Stewart Investors
Sustainable Funds Group

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Quarterly Client Update

1 April - 30 June 2019 | For US qualified investors

Source: Getty Images

Investment philosophy and objective

Investment philosophy

Since 1988 we have had an approach to investment founded on:

– Stewardship
– An absolute return mindset
– Bottom-up analysis
– Long-term thinking
– Searching for quality companies
– Finding sustainable and predictable growth
– Strong valuation disciplines

Investment objective

To generate attractive long-term, risk-adjusted returns by investing in the shares of those companies which we believe are particularly well positioned to benefit from, and contribute to, the sustainable development of the countries in which they operate.

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Portfolio resilience

An important tenet of our investment philosophy is to invest with an absolute return mindset. We define risk in terms of absolute not relative losses and gains as outright not relative gains. We are benchmark agnostic, believing the best way to beat a benchmark index over a decade or more is by completely ignoring it. We spend at least as much time worrying about how to hang on to gains as we do thinking about how we might make them.

Clients sometimes ask why we believe our portfolios might preserve capital when markets fall. That prompts us to think straight away about the circumstances in which we might not perform as well as we expect and hope. Two scenarios spring to mind.

The first is a market decline that is broad-based, synchronised, sudden and sharp. This is likely to have much the same impact on share prices that an outgoing spring tide has on boats: to begin with everything will retreat swiftly, including the market capitalisation of many companies we hold for you. Thereafter, boats with more conservative and secure mooring lines ought to hold steady, while the loosely moored and leakier ones get dragged further into deeper, more turbulent waters.

In evoking this coastal analogy we are mindful that contemporary stock market reversals are often accentuated by computerised trading algorithms that respond to negative market signals in remarkably uniform ways, and because index-tracking and exchange-traded funds account for a growing majority of trading decisions and volumes in equity markets. We think these effects were evident in the market downturns of early 2016 and late-2018.

The second scenario in which many of our portfolios would suffer absolute losses is a significant sector rotation towards riskier assets and away from consumer staples companies. Such a scenario is unlikely to be associated with a market fall. In fact, consumer companies have generally been resilient in past market downturns because their revenues derive mostly from less discretionary spending. It is a major reason why they comprise a sizeable portion of the portfolios we look after, but obviously our absolute performance suffers when the consumer staples sector becomes unfashionable (in such moments we often increase positions in our favourite companies).

Our job as investors, although far from easy, is very simple: to protect and grow your capital. We are great believers in the power of compounding, and acutely aware of how losses undermine this power. Losing 50% of $100 invested requires us to make 100% to get back up to the original $100. Losing 60% requires us to make 150% to get back above water. Even losing just 20% requires us to make 25% to return to the original level. The relationship between losses and the gains needed to recover the losses is always asymmetric.

This idea frames and habilitates our investment philosophy, it is the reason we focus on finding and selecting high quality, good sustainability companies. Companies which are led by responsible stewards who care about all stakeholders and make long-term commercial decisions; with socially useful, adaptive and competitive franchises; with conservative balance sheets; that are worth the price we need to pay to own a share of them on your behalf. It is why we are careful not to descend the quality spectrum to chase a lower near-term earnings or cash flow multiple, and are equally sceptical about popular, overvalued companies.

We believe the best protection for any portfolio must surely be the quality of each constituent investment. This is why we favour companies capable of delivering sustainable growth and cash flows through a cycle. It is also why the top ten portfolio positions account for a significant portion of assets: holding significant positions in great companies should be less risky than dozens and dozens of smaller positions in average companies.

With these points of orientation, we know our best hope of protecting your capital in a falling market is to remain disciplined and true to our investment philosophy at all times.

Of course our ability to protect your capital in a falling market will depend not just on whether we remain true to our philosophy, but on whether we make good judgements. It will also be influenced by the nature of any market downturn – the drivers, depth and duration – and by luck. Our complete lack of control over the latter variables only motivates us to focus even harder on trying to make good bottom-up[1] investment decisions, as this is the best way we know of mitigating broader risks and uncertainties brought on by macroeconomic policies and politics.

Still, we worry, all the time, about political economy and macro risks. We constantly ask ourselves what could go wrong. And we remind ourselves that the biggest risks often turn out to be things few people talked about.

