MAGELLAN
ASSET MANAGEMENT LIMITED

Policy on Consideration of Environmental, Social and Governance Issues for Investment Purposes

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1. Summary

Environmental, Social and Governance ("ESG") issues are a natural component of the Magellan Asset Management ("Magellan") investment analysis process, as gaining a robust understanding of these issues is a key part of assessing the outlook for future cash flow generation and risks of an investment.

Where appropriate, the investment team should engage with investee (or prospective investee) companies in regard to their ESG policies and their management of ESG risks. The objective of such engagement is to enhance the certainty of long-term cash flow generation we expect from the company.

Institutional investors increasingly require that investment managers incorporate ESG issues into their investment framework. Strong evidence of an investment manager's commitment to ESG principles is to become a signatory to the United Nations Principles for Responsible Investment ("PRI"). The principles provide a framework by which all investors can incorporate ESG issues into their decision-making and ownership practices. The principles are not a prescriptive set of rules, and are to be applied as appropriate within each asset class and investment approach. Magellan is a signatory to the UN PRI.

For Magellan's actively managed valuation-based portfolios, ESG issues are reviewed as part of the assessment of business risk and agency risk completed for the determination of investment grade status. ESG issues are explicitly discussed as part of the research report completed for each company and are reviewed on an annual basis as part of the ongoing analysis of companies. This review of ESG issues is to be evidenced in the research report completed for each company by including an analysis of environmental and social issues as part of the Business Risk assessment and an analysis of governance issues as part of the Agency Risk assessment.

Individual ratings for the Environmental and Social profile and the Governance profile will be awarded to each company on an A, B or C scale. The Environmental and Social and Governance ratings will reflect the issues faced by the industry that the company operates in and the company's practices. If a stock is to be awarded a Low rating for Business Risk then as a pre-condition the stock must be awarded an A rating for Environmental and Social issues. If a stock is to be awarded a low rating for Agency Risk then as a pre-condition the stock is required to achieve an A rating for Governance issues.

2. Introduction

This paper seeks to outline for Magellan's *registered managed investment schemes* ("funds") and *designated investment mandates* ("mandates"):

- How ESG issues are linked to Magellan's investment analysis framework;
- How ESG issues are incorporated as part of the investment process; and
- How analysis of ESG issues as part of the investment analysis framework should be evidenced.

3. Why ESG issues should be considered as part of the investment analysis process

There are two key reasons why it is important for investors to explicitly consider ESG issues: the veracity of the investment analysis and the demand for ESG from investors.

3.1. *Veracity of investment analysis*

Magellan's actively managed funds seek to identify high quality investments and acquire such investments at prices assessed as representing an appropriate margin of safety. As part of the assessment of a company's intrinsic value Magellan seeks to consider all issues that it is able to identify that may materially affect the investment outcomes for a company. ESG issues affect the investment outcomes for a company and Magellan specifically considers these issues as part of its analysis of agency and business risks.

The investment objectives of the Magellan managed investment funds are to (a) minimise the risk of permanent capital loss and; (b) achieve superior risk-adjusted returns over time. For its actively managed investment portfolios, Magellan seeks to achieve these objectives by investing in companies that meet Magellan's investment grade requirements and for whom the share price represents an appropriate discount to the assessed intrinsic value.

The investment grade rating of potential investments are evaluated by the Magellan investment team by applying the following qualitative assessment criteria:

1. ***Economic moat*** – Magellan seeks companies with sustainable competitive advantages and a consequent ability to generate high returns on capital for a long period of time;
2. ***Reinvestment potential*** - Magellan seeks companies with the potential to continue to reinvest capital into the business at high incremental returns;
3. ***Business risks*** – Magellan seeks investments with predictable cash flows and earnings. The assessment of business risk for each company is not an attempt to measure the volatility of the shares, but rather the predictability and strength of the underlying business; and
4. ***Agency risk*** - A key assumption inherent in a standard discounted cash flow valuation (DCF) is that free cash flows are returned to shareholders or are reinvested at the cost of capital. However, cash is often reinvested by companies at returns below the cost of capital. In these cases businesses can end up being worth substantially less than implied by a DCF analysis. We term the risk surrounding the deployment of the free cash flow generated by a business as "Agency Risk".

