generation

DECEMBER 2019

OUR APPROACH TO STEWARDSHIP

Californian Sequoia trees are amongst the longest living trees on Earth. The oldest Sequoia currently alive is around 3,200 years old.

STEWARDSHIP AND ENGAGEMENT POLICY

INTRODUCTION

Companies make an essential contribution to society. They can provide products and services that people need and thereby create jobs, pay taxes to governments and generate returns for shareholders. We believe that when companies are run to make such positive contributions over the long term, they can flourish and endure.

However, in our opinion, when companies focus on short-term profit maximisation, without regard to their own long-term health, they tend to stumble and ultimately fail. More broadly, many of the challenges that society faces, such as the climate crisis, inequality and obesity, are aggravated by companies operating without due regard to their consequences for society.

A company's board is responsible for confirming its strategy, overseeing management and ensuring that the interests of its shareholders and wider stakeholders are appropriately met. Effective corporate governance of companies by their boards is therefore essential for their long-term success and for the well-being of society.

In turn, investors can make a significant contribution to ensuring robust governance of the companies in which they are invested through the opportunities they have to engage with companies and to vote on matters of corporate governance. Such stewardship is natural for long-term investors.

Generation Investment Management LLP ("Generation") was established in 2004 with a dual mission. Since our inception we have sought to deliver superior investment returns[1] by taking a long-term investment approach and by fully integrating sustainability factors into rigorous investment analysis. More broadly, we are committed to contributing to a transition to a more sustainable form of capitalism. Stewardship is central to both aspects of our mission.

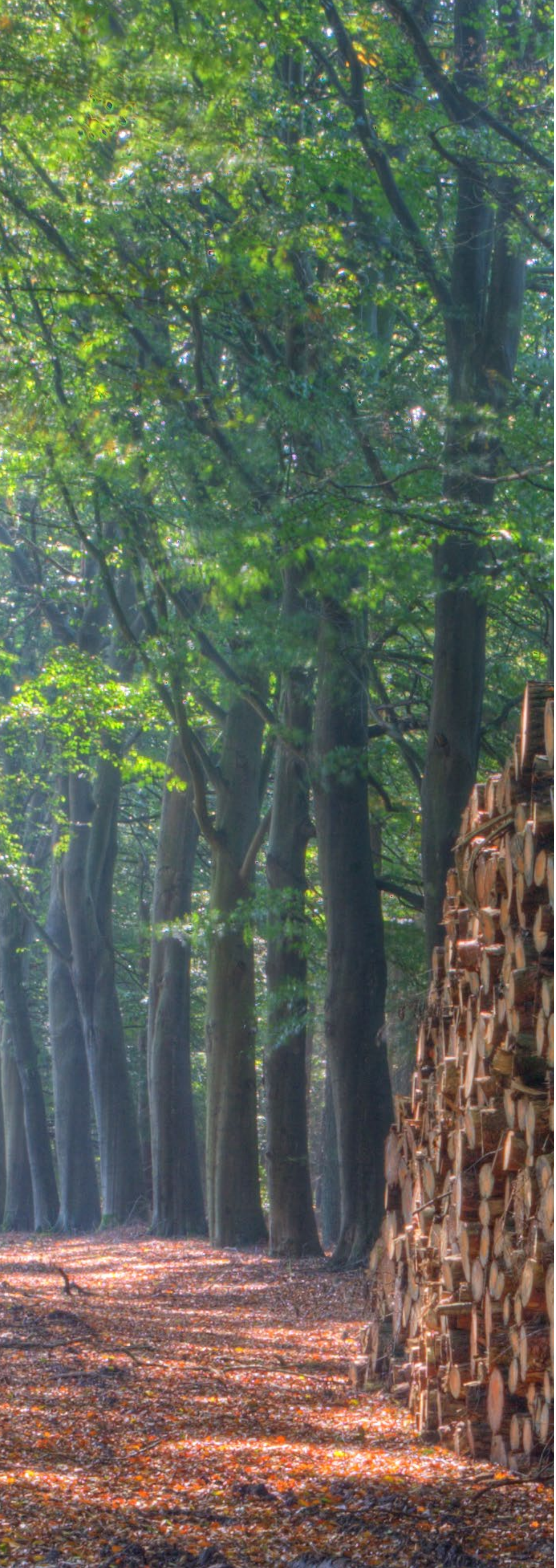
As we have pursued our mission over the years, we have noticed some improvement in stewardship and engagement in the markets, with a major step forward being the introduction of the UK Stewardship Code by the Financial Reporting Council in 2010.

