Stewart Investors
Sustainable Funds Group

Sustainable Funds Group

Quarterly client update

Q1

1 January - 31 March 2021 | For adviser use only

Image location: Jaipur, India

Contents

Investment philosophy

> **We are stewards:** Our role is to allocate society's capital to productive uses, in accordance with our Hippocratic Oath

> **We are long-term:** Our time horizon is measured in years, not weeks, and we value companies accordingly

> **We invest only in companies contributing to a more sustainable future:** We engage constructively as owners to help companies on their sustainability journeys

> **We invest only in high quality companies:** We seek out companies with exceptional cultures, strong franchises and resilient financials

> **We believe capital preservation is important for capital growth:** We define risk as the possibility of the permanent loss of client capital

Investment ojective

To generate attractive long-term, risk-adjusted returns by investing in the shares of high quality companies that are particularly well positioned to benefit from, and contribute to sustainable development.

Investment terms

View our list of investment terms to help you understand the terminology within this document.

Image location: Bangkok, Thailand

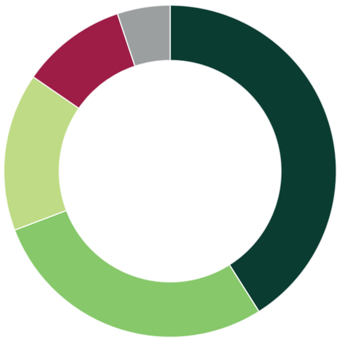
Strong investor enthusiasm at the start of the year gave way to fears of intensifying inflation and increasing bond yields. After a strong run, these fears impacted the valuations of Asian equities generally and caused a retracement in highly rated companies in the healthcare and technology sectors, in particular. Rather than contemplate the possible macro shifts and the vagaries of investor sentiment, we prefer to study, meet and discuss companies. In this way we enjoyed a stimulating quarter as normal. During the period we spent significant time evaluating a wonderfully stewarded business listed in India which is helping to address one of the most shocking outcomes of economic inequality – access to medicine. It is a harrowing fact that millions of people are incapable of affording necessary medicines, or are pushed into poverty as they deplete their savings to pay for medication. The pull back in healthcare valuations meant we were able to make a new investment in this area and top up on existing holdings in **Dr. Reddy's Laboratories** (India), **CSL** (Australia) and **Cochlear** (Australia). We also topped up weightings in three of the strategy's larger holdings – **Naver** (South Korea), **Unicharm** (Japan) and **Mahindra & Mahindra** (India), as well as **Infosys Technologies** (India). The quarter also marked the conclusion of our analysis ahead of initial investment in two new companies. The first company is involved in the physical backbone of internet connectivity and the second company provides software services to construction companies.

Despite two new investments and topping up many existing holdings, the cash in the strategy remains around the 8% level. A surge at the start of the year, after a strong 2020, presented us with valuation challenges, particularly for companies listed in China or involved in the semiconductor sector. It was for reasons of valuation only that we reduced position size in **Shenzhen Inovance**, **Centre Testing International** and **Kingmed Diagnostics**, all of which are listed in China. We also reduced the holdings in **Delta Electronics** (Taiwan), **MediaTek** (Taiwan), **Silergy** (Taiwan) **Tokyo Electron** (Japan) and **TSMC** (Taiwan) which are all contributors to different areas of the manufacture of semiconductors. We remain extremely confident in the quality of these stewards, the franchises they manage and the long-term outlook for semiconductors. However, investor enthusiasm for these companies had run ahead of their attributes. This was particularly true for **ASML** (Netherlands) which we sold completely. High quality companies in India were also popular during the period and we sold out of **Asian Paints** (India) completely. In addition to these complete sales we reduced the position size of **Tata Consultancy Services** (India), **Tech Mahindra** (India) and **Xero** (Australia) for reasons of valuation.

Proxy voting

Proxy voting by country of origin

Proxy voting by proposal categories



Asia Pacific Leaders Sustainability

During the quarter there were 39 company resolutions to vote on. On behalf of clients, we voted against seven resolutions.