ESG issues are part of the suite of issues that affect agency risk and business risk for companies and, accordingly, should be considered as part of the qualitative analysis of a potential investee.

Environmental Issues

In order to fully understand the business risks facing a company investors should consider environmental risks and opportunities that might affect the future operations of a company including issues such as pollution, climate change, resource depletion, ecosystem change, waste disposal, the use of toxic chemicals, the formal license to operate in communities, and other environmental issues.

Magellan believes climate change is a particularly important environmental issue for global businesses and investors to consider. In order to enhance assessments of the company-specific risks and opportunities associated with climate change, Magellan is a Signatory of CDP's climate change program through its parent company Magellan Financial Group. As a Signatory, Magellan is able to access companies' detailed climate disclosures including data on carbon emissions and climate change mitigation activities. Research reports include a discussion of climate change related risks facing companies, including emissions intensity[1], in the environment component of the Business Risk assessment.

Social Issues

Social issues (such as human rights, worker rights, health and safety, labor relations, child labor, community relations/development, indigenous rights, and respect for the rule of law) play an important role in the public's perception of companies. News of a poor safety record or the use of forced labor has the potential to damage a reputation, which can, in turn, adversely affect revenue or prompt new regulatory burdens. The social risks that threaten the reputation and brand integrity of companies is a component of business risk.

Magellan believes that companies engaging in business that undermines the rule of law or that have major detrimental impacts on human health warrant particularly close scrutiny by investors. Such business models may be the subject of future government regulation or changes in consumption patterns, making them a high risk investment from investors' perspective. For example, Magellan excludes companies engaged in "high roller" casino gaming and the production of tobacco from its investible universe.

Governance Issues

Corporate governance is concerned with the way corporate entities are governed, as distinct from the way businesses within those companies are managed on a day to day basis. Strong governance structures, appropriate executive control and high levels of transparency are amongst the factors likely to provide confidence as to the level of agency risk. For further information on the approach to governance issues please see Magellan's Corporate Governance Principles and Proxy Voting Policy.

3.2. *Investor demand for ESG analysis*

Institutional investors and consultants increasingly require that investment managers incorporate ESG issues into their investment framework. Strong evidence of an investment manager's commitment to ESG principles is to become a signatory to the United Nations Principles for Responsible Investment ("PRI").

[1] Emissions intensity is the total Scope 1 & 2 CO_2 equivalent emissions of a company in tonnes per million US dollars of revenue (t/$m). Scope 1 emissions are those produced directly by the company. Scope 2 emissions are those from purchased energy including electricity and steam.

4. How ESG Issues are integrated into the investment analysis process for each strategy

Valuation Based Investment Funds: Global Equity, Global Plus, High Conviction, Select Infrastructure

For the purposes of these strategies, the attainment of investment grade status for a company requires a research report assessing the company to be completed and approved by the Investment Committee. The quality criteria used by Magellan to assess investment grade status include economic moat, business risk, agency risk and re-investment potential.

As outlined above, ESG issues are relevant to the assessment of business risk and agency risk and should be reviewed as part of the assessment of business risk and agency risk completed as part of the research report. This review is to be evidenced in the research report completed for each company by including an analysis of environmental and social issues as part of the Business Risk assessment and an analysis of governance issues as part of the Agency Risk assessment. The template shown as Appendix 1 can be used as a checklist for ESG issues when undertaking investment research. This checklist was influenced by the United Nations' Sustainable Development Goals (SDGs), to identify relevant ESG issues facing companies.