However, we believe that overall standards of stewardship in investment markets remain inadequate. We are supportive of on-going regulatory and industry measures to further enhance governance, in particular the revised UK Stewardship Code (the "Code"), which is effective from 1 January 2020. Although the Code is focused on the UK, we consider it to be a good global framework, and intend to comply with its principles. We are hopeful that the Code, and other ongoing regulatory and industry measures, will ultimately overcome impediments to stewardship, such as fragmented ownership, pressures on costs and a focus for short-term returns, so that stewardship gets the same degree of focus as stock selection.

This document describes how we approach stewardship and also explains how we comply with our obligations with regard to shareholder engagement with public companies.[2] We hope it offers valuable perspectives on the importance of stewardship for companies, investors and society.

1. Although Generation seeks to provide superior investment performance, potential investors should be aware that this is an aspiration and there is no guarantee that this goal will be attained.

2. Obligations under the revised EU Shareholder Rights Directive, as implemented in the UK under COBS 2.2B.5R of the rules published by the Financial Conduct Authority ("FCA"), with regard to shareholder engagement with public companies.



WHAT IS STEWARDSHIP?

The principle of stewardship is illustrated well by different approaches to forestry management.

A well-tended forest can enable selected trees to be harvested each year.

However, if a forest is entirely felled at once, it will give a short-term flush of timber. The forest will be depleted and will not yield again for many years until new trees have been replanted and matured. Moreover, if a forest is clear-felled, the soil on which the trees depend risks being eroded.

The value of stewardship has been recognised by many communities over history. For example, when the Iroquois Confederacy, a group of Native American nations, was making decisions, it considered the possible consequences seven generations into the future.

In Europe, stewardship of forests was formalised in the 18th century in Saxony, a region of what is now Germany, in response to a problem. Forests were being felled at an increasing rate to supply timber for the expanding mining industry and growing population. Insufficient attention had been given to replanting trees to preserve the forests. The local silver mines needed timber, but it was becoming unavailable and unaffordable. Hans Carl von Carlowitz, the local tax accountant and mining administrator, studied forestry practices across Europe. In his seminal book "Sylvicultura Oeconomica," published in 1713, he proposed that the *"conservation and growing of wood is to be undertaken in order to have a continuing, stable and sustained use, as this is an indispensable cause, without which the country as we know it cannot survive."*

Drawing on this analogy, we understand stewardship to mean taking care of something of value, often on behalf of others, so it can deliver benefits for the long term.

A forest can offer a sustainable yield of timber, if it is well-tended and if selected trees are harvested each year.

HOW DOES STEWARDSHIP RELATE TO BUSINESSES?

When Generation was launched, we sought to integrate stewardship into the design of our investment approach. The principles of taking a long-term perspective and of nurturing the assets on which future yields depend inform our definition of a sustainable company.

Firstly, we recognise that a company can try to increase its profitability in the short term through measures such as reducing product quality, squeezing suppliers and postponing maintenance. However, this risks weakening the company and reducing its ability to generate strong future growth and profits. Conversely, if a company is managed for the long term, it will ensure it does not "borrow from its future earnings" and erode the assets on which its success depends in a bid to boost short-term results.

Secondly, we focus on what a company provides. If a company's products or services meet real needs of its customers, then it is likely to continue to generate strong revenues. We seek to invest in companies that are consistent with a clean, fair, safe, and healthy society. If, in contrast, a company serves more superficial or transient needs, it is less likely to endure. Companies whose products or services impose significant costs on society or the environment face risks to their growth, profitability and, potentially, even their existence if regulatory and consumer pressure force them to change or to raise their prices to reflect these costs.

Thirdly, we consider how companies are managed and governed. We recognise that companies which operate responsibly, treat stakeholders – such as employees, suppliers, customers and regulators – fairly, and take a long-term perspective in their decision-making tend to prosper. Research is now confirming this; finding that companies with more sustainable practices achieve better financial performance and stock market returns than their peers.[3]

3. See, for example, "The Impact of Corporate Sustainability on Organisational Processes and Performance"; Robert Eccles, Ioannis Ioannou and George Serafeim; March 2012

If a forest is entirely felled at once it will be depleted and will not yield again for many years. Moreover, if a forest is clear-cut, the soil on which the trees depend risks being eroded.