We voted against **Centre Testing International's** request to make amendments to a number of proposals including changes to their accounting policies as we did not have sufficient information to know what changes we might be voting for. (seven resolutions)

Source for company information: Stewart Investors investment team and company data. This stock information does not constitute any offer or inducement to enter into any investment activity. Portfolio data shown is from representative strategy accounts of each strategy shown above. Named new investments disclosed relate to holdings with a portfolio weight over 1%. It is not a recommendation or solicitation to purchase or invest in any fund. Differences between the representative account-specific constraints, currency or fees and those of a similarly managed fund or mandate would affect results. Proxy voting chart numbers may not add to 100 due to rounding.

Image location: Shanghai, China

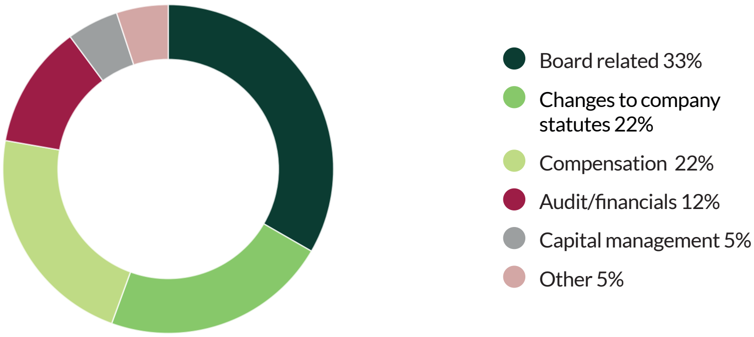
At Stewart Investors we operate as a team of generalists. We are indifferent, save for identifying macro headwinds and tailwinds, to the geography or sector to which a company belongs. Over the years, we have found that the absence of competition for capital between country or sector analysts better suits the culture of the Sustainable Funds Group; curiosity trumps compulsion when it comes to promoting higher quality analysis and discussion. This is not to say that we don't study competitors or industry peers. We pride ourselves in identifying leaders in terms of quality of stewardship or franchise, as well as companies which set an example on issues of sustainability. Often we find that smaller companies in an industry are higher quality than larger peers. We have found this to be the case in logistics where reliability and trust are more important than scale and price. Recently we were forced to sell **Expeditors**, a high-quality logistics operator, because of reduced income from the Asia Pacific region. However, in our study and ownership of Expeditors, we learnt a lot about the cultural traits that drive success in this competitive industry. During the quarter we were excited to initiate a holding in a medium-sized logistics franchise, listed in New Zealand, which exhibits many of the same characteristics demonstrated by Expeditors. We were also pleased to initiate holdings in companies listed in China, Hong Kong, Malaysia and India. In addition to these new purchases we topped up on existing holdings in **CSL** (Australia) and **Cochlear** (Australia). In both instances excessive concern over short-term disruptions appears to be masking the long-term attractions of these high-quality companies for many investors.

Over the period we sold two holdings. The first was **OCBC Bank** (Singapore). OCBC is a tremendously high quality bank and is exceptionally well stewarded. However, we are fortunate in the all capitalisation strategies to be able to choose from a larger pool of companies which we believe are offering a more attractive risk-reward ratio at present. The same rationale applies to **Metropolis Healthcare** (India), the second company we sold from the portfolio.
The other decision we made was to trim nine of the strategy's holdings where we remain convinced about the qualities of the companies but valuations are most stretched. The companies we reduced were: **Centre Testing International** (China), **Chroma ATE** (Taiwan), **Delta Electronics** (Taiwan), **Kasikornbank** (Thailand), **Kingmed Diagnostics** (China), **MediaTek** (Taiwan), **Shenzhen Inovance** (China), **Tokyo Electron** (Japan) and **Xero** (Australia).

Proxy voting

Proxy voting by country of origin

Proxy voting by proposal categories



Asia Pacific Sustainability

During the quarter there were 58 company resolutions to vote on. On behalf of clients, we voted against seven resolutions.

