EUROPEAN LONG/SHORT

MARTIN CURRIE
A Legg Mason Company

ENIVRONMENTAL, SOCIAL AND GOVERNANCE (ESG)

JULY 2018 FOR PROFESSIONAL CLIENTS ONLY

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- Effective stewardship of capital is at the heart of our client proposition
- ESG is integrated into our investment process
- We focus on governance factors and their impact on sustainable returns
- Company engagement is at the forefront of our investment approach
- The strategy benefits from Martin Currie's leading ESG approach and expertise
- Ultimately, ESG builds conviction in both long and short investments

WHY WE BELIEVE ESG ADDS VALUE

Environmental, Social and Governance (ESG) refers to a range of factors that may impact the ability of companies to generate sustainable and improving returns over the long term. ESG analysis helps us to understand how a company and its management will behave and provides insight into the risks and opportunities for the business. Our focus is always on what is material and relevant to the business concerned. Our approach means that we can make better informed decisions, identify areas to engage with the company and vote proxies in an informed manner.

OUR APPROACH TO ESG

We place particular emphasis on Governance, which stems from the belief that this is a fundamental determinant of long-term performance. Governance problems are more often than not reflected in a company's environmental and social track record, making it a reliable proxy for broader sustainability.

Through an understanding of how decisions are made, how capital is allocated in the business and how the management approaches both risks and opportunities, we gain invaluable insight into the corporate culture.

There are three core areas to our Governance analysis:

1 MANAGEMENT COMPENSATION

Strong practice

- CFROI
- Cashflow margin

Weak practice

- Revenue growth
- Adjusted/Core EBIT

We believe that incentives should be clearly linked to value creation, and metrics used should be aligned to strategy and not be subject to interpretation. We recognise the benefits of a focus on cash based measures such as Cash Flow Return on Investment (CFROI) and cashflow margins. When compensation is linked to revenue growth and adjusted margins, this can lead to misallocation of capital in an attempt to grow revenues rather than returns on invested capital.

2 MINORITY SHAREHOLDER TREATMENT

Strong practice

- Interests protected

Weak practice

- Interests ignored

We assess whether the ownership structure and strategic interests are aligned with minority shareholder interests, and explore how and why companies buy and sell assets and their cash return to shareholders.

In addition, understanding how a company identifies and manages the relevant material environmental and social issues also tells us a great deal about how the management are likely to strive to improve shareholder value.

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3 ACCOUNTING

	Strong practice	Weak practice
Cashflow margin	Stable/improving	Falling
DSO	Stable/falling	Rising
DSI	Stable/falling	Rising
Exceptionals	Infrequent	Continuous
Off Balance Sheet Items	Low	High

Our focus is on the quality of balance sheets and profit margins. Those exhibiting poorer governance will report deteriorating balance sheet metrics, notably receivables (DSO) and inventories (DSI). This can often be due to a focus on short term results, pulling forward revenues and profits at the expense of future profits. Under investment in R&D and IT will lead to problems in future growth and competitiveness.

There is an increasing tendency for management teams to focus on adjusted profit margins thereby booking continuous restructuring charges and cash outflow.

We also place great emphasis on understanding how credit investors view a company. A company strategy that is credit negative can only be bearish for equity investors.

Our long short strategy benefits from identifying those companies with robust or poor management of these Governance factors.

SHORT ⟷ LONG

Weak Governance management — Strong Governance management

ENGAGEMENT AND PROXY VOTING

We are motivated by a firm belief that company engagement and proxy voting both help protect, and enhance the risk-adjusted return on our clients' capital.

Engagement with company management

Engagement has always been at the forefront of our investment approach. We primarily meet management to understand and discuss the major long-term drivers within their industries and how their strategy will create shareholder value.

Our engagement is predominantly through one-on-one meetings with management but we also recognise the value of small group meetings and quarterly results' conference calls.