OUR INVESTMENT STRATEGY

Our investment strategy is to take a long-term perspective and to integrate fully sustainability research within a rigorous framework of traditional financial analysis. It is founded on a related set of beliefs: that much of the value of companies derives from their long-term performance, and that sustainability factors have a material impact on companies' returns over the long term. In contrast, we have observed that investment markets generally focus on the short term and that investors tend not to take full account of sustainability factors.

We undertake in-depth research to apply our investment strategy. Building on our definition of a sustainable company, we focus on two aspects of quality:

– "Business Quality": attractiveness and robustness of a company's strategy.

– "Management Quality": how well a company is managed and governed.

These criteria are used to select a "Focus List" of companies, from which the portfolios are constructed.

We are high conviction investors. Each investment analyst only covers around twelve companies. This means we develop a thorough understanding of the companies in which we are invested.

In Cherrapunji (Northeast India) tree roots are woven together to grow into bridges. Some bridges are strong enough to carry 50 people and thought to be over 500 years old.

HOW WE UNDERTAKE STEWARDSHIP

Stewardship is an integral part of our investment strategy.

As investors, we understand stewardship to mean using the opportunity we have to engage with companies in which we are invested, and voting on their proxy resolutions, to contribute to improving their long-term performance.

We are stewards of the capital of the ultimate beneficiaries. As an investment manager, we sit in the middle of a stewardship chain that runs from beneficiaries and asset owners (such as pension funds), to company boards and management teams.

In our stewardship work we draw a distinction between the closely-related activities of dialogue and engagement. We view discussions with a company to share and/or gather information as dialogue. We understand engagement to be interactions with a company with the objective of contributing to a specific change in the company.

Our dialogue with companies usually starts before we invest. As part of our due diligence we aim to form as thorough a view as we can of "Business Quality" and "Management Quality" through our own research and by talking with a company's management. As we are long-term investors, the relationships formed with companies often deepen over many years.

Discussions provide an opportunity to learn about companies and how they are managed. We also share insights from our research that we believe are material for each company. As we are a specialist sustainable investment manager, we find that management teams are often particularly interested in discussing our perspectives on how sustainability factors are materially affecting their company and sector.

We monitor all the companies on our Focus List by cconsidering insights gathered from public data, from our own research and from discussions with management of the companies. When monitoring companies, we specifically assess whether there are any changes to our evaluation of Business Quality and/or Management Quality or any changes that could affect our view of the fair value of the stocks. Our monitoring encompasses a wide range of factors including strategy; financial areas such as capital allocation and capital structure; corporate governance considerations such as remuneration; and sustainability issues such as disclosure and corporate culture. Typically, we then engage on topics identified through our monitoring that could, in our view, create material risks for a company or, in contrast, offer significant opportunities to enhance its performance. If a risk identified through our monitoring reduces our assessment of Business Quality or Management Quality below the threshold for inclusion on our Focus List, we will tend to remove the company from the Focus List.

We prefer to approach engagement constructively. In addition to specific engagements with individual companies, we also engage with all companies on our Focus List on topics such as diversity and the climate crisis that we view as material for all companies.

In line with our integrated investment strategy, our investment analysts are responsible for the monitoring of, and engagement with, companies. We believe this is beneficial, as the analysts have a thorough understanding of each company and can incorporate insights gained from discussions into their appraisal of the companies.

We take the issue of conflicts of interest very seriously. During our stewardship activity, and our overall business, we seek to identify potential conflicts of interest and to mitigate the risks they may pose. We believe our risk of conflicts of interest is relatively reduced as we only invest in one asset class and only undertake investment management. However, during our stewardship work we recognise the potential for conflicts of interest in areas such as acting on behalf of clients with different objectives, or engaging with a company with which we have a commercial relationship. Our Conflicts of Interest Policy explains how we manage such risks.