1 Analysis of a company focused principally on its management, franchise and financials rather than the broader industry in which it operates, or macroeconomic factors, such as economic growth.

We do not run models that perform sophisticated stress tests. However clever they may be, they still rely too much on hugely influential assumptions, which often don't seem to hold up in the real world. They distil very complex forces into a bogus objectivity. And they often seem prone to one of the most insidious of all financial risks: false precision. Instead, we challenge ourselves to wrestle with the uncertainty and complexities of qualitative what if questions.

1. What if rising inequality and political discontent erode the political centre, leading to more populist governments on the left and right that pursue pro-cyclical policies?
2. What if political and trade conflicts escalate to a point of another (different form of) Cold War?
3. What if consumers, corporates and governments slide deeper into debt than they already are?
4. What if public sector liquidity, broader money supply and US dollar liquidity, all continue to decline?
5. What if central banks switch the economic life support machine from monetary to fiscal policy mode, and administer too little or too much, of whatever treatment modality they hope might keep the ailing patient alive?
6. What if internet-driven entrepreneurial empowerment and price discovery mean large multinational consumer companies have had their time in the sun?
7. What if four decades of lower labour, manufacturing, transport, and corporate tax costs do not stretch to five?
8. What if the need for climate change adaptation erodes the profitability of companies responsible for producing the basic building blocks and infrastructure our societies depend on?
9. What if China fails to reflate its economy, and global growth rates neither stabilise nor reach levels that are sufficient to justify current excessive equity valuations?
10. What if valuations for high quality companies remain excessive for longer than anyone currently imagines?

We rarely, if ever, arrive at definitive answers to these sorts of questions. But asking them helps us turn our assumptions inside-out and our points of view upside-down. It helps keep our minds fresh and alert to the possible dangers that lie ahead. And the more difficult and uncertain the political economy context and market conditions get, the harder and closer we look at what we can best make sense of: companies, and how capable they seem to be at coping with contextual challenges.

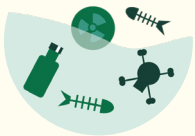
Engagement

As mentioned in previous quarterly reports, last year the team decided to adopt a more strategic approach to engagement with companies and have identified the following three priority areas for engagement across all portfolios:

Remuneration: With the aim to develop principles which we can encourage companies to adopt and also engage on remuneration at a broader level through a consideration of living and minimum wages.

Diversity: With the aim to engage on gender diversity across board and management throughout our portfolio companies.

Pollution: With the aim to initially focus on plastics and packaging and encouraging companies, particularly our consumer goods companies, to reduce their non-recyclable plastic waste and consider circular economy principles.



Remuneration update

Before we entrust your capital to companies, we spend a lot of time trying to understand whether the management team are empowered to make decisions critical to the protection and growth of that capital, and have a suitably long investment horizon.

We are increasingly coming across executive remuneration structures we believe are:

- Too short-term, complex and easy to manipulate in favour of executive management
- Discouraging long management tenure and weakening Board accountability to shareholders and other stakeholders
- Dampening employee morale and fuelling disillusionment with shareholder capitalism.

We have yet to see a perfect remuneration structure but we also know we don't have the perfect solution. Instead we have tried to distil our ideas down to five principles:

- Be simple
- Be long-term oriented
- Be inclusive
- Encourage responsible risk taking
- Embrace broader notions of 'success' (e.g. contribution to corporate culture) than easy-to-measure metrics allow.

During the quarter we wrote to the management of a number of companies we hold on your behalf in order to seek their views on their remuneration policies. Most endorsed the idea that remuneration policies and awards must be driven by principles. Most believe theirs are aligned with the ones we have suggested above. However we see a mixed picture, and we remain concerned that levels of executive remuneration are often excessive, particularly among US, Australian, and some European companies.

In future we are more likely to vote against executive remuneration policies and levels if we believe they fail to demonstrate originality, thoughtfulness and purpose, as well as alignment with shareholders.

We hope to be able to share further insights with you on these areas of engagement throughout the year.

