WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

Responsible Investing: An Integrated Investment Approach

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Introduction

This document was written and prepared in October 2018 and updated in October 2019.

As long-term, research-driven investors, investing responsibly has always been at the heart of Walter Scott's investment approach. Environmental, social and corporate responsibilty, and sustainability, are embedded in our research, analysis and assessment process.

Walter Scott's investment approach is based on the conviction that share prices are ultimately a function of the changes in the intrinsic value of a business, as profits, cash flows, equity and dividends grow over time.

We employ rigorous fundamental analysis in an effort to invest in exceptional, wealth-creating businesses on a long-term basis. The process requires intense and collective scrutiny. In seeking out market-leading companies, the examination of Environmental, Social and Governance (ESG) factors is integral to our deep analysis. The premise is simple: we believe that corporate adherence to the highest standards of procedures and practices across the ESG spectrum is inextricable from the long-term financial performance of a company.

Each company is viewed on its own merits, and from that standpoint, our process is deliberately structured to screen out companies where ethical, governance, environmental or social standards are deemed to put the achievement of the long-term portfolio return targets at risk. Any company that does not meet our rigorous standards will simply not be a potential investment candidate.

Similarly, any company we have invested in that no longer meets the firm's stringent investment criteria, of which ESG considerations are a component, will be sold.

We look for companies with the market position, financial strength and strategic vision to grow and compound returns over time. Companies with that vision, focus and perspective are rarely those that ignore, or seek to manoeuvre around, sustainable and ethical practices.

ENGAGEMENT*

Walter Scott takes an active approach to engagement. The firm's investment process leads to a relatively small number of investee companies. Coupled with a long term investment outlook, and generally long holding periods, conversations with senior management are typically regular and constructive.

The Research team aims to engage with the majority of investee companies annually. Before any investment is made, members of the team will generally have engaged with the company. Engagement activity typically involves face-to-face meetings, either at Walter Scott's office or on a research trip, and conference calls. Research trips may include site visits and meetings with various stakeholders. Written correspondence may augment engagement.

The approach to engagement is tailored, therefore interactions vary in nature and length with any material issues or concerns being prioritised. As Walter Scott invests in companies across different geographies and sectors, the environmental, social and governance issues each company faces will differ. It is the Research team's responsibility to identify salient issues, communicate with the company and to monitor progress and outcomes.

*Extract from Walter Scott's Engagement Policy

Our approach

As responsible investors we take a bespoke, rather than formulaic, approach to ESG analysis

We work hard to close our ears to short-term noise and transient uproar, while of course being alert to news and developments. Rather, we take a holistic view of how ESG considerations affect a company, its shareholders andits stakeholders.

Our ESG analysis is tailored according to each situation, and we do not employ generic templates or catch-all guidelines in the assessment of stocks. As active managers, we explore dimensions that quantitative processes ignore or neglect.

Our process assesses all aspects of a company's operations – from inputs to the final production and sale – to gauge the full spectrum of ESG considerations as they apply to a business.

Good ESG practices and successful businesses typically go hand-in-hand, and potential positions need to be analysed in that context. As such, Walter Scott does not have a separate ESG team. This is a deliberate policy and one that reflects our belief that ESG considerations should be integral to investment analysis and decision-making, not merely an adjunct to them. It is the responsibility of every member of the Research team to embrace ESG considerations in the investment process.

Each individual proponent of a stock identifies ESG-related material risks, challenges and opportunities – and assesses how a company manages them. This task is augmented by research meetings, making use of the wider group's vast experience and broad knowledge, embracing the synergy that a genuinely collegiate environment brings. Through desk-based research, meeting company management teams, attending conferences and engaging with industry peers, customers, suppliers and other relevant experts, pertinent ESG matters can be brought under the analytical lens and assessed.

Company engagement is a vital component of the process. Accordingly, the Research team meets senior management regularly to assess and analyse all aspects of a company's operations and practices, including those that are ESG-related. Last year, there were more than 700 contacts with companies, including face-to-face meetings, telephone calls and other communications.

As long-term shareholders, we build strong relationships with companies over many years. Through long-standing dialogue, we can question, prod, promote and argue various issues that are of importance and concern.

FINANCIAL LETTER: JAPAN INC.*

Open and transparent dialogue

Thank you for visiting us in Charlotte Square yesterday. We all felt that the meeting was a constructive and informative one.

