



Hosking Partners[®]

ESG and Active Ownership Report

Q2 2022

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Foreword



We are pleased to present our ESG and Active Ownership Report for Q2 2022. In this quarter's edition our headline article focuses on the interplay between the global energy transition and geopolitics in Russia. This is an intriguing and multifaceted story of geological fortune, conflicting interests, and geopolitical gambits. By studying this issue, we can better understand how low probability events emerge from long-term trends. Meanwhile, in our 'A focus on' section, we look at the 'S' in ESG, exploring in particular the impact of company culture on stock performance.

This quarter has seen the usual uptick in voting activity as we moved through proxy season. We have slightly reworked our discussion of voting issues, adopting a more thematic approach in place of simply highlighting examples company-by-company. We believe this change allows a broader and more interesting discussion of the issues we have encountered. We have also been busy engaging with companies across the spectrum of issues, with a particular focus on approaches to the energy transition in light of the volatility that has affected commodity markets over past months.

Finally, we would like to thank those clients who have reached out with comments, questions and feedback regarding last quarter's edition. We are always thrilled to further discuss the ideas we present in these reports, and welcome such engagement in the future.

Roman Cassini
Head of ESG

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VOTING SUMMARY **Q2 2022**

Meetings Voted	328	382
Proposals Voted	4565	5238

ENGAGEMENT SUMMARY **Q2 2022**

Targeted ESG	16	35
Total Direct (1-on-1)	40	121
Total Indirect (Group)	54	127
Conferences	24	49

CLIENT NOTICE

This version of the ESG and Active Ownership Report has been edited for public release. If you are a client of Hosking Partners and have not received the full version of this report, please contact us directly.

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The Gambler: Russia and the geopolitics of the energy transition

- Russia's recent actions in Ukraine can be better understood through the lens of the geopolitics of energy supply.
- Oil and gas exports make up 60% of Russia's export income and 40% of the federal budget. The vast majority goes to Europe.
- As the energy transition forces oil markets to consolidate, the Russian offering will become increasingly uncompetitive amidst rising marginal production costs.
- Russia's strategic approach is to encourage the transition to decelerate, while pivoting its export economy towards parts of the world where it will be slowest for longest.

"The whole question here is: am I a monster, or a victim myself?"

"But that is not the point at all," Raskolnikov interrupted with loathing. "You are quite simply disgusting, whether you are right or not, and so people don't want to have anything to do with you, they chase you away – so, go!"¹ (endnotes are on page 20)

Introduction

This quarter's thought piece focuses specifically on Russia. It has been over four months since air raid sirens first cut the crisp Kyiv night air and the steel-plated tracks of Russian T-80 tanks broke the frost over the Ukrainian border. Yet clarity regarding Russia's motivations remains poor, and the Western policy response increasingly fractured. Keeping in mind Marcus Aurelius' observation that "we are too much accustomed to attribute to a single cause that which is the product of several", it is nevertheless worth recognising that Russia's war in Ukraine is a war about energy. Specifically, to paraphrase the Prussian military theorist Carl von Clausewitz, the war in Ukraine is a continuation of the politics of the energy transition by other means. In this piece we will situate Russia's actions within the context of the energy transition. We start, in Parts 1 and 2, with some history. Including this contextual background means this piece is long, but we believe it is important to cover the past to better understand the present. In Part 3 we focus on the outlook for Russian oil, and how it is influencing Putin's decision-making. In Part 4, we outline the gamble that Putin is making in response to the energy transition, and why he may be making it. We conclude by

commenting on how this assessment is influencing the Hosking Partners portfolio.

Part 1: The Gift ²

Energy is the world's most geopolitical commodity sector, and energy transitions are generally accompanied by global upheaval. Geopolitics is the study of the effects of geography on politics and international relations. Hydrocarbon energy is a product of the ground under our feet. The lines drawn on maps to delineate which nations own what clumps of rock ultimately determine who has the most advantageous access to sources of this energy. The geopolitics of the 19th, 20th, and early 21st century is in large part attributable to the last major energy transition, from coal to oil.³ The geopolitics of the rest of this century – and likely the next one – will be similarly influenced by our current energy transition. But this energy transition is unusual. As we discussed in the last quarter's report, unlike previous transitions the early stages of this transition are not 'towards' a more efficient substitute, but 'away' from an unwanted incumbent. Specifically, it is about diversifying energy supply away from an 80% concentration in hydrocarbons and towards a more sustainable energy mix, the exact composition of which remains uncertain.

This simple observation has profound implications for the early geopolitics of the transition. Because the future energy mix is uncertain, the energy transition's 'winners' remain relatively difficult to identify. On the other hand, the potential 'losers' appear more clearly delineated. The countries that are most directly exposed to this transition are those whose

economies rely most heavily on exporting the things we are moving away from – most significantly oil. The impact of that exposure increases as the speed of the transition accelerates, and inversely against an exposed economy's ability to transform itself into something new. It is therefore in the geopolitical interest of exposed economies to slow the speed of the transition as much as possible in order to buy time to reposition.

The story of modern-day Russia, and the Soviet Union that preceded it, is in many ways a story about oil. Russia is highly exposed to a number of risks associated with the energy transition. This exposure results from the interaction between Russia's geology and its political history. Between 1950 and 1970, oil's contribution to world energy consumption doubled from 20% to 40%. In response, in the late 1950s and early 1960s, Russia re-emerged onto the world stage as a net exporter of oil. The oil flowed from new wells in the Volga-Urals region, and from the discovery of the vast Western Siberian basin, through the newly commissioned Druzhba ("Friendship") Pipeline into Hungary and onwards, eventually flowing directly into Germany from 1963. This disruption of the East/West Cold War bifurcation may have never come to pass had it not been for the Suez Crisis seven years earlier. Suez demonstrated not only that access to Middle Eastern oil was increasingly vulnerable to the rise of Arab Nationalism, but also that the US was not willing to come to Europe's rescue unless it served its own interests to do so.⁴ Hence, the Russian-German energy relationship was born. It is a relationship that has subverted the common interests of both NATO, and to a lesser but nevertheless notable extent the EU, ever since.

From 1963 onwards, the Soviet Union's ascent as an energy powerhouse was rapid. The Western Siberian basin was not only yielding oil, but also enormous volumes of natural gas. A network of pipelines emerged across Europe's Eastern flank, which deepened both the trade relationship and, by consequence, the growing fractures in NATO's strategic unity (Figure 1). Meanwhile, in 1970, US conventional oil peaked. US domestic production would not surpass that high oil-mark until 2018, several years into the shale revolution. By the time of the 1986 oil crisis, the Soviet Union was the world's leading oil producer. But its geological strength was fatally undermined by its economic weakness. The Soviet command economy was unable to deploy the required technologies or generate the human capital required to maintain such a productive hydrocarbon industry. By this point the budget deficit was so steep and government revenues so sensitive to the oil price that when Saudi Arabia crashed the market in 1986 there was no route back.⁵ Russian oil production, unsupported by a high oil price or additional government subsidies, and facing a raft of technological recovery challenges, collapsed. Shortly afterwards, the collapse of the Soviet Union followed.

Part 2: The Dream of a Ridiculous Man

Vladimir Putin's early reign in the early 2000s was defined by his efforts to bring the Russian oil industry back under effective state control. Although Putin's idea of state control is more nuanced than the inefficient command economics of the Soviet era, the plundering of Russia's energy assets by both Russian and Western companies in the 1990s has left the Russian president deeply wary of unbridled corporate power. Putin's system, therefore, is a hybrid system. On the one hand, a handful of domestic and foreign private interests are permitted to exist to attract foreign capital and Western technologies. On the other, their operations remain reliant on the government. This is not only guaranteed by intangibles like permits and exploration rights, but on actual physical infrastructure, most notably the pipelines.⁶ Concurrently, Putin has systematically replaced the early energy oligarchs with loyal allies, many of whom hail from the same intelligence circles as Putin himself.

The manipulation of the Russian oil industry was designed to harness the productive efficiency of private enterprise to the geopolitical will of the state. Putin spent years building a political-economic edifice in Russia that ensured the keys to the nation's greatest treasure – hydrocarbon energy – were owned by the state and merely lent out to private enterprise.

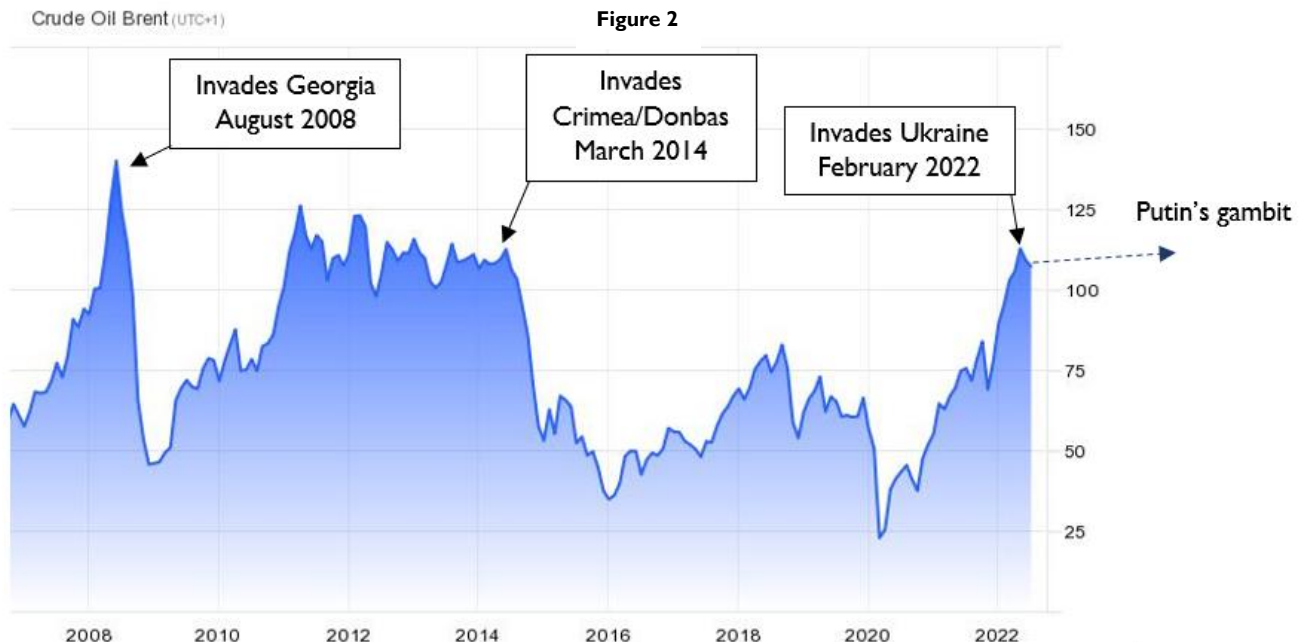


This system proved reasonably successful. Between 2000 and 2019, oil production rose 200%, export revenues 230%, and GDP/capita 230%.⁷ Unlike in Saudi Arabia, Iran, or Venezuela, where the National Oil Companies are indistinguishable arms of the government, in Russia the illusion of free enterprise has been nurtured in a more sophisticated manner. Levels of inward Foreign Direct Investment (FDI) more than doubled into Russia between 2005 and 2021. Over the same period, FDI into Saudi Arabia halved.⁸ Meanwhile, Russian oil companies have attracted significant investment from Western oil majors including BP, Shell and Total. In the lead up to February 2022, even Western ESG-labelled investment funds retained significant exposure to Russian equities.⁹ While Putin's foreign policy raised eyebrows in military circles, the belief was that a Western-facing corporate landscape would curtail the excesses of state power. This illusion, which was unceremoniously dispelled in February, has also hidden systemic conflicts of interest that will curtail Russia's ability to respond effectively to the structural challenge posed by the energy transition.