We voted against **Centre Testing International's** request to make amendments to a number of proposals including changes to their accounting policies as we did not have sufficient information to know what changes we might be voting for. (seven resolutions)

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Asia Pacific and Japan Sustainability

Image location: Tokyo, Japan

For us, the privilege of meeting a new management team tends to be an enjoyable experience. Especially one that embraces long-termism and talks with great pride and enthusiasm for its culture. We recently had such an opportunity with leading New Zealand-listed logistics provider, **Mainfreight**, and their veteran CEO Don Braid. Don, very humbly, places responsibility of Mainfreight's enviable long-term track record entirely with their very tangible culture of ownership, as well as the consistent application of a deeply ingrained one-hundred year vision in everything they do; from the executive suite to the truck yard. In a people-heavy, relationship-dependent business like logistics, our experience is that the great operators have truly unique, long-term, cultures. On top of their impressive track record and attractive fundamentals, we believe Mainfreight's culture should allow them to continue to flourish in New-Zealand while growing in the, much larger, fragmented markets of Asia and the US. A position in Mainfreight was initiated over the quarter.

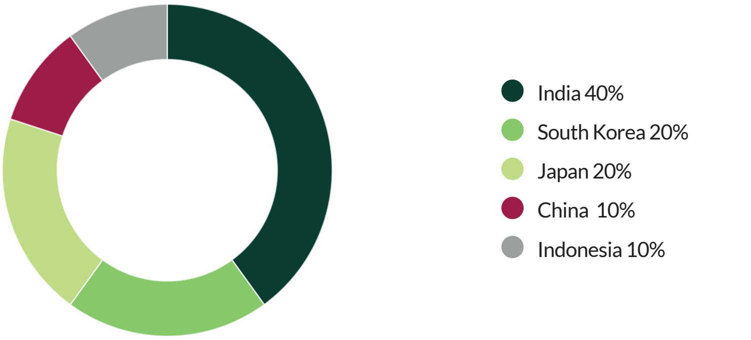
There are a number of companies in the strategy where we are backing management teams to evolve established franchises into new geographies or business areas. **Vinda International** (Hong Kong), is one such example. Here we have one of China's leading consumer tissue paper players, with help from their multi-national parent Essity (owner of the Tena brand), investing in growing their early stage personal hygiene business. A successful evolution has the potential to be very rewarding for shareholders, as feminine hygiene and incontinence care are markets that enjoy greater consumer loyalty, higher profitability and superior returns on capital than tissue paper. Over the period we had the chance to catch up with Vinda's CEO, Karen Li, when she talked with great enthusiasm of the long-term investments being made today, that are likely to pay off in the years to come: 70% sales growth in their feminine hygiene category last year shows some progress being made on this front.[1] Despite their well-articulated long-term strategy and early signs of success, valuation multiples fail to give Karen and her team the benefit of the doubt. The strategy's position in Vinda was increased over the quarter as the combination of improving quality of earnings as well as a potential valuation re-rating offers an enticing opportunity for attractive long-term returns.

Two small positions were sold over the quarter: **OCBC Bank** (Singapore) and **Kasikornbank** (Thailand). Although we have much admiration for these lenders, elevated levels of consumer debt and growing regulatory risks combine to make high-quality growth hard to come by, unlike the financial institutions that continue to be held in India and Indonesia.

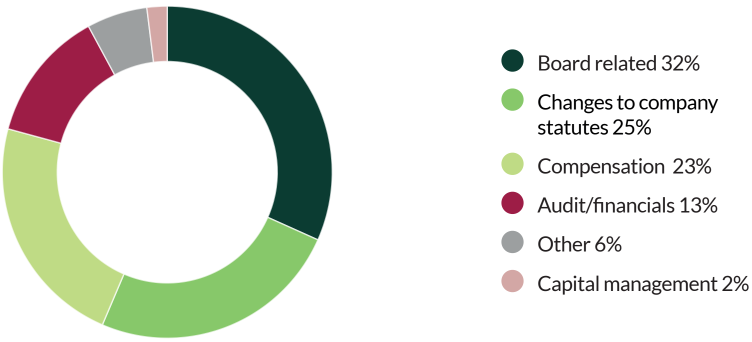
[1] Source: Stewart Investors investment team and company data.

Proxy voting

Proxy voting by country of origin



Proxy voting by proposal categories



Asia Pacific and Japan Sustainability

During the quarter there were 53 company resolutions to vote on. On behalf of clients, we voted against seven resolutions.

