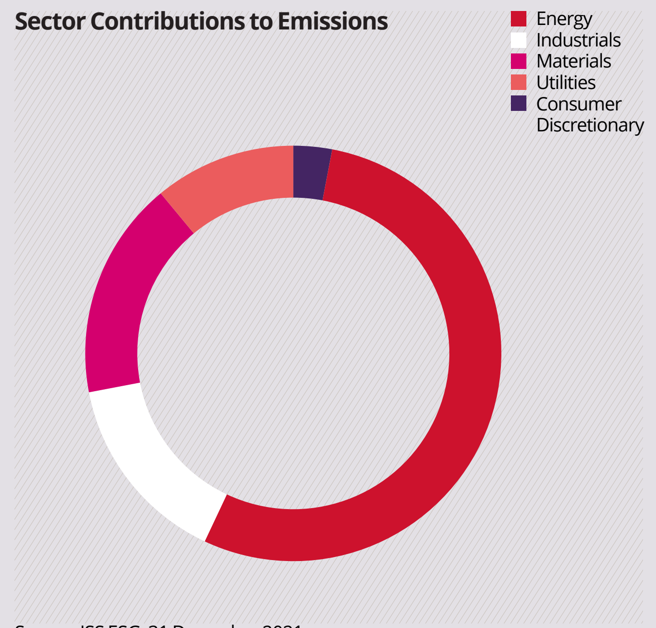
- TotalEnergies include traded products in their S3 calculation and in 2020 targeted a 60% reduction in intensity. This was upgraded in 2021 to "[a]chieve carbon neutrality (net zero emissions) worldwide for indirect GHG emissions related to the use by its customers of energy products sold for end use (Scope 3) in 2050 or sooner." The Transition Pathway Initiative in 2021 adjudged TotalEnergies' emissions intensity plans to be aligned with 1.5° in 2047.

- Perhaps another useful point is that S1 and S2 are under the control of a company, it is theoretically possible to have net zero emissions (even without offsets, albeit these will be required) under these two scopes. However, once the gas or oil produced is used in combustion by the customer, these S3 emissions have to be offset in some way by natural carbon sinks or carbon capture, utilisation, or storage. A company can improve the intensity with efficiency measures, i.e. you get more energy for a unit of carbon, but you cannot go to zero unless you change to a non-fossil fuel. In certain sectors, such as aviation, it is incredibly hard to get to net zero.

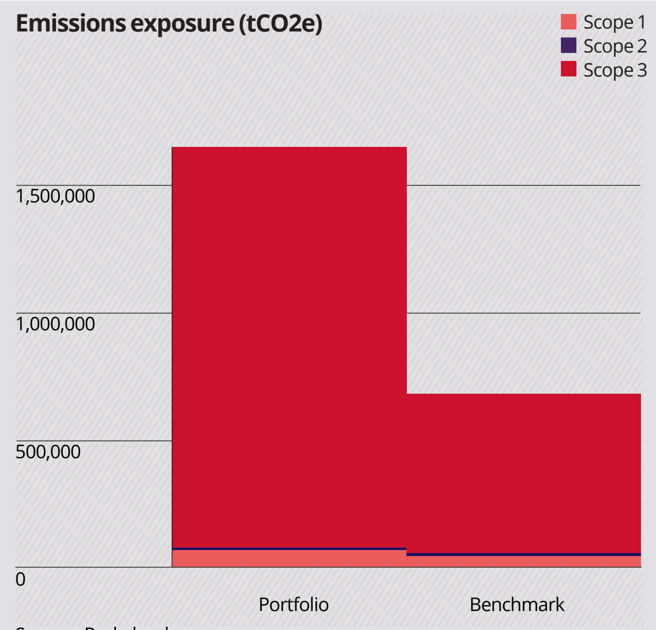
- Other nuances include controlled versus equity stake emission accounting. For example, BP excludes Rosneft S1 and S2 emissions as they do not control the company. Beyond controlled/equity accounting, there is the location-based versus market-based accounting for S2 that may make comparisons less reliable. The market-based approach reflects any specific contract a company has with an energy supplier to deliver green energy, versus the average intensity factor in the country of operation.

Carbon footprint

A portfolio's carbon footprint is the sum of a proportional amount of each portfolio company's emissions (proportional to the amount of stock held in the portfolio) (UN PRI, 2022).



Source. ISS ESG, 31 December 2021

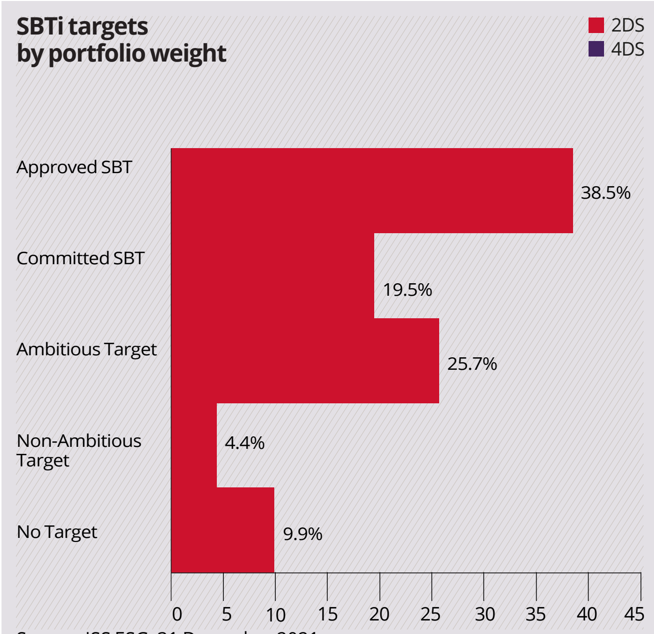


Source: Redwheel.

The information shown above is for illustrative purposes only and is not intended to be, and should not be interpreted as, recommendations or advice.

The two charts above show the sector contributions to emissions and the emissions exposure of the portfolio. Energy is the largest sector contributor to emissions, with Scope 3 emissions (emissions that are generated from value-chain activities) making up the bulk of emissions exposure.

Twenty-four of our twenty-six investee companies have a net zero emissions target by 2050 or sooner, this translates to 88% by portfolio weight. Publicly announced targets by companies vary in their trustworthiness. A company may make promises for 2050, but if it leaves the heavy lifting for future management, then those commitments may be suspect. A way of getting assurance on targets and ambitions is where a company engages with and gets approval from the Science Based Target initiative (SBTi). The SBTi provides technical assistance and expert resources to companies who set science-based targets in line with the latest climate science. It also provides independent assessment and validation of targets. Companies are slowly engaging with SBTi. Having initially got net zero commitments from companies, shareholders can ratchet up the pressure for a credible pathway by pushing their companies to join the SBTi initiative. This is a strategy we endorse and eleven of our portfolio companies are SBTi validated with a further five committed to taking action. However, SBTi is in the guidance development phase for certain sectors, such as oil and gas. This guidance will need to be finalised before the European majors in our portfolio can get validated by the organisation.



Source. ISS ESG, 31 December 2021

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At present, CK Hutchinson and Royal Mail are flagged by SBTi as having no Climate GHG Reduction Targets. Royal Mail state an ambition to be net zero by 2050 and CK Hutchinson are working on carbon reduction at an individual subsidiary level. Royal Mail was previously (2020) listed by SBTi as committed but dropped from the list, it is currently undergoing its regular update where the new targets will be evaluated and classified. We have engaged with CK Hutchinson to push them to set a net zero target, to set ambitious targets for 2030, to fully calculate and disclose their scope 3 emissions and to strengthen their board in respect to environmental/climate risk experience.

We hope we have demonstrated from the work in this section and our engagement work elsewhere in our report, that we take these issues with the utmost seriousness. We believe our companies can navigate these risks because 1) the vast majority accept the issues and are working towards solutions that will align them with global climate targets 2) they have the financial wherewithal to make the transition in terms of balance sheet strength and cash flows 3) their current valuations reflect an incredible pessimism about their ability to make the transition, this affords us the opportunity to invest in these companies, act as cheerleaders for their moves to a low carbon economy and make an attractive return for our investors. We are not for one moment complacent on these issues and continue to closely monitor our holdings; pushing the laggards to align with Paris, matching their companies' words with actions, monitoring their financial strength, and watching the risk/reward as indicated by their company valuation.

Top 10 contributors to portfolio emissions

Name	Contribution to portfolio emission exposure	Portfolio weight	Emissions reporting quality	Carbon risk rating
BP	20.7	6.0	Strong	Laggard
Shell	19.5	4.6	Strong	Medium performer
Anglo American	13.0	6.0	Strong	Medium performer
TotalEnergies	12.6	4.5	Strong	Medium performer
Centrica	11.0	4.9	Strong	Medium performer
CK Hutchinson	5.4	1.7	Moderate	Medium performer
Royal Mail	4.2	8.0	Strong	Medium performer
easyjet	3.3	0.7	Strong	Medium performer
Barrick Gold	2.6	1.8	Strong	Medium performer
Serco Group	1.4	2.0	Strong	Medium performer
Total for top 10	**93.7**	**40.1**		

Top 10 emission intense companies (tCO2e S1&2/Revenue mil)

Name	Emission Intensity	Peer Group Avg Intensity
easyjet	1,393.1	1,729.6
Shell	806.6	1,174.4
Barrick Gold	752.4	523.6
Anglo American	666.7	1,058.6
TotalEnergies	588.9	1,174.4
CK Hutchinson	434.7	88.5
Newmont	388.0	523.6
BP	323.2	1,174.4
Centrica	155.2	4,975.8
Serco Group	57.6	113.7

Source. ISS ESG, 31 December 2021
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Transition Metals

Digging metals out of the ground is the antithesis of sustainability and the circular economy. Yet, we believe it must be done to transition to a sustainable, low carbon world. Recycling can somewhat shift the sector away from a linear economy, for example recycled copper accounts for one-fifth of total copper demand, but it won't get us to the supply needed to align our energy system with the Paris Agreement.