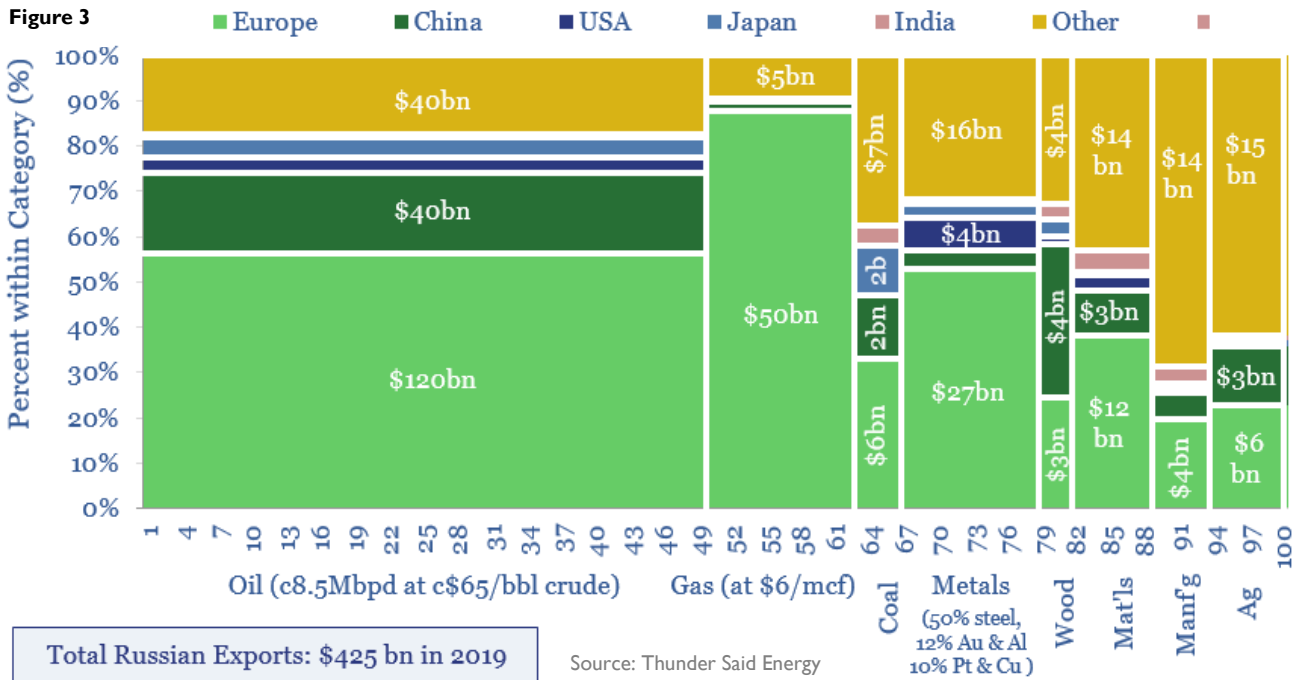
Despite two decades of attempted alignment, the strategic outlook for Russia's oil industry hangs in the balance between the conflicting interests of the federal government and the oil companies. This conflict of interests is partly ideological, but it is primarily financial. When oil prices are high, the government collects a higher proportion of revenue as tax, whereas when prices are low a greater percentage is retained by the companies. The idea is to ensure the companies have the resources to keep producing even when prices are low. The interaction between the oil price and federal income can become quite extreme at

the margin; when oil prices are over \$120/barrel (bbl), the government take is around 80%.¹⁰ Due to this system, in May 2022 when the average oil price was \$113/bbl, government revenues from Russian oil reached \$20bn in spite of Western sanctions, up 400% versus May 2016 when the oil price was depressed at \$43/bbl. This allowed the Russian government to splurge an additional \$10bn on the 2022 defence budget – a 20% increase – largely offsetting the impact of sanctions and contrasting grimly with the measly \$2bn in military aid provided to Ukraine by the entire EU.^{11, 12}

The Russian state reaps the profits from high oil prices even if output drops, while the oil companies generally prefer maintaining higher production at the cost of a lower oil price. This is a conflict that played out publicly in April 2020 when Putin and Igor Sechin, CEO of Rosneft, butted heads over the OPEC+ agreement to implement one of the most dramatic oil production cuts in history. The conflict rests on three issues. Firstly, and most simply, at lower prices a lower proportion of revenue is paid in tax. Secondly, producing West Siberian Russian oil has historically had low operating costs relative to global peers, allowing companies to retain their margin at a lower base price. Thirdly, a lower oil price makes Russian oil more attractive versus a range of competitors, notably including US shale oil which has a higher average break-even.¹³ The overall result is that high oil prices are more directly advantageous for the Russian government than – as may be assumed – the Russian oil majors. On the flip side, when oil prices are low, the government takes a crippling hit. This is why Putin's military adventurism is timed to coincide with elevated global energy prices (see Figure 2).



Source: Hosking Partners, Trading Economics



The continued manipulation of energy strategy to fund foreign policy led several major figures in the Russian oil industry to resign following the invasion of Ukraine, not least the outspoken CEO of Lukoil, Vagit Alekperov.¹⁴ This internal tension between the government and the corporates is just one of many inter-connected cracks that have been growing across Putin’s Russia. Pressure has also been building around the related issue of the nation’s approach to climate change and the wider energy transition.

Part 3: Moscow to the End of the Line

In recent years, the Russian government has begrudgingly begun to recognise the threat the energy transition poses to long-term oil prices. We do not know what the oil price will be tomorrow, or next year, or five years from now, or in 2050. But we can make some observations about oil supply and demand today, and the direction in which that could move over time. Today, global oil demand runs at around 100 million barrels per day (mbpd), of which Russia supply around 11m (12%).¹⁵ The range of possible demand scenarios reaching out to 2050 is wide, as we discussed last quarter. There is general agreement that oil demand is likely to peak in the late 2020s to early 2030s¹⁶ at around 105-110mbpd, before commencing a gradual decline. The International Energy Agency’s ‘Net Zero 2050’ pathway requires oil demand to decline 4x from current levels, to 24mbpd by 2050.¹⁷ More realistic estimates for 2050

demand sit between 85-100mbpd, with rapidly growing demand for liquified petroleum gas, petrochemicals and jet fuel in emerging markets largely offsetting developed market reductions achieved via the electrification of transport and industrial clean tech substitutions.¹⁸ In short, the outlook for gross global oil demand shows a gradual decline, although it will reduce more substantially as a proportion of overall energy consumed, from 25% to around 17%.

Plateauing demand means upstream greenfield investment is becoming much harder to secure, with investors and financiers concerned by the risk of stranded assets. Instead, the theory goes, existing brownfields should be squeezed, while shale oil – which is naturally short-run – ramps up and down to meet demand at the margins.¹⁹ This transition scenario is likely to produce price volatility, but history suggests that in the short to medium-term average prices are likely to remain elevated. Studies of previous energy transitions suggest demand for incumbent energy sources tends to be stickier than forecast, which leads to premature underinvestment in supply and high prices.²⁰ This is a pattern that we at Hosking Partners are keenly attuned to, as students of capital cycles. But history also shows that over the long-term (15+ years), the average price trend will be downwards, as oil’s share of overall energy supply shrinks. This long-term transition model is reasonably attractive for countries with large reserves of easily recoverable oil (Saudi Arabia) and for those with significant shale reserves (the US). But it is distinctly unattractive for Russia, as we will see.

