4Q 2016

NOMURA ASSET MANAGEMENT U.K. LTD.

# Responsible Investing Report

# Introduction

Nomura Asset Management U.K. Ltd. ("NAM UK") is committed to Responsible Investing on behalf of our clients.

Responsible Investing requires that we balance the objectives of multiple stakeholders – our clients, the investment community, the broader community and the environment. Over time we expect that through investing responsibly we can achieve superior returns for our clients and the broader stakeholder group.

Our equity investment process involves gaining sufficient information about the companies in which we may invest through research and due diligence. As a result we may have concerns about a company's performance or outlook which could be, for example, a financial or operational issue, or one of an environmental, social or governance (ESG) nature.

We actively engage with those companies in which it is felt that stakeholder objectives are not being fully met. Engagement may be in a variety of forms, though it is most likely to start with an initial telephone discussion with the investor relations team, with escalated action if necessary. Where appropriate, we may consider and partake in joint action with other institutional investors and companies. We hope that through our engagement and encouragement these companies will improve internal practices to the benefit of our clients and other stakeholders.

Proxy voting is an important way in which we discharge our stewardship responsibilities. We may direct our vote based on the recommendations of a third party proxy voting service vendor but will also take our own independent decisions where appropriate.

In this report we set out our Responsible Investment and corporate engagement activity over the last quarter.

| | |
|---|---|
| "NAM Group"<br>"NAM" | These references relate to the whole Nomura Asset Management organisation and will generally be used when referring to matters such as investment philosophy, style, company structure and other policies which are consistent across the Group. |
| "NAM UK"<br>"Our"<br>"We" | This refers to Nomura Asset Management UK Limited, the UK based subsidiary of NAM Tokyo. NAM UK will typically be appointed as investment manager and will retain responsibility for the management, control and servicing of the client portfolio and relationship. Responses within this document will refer specifically to practices and procedures undertaken within the NAM UK office. |



# Summary

Over the period 15 companies were reviewed and assigned ESG ratings. Of these, 7 were awarded a rating of 'N' (No Issues) and 8 a rating of 'I' (Issues to Address), with no companies assigned a 'U' (Uninvestable) rating. In addition, 6 companies were contacted, supplementary to full company reviews, to discuss ESG related queries that arose over the period.

Of the companies reviewed 13 were within Developed Markets, whilst 2 were within Emerging Markets. In total 8 companies were contacted to discuss ESG concerns. Of these, responses were received from 6 (75% response ratio).

| Companies reviewed | |
|---|---|
| N (No Issues) | 7 |
| I (Issues to Address) | 8 |
| U (Uninvestable) | 0 |
| **Total** | **15** |

| Companies contacted | |
|---|---|
| Number of contacts | 8 |
| Number of responses | 6 |
| **Response Ratio** | **75%** |

# Notes from our Responsible Investing Research

- **Environmental / Social:** Over the period we reviewed a number of companies that scored relatively highly within our framework for assessing Environmental and Social impact, as a result of having business operations that we felt will create substantial long-term value for not only us as shareholders but also the broader stakeholder group (society as a whole and the environment). This included operations within vehicle light weighting, the electric vehicle supply chain, industrial scale recycling and the renewables space.
- **Governance:** Over the quarter we ran into relatively few issues surrounding corporate governance standards, however, as within our last report a number of companies reviewed were majority owned or had a voting majority held by a parent. In these circumstances particular attention was paid to whether minority shareholders' interests have historically been protected. On balance, where possible, we favour those companies in which minority shareholder interests are best represented.

  There were also a number of concerns raised over the quarter with regards to senior executive level insider selling, which did not align with company strategy or communication – for instance, such behaviour is not aligned with aggressive share buybacks driven in part by management's view on valuation. Publicly available insider transaction data is an important component of our research process and we strongly favour management teams that behave in a manner that is aligned with our interests as shareholders.
- **Remuneration:** As within our previous reports the majority of the companies reviewed do not take return on capital into consideration with regards to executive remuneration levels. Indeed, of the 15 companies reviewed only 3 had ROIC or ROCE components and even for these companies return on capital metrics were only a small driver of total compensation. We continue to push for companies to use simple return on capital and free cash flow metrics that better align management with exactly what we as long-term shareholders are exposed to.
- **Other:** With regards to contacting companies to discuss our ESG concerns, we were relatively disappointed with both the response ratio and quality of responses received over the quarter. In general we still find that whilst the PR machines behind the companies do a decent job of portraying a picture of corporate responsibility and efforts surrounding sustainability, in reality much remains to be improved with regards to increasing accountability.