We voted against **Centre Testing International's** request to make amendments to a number of proposals including changes to their accounting policies as we did not have sufficient information to know what changes we might be voting for. (seven resolutions)

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Global Emerging Markets Sustainability

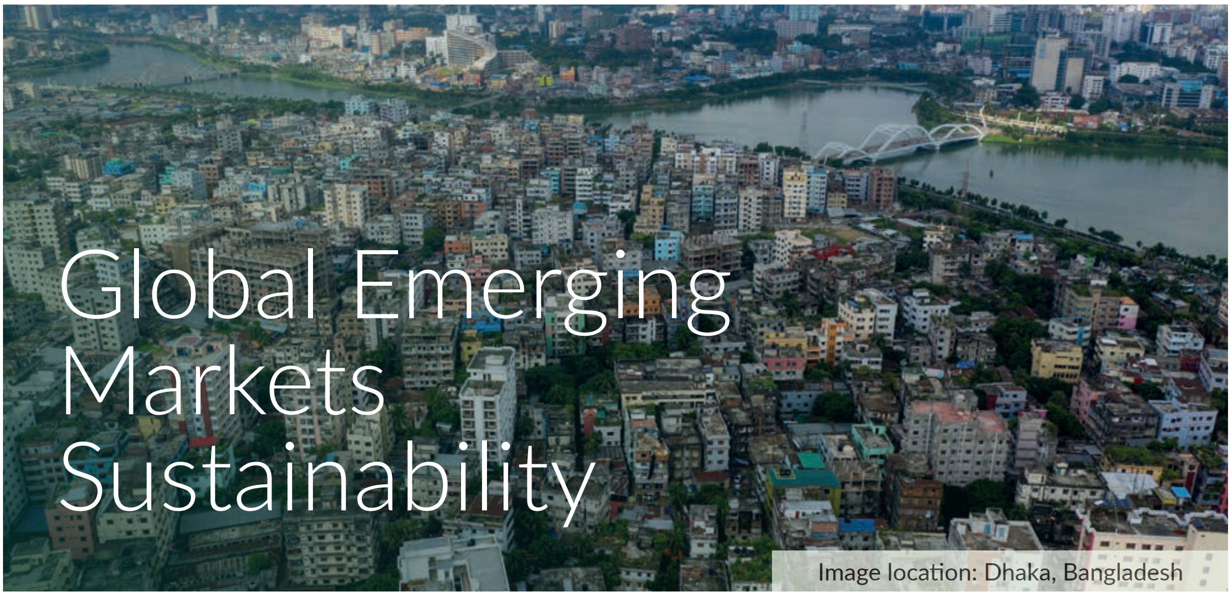


Image location: Dhaka, Bangladesh

The first quarter of 2021 witnessed a rally in emerging markets of what we would consider lower quality companies, driven by hopes of economic re-opening following the pandemic. In a period of synchronised global growth, very loose monetary policy stances in developed markets, and commodities inflation from a very low base, we will usually underperform.

This is because the companies whose shares rise fastest in such an environment are those with cyclical cash flows, weak balance sheets and limited pricing power, usually led by banks, oil and gas, and mining companies. They are typically those that have fallen the furthest in the preceding bear market. We tend not to keep up in such environments because we will not own many, or large positions in, such businesses, for both quality and sustainability reasons.

Our new purchases over the quarter fall into two broad categories.

We initiated some small positions in what we consider high-quality companies that nonetheless do stand to benefit from economic re-opening. Features of these companies include operational leverage and the capacity to grow earnings quickly in the early part of the cycle. A good example would be **Banco Bradesco** in Brazil. We have owned shares in Bradesco for many years in the past and have no doubts around stewardship and governance: the bank is controlled by a very long-tenured group of managers, and is ultimately controlled by a charity, with dividends funding educational philanthropy.

Banks are clearly cyclical and reflect the wider economy in which they operate, and given their leverage, see volatile earnings movements throughout the economic cycle. This is particularly the case in a country like Brazil with a risky currency. When we initiated our purchase, the market capitalisation, of Bradesco, was barely half the US dollar level that it was in 2011![1]

Our thesis in owning the bank is very much around falling credit costs and recovering returns on equity, as the Brazilian economy hopefully normalises post-Covid during 2021 and onwards. The inherent risks to such a business mean that we remain cautious with position size.