In such a 'sustainability' challenged sector, how should investors assess ESG risks and how might a sustainability focused investor justify a position in the sector?

ESG risks that may immediately spring to mind likely include carbon emissions (it is an energy intensive industry) and environmental problems including water, waste and tailing dam risks. However, often the greatest risks are under the social and governance banners: health and safety, community relations, labour, human rights, resource nationalism, bribery, and corruption.

Justification

If focused on supporting the energy transition and wondering what metals might be acceptable for a sustainable mandate, it is key to understand the role various metals play. The World Bank published a report in 2017 that is a very useful guide for this exercise. Figure 1 illustrates where each metal is used within wind, solar, carbon capture and storage, nuclear power, electric vehicles, energy storage and electric motors. Figure 2 gives a feel for the change in demand in these metals to reach a 2-degree scenario. Copper is much mentioned as a leading transition metal, driven by demand from electric vehicles (EVs), the electricity grid and renewables. It also benefits from low carbon intensity of production. Lithium is the preferred material in EV batteries, while it is estimated that committed supply and capacity expansions account for only 15% of demand growth between 2020 to 2050 required to support EV rollout. Many other transition metals are required, as illustrated.

Figure 1. Matrix of Metals and Energy Technologies

	Wind	Solar photovoltaic	Concentrating solar power	Carbon capture and storage	Nuclear power	Light emitting diodes	Electric vehicles	Energy storage	Electric motors
Aluminum	●	●	●	●		●		●	●
Chromium	●			●	●	●			
Cobalt			●	●	●		●	●	
Copper	●	●		●	●	●	●		●
Indium		●			●	●	●		
Iron (cast)	●		●			●		●	
Iron (magnet)	●								●
Lead	●	●			●	●			●
Lithium	●						●	●	
Manganese	●			●			●	●	●
Molybdenum	●	●		●	●	●			●
Neodymium (proxy for rare earths)	●						●		●
Nickel	●	●		●	●	●	●	●	●
Silver		●	●		●	●	●		
Steel (engineering)	●								
Zinc		●				●			

Source: The World Bank 'The Growing Role of Minerals and Metals for a Low Carbon Future' 2017
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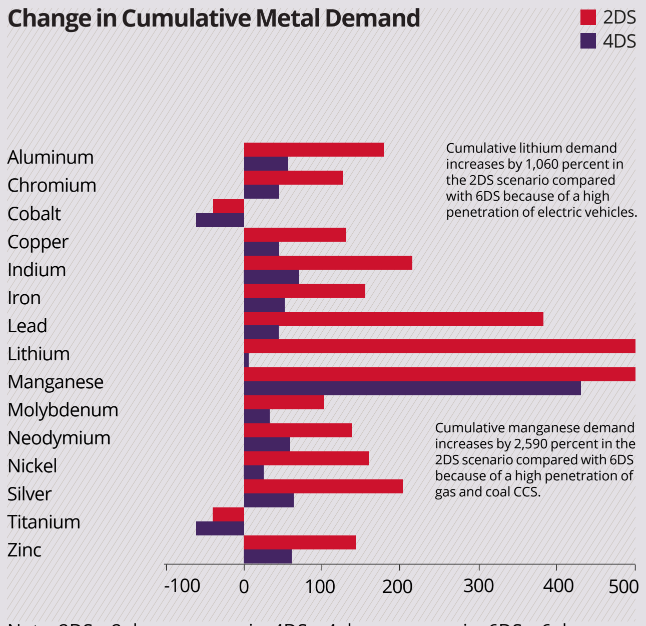
Figure 2 .

Change in Cumulative Metal Demand



Note: 2DS = 2 degree scenario, 4DS = 4 degree scenario; 6DS = 6 degree scenario; CSS = carbon capture and storage.

Source: The World Bank 'The Growing Role of Minerals and Metals for a Low Carbon Future' 2017
The information shown above is for illustrative purposes only and is not intended to be, and should not be interpreted as, recommendations or advice.

Assessment

If an investor is comfortable with the metal, then other risks mentioned should be fully assessed. Top level, mining companies should be in compliance with global norms, such as the UN Global Compact and UN Guiding Principles on Business and Human Rights as well as the OECD Guidelines for Multinational Enterprises. Behaviour and ethical standards in this sector are more fundamental to managing risk than most sectors.

Understanding exposure to and assessment of other risks may lean on the Sustainability Accounting Standards Board (SASB) Materiality Map, an individual company's own assessment, along with ESG rating agencies, broker research and non-profit organisations. The collapse in 2019 of a tailings dam in Brumadinho, Brazil, killing at least 259 people, prompted the Church of England Pensions Board and the Swedish National Pension Funds' Council on Ethics to launch the Global Tailings Portal. The collaboration aims to improve disclosure, safety and risk management, while investors can access the data on individual mining companies for free. Other non-profit organisations aim to inform investors on further risks, including the World Benchmarking Alliance's CHRB index on human rights.

Company disclosures, particularly for large cap stocks, are improving and allow for assessment on emissions, health and safety, and water management.

On greenhouse gases, mining companies are only waking up to their scope 3 emissions, they trailed the energy sector on taking responsibility and on setting meaningful targets. However, this started to change in 2021. In September, BHP (not held) reiterated a 30% cut in scope 1 and 2 emissions by 2030, while enhancing their scope 3 net zero by 2050 target, the latter heavily caveated. Glass Lewis recommended that shareholders vote against the company's plans at the AGM in November, but it subsequently passed receiving 84.9% approval. ISS have demonstrated how difficult these decisions are, by recommending both for and against... depending on how concerned you are as a shareholder about the environment!

In early October the Fortescue Metals Group (not held) upped the ante on peers by declaring it would be net zero on scope 3 by 2040.

Rio Tinto (not held) responded later in October with updated scope 1 and 2 emission targets, raising ambitions from 15% to a 50% cut in absolute emissions by 2030. They announced a significant capital expenditure plan to meet the aggressive new target. On scope 3, the company is focused on reducing carbon intensity of steelmaking and reducing emissions from shipping. Again, like BHP, somewhat fudging on scope 3.

The direct exposure for the portfolio is through Anglo American, Newmont Corp and Barrick Gold. Anglo American is a top five holding and thus is the main exposure. In November, they too increased their climate targets adding a target of 50% reduction in scope 3 emissions by 2040. The company aims to be carbon neutral across its operations (scope 1 and 2) by 2040. Newmont Corp had acted earlier, in 2020 setting a 30% reduction for scope 3 by 2030 and net zero by 2050. Barrick Gold has yet to set scope 3 reduction targets; however, we received a commitment during our engagement with the company that they would increase their disclosure on scope 3 emissions and to continue their work to understand how to reduce those emissions. We expect an update to that work in the first quarter of 2022.

In terms of transition metals, Anglo American is very much involved in this theme. Key transition metals such as copper, platinum, nickel and manganese account for over half of their revenues. They also spun off their South African thermal coal assets during the year. Newmont and Barrick Gold have low levels of exposure to transition metals due to their concentration in gold.

This is a sector where shareholders need to be deeply engaged with company management and very open to collaboration other shareholders to ensure good behaviour and to demand proper transition plans. Like the energy sector, this is a race to net zero in materials. In a resource sector, be it fossil fuels or materials, it is not enough to be above average, a company must be seen to be leading, to be best in class, to attract capital from less receptive, more climate-change aware investors.

Sometimes it may feel easier to pass, but therein lies the opportunity for an investor as many others will take that pass. It is also the irony of the energy transition, which requires companies to keep digging and sustainable investors to keep supporting them, to get to the end goal of a decarbonised energy system.

Water Scarcity

Water is one of the most important natural resources on the planet and needed for the survival of all living beings. According to the UN, more than 2 billion people live in water stressed areas (where water demand outstrips water supply) and this is expected to increase to 5 billion people by 2050 (UN CEO Water Mandate, 2021). The World Economic Forum has listed water crisis among the top five global risks in terms of impact in eight of the last ten years (World Economic Forum, 2021).

We are already seeing increased intensity of water-related natural events like droughts and floods. Tim Wainwright, Chief Executive of WaterAid, said that the global water crisis was being ignored at COP26. "The way that climate change affects human beings is almost entirely through water, either too much or too little. So why aren't we talking about water all the time?" (The Guardian, 2021).

Given its importance, we have recently been taking a deeper look into the water policies of our holdings to gain a deeper understanding of issues they may face and their approaches to water stewardship.

A starting point is to understand, what is water stewardship? The Alliance for Water Stewardship defines water stewardship as 'The use of water that is socially equitable, environmentally sustainable and economically beneficial, achieved through a stakeholder-inclusive process that involves site and catchment-based actions.' It is a set of practices to manage freshwater resources sustainably and equitably.

