Stewart Investors
Sustainable Funds Group

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Quarterly Client Update

Q3

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Contents

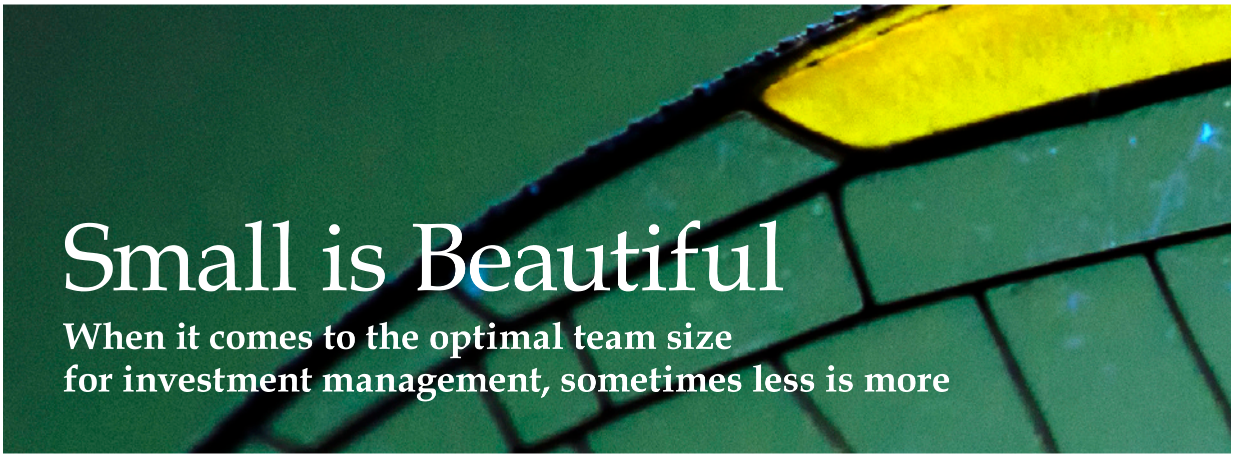
Investment philosophy

Since 1988 we have had an approach to investment founded on:

> **Stewardship**
> **An absolute return mindset**
> **Bottom-up analysis**
> **Long-term thinking**
> **Searching for quality companies**
> **Finding sustainable and predictable growth**
> **Strong valuation disciplines**

Investment objective

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



Small is Beautiful

When it comes to the optimal team size for investment management, sometimes less is more

Famously, Jeff Bezos thought that team size ought to be capped by the 'two pizza rule'; if a team couldn't be fed with two pizzas, it was too big. This rule of thumb was coined in order to combat a common challenge facing teams trying to solve complex problems. In pursuits like investing, there is a tendency to increase the number of people providing input to the point that the team gets bloated and functions less efficiently.

Intuitively, we tend to think that adding more people to a process will help it get done more quickly or better. This appealingly simple idea certainly holds for certain types of tasks. If the goal is to dig a hole, the more people helping the better. Many hands make light work, and the hole will undoubtedly get dug faster with a larger team.

Investment, though, is quite a different type of task. Investing is a complex, constantly-evolving problem-solving exercise, where the outcomes attained by individuals and teams are highly dependent on intangible factors like motivation.

We believe success in investing requires passion and intense curiosity. Without an environment that cultivates these, team members can quickly feel alienated and unmotivated.

Drilling into the accounts of a Japanese consumer company in a way that yields useful insight requires the analyst to feel that the effort is worth it, in the sense that the work can impact client portfolios directly and meaningfully. Investigating the links between Board members of an Indian IT company and former government ministers is akin to detective work, and if an analyst doesn't feel determined to get to the bottom of things, both for their own intellectual curiosity and to support client outcomes, he or she is unlikely to do a good job.

It is therefore essential to cultivate a sense of team belonging, a feeling of collective ownership for portfolios and of individual empowerment. These are crucial characteristics which are, in our view, far easier to achieve in a smaller team.

Undoubtedly, greater team size facilitates the gathering of more information. But good investment decisions do not follow automatically or even naturally from more data points. Usually, insight arises not from knowing more than anybody else, but from being able to identify the small handful of very important points from the sea of noise.

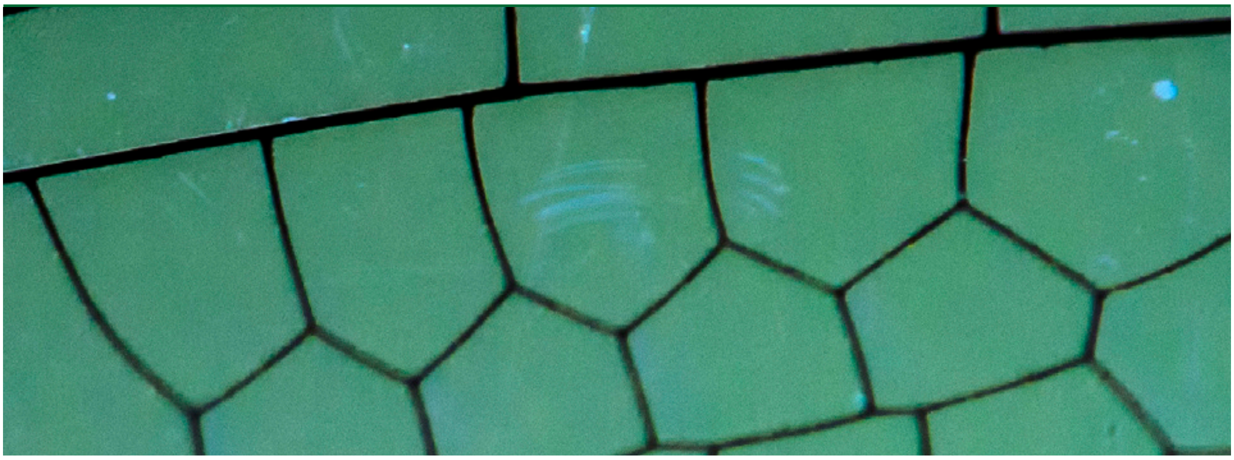
In most investment cases there are probably four or five central considerations which, in our view, constitute 80% of what one needs to know in order to approach investing: the competence and integrity of management, the sustainability of the business model and its profitability, the quality of the financials and a simple approach to valuation.

