Hosking Partners®

ESG and Active Ownership Report

Q4 2022

Foreword

I am delighted to introduce our fourth 'revamped' Active Ownership Report. In my last introduction a year ago, I wrote that ESG, indeed, all investment analysis, "needs to be washed down with a large dose of intellectual humility, curiosity and willingness to adapt."

Little did we know then!

In addition to the supply chain impacts of the war in Ukraine and lingering effects of Covid-19, market participants found themselves dealing with the fall-out of a series of financial (mis)adventures: QE, a totemic shift towards passive investing, and the rapid integration of ESG policy with a simplistic, exclusionary focus.

As orthodoxies of the last decade are reappraised, opportunities for patient, value-orientated investors abound. At Hosking Partners, we identify these opportunities not by becoming stuck in the weeds, but by stepping back and looking at the big picture. We emphasise open, honest and thoughtful debate. We recognise that complex issues rarely generate simple, binary answers. Comfortable rules of thumb are often just that. Received wisdom is a misnomer. The honest response to most questions is often, "I don't know."

I am delighted to share another report that gives our clients a window into our thinking. We hope that it spurs debate and very much look forward to hearing your thoughts in our next discussions.

With my best wishes and excitement for 2023,

James Batting

James Batting
Senior Partner

CONTENTS

VOTING SUMMARY	Q4	2022
Meetings Voted	48	492
Proposals Voted	462	6,388

ENGAGEMENT SUMMARY	Q4	2022
ESG	34	85
Total Direct (1-on-1)	157	330
Total Indirect (Group)	55	215

CLIENT NOTICE

This abridged 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.

Embracing complexity: The state of ESG heading into 2023

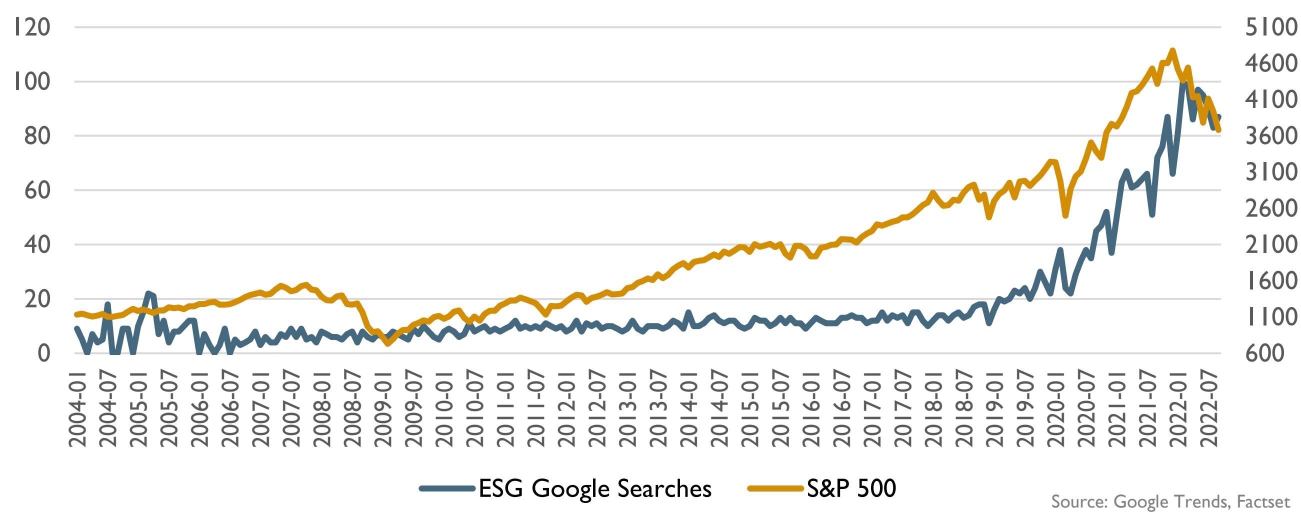
- Manufactured confusion over the role of ESG in investment has led to oversimplification and capital misallocation
- Supported by increasingly promising regulatory frameworks, asset managers and allocators must consciously resist this trend rather than fall prey to its deceptive allure
- By embracing complexity, and swapping easy falsehoods for harder truths, we can reset how we think about ESG and put our capital to work in a more effective and beneficial manner

