

OUR APPROACH TO ESG - ASIA EQUITY (EX JAPAN) TEAM

October 2018

The NIKKO AM Asia Equity (ex Japan) Team's perspective on ESG

ESG assessment is an integral part of the Team's Investment Process

ESG issues are taken into consideration as a part of the Asia Equity (ex Japan) Team's investment process and the management of client portfolios. ESG can (but does not always) impact valuation assessment where discounts may exist or companies may deserve a premium because of superior ESG considerations. The Team's analysts actively research and score companies based on their relative promotion of ESG factors. Strong ESG scores imply potentially long-term sustainable businesses and the relative attractiveness of those companies as an investment.

Supplementing the investment process with an ESG score

ESG factors alone do not determine the Team's final decision on a company. Acceptable ESG is a requisite for ultimate investment in a company but is not the sole determinant. Other considerations include the sustainability of a company's returns/profitability, fundamental positive changes if any, financial indicators, quality of management and stock price valuations. However, where negative ESG issues are identified in the investment process with little or no evidence that corrective measures are being taken, the company is excluded from investment consideration regardless of their strength in other areas.

The Team incorporates ESG across various stages of the investment process:

- **Idea Generation**
Screening flags, 3rd party data support
- **Fundamental Analysis**
Integrated research process and relative scoring on Environmental, Social and Governance factors. An assessment of the beneficial ownership track record here is also key. Active debate of investment merits will ensue before rating is finalised.
- **Portfolio Construction & Risk Management**
Sell Discipline. The rating of a company can be downgraded to SELL1 or SELL2 for negative ESG developments depending on the severity of the issue. Independent team checks on low ranked & downgraded stocks.



The outcome of an ESG assessment in the investment process is used as a risk flagging tool and can have a bearing on the final decision on a stock.

Navigating through the complexity of ESG factor analysis with past experience

There is consistent evidence good governance is a key indicator of long term value creation in emerging markets (EM). Recent research¹ has shown ESG momentum positive EM companies had higher average Sharpe Ratio vis-à-vis their ESG momentum negative counterparts.

¹ ECCE & NN IP Research "The Materiality of EG Factors for Emerging Markets equity investment decisions" Oct 2016

Nikko AM Asia Equity (ex Japan) Team

- **Cohesive Team**
The 18-member Team has an average of 17 years of industry experience. Key members share the same investment philosophy, having worked in close partnership for over a decade.
- **Robust Investment Process**
The investment process was developed and implemented by the same key members of the team ten years ago. Enhancements and refinements were made over the years to adapt to changing market dynamics.
- **High conviction portfolio**
To build a high conviction portfolio that is benchmark agnostic and fundamentally driven, with a macro overlay.

However, the use of ESG factors in the search for alpha is complex, particularly in Emerging Markets (EM). The subject of what constitutes proper ESG criteria is debatable. The varying standards in the quality and quantity of ESG related data from the companies in the region, as well as less than robust institutional controls, makes it harder to assess the effectiveness of ESG policies among corporates. Disclosures on environmental and social issues also tend to be weaker where most are focused on philanthropic activities. All these can add subjectivity to the methodology.

The contribution of ESG to investment performance is more a priori and often than not, difficult to establish in EM. ESG assessment – in particular (corporate) governance factors – has been an integral part of the Team’s investment process since inception over 10 years ago. The Team applies its defined set of ESG criteria to stocks within the investible universe. This allows the Team to look for alpha opportunities without relying on a benchmark screening approach. A good portion of the Asian Equity portfolios currently comprises stocks not covered in its benchmark (MSCI Asia ex Japan Index) but rate highly on the Team’s ESG criteria. These include companies involved in waste water treatment, healthcare services and solar panel glass manufacturing.

With past experience and attention on this subject, ESG is an area the Team can add value as active fundamental research based investors, and can set the Team apart from competition.

ESG Screening

The Team assesses ESG risks on the companies during the stock selection process. All known companies with negative ESG issues are flagged in the research database and are considered ineligible for investment unless the company has shown tangible efforts to improve. Analysts continually evaluate companies and their behavior towards ESG issues are updated in the database as appropriate. The team also utilises 3rd party data providers’ scoring and analytics tools.

ESG Assessment – An illustration

The Team actively researches and scores companies based on Environmental, Social and Governance factors. We believe that a company’s corporate governance framework must promote timely, accurate and transparent disclosure of important information, giving a complete picture of the company’s performance and prospects. The below chart is an example of a detailed research report.

Detailed Fundamental Research example

Company Name: nikko am

Background: Franchise & Competition, Management & Strategy, Fundamental Change

Key Findings:

- Established franchise, niche products
- High barriers to entry
- Low intensity of competition and low threat of substitute products
- Long term management track record
- Superior operating model vs. peers
- Capital allocation, shareholder focus and dividend characteristics
- Alignment of interests
- Sustainability of earnings growth
- Identify potential to surprise consensus
- Cross check for anomalies
- Actively research and score companies based on their relative promotion of Environmental, Social and Governance factors
- Strong ESG scores to identify long term sustainable businesses

ESG ASSESSMENT (1-10)

Valuations: P/E Ratio (FY), P/B Ratio (FY), EV/EBITDA (FY), EV/EBIT (FY), EV/FCF (FY)

Key Investment Drivers: [Listed in report]

Key Investment Risks: [Listed in report]

Source: Nikko AM, 30 April 2015

Voting & Engagement:

The Asia Equity (ex Japan) team regards voting as an integral part of being a responsible steward of capital. Proposals for existing investments are evaluated individually and voted accordingly. Voting recommendations and ballot services are utilised in carrying out proxy voting. Where a material proposal is put forth, the Team will seek to engage management to better understand the proposal and express the Team’s opinion in its capacity as investment manager acting on behalf of minority shareholders.

An Introduction to the Nikko AM Asia Equity (ex Japan) Team:

Philosophy

The Asia Equity (ex Japan) strategy is based on the belief that Asian markets are inefficient and individual stocks are prone to periodic mispricing. The Team’s investment process is driven by the belief that highly active management based on thorough fundamental research can take advantage of these mis-pricings to deliver strong returns over the long term.

All stocks in the portfolio reflect the Team’s conviction in the need to find sustainability of return and/or positive fundamental change.

Investment Process

The Asia ex Japan equity strategy adopts a five-step integrated investment process as shown below.



Nikko AM’s Commitments:

Nikko AM has been a **signatory of United Nations Principles for Responsible Investing (UN PRI)** since 2007. Nikko AM has also launched Japan’s first SRI fund and has a history of innovation across all asset classes. Our adoption of the Japan Stewardship Code is set out on our website.

Nikko AM is a member/signatory of the following organisations and initiatives:

- **Principles for Financial Action for the 21st Century:** Nikko AM actively engaged in initiatives from Japan's Ministry of Environment as one of the members of the drafting committee, and we are a steering committee member of Principles for Financial Action for the 21st Century
- **CDP (formerly Carbon Disclosure Project)** – Nikko AM is a signatory since 2006, a global disclosure system that enables companies to measure and manage their environmental impacts.

It is important to note that we do not exclude particular asset types, industry sectors or securities wholly on moral or ethical grounds, unless this is expressly built into the product’s investment strategy or client agreement.

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