Global energy under-supply runs at 2% in 2022, escalating to 10% by 2030

Source: Thunder Said Energy

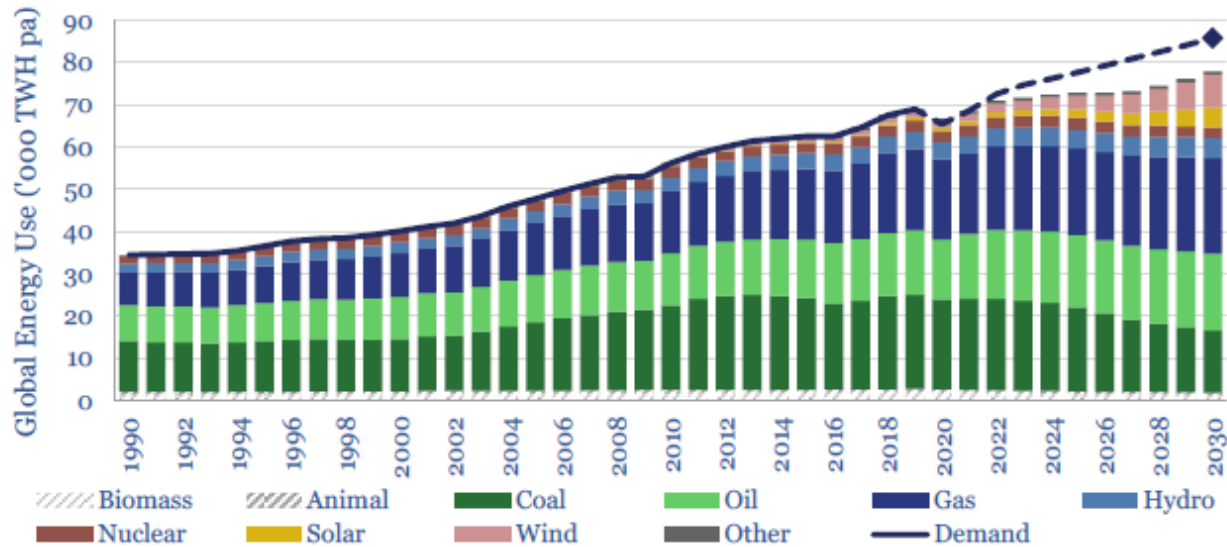


Figure 4

Russia is structurally exposed to the energy transition due to fiscal overreliance on oil export revenues that are facing sustained competitive pressure. It should be noted that oil and gas is not the only game in town. Russia has a strong chemicals and fertilizer industry, and over the last 10 years has quadrupled wheat and grain exports.²¹ Meanwhile, metals exports earn Russia around \$40bn per year, of which two thirds is steel and ferrous metals and the remaining third mostly aluminum and nickel.²² Demand for these exports will remain strong, and in some cases could grow advantageously for Russia. However, in 2019, oil and gas exports alone made up around 60% of Russia’s export income and 40% of the federal budget (see Figure 3).²³ As such, the single most important issue for Russia in relation the energy transition is the outlook for hydrocarbon production and exports. For oil the picture is bleak. In June 2020, the Russian Ministry of Energy published its *Energy Strategy to 2035*. This is a remarkable document not least because it breaks two decades of institutionalised ‘transition denial’ by the Russian government. The document accepts that oil demand could peak around 2030, and that prices will inevitably follow. The *Energy Strategy* goes on to argue that without significant tax relief a third of Russia’s proven but undeveloped reserves (the ‘TRIZ’ fields) will be unprofitable to develop without a sustained oil price above \$70-75/bbl, a 300% increase on historical breakevens. Failure to develop these fields could in turn cause oil production to fall as much as 40% as the legacy basins decline.²⁴ The vast Western Siberia basin has been the crown jewel of Russia’s upstream since its discovery in the 1960s. On average, it accounts for 50-70% of Russian crude production.²⁵ However, this figure has been

declining for over a decade, with maturing fields spitting out less oil and more water year-on-year.²⁶ In response, the government has been forced to increase subsidies for oil production, which makes it doubly exposed to drops in the global oil price. Outside of the slowly dying brownfield heartlands of Western Siberia and the Volga-Urals, Russia retains theoretically exciting prospects in Eastern Siberia and the Arctic. But while reserves are plentiful, costs are higher across the spectrum because the oil in these regions is harder to access, both physically and technologically.

In the long run, the oil industry will consolidate as oil’s market share of overall energy supply declines. Systemic underinvestment in upstream capacity over the last 5-10 years means we are currently facing an energy supply shortage, which has been exacerbated by Covid and the war in Ukraine. Studies suggest this shortage could get worse by 2030, as demand for energy (from any source) outstrips global supply (see Figure 4). However, it is important not to confuse near-term shortages with the long-term trend. Fixing today’s energy shortages will require an intense cycle of hydrocarbon investment, but in the long run diversification away from oil will continue. Far removed from the ‘peak oil’ fears of the late 20th century, as we move into the second half of the 21st, millions of barrels per day will simply remain in the ground. As the amount of potential oil supply begins to outweigh demand, competition to supply the circa 85mbpd remaining in the system will intensify.

Russian oil’s prospects in a consolidating market are doubly negative. Russia is not only beset by

greenfield underinvestment, but on an overreliance on imported Western technological and human capital.²⁷ The Russian economy is largely dependent on the export of raw materials. Russia imports twice as many manufactured goods and machinery as it exports. The picture is even more skewed for computing and other advanced technology, including many of those areas that are at the cutting edge of the energy transition.²⁸ Dieter Helm, professor of energy policy at Oxford University, is damning: “as far as new technologies are concerned, Russia is nowhere. Nowhere in robots, 3D printing, solar, or even mainstream software and data”.²⁹ This is the source of another area of tension between Putin and the energy companies. The companies are keen – and in some cases technologically dependent – on Western joint ventures. Putin, unwilling to abandon an anti-Western stance he has found politically advantageous, has relied on Russia’s energy stranglehold on Europe to guarantee cooperation. However, in recent years, as exemplified by the *Energy Strategy*, Russia’s confidence in its own position has begun to crumble. This is a situation with which Putin is grimly familiar. Russia has been in it before – in the late 1980s as the Soviet Union began to collapse. In 2005, the Russian President called the collapse of the Soviet Union “the greatest geopolitical catastrophe of the century”. This is a fundamentally emotional statement, hidden in the vocabulary of geopolitical realism. It tells us something about how Putin may perceive the threat Russia faces from the energy transition. To Putin, there is a threat of history repeating itself.

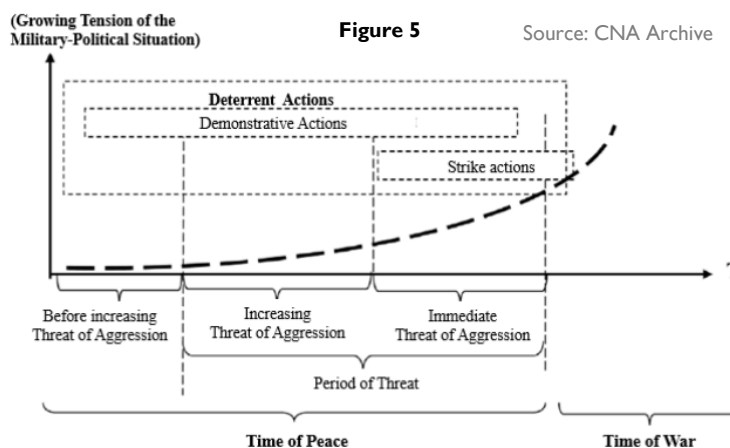
Part 4: The Gambler

Putin has realised that the levers driving the energy transition are increasingly out of Russia’s grasp. As shown in Figure 3, around 50-55% of all Russia’s exports go to Europe, including over 50% of its oil and almost all its gas. The same physical network of pipelines (Figure 1) that secured Putin’s control of the oil companies also ties the Russian economy to Europe’s demand for energy. In 2019, Russian imports constituted around 30% of Europe’s overall energy demand.³⁰ Since the Suez Crisis in 1956, this supply network has been Russia’s geopolitical ‘ace of spades’, providing powerful leverage over key nations within the EU. For two decades Putin largely dismissed the growing European sustainability movement

because the economic argument for hydrocarbons remained fundamentally strong. Furthermore, Russia may have proactively supported Western environmental causes to stoke division, while protecting the market for Russian gas.³¹ Meanwhile, Putin focused on shoring up Russia’s ability to pump gas into Europe without having to rely on Ukraine for transit, laying pipelines connecting Russia directly to Germany in the north and Turkey in the south. This served the dual purpose of removing Ukraine’s protective negotiating leverage while simultaneously deepening divisions in the key Western military and political alliances. This is all very well as long as Russian oil stays profitable and the oil price stays high enough to maintain the fiscal break-even. However, as we have seen, not only has Russia’s internal outlook for oil deteriorated, but Putin has concurrently become increasingly concerned that the pace of the energy transition is accelerating ahead of Russia’s ability to adapt. This has been an alarming realisation, and has shaken Russian strategic planning to its core. In his 1996 dissertation, Putin himself described strategic planning as “planning for the future under conditions of change, especially rapid change caused by circumstances beyond one’s own control”. This is the situation in which Russia finds itself now.

With this set of circumstances in mind, Putin’s recent actions – hastily dismissed as ‘irrational’ by the Western media – acquire a perverse but consistent logic. Russia’s defence strategy towards Europe and the US has long been based on the concept of “active defence”. This concept calls for strong deterrence (“threats of inflicting unacceptable damage”)³² combined with persistent destabilisation of adversary strengths, and opportunism in the face of adversary weakness.³³ Both military and non-military actions should be conducted throughout peace time, even when the threat of aggression is minimal (see Figure 4). Russia’s activity over the last 10 years – including everything from the Salisbury poisonings, to meddling in Western

elections, to facilitating the Syrian refugee crisis, to deepening European energy disparities, to the annexation of Crimea and the invasion of Ukraine – should be viewed through this lens of “active defence”.³⁴ The fundamental aim is to internally weaken the Western alliances (NATO and the EU) that Putin considers the primary threat to Russian power

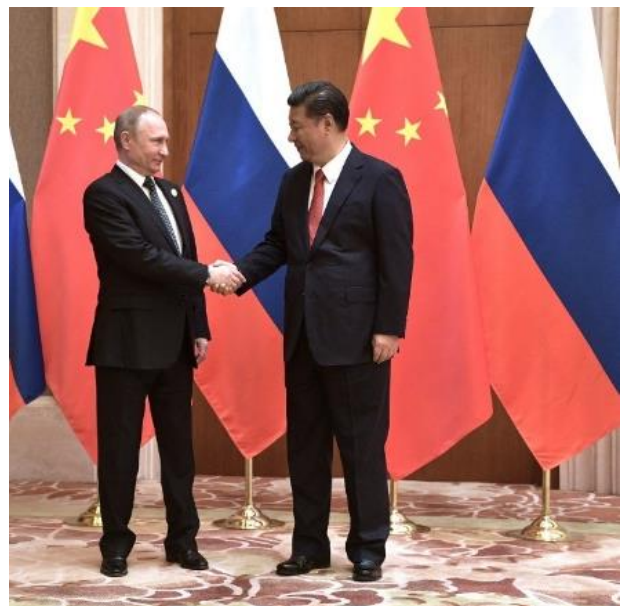


projection. This is not just a military threat. Putin understands that the energy transition can only succeed in an environment of close international cooperation. Destabilising that environment has become a core strategic aim, because it reduces the likelihood of the “rapid change under circumstances beyond one’s own control”. Russia has finally accepted that an energy transition is inevitable – but it believes that the speed and nature of that transition remains within its influence.

Russia’s strategic approach to the energy transition is to encourage it to unfold slowly, while pivoting its export economy towards parts of the world where it will be slowest for longest. This strategy has two core supporting aims. The first is to slow the energy transition down in Europe and, if possible, elsewhere. The second is to re-orientate Russia’s hydrocarbon export market towards China (as well as other key Asian markets like India). We have already touched on the benefits for Russia of slowing down the energy transition. In brief, a slower transition – especially one that is *slower than expected* – leads to higher hydrocarbon prices for longer, which buys Russia time and money to adapt. Prior to the Covid pandemic, Russia’s basic but relatively limited strategy was to sow division amongst the Western countries driving the transition while concurrently continuing to diversify its export options. By 2019, Russian investment in green, blue, and unconventional field developments was just starting to recover following the low oil prices of the mid-2010s. Then Covid arrived. The early months of the pandemic were brutal for Russia, but the oil price rebounded sharply and Russian export revenues soared.