Business update

Brexit fund updates

While the UK did not leave the EU as anticipated last quarter, we had previously completed our Brexit transition project in any event. This entailed us moving the accounts of investors in our Euro share classes in the UK OEIC fund range into our Irish VCC fund range. While the exact outcome of Brexit in terms of the impact on financial services remains unclear, the move to create equivalent funds in our Irish VCC fund range ensures EU investors can remain invested in an EU-based UCITS[2] fund, which our UK OEIC will not be following Brexit. The new funds which were created in the Irish VCC mirror the equivalently named funds in the UK OEIC fund range. Both UK OEIC and Irish VCC fund information is included at the back of this quarterly report.

Elephant in the room – Investing in the Indian Subcontinent Investor Forum

Having allocated a large part of our client's capital to the Indian Subcontinent over the years, we decided to host an Investor Forum, in London, focused on the region.

The morning started with an introduction and brief history of our involvement in the Subcontinent from David Gait and Sashi Reddy. Mohan Gundu and Sujaya Desai then went on to discuss the opportunities and challenges of sustainable urbanisation in the region.

We heard from three of our portfolio companies: Kotak Mahindra Bank, BRAC Bank (Bangladesh) and Tube Investments. Their presentations showcased the quality of the companies we are lucky enough to engage with, and helped us to articulate what we mean by sustainable businesses.

Dipak Gupta, Joint Managing Director of Kotak Mahindra Bank, spoke about the changes in Indian banking and the need to get more 'Phygital'[3] with customers. As a result they launched the '811' app. The name '811' derived from the date Prime Minister Modi announced demonetisation overnight with the aim of a cashless economy. Since launching this app Kotak have generated a fourfold growth in customer acquisition.

Vellayan Subbiah, CEO of Tube Investments, spoke of how their business has grown over the years whilst maintaining the founding family principles. Since first meeting them in 2000, Tube are now present in 18 countries including the UK. They operate using instinct rather than just relying on data and are focused on bringing back conscious thinking in place of compulsiveness and are committed to ensuring that the 'TI way' is the standardised way to operate across offices.

Selim Hussain, Managing Director of BRAC Bank (Bangladesh), highlighted to the group the differences between India and Bangladesh and explained that Bangladesh is about 20-25 years behind India in terms of development. 90% of the country remains unbanked so the opportunity is huge. He spoke about the need to support the small and medium entrepreneurs within the region, and that they were the first bank to cover this gap in the market. Although they are working to become more digitalised, knowing their customers remains a key priority for the business and they have 76 agents working in banking outlets to ensure they are able to maintain personal interactions in order to lend responsibly and with integrity to those whom were previously often left unfunded.

The day finished with an engaging panel session focused on building a sustainable business in the Indian subcontinent. Members of the audience asked the team and company representatives about: the support and opportunities available to women in Bangladesh to work in banking; whether education in the subcontinent is providing the appropriate skillsets required to support growth; how companies feel about our approach to engagement; how the region is going to combat the challenges of pollution; how to identify greenwash box ticking; and how family run businesses can retain their values as more millennials join their businesses.

We hope to be able to host similar events in the future across our office locations.

2 The Undertakings for the Collective Investment in Transferable Securities (UCITS) is a regulatory framework of the European Commission that creates a harmonised regime throughout Europe for the management and sale of mutual funds.
3 A combination of physical and digital

Trip reports

United States

Previous visits to the US Midwest and Seattle have left us wondering how and why clusters of quality companies develop. On this trip, an "unexpected" snowstorm in New York and the Midwest gave us cause and some time to contemplate a possible connection between extreme weather and risk aware cultures. Perhaps one has to plan better, withstand difficult working conditions, and be better prepared for externalities that can harm a business directly or indirectly? And is the opposite true in Silicon Valley, where the weather is seldom a distraction or a disruptor?

The San Francisco Bay Area in northern California is home to some of the world's most inventive and largest companies. The bay area has historically served us a weird cocktail of a massive investment universe but few investment opportunities. We must surely have been wrong? There must surely be conservative company cultures bubbling beneath the slick surfaces? Not for the first time, we head to The Valley seeking answers to these questions.

And not for this first time, we are struck by the energetic pace of innovation, a fail fast mentality, and a desire for control. Some aspects of this prevalent corporate culture sit uncomfortably with our investment philosophy, which places more emphasis on what could go wrong than what might go right. In this context, it was encouraging to come across some companies that appear to have chosen a more conservative path.