Part 1: Introduction

At the beginning of 2022 we wrote that a turning of the tide was underway in the ESG investment movement. We now find ourselves knee-deep, with the current drawing strong. Amid a flurry of regulatory activity, asset managers are scrambling to explain quite how strategies marketed (and priced) as 'ESG' are having the real-world impact they claim. Compounding the pain, many such products – which were rushed to market during an explosion in demand as asset valuations soared during Covid – have begun to underperform as their underlying sector biases are left strewn on the rocks of inflation, higher rates, and geopolitical upheaval. Amundi, the largest asset manager in Europe, has announced that it will downgrade almost all of its €45 billion worth of "deep green" Article 9 funds to the less stringent Article 8, citing an "evolving regulatory environment". Vanguard has withdrawn from the Net Zero Asset Managers Initiative (NZAMI) citing a need to "provide clarity to investors […] about the role of index funds". Meanwhile, the UK Financial Conduct Authority's (FCA) upcoming climate-related disclosure requirements have prompted confused articles about ESG and greenwashing to pop up in tabloid newspapers. It is a chaotic scene, and one which is understandably difficult to navigate as an investor. How did we end up here? How does ESG really relate to investment? How does Hosking Partners integrate it into our process, and why do we think we are – broadly – headed in the right direction? From the murk we would like to provide some clarity.

First of all, we will state an assumption up front: We assume that unless otherwise specified, and in line with the fiduciary principle to act in their clients' best interests, an asset manager's primary investment objective is to achieve a return on clients' capital. For active managers such as Hosking Partners, this return is generally measured relative to an index or benchmark, although other approaches do exist. This assumption is important. Much of the current

Interest in ESG rose sharply during the Covid asset price bubble



Source: Google Trends, Factset

confusion around what ESG investing should or shouldn't be is caused by conflating arguments that only function once you have accepted this assumption with arguments against the assumption itself. The debate over single versus double materiality, which asks whether or not companies should report non-financial data, revolves around this issue. Unfortunately, measuring externalities – the unpriced social byproducts of economic activity that ESG analysis attempts to describe – is an extremely complex problem. They are long-term, they are often largely intangible, and their materialisation represents a market failure. There are essentially two paths that an investor interested in the relevance of externalities can take. Either they can accept the above assumption, and work harder to incorporate the analysis of potential externalities into their valuations. Or, they can challenge the assumption and sacrifice the undiluted pursuit of returns to deliver a different measurable output – exclusively or additionally – which attempts to affect the size of the externality itself. Both options are legitimate but, as we will see, each lends itself to different types of investment, and should garner different expectations from asset owners. As such, asset managers must be honest about which path they are on and how they intend to walk it. Cherry-picking the most attractive parts of each has become commonplace, and is not only deceiving investors but contributing to a worrying misallocation of capital.

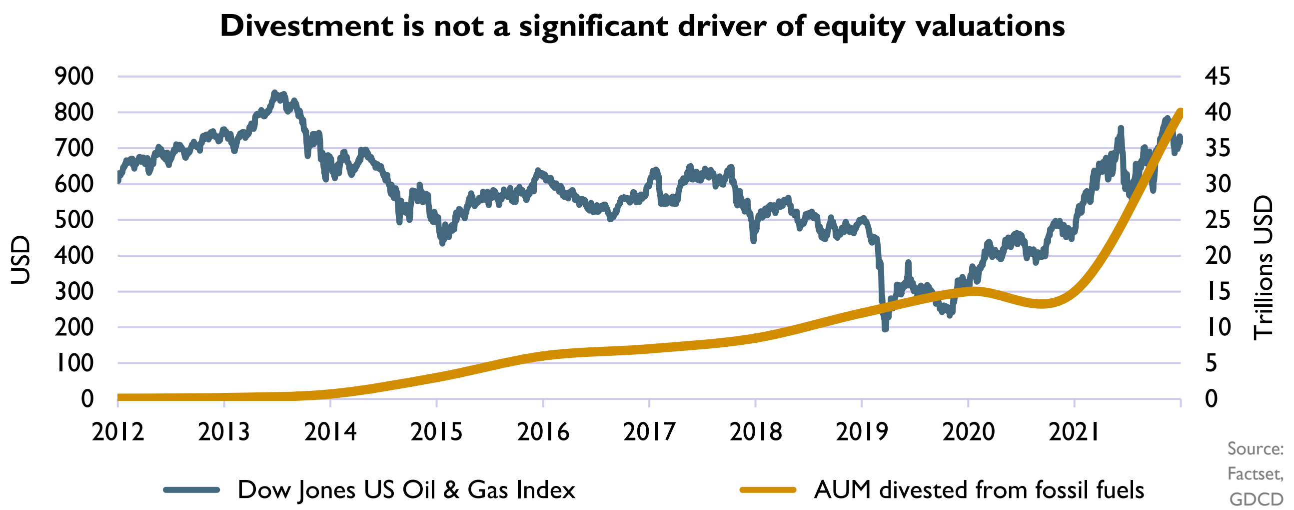
> *"Whenever a theory appears to you as the only possible one, take this as a sign that you have neither understood the theory nor the problem which it was intended to solve."*
>
> Karl Popper