We meet around 300-400 company management teams each year. Engagement topics include:

- Identifiable business strategy
- Barriers to entry
- Quality of management
- CFROI spread to cost of capital
- Balance sheet
- Cashflow
- Valuation of a company is determined by the cash flow that it generates

ENGAGEMENT ACTIVITY EXAMPLE:

UK MATERIALS COMPANY

Reason for engagement

The company was pursuing a highly acquisitive strategy but we noted the main KPIs for executive compensation were 'adjusted' Earnings Per Share (EPS) and Earnings Before Interest and Tax (EBIT), which excluded a large proportion of costs associated with this strategy e.g. goodwill, integration and transaction costs. To finance the continuous stream of acquisitions, the company had carried out a large rights issue which diluted Return on Capital Employed (ROCE). This raised a material concern that management were being incentivised to acquire companies to bolt on adjusted profits without regard for reported margins including exceptionals and ROCE.

Furthermore, despite the company spending 2x on capital expenditure as % of sales, relative to peers, there was no reference to organic growth in the compensation mechanism.

We also felt that the targets set for management were not challenging enough. They had paid out at nearly 100% for three years running, with the resultant compensation (cash and shares) coming at further expense to the minority shareholders.

ISS, our proxy voting advisor, noted in their voting recommendations* that acquisitions created "a situation whereby Executive Directors benefit from the uplift in earnings delivered through M&A activity, but are not exposed to the drag of related transaction, integration and restructuring costs, which are treated as exceptional items. Effectively, the incentive structure allows EDs to access the upside of the highly acquisitive strategy, without assuming downside risk. "

Objectives

We wanted an incentive scheme that placed greater emphasis on ROCE and free cash flow generation, which we think are the primary drivers of shareholder returns in the long run, along with more ambitious targets, to make the performance-related pay more meritocratic.

Scope and process

We sent a letter to the remuneration committee in June 2017, outlining these concerns and our recommendations. At the 19 July 2017 trading update, the company announced a review of the remuneration performance measures and targets used under both the annual bonus and long-term incentive plan.

Given our early engagement on the topic, we met with the head of the remuneration committee in January 2018 to discuss the framework for KPI selection and target setting.

Engagement outcome

Whilst the dominance of adjusted EBIT in the annual bonus plan was reduced and an adjusted ROCE measure was added to the longer-term incentive plan, we felt that these changes were not radical enough.

They still excluded a large proportion of costs inherent in the strategy and did not incorporate anything tied to the return on organic capital investment – which led us to question the true merits of their outsized organic capex.

This outcome, in conjunction with our further work on the regulatory outlook for plastic packaging, led us to dramatically reduce our mid-term financial estimates and the ratios we used to value the business. As a result, we sold our long position later in January 2018 and initiated a short position in May 2018.

Daniel Medley
Investment Analyst

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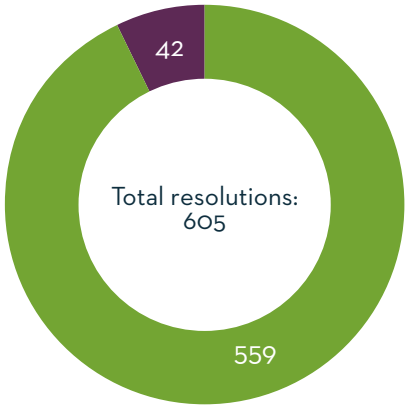
*ISS Proxy Analysis & Benchmark Policy Voting Recommendations, July 2017.

ADVOCACY THROUGH PROXY VOTING

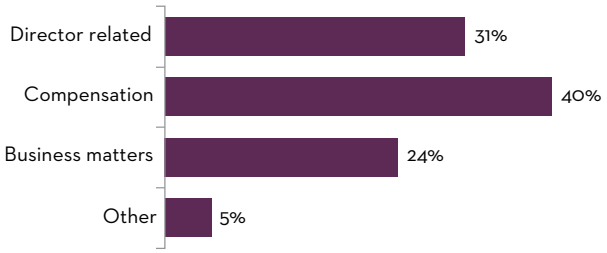
As well as helping improve our understanding of companies and their governance structures, company engagement also informs our voting decisions. In addition to our own internal assessment work, we work with ISS as our proxy voting advisor. All our voting decisions are made in-house and are in line with our clients' best interests. We assess voting matters on a case-by-case basis, taking into account a company's circumstances and guided by our Global Corporate Governance Principles and Proxy Voting Policy.