Environmental and social issues are reviewed in the research report for a company as part of the analysis of Business Risk issues with each company under review receiving a specific rating for its Environmental and Social profile. The rating for the Environmental and Social profile will be A, B or C. The rating will reflect the Environmental and Social issues faced by the industry that the company operates in and the company's environmental and social practices. If a stock is to be awarded a Low rating for Business Risk then as a pre-condition the stock must be awarded an A rating for Environmental and Social issues.

Governance issues are reviewed in the research report for a company as part of the analysis of Agency Risk issues with each company under review receiving a specific rating for its Governance profile. The rating for the Governance profile will be A, B or C. The rating will reflect the Governance issues faced by the industry that the company operates in and the company's governance practices. If a stock is to be awarded a low rating for Agency Risk then as a pre-condition the stock is required to achieve an A rating for Governance issues.

Research reports should indicate whether the company under review is a member of the common applications of ESG considerations such as the Dow Jones Sustainability Indices, the London Benchmarking Group and/or the United Nations Global Compact. The membership of such applications is viewed as persuasive but not conclusive evidence that the company meets Magellan's ESG requirements.

As part of the ongoing analysis of companies, ESG issues will be explicitly reviewed on an annual basis. The focus of this analysis will be whether and how ESG issues affect the potential distribution of future cash flow generation and, accordingly, whether the qualitative ratings for the company appropriately reflect underlying risks.

Non-Valuation Based Investment Funds: Core Infrastructure

Whilst the constituents of the Core Infrastructure portfolio are not required to attain Investment Grade Status, over 40% of the portfolio (as at 30 June 2016) had done so. For the remainder of the portfolio, the constituents do not undergo explicit ESG scoring however:

- **a.** Companies must meet acceptable governance standards to be included in the portfolio; and
- **b.** Proxy voting and engagement are conducted in line with our Proxy Voting Policy and Corporate Governance Principles, consistent with other strategies

5. The Principles for Responsible Investment

The United Nations-backed Principles for Responsible Investment (PRI) is a network of international investors working together to put Principles for Responsible Investment into practice. The UN PRI are a series of investing principles drafted by institutional investors who believe that ESG factors can affect the performance of investment portfolios and should be given appropriate consideration by investors if they are to fulfill their fiduciary duty. The principles provide a voluntary framework by which all investors can incorporate ESG issues into their decision-making and ownership practices. The PRI Secretariat notes that the principles are intended to be aspirational and not a prescriptive set of rules, and are to be applied as appropriate within each asset class and investment approach.

5.1. Integrating PRI principles into the investment process for Magellan's actively managed funds

Investment managers that sign up to the UN PRI are committing to 6 principles. The principles are outlined below along with suggested practices to ensure the investment process for Magellan's actively managed funds are consistent with the principles 1 to 5.

i. ***We will incorporate ESG issues into investment analysis and decision making processes***

- **a.** Magellan will ensure that all investment professionals are aware of ESG considerations to ensure that the principles are adopted. Practically, ESG considerations will be specifically identified in Magellan's assessment of agency and business risk in company research reports. .

- **b.** Additions to investment staff will be provided with Magellan's ESG policy. Any changes to this ESG policy will be advised promptly to all members of the Magellan investment team.

ii. ***We will be active owners and incorporate ESG issues into our ownership policies and procedures***

- **a.** Where a company has a particularly poor ESG track record that has a material impact upon the risk associated with future cash flow generation, it is likely that Magellan will exercise its ESG policy through non-investment, rather than engagement. However from time-to-time Magellan may engage with potential investee companies to discuss and/or request ESG process improvements (or intended improvements). Ultimately, the assessment of investment grade status for an investee company will reflect the future cash flow generation and associated risks for the investee company.