In today's always-online media milieu, confusion around ESG comes thick and fast. This was exemplified in a recent comment piece in a UK tabloid, in which the author expressed outrage that so-called "sin stocks" have higher ESG ratings than the FTSE 100 average. This represents a basic error in the way many people think about ESG, which is to broadly equate it with ethical investing. We touch on this point again later, so for clarity we will recap the basic difference: Ethical investing explicitly considers your chosen values – be they religious or otherwise – before it considers returns. So-called ESG investing is not supposed to do this; instead, it is supposed to consider social externalities as an input into returns. The categorisation of "sin stocks" – which is ethical in nature – challenges our assumption by supposing that asset managers should bias their selection according to something other than expected returns. ESG ratings, on the other hand, are treated as a quantified assessment of material risk to a specific business, and therefore should exist *ex post* our assumption to hold value as a comparative tool. Playing one argument off the other inevitably results in bewilderment. This mixing of ethics and economics, of the qualitative and the quantitative, and of social impact and financial performance, are at the heart of the ESG muddle. They are also the reason that ESG has become an increasingly politicised issue, as political actors that question our assumption conflict with those that share it.

In 2023 the UK Financial Conduct Authority's Sustainability Disclosure Requirements (SDR) come into force. This policy obliges asset managers with over £5 billion in assets under management to report against a number of qualitative and quantitative standards to help investors understand how the manager, and the products they offer, incorporate sustainability into their investment process. The FCA's requirements draw heavily on those laid out by the Taskforce for Climate-Related Disclosures (TCFD), but has an expanded scope that targets not only how managers deal with E but also S and G under the umbrella term of "sustainability". The lever is a series of formal labels (Impact, Focus, Improver) which will be granted to investment entities and products that meet the FCA's qualifying standards. In the words of the FCA's own Director of ESG, Sacha Sadan, the idea is to "raise the bar" by making it harder for a manager to claim to follow an ESG-related strategy without being clear about how that strategy functions and impact it may or may not have on performance. The FCA's policy is a particularly interesting example of a wider regulatory theme designed to help investors navigate the ESG muddle described above. Unlike the EU, the FCA understands that its role is not to try to directly influence the behaviour of investors to further a political agenda. Instead, the FCA is attempting to mediate the manner in which investment products are marketed to try to protect the integrity of an investor's decision making. Broadly speaking, this is the right approach. However, the proposed methodology remains exposed to several of the same flaws it is trying to ameliorate. These issues pertain to several of the major inconsistencies that still exist around ESG, and which continue to fuel the confused picture described above.

Part 2: The great asset class discrepancy

The first issue is that the FCA states that it does not want its new rules to favour certain asset classes over others. This is an understandable position to take on the surface given the organisation's hands-off approach. However, it fails to acknowledge that



Source: Factset, GDCD

investment in certain asset classes is demonstrably easier to link to a decisive impact on the behaviour of an underlying entity than in others. For example, investment in primary markets directly and immediately increases the capital available to a company in a way that trading shares between secondary market participants does not. Furthermore, participation in the former is often explicitly tied to specific terms or covenants which define the manner in which raised capital should be deployed, while the latter is not. Although there is a theoretical connection between secondary market activity, the value of a firm's equity, and as such its cost of capital, this connection is fairly weak in the absence of widely coordinated action by a majority of shareholders and targeted regulatory support. For example, even as increasing numbers of investors exclude fossil fuel stocks from their equity portfolios – particularly in the past year – earnings and accordingly share prices have soared. As the ex-Head of Sustainability at Blackrock Tariq Fancy has put it, "10% of the market not buying your stock is not the same as 10% of your customers not buying your product". As such, it is not enough for a public equities product to simply claim that an exclusionary, best-in-class, or other metrics-driven mandate delivers a sustainable outcome. Although it may seem counter-intuitive, the reality is that owning or not owning an oil company's shares has very little real-world impact on the emissions that firm does or does not generate. As investors David Blitz and Laurens Swinkels write in a 2019 study on the effectiveness of exclusionary mandates, "if one investor lowers the carbon footprint of their portfolio, another will have a higher footprint *by definition*".