As you know, we invested in Japan Inc.* back in 1991 and since then have met with senior management as well as factory managers many times. Over those years, we have established a very healthy level of dialogue, certainly from our perspective. We have talked many times about more open investor communications and the merits of a dedicated investor relations team. While we were always aligned in a belief that senior management should be focused on the business, and the long term, rather than be distracted by what might be viewed as short-term public relations, transparent and open communications with shareholders is now an accepted norm; a minimum requirement for many.

As we expressed in our meeting, we were delighted to learn that you had established an investor relations department. We were also honoured that your first ever meeting with investors outside Japan took place in our offices.

As we hope you will have gathered from us over the years, our focus is long-term, and consistency runs through everything we do. In that context, we appreciate your disciplined focus on long-term growth, evidenced in the company's success over many years. While not distracting from that focus, we equally appreciate your gentle evolution in investor communication and transparency of information.

In any company investment, we are in many ways delegating the responsibility we owe to our clients to the management of that company. Such delegation requires a lot of hard work on our part, but also trust and communication. Over many years, our confidence in your company has only grown.

This is indicative of a handwritten letter.

*In communicating with clients, handwritten notes and letters are often sent as well as emails. Likewise, meeting feedback can be shared with the team through long and short form reports as well as bullet point speaking notes. In sharing these communications in this document, we have edited original documents and replicated from memory handwritten notes in order to share the spirit of our views in a more concise manner. We have also removed the actual company names for regulatory reasons.

RESEARCH TRIP NOTE: FRACKING

Understanding the true sustainability of shale gas production.

West Texas is very much the home of the fracking industry, which is synonymous with environmental issues. This trip allowed us to evaluate the proactive initiatives being taken by oil and gas companies operating in this area to address environmental costs and social questions.

Fracking requires vast quantities of water and much of the productive shale acreage in the US is in water-stressed regions, such as West Texas.

We met the CEO of long-standing holding Energy Inc.* to discuss this matter, among other operational aspects. Relative to its peers, Energy Inc. is in a better position regarding water assets. But generally in this industry, substantial infrastructure is required to develop the water resources necessary to fracture thousands of acres of rock. And this requires considerable spending.

Multiple stakeholders in the shale industry are demanding environmentally friendly resource development, and responsible water usage and recycling are playing a key role in that. Energy Inc. is at the forefront of water recycling initiatives. With water being a big input cost for the business, recycling initiatives align environmental considerations with resource utilisation in a relatively cost-effective manner.

On the health and safety front, the company's recordable incident rates are falling. Safety and environmental management are among the factors considered in evaluating employee performance and compensation throughout the organisation. While Energy Inc. has been an exemplar of this, tying ESG considerations to remuneration has become more prevalent throughout the entire industry.

*These are edited notes, please see page 5 for further explanation.

Seven steps to evaluate ESG factors

How our research process determines risks and opportunities

Assessments are conducted in the context of an analytical framework that is applied across all companies, regardless of geography or sector. Our framework forms an important part of the overall research process and is based on our seven areas of investigation. We evaluate ESG factors across all aspects of a company's business and therefore across all of these areas.

AREAS OF INVESTIGATION

1. **Company**
2. **Integrity**
3. **Market Characteristics**
4. **Control of Destiny**
5. **Financial Profile**
6. **Management & Board**
7. **Valuation**

Company

We must understand all aspects of a company's operations in order to determine its market position, the basis of its growth prospects and its sustainability, and therefore its long-term outlook. We must understand what matters most for that company, and its industry, in determining long-term, sustainable, success. If a business is not well positioned then, with our long-term investment horizon, it is uninvestable. In this way, we take a bespoke approach to each company, and industry, in order to focus on the issues that matter most.

We don't apply broad brush rules or sweeping exclusions. Instead, we collectively consider the context. We weigh up different factors and we acknowledge that progress towards change is often more important that the starting point.

Integrity

A company that cannot show integrity in its operating structure and practices is not a valid long-term investment proposition.

A judgement on a company's integrity depends on both financial and non-financial criteria. Any questionable practice in terms of financial management or reporting can suggest a short-termist, imprudently aggressive or, indeed, improper corporate culture. At the very least, this may diminish a company's potential to generate profitable growth over the long term.

However, the assessment of integrity goes beyond examining accounting methods. It includes looking at issues such as treatment of minorities, care for the environment and workplace rights, as well as a plethora of other ethical and governance factors.