- **b.** Additionally, Magellan may be entitled to vote on issues relating to ESG matters for investee companies. To this end Magellan undertakes to vote in a manner that it considers most likely to maximize shareholder value using a long-term framework.

iii. ***We will seek appropriate disclosures on ESG issues by the entities in which we invest***

- **a.** Magellan has a preference for investee companies to be either an active participant in the UNGC program, or a member of the Dow Jones Sustainability Index ("DJSI") family. Magellan has a preference for participants in these programs due to their robust reporting and monitoring framework.

The membership of such applications is viewed by Magellan as persuasive but not conclusive evidence that the company meets Magellan's ESG requirements. The key test for Magellan is how the company's ESG practices affect future cash flow generation and the associated risks.

Where an investee company is either inactive or does not participate in the UNGC or the DJSI then Magellan will consider the ESG policies of the company, and may choose to engage the company in certain instances where it is not satisfied that they are adequate.

b. Magellan seeks reporting on ESG issues by investee companies to be integrated within the standard annual report.

iv. ***To promote acceptance and implementation of the Principles within the investment industry.***

Magellan will include Principles-related requirements in requests for proposals it answers.

v. ***To work together to enhance our effectiveness in implementing the Principles.***

Magellan will address emerging issues and will support the use of investor reporting as a source of learning.

vi. ***To each report on our activities and progress towards implementing the Principles.***

This requires Magellan to complete an annual questionnaire each year in March/April. The questionnaire is approximately 100 questions long and deals with the extent to which Magellan uses ESG principles. The answers from the questionnaire are compiled with other investment managers to enable the UN PRI to assess the success of their promotion of PRI.

5.2. Integrating PRI principles into the investment process for Magellan's non-valuation based portfolios

Magellan's non-valuation based portfolios are designed to provide clients with an efficient and highly diversified exposure to particular sectors or segments of the market. While the investment process for these funds is not simply passively managed index replication there are similarities to passively managed investment styles when considering the Principles.

When the Principles were drafted in 2005/06 the PRI secretariat noted that passive investors' responsibilities are largely exercised through the active ownership activities outlined in Principle 2. The PRI secretariat notes that "passive managers can rest assured that the PRI is entirely compatible with their strategy, even if there is no consideration of ESG factors in the portfolio construction process" (Source: Responsible investment in passive investment strategies – Case studies and guidance, UNEP Finance Initiative, January 2011).

A commitment to active ownership implies additional costs in the investment process ie the time taken across a potentially large number of companies in the investment portfolio to monitor shareholder meetings, consider voting intentions and exercise voting rights. This is usually passed onto the client by way of higher management fees, thus decreasing its efficiency to clients. For clients who require an active ownership overlay a specialist engagement and voting overlay provider can be appointed on their behalf to execute proxy votes and to engage with companies on ESG issues across the portfolio, approaching a company's ESG performance from a shareholder's perspective. For clients who seek active ownership the costs of the specialist provider can be directly passed through.

Appendix 1 - Checklist for ESG Issues

ESG Issues Checklist

Environmental

Climate change
- Clean energy
- Greenhouse gas emissions
- Energy Efficiency
- Ecosystem change
- Changes in physical climate parameters
- Insuring Climate Change Risk

Natural Resource Consumption
- Sustainable use of land and water
- Biodiversity on land and water
- Natural resource use, depletion and degradation eg water scarcity
- Environmental efficiency - minimising waste and managing demand for water and energy
- Sustainable sourcing
- Deforestation
- Clean water and sanitation

Waste Management
- Toxic material use and disposal
- Packaging material and waste
- Hazardous waste disposal/cleanup
- Electronic waste
- Pollution

ESG Issues Checklist

Social

Labour and human rights
- Labour relations and standards
- Use of child and indentured labour
- Discrimination
- Diversity
- Gender equality
- Sexual harassment
- Living wage disputes
- Education and human capital

Health and safety
- Tobacco
- Drug addiction
- Workplace health and safety
- Consumer health and safety
- Product safety
- Genetically modified organisms
- Privacy and data security
- Food security