The standard of evidence required for a secondary market product to claim sustainable credentials should therefore be held significantly higher than for primary market alternatives. This is particularly important because the overwhelming majority of investment activity happens in secondary markets (88% in 2021). It is also important because as both retail and institutional investors are increasingly exposed to soundbites describing the amount of investment that is needed to help the world reach net zero, we need to be clear about what the word 'investment' actually means in that context. In brief, what it does mean is primary market allocations, government spending, corporate capital expenditure, and research and development. What it does not mean – for the same reasons as discussed above – is manipulating the public equity allocations in your pension pot to provide more exposure to wind and solar companies. While the latter may help one benefit *from* the energy transition, the former is what will actually make it happen in the first place. This is an important point, because the generally good intentions of ESG-focused investors will never be realised until we are more honest about the varying degrees of agency that capital flows into different asset classes actually have to make an impact.

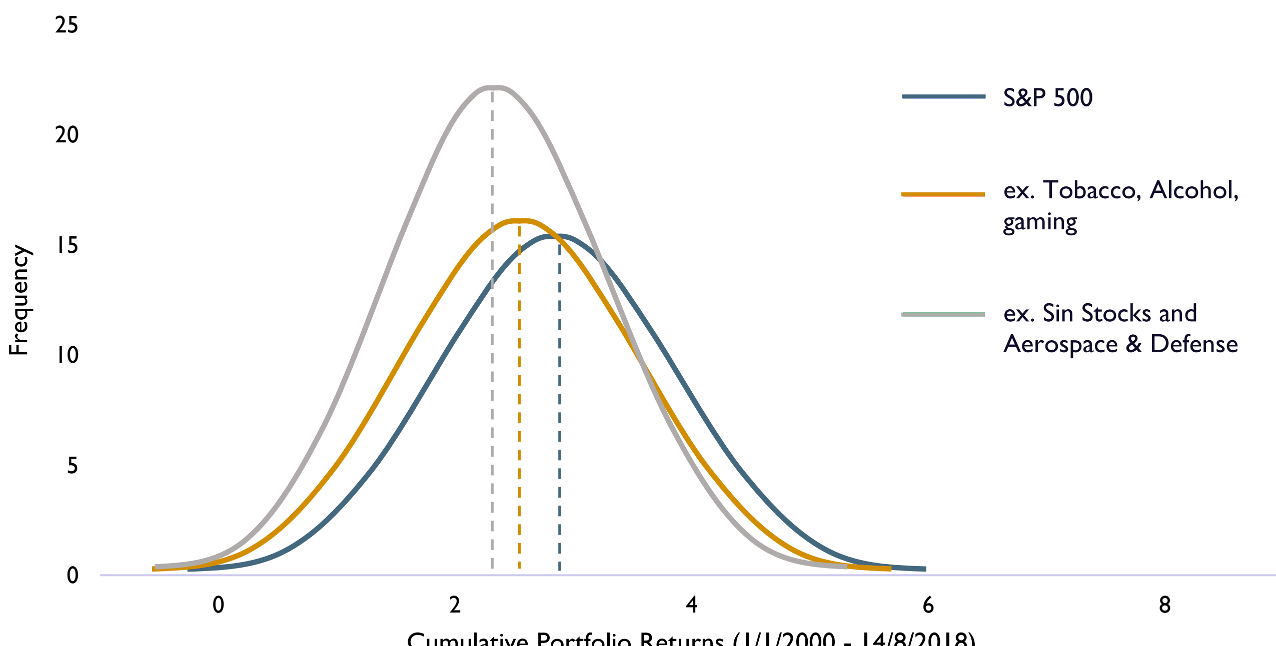
Confusing these different types of investment has inflated demand for sustainable investment strategies in the secondary markets with the weakest claim to real-world effect. This new demand has in turn created substantial financial incentive for asset managers – and other market participants – to overplay their credentials, which reinforces the misunderstanding. Studies have shown that funds which change their name to match in-trend investment strategies (for example, adding "Growth" in an upswing) enjoy abnormal inflows of 28% over the next year even if their holdings remain constant. This phenomenon has been rife in ESG over the past several years, and has resulted in a swathe of supposedly 'sustainable' funds that appear indistinguishable – in strategy, impact or holdings – from less deceptively marketed alternatives. Regulation such as the FCA's, which is designed to protect consumers from such claims, should be bolder in explaining that certain forms of investment are fundamentally easier to link to real-world impact than others, and require asset managers' justifications of their strategies to account for this inequality.