KLA Tencor is a leading provider of equipment to semiconductor chip manufacturers. The company had an options[4] accounting scandal more than a decade ago. This, among other things, led them to simplify their approach to compensation. They have turned their back on the issuance of options and the use of complex performance metrics in their remuneration policies. This has helped the company focus on the long-term, attract and retain the right people, and foster a culture which is slowly but steadily heading in a different – and we think more positive – direction. Their compensation practices are far from perfect, but they stand in quite stark contrast to most in the valley.

Fortinet, a founder-controlled and managed security software company, has had to fight recent battles on two fronts. First, an activist investor showed up on the share register for less than a year and demanded bigger profits, a 'return' of cash to investors (which these days almost invariably means share buybacks rather than dividends), and a riskier balance sheet. Meanwhile the company

4 Options are financial instruments that are derivatives or based on underlying securities such as stocks, bonds, commodities

Source: Getty Images

was dealing with ever-greater competitive pressure, including from the well-funded Palo Alto Networks, where management are on option steroids. Fortinet has seen off the first battle: the activist investor sold its stake for a quick buck. The experience has helped Fortinet to better balance profitability and long-term aspirations without losing the sanctity of their balance sheet.

None of this is new to the founder, whose previous company's fortunes were dictated by venture capitalists. That experience led him to be wary of short-term influences determining the future direction of Fortinet. However, Fortinet continues to fight the battle of retaining high quality people; their fiercest competitor down the road just offered USD130 million to their new CEO.

Intuitive Surgical is a pioneer in the world of robotic surgery and now almost ubiquitous in the American surgical ecosystem. But the journey to get to this position involved some interesting twists and turns. Intuitive had to part ways with founder Fred Moll in 2002 because of differences over the company's future direction of travel. It was a bold decision for professionals and the Board directors to disagree with their iconic founder and inventor. But their decision to focus on the company's core strengths has proven to be the right one for a wide range of stakeholders. Over the last two decades, Intuitive has been competing mostly with its founder, who recently sold his latest venture to Johnson and Johnson. History might suggest neither were wrong but only if financial returns to shareholders are the sole criterion used to gauge success.

What companies like KLA Tencor, Fortinet and Intuitive share is a desire to remain independent, to be second to none in their respective fields, and to safeguard a conservative balance sheet. Their size and profitability enable them to keep spending more than their peers on developing technologies of the future. Huge research budgets are no guarantee of future success, but they are a necessary condition to survive and succeed in the technology arena. Even more importantly perhaps, they are evidence of a long-term mindset and culture.

Circumstances and events have played a decisive role in shaping the histories of these companies. And the responses and choices of those who have stewarded them have instilled some attractive traits in their cultures. Understanding company histories is an important part of the quality puzzle for us.

A trip that got off to a difficult start due to poor weather ended with a pleasant surprise in the sunny valley. We have enough reasons to believe there is quality lurking beneath that bubbly surface.

Worldwide Sustainability Strategy - 30 June 2019

Strategy Size US$1.8bn (as at 31/12/2018) **Number of Holdings** 43

Ten Largest Holdings

Stock Name	Portfolio Weight (%)	Index Weight (%)
Unilever PLC	8.0	0.1
Henkel AG & Co. KGaA	6.6	0.0
Cerner Corporation	4.4	0.1
Beiersdorf AG	4.2	0.0
Merck KGaA	4.0	0.0
Deutsche Telekom AG	3.9	0.1
Ain Holdings	3.5	0.0
Novo Nordisk A/S Class B	3.2	0.2
Unicharm Corporation	3.1	0.0
Expeditors International of Washington, Inc.	2.9	0.0
Total	**43.8**	**0.5**

New Additions

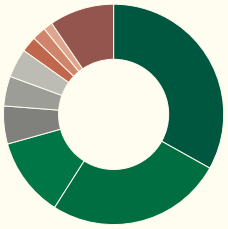
Stock Name	Sector
Pigeon Corporation	Consumer Staples
WEG S.A.	Industrials