But there is almost no end to the amount of extra information one could, if inclined, supposedly seek to bolster the robustness of an investment conclusion.

One very likely outcome in our view, though, is that you end up with a 'woods for the trees' situation. All that extra information serves only to disguise the key points on which the investment ultimately turns.

This is very common because the investment industry has tended to encourage a high degree of specialisation, with analysts providing 'coverage' of a particular sector. A sector specialist may be able to value the shares of their allotted companies to the second decimal point, but be unable to undertake meaningful comparative analysis across countries or synthesise insights from indirect sources and other industries.

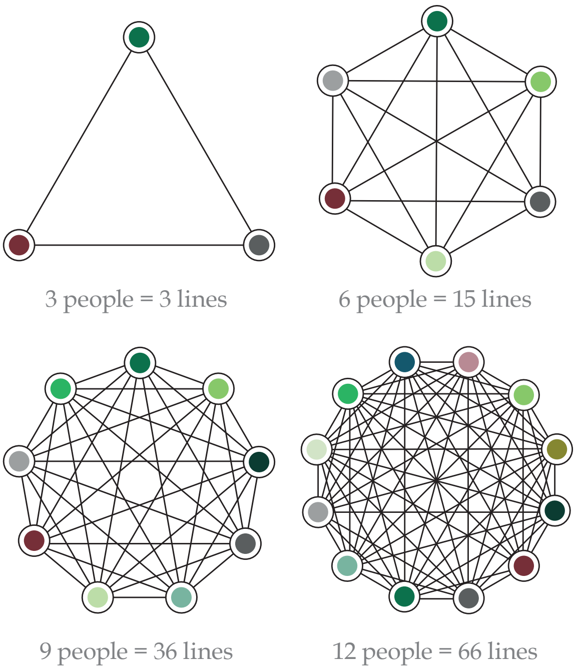
A small team is often much better placed than a large team to focus on the few salient points of an investment case, and to utilise collective ownership and widely dispersed knowledge.



And of course there are obvious acute downsides which come with large teams. With a tight-knit team of three, there are just three relationships – or 'communication pathways' in the parlance of psychologists – which the team has to nurture and manage.

But as more members are added, this number grows exponentially. Between six team members, there are 15 relationships. At 12 members, this jumps to 66 links. By the time you have a team of 50 analysts, there are 1,225 different relationships within the team. It is impossible for a team above a certain – quite small – size to be internally cohesive.

Communication Pathways



In practice, it is very difficult for anyone to maintain strong working relationships with more than a relatively small handful of other investors, especially if these colleagues are spread around the globe. And without a strong sense of mutual respect, trust, and ultimately friendship, robust investment discussions become harder.

The ability of an analyst to take challenging questions on their work and ideas in their stride is greatly aided by having mutual understanding built on many hours of interaction over years. Such strong relations between colleagues are, simply due to the numbers outlined previously, much easier to attain in smaller groups.

And there is a real sense in which an individual in a large team can very often feel that their voice is not easily heard, especially if that person is relatively junior. We know from our own team that when we have in the past tried to have 30-something voices around a table on video-conference, it is nigh-on impossible to discuss constructively a company's approach to its supply chain or the quality of its accounting.

More junior people, younger people and introverts are far less likely to make their views known in such a setting, denying the team the benefit of their opinion. In such crowd-like environments, it is often the person who speaks loudest or most forthrightly who gets the most air-time, rather than the one who has the most to offer the conversation.

In order to preserve the efficacy of the team's investment process, we have strived to maintain a structure which enables small teams to thrive. In 2015, the First State Stewart team split to form two separate teams: First State Stewart Asia and Stewart Investors, in order to allow both teams to preserve investment outcomes through reduced team sizes.

The success of Stewart Investors going back to the 1980s has always been built on small, tight-knit investment groups who feel passionately connected to the companies in which they invest and to portfolio outcomes. We will continue to evolve our structure in order to enable small teams to flourish and aim to deliver attractive risk-adjusted returns for clients. For our approach, small remains beautiful.

Worldwide

During the quarter we initiated positions in Alcon, Fortinet and Siemens Gamesa Renewable Energy.

Alcon is the largest eye-care device company in the world, manufacturing prescription contact lenses and eye surgery equipment. It has operated for over 70 years and in April 2019 was spun out from Novartis. Its competitive advantage comes from high quality brands, global scale, and strong relationships with eye-care professionals. It is well placed to address the growing need for vision correction. Margins have weakened lately due to increased investment in R&D, manufacturing and people, which should benefit the business longer-term.

Siemens Gamesa, listed in Spain, is also a relatively new company, created by a merger of two established wind businesses: Siemens, which dominated the offshore wind market, and the Spanish turbine manufacturer Gamesa, with a strong presence in Brazil and India. The combined business has a dominant market share in a consolidating industry with high barriers to entry. We like its reputation for quality and innovation, its net-cash balance sheet, and its ability to benefit from the increasing competitiveness and demand for renewable energy from both offshore and onshore wind.

Fortinet is one of the world's largest providers of network cyber security and software. It is led by its founder-stewards, the Xie brothers, who have strong technical and entrepreneurial backgrounds and over 30 years' industry experience. Listed in the US in 2009, the company has grown more than 20% per annum. Its structural growth prospects remain promising, as the rollout of 5G broad-band gathers pace, enterprises become increasingly distributed, and data transactions and volumes multiply.