Part 3: The false promise of metrics

This brings us to the next problem with the FCA's approach, which is inconsistency over the role and utility of quantitative analysis in managing ESG strategies. At first sight it appears that the FCA stand out from their regulatory peers in their overall scepticism towards metrics-based approaches, highlighting – for example – that "exclusion on its own is not enough" to justify a sustainable label. Encouragingly, they are preparing complementary regulation designed to reign in the ESG ratings agencies, who have profited immensely from the dark art of presenting opinion as fact. The FCA also accepts that the very concept of a sustainable investment product is largely subjective, stating that in the absence of an objective standard, "if someone thinks their product is sustainable they need to define what they think sustainability is themselves". So far, so good. The problem is that after all that, the regulation will still require firms to publish a collection of mandatory numeric metrics and targets, which are identical regardless of the nature or mandate of the fund. The inevitable implication is that this data tells investors something useful about how sustainable a product is or isn't (it probably doesn't), and worse, that it can be used comparatively on an apples-for-apples basis (it almost certainly can't). Furthermore, because of the primacy the investment industry affords to data-driven interpretations of reality, the oversimplified world these metrics describe ends up trumping the more balanced qualitative analysis that is generally required to properly evaluate the complexity of ESG-related materiality. This dynamic only serves to perpetuate the idea that long-term, intangible value drivers can be reduced to a set of figures, and benefits funds with deceptively simplistic quantitative approaches at the expense of those that champion nuance and pragmatism.

The most common metrics-driven strategies for ESG-labelled funds are positive and negative screening. Negative screening or exclusion, which involves avoiding investments in firms that breach some pre-defined red line, is by far the most common. As of March 2022, exclusionary screens of some form were incorporated into 75% of index funds and 69% of active funds bearing an ESG label. The opposite approach – only investing in the 'best' ESG performers – is positive screening, although it accounts for about ten times less in ESG-labelled AUM than exclusion. The boundaries of inclusion or exclusion are usually defined by one or more quantitative metrics, which are selected to align underlying securities to the theory or idea to which the fund – and its clients – subscribe. Unsurprisingly, similar methods are used by funds with ethical mandates to exclude companies operating in certain sectors (e.g. alcohol). The key difference is that for ESG-labelled funds that supposedly accept our assumption, using these metrics to define portfolio construction should also be linked to a clear rationale for enhancing alpha.

Portfolios with more exclusions underperform those with fewer



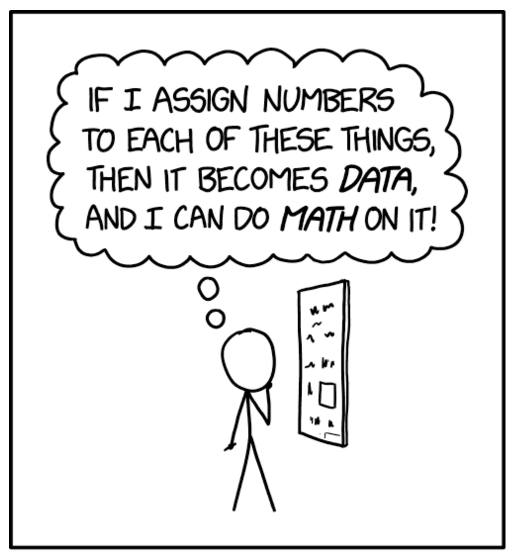
Source: FactSet, Bernstein

Unfortunately, conclusively proving or demonstrating this link is elusive. In their 2021 paper 'Honey, I Shrunk the Alpha', Giovanni Brun (et al.) show that "while many ESG strategies have positive returns, adjusting these returns for risk shrinks alpha to zero". Similarly, with specific reference to exclusion, the evidence is clear that more constrained portfolios underperform their unconstrained peers. To disguise this disappointing reality, asset managers and ratings agencies have instead performed a methodological bait-and-switch whereby ESG value drivers are quantified to look like the traditional financial factors we are all familiar with such as growth, quality, momentum and so on. This has made these strategies far easier to sell, often at higher fees, despite the non-existent evidence for either sustained outperformance or – for secondary market products in particular – real-world impact.