Suddenly, an opportunity emerged. Russia, an economy driven almost entirely by the production of raw materials, was well placed to read the tea leaves. Putin appears to have recognised the effect the pandemic would have on supply chains and commodity prices, and likely welcomed the US Fed’s expansionary response. Western economies were directly stimulating demand while underlying supply was tightening sharply. As inflation began to bite in late 2021, with the oil price approaching \$100, Russia added fuel to the fire with every battalion that arrived on the Ukrainian border. Putin’s great gamble is that a war in Europe will accelerate the inflationary trends that sustained upstream underinvestment and Covid have already set in motion. As we discussed last quarter, the energy transition is extremely capital intensive. Inflation and higher rates both disincentivise the rapid, renewables-led model that the EU has been pursuing. Furthermore, the transition requires extensive international cooperation. Given Russia’s control over European imports of gas, the decade of groundwork already laid inflaming tensions between NATO and EU member states, and the flaccid

response to Crimea, Putin appears to have been confident that a united opposition to military action was unlikely. In fact, the effects of the war may further divide Western powers’ approach to the transition. For Putin, here was an opportunity to complete unfinished business in Ukraine while concurrently taking back a degree of control over the long-term trend that most threatened the Russian economy. This is what Bob Brackett, oil analyst for the research consultancy Bernstein, calls “the Putin put”.³⁵ The invasion of Ukraine, combined with the weaponisation of hydrocarbon supply to Europe, has raised the upper floor price for oil in the medium term. Critically, due to the systemic underinvestment depicted in Figure 4, Russia has gained some control over the length of time these conditions last.



Source: Google Images

Meanwhile, Russia will gradually continue to pivot its hydrocarbon export economy towards that part of the world that will be the slowest to decarbonise. China alone currently consumes around 20,000 TWh of useful energy per year – 30% of the global total – of which 65% is generated from coal. China’s reliance on coal has been a ‘feature and not a bug’ of its economy; because the Chinese Communist Party (CCP) sets the internal price of coal it is able to continue to undercut renewables even as their levelised costs reduce. This has encouraged Western supply chains to relocate to China to remain competitive, and means Western efforts to decarbonise are effectively meaningless without Chinese cooperation. Subject to future rates of economic growth, Chinese energy usage could double or even triple by 2060. In turn, this will lead to anywhere between 5 and 20 gigatonnes (IGt = 1bn tonnes) of unabated CO₂ emissions per year, depending on the success of China’s decarbonisation program. To put this in context, the

entire world currently emits around 50Gt per year. The picture is similar in India, which currently consumes around 5000 TWH of useful energy, of which around 50% is coal derived.³⁶ India is also subject to significant growth projections. Ultimately the fastest and most economical way for India and China to reduce their emissions – while also retaining the cost competitiveness of their supply chains – is through massive coal-to-gas switching.³⁷ In China alone, gas demand is forecast to grow from 300 billion cubic meters per year (bcm/y) to somewhere between 1,000-3,500bcm/y by 2060, depending on the transition pathway adopted. Even under the most aggressive decarbonisation scenario, gas demand more than trebles. In the middle-of-the-road scenario, by 2030 China needs to add more LNG supply per annum than is currently forecast to be added globally.³⁸ The market opportunity Russia has its eye on is real.

Russia believes its natural gas supply potential is strong enough to attract long-term strategic partnerships in Asia that can balance a decline in European demand. Russia is the world's largest gas exporter and has the world's largest gas reserves. In 2021 the country produced 762 bcm of natural gas, of which it exported approximately one third. Currently, around 75% of this gas goes to Europe, although in terms of revenue Europe accounts for closer to 90% due to more favourable contracts and lower transport costs. Only 6% of Russia's gas is currently exported to China, which is a mixture of LNG and gas transported by the Power of Siberia (POS) pipeline that links the Eastern Siberian Yakutia field to China. Construction of this pipeline commenced in 2012, with a 30-year supply deal inked in May 2014, three months after the 'little green men' had first emerged in Crimea.³⁹ A second pipeline, Power of Siberia 2, is planned, and another 30-year deal was reportedly agreed in early February 2022.⁴⁰ The Power of Siberia 1 pipeline targets a capacity of 38bcm/y by 2025, while Power of Siberia 2 could carry as much as 50bcm/y. The government has also released an LNG export target of 110-190bcm/y by 2025, a dramatic increase from the current 5-year average of 27bcm.⁴¹ If by 2025 we assume 75% of Russia's LNG goes to China or other non-European countries, then combined with the two POS pipelines Russia could be exporting 210bcm/y of natural gas to non-European markets. Given that Western Europe currently imports around 185bcm/y, this growth more than offsets any partial decreases in European demand due to sanctions and supply diversification. At \$4-6 prices,⁴² this export market alone would net Russia \$30-50bn per year, equivalent to 18-30% of the income currently derived from total European oil and gas exports.⁴³ There are significant frictions that would need to be overcome to realise this ambition, and on balance the odds seem to be against smooth execution. Nevertheless, we believe that Putin's confidence in this

strategy, combined with the effect of an overall slowdown in the energy transition, has underwritten Russia's risk assessment in Ukraine.

Part 5: What Is to Be Done?

At Hosking Partners we have been thinking deeply about the impacts of Russia's actions on clients' portfolios. Prior to the invasion of Ukraine we were firm believers that the progressive edge of Russian free enterprise – so well characterised by companies like TCS, Lukoil, and Lenta – was sharp enough to keep at bay the excesses of Putin's authoritarian regime. On this front we were, like so many in the West, mistaken. We will not dwell here on the short-term impact of the war on performance, or the post-mortem we have conducted into our thinking leading up to the invasion, which we have discussed previously elsewhere. Instead, we conclude by highlighting some ideas that have gained prominence since 24th February, and which we believe position Hosking Partners to take advantage of some of the long-run trends we have discussed above.

Firstly, we believe that Putin has got one element of his gamble right: The war in Ukraine will slow the energy transition down, at least in the near-term. We are already seeing this effect. While European politicians make loud announcements about outlawing internal combustion engines, they are quietly reopening coal-fired power stations.⁴⁴ Meanwhile, Indian coal demand is expected to grow 20% by 2024, while the US Supreme Court has ruled against enhanced climate regulations.⁴⁵ Regrettably, this year could prove to be the highest emitting year in history. In June, Russia reduced Nordstream gas flows by 60%.⁴⁶ The energy crisis is far from over, and we expect it to intensify as we enter the colder months. This combination of a pragmatic reset on the utility of fossil fuels with increasing idealism for certain transitional technologies sets the stage for a long-run and self-fueling commodity super-cycle spanning both energy and metals and mining. Although a recession could undermine demand in the near term, this would be an event and not a trend. The 'Putin put' described above is a powerful idea, and average oil prices could plausibly remain elevated for years rather than months, because although a supply response is inevitable, it will take time for capital to transform into energy. Energy is subject to the laws of thermodynamics, and to make more of it you have to spend it up front.⁴⁷ Central banks can't print oil, or solar, or copper. We continue to believe that traditional hydrocarbons, which are required to ease short-term energy shortages, complement renewables and support the long-term energy transition. We are looking for opportunities to increase our exposure to attractively valued companies across these areas.

Secondly and relatedly, we believe that non-OPEC+ producers may experience a resurgence as Europe seeks to diversify supply away from unreliable regimes. In a slower-for-longer transition scenario oil demand will remain strong, even in Europe, into the 2030s. However, following the war in Ukraine supply will inevitably diversify. Although the big, cheap, OPEC producers will gain some of the business, we believe well-placed smaller producers in non-OPEC regions will also benefit. In a recent meeting with an African-based oil producer, the CEO recounted that the President of one West African country had recently commented to him that his nation is being priced out of the market as LNG – which is generally contracted to provide the seller considerable flexibility – is redirecting towards European and Asian consumers able to pay a higher spot price. This is a simple example of how energy shortages in the developed world are hurting emerging economies today. The company in question, which had traditionally treated gas as a waste product, is now exploring a long-term agreement to supply natural gas to the country at a fixed cost. This is a triple ‘win’: security of energy supply for a developing economy in need; biomass/oil-for-gas switching to reduce national emissions; and reduced operational flaring and associated methane emissions. We believe that as approaches to ESG becomes more nuanced, and the interplay between E, S, and G better articulated, such companies could further benefit. We are exploring several ideas in this vein.

Thirdly, in the medium to long-term, we believe that the war in Ukraine will accelerate ‘de-globalisation’. Ukraine has provided a powerful ‘reality check’ to the idea that highly globalised supply chains conclusively disincentivise military aggression. Although some commentators have suggested that the impact of Western sanctions on Russia could deter Chinese aggression in the South China Sea, unfortunately we are more skeptical. Over the past two decades, rising Western prosperity, cheap capital, and low inflation has been underpinned by taking advantage of cheap, offshored supply chains. Those associated with energy transition technologies are particularly concentrated, with around 90% of the market share located in China.⁴⁸ China produces 50% of the world’s metals, 60% of its wind turbines, 70% of its solar panels and 80% of its lithium iron batteries.⁴⁹ While parts of Europe have nurtured an unhealthy reliance on Russian energy, the entire Western world is over-reliant on China for a vast swathe of critical commodities, affording Xi Jinping considerably more leverage than Putin. The geopolitical imperative to re-shore these supply chains, particularly for the US, has never been clearer. But it will not be easy, or cheap, and such efforts are likely to further re-inflate costs across the energy transition. This theme, therefore, feeds back

into our first conclusion. The energy transition will decelerate, and the pricing environment may remain inflationary rather than deflationary for longer than forecast. We are exploring a number of diverse ideas related to this conclusion, including in US domestic gas (the only feasible cost competitor to Chinese coal), and diversified (i.e. non-Chinese) metals.

In poker terms, Russia’s geopolitical gamble is ‘pre-flop’, and the cards are yet to be revealed. Putin has bet that an invasion of Ukraine serves the short-term purpose of slowing Western decarbonisation efforts and elongating the global runway for fossil fuels. Concurrently, Putin believes the conflict’s second-order effects – high commodity prices, energy shortages, and exacerbated post-Covid inflation – will widen existing rifts between and within Western powers. Putin has also gambled that Russian energy is too valuable for Europe to lose in the short run, while in the long run the geopolitical play is in Asia, mainly via ballooning Chinese demand for natural gas. Meanwhile, Putin has bet that increasing Russia’s territorial presence in Ukraine enhances long-term Russian security by pushing back NATO and gaining access to new natural resources and warm water ports. The counter-play is that Western resolve holds or even strengthens in the face of division, and that a drive for energy security can coexist with an accelerated energy transition away from Russian hydrocarbons. Perhaps de-globalisation can serve as a positive rather than destabilising force in the West, and maybe the financial and reputational damage inflicted on Russia could catalyse the internal disintegration of Putin’s edifice. It is an almighty gamble. The possible outcomes are multifaceted and opaque. Many secondary effects will not be felt – or even identified – for years and even decades.