The second type of company in which we have initiated positions are those high-quality, high growth companies which became less popular as investors rotated into cheaper and lower quality companies. One example would be an Argentine e-commerce and fintech business, with operations across Latin America. The team first met with the company over a decade ago, and over time we have watched it grow into Latin America's pre-eminent consumer tech platform. The company operates in a very large and unpenetrated market, and its very high quality management team and culture are ones we believe can continue to deliver on that opportunity. We were able to initiate a position after the company's shares fell around 25% during the quarter as high growth stocks became less popular.[1]

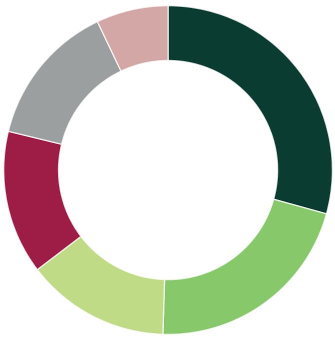
In order to fund our new positions, we exited a total of five holdings over the quarter. We sold **AVI Limited**, a food producer in South Africa, and **Jerónimo Martins**, a grocery retailer with most of its cash flows from Poland. Both are companies whose earnings were relatively resilient during 2020 but which seem unlikely to grow quickly as the global economy recovers. **Pigeon** (a Japanese babycare company deriving the vast majority of its cash flows from China), **OdontoPrev** (a Brazilian insurance company) and **Selamat Sempurna** (an Indonesian auto components company) were all small positions which we exited after changing our minds on quality and in order to invest in better ideas.

As we hopefully move beyond COVID-19 throughout 2021 and beyond, we are optimistic about the opportunities for long-term returns through owning high-quality companies in emerging markets.

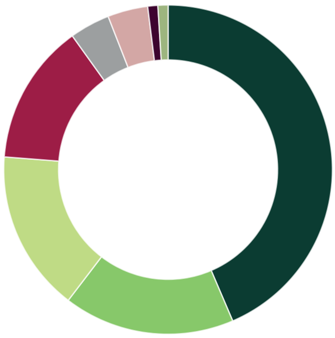
[1] Past performance is not a reliable indicator of future results. Source: FactSet.

Proxy voting

Proxy voting by country of origin



Proxy voting by proposal categories



Global Emerging Markets Sustainability

During the quarter there were 96 company resolutions to vote on. On behalf of clients, we voted against one resolution and abstained on one resolution.

We abstained on voting on the election of **Banco Bradesco's** Supervisory Council candidates as we were happy to support the candidates presented by the minority and preferred shareholders. As a result of this vote, we voted against the recasting of votes for the Amended Supervisory Council Slate. (two resolutions)

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Indian Subcontinent Sustainability

Image location: Ganga River, India

The strategy raised cash during the quarter by trimming companies where valuations are discounting much of the optimism in the near to medium term. We sold out of **Asian Paints** completely. Asian Paints is one of the highest quality companies in our investment universe but valuations broke through our high tolerance barriers and we did not see much potential for sensible returns in the medium term. We would love to own the company should valuations become more reasonable. We also continued to trim **Dabur** and **Godrej Consumer Products**. Both of these are high-quality companies and well positioned in the markets they operate in, but high valuations temper our optimism for absolute returns.

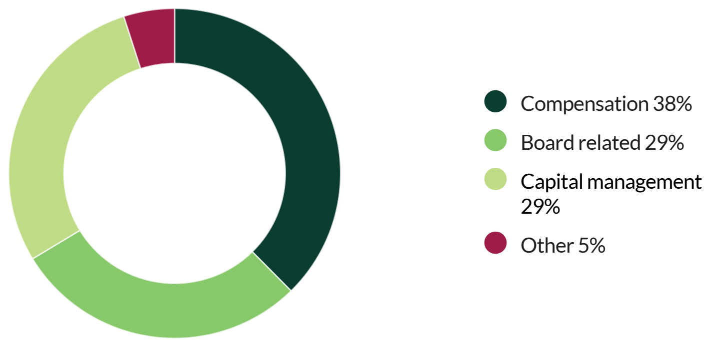
Amongst others, we continued to add to our holdings in **Syngene** and **Tata Communications**. Syngene has been investing over decades, building a relationship of trust with its global pharma customers. A rise in capital expenditure in the last few years makes it well positioned to grow faster in the coming decade, providing quality research and manufacturing support for its customers. Tata Communications is a leading IT infrastructure provider, particularly in digital, security and cloud services. The pandemic has made the need for robust digital infrastructure abundantly clear. Roughly 30% of the world's data flows through Tata Communication's networks.[1] With a new CEO from Tata Consulting Services and the sale of the government's stake in the business, the company's prospects look bright in the coming decade. The parent Tata Sons has increased its stake to 60% in the business, which we think is a sign of confidence.[1]