> *"There's always an easy solution to every human problem – neat, plausible, and wrong."*
>
> H. L. Mencken

We have mentioned several times so far that ESG factors are essentially little more than long-term, often intangible value drivers. In some cases, these are relatively easily quantifiable. For example, at Hosking Partners we might consider the methane leakage rate of an oil and gas E&P, or the replacement value of assets located in a potential future flood plain. We may look at the relative turnover of minority ethnic employees at a local retailer, or the remuneration structure of an investment bank. In all these examples, the analysis is designed to determine if these factors represent material risks that should be discounted against the valuation of a potential investment. Different analysts will look at the same data and exercise judgement in ascribing varying degrees of importance to what it tells them, just as they do with free cash flow forecasts. When an asset owner allocates to an active fund, they are implicitly expressing confidence in the particular way that firm or portfolio manager exercises that judgement. As such, the judgement of value drivers related to ESG should be considered holistically alongside that related to other long-term factors and indeed traditional financial metrics. All are as potentially relevant as each another, and the weighting of that relevance will vary on a company-by-company basis. As LSE Professor Alex Edmans has put it, "considering long-term factors when valuing a company isn't ESG investing, it's investing".

ESG integration gets into particular trouble when it tries to quantify factors that are resistant to simplification, especially when that quantification leads directly to inclusion or exclusion in a strategy. An obvious example is the aggregated score-carding that ESG ratings agencies have made common, whereby tens or even hundreds of value drivers that should be considered individually are rolled into a single data point. Here, the sum is most certainly not greater than the parts. These scores are nothing more than simplistic summaries of a subjective opinion. Nevertheless, entire funds are constructed by screening securities with good scores, and subsequently marketed as sustainable. This is the equivalent of building a portfolio solely on the buy recommendations of a single analyst. No diligent investor would would buy such a product, but funds screened by ESG ratings sell like hot cakes. In a vicious cause-consequence cycle, companies have in turn begun manipulating their own behaviour to earn a better score. While in some cases this may encourage companies to adopt genuinely more responsible behaviour, more often than not it results in questionable decisions such as altering remuneration structures to favour ESG over other – perhaps more relevant – long-term value drivers (for a more detailed discussion of this particular issue, see our 'A focus on..' section on page 12). While the arrival of long-needed regulation may bring some semblance of utility to ESG ratings, we would nevertheless do well to recall Goodhart's Law that "when a measurement becomes a target, it ceases to be a good measure".



Source: XKCD

The problem is not limited to aggregated ESG scores. There are also problems with the individual metrics that contribute to them. Unhelpfully, the confusion is most pronounced where the data has the most superficial claim to objectivity. Emissions data are a major culprit, primarily because the narrative that 'higher emissions are always bad' drowns out more nuanced analysis, which is often – disappointingly – dismissed out of hand as regressive. We can illustrate the importance of nuance when considering emissions data by examining one very common metric, carbon intensity (tons of CO_2 per million USD in revenue). In its portfolio weighted form (WACI) this metric also constitutes one of the FCA's mandated disclosures. The idea is to determine which companies are more reliant on emissions to generate revenue, which seems on the surface like a reasonable approximation for how sustainable that company is. In turn, the weighted combination of that same data is used to describe the sustainability of an investment portfolio.

This problem is the emergent result of two underlying issues. Firstly, we need to think about the numerator (emissions) and the denominator (revenue) that form the basic intensity ratio, and how they interact. The latter, gross revenue, is units sold multiplied by price per unit. For different industries and sectors, the balance of this equation changes substantially. Some sectors sell a few expensive products at high margins, others sell millions of cheap products at low margins. If you just take revenue, two companies from opposite ends of this spectrum look the same. Calculating gross emissions is a more complicated process, but for the purposes of this discussion we will focus on embedded CO_2 intensity. This measures how much CO_2 goes into a product on a kilogram-for-kilogram basis. What's particularly interesting is that a company having a high carbon intensity by revenue does not necessarily mean its products have a high embedded CO_2 intensity. For example, cement and steel have CO_2 intensities of 1kg/kg and 1.6kg/kg respectively, so to make 1kg of cement you emit an average of 1kg of CO_2. IT hardware, on the other hand, emits an average of over 100kg per kilogram of product. Producing a MacBook emits 170kg of CO_2 per 1.3kg device. This is not to suggest that the cement industry is less of a problem for the energy transition than the IT industry. But what it does show us is that sectors that produce on the high-volume, low-margin end of the spectrum tend to display substantially higher carbon intensities simply as a by-product of the way the metric is constructed.

