

OUR JOURNEY

How we're moving forward on responsible investing

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Investors who are looking at environmental, social and governance issues are all at different stages of a long journey.

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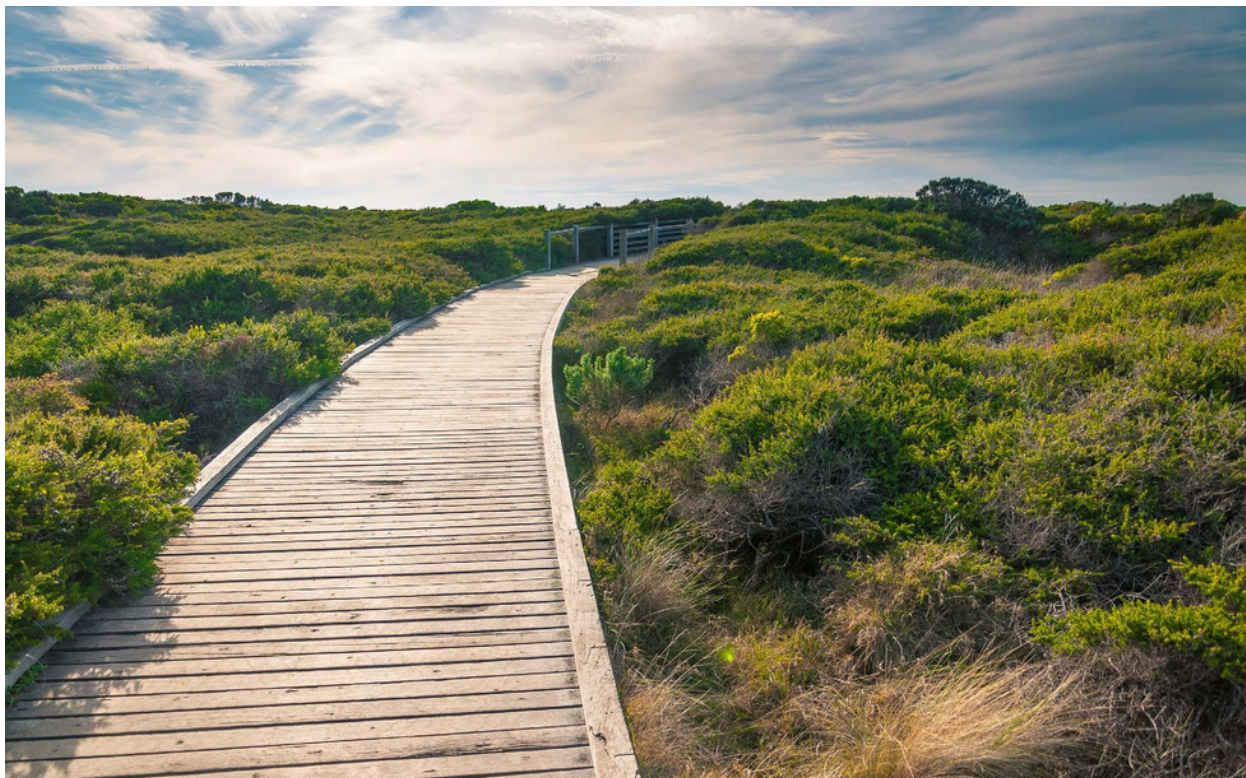
In this section we demonstrate how our three step process works. The case study example we have chosen is for Aurizon.

11 SUMMARY

ARC has evolved to meet the demands of a changing world. ESG is now fully integrated into our investment process.



WHAT IS THE BEST WAY FORWARD?



Many investors who are looking at environmental, social and governance (ESG) issues are on a journey. What should their policy be? What is the best way forward? How can ESG and responsible investing become part of the process?

The CFA Institute recognises that the approach to ESG was still evolving. In 2018 they published an ESG research article based on workshops, case studies, data from PRI and the results of a global survey of 1,100 financial professionals. The CFA Institute was able to report that:

- There isn't a "best way" or "silver bullet" solution to achieve ESG integration.
- Governance is the ESG factor most investors are integrating into their process.
- Environmental and social factors are gaining acceptance, but from a low base.
- ESG integration is further along in the equity world than in fixed income.
- Portfolio managers and analysts are more frequently integrating ESG into the investment process but are rarely adjusting their models based on ESG data.
- The main drivers of ESG integration are risk management and client demand.
- The main barriers to ESG integration are a limited understanding of ESG issues and a lack of comparable ESG data.
- Investors acknowledge that ESG data has come a long way, but advances in quality and comparability of data still have a fair way to go.
- It would be helpful for all parties to agree on a single ESG reporting standard that could streamline the data-collection process and produce more quality data. Many workshop participants were concerned that ESG mutual funds and exchange traded funds (ETFs) offered to investors may be driven by marketing decisions and may not be true ESG investment products.