2017 European Long/Short voting activity



- Number of resolutions voted in line with management
- Number of resolutions voted against management

2017 categories for votes against management



Source: Martin Currie. Voting activity between 1 January 2017 and 31 December 2017, for the representative Martin Currie European Long/Short account.

ESG RESEARCH

In addition to our own in-house research, we have access to external research acquired from both brokerage houses and from dedicated ESG research providers. MSCI ESG is our main external ESG research provider – they produce both company specific and industry research. This can provide a useful assessment of the ESG risks and opportunities facing a company, how they are being managed and a perspective on where the company sits relative to peers via a rating system.

SUPPORT FROM ESG INFRASTRUCTURE

The European Long/Short strategy benefits from Martin Currie's leading ESG approach and expertise:

Dedicated resource

Martin Currie has a senior member of the investment team dedicated exclusively to ESG – David Sheasby, Head of Stewardship and ESG. In this role, David oversees implementation, identifies best practice and provides ESG expertise. He also ensures we have the tools and training needed to articulate our approach externally to clients and consultants, and manage relationships with external service providers, specifically the relationship with the PRI.

As we know the companies best, we are responsible for day-to-day ESG analysis and active ownership; however, we work in close collaboration with David to consider the material and relevant ESG factors that could impact the ability of the company to generate sustainable returns.

"We assess voting matters on a case-by-case basis, taking into account a company's circumstances and guided by our Global Corporate Governance Principles and Proxy Voting Policy."

Principles for Responsible Investment

We have been signatories to the PRI since 2009 and report each year to the PRI on our approach to ESG integration, governance of the process and our approach to active ownership including engagement and proxy voting. In 2017, the PRI awarded Martin Currie an 'A+' (highest performance band) for each of the three top-level categories: 'strategy and governance', 'incorporation' and 'active ownership'. Given our emphasis on stewardship and active ownership, this is a significant endorsement.

David works extensively with the PRI on their collaborative engagement programmes. He was appointed to the ESG Engagement Committee in 2017 which oversees the collaborative engagement program. David has also been on the steering committees of a number of collaborative initiatives, such as cyber security and tax reform, as well as participating and leading engagement on target companies in these engagements.

*A copy of the PRI's assessment of Martin Currie and methodology is available on request.

**Categorised as Tier 1 signatory to UK Stewardship Code. The trademark shown is that of the respective owner and is used for descriptive and illustrative purposes only. The company trademark shown is not in any way associated, or to be deemed to be associated, with Martin Currie or its group of companies.

Signatory of:

PRI Principles for Responsible Investment™

PRI signatory – since July 2009

Industry recognition

A+ **Strategy and governance**

A+ **Incorporation**

A+ **Active ownership**

Highest possible ratings by PRI*

Tier 1

Tier 1 ranking by the Financial Reporting Council**

FIND OUT MORE

For further information on Martin Currie or our strategies, please visit our website – **www.martincurrie.com**
You can find your local contact at **www.martincurrie.com/contact_us**

IMPORTANT INFORMATION

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Risk warnings - Investors should also be aware of the following risk factors which may be applicable to the strategy.

Investing in foreign markets introduces a risk where adverse movements in currency exchange rates could result in a decrease in the value of your investment.

Emerging markets or less developed countries may face more political, economic or structural challenges than developed countries. Accordingly, investment in emerging markets is generally characterised by higher levels of risk than investment in fully developed markets.

This strategy may hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the portfolio's value than if it held a larger number of investments.

Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.

Investors should be aware that the currency hedging strategy employed by the strategy mitigates the currency exchange risk, but may substantially limit shareholders from benefitting if the portfolio currency falls against the reference currency.

The strategy may invest in derivatives (CFDs (Swaps), Index futures and FX forwards) to obtain, increase or reduce exposure to underlying assets. The use of derivatives may restrict potential gains and may result in greater fluctuations of returns for the portfolio. Certain types of derivatives can be difficult to purchase or sell in certain market conditions.

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