# Responsible Investing Case Study

Over the quarter we reviewed a UK utility that is predominantly engaged in the development and operation of transmission and distribution (T&D) assets; the wires, pipes and broader infrastructure that ultimately connect power generation and gas facilities to the consumer. In analysing the total impact of the company on all stakeholders, we considered the following:

**Environment –** On balance we felt that the impact of the company on the environment was ultimately positive. Whilst an undeniably negative impact is the degradation of natural scenery as a result of the construction of transmission infrastructure, we took into consideration the fact that there is currently no economically feasible alternative to facilitate electricity transmission. Furthermore, the company has a strong track record with regards to limiting this impact, and working with NGO's to support conservation and biodiversity.

The overriding positive impact of the business, however, is that it will be instrumental in supporting increased levels of renewable and zero carbon power generation, which will ultimately support the lowering of national carbon emissions. The incumbent network within the UK does not support a high level of renewable generation as a result of both geographical (wind and solar sites are located much further from high consumption regions than current fossil fuel generation) and technical factors (the far less constant output from renewables for instance, requires different network technology). Huge investment in transmission and distribution infrastructure is therefore required and the company, as the incumbent with substantial investing firepower and vast experience, will be crucial in supporting this transition. The company furthermore has a strong track record in increasing the efficiency of its network, thereby decreasing the levels of power generation required.

**Society –** The business provides a vital service to society in facilitating the connection between power generating assets and the residential, commercial and industrial consumers that are entirely dependent on electricity and gas to operate. Whilst clearly the company does not provide these services without reasonable remuneration, we would argue that with regards to creating value to society as a whole, its operations add far more than, for instance, a generic retailer or recreational software application. Ultimately therefore we view the impact of the company on society as very positive.

# Proxy voting record 4Q16

Nomura Asset Management (UK) seeks to act in a manner that it believes is most likely to enhance the economic value of the underlying companies owned on our clients' behalf. We engage with companies based on our "Ideal Form of Business Management of Investee Companies" in order to enhance our mutual understanding and to seek changes in their company practices. Nomura Asset Management (UK) employs the services of ISS (Institutional Shareholder Services) to efficiently apply our proxy voting policy to individual proposals. ISS are provided with comprehensive guidelines detailing Nomura Asset Management (UK)'s proxy voting policy.

Nomura Asset Management (UK) will closely consider the voting agenda of a company that meets certain conditions (including, but not limited to, the violation of any applicable laws, inadequate board composition, and financial strategies that are not deemed to be in the best interests of shareholders). Where we believe that a specific agenda item is not in the best interests of shareholders, Nomura Asset Management (UK) will decide either to vote against or to abstain from voting on the item. Please see the Nomura Asset Management Proxy Voting Policy for full details.

# Voting data

Over the quarter Nomura Asset Management (UK) voted on 163 proposals across 22 shareholder meetings and 24 ballots. In total 39% of proposals were Director related with a further 47% in relation to the general course of business. Other proposals related primarily to compensation and M&A.

In total Nomura Asset Management (UK) voted 'With' management on 138 (85%) proposals and 'Against' management (or 'Withheld' our vote) on 25 (15%) proposals. Of the 25 Votes 'Against' management, these related predominantly to Directorship proposals, but also with regards to Routine Business. Examples of where we voted 'Against' management, or elected to 'Withhold' our vote included:

- Voted Against the Directorship proposal of a Pakistani Cement Manufacturer as a result of concerns over a lack of information being provided with regards to the nominees
- Withheld our vote on the Directorship proposals of a US Tech company, specifically in relation to the re-election of the incumbent audit committee members and concerns with regards to both risk oversight and pledging activity

**Proposals voted on in 4Q16**

| Proposal subject | Count | Percentage |
|---|---|---|
| Anti-takeover | 2 | 1.2% |
| Capitalisation | 3 | 1.8% |
| Directorships | 63 | 38.7% |
| Compensation | 5 | 3.1% |
| Reorg / M&A | 11 | 6.7% |
| Routine Business | 76 | 46.6% |
| Other | 3 | 1.8% |
| **Total** | **163** | **100.0%** |

**Proposals voted 'Against' in 4Q16**

| Proposal subject | Count | Percentage |
|---|---|---|
| Anti-takeover | 0 | 0.0% |
| Capitalisation | 0 | 0.0% |
| Directorships | 12 | 48.0% |
| Compensation | 1 | 4.0% |
| Reorg / M&A | 1 | 4.0% |
| Routine Business | 9 | 36.0% |
| Other | 2 | 8.0% |
| **Total** | **25** | **100.0%** |

**Voting record vs. management in 4Q16**

| | With | Against |
|---|---|---|
| Votes | 138 | 25 |
| *Proportion* | *84.7%* | *15.3%* |