By implementing a good water stewardship structure, a business can help understand the risks they face whether that is through their own operations or through changing environmental conditions. While it is impossible to eliminate all risks, a company with a solid water stewardship policy should be in a better position to mitigate and manage those risks.

Water is not just an environmental issue, but also a social one. Some 2.2 billion people around the globe lack access to clean water in their homes, and 50% of people around the globe lack access to safe sanitation services (UN CEO Water Mandate, 2021); this has a larger impact on females. There are increased risks in the workplace and in private homes if there is no access to drinking water, sanitation, and hygiene (WASH) services. Without these services employees are more likely to become ill, reducing productivity.

We began by reviewing the water polices of our mining companies Anglo American, Barrick Gold and Newmont. Mining is on the front line of water security risk. The sector is a major user of water as it is needed to get raw materials from the ground and extract desired elements. The mining sector is also exposed to risk from water pollution as the by-product of extraction, processing can be highly acidic and there is potential to pollute both ground and surface water. Many countries where mining is located are exposed to decreasing water availability including Peru, Chile and Australia. In the next 20 years, the World Resources Institute predicts these countries will become more water-stressed, making mining more difficult and costly.

So far, we have engaged with Anglo American and Newmont on their water policies, water stewardship and their vision for the future. It was clear from our discussions that these companies recognise the critical nature of water as an asset to not only their own business activities but also the wider communities where they operate. For example, Anglo American have spent the last three years improving their governance processes, tools and data collection to help provide a water roadmap for the next ten years where they can optimise water management, reduce consumption and increase the efficiency of water usage. Newmont have continued to build on their Global Water Strategy which was originally published in 2014 and have partnered with the World Resources Institute to support their water stewardship activities and provide context on how global water risks translate to their operations. CDP (a not-for-profit charity that runs the global disclosure system for investors, companies, cities, states and regions to manage their environmental impacts) publish annual scores for companies that make submissions to them on climate, water and forests. Among our mining companies Anglo American scored best, with an A-, while Barrick Gold and Newmont Mining both scored a B.

Many of our companies have set water related targets which we can use to monitor their progress. However, from our engagements so far it is clear the issues are more nuanced than one that can be distilled down to a single number. With the mining companies, for example, each site will have its own challenges depending on location, mine type and the material being extracted. We need to be comfortable that our companies have the systems in place to identify and mitigate the risks they face when it comes to water. This highlights the importance of engagement on the topic as we will not wholly rely on scores from bodies like the CDP.

We will continue to engage with our companies on the issue of water, signalling to them that this is an area of importance for us, acting on behalf of shareholders. Ignoring the issue, as seen at COP26, will send the wrong message and in a world of competing demands the lack of attention from shareholders and subsequently from management may allow this risk to increase unseen within our portfolios.

We will encourage companies at risk from water scarcity to improve their disclosure and improve their risk management. This work, we hope, will contribute to reducing risks within the portfolio and improves the outcome for society in general.

Remuneration

Governance within UK companies is generally of a very high standard. This reflects the UK Corporate Governance Code and long history of efforts to raise standards. However, remuneration is one area of extreme importance and of active engagement for us. In 2021 it ranked as the second most common topic for engagement with investee companies, only climate accounted for more.

However, our engagements in 2021 on the subject were often frustrating. We tend to find companies engage in name rather than in spirit. We find that the remuneration proposal is rarely adjusted and the Remuneration Chair relays to us that most shareholders are happy with the original proposal. We are not alone with this experience, LGIM, which manages £1.3 trillion, were quoted in the Financial Times as saying, "Most companies don't act on the remuneration feedback we give them... Companies tend to do what's right for management rather than listening to us a shareholder" (link). We have therefore reviewed our approach to remuneration engagements and will concentrate on companies where we are one of the top shareholders. We will be spending less time with other remuneration chairs, rather sharing our remuneration policy for their guidance. Our experience tends towards hardening our voting stance at AGMs.

In our 2016 investor letter, Reforming capitalism (link), we set out some of the issues we wished to focus on with regards to remuneration, in the context of capitalism working for all stakeholders in society. Our key objectives are to increase long-term thinking and encourage greater alignment of management to shareholder interests. These objectives also include a greater emphasis on other stakeholders.

The basis of a good corporate remuneration policy is a well constituted remuneration committee. This requires both the independence of the committee members and relevant experience in the field of remuneration. We are somewhat circumspect on remuneration consultants; the committee must retain control and ownership of the policy. The committee must guard against the ratcheting upward of compensation awards, balancing this with attracting and retaining talent. We are also highly sensitive to cross boarding, and how this may lead to increasing remuneration levels.

Where a policy has been adopted, we take a very dim view of subsequent 'exceptions' or alterations to fit circumstances. We may reflect such displeasure on subsequent votes regarding the remuneration report, remuneration policy or committee member re-election.

We encourage companies to set metrics that align with the overall strategy, reflecting appropriate financial metrics, in combination with non-financial metrics relating to ESG issues, specifically environment and social issues. The environmental objectives should be set to meet specific challenges within the industry of operation, while on social issues, relations with employees, customers, suppliers and the community should be reflected as appropriate.

Performance metrics should be stretching for executives. A remuneration committee should retain and employ discretion to ensure pay-outs are matched by the quality and sustainability of the underlying performance. Malus and clawback should have a wide interpretation and be formally accepted by management.

Executives should have significant 'skin in the game' and this should include purchasing shares from own resources.

The following are specific proposals we would like remuneration committees to incorporate in their policy reviews:

- Executive shareholding (CEO and CFO) of 300% of salary within five years of appointment
- Minimum long-term performance vesting periods should be five years, we strongly encourage an extension to seven years
- Minimum post-employment shareholding period of 100% of in-employment guide to end of year two, we strongly encourage 50% to end of year three and 25% end year four
- A 'handbrake test' at 75% of maximum pay-out to ensure large pay-outs are matched by the quality and sustainability of the underlying performance

The trend we saw in 2020 of companies seeking shareholder approval to move away from Long-Term Incentive Plans (LTIPs), to restricted share awards (RSAs) continued in 2021. RSAs can be a more appropriate incentive structure for some companies. RSAs may reduce excessive complexity, volatile or unjustified outcomes and a tendency to encourage short-term behaviour, or other unintended outcomes not supportive of long-term value creation. While the structure may be attractive, the motivation of a company needs to be clear in making the switch and should not reflect 'out of the money' LTIPs. In switching to RSAs we have specific questions and proposals for companies:

- Why is an RSA scheme appropriate, why is the change happening now and why is the existing arrangement no longer suitable?
- Award levels should be reduced to 50% or less than the normal LTIPs to reflect the greater level of certainty
- The holding period should be a minimum of five years, we strongly encourage an extension to seven years
- The remuneration committee should retain the right to adjust the award before the end of the restricted period
- Underpins should be included to ensure the outcome reflects the shareholder experience

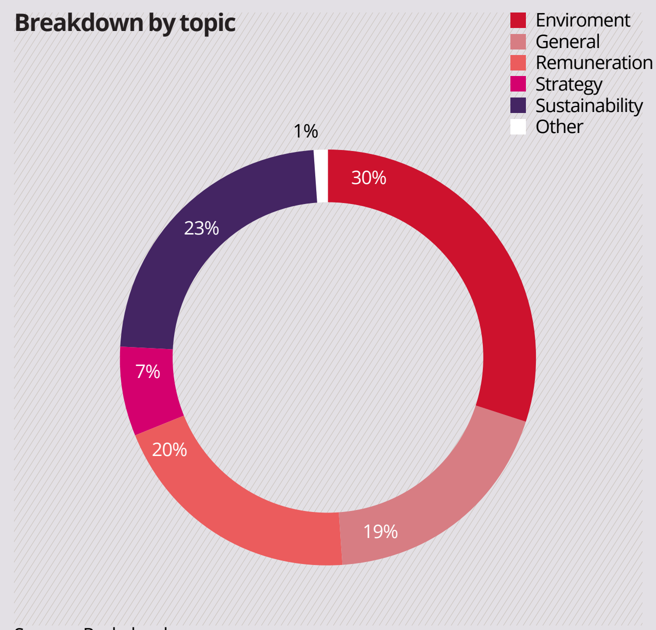
We encourage companies to reflect on the guidance and research from The Purposeful Company and to be more imaginative in design of RSAs. In return for longer holding periods, we are willing to consider a lower discount level.

Remuneration is a complex area and challenging to get the right balance between the various objectives and agendas. Shareholders will invariably give conflicting feedback to remuneration committees. Where we have significant influence, we will engage with companies in the construction of the remuneration policy. Where we feel our shareholding is not as significant then we will share our own remuneration policy to make clear to companies what we expect.

