1Q 2017

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, 2 were awarded a rating of 'N' (No Issues) and 12 a rating of 'I' (Issues to Address), with 1 company 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 16 companies were contacted to discuss ESG concerns. Of these, responses were received from 9 (56% response ratio).

| Companies reviewed | |
|---|---|
| N (No Issues) | 2 |
| I (Issues to Address) | 12 |
| U (Uninvestable) | 1 |
| **Total** | **15** |

| Companies contacted | |
|---|---|
| Number of contacts | 16 |
| Number of responses | 9 |
| **Response Ratio** | **56%** |

# Notes from our Responsible Investing Research

- **Governance:** Over the period we reviewed a US Media company that had been involved in a well-publicized phone hacking scandal. We followed up with the company and made an assessment of the control procedures that had since been implemented to prevent a reoccurrence of this activity. Whilst we felt the company had learnt from its prior mistakes we did not feel that it was investable from a 'Responsible Investing' perspective at this point in time.
- **Remuneration:** Just 2 of the 15 companies reviewed over the quarter had management remuneration targets that incorporated Return on Capital components. We continue to push for management to be remunerated based on Return on Capital metrics, which more closely reflect what we, as shareholders, experience.
- **Environmental / Social:** A number of companies reviewed over the quarter were flagged for labour management concerns, which ranged from substantial workforce reduction to allegations of using child labour. In response to the child labour allegations we contacted the company to formally explain these. The issues were in relation to an Indonesian subsidiary and the complex relationship between its farmers and their families (children helping out with the family business). Whilst it is difficult to get entirely comfortable with such issues we appreciate the company's position against exploitative child labour and the efforts taken to eliminate it.
- **Other:** We were particularly disappointed this quarter by the willingness of companies to respond to our ESG queries and feedback. Notably we contacted five UK listed miners to discuss concerns predominantly in relation to capital allocation and the failure to incorporate ROIC metrics within management remuneration targets; solely one company responded. Given both the environmental controversies and capital allocation concerns that have hampered the industry this was particularly disappointing.



# Responsible Investing Case Study

Will the interests of minority shareholders be protected?

We recently met one-on-one with a listed Japanese telecom services company to discuss fundamental trends in addition to ESG issues. We fear that the interests of minority shareholders for one of their listed subsidiaries are at risk of being compromised. The founder of this telecom company is an investment genius and has made many great investments. His prescient early stage investment in a Chinese company has created immense value for his shareholders.

Many of his listed subsidiaries have also done well since going public. One of his subsidiaries is a leading internet company in Japan. The parent consolidates the subsidiary with only a 36% stake as it effectively controls the company. The subsidiary does not have an independent majority board and the founder of the parent is on the board of directors. In our opinion, there have been corporate governance red flags raised at the subsidiary related to activities of the parent.

In 2014, the parent announced they would sell one of their telecom subsidiaries to the Japanese internet subsidiary. The reason given for this sale was that the internet subsidiary was looking for the next growth driver and getting into telecom services was one option. However, mobile phone penetration was already high in Japan in 2014, hence telecom services was and is a low growth industry in Japan. Adding telecom services would in fact have been dilutive to the internet company's growth rate as their internet businesses were growing faster. This led us to believe that the reason for this sale was to access the subsidiary's rich cash balance. As a telecom operator, the parent has high debt ratios and in order to acquire companies, it needs financing. Accessing the subsidiary's hoard of net cash would have been a cheap source of funding. This proposed merger was cancelled, in part due to minority shareholders of the listed subsidiary resisting. However, the lack of independent board majority increases the risk of decisions being made that may not represent the best interests of minority shareholders.