Now, let's take these two observations and look at the bigger picture. Many of the products that rely on this sort of high volume, low margin model are commodities like cement, steel, aluminium, and concrete. These low margin commodity-centric businesses are doubly misrepresented by carbon intensity, because in addition to the structural disadvantage described above, their scores also exhibit volatility unconnected to underlying emissions as commodity prices fluctuate. While demand for some of these commodities may decelerate between now and 2050 as new technologies develop, gross demand will grow substantially and, in some cases, intensify (e.g. aluminium and steel). These are industries that are called "hard to decarbonise". The manufacturing bases tend to be in emerging economies and are primarily powered by fossil fuels like coal. In many cases, although technology is progressing, at present viable alternatives are either non-existent or remain prohibitively expensive, especially for sale into emerging markets where demand is rising fastest. But the difficulty of decarbonising these industries is matched by the reward, in emissions terms. Cement alone is responsible for almost 8% of global CO_2 emissions, a significant amount for a single material. Hard to decarbonise industries are not limited to commodities; aviation is another. As you might expect, aviation companies have much higher than average carbon intensities.

"What do you mean they want us to demonstrate how their investment has made an impact? Didn't they see the fund's name?!"

A difficult afternoon at Sustainable ESG Impact Equities LLC

Source: Hosking Partners, Google Images

A pattern is emerging, and it is a worrying one. Metrics such as carbon intensity are being used to infer sustainability, but actually describe a cross-sectional snapshot of a world in which the largest gross emitters are the worst, regardless of the fact that the largest emitters also have the most potential impact to deliver by decarbonising. These metrics ignore change over time, efficiency of production, and the wider societal importance of the underlying product. When applied to influence investment flows, the result is either counter-productive or illusory. Primary market participants that screen investments using metrics like carbon intensity in the name of pursuing a sustainable strategy are denying capital to the parts of the market that most need it to decarbonise. This puts these sectors in a strange Catch-22 position: they require investment to achieve decarbonisation breakthroughs, but are denied it for the very reason that the breakthrough has not yet been achieved. This is counter-productive. In secondary markets, constructing portfolios by screening according to these metrics appears low-carbon on paper, but as we have already discussed, trading secondary assets has a weak claim to affecting the actual behaviour of companies. In these markets the most common result of these strategies is deception. Investors are sold the idea that they are having an impact when they aren't. This is illusory.

Part 3: Getting real on engagement

There is another lever that secondary market participants can pull to have a direct effect on the behaviour of a company: engagement. Engagement can take the form of voting or communication, both of which can be approached individually or collaboratively with other investors. The larger your shareholding in a company, the more agency you have to affect change. This means that although highly diversified active funds (such as our Hosking Partners portfolio) and passive index funds can still make useful contributions to help influence company behaviour, particularly when collaborating with others, the overall ability to drive direct change is frequently limited by their minority positions. This is why so-called impact investors generally rely on the combination of engagement with large, concentrated positions to deliver effect when operating in secondary markets. That said, according to the Global Impact Investing Network (GIIN), only 3% of impact funds' AUM is invested in public equities, versus 31% in real assets and 60% split approximately evenly between private equity and private debt. This reflects the fact that impact funds themselves recognise the asset class discrepancy we discussed earlier. If you have an impact mandate, why concentrate your portfolio in the part of the market where it is hardest to realise?

Importantly, impact investors generally define their mandate as something other than solely delivering alpha. This differs from activist investors, who use similar tactics to try to enhance returns, often by encouraging changes that benefit shareholders. When managers intend to achieve an outcome other than return on clients' capital, this generally comes at the cost of alpha. For example, studies show that venture funds with both societal and financial goals earn around 5% lower returns. More broadly, across the entire spectrum of private equity impact funds, average IRRs are 100bps below peers with an undiluted mandate. As a result, impact investors may temporarily operate in direct opposition to an activist – one has a short-term focus on shareholders, the other a long-term focus on wider society. This should not come as a surprise, because the sort of long-term, intangible value effects associated with social externalities are rarely priced into a security to the same degree as more clearly measurable short-term financial factors. When an impact investor encourages a board to increase capital spending aligned to energy transition, or replace low-cost suppliers with higher-cost ethically sourced alternatives, these actions may depress earnings in the near to medium term due to their associated costs. Longer-term, these may well be recouped where the targeted externality proves genuinely material to performance and its elimination provides a competitive advantage. But nevertheless, the materiality of these long-term and intangible factors remains extremely difficult to measure and therefore the decision to invest in an impact fund remains a highly subjective and qualitative affair. Where a fund has not explicitly declared a non-financial mandate, it should therefore retain our assumption as the primary objective of its engagements: that the primary objective of an asset manager is to deliver a return on clients' capital.