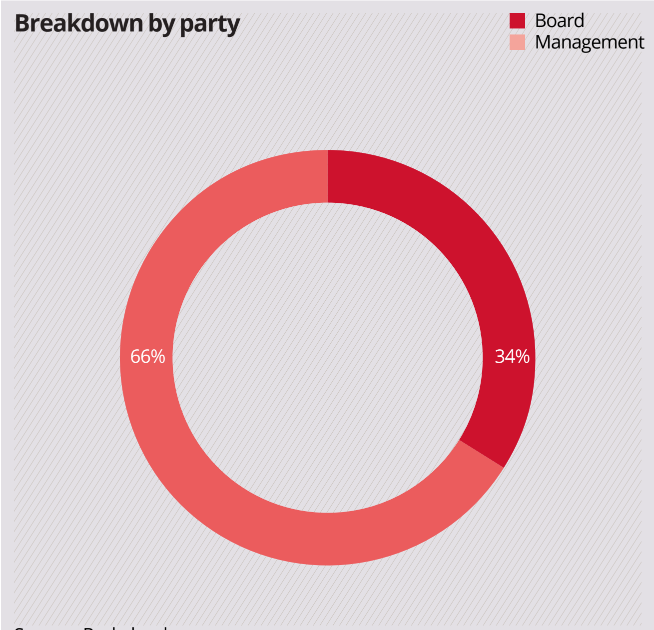
We expect companies to supply us with a clear link between the remuneration policy and the long-term strategic objectives of the business. We also expect them to provide us with clear links between remuneration and sustainability issues that are relevant for their company. Should we fail to have a satisfactory response from the company, we may escalate via collaboration with other shareholders and voting against the remuneration policy. We will vote against the election of the remuneration chair and individual board directors where we do not support the remuneration report for a second consecutive year or there is a significant breach of the remuneration policy. We will also use our votes to display our displeasure where there is a failure to employ discretion, when appropriate.

We will continue to develop our own policy and push for higher standards, ensuring that we protect shareholder interests and promote long-termism, set in the context of sustainability for all stakeholders.

Engagement record



Source: Redwheel.



Source: Redwheel.

Engagement is of great importance in understanding and communicating with our investee companies. With a long-term investment horizon and a concentrated portfolio, we can build meaningful engagements. The engagement process is led and carried out by the portfolio managers. Engagements are an extension of monitoring, and it is important to add that we feel management time should be protected from excessive demands from shareholders, so we will typically focus on annual meetings with management where a company is operating as expected.

Engagements will be determined by the size of the exposure within the portfolio and the materiality of the identified risk, including ESG risks. We will draw from experience in assessing materiality risks, plus we draw from both the company's own materiality assessment and independent assessments on a sector basis, such as the SASB Materiality Map. Please refer to our Team ESG Policy for more detail on how we prioritise engagements.

The number of engagements with companies increased further last year, having also increased in 2020 over 2019. The trend is driven by our desire to understand sustainability risks better, at the same time as companies wish to have the opportunity to explain their sustainability plans to us. In 2021 we had seventy-four interactions with companies. The line between engagement and monitoring is sometimes grey, however we would define half of the interactions as engagement and half as monitoring. The majority of our interactions were done at the management level. We will engage with the board when there are question marks over strategy, when there are issues around governance and remuneration or on succession. Additionally, we may engage with the board on sustainability issues when we feel the management team is not engaging sufficiently on the matter or we wish to apply greater pressure on specific topics such as emission reduction targets.

Individual engagements

Anglo American PLC/Thungela Resources LTD

Issue

In last year's Stewardship Report we wrote about Anglo American's exposure to thermal coal and our engagement with the company on the subject. We also noted how Norges Bank Investment Management (NBIM), the $1.4 trillion sovereign wealth fund, had announced its divestment from the company, adding it to their exclusion list. At the end of last year, the company stated that the "Planned divestment of SA thermal coal production capacity [was] expected no later than May 2022 – May 2023".

Anglos delivered on its promise, spinning off its South African thermal coal business, Thungela, in June. We wrote about the event for Investment Week (here), asking the question as to whether the company would now be removed from the NBIM exclusion list. Having reviewed their list, NBIM did remove Anglos from their exclusions in July. The action by the NBIM sends a powerful signal to corporates on their hydrocarbon assets, most immediately thermal coal assets. It is debatable whether the result is as climate friendly as claimed, but it offers a clear incentive to companies to divest their dirtiest assets.

The spin off resulted in one share of Thungela for every ten shares of Anglo American held. However, due to the difference between Anglo American's share price and Thungela's, the resulting Thungela position was less than half a percent of the Anglo's position, less than 0.05% for the strategy. Therefore, not a meaningful position for us. The decision thus had to be made to increase the weight or to divest the shares.

Outcome

We engaged with Anglo and Thungela management separately to fully understand the new company, its strategy, and its prospects. The conclusion was to divest the shares as we believe there is a wide range of outcomes for future environmental rehabilitation costs, thus unknown large future liabilities. These future liabilities may encourage the company to extend the life of coal mines and develop new mines as a way to push those liabilities further into the future. While Anglo American was running the mines down, this would be a change of direction and not moving into alignment with the Paris Agreement. It may also mean that the position would be hard to liquidate in the future, both due to the illiquidity of the shares and the likely lack of willing buyers for coal assets.

Shell PLC

Issue

Climate warming and the need to transition to a low carbon world, remains at the top of the agenda for energy companies. We continued our engagements with the energy companies and Shell in particular. While Shell demonstrated early leadership on the transition among peers, it has been surpassed by the likes of TotalEnergies, ENI and BP, who all have increased their ambition on emission reduction and on transition to a low carbon business. Against US peers Shell compares well.

Shell and their Investor Relations have been very helpful in explaining their strategy to us, including the updated strategy delivered in April 2021. Parts of it are very encouraging, including the opportunity to vote on the plan in what is sometimes described as 'a say on climate'. However, to move to the next phase of transition, where the company would be afforded the time and space to execute on their strategy, the starting point must be ambitious enough. We do not believe Shell's starting point is ambitious enough to do this. The intensity reduction target of -20% by 2030 is not enough to align with The Paris Agreement. Unlike BP who have announced cuts to hydrocarbon production, Shell will continue to invest in hydrocarbons and the ClimateAction100+ benchmark highlights that those capital expenditure plans are not aligned with Paris (whereas BP and TotalEnergies are more aligned). Shell also relies on carbon capture and carbon offsets (carbon capture and storage and nature-based solutions such as tree planting), which many independent organisations characterise as not being credible.

Shell was also the subject of other controversies over the year, including its stake in the Cambo Field, located 125 km north-west of the Shetland Islands. The field was discovered in 2002 and is 70% owned by private equity firm, Siccar Point Energy, and 30% by Shell. The Cambo Field has sparked debate among campaign groups like Greenpeace, the oil industry and the UK government with activists arguing that using the field's estimated 170 million barrels of reserves is inconsistent with the country's policy of achieving net-zero carbon emissions by 2050.

We reviewed this issue and concluded that we should not take views on individual projects, as such we could not advise the company to voluntarily strand valuable assets. Licencing of an oil field is a government issue and, in this case, comes under the Oil and Gas Authority (OGA), a regulatory body in charge of overseeing the exploration and development of oil and gas fields across the UK. The priority for us is avoiding oil sands, due to the large emissions they cause, and Arctic drilling, due to concern over the fragile environment in the North Pole. Oil sands and Arctic drilling, similar to coal, are top of the list of hydrocarbons to remove from the energy system. Conventional oil and gas are still required over the transition period to a lower carbon economy. In December, Shell announced it was pulling out of the project based on poor expected financial returns.

Shell announced in November that they were seeking to consolidate the share structure (A and B shares) into a single line, listed in the UK and that they were moving their incorporation and headquarters to the UK. We engaged with the CEO, Ben van Beurden, where he explained the logic of the corporate change. The move would enable more flexibility, for example on how they change their portfolio of assets (in the current very complicated corporate structure, dividends for A and B shares must link to individual underlying assets) and flexibility on the size of their share buyback programme. Shell said The Netherlands has also become a more hostile environment for the company to operate, with the court ruling (described below) along with politicians lobbying against the company in Brussels, illustrating this shift.

Greater flexibility is a good thing for Shell at this point in their transition. The transition will require flexibility of thinking and flexibility of action. We spoke with Third Point (US activist) on their suggestion for Shell to break itself up. If breaking the company up becomes the necessary action, a simplified structure, as proposed by the company, would help in executing the plan.

Outcome

We voted against the Shell Transition Strategy (Resolution 20) and for the Shareholder Resolution (Resolution 21). Ahead of the Royal Dutch Shell AGM, we wrote to the incoming Chair, Sir Andrew Mackenzie, to explain our position. Redwheel also released a public statement declaring our voting intentions ahead of the vote. This encourages other shareholders to follow suit. The Shareholder Resolution got 30% of the vote, up from 14% in 2020, while the company's own Transition Strategy Resolution received 89% support.

The start of a new chairmanship offers the opportunity to reset plans. We are hoping the new chair takes this opportunity to increase ambition and hears a clear message through these two votes. To vote just on the transition plans (and against the shareholder resolution), would not be clear enough.

Since the AGM vote The Hague District Court ordered Shell to cut its carbon emissions by a net 45% by 2030 compared to 2019 levels, which compares with Shell's existing plans to reduce its net carbon intensity footprint by 20% by 2030, 45% by 2035 and net zero by 2050. The court argued Shell has a duty of care to reduce emissions and that current reduction plans were not enough. Shell has confirmed that it will appeal the court ruling.

As things currently stand, Shell has a legal obligation to reduce absolute emissions far quicker than currently planned. This court ruling acts as a cautionary sign for oil major peers. We have been very consistent in justifying energy holdings by saying that engagement works, which puts pressure on companies to improve their environmental performance, is better for shareholders and society than divestment. If Shell's appeal fails, the scale and speed at which the company will have to reduce absolute emissions by 2030 to comply with the court order may have to be achieved in part via divestments from its oil and gas portfolio, which may ultimately risk being climate counterproductive.