[1] Source: Stewart Investors investment team and company data.

Proxy voting

Proxy voting by country of origin

Proxy voting by proposal categories



Indian Subcontinent Sustainability

During the quarter there were 21 company resolutions to vote on. On behalf of clients, we did not vote against any resolutions.

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After a period of much change in the strategy through 2020, we took the opportunity this quarter to continue building our positions in some of our more recent holdings. We increased our positions in companies such as **bioMérieux**, a family-owned in vitro diagnostics provider, and **Synopsys**, a leading electronic design automation software provider. We believe that these companies are good examples of the marriage of quality and sustainability that we look for – well stewarded cultures, with leading market shares in their businesses, and profit pools expected to expand over the next decade, through a focus on accessible healthcare, in the case of bioMérieux, and increasing efficiency in semiconductor chip design in the case of Synopsys.

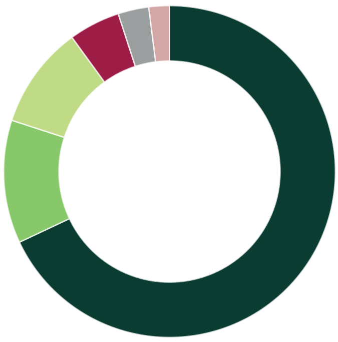
As well as adding to many of our favourite holdings, we also initiated and built a position in one new company – **Jack Henry & Associates** – taking the opportunity provided by some shorter term volatility in share prices. Jack Henry is a provider of core information technology to small and mid-sized banks and credit unions in the US. This is a company we have known for many years, built on a culture that we have much admiration for. The stickiness of their business was demonstrated by both the resilience of their margins as well as their continued ability to grow through a period of turbulence, such as last year. The preservation of a strong, net cash balance sheet is another example of their conservative culture. We recently interviewed Jack Henry's CEO on their company culture, which we admire greatly. Click here to watch the video.

In a period of readily available, cheap credit, we remain wary of and concerned about stretched valuations. We exited three positions through this quarter where we believed valuations to be getting expensive. These were **Cadence**, **Sysmex Corporation**, and **Fanuc**. To our minds, all three businesses remain high-quality, managed by competent stewards who have built franchises that are now the leaders in their industries. We chose to exit these positions as we did not see sufficient opportunities for growth to justify extended multiples. Given the quality of these companies however, we continue to pay careful attention to them and would be happy to own them again at more comfortable valuations.

Proxy voting

Proxy voting by country of origin

Proxy voting by proposal categories



Worldwide Leaders Sustainability

During the quarter there were 93 company resolutions to vote on. On behalf of clients, we did not vote against any resolutions.

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Image location: Sao Paulo, Brazil

We sometimes use a gardening analogy to describe how we tend to portfolios. Last quarter saw less new planting with the introduction of one new company, but continued care of the portfolios through company meetings, additional investments in existing holdings, and the complete sale of three companies. This period of lower turnover is a return to some normalcy after an extraordinary 2020. However, it does not mean complacency as we remain concerned about high valuations, government and central bank interventions, and stop-start progress in terms of COVID-19 vaccine roll outs.

The new investment was **Texas Instruments**, a US manufacturer of analogue and embedded chips that allow the digital world to interact with the physical world. Their products are high-quality, low cost and durable, with some chips in use for more than 30 years! While the applications are diverse, the company focuses on industrial and automotive segments (57% of revenues) and plays an important role in helping improve safety and resource efficiency, including in building and industrial automation.[1] Texas Instruments is run with a long-term mindset, strong capital management and a clear goal of growing free cash flow.