In a more recent and yet to be resolved example of what we believe to be another corporate governance red flag, we asked the parent telecom company about a large stake that a foreign company held in the listed internet subsidiary. The telecom company used to be a major shareholder of the foreign company as well. A large US company agreed to acquire the core operations of the foreign company which did not include the stake in the listed subsidiary. The stake will be put into a fund. It is our opinion that the listed subsidiary should use its cash to buy the stake from the foreign company. It would be an efficient use of cash and it would allow for more of the earnings to remain with the company rather than share it with outside investors. Over time, the shares bought back could be retired which would add shareholder value in our opinion. We fear that this may never take place as if it did, it would worsen the debt ratios of the parent. The parent already has a high net debt-to-EBITDA ratio and if their consolidated subsidiary used its cash to finance the purchase, it would lead to a further worsening of the parent's net debt ratios which would make it harder for the parent to continue its acquisition strategy.

We expressed our concern to the parent company regarding corporate governance in the relationship between parent and subsidiary. They acknowledge our concern in the minutes of our meeting.

A few days after our meeting, it was announced that a new CEO would lead the fund that holds the listed subsidiary. According to a Fortune article, the new CEO may receive up to $24m in annual stock awards, just for effectively overseeing a fund with no operating businesses. This raised yet another red flag and we enquired about this with the foreign company. The company essentially denied the contents of the article citing rules in the Investment Company Act of 1940.

This is important for minority shareholders because if the Fortune article is correct, it would be a disincentive for the fund's CEO to sell their stake back to the listed subsidiary.

We continue to maintain a dialogue with the companies, and push for stronger governance practices, but for now these concerns keep us from establishing an investment in the listed subsidiary.

# Proxy Voting Record 1Q17

Nomura Asset Management U.K. Ltd. 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 U.K. Ltd. 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 U.K. Ltd.'s proxy voting policy.

Nomura Asset Management U.K. Ltd. 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 U.K. Ltd. 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 U.K. Ltd. voted on 320 proposals across 66 shareholder meetings and 87 ballots. In total 54% of proposals were Director related with a further 17% in relation to the general course of business. Other proposals related primarily to compensation.

In total Nomura Asset Management U.K. Ltd. voted 'With' management on 304 (95%) proposals and 'Against' management (or 'Withheld' our vote) on 16 (5%) proposals. Of the 16 Votes 'Against' management, these related predominantly to Directorship proposals, but also with regards to Compensation. Examples of where we voted 'Against' management, or elected to 'Withhold' our vote included:

- Voted against the Statutory Auditor proposal of a Japanese Telecom as the individual did not meet our independence criteria
- Voted for the Directorship proposal of a US Cap Good, specifically that an Independent Board Chairman should be appointed. Management guidance had been to vote Against the proposal

**Proposals Voted on in 1Q17**

| Proposal subject | Count | Proportion of |
|---|---|---|
| Anti-takeover | 4 | 1.3% |
| Capitalisation | 16 | 5.0% |
| Directorships | 174 | 54.4% |
| Compensation | 36 | 11.3% |
| Reorg/M&A | 3 | 0.9% |
| Routine Business | 55 | 17.2% |
| Health/Environment | 3 | 0.9% |
| Other | 29 | 9.1% |
| **Total** | **320** | **100.0%** |

**Proposals Voted 'Against' Management in 1Q17**

| Proposal subject | Count | Proportion of |
|---|---|---|
| Anti-takeover | 0 | 0.0% |
| Capitalisation | 1 | 6.3% |
| Directorships | 9 | 56.3% |
| Compensation | 2 | 12.5% |
| Reorg/M&A | 0 | 0.0% |
| Routine Business | 1 | 6.3% |
| Health/Environment | 1 | 6.3% |
| Other | 2 | 12.5% |
| **Total** | **16** | **100.0%** |

**Voting Record vs. Management in 1Q17**

| | With | Against |
|---|---|---|
| **Votes** | 304 | 16 |
| ***Proportion*** | *95.0%* | *5.0%* |

**Voting Record vs. ISS in 1Q17**

| | With | Against |
|---|---|---|
| **Votes** | 319 | 1 |
| ***Proportion*** | *99.7%* | *0.3%* |