**Voting Record vs. ISS in 4Q16**

| | With | Against |
|---|---|---|
| Votes | 163 | 0 |
| *Proportion* | *100.0%* | *0.0%* |

# ESG queries raised

| Stock | ESG Rating | ESG queries raised: Governance | ESG queries raised: Specific Management/Pay | ESG queries raised: ROIC Driven Pay? | ESG queries raised: Environmental/ Social | Company Contacted? | Company Responded? | Notes from Company Contact |
|---|---|---|---|---|---|---|---|---|
| **UK Utility** | N | Scores very highly on Governance with no major flags. We do highlight the potential for a lack of board independence with both the CEO and CFO on the board, and somewhat low risk management expertise on the board, however these are only minor concerns at this point in time | No concerns though we note the recent CEO transition which will have to be monitored | N | Scores well with regards to environmental & social matters; concerns are low given almost the entire business is transmission & distribution. The company will be instrumental in facilitating renewables growth in the UK. Only minor concern is the impact on the natural environment as a result of the transmission network | N | N/A | N/A |
| **US Computer Hardware Business** | I | "Relatively aggressive accounting score driven by very large recent acquisition, in addition to the level of intangible assets. Further highlight one director who is "over boarded" and one who served on a company that filed for Chapter 11 bankruptcy protection. Limits on shareholder control flagged | No major concerns. Significant portion of total compensation is variable - linked to EPS and revenue growth. Base salaries at median of peer group | N | Although it has initiatives in place for issues like electronic waste and sourcing conflict minerals it falls short of best practice demonstrated by peers | N | N/A | N/A |
| **US Beverage Company** | I | Designated as a 'controlled entity' by the NYSE as it is controlled by the founding family through their 53% holding in the voting 'A' shares. With voting control and the lack of an independent majority on the board there is limited scope for minority shareholders to influence management | Founding family member chairs the board | N | There are certain ethical & social considerations with regards to hard liquor operations. Environmental concerns are low | N | N/A | N/A |
| **US Telecoms Company** | N | No controlling shareholder. Independent majority board. CEO & Chair positions are however combined | Driven by FCF and TSR. In the region of 90% of remuneration is variable | N | Operates in an industry that is not heavily exposed to environmental or social issues | N | N/A | N/A |
| **US Defence Company** | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Y | Y | The company was contacted with regards to an internal flag in relation to involvement in the cluster munitions space. The company strongly clarified its position - it has never been in the business of producing cluster munitions and has ceased all marketing of rockets, missiles or other delivery systems incorporating such warheads. Has been removed from NGO blacklists |
| **US Semiconductor Business** | I | Conservative accounting; minor flags on revenue growth/operating expenses and liquidity: cash ratio. The board is dominated by long term directors (6 out of 10 serving for more than 16 years). Only governance issue relates to the significant share repurchases | The company scores low on lack of diversity and CEO pay | N | Scores highly with no controversies | N | N/A | N/A |

# ESG queries raised (cont'd)

| Stock | ESG Rating | ESG queries raised: Governance | ESG queries raised: Specific Management/Pay | ESG queries raised: ROIC Driven Pay? | ESG queries raised: Environmental/ Social | Company Contacted? | Company Responded? | Notes from Company Contact |
|---|---|---|---|---|---|---|---|---|
| **US Bank** | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Y | Y | Company contacted in relation to concerns over accountability across employees within the firm and its 'fake account scandal'. We have arranged to meet the company in person in the New Year to discuss these concerns in greater depth |
| **UK Pharmaceutical** | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Y | Y | The company was contacted with regards to the quality of reported financials, and we pushed our view that the company must make an effort to improve this and close the gap between 'core' and GAAP earnings. The company expressed that this is a current priority of the board |
| **Italian Bank** | I | OK on governance, some concerns on the lack of independence of the board | CEO compensation is too high given the performance of the shares (ca. €9mn in 2015) with relatively poor level of disclosure | N | No flagged controversies but would note human capital strategy where the company intends to lay off 18,200 employees (high stock of NPLs necessitating additional capital and potential financial distress as a result of a low CET1 ratio) | N | N/A | N/A |
| **US Utility** | I | Accounting practices considered Aggressive (notably pension assumptions) though given the fully regulated nature this is less of a concern. Shareholder dissent over a certain director's re-election also flagged | CEO pay has been very high given the track record of EPS growth and relative share performance vs. peers. EPS growth is the primary driver with the LTIP also driven by TSR | N | Scores poorly driven by its coal heavy generation fleet. Company is involved in a very large scale nuclear project which will lower emissions but increase exposure to spent nuclear fuel accidents | N | N/A | N/A |
| **UK Cap Good** | I | Divestures, asset turnover, level of intangibles and 'exceptional items' flagged. Scores relatively well on Governance though shareholder voting against management remuneration is flagged | Largest rejection of Say on Pay in UK with less than 27% supporting proposals. CEO recently stepped down. ST Bonus 60% normalized NPBTA, 20% CF & 20% personal targets. LTIP based on relative TSR, EPS growth and ROCE. | Y (ROCE) | Exposure to fracking and mining raises some concerns but we do note policies focused on at least attempting to reduce emissions | Y | Y | IR were surprisingly dismissive of the discontent SH's had expressed with regards to management pay |
| **US Retailer** | I | Accounting practices are aggressive – high level of M&A and restructuring. Entrenched board and over boarded Board members also flagged | Annual incentive plan is based on EPS (50%), Gross Profit $ (25%) and Total Sales (25%). Long-term incentive plan is based on Return on Net Assets (50%) and Operating income $ Growth (50%). CEO received $9.9mm in 2015 | N | Given the business model (very large sourcing of paper) environmental impact is high | Y | N | Management were contacted with regards to poorly aligned remuneration targets, however no response was given with regards to our concerns |
| **European Materials Business** | N | Very strong on Governance (97th percentile); minor concerns include over boarded non execs. Accounting flags include the level of divestures/ restructuring | Bonuses driven by ROCE, but share and stock options are not linked directly to business performance | Y (ROCE) | Give credit for pollution control & EV operations which more than offset high energy intensity of the business | N | N/A | N/A |

