Signatory of:

PRI Principles for Responsible Investment

Sparinvest

Sparinvest Responsible Investment Review

July 2014

Sparinvest signed UN PRI in 2009.

The intention of the UN PRI is not to avoid investment in companies operating in controversial sectors, but to build awareness of the potentially heightened ESG risks that may be involved.

ESG risk analysis is now fully integrated into the investment process for all Sparinvest strategies.

Jacob Nordby Christensen, Sparinvest's Responsible Investment Director, gives us some examples of the kind of ESG analysis process that can result in a company either entering a portfolio or not.

Dear Investor

As a committed Value investor, Sparinvest's global search for promising investments is diversified across regions and sectors. As a result, we can find ourselves considering investments in companies operating in sectors that might be viewed as controversial.

But responsible and ethical investment should not be confused. The United Nations Principles for Responsible Investment were never intended to restrict the mainstream investment universe to the 'ethically acceptable' few. Instead the intention was to raise investors' awareness of the environmental, social and governance risks run by all companies - and governments. By encouraging investors to become critical of these risks, and to identify the companies that handle them well, it is hoped that the UN PRI will be a gradual force for improvement. Over time, best practice should be rewarded with stronger returns and corporate malpractice reflected in lower share or bond prices.

Case Study 1 – Emerging Market Equities

Sesa Sterlite Ltd (SESA : IN) is the Indian unit of the London-listed mining conglomerate, Vedanta Resources which owns a 58% stake. The company's operations focus on natural resource extraction – namely zinc-lead-silver, oil & gas, iron ore, copper, aluminium and commercial power.

Based solely on its Value metrics (low price-to-book, low net-debt-to-equity, etc.), Sesa Sterlite caught the attention of our Value Equities team as a potential new candidate for our Emerging Markets Value Equities fund. But passing the initial financial screening only permits a candidate company to enter the first part of our rigorous security analysis process.

The next stage involved researching the company's website and annual reports to look deeper into potential areas of risk. Given that this was a mining company, we were particularly interested to see what the company had to say about ESG matters. In this regard, the company website looked impressive. There were statements of policy with regard to minimising the risk of harm to people and the environment, reports on metrics designed to monitor the impact of operations. The company's communications department certainly 'talked the talk' but we still wanted to know whether the company itself 'walked the walk'. On deeper investigation and consultation with our ESG research providers, a different kind of picture of Sesa Sterlite began to emerge.

We began to suspect that the corporate culture did not support the communication. Over the years, there had been a number of serious incidents which suggested that the company was only paying lip service to ESG concerns and in fact was operating with an unacceptable risk of environmental damage and serious violations of human rights:

- The company had a history of failing to monitor pollution emissions for which it had been fined in the Indian law courts. During the time we were investigating them, they were forced to close down a copper smelter for the same reason.

- Up until 2012, the company had been mining within barely a Kilometer of residential areas in Lamgao, Goa without consulting residents. It had then tried to forcibly relocate them.
- Sesa Sterlite has invested heavily to create India's largest refinery for turning alumina into the metal aluminium – a process that requires bauxite. In December 2013 the company suffered a setback when the Government of Odisha failed to grant it a bauxite mining licence, forcing the closure of the refinery.

Sesa Sterlite had made the huge mistake of investing heavily in operational infrastructure without getting the relevant environmental standards and permissions in place beforehand. Its cavalier attitude towards the rights of indigenous populations and poor track record on health and safety was destroying its reputation, its revenue generation and, inevitably, the value of its shares.

Appearances can be deceptive. Judging from Sesa Sterlite's own website, the company was well-aware of the importance of addressing ESG issues but management's actions told a different story. Within the mining sector, the risk of new problems occurring as a result of mismanagement of ESG issues is high. As a result, this is a company that has failed to make it into Sparinvest's investment portfolios on the grounds of its poor ESG track record.

Case Study 2 – Global Equities

Mosaic (MOS : US) is the world's leading producer and marketer of concentrated phosphate and potash, used in the agricultural industry to improve crop yields. The company employs approximately 8,900 people in eight countries. Its annual production of Potash is 8 million tonnes and of Phosphate, 11 million tonnes. By 2015, world fertilizer consumption is estimated to reach nearly 190 million tonnes.