Poverty
- Economic growth and employment
- Industry, innovation and infrastructure
- Sustainable financial systems
- Predatory lending

Social - Other
- Rule of law
- Gambling
- Community relations
- Animal welfare
- Political contributions
- Political risk of involvement in troubled markets, countries
- Peace, justice and institutions
- Sustainable and inclusive development

ESG Issues Checklist

Governance

Shareholder rights
- Cumulative voting
- Dual-class share structure
- Majority voting
- Poison pills
- Takeover defenses/market for control

Board composition and independence
- Separation of chairman/CEO position

Executive compensation
- Say on pay
- Shareowner advisory vote on executive compensation

Corporate accountability structures
- Compliance
- Bribery and Corruption
- Conflicts of Interest
- Accounting and audit quality

Appendix 2

Background to the United Nations Principles for Responsible Investment

The PRI are a series of investing principles drafted by institutional Investors who believe that ESG factors can affect the performance of investment portfolios. The principles support the signatories' belief that Investors fulfilling their fiduciary (or equivalent) duty need to give appropriate consideration to these factors and that the PRI provide a framework for making access to ESG information more widely available and for incorporating these factors into the decision-making process.

What do signatories commit to?

Signatories commit to two mandatory requirements on becoming a signatory.

1. **Reporting and Assessment process -** After an optional one year grace period, all asset owner and investment manager signatories must participate in the annual Reporting and Assessment process. This process involves the manager completing a questionnaire with approximately 100 questions. The questionnaire is similar to an RFP.
2. **Membership fees -** All signatories must pay an annual fee. Mandatory fees for asset management companies are calculated based on "asset under management". For service providers they are scaled according to the number of employees. Set fees are £2,300 for AUM of US$1b to US$5b and £5,000 for AUM of US$5b to US$10b.

Frequently Asked Questions

- ***Do the Principles call for exclusion or screening out of particular companies or sectors?***

No. The Principles suggest a policy of engagement with companies rather than screening or avoiding stocks based on ESG criteria (although this may be an appropriate approach for some investors). The Principles are generally designed for large investors that are highly diversified and have large stakes in companies, often making divestment or avoidance impractical.

- ***What are the implications for fiduciary duty?***

The Principles are based on the premise that ESG issues can affect investment performance and that the appropriate consideration of these issues is part of delivering superior risk-adjusted returns and is therefore firmly within the bounds of investors' fiduciary duties. The Principles clearly state they are to be applied only in ways that are consistent with those duties.

- ***What is the goal of Principles for Responsible Investment (PRI) ?***

PRI aim to help investors integrate the consideration of ESG issues into investment decision processes and ownership practices.

Appendix 3

Background to CDP's climate change program

Each year on behalf of institutional investor signatories, CDP contacts large global companies asking them to disclose climate change related information.

CDP signatories believe that measurement of carbon emissions and disclosure of other climate change related information will improve investors' ability to manage the risks of climate change. Stakeholders such as investors, customers and governments have an important role to play in motivating disclosure and management of climate change issues by companies. Furthermore, CDP signatories believe it is part of investors' fiduciary duty to evaluate the possible impacts of climate change on the value of investments including:

- Taxation and regulation;
- Changes in the climate system;
- Technological innovations; and
- Shifts in consumer attitude and demand.

Signatories of CDP's climate change program commit to an annual **Reporting and Assessment process**. After an optional one year grace period, all investor signatories must participate in the annual Reporting and Assessment process. This process involves signatories completing a questionnaire on their carbon emissions and other climate change related activities. Questionnaires are assessed and scored by CDP-approved evaluators.

CDP holds the world's largest collection globally of self-reported climate change data. Signatories of CDP's climate change program are able to access detailed company disclosures made to CDP, including data on carbon emissions and any climate change mitigation activities, and use them for investment purposes. As a Signatory of CDP's climate change program, Magellan will be able to more rigorously assess climate change related risks and opportunities facing companies on behalf of clients.