At Hosking Partners we do not try to predict the future, but we do try to find opportunity in complexity, using the simple elegance of the capital cycle to identify companies that are positioned to benefit from long-run trends. This quarter we have focused on how a low-probability event may have emerged from such a trend. We believe that understanding and responding to the underlying causes of such events will help us navigate both the energy transition and the global upheaval that will inevitably accompany it.

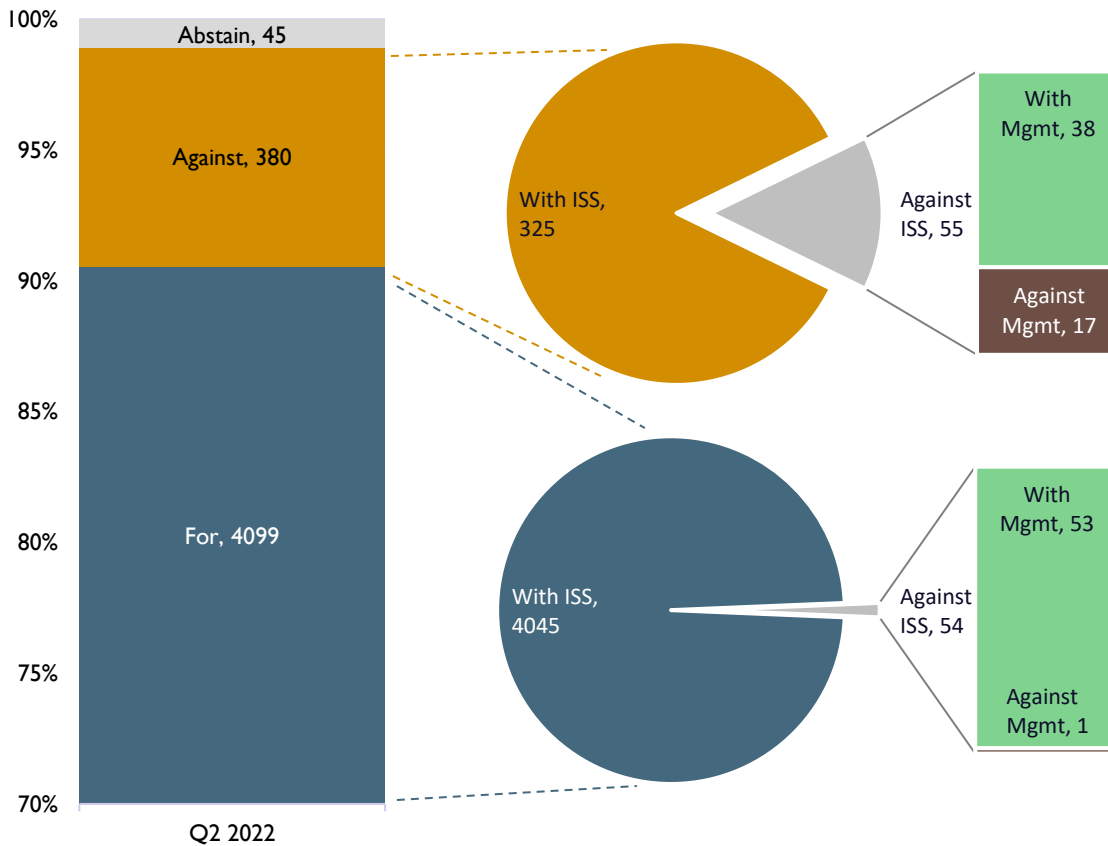
Next time

In next quarter’s ESG and Active Ownership report, we will return to our original plan for this quarter, and widen our lens to look at the rest of the world, highlighting other potential winners and losers from the energy transition including the US, China, Europe and the Middle East.

Voting Summary

Proxy voting is a fundamental part of active ownership and our procedures are designed to ensure we instruct the voting of proxies in line with our long-term investment perspective and client investment objectives. We use the proxy voting research coverage of Institutional Shareholder Services Inc (ISS). Recommendations are provided for review internally, and where the portfolio manager wishes to override the recommendation they give instructions to vote in a manner which they believe is in the best interests of our clients.

Q2 2022 VOTING BREAKDOWN



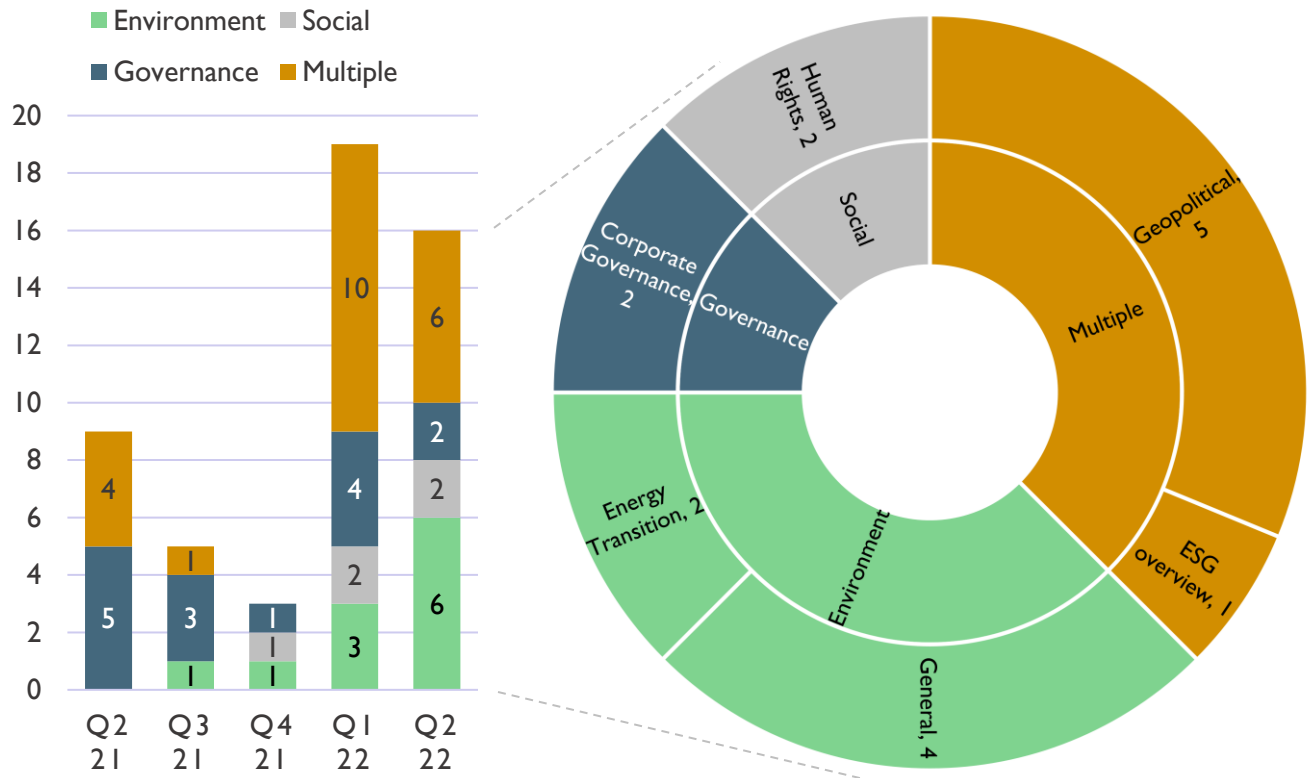
2022 THEMATIC BREAKDOWN	FOR		AGAINST		ABSTAIN		AGAINST ISS	
Director related, elections etc	2,448	54%	177	4%	51	1%	44	1%
Routine/Business	865	19%	24	1%	2	<1%	1	<1%
Capitalisation incl. share issuances	395	9%	39	1%	--	--	10	<1%
Remuneration & Non-Salary Comp	620	14%	82	2%	--	--	13	<1%
Reorganisation and Mergers	67	1%	6	<1%	1	<1%	1	<1%
Anti-takeover Related	49	1%	2	<1%	--	--	--	--
Other, incl. wider ESG	248	5%	112	2%	7	<1%	45	1%

* Not depicted 35x instructions to 'Withhold', 3x instructions for 'One Year' (advisory vote on pay frequency), and 3x instructions to 'Do Not Vote'

Engagement Summary

Corporate engagement is a core component of Hosking Partners' process. As well as engaging in specific situations, we focus on company management, and careful consideration is undertaken by the portfolio managers to assess whether the management teams' time horizons and incentive frameworks are aligned with the long-term interests of our clients. We also look to confirm management's understanding of capital allocation and believe part of getting capital allocation right is to consider environmental and social risks, along with other factors that might affect a company's long-term valuation.

Q2 2022 ESG ENGAGEMENTS BREAKDOWN



Targeted ESG engagement this quarter dipped slightly versus Q1 as our attention shifted to a busy proxy voting season, but remains sharply elevated year-on-year. In particular, we continued to increase our engagements focusing on 'E', with a particular emphasis on how companies are positioning themselves with regard to the energy transition. This quarter we conducted sixteen targeted ESG engagements, of which 68% (11/16) were with companies already in the Hosking Partners portfolio, and five were with prospects.

Over the quarter we observed a distinct shift in emphasis in industry-wide discussions of ESG issues. Enthusiasm for broad metric-based divestment is shrinking in favour of a more nuanced approach that prioritises active ownership and engagement. This reflects growing evidence that 'ESG ratings' display a poor correlation both with one another (i.e. between ratings agencies) and with underlying performance. Furthermore, high-profile accusations of greenwashing in ESG-labelled funds have placed pressure on asset managers to re-think their approach to ESG. Overall, we have been encouraged by this shift, which aligns the wider industry with the position Hosking Partners have articulated for some time. This position is that the complexity of ESG issues cannot be simplified into a single metric or rating, and positive ESG effects cannot be achieved via divestment alone. Instead, active ownership and identification of overlooked improvers across all sectors offers a more constructive and value-accretive strategy for ESG-focused investors.

A focus on... The rise of the 'S' in ESG

- In the wake of Covid, and amplified by the tragic Russia/Ukraine conflict, the 'S' in ESG is garnering increasing investor attention.
- New regulation – including the much-anticipated EU 'Social Taxonomy' – could be a powerful step in the codification of minimum standards.
- However, 'S-factor' analysis should extend beyond simple risk mitigation to generate the most value for client portfolios.
- Specifically, corporate culture is a source of market inefficiency that holds the potential for long-term alpha capture.