We sold out of Bucher Industries, a well-stewarded, Swiss-listed company that makes agricultural and other machinery. The valuation concerns us, considering the company is vulnerable to end-market cyclicality and conditions for agriculture are challenging and complicated by climate change in many regions.

Worldwide Leaders

During the quarter, we initiated a position in Swiss-listed Alcon and US-listed Fortinet, as referenced above in the Worldwide Sustainability commentary. The final new position initiated for the strategy was in CSL, an Australian-listed biotech company, which we have been invested in since 2006 in our other strategies. It is a global leader in speciality products like immunoglobulin, albumin, and other serums and vaccines.

We exited our position in Johnson & Johnson as we were disappointed with the company's response to legacy issues. We also sold our position in Dr Reddy's Labs as we continue to find other higher quality franchises.

This stock information does not constitute any offer or inducement to enter into any investment activity.

Emerging Markets

During this quarter, we initiated two new positions in the Emerging Markets portfolio: Koh Young Technology and Hangzhou Robam.

Koh Young is a leading maker of 3D inspection equipment, headquartered in Seoul. This testing equipment is primarily used to detect defects in electronics and semiconductor manufacturing processes, but they are steadily entering new areas such as automotive manufacturing. This equipment has become essential to the manufacturing process as components become both more complex and smaller in size, and manual checking is no longer sufficient to ensure quality. The company is stewarded by Dr Kwangil Koh who founded the business in 2002, remains the CEO, and owns 19% of the company. Dr Koh has demonstrated clear technological competence and the ambition to build a unique business here, turning down an acquisition attempt by KLA, a much larger inspection equipment maker. Consistent investments of more than 10% of sales on R&D has resulted in Koh Young being able to command the leading market share in both the varieties of testing equipment they produce. We believe that inspection equipment will remain an intrinsic part of the manufacturing process, and that Koh Young will continue benefiting from tailwinds around increasing efficiency by reducing costs and time in manufacturing.

Hangzhou Robam is a household appliance maker, based in Zhejiang Province, China. Robam primarily makes gas stoves and range hoods, controlling about 40% market share in the higher-end segment in which they operate. The company was founded by Ren Jianhua and is controlled by the Ren family who own 55%. There are some clear positive signs in terms of governance, including cleaning up the structure prior to listing by injecting all the appliance businesses into this entity, as well as the Robam brand and relevant patents. Other signs of stewardship include a zero debt balance sheet for the past ten years and consistently putting profits ahead of short-term market share gains. The business itself is built on growing via premiumisation of products, preserving their brand identity through spending on innovation and marketing rather than competing with the likes of Midea and Gree on cost. The franchise is somewhat linked to property cycles given that their products are in-built and bought while initially furnishing a home. As such, we used the recent cyclical opportunity to initiate a position in the company.

During this quarter, we also took an opportunity to reduce our position size in the Bank of the Philippine Islands (BPI). Although it remains one of the best banks in the Philippines, stewarded by the Ayala family, we remain wary of the proportion of the loan book that is accounted for by the real estate sector. We also reduced our positions in Raia Drogasil and Foshan Haitian, two very high quality companies that had become quite fully valued. Raia Drogasil is a leading drugstore chain in Brazil continuing to deliver steady growth supported by structural tailwinds around consolidation in the industry. Foshan Haitian is a dominant soy-sauce and related condiments brand in China that continues to grow sales at 15% a year. Despite the high quality nature of both of these companies, our focus on capital preservation in the face of very high valuations led us to reduce our position sizes during this quarter. This also highlights our continued cautious positioning in a world where there is no dearth of risk in emerging markets.

Asia

During the quarter for the strategy we initiated two new positions in Cochlear, listed in Australia, and Voltronic Power Systems, listed in Taiwan.

Cochlear is one of the leading players in the provision of implantable hearing solutions. Their portfolio includes Cochlear devices (for profound hearing loss) and bone conduction implants (for less serious hearing problems). We believe an impressively long-term and innovative culture will allow Cochlear to continue to develop industry leading technology and protect their dominant market share; a position they have held for the last forty years. Ageing demographics in developed markets, and growing penetration in developing markets, should provide many more years of demand for the hearing improvement provided by Cochlear's devices.

Voltronic Power Systems is a manufacturer of uninterruptable power supplies; products that provide critical backup systems for their customers, e.g. emergency power for factories, hospital equipment or data centres. We are comfortable investing alongside the very capable founder, and industry veteran Alex Hsieh and his aim to build a franchise renowned for its quality and trustworthiness. Although having some cyclical elements to demand, Voltronic is well placed to benefit from both the structural growth of the industry and taking market share from lesser quality peers.

During the period we sold Kansai Paint which was held in the fund for less than a year. We initiated the original position as we believed Kansai offered an attractive way of gaining exposure to Asia's growing demand for paint. However, recent company presentations and their rumoured interest in a large US acquisition suggest Asia is unlikely to be the key driver of growth over coming years. It was for this reason that we sold the fund's 0.5% position. We never like to see companies come in and out of the fund so quickly but there will be instances, such as this, where selling and admitting a mistake is preferable to holding onto a position where we have little conviction in a company's ability to protect and grow capital over the long-term.

Sadly, we were also forced to exit our position in Expeditors, a US-listed freight forwarder, which has been a strong performer for the fund over the years it has been held. Their Asian exposure, the reason we could hold it, has been heading in the wrong direction in recent years. We will continue to monitor the company in the hope that it may again qualify for an Asian fund.

Asia Leaders

During the quarter we initiated a new position in Australian listed Cochlear, as referenced above in the Asia Sustainability commentary.

We sold the fund's positions in Kansai Paint and Expeditors for the same reasons mentioned in the Asia Sustainability commentary above. We also sold our fifteen-year holding in Hong Kong & China Gas. Over this time, the company has successfully managed their Hong Kong concession while taking a very long-term time horizon on building what is now one of the highest quality gas distribution businesses on the Mainland. However, valuations reached levels that we believed to be extreme for both future growth and growing political risk.