While deep financial analysis and extended engagement with management are important ingredients in assessing the extent of a company's integrity, there are other avenues we pursue. Talking to competitors and suppliers, and assessing available ESG data and pertinent news flows relating to the company can provide meaningful insights.

We access Sustainalytics controversies reports which also helps flag areas of potential focus.

Market Characteristics

Given our long-term investment outlook and a pursuit of companies that can provide long-term growth to satisfy our return requirements, the Research team has a disciplined focus on companies with a market-leading position. The team must be assured that this position can both grow and be defended over time.

Through rigorous analysis and engagement, they must also be assured that it is grounded in a real competitive advantage or a proper barrier to entry.

There can be no shortcuts or unfair advantages derived from unethical behaviour. Such steps will not permit success beyond the short term.

Over the longer term, customer or client loyalty, as well as staff loyalty, will rest upon appropriate, proper and ethical business practices.

Control of Destiny

Walter Scott's investment effort is directed towards the search for world-leading companies, typified by those that can exercise strong influence over their future.

So, while we seek to invest in companies with the strategic and market strength to grow meaningfully over time, the team must also be assured that a commitment to the highest operational and ethical practices is central to that growth strategy.

We believe that only companies with market leadership based on reputable and ethical operating practices will retain control of their destiny.

Assurance will come from close scrutiny of a company's report and accounts, not just from the current year but dating back in time, as well any CSR or environmental reports. Industry research will be consulted and the team will engage with peers and experts as well as the company itself to gain the requisite level of confidence.

Financial Profile

Financial strength is a key evaluation metric for us – not just with regard to numbers, but also in the probity with which a company conducts its financial affairs. It is an important aspect of sustainability.

Deep inspection of a company's current and historical track record, the quality of the accounts and the auditing process permeates our analysis. Financial strength is desirable from both an operating and governance angle, as it helps a company to weather external or internal pressures as they arise. This provides us with confidence that rigorous operating procedures, standards and practices will not be sacrificed due to particular financial constraints.

Meaningful, profitable and sustainable growth cannot be met by short-term financial engineering and cost-cutting. Nor can it be achieved over the long term by intolerable business practices - be they the use of child labour or the suppression of workers' rights, for example.

Management & Board

In view of our long-term investment horizon, assessing the strategy, capability and probity of management is vital. We view this in the widest sense and examine the past records of all executive and non-executive directors. A black mark in the record of any single member of the board or senior management team will often be sufficient to bar investment.

Management structures are also carefully considered. A corporate culture that supports and respects formal policies, as well as informal practices, across the ESG spectrum must be identifiable and consistent. Therefore, the Research team will seek to understand management culture and structures. We consider how well ESG considerations are integrated into a company's strategy and operations. For instance, an increasing number of companies incorporate ESG achievement metrics in their remuneration strategy.

The team will also examine the board composition, oversight and diversity, including the role and scope of non-executive directors.

Valuation
As long-term investors, short-term, "noise-related" share price movements are generally only of interest in that they might provide a timely buying opportunity. But while we are not swayed by short-term market rumours, we are conscious that ESG-related issues can have very long-term consequences and, indeed, any such issue will be considered only in that long-term context.

The individual championing the stock, in discussion with the Research team, the company itself and if required with assistance of subject-matter experts, will determine the materiality of any particular issue as it arises.

LOG OF PROXY VOTE DECISIONS: DIVIDEND PAYMENTS

Using our Annual General Meeting vote to question historical policy.

Our first investment in Japan Corp.* was made in 1993. The subject of dividends has been an almost constant topic of questioning with company management. This is a strongly cash-generative business and the balance sheet is replete with cash. This is not a business that demands high levels of capex, yet its dividend policy has been miserly.

We have raised this matter countless times with management and have consistently voted against the approval of the dividend at the company's AGM.

Following internal discussion, we agreed to vote against the election of the company's founder, who remains a director, to further express our view that the dividend policy requires reconsideration.

*These are edited notes, please see page 5 for further explanation.

PROXY VOTING CRUCIAL TO OUR ROLE AS STEWARDS

While direct contact is a key component of our engagement with companies, proxy voting represents an important aspect of our responsibilities as stewards of client capital. It is the firm’s duty to vote client proxies in a manner consistent with the client’s best interests, without regard for any interest Walter Scott may have in the matter.

Owing to the nature of most voting proposals, our proxy voting engagement tends to fall into the governance bracket. As with all aspects of the review and monitoring of company investments, responsibility for proxy voting rests with the Research team and the relevant “stock champion”, with our Investment Operations team providing structured support.