Complete Disposals

Stock Name	Sector

No significant stocks were sold in this period

Sector Breakdown

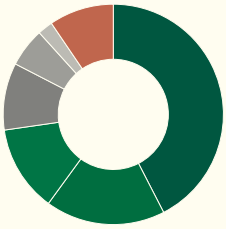


- Consumer Staples 33.1% (8.3%*)
- Health Care 25.9% (11.4%*)
- Industrials 11.7% (10.5%*)
- Communication Services 5.6% (8.7%*)
- Information Technology 4.4% (16.0%*)
- Materials 4.2% (4.9%*)
- Utilities 2.3% (3.3%*)
- Consumer Discretionary 2.0% (10.8%*)
- Financials 1.3% (16.9%*)
- Other 0.0% (9.1%*)
- Cash and Cash Equivalents 9.5% (0.0%*)

*Index Weight

Cash Equivalents may include T-Bills.

Regional Breakdown



- Europe & Middle East ex UK 42.4% (14.0%*)
- North America 17.6% (58.3%*)
- Japan 12.7% (7.1%*)
- UK 9.8% (5.0%*)
- Pacific ex Japan 5.7% (3.8%*)
- Emerging Markets 2.2% (11.8%*)
- Cash and Cash Equivalents 9.5% (0.0%*)

*Index Weight

Market Capitalisation

	0 to 500m	500m to 1bn	1bn to 2.5bn	2.5bn to 5bn	5bn to 10bn	10bn to 50bn	50bn to 100bn	100bn+
Portfolio Weight	0.2	0.0	7.9	5.9	13.7	43.4	19.4	0.0
Benchmark Weight	0.0	0.0	0.3	2.2	7.5	36.6	15.0	38.3

Style Research does not always have full stock coverage; weights may not total 100%

Contribution Analysis - 12 Months

Top Three Contributing Stocks

Stock Name	Portfolio Weight (%)	Value Added (bps)
Unilever PLC	8.0	127
Vitasoy International Holdings	2.1	117
Cerner Corporation	4.4	97

Bottom Three Contributing Stocks

Stock name	Portfolio Weight (%)	Value Added (bps)
Henkel AG & Co. KGaA	6.6	-132
Ain Holdings	3.5	-84
EssilorLuxottica	2.0	-41

Annualised Composite Performance

	Since Launch	10 yrs	5 yrs	3 yrs	1 yr	YTD	6 mths	3 mths
Strategy*	10.4	-	7.9	10.4	6.4	12.3	12.3	3.6
Benchmark**	9.9	-	6.7	12.2	6.3	16.6	16.6	3.8

Calendar Year Composite Performance

	2018	2017	2016	2015	2014
Strategy*	-4.1	27.0	8.2	1.8	1.2
Benchmark**	-8.9	24.6	8.5	-1.8	4.7

Past performance is not a reliable indicator of future results.

*The inception date is 30 Nov 2012. Returns are cumulative, gross of fees, denominated in USD and based on Fund Composite.
**The benchmark for the composite is MSCI All Countries World Gross Index and is calculated gross of tax.

Data shown is from a representative Stewart Investors Worldwide Sustainability account

Data source: This information is calculated by Stewart Investors using the Eagle Pace system. Index information is provided by RIMES.

Past Performance is not a reliable indicator of future results. Performance figures do not reflect the deduction of investment advisory fees. A client's return will be reduced by the investment fees. If a client placed $100,000 under management and a hypothetical gross return of 10% were achieved, the investment assets before fees would have grown to $259,374

Global Emerging Markets Sustainability Strategy - 30 June 2019

Strategy Size US$847m (as at 31/12/2018) **Number of Holdings** 47

Ten Largest Holdings

Stock Name	Portfolio Weight (%)	Index Weight (%)
Unilever PLC	8.0	0.0
Tata Consultancy Serv. Ltd	6.3	0.5
Vitasoy International Holdings	3.7	0.0
Marico Limited	3.6	0.0
Tech Mahindra Limited	3.5	0.1
Unicharm Corporation	3.2	0.0
Housing Development Finance Corporation Limited	3.0	0.9
Foshan Haitian Flavouring & Food Co Ltd	2.9	0.0
Mahindra & Mahindra Ltd.	2.7	0.1
Colgate-Palmolive Company	2.5	0.0
Total	**39.4**	**1.6**