# ESG queries raised (cont'd)

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|---|---|---|---|---|---|---|---|---|
| **US Pharmaceutical** | N | Presence of controlling foundation, but overall governance is solid. Main accounting issue relates to the large amount of inventory versus sales (DSIs 259 days) but this is a function of protein manufacturing/validation and storage | CEO & CFO have been with company since 2000. Pay is reasonable, but only around 25% of 2015 compensation was share-based incentives, 60% salary/bonus. Annual performance metrics are an ambiguous composite but LTIP includes a ROCE-WACC formula | Y – ROCE is a component | – | N | N/A | N/A |
| **Philippine TV broadcaster** | N | Controlling family owns 51% of the company. Company does not earn its cost of capital suggesting poor allocation of resources | – | N | Operates in an industry that is not heavily exposed to environmental or social issues | N | N/A | N/A |
| **Satellite communications provider** | N | No controlling shareholder. Independent majority board. Executive compensation reasonable | Management share based compensation based on 3 objectives: 3 year TSR (30%), 3 year EBITDA (30%), strategic objectives (40%) | N | Operates in an industry that is not heavily exposed to environmental or social issues | N | N/A | N/A |
| **Israeli Pharmaceutical Company** | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Y | N | Company contacted with regards to insider transactions and further colour on current legal proceedings, however no response was received |
| **UK Food Retail** | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Y | Y | Company was contacted with regards to the very large increase in the pension deficit reported with earnings and furthermore concerns that potentially the movement in the liability should have been larger as suggested by notes within accounts and IR movements. This was also of interest with regards to other UK companies that will face similar requirements. Management talked through the moving parts and helped reconcile the reported figures |
| **UK Materials Business** | N | Inventory/CoGs and receivables/sales have notably been increasing - revenue recognition practices to be monitored | CEO has been with the company since 1993, remuneration levels seem reasonable though bonus is driven by PBT and LTIP by EPS &TSR. We would prefer a closer link to ROIC | N | Generally low impact. We highlight further that the company's products are actually used in the auto sector to reduce emissions | N | N/A | N/A |
| **US Pharmaceutical** | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Contacted outside formal review | Y | Y | The company was contacted with regards to the CEO selling shares in the business despite the very attractive valuation of the business and the company's buyback strategy. Management offered a follow up call to discuss this, though the reasoning provided was relatively unsatisfactory |
| **Hong Kong Listed Support Services** | I | Controlling shareholder (family) owns ca. 60% of the business | CEO pay is 3m RMB. Base salary 2.3 RMB. Bonus metrics not disclosed | N | – | N | N/A | N/A |

# Glossary

| | |
|---|---|
| **COI** | Conflict of Interests |
| **EBIT** | Earnings Before Interest and Tax |
| **EM** | Emerging Markets |
| **EPS** | Earnings Per Share |
| **ESG** | Environmental, Social, Governance |
| **FCF** | Free cash flow |
| **ND** | Net Debt |
| **Opex** | Operating Expense |
| **RoA** | Return on Assets |
| **ROCE** | Return on Capital Employed |
| **ROIC** | Return on Invested Capital |
| **SH** | Shareholder |
| **SOE** | State owned Enterprise |
| **WC** | Working capital |

**Disclosures**

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