# ESG queries raised

| | ESG queries raised | | ESG queries raised | | | | |
|---|---|---|---|---|---|---|---|
| Stock | Governance | Specific Management/Pay | ROIC Driven Pay? | Environmental/Social | Company Contacted? | Company Responded? | Notes from Company Contact |
| US Drug Retailer | Concerns arose over the quarter with regards to a lack of insider buying. This is completely out of line with managements commentary around valuation and the corporate strategy of buying back shares | Lack of insider buying | Contacted outside formal review | – | Y | Y | We followed up with the company with regards to the lack of insider buying. The company did provide a detailed response in relation to our query, highlighting the level of ownership across management |
| European Cap Good | – | – | Contacted outside formal review | The company is potentially set to be involved as the supplier for a Brazilian hydropower project that Greenpeace have flagged for significantly negative impact on both the rainforest and the indigenous people | Y | Y | We contacted the company with regards to its potential involvement in the Brazilian hydropower project, and urged them to push, in its capacity as the supplier, for the limiting of the impact on the environment |
| US Internet Company | Parent, subsidiary relationship and proposed portfolio transactions raise concerns over corporate governance and conflicts of interest | – | Contacted outside formal review | – | Y | Y | The company denied the Fortune article's claim that up to $24m in stock awards would be available to the new CEO citing the Investment Company Act of 1940. Effectively, they are saying that post upcoming transactions the remaining stub will be classified as a fund and as such, equity awards will not be permitted to the CEO. We will continue to follow the situation |
| Japanese Telecom | The company has attempted intra group transactions that in our opinion violate reasonable corporate governance standards and raise concerns with regards to the protection of minority shareholder interests | – | Contacted outside formal review | – | Y | Y | We provided feedback to management over the attempted transactions in 2013. The company provided its rationale for the transaction however we did not feel the answer was entirely satisfactory. The company acknowledged our corporate governance feedback in the minutes of our meeting |
| Danish Pharmaceutical | Our research raised concerns over the level of detail provided on insider stock ownership transactions | Lack of disclosure with regards to insider share transactions | Contacted outside formal review | – | Y | Y | The company was contacted with regards to providing further detail on insider stock ownership transactions. Management provided additional information, but we would still prefer to receive greater detail |
| US Pharmaceutical | Our fundamental company research raised red flags with regards to working capital level trends | – | Contacted outside formal review | – | Y | N | We contacted the company with regards to the working capital flags, however no response was received |