Fertiliser production is another controversial sector of industry. Without fertilizer, much of the world's population could be without food and widespread global food riots in 2008 showed how easily these can spill over into political unrest. So, on the one hand, fertiliser is a force for good in that it keeps populations fed. But on the other hand, overuse of fertiliser is credited with environmental degradation with chemicals leaching into water supplies. Processing phosphate and potash-based fertilisers drains large quantities of water from ecosystems, removes vegetation, requires the burning of fossil fuels which discharges greenhouse gases and generates radioactive waste (in the case of phosphate production). In brief, there can be no consideration of an investment in a fertiliser manufacturer without a long, hard look at its ESG risk management credentials.

When Mosaic appeared in Sparinvest's Value Equities screening, we immediately contacted our ESG research providers to try to get a clear view of this company's ESG rating. The research came back showing that Mosaic was rated roughly at the mid-level of the industry. It was strong on corporate governance but rated weaker than its peers on environmental factors. Being Sparinvest, we didn't just accept the research, we analysed it further.

Three things struck us:

- Whilst Mosaic had been subject to lawsuits in the past, it appeared that the issues had been resolved and settled quickly and that company operations had been adapted to try to avoid further problems. We saw a company that took its responsibility to manage its impact seriously.
- Mosaic was held up as an example of good ESG practice when (in contrast to its competitors) it immediately terminated involvement with the Non-Self-Governing Territory of Western Sahara once alerted to the fact that it was against international norms to exploit the natural resources of a territory with unresolved sovereignty.
- There was evidence that Mosaic's lower than average 'E' –score was because it was penalised by ESG researchers for not being involved in research & development of the more 'eco-friendly fertiliser of tomorrow'.

As value investors – although it is positive for a company to do research in new technologies – we find it hard to put an actual value on the R&D until the products actually start to materialise. In our investment process we attach more importance to the company's existing business, i.e. from a valuation standpoint we are more focused on a company's ability to generate continued revenue streams from its established business model/products than on speculating about products that it may or may not develop in the future.

Another thing that we liked about Mosaic is that as part of its commitment to sustainability reporting, it had, in 2013, engaged a third-party auditor to do a full-scale materiality study focusing on its impact in five areas: food, environment, people, community and company. As a result, it had established a number of reporting metrics, showing such things as water usage and emissions per acre mined as well as acreage returned to a natural state post-mining. Thus the company is now able to monitor whether its record is improving or deteriorating. Since signing up to the UN Global Compact in 2012, Mosaic has won numerous awards, including a position in

Ethisphere's top 100 ethical companies and CR's 100 best corporate citizens. We believe that Mosaic truly has a culture of accountability. As an investor (since May 2014), this is good for us because it indicates that the ESG risk is less with this company than with others operating in the same sector.

Case Study 3 – Global Corporate Bonds

Our third controversial sector is nuclear power and the investment case is one from our corporate bonds portfolio. UPM-Kymmene Corporation is a Finnish pulp, paper and timber manufacturer. It was formed by the merger of Kymmene Corporation and Repola Ltd and its subsidiary United Paper Mills Ltd in 1996. HQ is Helsinki.

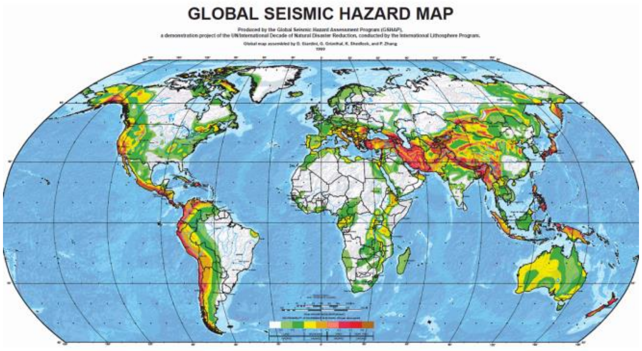
We first started looking at the bond issue UPMKYM 7.45% 2027 from UPM-Kymmene in January 2011. The yield and price both looked attractive (in fact we judged the bond to be trading at around 109bp too cheap when we bought it.) However, as with all of our value investments, we needed to take a close look at the potential risks. Our first consideration is whether a company is in good shape financially and whether it is likely to be able to service its debt to maturity.

Then we look to see what hard assets it has in place to support the bond issue in case of any recovery claim. In the case of UPM-Kymmene, we discovered that the estimated net value of the company's energy division almost covered the entire net debt of the company, making the risk of 'credit loss' from default zero. But there was a catch. UPM-Kymmene's energy division actually consisted of a number of nuclear power plants. The jury is still out on whether nuclear power is good (zero greenhouse emissions) or bad (problem of how to dispose of waste safely and potential for catastrophic melt-down.) Indeed, only two months after our purchase of the UPM-K bond, the nuclear problem hit the headlines with the Japanese Tsunami and Fukishima disaster.