We increased holdings in 14 of our favourite sustainability companies that suffered share price declines in late 2020 and early 2021, including world-leading plasma business **CSL** and diagnostics businesses **bioMérieux** and **Tecan**. We also added to **Jack Henry & Associates**, a critical IT provider to small and mid-sized US banks and credit unions. We recently interviewed Jack Henry's CEO on their company culture, which we admire greatly. Click here to watch the video.

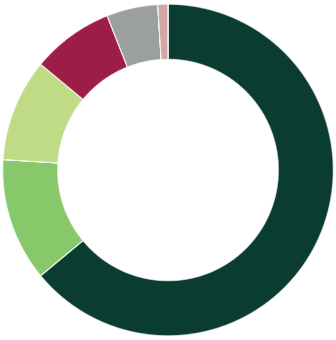
Lastly, we completely sold **Merck KGaA**, **Energiedienst** and **Demant** due to concerns about financial quality or constraints on profit growth.

[1] Source: Stewart Investors investment team and company data.

Proxy voting

Proxy voting by country of origin

Proxy voting by proposal categories



Worldwide Sustainability

During the quarter there were 91 company resolutions to vote on. On behalf of clients, we voted against one resolution.

We voted against the approval of **Nordson Corp's** executive compensation (as we did last year) due to the use of earnings per share (EPS) across both short and long-term metrics and the use of options in conjunction with Restricted Stock Units (RSUs) and Performance Stock Units (PSUs) which we believe is unnecessarily complex. This year the company have also changed the goal posts for the PSUs for the 2020-2022 period. Whilst we understand the background and unusual circumstances that prompted this decision, we believe changing remuneration goal posts can undermine the integrity of the plan itself. (one resolution)

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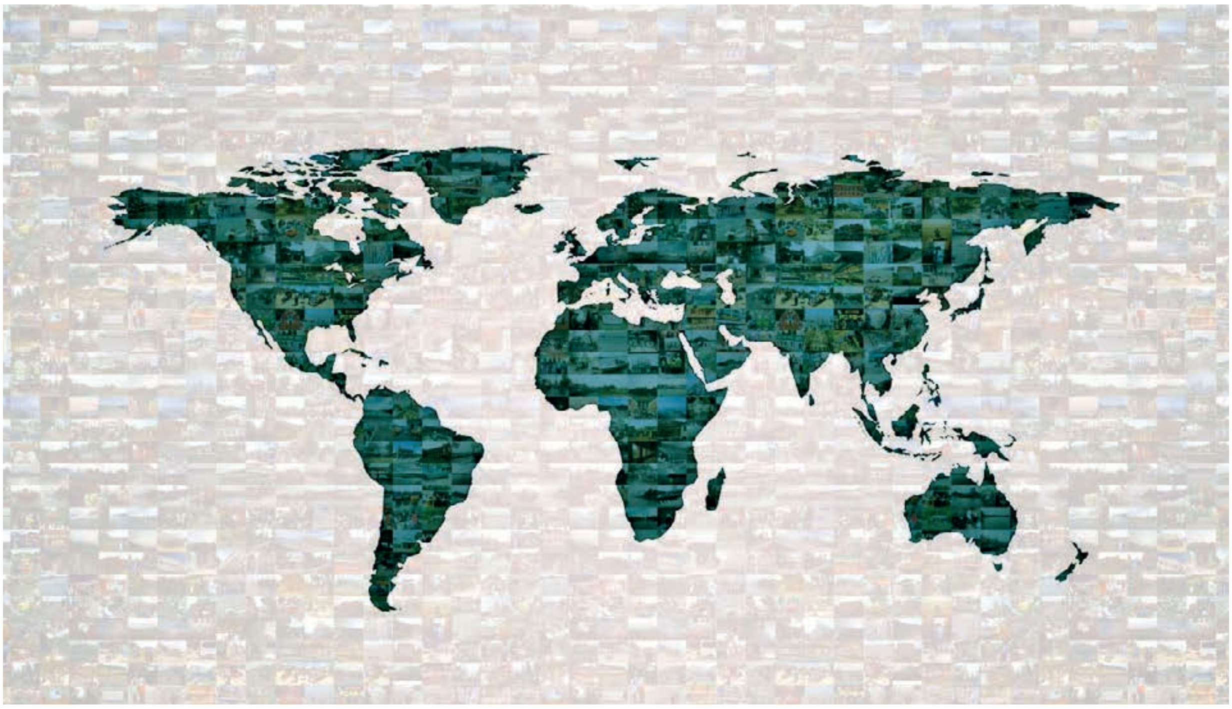
A world of sustainable companies



Explore how the companies in our strategies are contributing to sustainable development.