Following the engagement on the change of corporate structure and engagement with Shell on the matter, we voted for the adoption of the new Articles of Association, required to enact the proposed changes. The vote passed at a special meeting in December.

In November, we were included as a Collaborative Investor in the CA100+ engagement with Shell. The inclusion gives us a platform to deepen our already extensive work on Shell and through the collaboration further contribute to making Shell a more sustainable company, by encouraging the company to promote energy transition and carbon footprint reduction.

Pearson PLC

Issue

In September 2020 Pearson held a special shareholder vote to approve the remuneration package for the in-coming CEO. The vote was required as it was in breach of the company's remuneration policy. The co-investment award for the new CEO was both substantial and lacking meaningful performance criteria. This behaviour is very poor practice and clearly breaches guidelines from the IA and PLSA. While the vote was successful, there was a significant shareholder revolt. We cast our votes against the proposal.

This was a material governance issue as it undermines the UK investor codes on compensation, it undermines the work done by shareholders in developing remuneration policies and the quantum of the award was large and lacking performance criteria.

We conveyed our dissatisfaction to Pearson's outgoing Remuneration Chairperson and incoming Chairperson. The message was clear, that the action would undermine our efforts to support the development of remuneration policies if companies subsequently ignored them. We spend a lot of time considering remuneration policies, the objective being to pay executives well, while encouraging more 'skin in the game' and longer-term thinking. We look very unfavourably on instances where companies make exceptions to their own remuneration policies.

An issue raised by Pearson, and one that has been raised by other companies, is the difficulty in attracting talent in a global context. As compared to UK firms, US firms can offer far more lucrative incentive packages. Pearson felt what they offered was needed to attract the right CEO. While there can be some sympathy for the challenges companies face in this area, it is vitally important that there is an alignment of interests between shareholders and management, and control maintained on the overall quantum of pay-outs.

Outcome

We cast our votes against the re-election of the Chairperson of the Board, against the re-election of Chairperson of the Remuneration Committee and against the Remuneration Report at the 2021 AGM. However, both directors were re-elected, albeit with significant votes against. Subsequently, both directors have announced their intention to step down from the board.

CK Hutchison Holdings LTD

Issue

CK Hutchison, as a conglomerate, operates in multiple jurisdictions and diverse business areas and therefore it is exposed to a broad range of ESG risks. The company has made good progress over the last couple of years, including the publication of the group's first standalone sustainability report. This has led to an improvement in its Sustainalytics ESG Risk Rating; however, there are levers the company can pull to get a higher rating. They must also disclose and set targets on GHG emissions in line with the Paris Agreement.

The ESG ratings agencies and data providers are but one input factor when we form a view on an investee company's ESG risks. However, recognising that other investors will frequently use ESG data and ratings from third-party providers as part of their investment analysis and that some of our clients may also reflect on the ratings via Morningstar, which use Sustainalytics as the underlying rating agency, the actual rating themselves take on a greater importance.

Therefore, it is important that companies like CK Hutchison engage with ESG rating agencies (particularly Sustainalytics and MSCI as the most influential), to ensure the agencies have full access to the range of ESG data points needed to accurately assess the company's sustainability performance. Thus, the material risk from our perspective is one of the company's valuation and ultimately the cost of capital, were the company to be perceived as a less sustainable firm than is actually the case .

We engaged extensively with CK Hutchison over the year. This included writing to the Chair and Group Managing Director, meeting with the CFO and Company Secretary, having multiple meetings and exchanges with Investor Relations and the Group Senior Sustainability Manager. The initial focus was on pushing the company to set appropriate GHG emission reduction targets, encouraging the Board to 1) set ambitious targets for carbon emission reductions by 2030, with a minimum target of 30% reduction in scope 1 and scope 2 emissions, 2) set the company on a path to net zero by 2050 and declare this publicly, 3) fully calculate and disclose scope 3 carbon emissions, and 4) strengthen the Board Sustainability Committee with independent environmental/climate risk experience, and have a requirement for it to convene more regularly than the current minimum of twice per year.

Further engagement pushed for participation in the UN Global Compact and the need for greater diversity on the board (gender, age, and ethnicity). Finally, we worked with CK Hutchinson on improving their ESG ratings as it was felt the company's rating did not fairly reflect the actual reality. The latter was partly a function of the classification of the company as an industrial conglomerate. For example, under Sustainalytics the company has a beginning score of 60 (lower the better), whereas a similar company like Berkshire Hathaway defined as a Multi-Sector Holding company, is assigned a beginning score of 21. Classifications such as the Global Industry Classification Standard (GICS) are managed by S&P Dow Jones Indices and MSCI and are not easily changed, so it makes it much harder for CK Hutchinson to be rated as highly as Berkshire Hathaway.

After the publication of the company's latest sustainability report we spoke to their sustainability team to provide feedback on that report. We again pointed out the issues surrounding the rating agencies and the impact on their ESG rating. At the same time, we engaged with Sustainalytics on CK Hutchison's score to push them to reflect the progress made by the company on ESG matters. Following the latest review by Sustainalytics, CK Hutchison's ESG Risk Score improved by 8 points, which is a significant improvement.

Outcome

CK Hutchinson is striving hard to improve its sustainability. In June it became a participant in the UN Global Compact.

The company is undertaking a detailed project to calculate and disclose all carbon emissions from each of its divisions. It has set a range of target reductions for those divisions, for example, in Telecoms they are currently in the process of setting a target which will be validated by the Science Based Target initiative, in Retail they have set a target of reducing scope 1 and 2 emissions by 40% by 2030 versus a 2015 baseline. However, in Infrastructure, where most scope 1 and 2 emissions arise, targets are set at an individual asset or subsidiary level and while many have a net zero by 2050 target, it is difficult to get the overall picture.

The company accept these deficiencies and are working towards a group wide framework, which in turn will help the market to understand better their green credentials.

With the sale of their stake in Husky Energy to Cenovus (completed in January), in return for shares in Cenovus, they will no longer account for carbon emissions from this position (they no longer have a controlling stake). This does not actually reduce any emissions globally, but it does reduce exposure for the company itself in the eyes of the market. The Cenovus holding is problematic due to the underlying exposure to Canadian oil sands.

In addition to engaging with the company on their Sustainalytics rating, we conveyed to Sustainalytics our views, specifically on the classification issue. It is difficult to assess how our work contributed to Sustainalytics review, the outcome however from the progress made by CK Hutchinson over the year and a review by Sustainalytics was a very impressive rating upgrade, dropping 9 points from 38 to 29 over the year, moving from high to medium risk as defined by Sustainalytics.

Barrick Gold CORP

Issue

Barrick Gold is a Canadian based mining company. In early 2019 it completed its merger with Randgold Resources to create the world's largest gold miner at the time. The company was responsible for 4% of total global gold mine production in 2020, second to closest peer Newmont Corp (4.9%) and ahead of AngloGold Ashanti (2.5%). By revenue gold accounts for 93% of company revenue, copper 6%, other 1%, by assets the company has greater exposure to emerging markets (57%), than developed markets (43%).

Barrick has had major historical environmental and community issues, which continue to cause problems. The company failed to resolve these issues over the last decade, only coming to grips with the problems in the last couple of years, under new management from Randgold. The company also ranks as one of the most carbon intensive companies within the portfolio.

Barrick Gold's shares have underperformed Newmont's shares, with several factors driving the underperformance, however, we believe Barrick Gold is suffering a discount to Newmont due to the latter's superior ESG ratings. Barrick's environmental and human rights issues is discouraging ESG focused investors, notably the company is on the Norges Bank IM Exclusion List for 'severe environmental damage'.

We believe that rectifying these issues will improve community relations, address environmental concerns, thus improving the company image and improve ESG ratings. This should lead to a re-rating of the company closer to peer Newmont.

In November 2020, we met with the CEO, CFO and Head of Sustainability. In that meeting, the CEO laid out the sustainability credentials of the firm, its strong track record and his views on carbon emissions. He believes demands for reductions in carbon emissions by many investors, ignores the impact on the developing world. In January 2021, we wrote to the Chair requesting that the Board 1) revisit the 2030 target of a 10% reduction in GHG on scope 1 and scope 2 emissions, with a view to being more ambitious, 2) set the company on a path to net zero by 2050, 3) fully calculate and disclose scope 3 carbon emissions and 4) strengthen the Board with respect to independent environmental/climate risk experience.

We engaged with one of the company's top shareholders, to get their views on the various issues identified at Barrick, engaged with Sustainalytics analysts to dig deeper into their rating for the company and an NGO based in Africa. Seeking other viewpoints helps to paint a more complete picture of the issues and which issues are a priority to be addressed directly with the company.

Outcome

We received a letter of response from the Chair and CEO in January 2021. The letter noted that 1) in their upcoming sustainability report, Barrick planned to increase their emissions reduction target to 15% by 2030, on a path to get to 30%; 2) they would work towards net zero but wanted a clear roadmap for how it could be achieved; 3) Barrick will publish scope 3 estimations during the year alongside an effort toward supplier engagement to reduce scope 3 emissions; 4) Barrick acknowledged the need for climate change understanding at the board level. At the Barrick Gold Sustainability Investor Day, the company did increase their emissions reduction target to 15% by 2030 with an intended target of 30% in due course and noted their 'vision' is to achieve net zero GHG emissions by 2050. To a degree this has been a successful engagement given the original target of a 10% reduction by 2030 and no net zero ambition. It is a work in progress.