India

In the Indian Subcontinent strategy this quarter, we continued to slowly and cautiously increase our exposure to cyclical companies demonstrating resilient cash flows, which are poised to benefit from tailwinds around increased industrial investments. The two new additions to the portfolio this quarter were SKF India and 3M India.

SKF India is a company that makes ball bearings for automotive and industrial original equipment manufacturers (OEMs), controlling about 30% market share in the Indian Subcontinent where nearly a third of the market still remains unorganised. These ball bearings are a fraction of the cost of the end product – be that an automobile or wind turbine – but the cost of failure for each is very high. As such, the company is focused on producing high quality bearings that improve efficiency for end customers. With a net cash balance sheet, the company continues to focus on growth in the higher margin areas of electric vehicles and industrial consumers, slowly reducing their dependence on the auto sector.

3M India, like SKF India, is the only listed subsidiary of the multinational parent company. The 3M Group owns the upper limit of 75%, and took a positive step forward in 2018 when they merged an unlisted Indian entity with the listed business, creating one company through which they operate in the Subcontinent. Running a net cash balance sheet as well, 3M India produces niche but critical products like adhesives, filtration products, wound care, and road safety items, with a wide range of end applications for both individual and industrial end customers. SKF India and 3M India remain at the higher end of our valuation appetite, so we have taken small stakes in both and remain watchful for better opportunities to build our position.

During this quarter, we have also reduced our position sizes in a small way in the generic pharma companies – Dr Reddy's Labs and Cipla. We remain convinced of the long-term need for accessible pharmaceutical products across the world, but are wary of the risks around regulated franchises that face an intense competitive environment in North America.

Koh Young Technology

Country	South Korea
Market Cap	US$940million
Shareholders since	January 2017
Classification	Required Infrastructure
Description	World-leading optical inspection equipment manufacturer

SDGs supporting

> **SDG 9 Industry, Innovation and Infrastructure:** contributing to advances in computing, industrial production and science across a broad range of industries.

> **SDG 12 Responsible consumption & production:** minimizing waste in high value production processes saves clients time and money, and preserves resources.

SDGs to engage on

> **SDG 5 Gender equality:** relative absence of female professionals or Board members may suggest the company is not effectively accessing all potential talents.

Koh Young is the world leader in 3D optical inspection and measurement technology. It has dominant market shares in niche equipment which is used for high-resolution inspection at tiny scale. Almost 90% of its sales are outside of its home market in Korea.

Customers of Koh Young use its equipment to detect and diagnose defects in their manufacturing processes in real time. Many such customers – in automotive, electronics and advanced manufacturing industries – are producing high value items which require accuracy at minute scale. Investing in the world's best inspection equipment to ensure production runs smoothly with minimal waste makes sense for these clients, enabling Koh Young to generate impressive margins and returns.

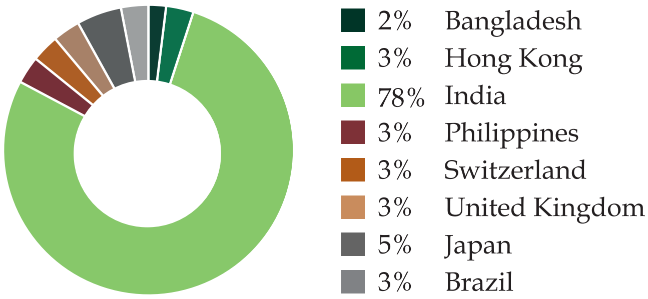
The company was founded by Dr Kwangil Koh in 2002, an entrepreneur who still retains ownership of 19% of the company. Other employees and managers own a further 9% of the company. We appear quite clearly aligned with Dr Koh, and there is lots of evidence of stewardship and long-termism. The company consistently invests well over 10% of sales in research and development, deferring some profits today in order to reap greater rewards in future. During cyclical downturns, the company has been willing to accept short-term margin pressure by retaining staff in order to ensure it is well-placed for the subsequent rebound in demand.

Koh Young pays well to attract the best engineers, and has maintained a highly innovative culture which seeks to push technological boundaries. The company is around five years ahead of its nearest competitors in its core technologies.

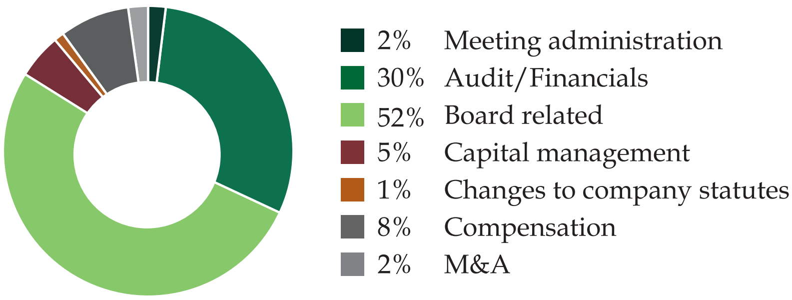
The company has grown sales at over 20% compound over the last decade and has plenty of opportunities ahead of it. It is particularly well-positioned for trends in industrial automation, medical robotics as well as the march of semiconductor circuits to smaller nanometre sizes.

The Stewart Investors Sustainable Funds Group supports the Sustainable Development Goals (SDGs). The full list of SDGs can be found on the United Nations website.

Proxy voting by country of origin (%)



Proxy voting by proposal categories (%)



During the quarter there were 322* company resolutions to vote on. On behalf of clients, we voted against four and abstained on two resolutions relating to corporate structure.