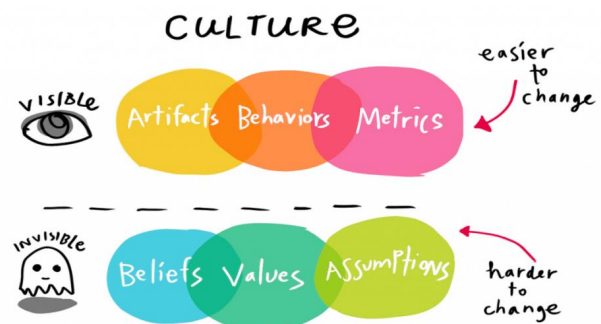
“An organisation is nothing more than the collective capacity of its people to create value.”

Louis Gerstner, Former Chairman & CEO of IBM

Consideration of the often-overlooked 'middle child' of ESG analysis – 'social' – is on the rise.

Amidst the reverberations of a global pandemic and growing geopolitical unrest, and as 'E' is re-evaluated within the context of a greater focus on energy security, 'S' is staging a comeback. The public scrutiny of corporate values has long been part of what is now known as stakeholder or ethical capitalism; indeed, it is the only direct handover from one of ESG's progenitors, Corporate Social Responsibility (CSR). However, significant challenges in assessing and integrating social factors to the investment process remain. The EU's much-anticipated 'Social Taxonomy'¹ may prove a pivotal step in the codification of minimum standards, but as long-term investors we submit that the thoughtful consideration of social factors can reach beyond simple risk mitigation. Rather, it should also be considered a source of alpha capture. More explicitly, we believe that corporate culture – one element of s-factor analysis – can be a fertile ground for assessing competitive advantage and fundamental performance. Yet assessing culture is not without its own challenges. Culture lacks obvious and universal metrics for comparability. It is an oft-applied catch-all term for all manner of virtues (and sins!). Furthermore, it is implicitly long-term and dynamic, reflecting the organic makeup and complex adaptive systems in which it exists. As global, generalist investors with an atypically long investment horizon, at Hosking Partners we are well-positioned to meet these challenges. Specifically, we believe our long-term approach, supplemented with a series of behavioural models, enables us to assess, identify and reap the rewards of this intangible-oriented market inefficiency. This piece will

provide some context to the challenges of 'S' integration, and describe how the EU Social Taxonomy – amongst other regulation – is cause for hope in establishing standards. It will go on to make an argument for the importance of culture in corporate performance, and offer some initial reflections on what makes a great culture. It will end by proposing an initial framework for the assessment and integration of culture into the investment process.



Source: Google Images

“Absence of evidence is not evidence of absence.”² Analysis of social factors has historically lagged environmental and governance considerations given challenges in deciding what metrics matter. A clear exception that proves American venture capitalist John Doerr’s maxim to “measure what matters”, the investment community has repeatedly struggled to reflect the true standing of social factors in ESG analysis.³ At its most simplistic, the breadth of ‘addressable’ s-factors makes consensus on what exactly is and isn’t material difficult to reach. Vaclav Smil has observed the “atomisation of knowledge” in today’s society, whereby inherently linked fields of study are segregated to the point that their relevance to reality fades.⁴ This effect is visible in ESG analysis today, and nowhere more so than in the crossover between ‘S’ and its traditionally more popular and quantifiable cousins.

The difference between ‘E’ and ‘G’ compared with ‘S’, appears to be the lack of a common enemy (i.e. carbon emissions), and the absence of a long and rich history,⁵ respectively. To quote a recent Harvard study on the matter, “while some things are inherently easier to measure than others, doesn’t mean they’re more valuable.”⁶ The conundrum for the investment community is compounded by the lack of standardisation in s-factor corporate reporting. Anyone who sits down to read several modern corporate sustainability or ESG reports will be struck by the fact that while the reporting for ‘G’ factors is near universal, and ‘E’ factors are increasingly aligning, ‘S’ is treated as a catch-all for largely subjective ‘feel-good’ initiatives. This is highlighted explicitly by a 2021 Global ESG Survey conducted by BNP Paris⁷, which reported that more than half of respondents across over 350 asset managers identified ‘S’ as the most difficult ESG factor to analyse, and therefore the hardest to integrate into the investment process in a systematic and repeatable manner.

The Covid pandemic, “first sustainability crisis of the 21st century”, has compounded both investor and regulator focus on social factors.⁸ Covid-19 presented an explicit challenge to social contracts between numerous stakeholders: employers and their employees; customers and their suppliers; governments and their people. In response, a clear and consistent push to better understand, track and engage with the social component of ESG has emerged.⁹ Set against the backdrop of an increasing focus on social, or ‘purpose-led’ capitalism,¹⁰ the EU’s work-in-progress ‘Social Taxonomy’ is just one initiative seeking to more clearly distil what might be considered ‘socially’ sustainable. Delineating social objectives across the three main stakeholder groups of employees, customers, and communities, the most recent report on the taxonomy advocates high-level objectives for: (1) decent work (including within supply chains); (2) adequate living standards and well-being, and; (3) inclusive and sustainable societies. Broken down further the report implores the EU to define standards for health and safety, labour practices, fair wages and remuneration, the avoidance of discrimination, and the promulgation of diversity and inclusion. While we remain some time away from any formalised regulation published by the European Commission, the movement towards minimum social standards across stakeholders (and associated reporting) is being complimented by additional regional, national and member-led bodies. Examples include the UK’s gender pay gap reporting requirements and Germany’s upcoming regulation targeted at labour safeguarding in supply



Source: IMC

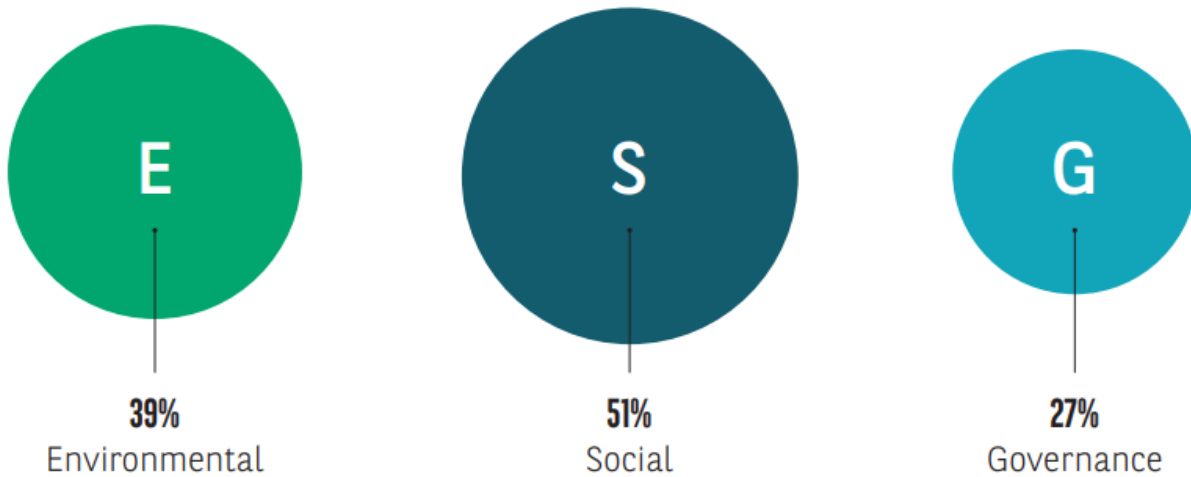
chains. While no doubt multiple chefs in the kitchen has the potential to add unnecessary complexity, the greater focus on ‘S’ will ultimately result in more effective policy, transparent reporting and opportunity for credible engagement.

Current energy supply deficits are raising well-founded questions around the interplay of ESG metrics, and in particular the interaction between ‘E’ and ‘S’. While the reverberations of Covid in our personal and professional lives persist – including the well-documented ‘Great Resignation’ – the more recent and tragic events in Ukraine have equally important ESG implications. Nations and citizens alike face a meaningful global energy supply deficit in the wake of years of underinvestment compounded by the Russia invasion (see chart on page 6 of this report). As highlighted in the lead piece to last quarter’s report, ‘The Maze to Net Zero’, access to affordable energy hits the poorest and most vulnerable in society hardest. Amidst the fuel and food shortages catalysed by current energy crisis, there is growing acknowledgment that the transition must be managed in a way that does not end up doing more economic harm to developing nations in the present than may otherwise materialise from the physical damage unabated emissions could cause in the future. This is prompting a growing interest in the interplay between ‘E’ and ‘S’, which is in turn supporting an emerging and more nuanced discussion about materiality and risk trade-offs. While constraining carbon-intense investment appears to support the virtuous ideal of a swift transition to net zero, the unintended consequences of poorly managed divestment are energy rationing, inflation, and both domestic and international instability.¹¹ Governments, investors and companies alike will increasingly be expected to consider, balance and report on these trade-offs as part of a holistic ESG analysis.

“Capital will go where it is wanted, it will stay where it is well-treated.”¹² Investors have historically focused on avoiding the obvious ‘S’ offenders, but must also be alert to less intuitive laggards. London-listed Boohoo serves as a stark reminder of the example that all investors wish to avoid.¹³ Deficiencies in the labour practices of their supply-chain partners and associated contraventions of basic human

BNP Paribas reported that over 50% of investors found s-factors the hardest to incorporate into investment analysis

Source: BNP Paribas



rights were discovered and reported on by *The Times* in July 2020. The company was forced to undertake a material reassessment of their procurement practises, conduct an external-led enquiry, and suffered a material decline in their stock market valuation. It is worth noting that in the years leading up to the discovery, Boohoo was considered an ESG ‘darling’ by ratings agencies and ESG-labelled funds, despite relatively low levels of transparency.¹⁴ Boohoo is a prominent example of poor ESG evaluation and investor oversight. However, investors should also be alert to less obvious, yet still costly examples of potential ‘social offenders.’ Looking at the right metrics can help reveal such companies. A 2015 Harvard Business Review article revealed that 60-80% of workplace accidents can be attributed to stress or a high-pressure environment. Similarly, companies scoring poorly on employee engagement record have 15% lower productivity all else held equal. Finally, employee turnover at companies with ‘toxic cultures’ increases by almost 50%.¹⁵ The latter is particularly notable given the Centre for American Progress estimates that the cost of replacing a single employee is approximately equivalent to 20% of that employee’s salary.¹⁶ Put simply, risk mitigation in s-factor analysis is not necessarily as blunt as merely articulating headline risk. Instead, it should be alert to upstream examples of ‘Boiling Frog Syndrome’, whereby inability or unwillingness to act against a problematic situation over the long-term increases the likelihood of a catastrophic failure. High quality integration of s-factor analysis should not simply *react* to the failure (à la Boohoo), but rather look for the associated risk factors, the mere existence of which can also contribute to long-term underperformance.