Furthermore, our research improved our understanding of the legacy environmental, community relations and human rights issues. The CEO of Barrick Gold, previous CEO of Randgold, has demonstrated an understanding of the problems and the urgent need to resolve them. In April, the CEO said "Generally, you can operate in the majority of mineral-endowed countries in the world, provided that you're prepared to recognize and build a licence to operate, and what happened in Papua New Guinea is, we lost that." (Financial Post 15/04/2021)

In North Mara (Tanzania) where there were allegations of human rights violations, the company made an agreement with the Tanzanian government and undertook other measurers to address the issues. In Porgerain (Papua New Guinea) where riverine tailings from a mine were the issue, the company entered a binding deal in April 2021. Following the deal PNG's stake will increase in the entity that owns the mine from 5% to 51%, making Barrick a minority owner in the mine.

At the Pascua-Lama Project (Chile) Barrick has accepted a Court closure order.

The company introduced Community Development Committees at all operational sites. It has an Environmental & Social Oversight Committee at board level, chaired by CEO. It is working towards external assurance on conformity with the Responsible Gold Mining Principles (RGMPs+).

The work is not complete, and the company remains on the Sustainalytics watch list for breach of global norms. However, we believe the company is on the right track and with shareholder encouragement should continue to make progress in resolving the outstanding sustainability issues, with the future potential of closing the sustainability discount to Newmont.

Barclays PLC

Issue

For the 2021 Barclays AGM, a shareholder resolution was put forward by environmental organisation Market Forces seeking to have Barclays phase out lending to fossil fuel companies. In 2020, Barclays set out a new policy to become a net zero bank by 2050; aligning their portfolio of financing activities to the Paris Agreement; increasing restrictions for financing in energy sectors; and increasing green financing by £100bn by 2030. The sponsors of the shareholder resolution said Barclays had not gone far enough.

We see Barclays as a laggard with regards to the energy transition as compared to European peers and a past laggard on ESG issues in general. There have been other governance issues in recent years (we voted against the remuneration Report in 2019). The 2020 transition plan is not sufficient, but it is a start, and it is expected that the bank will build on that plan in the short-term. On the AGM resolution, the wording was controversial in that it focused on phasing out lending to companies, rather than fossil fuels projects. This makes it vastly more complicated for companies to commit to, particularly in developing markets where conglomerates will have numerous subsidiaries. There may be a more nuanced approach to arrive at the same outcome and we are willing to allow companies find that route, while acknowledging the urgency of the issue.

Banks have had significant trust issues, with the Global Financial Crisis undermining that trust to a huge degree. As they build back that trust, making progress through their actions to support businesses and support government lending initiatives during the pandemic, they must not now lose ground by a failure to act on climate change. From a business perspective were this to happen they would suffer further brand and reputational damage and offer challenger banks an opportunity to take customers. Thus, impacting profitability, valuation, and the cost of capital.

The new Chair, Nigel Higgins, is attempting to build a message of purpose for the bank. In the 2020 annual report letter to investors, he said "Over the last year, the Board has spent significant time looking at Barclays' purpose, and how the organisation can make a real difference to society, not least in the preservation of our environment." To further that effort, he engaged with investors through the Investor Forum. We took part in one of those engagements and questioned the Chair on what that means and how the culture of Barclays would change. We also questioned the Chair on what we deemed as inadequate transition plans. This led to a further engagement between us and the Company Secretary and Group Head of Public Policy and Corporate Responsibility.

Outcome

Having engaged with the company and having been given commitments that Barclays would include a 'Say on Climate' at the 2022 AGM, we decided to vote against the Shareholder Resolution. In this instance a constructive engagement might afford us greater influence.

We also believe that following the exit of the CEO during the year that the Chair has an opportunity to change the culture within the bank, as his 2020 statement set out to do.

Forterra PLC

Issue

Forterra manufactures and sells masonry products in the United Kingdom. With c. £600 million of market cap, it is considered a small cap company. Whereas large cap companies have greater resources to direct toward sustainability issues, particularly disclosures, small cap companies can struggle with the increasing demands from regulators, ESG rating agencies and shareholders. Forterra is making efforts to close the information gap, their 2020 Annual Report & Accounts saw the inclusion of their first Sustainability Report. The report itself was comprehensive, defined their ESG strategy and set future targets for emission reductions. However, Forterra scores poorly under the Sustainalytics scoring framework, both individually and relative to peers.

We investigated the issue and discovered part of the reason for this is that Forterra is scored under Sustainalytics' Core Framework rather than their Comprehensive Framework; this is generally used for smaller cap companies and uses a reduced set of data to produce the ESG Risk Rating. At the same time, we noted much of the information Sustainalytics referenced was out of date.

While the data providers are one input factor when forming our view on ESG issues, there are many more factors and sources of information considered. However, recognising that many other investors will often more heavily rely on ESG rating agencies to inform their opinion, or to positively screen for 'best-in-class' companies and negatively screen out worst-performing companies, the ratings are important. At the same time, our investors may also reflect on the ratings of portfolios via Morningstar, which use Sustainalytics as the underlying rating agency. Thus, it is important that companies, such as Forterra, engage with rating agencies like Sustainalytics and MSCI, to ensure they have full access to a range of ESG data points required to accurately assess the company's sustainability performance. The material risk is thus one of company valuation and ultimately cost of capital, were they to be perceived to be a less sustainable firm than is the case.

Outcome

We initially contacted Forterra to highlight the issue and to encourage them to engage with the ESG rating agencies. This was followed by a call with the CFO and a senior member of the Strategy and Development team who has been speaking to the rating agencies. We explained the issue and implications as outlined above, stressing the importance of the ESG rating agencies, and the potential benefits of an improved score. We also highlighted examples of missing and out-of-date data. The CFO acknowledged that he had not fully appreciated the importance of the ESG ratings and how they are derived. They committed to work on the matter.

We also spoke to Sustainalytics to push them to do a full review of Forterra, having encouraged Forterra to speak to their other large shareholders to get them to do the same. Subsequently, Sustainalytics reviewed Forterra and gave them an ESG Risk Score of 18.9, a 15.6 point drop from the end of 2020 rating of 35.4 and a move from High-Risk ESG rating to a Low-Risk ESG rating.

BP PLC

Issue

The integrated oil and gas industry face a range of material ESG issues. The most impactful and the one that gets greatest attention is the need to reduce carbon emissions and therefore the need to reduce reliance on fossil fuels. A move away from fossil fuels raises the risk of stranded assets for the energy companies, less of a demand for the products they sell, increasing the risk of an impairment of assets and drop in profitability. Ahead of that future risk potentially materialising, there is the risk that the companies will lose their licence to operate. They must be seen to be supportive in word and action of the move to a low carbon future. A loss of licence to operate could materialise in political or regulatory action, court action and a depressed valuation multiple. To some degree this has already begun to happen as events showed in 2021 with the Dutch court case against Shell, strong support for shareholder resolutions and continued divestment by various shareholders. Offsetting these risks are very low valuations, offering shareholders very attractive returns should the energy companies navigate these risks successfully.

Bearing these risks in mind, we engage closely with the energy holdings to keep abreast of developments and to push them along the transition path. In 2021, we communicated with BP at various levels of the board and management including the Chair, CEO, Company Secretary, and Investor Relations.

We discussed a wide range of issues including: a 'say on climate' at the AGM as a framework for shareholders to offer clear feedback on transition plans, expanding scope 3 emission targets beyond own products, the Rosneft stake (BP owns 20% of the Russian energy company) and Resolution 13, a shareholder proposal put forward by Follow This.

BP are clear in the direction of travel, targeting a 40% cut in hydrocarbon production by 2030 and focusing on five low carbon growth businesses – bioenergy, convenience, EV charging, renewables and hydrogen. The management also acknowledged that their transition plans had room for improvement.

Outside of the transition issues we encouraged BP to consider dividend growth, as this was important to our investors. BP had signalled a flat dividend to 2025. However, we also emphasised the importance of a strong balance sheet ahead of dividend growth, to enable the company to navigate the tricky energy transition.

Outcome

We voted against the shareholder proposal, Resolution 13, as we believed BP is moving in the right direction, while the company acknowledges the need to further develop their plans. In August, BP announced a plan to increase the dividend by 4% (when oil was above $60 per barrel), and reduced gearing throughout the year as oil prices rose strongly.

In early 2022, BP confirmed their plan to put a climate advisory vote to shareholders. They also increased their emission reduction targets on scope 3, moving to net zero by 2050 from 50% reduction. Issues remain, including the Rosneft stake, but BP is on the right path for its shareholders and society.

NatWest Group PLC

Issue

Following NatWest Group's earnings release in February 2021 when a direct share buyback from the UK government was announced and the news that the FCA have said it has commenced criminal proceedings against NatWest Group in respect of offences under the Money Laundering Regulations 2007, we felt it necessary to speak to the Chair about these issues and find out how he gets comfortable with the risk controls in place, and how should shareholders assess these risks from outside?