- We voted against Philippine Seven Corporation's request for management to approve all other business matters before the annual meeting of shareholders. We consider ourselves active shareholders and prefer to vote on matters arising at the AGM.
- We voted against Dr Reddy's request to elect Shikha Sharma as an independent director to the Board. We believe decisions taken by Ms Sharma in her previous role as Managing Director and CEO at Axis Bank demonstrate a willingness to take on a high level of risk which we do not believe is a quality that would enhance the board.
- We voted against Colgate-Palmolive India's request to elect Vikram Singh Mehta and Rajendra Ambalal Shah to the board as we believe they sit on too many other boards to be truly independent.
- We abstained on Mahindra & Mahindra and Tech Mahindra's request to elect Ms Shikha Sharma as an independent director to the Board for the same reasons noted above in relation to Dr Reddy's. Our choice to abstain on Mahindra & Mahindra and Tech Mahindra's proposals in comparison to Dr Reddy's is primarily driven by the long-term stewardship that the Mahindra family provides to the Group.

Should any client like a full list of all proxy voting for the companies held in the strategies, please contact us directly.

Further information on our Stewardship and Corporate Engagement policy is available online:

https://www.stewartinvestors.com/scep.

*all votes were cast, 0 not voted

Engagement

In the last 18 months, the team has decided to adopt a more strategic approach to engagement with companies and have identified the following three priority areas for engagement across all portfolios:

Remuneration: with the aim to develop principles which we can encourage companies to adopt and also engage on remuneration at a broader level through a consideration of living and minimum wages.

Diversity: with the aim to engage on gender diversity across board and management throughout our portfolio companies.

Pollution: with the aim to initially focus on plastics and packaging and encouraging companies, particularly our consumer goods companies, to reduce their non-recyclable plastic waste and consider circular economy principles.

We hope to be able to share further insights with you on these areas of engagement throughout the year.

Collaborative Engagement Update

Micro-insurance: Inclusive protection at the Bottom of the Pyramid

In March earlier this year we wrote to 49 local insurance providers in Latin America, Africa, Emerging Asia Pacific and European markets as part of collaborative engagement initiative that we carried out alongside 34 investors whom collectively have US$1.4trillion assets under management. We wrote to these companies to encourage them to take a leading position in the development of best practice around the provision of micro-insurance tailored for and aimed at those who are simultaneously in the most desperate need and yet are the least well served today.

We have received many responses from a variety of companies across different markets who are at various stages of evolution in this area. In an attempt to find those companies which are both interested and keen to pursue the opportunity of micro-insurance, but have not yet built up their capabilities to the fullest extent possible (of which we believe there are several examples), we have been engaging in phone conversations with the relevant executives in these target companies to further discuss the opportunity.

At the same time, we are speaking to a non-governmental organisation (NGO), the MicroInsurance Centre based in Wisconsin, who are helping us talk to companies about this engagement project. The MicroInsurance Centre is dedicated to generating access to micro-insurance products to low-income people across the globe.

Our goal, having identified a small number of companies which share enthusiasm for the micro-insurance opportunity, is to move forward with them alongside the MicroInsurance Centre to see if we can create some real world impact on their businesses and in the societies they operate in.

Access to Medicine and SDG 3 collaborative engagement

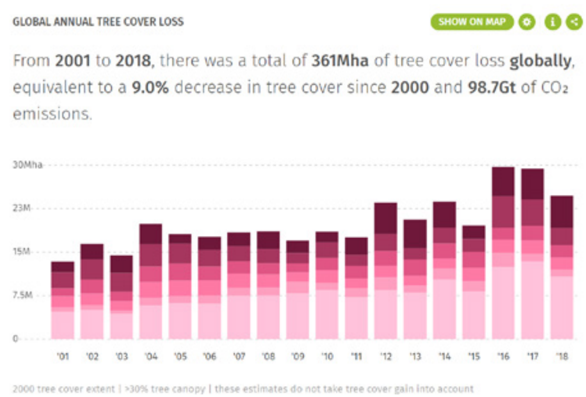
We supported a collaborative engagement initiative led by the signatory investors of the Access to Medicine Foundation to engage with 19 pharmaceutical companies on improving access to medicine in low- and middle-income countries and achieving SDG 3: to ensure healthy lives and promote well-being for all at all ages.

UNPRI Investor statement on deforestation and forest fires in the Amazon

We signed the UNPRI global investor statement on deforestation and forest fires in the Amazon. Although hundreds of companies have committed to end commodity-driven deforestation by 2020, evidence of progress towards commitments is limited. This statement calls on companies to redouble their efforts and demonstrate clear commitment to eliminating deforestation within their operations and supply chains. The statement was signed by 230 investors representing approximately US$16.2trillions in assets under management.

Amazon fires, Global Deforestation and what we are doing about it

Background
The fires in the Amazon have rightfully captured a lot of attention given the global significance of the biome[1]. However, it is important to recognise that deforestation is a global crisis. Countries like Cambodia, Malaysia and Paraguay have lost more than 10% of their forests in just six years. Globally,



Source: Global Forest Watch. "Tree Cover Loss Globally". Accessed on 3rd October 2019 from www.globalforestwatch.org

we have lost 9% of forest cover since 2000. There are many reasons for tree cover loss with the primary drivers of permanent deforestation being agriculture and urbanisation (agriculture is a 4,000 times larger contributor than urbanisation).

