Veritas
— Asset
Management

Real Return
Investing

Veritas Asset Management LLP

Environmental, Social and Governance (ESG)

Global Strategies Policy

Philosophy

At Veritas Asset Management LLP ("Veritas"), our aim is to buy high quality companies at the right price. We define a high quality company as one that generates both an attractive return on its capital, significant and substantial free cash flow, benefits from growth drivers that ensure future cash generation and exhibits high barriers to entry to protect those future cash flows. Predictability of management on how it deploys the cash is also key. In short, we seek to invest in businesses that are sustainable over the long term, at an attractive price. We do not believe in compartmentalising E, S and G into separate considerations. The E and S factors are clearly dependent on the management of a business, its governance structure ("the G") and whether incentives are aligned with long term shareholders. Well governed businesses will address risks and opportunities that are not only relevant today but also in the future. Where relevant this will include environmental and social factors. The quality characteristics we seek are synonymous with sustainability and many of the factors labelled under ESG.

1. Sustainability

Sustainability can take several forms and we have a more detailed paper available on this. An example is sustainability of demand for a product or service. We don't like to invest in companies that may benefit from a short-term fad e.g. gin lovers are happy to swap brands and try out a new entrant whereas mothers buying infant formula for their children remain loyal to a premium brand. This has a bearing on the type of consumer staple company we would buy. In the same way, we do not see oil and coal companies as having sustainable demand over the long term. We are not avoiding these companies simply because of their carbon footprint but because there is little visibility to the long-term growth demand for oil. In short, they do not qualify as quality companies as we define quality. The result is, however, the same. A portfolio with a low carbon footprint.

i. Sustainability of the business model is also critical. Having demand for the product is optimal only with the right business model. A great example of this has been the success at Microsoft. Microsoft has taken the enduring demand for its Office 365 and Cloud services and coupled this with a subscription-based model. Clients pay an annual subscription fee which may increase as Microsoft cross sells other products. The company has extremely high barriers to entry as its products are difficult to replicate and are well entrenched. This enables it to add in inflation plus pricing if necessary. There is relevant environmental consequences as corporate customers move increasingly over to a cloud offering and away from in-house databases, which significantly reduces carbon generation. Given the growing awareness of carbon output, this trend is likely to continue.

ii. Sustainability of governance. It's fine to have the above attributes but if management are not forward looking or investing for the long term in a sustainable manner then predictability of the business is reduced. Spread financials like banks are notoriously opaque and few measure up to the quality characteristics we seek. An exception would be Svenska Handlesbanken. This Swedish bank has delivered superior returns on capital for over 40 years and has not fallen into the social pitfalls of anti-money laundering or having to be bailed out during the Swedish Financial Crisis or the Global Financial Crisis. The employees are not paid annual bonuses but receive a deferred payment into a long-term savings scheme. They all receive the same rate of payment and should the company not meet targets they all suffer and money can even be clawed back. What this means is the bank does not take on the risks often seen at other banks which are rewarded over short periods.

2. Investment Process & ESG

As highlighted above, our aim is to look for high quality companies and remain patient to buy these companies at the right entry point (typically we aim for a 15% p.a absolute rate of return over a 5 year rolling period). The more predictable a company, the easier it is to model, the higher the likelihood to make the desired return. ESG can be demonstrated to be considered throughout the process.

The first part of the process, idea generation, is identifying high quality companies to add to our Universe List. The analysts focus on a list of stocks that have been identified in a number of ways. These include 'themes' (looking for management that are aligned with enduring tailwinds which will ensure cash generation will continue), 'screening' (looking for good quality companies that for some reason look undervalued, usually because the company has suffered from some short term issue that most investors believe will be enduring) and 'proprietary insights' (ideas generated from the networks that we have developed over the years, including trade conferences that we attend to better understand future risks/opportunities).

Some of the themes/trends we have focused on have a clear environmental and social impact which have been recognized by the management teams of the companies in which we are invested. Examples include the move toward value-based healthcare. Governments are increasingly unable to pay for the rising cost of health and this is an opportunity for companies that help take cost out of the system, those that produce consumer health products which will become increasingly available 'over the counter' but, arguably an opportunity for risk for those companies relying on increasing drug prices twice a year to drive profits. Also, within healthcare is the rising trend of lifestyle diseases. One such condition reaching epidemic proportions is Myopia (short-sightedness) not helped by excessive use of smartphones. Age related eye diseases like glaucoma are more prevalent in those suffering from myopia from a young age. This is a tailwind for those companies providing solutions (surgery, contact lenses etc.) and risk for others (China restricting the time spent playing games on smartphones).

Within aerospace, the biggest risk to aero-engine developers is that battery technology is developing quicker than expected. As such, forward looking management at companies like Safran and Rolls Royce are themselves working on hybrid solutions rather than facing a cliff edge at some point in the future.

The resulting short list of companies are those that at first sight look as if they may be attractive long-term investments and warrant further analysis. The appropriate analyst(s) will analyse the company in depth and at this stage include any consideration that may affect the sustainability of the business. Since management is core to this, we score management based on criteria that includes past/ present stewardship, management of expectations and crucially, vision. How a company intends to deploy cash given its expectations over the next 10 years as to the direction of travel of their industry is key. If the score falls over time, the investment is re-considered and thesis tested.