While we are active, we are not activists – we rarely get involved in companies where shareholder activism is required.

We seek companies whose goals are aligned with ours, and if they are not at the outset, we do not invest. One outcome of this is that we have tended to vote with management resolutions, but it is far from a default position. We vote on all issues on a case-by-case basis with reference to the firm’s guidelines on certain specific issues.

CALL NOTE: REMUNERATION

Acting to align business with shareholders' best interests.

This call was arranged to express our objection to the proposed remuneration package of Entertainment Corp's* CEO, and in particular the conditions under which it would be awarded.

The CEO's tenure has been a successful one. But the call with management was specifically to address the shareholder vote regarding the granting of 933,000 shares (worth about $100 million) to retain the CEO until the end of 2021, a date that would mark the end of a proposed strategic merger.

Should the transaction not complete, the award would be 245,000 restricted stock units vesting over four years. Regardless of the transaction outcome, the proposal also included 688,000 performance-based units to vest at the end of 2021, subject to completion of the merger and achievement of the 50th percentile return relative to the total shareholder return (TSR) of the S&P 500 index.

We informed management that we intended to vote against the proposal on behalf of our clients. We expressed our view that that 50th percentile TSR target, relative to the S&P 500, was not stringent enough to merit a 100% payout. The quantum of the award was excessive in our opinion, and not aligned with shareholders' best interests.

Despite some management protestations to the contrary, we explained that we did not see this as a vote of no confidence in the merger and made it clear that we would like to see the CEO remain in his position until 2021.

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We believe in collaboration and knowledge sharing

Continuous improvement and staying abreast of trends

At Walter Scott, we employ our own approach to ESG research. But in recent years, we have signed up to a number of ESG initiatives and organisations. This is because we support and are in broad accord with their principles. We also welcome the opportunity for information exchange.

The firm is a signatory to the Principles for Responsible Investment (PRI). We are also a signatory to CDP, previously known as the Carbon Disclosure Project, and have also publicly acknowledged our commitment to support the broad ethos of the UK Stewardship Code. We have also formally responded to Japan's Stewardship Code.

More recently, we became a signatory to Climate Action 100+, an investor-led initiative aimed at engaging more than 100 of the world's largest corporate greenhouse gas emitters. The purpose is to encourage companies to curb emissions, strengthen climate-related financial disclosures and improve governance on climate change risks.

Just as important, from our perspective, is that as information across the wide spectrum of ESG-related issues becomes more readily available, we will continue to selectively sift that content and bring new sources of intelligence to our research and team discussions.

Our long-term investment horizon and depth of original research has stood us in good stead since the firm was founded 35 years ago. The founding belief that a sound long-term investment must also be a responsible one has not changed.

Over time, ESG is an area that has continued to grow as part of our research work and dialogue. That trend is likely to continue and with the benefit of our clearly defined investment approach, we will filter the good and the bad, which can only aid our search for long-term winners across sectors and around the world.

CONSIDERATIONS, OPPORTUNITIES AND THREATS

In the course of conducting research, each stock is assessed on its own merit, with material risks, challenges or, indeed, opportunities specific to that company being analysed. This means our ESG net is cast across a wide range of sectors.

COMPANY NOTE FOR CLIENTS: SEMICONDUCTORS

Evidencing improved CSR performance through data.

Semiconductor foundries are certainly among the largest and most expensive manufacturing facilities today. Is the scope for environmental savings and efficiencies as significant?

Semiconductor Inc.* has demonstrated notable progress. The Taiwanese company has the obligatory and ubiquitous glossy corporate social responsibility (CSR) brochure. But it has also evidenced change with data.

The company's wafer capacity has doubled in the past 10 years and production processes have grown ever more complex. However, the average power consumption of a wafer unit has decreased by 6.4%, process water consumption 31.7%, and greenhouse gas and petrofluorinated compound emissions 46.5% and 85.1% respectively over that time.

The company views the sustainable development of its supply chain as an integral part of its CSR. It has assembled a supplier counselling team, which ensures compliance with its code of conduct by way of evaluation, audit, training and its annual Supply Chain Management Forum. Tangible benefits include an 18.8% decrease in waste output among its domestic suppliers between 2014 and 2016.

External validation is also evident. The company is part of the Dow Jones Sustainability World Index and the MSCI Global Sustainability Index, and has been recognised as one of the leaders in climate disclosure by environmental researcher CDP.

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