One such upstream risk factor – corporate culture – is beginning to garner empirical attention as a source of alpha. While much of this piece has focused

on the increasing attention towards and regulation of social factors as a risk management tool, as long-term investors we posit that such considerations – specifically in the case of corporate culture – can also be a source of alpha generation over time. Independent studies by Irrational Capital in conjunction with JP Morgan¹⁷ and MIT/Glassdoor¹⁸ suggest that companies scoring best on human capital management (or corporate culture) can exhibit periods of stronger financial performance and historically have delivered excess returns. Although naturally sceptical of any touted ‘silver bullet’ promising long-term outperformance, we can bear witness to multiple examples where we perceive great culture exists in our clients’ portfolio companies, which in turn has supported fundamental performance. Costco is a well-famed, yet nonetheless impressive example of a purpose-led organisation which places the customer and employee at the centre. The benefits of which include, amongst other things, a dramatically higher staff retention versus peers (7% turnover vs. US retail average >50% per annum). Google’s innovation-first approach, Haidilao’s job security commitment, and Greggs’ treatment of suppliers through the pandemic (making payments in advance rather than in arrears, delayed, or not at all) all offer us breadcrumbs of where great culture might exist.

When companies make their culture a source of competitive advantage and most convincingly align that to the strategy of the company the positive reflexivity appears to have a compounding effect over time relative to the competition. This is evident across the Hosking Partners portfolio, whether it be in the meaningful, broad-based remuneration alignment at companies like Saga, the “go the extra mile for our team” mantra at Tractor Supply, or the well-researched long-termism inherent in family/founder-led businesses¹⁹ such as

Berkshire Hathaway and Tamburi Investment Partners. After all, as Peter Drucker famously said, “culture eats strategy for breakfast.” Indeed, as capital cycle investors, we cannot help but sit up and take note when prodigious culture commentator Edgar Schein asserts that as allocators of capital, “the only thing of real importance that [management teams] do is to create and manage culture,” otherwise known as human capital. It is also worth noting that in a recessionary environment the beneficial effects of a positive culture are magnified by reducing the comparative exposure of human capital-intensive companies to the labour and productivity headwinds that recessions bring.



Great corporate cultures that we have studied appear to vary by geography, sector and strategy. However, we believe that adopting a robust yet qualitative framework can support repeatable assessment to exploit this market inefficiency. Culture at its most basic is a collective pattern of norms or behaviours. Establishing a framework to assess culture necessitates finding, as Schein notes, the artefacts of great culture, and counterfactually the inconsistencies. Applying Soros’ work on reflexivity, we believe that great culture is evidenced by norms, incentives and structures that have an effect of positive (or negative) self-reinforcement. Furthermore, the external context is an equally critical ingredient to understanding corporate culture advantage and disadvantage. A lifecycle – or capital cycle – analysis for a company or sector appears a sensible inclusion here, socio-economic scholar Carlota Perez’ work on the innovation cycle in technology being one instructive example. While the human psychology is hardwired to extrapolate current trends of today’s winners sustaining advantage tomorrow, and with future growth as a great seducer of today’s capital, the fundamental observation of innovation cycles is that technological progress is not smooth. Put more explicitly, what ensured success historically – including exceptional corporate culture – may not be what guarantees success tomorrow. As Stratcherey analyst Ben Thompson asks, did Blackberry’s success come to an end because they started to release worse smartphones, or because a misdirected company culture left them lagging industry innovation as the role of the smartphone shifted outside of their core capabilities?

We suggest that an initial framework to support the analysis of culture in a prospective investment should investigate:

1. The **articulation and codification** of a culture, purpose or set of values by executive management;
2. The existence of **norms, structures and incentives** (monetary and non-monetary) that amplify the culture over time;
3. **Process and outcome alignment** throughout the organisation (‘one team, one dream’);
4. **Internal engagement** across the business and **external engagement** with relevant ecosystems;
5. Trust, autonomy and degrees of decentralisation importantly supporting **empowerment of colleagues**;
6. An **emotional connection** with the strategy or mission, and;
7. Getting what Irrational Capital call “**the basics**” right (training, health & safety, career progression).

As external, global public equities investors we are necessarily limited to searching for the indicative breadcrumbs of the above, through both the study of primary or derived metrics and via qualitative engagement. The source of market inefficiency, and opportunity for Hosking Partners, lies in the intangibility of such considerations and the inherently long-term investment horizon necessary to derive alpha from their existence. It is our suggestion that investors aligning their analysis to these matters, and more explicitly seeking to understand these artefacts of culture in meetings with executive management teams, are few and far between.

At Hosking Partners we develop and apply simple models to render opportunity from complexity. Owing to their inherently organic nature, the assessment of social factors such as corporate culture is undoubtedly complex. Analogous in many ways to Robert Pirsig’s commentary on quality in his seminal work *Zen and the Art of Motorcycle Maintenance*, culture is... “you know what it is, yet you don’t know what it is. But that’s self-contradictory.” And therein lies the alpha. At Hosking Partners, we are long-term, engaged investors. We pursue investment management with a global generalist, multi-counsellor approach. We leverage a collection of behavioural models in our process. Orthodoxy is not for us. We believe that it is precisely this leeway in the way in which we consider the world that allows us to more comprehensively assess a company’s culture, and capitalise on the related market inefficiency for the benefit of our clients’ portfolios.

References

THE GAMBLER: RUSSIA AND THE GEOPOLITICS OF THE ENERGY TRANSITION

In addition to footnoted sources listed below, this article draws primarily on the following six books, all of which come highly recommended for all those interested in Russia, geopolitics, and the energy transition:

- *Klimat: Russia in the Age of Climate Change* (Thane Gustafson)
- *The New Map: Energy, Climate, and the Clash of Nations* (Daniel Yergin)
- *Burn Out* (Dieter Helm)
- *Disorder: Hard times in the 21st Century* (Helen Thompson)
- *Prisoners of Geography* (Tim Marshall)
- *Shadow State: Murder, Mayhem and Russia's Remaking of the West* (Luke Harding)

¹ The villain Svidrigailov speaking to Raskolnikov, in Fyodor Dostoyevsky's *Crime and Punishment*.

² Eagle-eyed readers will notice that the article's parts are named after some of the great works of Russian literature.

³ For a masterful discussion of this topic, see *The Prize*, by Dan Yergin.

⁴ Helen Thompson, *Disorder*, Oxford University Press, 2022, p43

⁵ Dan Yergin, *The New Map*, Penguin Books, 2021, p73

⁶ Dieter Helm, *Burn Out*, Yale University Press, 2018, p132

⁷ All dollar figures are quoted in 2015 real terms. For data, see [CEIC](#), [World Bank](#), [MacroTrends](#). It should be noted that while Russian GDP per capita has risen steadily since Putin came to power, it lags behind Poland and the three Baltic states, leading only Belarus and Ukraine.

⁸ [OECD](#)

⁹ [Bloomberg](#)

¹⁰ Thane Gustafson, *Klimat: Russia in the Age of Climate Change*, Harvard University Press, 2022, p67

¹¹ [The Times](#)

¹² [Consilium](#)

¹³ [Wall Street Journal](#)

¹⁴ [Forbes](#)

¹⁵ IEA, Russian Ministry of Finance

¹⁶ Gustafson, p49

¹⁷ IEA

¹⁸ [Thunder Said Energy](#); Gustafson, p49

¹⁹ Helm, p183-203

²⁰ [Thunder Said Energy](#)

²¹ [World Grain](#)

²² Gustafson, p203; [Metal Expert](#)

²³ Gustafson, p52

²⁴ Gustafson, p56

²⁵ Gustafson, p54; [Petronet](#)

²⁶ Gustafson, p55

²⁷ Yergin, p97; Helm, p140

²⁸ Gustafson, p136

²⁹ Helm, p140

³⁰ [Thunder Said Energy](#)

³¹ [The Telegraph](#)

³² Anastasiya Sviridova, "Vectors of development of military strategy", *Krasnaya Zvezda*, Mar. 4, 2019

³³ For an excellent discussion of this topic, see [here](#).

³⁴ For a discussion of Russia's destabilising activity in the UK, US and elsewhere, we recommend *Shadow State* by Luke Harding.

³⁵ Bernstein Energy & Power, 'The Putin Put', July 2022

³⁶ [Thunder Said Energy](#), IEA, CEIC Data

³⁷ The CO2 abatement cost of coal-to-gas switching is around \$40/tonne, which compares favourably to alternative solutions like decarbonised coal (\$60/tonne), Direct Air Capture (\$200/tonne), and full industrial CCS (\$300/tonne). Data from [Thunder Said Energy](#).

³⁸ [Thunder Said Energy](#)

³⁹ Helm, p139

⁴⁰ Although details remain vague and construction is yet to begin.

⁴¹ [IEA](#)

⁴² Per million cubic feet (mcf) – the standard metric for international gas prices.

⁴³ [Thunder Said Energy](#), EIA

⁴⁴ See, for example, [The Guardian](#)

⁴⁵ See, for example, [Business Standard](#)

⁴⁶ [The Financial Times](#)

⁴⁷ This is called the Energy Return on Energy Invested (EROEI). It takes 1.5 years to get a net energy gain out of an average wind project, 2.5 years for solar, 3.5 years for an EV. Building more renewables can't solve energy shortage in the near term. The quickest solutions are cancelling the closure of existing energy assets, which have an almost immediate energy payback.

⁴⁸ Rob West, 'Chain Reaction', *Wall Street Journal*, Issue 13, Summer 22

⁴⁹ [Thunder Said Energy](#)

A FOCUS ON... THE 'S' IN ESG

¹ [European Commission](#)

² Douglas W. Hubbard, *How to Measure Anything Finding the Value of Intangibles in Business*

³ We recommend his book by the same name (John Doerr, *Measure What Matters*, Penguin, 2017).

⁴ Vaclav Smil, *How the World Really Works*

⁵ Corporate governance concepts date back to the establishment of corporations such as the East India Company and the Hudson's Bay Company, during the 16th and 17th centuries.