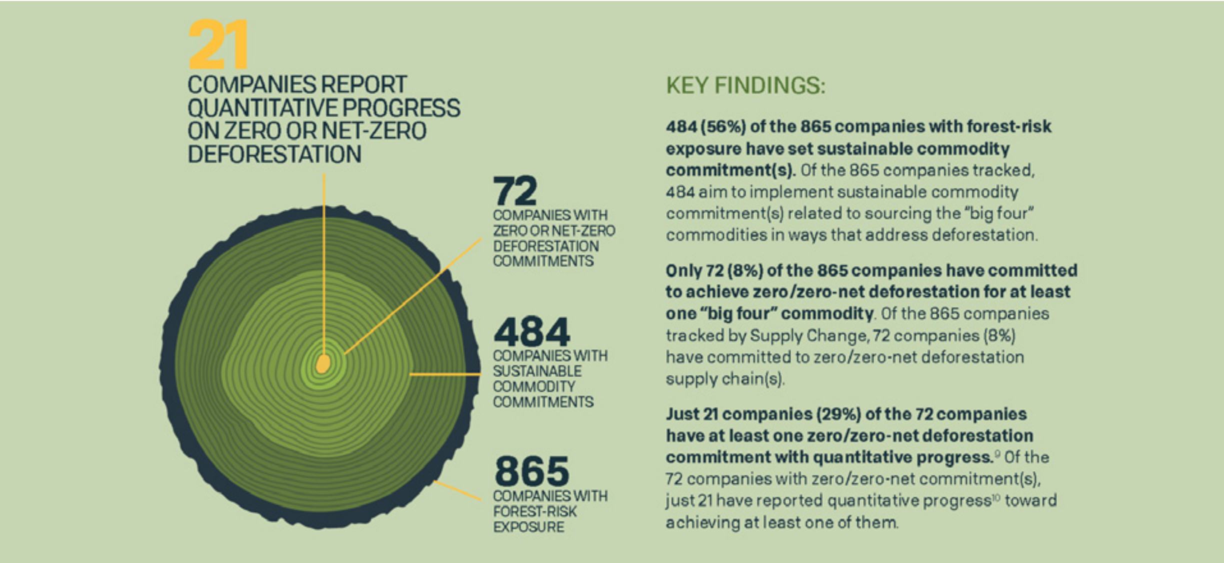
Deforestation, like many issues today, is complex and often painted as competing with objectives of economic development and feeding a growing population.

However, the impact of deforestation on issues like the extinction crisis (with 75% of the terrestrial environment "severely altered" by human actions[2]) and climate change (around 13% of global emissions) makes this a Faustian bargain. Both economic development and food security are ultimately compromised if the causes of the climate and biodiversity crises are not addressed.

It doesn't need to be this way
Between 2000 and 2010 Brazil achieved a 70% reduction from the 1960-1999 average in deforestation. Looking only at tree cover loss it was closer to 50%. This was an extraordinary conservation success story with the success being attributed to many players: "The factors responsible for this accomplishment include government policies and enforcement actions by prosecutors, on both the federal and state levels; incentives created by Norway's pledge of up to $1 billion in results-based compensation; the concerted pressure exerted by non-government organizations (NGOs) on the government and the soy and beef industries; and the positive response by those industries, resulting in the 2006 soy and 2009 beef moratoria."[3]

The role of companies
While governments are clearly very important, zero deforestation commitments and supporting actions from companies are critical for turning the issue around. Unfortunately, despite the seriousness of the issues linked to deforestation the New York Declaration on Forests (NYDF) assessment report found that corporate commitments had slowed. [4]

They also found that while "Commitments cover large shares of production in international palm



Source: CERES. "Out on a limb: The State of Corporate No-Deforestation Commitments and Reporting Indicators that Count" (June 2019)

oil markets (65%) as well as the largest paper and pulp players operating in tropical regions (70%), the shares are low in the global soy and beef markets."

More important than commitments is action. A recent CERES report found that while there were many commitments, there was less tangible action and progress, with only 21 companies out of more than 800 disclosing quantitative indicators of progress.[5]

A CDP report similarly found governance gaps and a lack of disclosure, with 70% of companies with a high impact on forests failing to disclose. Those that did disclose reported over US$30bn in losses due to deforestation risks.[6]

Deforestation is a business issue
Deforestation creates business risks. The potential for regulatory and community changes threaten companies with compromised supply chains, including sudden cost increases, unavailability of key product inputs and delays. Reputational harm, particularly through consumer boycotts are a real threat in an age of rapidly transmitted social media controversies. We have seen some brands react quickly to cease purchases of leather from Brazil in response to the fires.

As investors, we are not forest experts and cannot claim to have the solutions, but we do try to understand risk. The deforestation trends suggest that the current approach is not working and something different needs to be done.

What does this mean for our investments?
For Stewart Investors Sustainable Fund Group, sustainable sourcing and environmental stewardship are critical considerations in our company analysis. We have never owned livestock, big agricultural or trading companies due to the quality of franchise, quality of management and sustainability head winds.[7] However, the complexity and opacity of soft commodity[8] supply chains make complete avoidance of deforestation very difficult, and near impossible for global food companies.

Consumer companies we invest in, including Henkel, Unilever, Jeronimo Martins, Marico, Kikkoman and Vitasoy, all buy and use agricultural commodities. Due to the complexity and limited traceability in soft commodity markets, particularly for soy, it is likely Brazilian sourced soft commodities linked to deforestation exist in these companies' supply chains.

90% of the soy used in the EU is for livestock feed

For example Jeronimo Martins, a Portuguese company operating in food distribution and specialised retail, notes that despite having a strong sustainable sourcing framework, 9,366 tonnes of soy, almost two thirds of the total purchased, came from countries at risk of deforestation, with only 20% of this soy being certified sustainable. Most companies do not disclose this information nor have the sustainability ethos of Jeronimo Martins.

In various assessments including Forest 500, the CERES report mentioned above and our commissioned research, Henkel and Unilever are consistently amongst the best-rated companies globally for deforestation commitments and actions. Jeronimo Martins and Vitasoy have strong and evolving sustainable sourcing strategies which explicitly call out deforestation. Marico has a responsible sourcing programme which is focused on farming communities but does not explicitly highlight deforestation. While Marico does sell soy sauce in Indonesia, it is mostly exposed to coconuts and we expect total exposure to commodities linked to deforestation to be limited. Kikkoman provides limited disclosure on their sourcing practices.

We also invest in companies providing solutions like Novozymes who are producing microbes that help increase soft commodity yields and reduce the need for chemical herbicides and pesticides.