# 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 |
|---|---|---|---|---|---|---|---|---|
| **British Tobacco Company** | I | Scores "OK" on governance but we do flag significant votes against pay practices, over boarded non-executive directors and Audit. Committee members, and discretionary elements in the company's pay practices | Significant votes against pay practices. In general it is our view that executive pay practices of the board appear to be generally well aligned with sustainable shareholder interests | N | There are concerns surrounding the Indonesia business, leaf supply and allegations of bribery/ corruption and child labour | Y | Y | Company contacted with regards to child labour allegations in Indonesia and bribery allegations. The company was unable to discuss the bribery allegations in detail due to ongoing investigations, but highlighted their anti corruption policies whilst also commenting that such incidents can happen with such large global companies. With regards to child labour concerns the company argued that they did not condone child labour in any shape or form but children do tend to help out parents on family farms in Indonesia |
| **US Cap Good** | I | Corporate governance is flagged as concern, most notably surrounding the qualification of the board. Entrenchment and over boarded directors. Average accounting practices; it is flagged for the recent high level of divestures and M&A activity. The company is also flagged for the pension actuarial assumptions (notably the discount rate). A low level of COGS/ Revenue is possible an indication of expense recognition as is large revenue/opex | Longer-term financial measures include sustained EPS and cumulative cash flow relative to G7 GDP growth | N | Labour management concerns in relation to risks surrounding the significant work force reduction efforts that it has been carrying out | Y | Y | We contacted the company to raise concerns on pension assumptions, management remuneration and entrenchment. Whilst the company came back with thorough responses to our questions we were disappointed by the level of receptiveness to our suggestions |
| **UK Listed Miner** | I | Accounting flags as very aggressive – mainly divestitures/mergers and high intangible assets | STIP – KPIs not that clear,LTIP – relative TSR vs comparator group over 5 years. 25% vest if TSR is inline | N | Poor environmental impact e.g. on recent disaster, although they have responded well | Y | N | N/A |
| **UK Listed Miner** | I | Accounting aggressive – mainly on divestitures | Bonus Share Plan – 50% EPS based on budgeted commodity prices, 50% strategic targets (40% cash 60% deferred shares). LTIP – 50% ROCE, 50% TSR over 3 years. The original ROCE target was 15%, but now it is not as clear | ROCE component | Poor environmental impact mainly due to labour disputes in South Africa and heavy water usage | Y | N | N/A |
| **UK Listed Miner** | I | Accounting aggressive – mainly on DTA and divestitures, understandable | STIP is 50% deferred in share, but KPIs unclear. PSP 1/3 TSR vs Global Mining, 1/3 TSR vs MSCI World and 1/3 relative improvement in EBIT margin | N | Poor environmental and social impact due to human/labour rights, and environmental issues. Caught up in a corruption/bribery scandal in Guinea | Y | Y | Contacted in regards to why a ROC component was not included in remuneration calculation. Were told that a remuneration review with investors was carried out 5 years ago. The feedback then was that they wanted an earnings measure and not just TSR. Will pass on our feedback |
| **UK Listed Miner** | I | Accounting flagged as aggressive. Members of the board are closely linked to the BP/Macondo scandal | CEO not participating in annual bonus. CEO owns 8.4% of the stock | N | Social concerns in relation to labour rights controversies. Members of the board are closely linked to the BP/ Macondo scandal | Y | N | 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 |
|---|---|---|---|---|---|---|---|---|
| UK Listed Miner | I | Accounting aggressiveness is average. Note the CEO was previously associated with an apparently corrupt payment whilst at a competitor | Annual bonus – drivers not clear | N | Standard concerns for mining companies | Y | N | N/A |
| Indian Automotive OEM | I | Board doesn't include independent majority and there are related party transactions | CEO's compensation was INR 39,544,573 (US$ 590k) in FY16, out of which US$ 190k (32%) was performance linked bonus | N | Faces moderately high level of regulatory pressure with respect to carbon emissions of vehicles but has an average level of fleet emissions owing to wide range of compact vehicles. Exposure to regulatory and reputational risks associated with product quality and safety problems but only modest efforts to mitigate these risk. High labour risk but weak efforts to mitigate these risks | Y | N | Contacted management to express our view that as investors we very much expect there to never to be repeat of 2012 labour relations events. We further requested greater clarity on senior management compensation |
| US Bank | I | Key areas of concern include over boarded members, accounting risks and pay performance alignment. Accounting aggressive. Flags include revenue recognition (non-interest income and loan & fee income), high leverage ratio, frequent corporate divestures and M&A and pension discount rate being too high | Against peers seems reasonable. The metrics used do have an element that supports return on capital. Furthermore as a banks can increase returns through risk also believe it appropriate to have a risk ratio in the structure. Therefore believe the quantification tools are correct although would like to see the targets set at more ambitious level | N | Ongoing litigation and investigations from a number of authorities. NAM is aware of and has reviewed the issues cited and concluded that they do not render the company un-investible | N | N/A | N/A |
| Chinese Industrial & Rail Automation | I | Rates as relatively aggressive on accounting; flag the level of receivables in addition to asset turnover and low SG&A as a proportion of opex. Of note is the divergence between NI and cash flow which should be monitored closely | Significant management stakes within the business. No disclosure on remuneration targets | N | Industrial Automation business is heavily involved in China's process industries (chemicals, power & steel). Peers have been involved in high speed rail scandal | N | N/A | N/A |
| Japanese Internet Company | I | Parent controls 80% of company. No independent majority board | – | N | Operates in an industry that is not heavily exposed to environmental or social issues | N | N/A | N/A |
| UK Insurer | I | Board has an independent majority and a majority standard for director elections. CEO and Chairman role are seperate. Generally OK on accounting – small flags on revenue recognition, expense recognition and asset-liability valuation | Remuneration screens as one of the most reasonable in the peer group | N | Screens poorly on both environmental and social concerns including lack of commitment to best practices related to collection of personal data and minimal policies to manage risk of reputational damage from data related breaches and no efforts to integrate or manage ESG risks for clients | 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 Media | U | Screens poorly on governance , but does appear to have learnt from its mistakes. Previous scandals (phone hacking) are highlighted, though we note new internal standard committees and revamped policies since | CEO total compensation of $5.3mm. Performance based equity is based 40% on EPS, 40% adj FCF, 20% TSR vs. S&P | N | Scores very poorly on business ethics (phone hacking) and raw material sourcing | Y | N | N/A |
| US Fast Food Restaurant | N | No independent board. No stock ownership guidelines | – | N | No concerns | N | N/A | N/A |
| UK Support Services Business | N | No major concerns, but would highlight both the relatively recent large acquisition (which brings into question capital allocation). Officer changes, asset turnover and pension deficit flagged on the accounting side | Executive pay: average. CEO pay as % of EBIT: ~0.6% last year. Officer (CEO) changes flagged but not a particular issue in our view | Y-ROCE is a component | The company is heavily connected to the defence industry through servicing and training contracts (NOT involved in munitions manufacturing), but also involved in training and supporting emergency services | Y | Y | Contacted to clarify our understanding of management remuneration and the recent (ultimately relatively unsuccessful) acquisition, whilst management stopped short of conceding the acquisition was an error the impression was given that the team have learnt from it and the risk of further value destructive M&A is minimized |