TAKING STEPS ON THE BIG ISSUES



ENVIRONMENTAL

Climate change
 Biodiversity
 Energy resources
 Energy management
 Biocapacity
 Ecosystem quality
 Air pollution
 Natural resources
 Water resources
 Pollution

SOCIAL

Human rights
 Employee relations
 Skilled labour
 Health and safety
 Diversity
 Customer relations
 Product responsibility

GOVERNANCE

Business integrity
 Shareholder rights
 Executive pay
 Audit services
 Board independence/
 expertise
 Fiduciary duty
 Transparency/ accountability
 Related- party transactions
 Dual- class share structures
 Tax practices



INTEGRATION

ESG is not an extra layer of analysis.
It is part of the process.

WORKING TO A FRAMEWORK

The CFA Institute defines ESG integration as “the explicit and systematic inclusion of ESG factors in investment analysis and investment decisions.”

To help equity and fixed income managers achieve this integration, the Institute has published a recommended framework. At ARC we've looked to this model as a basis to build on for our own approach. Shown here is an excerpt of the full framework.

ESG INTEGRATION

RESEARCH LEVEL

- ESG-integrated research note
- SWOT analysis
- ESG agenda at meetings
- Materiality framework
- Watch lists
- Red-flag indicators

VALUATION LEVEL

- Forecasted financial ratios
- Valuation multiples
- Valuation-model variables
- Forecasted financials

PORTFOLIO LEVEL

- ESG & financial risk management - exposures & limits
- Portfolio construction - weightings

Excerpt of CFA Institute's ESG integrated framework

OUR 3 STEP PROCESS



1. RESEARCH

We have enhanced our research processes to formally include ESG elements throughout the process. This will continue with the additional requirement for a formal consideration of issues within the dedicated ESG section of the Investment Checklist.

This achieves a decentralised structure with broad based responsibilities across the entire investment team rather than concentrated under one ESG specialist.

SUMMARY OF THE PROCESS

Investment Checklist

The investment checklist is designed to identify and assesses a company's ESG risks. Within the investment checklist, ESG factors are analysed under industry and management sections.

Focused Questionnaire

The ESG questionnaire focuses on the ESG factors identified in the CFA Institute

integrated framework.

Materiality Assessment

Factors are assessed to determine whether or not they are material to the business.

When factors/issues are determined to be immaterial to the business, no action is taken.

When factors are identified as negatively material to the business, we will:

- make a judgement for expected timeframe
- decide if this is an issue within our forecast period
- make what the team deems to be necessary adjustments to the forecast profitability modelling
- beyond the forecast period, adjust the multiple to reflect the longer term risk

Financial Models

- Updated to reflect ESG risk adjusted return
- Materiality factors are stored in our database and flow through to the screening output

Screening Output

- Provides a portfolio level ESG risk overlay

2. SECURITY VALUATION

The ESG questionnaire and traffic light flow through to the financial model where they act as a prompt for the consideration of ESG issues.

ESG related factors are considered within the;