⁶ [HBR](#)

⁷ [BNP Paribas](#)

⁸ [Pimco](#)

⁹ [KPMG](#)

¹⁰ For a masterful exploration of this topic we highly recommend *Grow the Pie* by Alex Edmans

¹¹ [Thunder Said Energy](#)

¹² Walter Wriston, Former Chairman of Citibank

¹³ [The Times](#)

¹⁴ [The Financial Times](#)

¹⁵ [HBR](#)

¹⁶ See [here](#), for example

¹⁷ [Irrational Capital](#)

¹⁸ [Sloane Review](#)

¹⁹ Eugster and Dušan, *Founding Ownership, Stock Market Returns, and Agency Problems*

Appendix I

VOTING PROCESS

Hosking Partners has subscribed to the 'Implied Consent' service feature under the ISS Agreement to determine when and how ISS executes ballots on behalf of the funds and segregated clients. This service allows ISS to execute ballots on the funds' and segregated clients' behalf in accordance with ISS recommendations. Hosking Partners retains the right to override the vote if it disagrees with the ISS recommendation. In practice, ISS notifies Hosking Partners of upcoming proxy voting and makes available the research material produced by ISS in relation to the proxies. Hosking Partners then decides whether or not to override any of ISS's recommendations. A range of factors are routinely considered in relation to voting, including but not limited to:

- **Board of Directors and Corporate Governance.** E.g. the directors' track records, the issuer's performance, qualifications of directors and the strategic plans of the candidates.
- **Appointment / re-appointment of auditors.** E.g. the independence and standing of the audit firm, which may include a consideration of non-audit services provided by the audit firm and whether there is periodic rotation of auditors after a number of years' service.
- **Management Compensation.** E.g. whether compensation is equity-based and/or aligned to the long-term interests of the issuer's shareholders and levels of disclosure regarding remuneration policies and practices.
- **Takeovers, mergers, corporate restructuring and related issues.** These will be considered on a case by case basis.

In certain circumstances, instructions regarding the exercise of voting rights may not be implemented in full, including where the underlying issuer imposes share blocking restrictions on the securities, the underlying beneficiary has not arranged the appropriate power of attorney documentation, or the relevant custodian or ISS do not process a proxy or provide insufficient notice of a vote. The exercise of voting rights may be constrained by certain country or company specific issues such as voting caps, votes on a show of hands (rather than a poll) and other procedures or requirements under the constitution of the relevant company or applicable law.

The decision as to whether to follow or to override an ISS recommendation or what action to take in respect of other shareholder rights is taken by the individual portfolio manager(s) who hold the position. In circumstances where more than one portfolio manager holds the stock in question, it is feasible, under the multi-counsellor approach, that the portfolio managers may have divergent views on the proxy vote in question and may vote their portion of the total holding differently.

ENGAGEMENT PROCESS

Hosking Partners recognises that ESG considerations are important factors which affect the long-term performance of client portfolios. ESG issues are treated as an integral part of the investment process, alongside other relevant factors, such as strategy, financial risk, capital structure, competitive intensity and capital allocation. The relevance and weighting given to ESG and these other issues depends on the circumstances relevant to the particular investee company and will vary from one investee company to another. Whilst Hosking Partners may consult third-party ESG research, ratings or screens, Hosking Partners does not exclude any geographies, sectors or stocks from its analysis based on ESG profile alone. The multi-counsellor approach, which is deliberately structured so as to give each autonomous portfolio manager the widest possible opportunity set and minimal constraints to making investment decisions, means that ESG issues and other issues relevant to the investment process are evaluated by each portfolio manager separately, with the support of the Head of ESG.

Interaction with management and ongoing monitoring of investee companies is an important element of Hosking Partners' investment process. Hosking Partners does however recognise that its broad portfolio of global companies means that the levels of interaction are necessarily constrained and interaction will generally be directed to those investee companies where Hosking Partners expects such involvement to add the most value. Monitoring includes meeting with senior management of the investee companies, analysing annual reports and financial statements, using independent third party and broker research and attending company meetings and road shows.

Hosking Partners looks to engage with companies generally, and in particular where there is a benefit in communicating its views in order to influence the behaviour or decision-making of management. Engagement will normally be conducted through periodic meetings and calls with company management. It may include further contact with executives, meeting or otherwise communicating with non-executive directors, voting, communicating via the company's advisers, submitting resolutions at general meetings or requisitioning extraordinary general meetings. Hosking Partners may conduct these additional engagements in connection with specific issues or as part of the general, regular contact with companies.

Some engagements highlighted in this publication are part of an ongoing two-way dialogue, and as such Hosking Partners may not always publish the specific details of engaged firms. Where this is the case, further information about the engagements is available to clients upon request.

Appendix II

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The Gambler: Russia and the geopolitics of the energy transition

- ¹ The villain Svidrigailov speaking to Raskolnikov, in Fyodor Dostoyevsky's *Crime and Punishment*.
- ² Eagle-eyed readers will notice that the article's parts are named after some of the great works of Russian literature. This is a nod to the vast depth of Russian culture, which we fear risks becoming tarnished by the recent actions of the country's current leadership.
- ³ For a masterful discussion of this topic, see *The Prize*, by Dan Yergin.
- ⁴ Helen Thompson, *Disorder*, Oxford University Press, 2022, p43
- ⁵ Dan Yergin, *The New Map*, Penguin Books, 2021, p73
- ⁶ Dieter Helm, *Burn Out*, Yale University Press, 2018, p132
- ⁷ All dollar figures are quoted in 2015 real terms. For data, see [CEIC](#), [World Bank](#), [MacroTrends](#). It should be noted that while Russian GDP per capita has risen steadily since Putin came to power, it lags behind Poland and the three Baltic states, leading only Belarus and Ukraine.
- ⁸ [OECD](#)
- ⁹ [Bloomberg](#)
- ¹⁰ Thane Gustafson, *Klimat: Russia in the Age of Climate Change*, Harvard University Press, 2022, p67
- ¹¹ [The Times](#)
- ¹² [Consilium](#)
- ¹³ [Wall Street Journal](#)
- ¹⁴ [Forbes](#)
- ¹⁵ IEA, Russian Ministry of Finance
- ¹⁶ Gustafson, p49
- ¹⁷ IEA
- ¹⁸ [Thunder Said Energy](#); Gustafson, p49
- ¹⁹ Helm, p183-203
- ²⁰ [Thunder Said Energy](#)
- ²¹ [World Grain](#)
- ²² Gustafson, p203; [Metal Expert](#)
- ²³ Gustafson, p52
- ²⁴ Gustafson, p56
- ²⁵ Gustafson, p54; [Petronet](#)
- ²⁶ Gustafson, p55
- ²⁷ Yergin, p97; Helm, p140
- ²⁸ Gustafson, p136
- ²⁹ Helm, p140
- ³⁰ [Thunder Said Energy](#)
- ³¹ [The Telegraph](#)
- ³² Anastasiya Sviridova, "Vectors of development of military strategy", *Krasnaya Zvezda*, Mar. 4, 2019
- ³³ For an excellent discussion of this topic, see [here](#).
- ³⁴ For a discussion of Russia's destabilising activity in the UK, US and elsewhere, we recommend *Shadow State* by Luke Harding.
- ³⁵ Bernstein Energy & Power, 'The Putin Put', July 2022
- ³⁶ [Thunder Said Energy](#), IEA, CEIC Data
- ³⁷ The CO2 abatement cost of coal-to-gas switching is around \$40/tonne, which compares favourably to alternative solutions like decarbonised coal (\$60/tonne), Direct Air Capture (\$200/tonne), and full industrial CCS (\$300/tonne). Data from [Thunder Said Energy](#).
- ³⁸ [Thunder Said Energy](#)
- ³⁹ Helm, p139
- ⁴⁰ Although details remain vague and construction is yet to begin.
- ⁴¹ [IEA](#)
- ⁴² Per million cubic feet (mcf) – the standard metric for international gas prices.
- ⁴³ [Thunder Said Energy](#), EIA
- ⁴⁴ See, for example, [The Guardian](#)
- ⁴⁵ See, for example, [Business Standard](#)
- ⁴⁶ [The Financial Times](#)
- ⁴⁷ This is called the Energy Return on Energy Invested (EROEI). It takes 1.5 years to get a net energy gain out of an average wind project, 2.5 years for solar, 3.5 years for an EV. Building more renewables can't solve energy shortage in the near term. The quickest solutions are cancelling the closure of existing energy assets, which have an almost immediate energy payback.
- ⁴⁸ Rob West, 'Chain Reaction', *Wall Street Journal*, Issue 13, Summer 22, p31
- ⁴⁹ [Thunder Said Energy](#)

Social

- ¹ https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/280222-sustainable-finance-platform-finance-report-social-taxonomy.pdf
- ² How to Measure Anything Finding the Value of Intangibles in Business, Douglas W. Hubbard
- ³ We recommend his book by the same name (John Doerr, *Measure What Matters*, Penguin, 2017).
- ⁴ How the World Really Works, Vaclav Smil
- ⁵ Corporate governance concepts date back to the establishment of corporations such as the East India Company and the Hudson's Bay Company, during the 16th and 17th centuries.
- ⁶ <https://hbr.org/2021/01/esg-impact-is-hard-to-measure-but-its-not-impossible>
- ⁷ <https://securities.cib.bnpparibas/esg-global-survey-2021/>
- ⁸ <https://www.pimco.co.uk/en-gb/insights/viewpoints/in-depth/sustainability-in-bond-markets-amid-covid-19-esg-in-focus/>
- ⁹ <https://home.kpmg/uk/en/blogs/home/posts/2021/08/what-does-the-s-in-esg-mean-for-reporting.html>

¹⁰ For a masterful exploration of this topic your author highly recommends 'Grow the Pie' by Alex Edmans

¹¹ <https://thundersaidenergy.com/downloads/energy-shortages-priced-out-of-the-world/>

¹² **Walter Wriston, Former Chairman of Citibank**

¹³ <https://www.thetimes.co.uk/article/boohoos-sweatshop-suppliers-they-only-exploit-us-they-make-huge-profits-and-pay-us-peanuts-lwj7d8fg2>

¹⁴ <https://www.ft.com/content/ead7daea-0457-4a0d-9175-93452f0878ec>

¹⁵ <https://hbr.org/2015/12/proof-that-positive-work-cultures-are-more-productive>

¹⁶ <https://www.americanprogress.org/article/there-are-significant-business-costs-to-replacing-employees/>

¹⁷ <https://www.irrational.capital/post/jp-morgan-chase-and-irrational-capital-release-paper>

¹⁸ <https://sloanreview.mit.edu/culture500>

¹⁹ *Founding ownership, stock market returns, and agency problems*, Eugster and Dušan