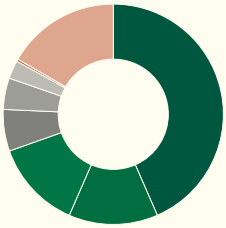
New Additions

Stock Name	Sector
President Chain Store Corporation	Consumer Staples
PT Bank Central Asia Tbk	Financials

Complete Disposals

Stock Name	Sector
Manila Water Co. Inc.	Utilities
Delta Electronics Thai - Foreign	Information Technology
Unilever Nigeria PLC	Consumer Staples
Standard Foods Corporation	Consumer Staples
Sul America SA Ctf de Deposito de Acoes Cons of 1 Sh + 2 Pfd Shs	Financials
Aguas Andinas S.A Class A	Utilities

Sector Breakdown

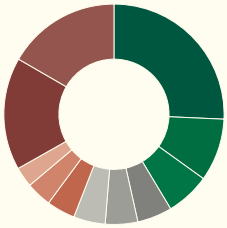


- Consumer Staples 43.4% (6.6%*)
- Financials 13.1% (25.1%*)
- Information Technology 13.0% (13.9%*)
- Industrials 6.1% (5.4%*)
- Health Care 4.6% (2.6%*)
- Consumer Discretionary 2.7% (13.4%*)
- Materials 0.3% (7.6%*)
- Other 0.0% (25.3%*)
- Cash and Cash Equivalents 16.7% (0.0%*)

*Index Weight

Cash Equivalents may include T-Bills.

Country Breakdown



- India 25.7% (9.0%*)
- UK 9.2% (0.0%*)
- South Africa 6.5% (5.9%*)
- Philippines 5.1% (1.1%*)
- Brazil 4.8% (7.6%*)
- Japan 4.7% (0.0%*)
- Taiwan 4.2% (10.8%*)
- Hong Kong 3.7% (0.0%*)
- Nigeria 3.0% (0.0%*)
- Other 16.5% (65.5%*)
- Cash and Cash Equivalents 16.7% (0.0%*)

*Index Weight

Market Capitalisation

	0 to 500m	500m to 1bn	1bn to 2.5bn	2.5bn to 5bn	5bn to 10bn	10bn to 50bn	50bn to 100bn	100bn+
Portfolio Weight	2.1	3.3	10.6	11.0	24.9	17.2	14.2	0.0
Benchmark Weight	0.0	0.2	5.0	11.9	15.9	33.6	10.7	22.8

Style Research does not always have full stock coverage; weights may not total 100%

Contribution Analysis - 12 Months

Top Three Contributing Stocks

Stock Name	Portfolio Weight (%)	Value Added (bps)
Vitasoy International Holdings	3.7	195
Tata Consultancy Services Limited	6.3	157
Unilever PLC	8.0	154

Bottom Three Contributing Stocks

Stock name	Portfolio Weight (%)	Value Added (bps)
Lafarge Cement Wapco Nigeria PLC *	0.0	-82
Unilever Nigeria PLC *	0.0	-64
Mahindra & Mahindra Ltd.	2.7	-63

** Not held at end of Period*

Annualised Composite Performance

	Since Launch	10 yrs	5 yrs	3 yrs	1 yr	YTD	6 mths	3 mths
Strategy	15.4	11.6	4.7	10.0	5.4	9.5	9.5	3.6
Benchmark	10.5	6.2	2.9	11.1	1.6	10.8	10.8	0.7

Calendar Year Composite Performance

	2018	2017	2016	2015	2014
Strategy	-5.3	30.8	7.9	-11.0	4.4
Benchmark	-14.2	37.8	11.6	-14.6	-1.8

The inception date is 28 February 2009. Returns are cumulative, gross of fees, denominated in USD and based on Fund Composite. The benchmark for the composite is MSCI Emerging Markets Net Index and is calculated gross of tax. Investment returns are annualised for periods greater than one year.
Data source: This information is calculated by Stewart Investors using the Barra Enterprise Performance system. Index information is provided by RIMES.
Past Performance is not a reliable indicator of future results. Performance figures do not reflect the deduction of investment advisory fees. A client's return will be reduced by the investment fees. If a client placed $100,000 under management and a hypothetical gross return of 10% were achieved, the investment assets before fees would have grown to $259,374

Representative Fund is the Stewart Investors Global Emerging Markets Sustainability Fund B Acc GBP

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