During conversations with companies, we generally seek to avoid becoming "insiders" as we are conscious that this may impact our ability to effectively manage our clients' assets. However, should circumstances warrant it, following advice from the firm's General Counsel and a discussion with the Senior Partner and adhering to all required protocols, a senior portfolio manager may become an insider. The key rationale in making this decision would be based upon the seriousness of the issue and the prospect of influencing a satisfactory outcome.

ACTIVE STEWARDSHIP

We seek to be engaged investors in the best interests of our clients. Sometimes clients ask us about our position on "activism". While there is no common definition of activism, we note the comments by past SEC Commissioner Daniel M Gallagher that *"it is simply the actions of investors who are dissatisfied with management's decision-making and corporate strategy and who, rather than selling their shares, try to force those companies to change"*. We think this is a helpful summary.

On this definition, Generation would typically not be viewed as activist in the classic sense. We generally do not seek to invest in companies that are "broken" and subsequently express our dissatisfaction with the decision-making and corporate strategy that got them there. Rather, the opposite is true; we will have formed a broadly positive view on the Management Quality of the business – possibly with some reservations or expectations for improvement. We therefore tend to work in a constructive way alongside management teams, helping them to develop companies in which we have conviction. This approach is increasingly being termed "constructivism" and is the bedrock of Generation's approach to engagement.

It is, of course, possible that companies in which we have conviction at the start of our investment process subsequently meet management and strategy challenges. Should this occur, Generation is entirely open to becoming more activist but this is a step that is likely to occur infrequently. A key reason for this is the impact of accompanying regulations around the world which can constrain our flexibility to manage portfolios on behalf of our clients. At one extreme, taking steps (potentially with third parties) to seek substantial changes, such as changing the composition of the board of a company or materially alter its strategy, is something that is of general interest to the market. Consequently, applicable regulations put in place disclosure obligations as well as, in certain circumstances, restraints on further purchases or sales of the securities and rules about how a shareholder may work in concert with others. (An example is given in the Notes section at the end of the document.)

Nine out of thirteen of Africa's oldest Baobab trees have died since 2005. It is thought their demise is associated with climate change. Some of these trees were up to 2,500 years old.

HOW WE APPROACH VOTING

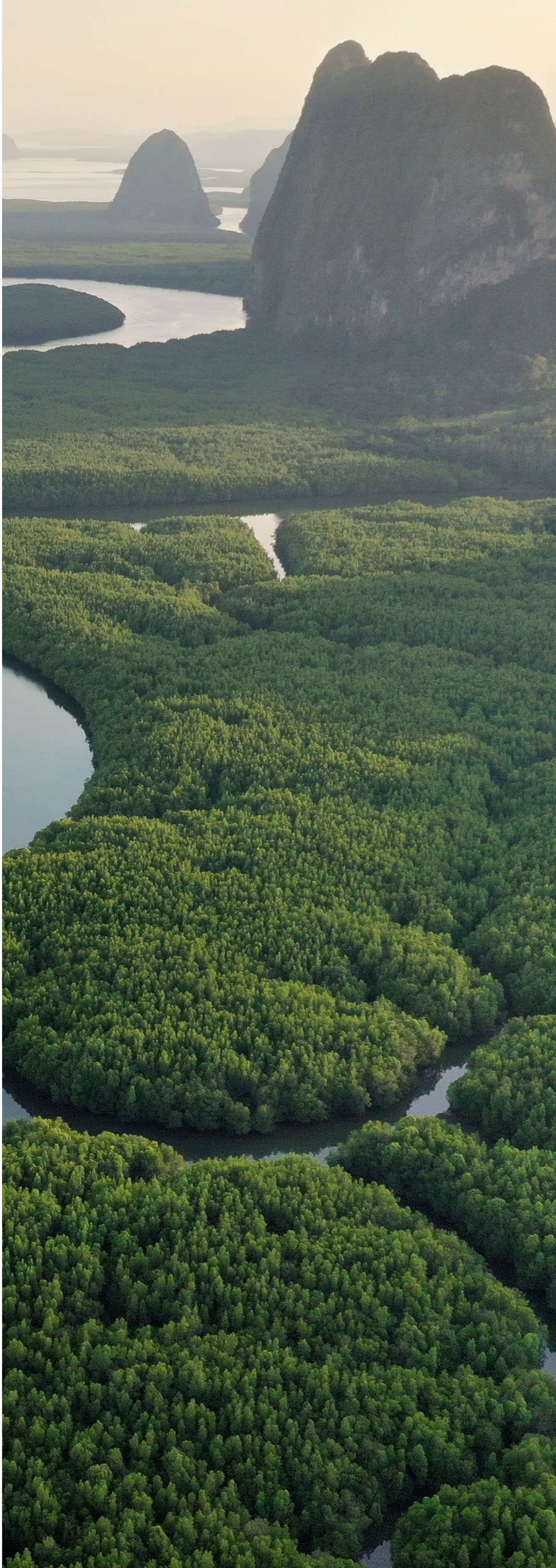
We see exercising our voting rights as an essential part of stewardship.