We provide full transparency of company holdings and their investment rationales via an interactive map on our dedicated sustainability microsite including their contribution to the Sustainable Development Goals.

We believe sustainability is core to any company's business model, not an optional extra. We look for businesses whose success is tied to the social and environmental benefits they deliver, whether the provision of basic sanitation products or advanced engineering software.

Visit our:

- Interactive map
- Microsite

Stories of sustainable investment

Our investment process starts with a blank page, not a benchmark.

Below are links to our latest articles, webcasts and videos which explore our thinking on sustainable investment, including the challenges and issues we grapple with in our search for high quality companies.

We believe that our focus on quality, sustainability positioning and stewardship should reward both patient investors and society. We hope our content highlights the careful and deliberate way we invest and engage with companies – both when we get it right and when we do not.

Why do Payable Days matter?

Investors often learn that the longer a company takes to pay its suppliers the stronger its bargaining power is with them. Consequently, this is considered as key evidence of a strong franchise.

We beg to differ!

> Read the full article

The sustainability of an imperfect giant

No company is perfect but the best companies are always on a journey of evolution and the giants, who desire to, can make a material difference to sustainable development.

> Read the full article

Indian Subcontinent: the decade ahead

Quality companies should benefit from the many macro-economic factors beginning to turn in India's favour. We believe there is a real opportunity for investors in the decade ahead.

> Read the full article

CAMFED - Learning from success: supporting girls and sustainable development

Education is not freely available to everyone - and in many parts of the world girls are the first to be excluded from it.

We spoke to CAMFED - Campaign for Female Education, who are changing girls' education in Africa.

> Watch the video

The importance of culture

Culture can make or break a company. We spoke to the CEO of Jack Henry & Associates, a provider of banking software and cyber security, about the impact things like location and 'misfits' can have on culture.

> Watch the video

Our approach to Research Tenders

A vital part of our investment process is to challenge our thinking and extend our understanding of sustainable development issues. Key questions on these matters, are not adequately addressed by 'off the peg' research. We have been commissioning our own research since 2015.

> Read the full article

For more articles and videos please visit our website or subscribe to our updates via email

Other news

RI Australia 2021 conference

We are proud to be sponsoring the Responsible Investment Association Australasia - RI Australia 2021 conference, taking place in Sydney and online in May 2021. This conference is the largest meeting of RI industry stakeholders and influencers in Australia.

Jack Nelson from the Sustainable Funds Group will be presenting on his extensive work enhancing how we measure and report on how companies are contributing to solutions for the multitude of human development challenges we face. He'll be focusing in particular on emerging markets.

Tickets are available via the RIAA website

To learn more, visit responsibleinvestment.org

Sustainable Finance Disclosures Regulation (SFDR)

We are pleased to announce that all EEA-domiciled strategies managed by the Sustainable Funds Group are to be classified as Article 9 under SFDR. Phase one of the regulation came into effect on 10 March 2021.

In order to fulfil this classification all strategies must have a clear sustainability objective, incorporating both environmental and social aims, and also meet various sustainability-related disclosure and reporting requirements.

The following article provides an overview of the regulatory developments in sustainable finance.

The Big Exchange

As well as being one of the founding supporters of The Big Exchange – the UK's first actively managed social, environmental and positive impact investment platform - we are delighted that six of our Sustainability funds have successfully passed their independent impact committee's assessment process and have been listed on The Big Exchange platform for UK domiciled investors.

To learn more, visit bigexchange.com

Important information

This document has been prepared and issued by First Sentier Investors (Australia) IM Limited (ABN 89 114 194 311 AFSL 289017) (FSI AIM).

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SFG-QCU-AUSadv-Q121