- **Modelling of financial forecasts**
- **Valuation multiples**

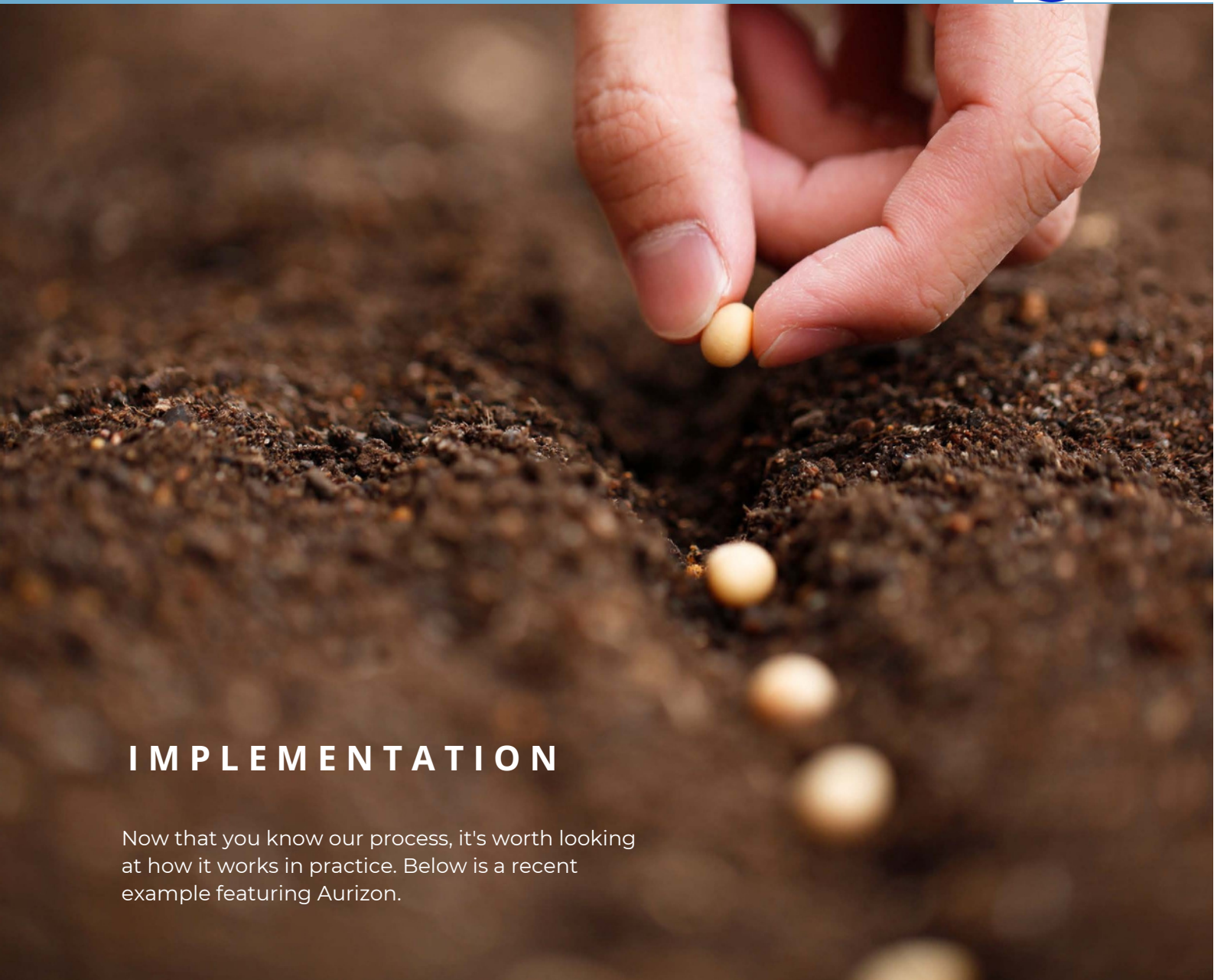
Factors are incorporated within the financial model when the issue is considered to be material, i.e. a high probability of impacting the company's earnings within the forecast period.

Factors are incorporated within the Valuation Multiples when the issue is considered to be material, i.e. a high probability of impacting the company's earnings post the forecast period.

3. PORTFOLIO CONSTRUCTION AND MANAGEMENT

The identification and assessment of ESG related factors and resulting incorporation within the financial forecasts and valuation multiple results in the generation of an ESG adjusted Expected Total Return (ETR) for each company. Therefore, whilst the PM's will discuss ESG issues within a holistic approach to portfolio construction, it is not required to tilt individual portfolio weights based on ESG considerations.

Ongoing management and monitoring of ESG related issues is achieved through regular discussion during Investment Committee Meetings (ESG being a specific agenda item) and monitoring reports which list a portfolio's exposure across the ESG risk levels (high, neutral and low).



IMPLEMENTATION

Now that you know our process, it's worth looking at how it works in practice. Below is a recent example featuring Aurizon.

AURIZON ISSUE: CARBON EMISSIONS



- **Impact: Material and Negative**
- Utilised external research to gauge longer term, scenarios (IEA, Aust Govt)
- Expect external pressures to negatively impact Coal volumes

- Impact determined to be outside of forecast period
- Adjusted terminal growth rate from 2.0% to -0.5%
- Terminal EBIT Multiple reduced from 10.5 to 8.5
- Expected return reduced by 7.0% p.a.

- Not currently held within the Large Companies Portfolio (income model)
- Business monitored
- Registered within our ESG database to have environmental factor issues

WAVES OF CHANGE

The world is changing. ARC is evolving. Our expectations have been raised and our process has been enhanced to ensure companies are now measured within a more holistic framework.