# Glossary

| | |
|---|---|
| **COGS** | Cost of Goods Sold |
| **COI** | Conflict of Interests |
| **DTA** | Deferred Tax Asset |
| **EBIT** | Earnings Before Interest and Tax |
| **EM** | Emerging Markets |
| **EPS** | Earnings Per Share |
| **ESG** | Environmental, Social, Governance |
| **FCF** | Free Cash Flow |
| **KPI** | Key Performance Indicator |
| **LTIP** | Long Term Investment Plan |
| **ND** | Net Debt |
| **Opex** | Operating Expense |
| **PSP** | Performance Share Plan |
| **RoA** | Return on Assets |
| **ROCE** | Return on Capital Employed |
| **ROIC** | Return on Invested Capital |
| **SH** | Shareholder |
| **SOE** | State owned Enterprise |
| **STIP** | Short Term Investment Plan |
| **TSR** | Total Shareholder Return |
| **WC** | Working capital |

## Disclosures

This information was prepared by Nomura Asset Management U.K. Ltd. (NAM UK) from sources it reasonably believes to be accurate. This document is for information purposes only on the general environment of investment conditions.

As with any forms of investment, they carry risks and this material does not have regard to the specific objectives, financial situation or needs of the recipient. Unless otherwise stated, all statements, figures, graphs and other information included in this presentation are as of the date of this presentation and are subject to change without notice. Although this report is based upon sources we reasonably believe to be reliable, we do not guarantee its accuracy or completeness. The contents are not intended in any way to indicate or guarantee future investment results as the value of investments may go down as well as up. Values may also be affected by exchange rate movements and investors may not get back the full amount originally invested. Further, this report is not intended as a solicitation or recommendation with respect to the purchase or sale of any investment fund or product. Before purchasing any investment fund or product, you should read the related prospectus and/or documentation in order to form your own assessment and judgment and, to make an investment decision. To the extent permitted by law, NAM UK does not accept liability for any statement, opinion, information or matter (express or implied) arising out of, contained in or derived from, or any omission from this document, whether negligent or otherwise.

This report may not be reproduced, distributed or published by any recipient without the written permission of NAM UK.

NAM UK is authorised and regulated by the Financial Conduct Authority.

NOMURA

**Nomura Asset Management U.K. Ltd.**
1 Angel Lane
London
EC4R 3AB
+44 (0) 20 7521 2000

**Alex Rowe, CFA**
Equity Research Analyst, Global Industrials & Utilities
Nomura Asset Management U.K. Ltd.
alex.rowe@nomura-asset.co.uk
+44 (0) 20 7521 1059