At this point our Value Bonds team were forced to reassess the 'E' risk involved with their investment in UPM-Kymmene. There were a number of considerations:

- Potential level of seismic activity in Finland
- Security standards enforced by the Government
- Likelihood of a German-style reaction to Fukishima (ie total ban on nuclear power.)

Working with our ESG researchers, the team discovered that Southern Finland had a history of near zero seismic activity, that its solid rocks were a good stable base for power plants, that the Finnish government had the highest of safety standards and top technology to monitor them and that Finland was committed to retaining access to nuclear energy.



In short, if you were going to choose somewhere in the world to build a nuclear power plant, Southern Finland would be one of the best locations.

In time, other investors realised the value of UPM-Kymmene's hard assets, the bond price went up and we continued to collect an attractive coupon until we sold our holding in June 2013.

Case Study 4 – Global Sovereigns

Our final case study demonstrates that there are many sources available for investment risk information. In the case of one of our Danish-domiciled funds which invests in global sovereign bonds, we were contacted by a US-based NGO. They had identified Sparinvest as holders – through this fund – of Lebanese Government Bonds and they asked to bring some information to our attention. The fund in question must follow its benchmark fairly closely but, at the fund manager's discretion, it is permitted a small margin of overweight or underweight. At the point when the NGO contacted us, Lebanese Sovereigns were part of the benchmark but we were overweight our position in them.

Obviously we could not afford to ignore any information that might pose a risk to the value of this holding. We made contact with the NGO. They informed us of anecdotal evidence (but no hard evidence) alleging that these sovereign bonds were being used as a money-laundering instrument, designed to enable Iran to fund the activities of the illegal terrorist organisation, Hezbollah. What's more, they had more anecdotal evidence of a money trail that began in Iran, passed through Syria and ended up in Lebanon via these sovereigns. The NGO was not in possession of any 'smoking gun' but they had statements from a number of individuals that seemingly backed their position. The story seemed plausible and, from our perspective, the idea that the Lebanese Sovereign bond price might have been artificially inflated as a result of terrorist money-laundering was a new piece of risk information worthy of consideration by the portfolio managers. Also, at around the same time, President Assad in

Syria was facing internal issues. His downfall could interrupt the money supply alleged to be supporting the bond price.

After hearing all the concerns of the NGO, the sovereign bonds team decided that the risk of discovering artificial pricing in a portfolio holding was not one that we wanted to take. It was by far a better option to reduce the holding of Lebanese bonds to the minimum possible and find another territory to invest in with the same promise of return but less risk attached.

Despite the fact that President Assad remains in place and that there is still no hard evidence to substantiate the money-laundering allegations, we consider that our decision to find an alternative investment – of equal benefit to investors – was the right one. The possibility of sudden event risk concerns us and it is one that we try to avoid.

The LuxFLAG Initiative

Since the last time that I reported to you on Responsible Investment matters, Sparinvest has been heavily involved in setting up a new initiative with LuxFLAG, the Luxembourg fund-labelling agency, to launch a new LuxFLAG ESG label. The label will be awarded to funds incorporating strict ESG criteria in their investment process.

What we find particularly appealing about this new label is the fact that it has an Eligibility Board attached to it, made up of senior figures from the European ESG research industry. Any fund seeking to obtain such a label will not only have to be approved by this Board, it will also have to undergo an annual external audit to ensure that it remains ethical. We find this a very credible approach, providing smaller investors with the same kind of level of due diligence that institutional investors get by employing consultants. We find this both innovative and democratic.

One of the first funds to apply for the LuxFLAG ESG label will be Sparinvest Ethical Global Value.

Participation with ICGN

The International Corporate Governance Network – or ICGN is an investor-led organisation of governance professionals. ICGN's mission is to inspire and promote effective standards of corporate governance to advance efficient markets and economies world-wide through three core activities:

- **Influencing policy** by providing a reliable source of practical knowledge and experiences on corporate governance issues, thereby contributing to a sound regulatory framework and a mutual understanding of interests between market participants;
- **Connecting peers** and facilitating cross-border communication among a broad constituency of market participants at international conferences and events, virtual networking and through other media; and
- **Informing dialogue** amongst corporate governance professionals through the publication of policies and principles, exchange of knowledge and advancement of education world-wide.

To date three of our investment professionals have attended ICGN meetings and found the free and fair exchange of information invaluable. Thus Sparinvest has committed to joining this network during 2014.

Yours faithfully

Jacob Nordby Christensen

Responsible Investment Director