What are we doing from here?
Our plan in response to the most recent Amazon fires is to:

1. Join the PRI's (Principles of Responsible Investment) joint Investor statement on deforestation and forest fires in the Amazon.
2. Continue our support of CDP Forests.
3. Write to targeted companies we are invested with who have an exposure and potential influence on deforestation.
4. Include notes in our company engagement system to prompt us to follow up on the issues in our future face-to-face meetings.
5. Write to our clients to ask them to join with us in these activities.

We have also commissioned our own research on Palm Oil and Soy, to understand better the issues faced and shape our engagement on these soft commodities.

What we are asking of companies
In our letter we refer to the CERES report, "Out On a Limb: The State of Corporate No-Deforestation Commitments & Reporting Indicators that Count", which recommends three measures from the CDP Forest questionnaire investors should be asking companies to disclose in support of their commitments:

- Percent of total production/ consumption covered by commitment.
- Percent of total production/ consumption volume traceable; point to which commodity is traceable.
- Whether the company specify any sustainable production/procurement standards for its disclosed commodity(ies), other than third-party certification? And to indicate the percentage of production/ consumption covered and if it monitors supplier compliance with these standards.

In addition, we ask companies to show greater ambition in terms of deforestation, engage with the large trading companies who dominate deforestation-linked soft commodities, and to review industry group memberships to ensure alignment on deforestation commitments.

Conclusion
Like many of the sustainability challenges we face, deforestation is complex, interconnected with other issues and not something any organisation can solve on their own. However, the 70% reduction in land use change achieved in Brazil in the early 2000s shows what is possible with concerted effort. The backward steps since then shows more needs to be done and different approaches will be needed. Investors have a key role to play. For our part, we will continue to encourage the companies we invest in, our clients and the broader industry to join the movement for a zero-deforestation future.

[1] A biome is a community of plants and animals that have common attributes adapted for the environment they live in.

[2] Source: Sustainable Development Goals. UN Report: Nature's Dangerous Decline 'Unprecedented'; Species Extinction Rates 'Accelerating' (May 2019)

[3] Source: Boucher, D. How Brazil has dramatically reduced tropical deforestation. (March 2014)

[4] Source: https://forestdeclaration.org/goals/goal-2/

[5] Source: CERES. "Out on a Limb: The State of Corporate No-Deforestation Commitments and Reporting Indicators that Count" (June 2019)

[6] Source: CDP. The Money Trees: The role of corporate action in the fight against deforestation (2019)

[7] Sustainability head winds are conditions which can slow company growth.

[8] A soft commodity is a commodity such as sugar, corn, soy, wheat. They are grown rather than mined.

Recent history in Brazil has seen a push towards identifying and weeding out the linkages between corporate and political networks that have intertwined over decades to breed a culture of impunity.

The ongoing investigations under Operation Lava Jato continue to uncover steadily the scale of the kickbacks and fraudulent nature of numerous corporate contracts across sectors, with federal prosecutors seeking to recover approximately USD12 billion from those implicated. These attempts at justice and reform, however, are still very much in their infancy in the long road to truly addressing a political and corporate nexus where systemic corruption has become endemic. This was the backdrop to a trip to the country in August 2019, where meetings with management teams repeatedly reiterated the crucial nature of investing alongside stewards who demonstrate competence, integrity and humility.

As a team, we constantly try to challenge our conceptions about franchises and their stewards and as such, we spent some time during this trip with a few companies that we have not met in some years, revisiting our views about them.

A couple of the companies we met looked quite attractive on paper, with little debt on the balance sheet, growing fast, and with decent profit margins. However, further research into the founders of these businesses revealed quite a different story. We came across a regulated business whose founding family also owned a media and publishing entity in the North East of Brazil, where the links between political influence and business can sometimes be even more explicit than the rest of the country. Another example we came across was a company with dominant market share in their sector that has been found to be channel stuffing[9] twice in the past five years, and whose founder-Chairman and the former CEO have both recently resigned as part of an investigation into bribery charges.

> “
> **If there is a lack of machines, you can buy them; if there is no money, you can borrow some; but people you can neither buy nor borrow, and motivated people are the basis of success.**
>
> Eggon João da Silva, co-founder of WEG

These instances highlight the simple but essential fact that every founding family is not made equal, and emphasize the need to continue to be extremely rigorous where we look to invest clients’ capital. We continue to believe that management teams and founders that build franchises through political connections, those that do not treat all stakeholders appropriately, or demonstrate large risk-taking appetites might, at some point, disadvantage minority shareholders as well.

In today's world of casino capitalism, having a patient steward at the helm gives companies the tangible advantage of being able to withstand short-term pressure from aggressive competitors funded by deep pockets.

We came across this in Brazil during our meeting with Raia Drogasil, the leading drugstore chain in the country and one of our holdings from Brazil in the emerging markets portfolio. The company was formed through the merger of Droga Raia and Drogasil, two strong brands who have a century of history and experience behind them, with the founding families continuing to own close to 32% of the company.

Over the years, management have proved themselves time and again to be able to execute just the right balance between growth, via new store openings, and consistent profitability. Attracted to a profitable, consolidating industry, recent years saw a number of risk-happy competitors entering the market and rapidly opening new stores. However, with neither the history nor the experience of what running drugstores entails, the most exuberant of these new entrants are now heavily debt-laden, loss-making, closing stores, and looking for opportunities to exit the business.

During two years of aggressive competition, the stewards at Raia demonstrated the ability to unwaveringly stick to a strategy that has served them well for a century, taking slower short-term growth in their market share rather than sacrificing their solid balance sheet to match the risk appetites of their competitors. They are now picking up the fruits of this long termism, with a range of consolidation opportunities to choose from as competitors depart and market shares gradually shift their way.