Outcome

We held a call with Howard Davies, Chair of NatWest Group. He gave commentary around the buyback and the size of dividend given guardrails put in place by the Prudential Regulation Authority. With regards to the FCA commencing criminal proceedings against NatWest Group, it was noted that this refers to one specific case and that the issue is not systemic. To help them get comfort as to systems in place, NatWest employ external authorities to perform 'attacks' on their systems to test everything works as expected and highlight any potential areas of weakness. The bank invested £700m in anti-money laundering systems between 2010 and 2015. Since 2016 it has invested a further £700m in financial crime compliance.

In December, NatWest Group received a criminal conviction and a fine of £264.8m by a London court. The bank pleaded guilty to failing to prevent a £365m money laundering scheme between 2012 and 2016.

NatWest are making industry leading advances on climate issues; we applaud them for that leadership. We recommended to the Chair that the company should include a 'Say on Climate' in their annual AGM to keep a future board and management team in line to what they have currently committed to.

Capita PLC

Issue

Capita is a leading UK Business Process Outsourcing (BPO) player, serving both public and private sector customers for business process management, HR solutions, customer management and IT services. It was a market growth darling for many years, driven by UK government outsourcing (such contracts include emergency services, healthcare, recruitment for the British Army etc) and corporations such as British Airways and Marks & Spencer (HR solutions, call centres, automation). However, as outsourcing opportunities slowed, particularly government outsourcing, the company replaced organic growth with acquiring growth via M&A. This resulted in a very complex company, a stretched balance sheet, under investment in systems and furthermore a counterproductive incentive structure that emphasised growth and contract wins above risk and profitability (margins sacrificed for revenue growth).

A new Chair was appointed in 2017 and he appointed a new CEO, Jon Lewis. The new management has faced up to these issues, they delivered profit warnings accompanied by a dividend cut, a rights issue and asset sales. However, a combination of higher-than-expected contract attrition and lower than expected revenue growth and legacy contract problems, compounded by Covid, has meant there has been pressure on cash flows and thus the balance sheet. We engaged with the company on several occasions over the course of 2021.

At the company's instigation we engaged with the Remuneration Committee Chair on a new incentive structure. At our instigation we engaged with the company on a new strategic plan, recognising the continued challenges the company faces.

Outcome

On the incentive structure, the company communicated that they wanted to move from a Long-Term Incentive Plan (LTIP) structure for long term performance, to a Restricted Stock Award plan (RSA). We have done an amount of work understanding the benefits of RSA schemes and engaged on the matter with The Purposeful Company, who have published research and guidance on the schemes. RSAs have the benefit of being less complicated, more aligned with shareholders and less likely to create aberrant management behaviour. The challenge with LTIPs is setting the right performance metrics, the right threshold levels, and how those metrics may lead to unintended management behaviour. The greater certainty with an RSA award means that the award comes at a discount to the maximum LTIP award, typically 50%. Unlike the performance hurdles of LTIPs, RSAs have underpins. Our objective in engaging on remuneration is to encourage more 'skin in the game' for management and to increase holding periods. The minimum requirement for in-employment shareholding is 200% of base salary as recommended by The Investment Association (IA), long-term performance total holding periods are usually 5 years and a 2-year post-employment holding is also required. Capita requires 300% of base salary for in-employment and a 2-year post employment holding period. Following our engagement, the company agreed to lengthen the RSA holding period from 5 years to 6 years. We think this is a good result from this engagement, further aligning management with long-term shareholders.

We engaged with the company on their strategic direction. By their own admission the previous plan was done under time pressure due to the crisis that hit the business at the time. We felt that given the continued gravity of the situation, including the disappointing result from the sale of their Education Software Solutions business, management had to produce a strong plan to address the situation. We had multiple engagements with the chair and CEO to discuss the situation. After this engagement the company announced their new strategic plan; simplifying the structure of the business, addressing balance sheet issues through non-core asset disposals and increasing cost cutting targets. If management succeeds in executing their plans successfully over the coming year, then it should significantly reduce the pressure on the company and is likely to reduce the negative market sentiment towards the stock. It has been a bruising experience for shareholders and further example of how previous reckless inorganic growth can trouble a company for years. We will continue our close engagement with the company as they move through the recovery.

Voting policy

We recognise our responsibility to actively exercise our voting rights. It is therefore our policy to vote all shares at all meetings, except where there are onerous restrictions, such as share-blocking (where we must surrender our right to dispose of the shares for a period). We do not lend stock.

As an independent investment team within Redwheel we set our own voting policy, however, we draw on the support of the central Redwheel Sustainability team in developing the policy. Our policy is to vote in the best interests of our clients and in line with the high standards of corporate governance as set out in the UK Corporate Governance Code 2018. Our voting is shaped by our fundamental research, by our engagements with our investee companies and by Institutional Shareholder Services (ISS), the proxy voting service. ISS follows best corporate governance practice in each market, based on local norms, codes and regulations. In the UK ISS policy is rooted in the voting guidelines of the Pensions and Lifetime Savings Association (formerly the National Association of Pension Funds, or NAPF) and follows the guidance provided by the Financial Reporting Council in the UK Corporate Governance Code. The PLSA and the UK Governance Code 2018 set a high standard globally on governance matters, along with reference to the ICGN Global Governance Principles, we use these standards as a benchmark on votes outside the UK, and where appropriate we will override local ISS policy for the higher standard.

In 2021 the proxy recommendations were based on the ISS Benchmark Policy; this will change in 2022 when we will refer to the ISS Climate Voting Policy. The move reflects our own evolving views on governance and climate risk. As previously, we will, however, diverge from the recommendations when our own research or engagements leads us to an alternative view on what is in the best interests of our clients.

Focus areas

We will continue to develop our voting policy to ensure we lever this very important and influential shareholder tool to improve outcomes. We will use our position to cast votes on behalf of our investors to support policies that we believe improve corporate social responsibility, many which were set out in our investor letter, Reforming Capitalism (link), in 2016. These include; 1) improving professionalism of non-executive directors, 2) including employees on company boards, 3) reforming pay and promoting greater 'skin in the game' for management, 4) ending quarterly reporting, 5) encouraging more responsible ownership. Some are more immediately attainable than other.

On remuneration we have set out a clear policy as described in the Remuneration section of this report. Our experience on remuneration engagements tends towards hardening our voting stance at AGMs.

We subscribe to the UK Governance Code on board composition (principle 3) "appointments... should be based on merit and objective criteria and, within this context, should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths."

Diversity offers a defence against 'group think' and improves a board's ability to manage the many opportunities and challenges it will face through a range of experiences, skill sets and backgrounds. We believe the board should be regularly refreshed to benefit from new skills and views. Diversity is also an increasingly important subject for customers and employees, which company management needs to consider.

In addition to composition, we review the election of directors in the context of external commitments, we wish to avoid non-executive directors being overextended with such commitments. While in the normal course of events a portfolio of directorships is perfectly manageable, in a crisis the demands placed on NEDs may increase substantially and we need to see this reflected in board members' obligations. ISS recommends no more than five public company board directorships for an individual, a Chair position counting as two mandates and an executive director counting as three. However, this recommendation fails to account for non-public board memberships or other commitments, nor does it account for how demanding individual company situations may be. As value managers, many of our companies are going through intensive transitions and require a deeper level of commitment than normal. Therefore, we take a more hard-line stance on over boarding by directors. Should a board member be over committed we may communicate this via the Chair or Senior Independent Director and vote accordingly at the AGM.

Shareholder proposals

We will support shareholder proposals (a proposal put forth at the AGM, sponsored by one of the company's shareholders or a group of shareholders) linked to our focus areas, or which aim to raise the standards of corporate governance in other ways. We will also support proposals where we are aligned and where management is not engaging on the specific issue. Where management is responding to shareholder pressure in a constructive manner, we will allow them the flexibility to find the best and most appropriate resolution of an issue, rather than tying their hands through shareholder proposals.

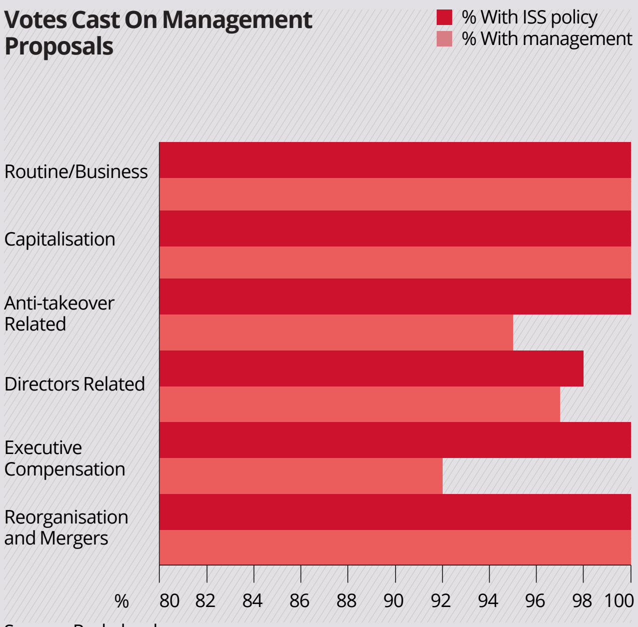
We support proposals that seek greater disclosure. For example, we dislike companies making political donations and with both political donations and lobbying we will support disclosure proposals from other shareholders. We accept some lobbying is necessary to educate and represent industry to those making laws and regulations pertaining to the industry. However, we monitor companies' memberships of trade associations and non-profit organisations for alignment to the stated principles and policies of a company.