In accordance with appropriate regulations, boards have a fiduciary duty to ensure that companies are managed in the interests of their shareholders and other stakeholders. Voting is a way of signalling to a company's board our views on corporate governance matters. It is also a way of holding a board to account. We coordinate our engagement and voting activities. For example, if a company is unresponsive to engagement on a particular topic, we may vote against the most relevant proxy at the next opportunity.

We vote our own proxies and undertake engagement activity ourselves, rather than employing service providers to handle these activities on our behalf. We aim to vote all of the proxies of companies in which we are invested. We draw on the research of an independent voting service provider to help inform our voting decisions. However, we do not automatically adopt global proxy voting rules from any third-party service as a default setting. This is because we believe each analyst should review the relevant corporate governance issues on a case-by-case basis and exercise their best judgement on how to vote, given their deep knowledge of the company. In part, this is feasible because we have a small portfolio.

Each year we will disclose publicly, and to our clients, a summary of our voting and engagement activity. Our Proxy Voting Principles describe further our approach to voting.

Forests are home to around four fifths of the world's terrestrial biodiversity, help regulate global weather systems, and contribute to mitigating climate change by absorbing carbon dioxide. Around half of the world's forests have been lost since 1950.



HOW WE COLLABORATE ON STEWARDSHIP

We recognize that as participants in the capital markets, we have an opportunity and responsibility to work with other investors to protect and enhance long-term shareholder value in line with our collective clients' best interests.

We tend to engage with companies on an individual basis as we find personal, direct conversations are often most effective and contribute to building long-term relationships with management teams. However, where appropriate, and subject to careful legal analysis around "concert party", "group" and related regulatory issues, we consider collective engagements.

At a systemic level, collaboration with other shareholders, stakeholders and policy makers is essential to promote continued effective functioning of the financial markets and to address the sustainability challenges we face. As part of our investment research, we focus on identifying systemic risks, particularly those created by sustainability factors.

OUR FOUNDATION'S WORK ON STEWARDSHIP

The Generation Foundation, which is a distinct entity from the investment manager, focuses on advocacy and policy work to address systemic risks created by sustainability factors. Our Foundation identifies opportunities for collaboration with policy-makers, NGOs and other investors on policy engagement topics which are high priorities for protecting systemic integrity and on which its insights are particularly applicable. Since its establishment, it has, for example, focused its systemic engagement work in the areas of the climate crisis and fiduciary duty.

The Pando aspen in Utah (USA) is the largest living organism on Earth. Around 47,000 trunks share a common root system.

NOTES

Example of regulations relating to activism:

An example of this occurs in the United States. Under US disclosure rules, Generation will typically be a "Schedule 13G" filer which, in broad terms, means that we are subject to fewer market disclosure rules because we are seen to be a "passive" investor. Schedule 13G allows a degree of nimbleness to passive investors that is welcome. Active investors, on the other hand, file under "Schedule 13D" which requires more extensive and frequent disclosure. In addition, a particular consideration here is the potential need for a "Hart-Scott Rodino Act" ("HSR") filing as a Schedule 13D filer that would typically not arise in the case of a Schedule 13G filer. HSR requires parties to mergers, acquisitions and certain other transactions to file pre-merger notification with the Federal Trade Commission and the Department of Justice Antitrust Division, and then observe a 30-day statutory waiting period before consummating the transaction. Such a filing would typically not reflect Generation's intention in acquiring securities but may be triggered by an overtly activist approach. These filings are complex and relatively costly, so are not undertaken as a matter of routine. Similar regulatory considerations apply around the world. of routine. Similar considerations apply around the world.

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