Another example where the patience and long-term vision of the stewards has been essential to the business is WEG, our other holding in Brazil. Set up in the 1960s, WEG, named after the initials of the founders – Werner Voigt, Eggon da Silva and Geraldo Werninghaus – produces electric motors. They are one of the few globally competitive industrial companies to come out of Brazil, challenging the likes of ABB, Siemens and Emerson across the world.

The vision of these stewards to take an evolutionary approach to building out the business internationally has seen the company go from a predominantly domestic business in the 1980s to 34% of products being exported in the 2000s to 30% of products now being produced and sold abroad, with another 30% being exported from Brazil. Slow but steady vertical integration is one of their main advantages, allowing them to maintain both flexibility and a competitive cost structure by setting up manufacturing much closer to customers. Above all else, they have shown a consistent adherence to their mission of continuous and sustainable growth while maintaining simplicity. This continues to be seen in their core focus on a business they have proved themselves in over the decades, a conservative balance sheet maintained to take advantage of opportunities when competitors suffer and disciplined capital allocation.

Having a family behind a company is no automatic guarantee of returns, and trying to find and back true family stewards is a key part of our jobs as active investors. We believe that these stewards provide long-term competitive advantages in the form of the patience to build sound businesses over decades, the resilience to overcome short-term setbacks and the institutional memories not to get carried away, both in times of elation or gloom. In a world where corporate time horizons continue to shrink, we remain on the lookout for these stewards managing durable franchises with structural growth tailwinds.

[9] Channel stuffing is a deceptive business practice used by a company to inflate its sales and earnings figures by deliberately sending retailers along its distribution channel more products than they are able to sell to the public. (Source: Investopedia)

Acquisition complete

Mitsubishi UFJ Trust and Banking Corporation completes acquisition of Colonial First State Global Asset Management and rebrands.

On 2 August 2019, our parent company First State Investments (FSI)/Colonial First State Global Asset Management (CFSGAM) announced the completion of its sale from the Commonwealth Bank of Australia to Mitsubishi UFJ Trust and Banking Corporation (MUTB), a wholly-owned subsidiary of Mitsubishi UFJ Financial Group, Inc. (MUFG), for US$2.7 billion.

Under this change of ownership, FSI/CFSGAM which will now operate as a standalone global investment management business within the MUFG group, was required to change their brand name. The business has decided to take the opportunity to adopt a single global brand name, First Sentier Investors. Over the next 18 months, the name First Sentier Investors will be adopted in all markets which our parent company operates. Stewart Investors will continue to operate as a sub-brand within First Sentier Investors and retain its investment autonomy and the ability to control capacity as the existing governance agreements remain in place.

We are pleased to conclude this period of ownership uncertainty and thank you for your patience during the last two years.

Cash positions across funds

We understand and empathise with clients who may be frustrated by the high levels of cash in our funds. It is always frustrating to look back on any period of positive performance and contemplate the drag cash has had on the numbers.

We do not follow a formula or set top-down targets for cash. The cash holding is, like all other portfolio exposures – to individual companies, sectors, regions, currencies, and anything else – a residual of our bottom-up stock selection and portfolio management process, and our judgements about quality, sustainability and price.

When cash levels rise in any time period, it is simply an outcome of us not finding enough compelling buy opportunities to offset the cash impact of any reductions or liquidations of company holdings (often because of concerns about excessive valuations).

Team updates

Pablo Berrutti joined the team in July 2019 as an investment specialist and will be helping the team coordinate communications, reporting and company engagement.

Pablo was the Head of Responsible Investment Asia Pacific for our parent company Colonial First State Global Asset Management (‘CFSGAM’) for seven years. In his role, he was responsible for supporting investment teams across the group incorporate sustainability considerations in their investing.

Pablo is also the founder of a not-for-profit library and resource centre, Altiorem, dedicated to helping people inside and outside finance supporting a sustainable financial system, is the former Chair and current Deputy Chair of the Responsible Investment Association of Australasia and is on the management committee of the Investor Group on Climate Change.

Our views on how loyalty shares can promote better long-term stewardship

If capitalism is going to survive long-term and benefit all stakeholders, we need to question the status quo.

The one-share-one-vote principle is one example which is standing in the way of sensible initiatives like loyalty shares. While short termism and all the ills that go with it will not be fixed by loyalty shares, they can help. We wrote an article published in the Financial Times on 25 September 2019 explaining how and why we believe loyalty shares can promote better long-term stewardship.

https://www.stewartinvestors.com/loyaltyshares

Important information

This information has been prepared and issued by First Sentier Investors (Australia) IM Limited (ABN 89 114 194 311, AFSL 289017) (FSIIM). Stewart Investors is a trading name of FSIIM. FSIIM forms part of First Sentier Investors, which is ultimately owned by Mitsubishi UFJ Financial Group, Inc (MUFG), a global financial group.

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The product disclosure statement (PDS) and Information Memorandum (IM) for the Stewart Investors Wholesale Global Emerging Markets Sustainability Fund (ARSN 133 696 465), Stewart Investors Wholesale Worldwide Sustainability Fund (ARSN 160 711 106), Stewart Investors Wholesale Worldwide Leaders Fund (ARSN 087 563 755) (Fund(s)), issued by Colonial First State Investments Limited (ABN 98 002 348 352, AFSL 232468) (CFSIL), should be considered before deciding whether to acquire or hold units in the Fund(s). The PDS or IM are available from Stewart Investors which is the trading name for FSIIM.

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Contact details

Chris King

Head of Investment
Sales & Key Accounts
0413 984 600

Nick Everitt

Key Account Manager
VIC/TAS
0499 454 206

Angela Vincent

Key Account Manager
NSW
0477 347 260

Nathan Robinson

Key Account Manager
WA/SA/NT
0403 272 440

Quin Smith

Key Account Manager
QLD
0455 095 505

stewartinvestors.com

SFGQIRAusAd Q319