We caution investors seeking blanket support for shareholder proposals. Some proposals may be poorly formulated and have unintended consequences. There are also examples of shareholder proposals countering the spirit of greater diversity and inclusion. One recent example is a shareholder proposal at Disney (Workplace Non-Discrimination Audit link), which works against efforts to foster a diverse and inclusive workforce.

Voting record [1]

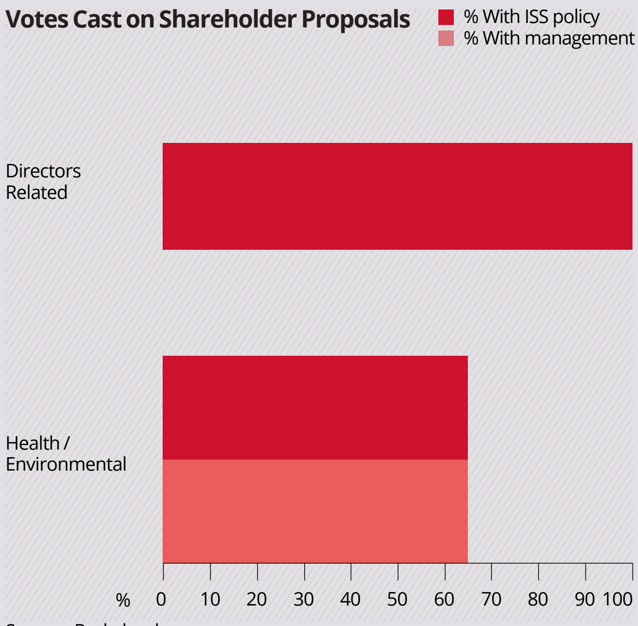
	Meetings	Proposals	% of proposals voted with management	% of proposals voted against management and abstentions	% of proposals did not vote	% of proposals voted against ISS recommendation
2019	30	570	98.4	1.6	0.0	0.4
2020	35	649	96.9	3.1	0.0	0.3
2021	38	603	98.3	1.7	0.0	0.7

Votes Cast On Management Proposals



Source: Redwheel.

Votes Cast on Shareholder Proposals



Source: Redwheel.

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In 2021 we voted on four shareholder proposals. We voted 'For' two of these proposals and 'Against' two. An example of which was the shareholder proposal filed by Follow This and ACCR at Shell's 2021 AGM; this is discussed within the Engagement Record section of report.

[1] The voting record represents voting across all Team strategies.

Commitment to our community and industry

In 2020, Redwheel reinitiated programmes on social enterprise, environment, and diversity which together are referred to as SEED. A SEED Steering Committee now has formal oversight of activities, with work in each area being driven by employee volunteers from right across the business.

At a team level we have sought to contribute to our local community. In 2019 we initiated an internship programme for secondary school students. The students were given two-week, paid internships and sat with the Equity Income team, while also gaining exposure to other parts of the company. The students were selected from the Westminster Academy, a non-selective secondary school based in one of the most deprived areas of our borough. Of the Academy's student population 77% do not have English as their first language (England secondary school average 17%), 58% are eligible for free school meals (England secondary school average 28%) and 23% of pupils receive SEN Support (England secondary school average 11%). In July 2021, five students who had been selected for the disrupted internship programme in 2020, completed a two-week internship.

For 2021 and beyond we committed to support the Felix Project. This is a London-based food redistribution waste charity set up in 2016 to tackle the issue of food poverty in London and the waste generated by the food industry (restaurants, food retailers, food producers). The food retailers in our portfolio have committed to reducing such food waste with Tesco and Marks & Spencer committing to a 50% reduction by 2030. Charities, like the Felix Project, have a huge role to play in helping to achieve the latter, while alleviating food poverty on our doorstep.

We endeavour to contribute to the betterment of the industry through participation in industry bodies. John Teahan volunteers for the CFA Institute, he is currently on the CFA Climate Change content working group, hosting the Climate Change podcast series.

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Sustainalytics data

We use Sustainalytics as our primary ESG ratings provider. In 2019 Sustainalytics transitioned to a new, risk-based, scoring system significantly improving their service and bolstering our internal research. The Sustainalytics ESG Risk Rating measures the degree to which a company's economic value is at risk driven by ESG factors.

Best ranked

	Risk score	Exposure	Overall unmanaged risk	Mgmt gap as % of manageable risk
1	Pearson PLC	Pearson PLC	Pearson PLC	Eni SpA
2	Kingfisher PLC	ITV PLC	Kingfisher PLC	Anglo American PLC
3	HP Inc	Kingfisher PLC	HP Inc	TotalEnergies SE
4	ITV PLC	Currys PLC	ITV PLC	HP Inc
5	WPP PLC	WPP PLC	WPP PLC	Newmont Corp

Lowest ranked

	Risk score	Exposure	Overall unmanaged risk	Mgmt gap as % of manageable risk
1	Shell PLC	BP PLC	Shell PLC	Capita PLC
2	BP PLC	Eni SpA	BP PLC	easyjet PLC
3	easyjet PLC	Shell PLC	easyjet PLC	Honda Motor Co Ltd
4	Barrick Gold Corp	TotalEnergies PLC	Barrick Gold Corp	KDDI Corp
5	CK Hutchison Holdings Ltd	Barrick Gold Corp	CK Hutchison Holdings Ltd	Serco Group PLC

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Sustainalytics ESG Risk Rating Methodology

The ESG Risk Rating is a measure of a company's 'overall unmanaged risk' which is made up of unmanageable risks (risks that are inherent to a particular business model that cannot be managed by programmes or initiatives – such as product-related carbon risks for an oil company that arise from the burning of oil in the use phase), as well as risks that could be managed by a company through suitable initiatives, but which may not yet be managed (a management gap).

This ESG Risk Rating is made up of:

1. Exposure. Reflects the degree to which a company's enterprise value is exposed to material ESG issues.

2. Management. A measurement of a company's ability to manage it exposure to material ESG issues.

A lower ESG Risk Rating represents less unmanaged risk. Unmanaged risk is measured on an open-ended scale starting at zero (no risk) and, for 95% of cases, a maximum score below 50. Based on these quantitative scores, Sustainalytics can group companies into one of five risk categories (negligible, low, medium, high, severe). These risk categories are absolute, meaning that a 'high risk' assessment reflects a comparable degree of unmanaged ESG risk across all industries covered. This means that a bank, for example, can be directly compared with an oil company or any other type of company Sustainalytics cover.

The chart below illustrates this process for NatWest Group. NatWest Group has been determined to have a low ESG Risk Rating.

Engagement with Sustainalytics

Where we feel that a company is not being treated fairly from a scoring perspective, we will look to engage with both Sustainalytics and the individual company. An ESG score is only one small input in our process, however, it does matter for many funds and thus a weak score indicating high ESG risk may preclude many funds from buying shares in the company and act as an impediment to a higher stock valuation.

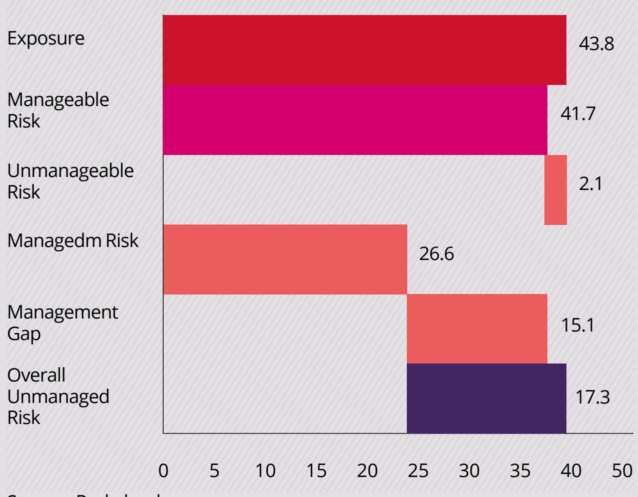
We detail an example of an engagement with Sustainalytics under the individual engagements section with regards to CK Hutchinson, and Forterra.

Comparison to MSCI ESG Ratings

To aid in our analysis, we cross check the Sustainalytics ESG Risk Ratings[2] versus the publicly available MSCI ESG Ratings ; there are some differences between the two. For example, Pearson is the best ranked of our companies on Sustainalytics, while Kingfisher is the best ranked of our companies using MSCI (AAA rating). Shell ranks as the lowest rated company in the portfolio using Sustainalytics, while CK Hutchinson Holdings is the lowest using MSCI ratings (B rating).

Of the MSCI ESG Ratings data publicly available, Kingfisher, KDDI and KPN (the latter two companies held in Redwheel Enhanced Income Fund) attain the highest rating of 'AAA', and thirteen companies achieve the second highest rating of 'AA'. Six companies are rated A, and two BBB. We have eleven companies for which we do not have access to MSCI ratings. 61% of our holdings are rated A or above on the MSCI ESG Ratings scale.

Sustainalytics NatWest ESG Risk Rating



Source: Redwheel.

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[2] MSCI ESG Ratings range from leader (AAA, AA), average (A, BBB, BB) to laggard (B, CCC).

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Contact us

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