Once a company has been selected for inclusion on to our Universe List, it remains there until the right entry point can be achieved. We capitalise the cash generated by the company 5 years out to place a value on the business and compare this value with today's price. Typically, we seek an investment rate of return (IRR) of 15% p.a. over a 5-year time horizon before investing. Sustainability factors are also considered at this stage of the process. The Universe List consists of approximately 250 companies of which, for the majority, we seek the 15% p.a. IRR mentioned above. However, companies are rated and those with a 1 rating have greater predictability and better corporate governance, so we reduce the targeted IRR to 12% i.e. there is a lower margin of safety due to less risk factors. Most companies are rated 2 and a 15% IRR sought. Companies with a 3 rating are those where we have some concerns regarding corporate governance (board structure etc.) including many Emerging Market companies and as a consequence we seek a 20% IRR. The portfolio will be constructed with the lowest risk possible. Given the choice of buying a position with the potential of a 12% IRR versus one with a 20% IRR, we would select the former.

3. Research

As detailed above, ESG factors are embedded within the process and it is the responsibility of the investment team to consider relevant risk/opportunity factors. We do not use third party ESG ratings or believe they have any value add to a manager like Veritas which follow a concentrated approach. Many of the ratings placed on companies are based on poor underlying research or a flawed methodology.

4. Company Engagement

As long-term custodians of quality companies focused on management's sustainable stewardship of those companies, we actively engage with our investee companies, where we perceive there to be a potential risk to shareholder value and where we believe action taken by management could avert those risks. Engagement often takes place where there is potential poor deployment of cash (e.g. a company buying an unsuitable business rather than paying dividends), lack of transparency in some part of business (this may relate to incentives or company structure), reputational risk (e.g. data protection in Healthcare IT businesses) or working conditions (e.g. factory standards in clothes outsourcing). In other instances, we will engage where we believe the management have not demonstrated the long-term vision to ensure future success. The investment team will be responsible for any company engagement with the portfolio managers and the analyst involved in the dialogue with the company. We believe it is necessary to treat management with respect and will endeavor to work with management to find a solution. To retain a strong long-term relationship, we hold our discussions with companies in a confidential manner but will include engagement summaries for client reporting purposes. Discussions can often be ongoing, and we will make it clear where there are key thresholds we expect to be met. Occasionally we may vote with management on an issue but set a deadline for change to take place i.e. introduction of more Non-Executive Directors (NED's) or the introduction of fairer long-term incentive plans. If engagement fails, we may vote against the company if relevant and ultimately sell the stock if risk still prevails. We maintain a log to record the details of our engagement.

5. Environmental, Social and Governance (ESG) Resources

The ESG team is comprised of Ramesh Narayanaswamy (Emerging Markets Fund Manager/Roving analyst), Antony Burgess (Managing Partner & Head Investment Specialist), Natalia Wileman (Client Executive – ESG Reporting).

The objective of the team is to;

a) Keep abreast of developments within ESG and educate colleagues

b) Assess third party entities to gauge whether there is any value add to either the investment process or client reporting

c) Respond to client reporting requests

d) Maintain the engagement log

e) Complete submissions to UN Principles of Responsible Investment ("UNPRI") and Task Force on Climate-related Financial Disclosures ("TCFD") etc.

6. Accountability

Veritas has a Managing Partners Board which consists of three of the Portfolio Managers, the Chief Operating Officer ("COO") and the Head of Clients and Investment Specialists. The responsibility for investment and the integration of ESG practices rest with the investment teams and ultimately the Portfolio Managers. Any significant policy updates written up by the ESG team which consists of a Managing Partner, will be signed off by the Managing Partners Board. To date, there have been initiatives to assess signing up to Red Line Voting, the introduction of Carbon analysis to reporting and the assessment of third party ESG ratings.

Veritas is a signatory of the United Nations Principles of Responsible Investment ("UNPRI") , the Task Force on Climate-Related Financial Disclosures ("TCFD") and rated Tier 1 by the Financial Reporting Council ("FRC") for adherence to the Stewardship Code.

7. Client Reporting

It's becoming increasingly important to produce more comprehensive reporting on ESG related areas to clients. Whilst we currently have reservations on the validity of third party ESG ratings, we strongly believe in addressing the areas of interest to our clients and educating on the rationale behind some of the positions.
Currently, our quarterly reports contain the following ESG related reporting;

i. Red Line Voting

The Association of Member Nominated Trustees ("AMNT") developed the Red Line Voting policy to enable pension schemes to take a more active asset ownership role in relation to ESG and in so doing help improve the way companies are run. The aim is to empower pooled fund investors to direct their investment managers in how to vote. If a red line is breached, the manager votes against management or explains why they have not done so.

There are 37 Red Lines related to ESG criteria. We recognised that the policy was designed for UK equities only and aimed at pooled fund investors but had sympathy with its aim to encourage investment managers to explain why they felt differently to a perceived risk. As such we have directed ISS to execute a customised policy based on the AMNT Red Lines which can be applied globally and to all Global mandates.

ii. Engagement reports

Any material engagement with management over the quarter will be documented. A follow up to the engagement efforts will be given in future reports if the engagement is ongoing.

iii. Carbon Analysis

Once a year from 2020 we will be producing a carbon analysis report on the portfolio and explaining the rationale behind the positioning of the portfolio and any relevant engagement with management if relevant.

For further information please contact:

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