Source: www.cartoonstock.com

"How can a fund that's losing us money call itself socially responsible?"

This is especially the case for diversified secondary market participants, for whom the primary utility of engagement should be to encourage long-term performance. As mentioned previously, this is not to say that minority shareholders cannot participate in active engagement with a co-incidental societal impact. At Hosking Partners we routinely engage with companies to encourage them to act in a certain manner. These engagements cover a broad range of topics, from capital allocation policies, to energy transition strategy, to supply chain integrity and human rights. As an investor with an average holding period approaching ten years, we believe that the sort of corporate behaviour that produces long-term outperformance generally overlaps with being a productive and progressive member of society. That said, all of our engagements are linked by the golden thread that we believe the change we are advocating for will be of material benefit to the long-term value of the company, and therefore to our clients' returns. This golden thread prevents us from confusing or diluting our mandate, or being unrealistic about our ability or responsibility to effect change.

Furthermore, let us not forget that generating strong returns for pensioners and other investors provides deep value for wider society in and of itself. As we have discussed elsewhere, a transformative societal change like the energy transition cannot occur in a world of shortages and financial hardship. Investing in secondary markets may not be the most efficient way to make your money 'do good' directly, but it does contribute to the sort of economic growth that makes the doing of good elsewhere more probable. Unfortunately, the manufactured confusion over what ESG investing means, the misrepresentation of subjective opinion with oversimplified data, and unrealistic claims to impact are instead contributing to the misallocation of capital, much of which is hidden from asset owners by nothing short of dishonesty and illusion on the part of unscrupulous managers. While broadly we support the FCA's approach to correct this problem, rightly aimed as it is on restoring the primacy of qualitative analysis, we feel it could go further in its approach to the asset class discrepancy, the distortionary effect of metrics, and the variable utility of engagement as an effective tool for change.

Part 4: The Hosking Partners way

At Hosking Partners, we integrate ESG analysis in the most pragmatic, honest, and value-accretive manner we can. We embrace the importance of long-term, intangible drivers of companies' valuations. We assess and re-assess the trends, externalities, risks, and opportunities which affect us all. We use the simple elegance of the capital cycle lens to distil the world into a collection of ideas that we believe will generate our clients the best relative long-term return on their capital, and thus encourage economic growth. We are also always honest about what we are. As a highly diversified manager that mostly operates in the secondary market, we do not claim to have an impact unless we can demonstrably explain how that impact was achieved. We are not afraid to question received wisdom. We are deeply supportive of efforts to minimise the negative externalities associated with issues such as climate change, but we acknowledge the complexity of such efforts rather than trying to sell a false simplicity. We do not rely on quantitative screens as a crutch, but rather use data as a tool to challenge or reinforce deep, qualitative analysis.

In place of the oversimplifications, illusions, and counter-productive strategies that have come to blight ESG investing, we offer the following suggestions to forge a constructive way ahead:

1. A diversified public equities product can occupy a key position in a sustainable allocator's portfolio, but its primary objective should be to generate outperformance rather than impact, as the latter is more effectively accomplished through primary markets.

2. Where a manager or ratings agency uses a metrics-based approach to justify sustainability credentials or judgements, it should be rigorously informed by a qualitative discussion that frames the terms of reference of those metrics and is honest about the real-world impact of their usage. Furthermore, the impact those metrics have on stock selection should be clearly linked to a thesis for outperformance.

3. As such, when assessing a public equity manager's sustainable credentials, allocators should focus on the qualitative way in which the manager thinks about long-term, intangible value, rather than rely on misrepresentative ESG metrics which generally offer an incomplete or even deceptive description of a portfolio's approach.

4. Consideration and analysis of ESG factors should form a critical part of all high-quality investment processes, because ESG factors are a subset of a wider pool of long-term, intangible value drivers. However, ESG should not be placed on a pedestal over other such factors, and the importance attributed to the valuation impact of each should be weighed by its assessed materiality to the underlying investment.

5. Engagement is a fundamental responsibility for all asset managers, because it offers a lever to effect change. However, managers should be realistic and honest about both their mandate and their agency, and align the goals of their engagement accordingly.

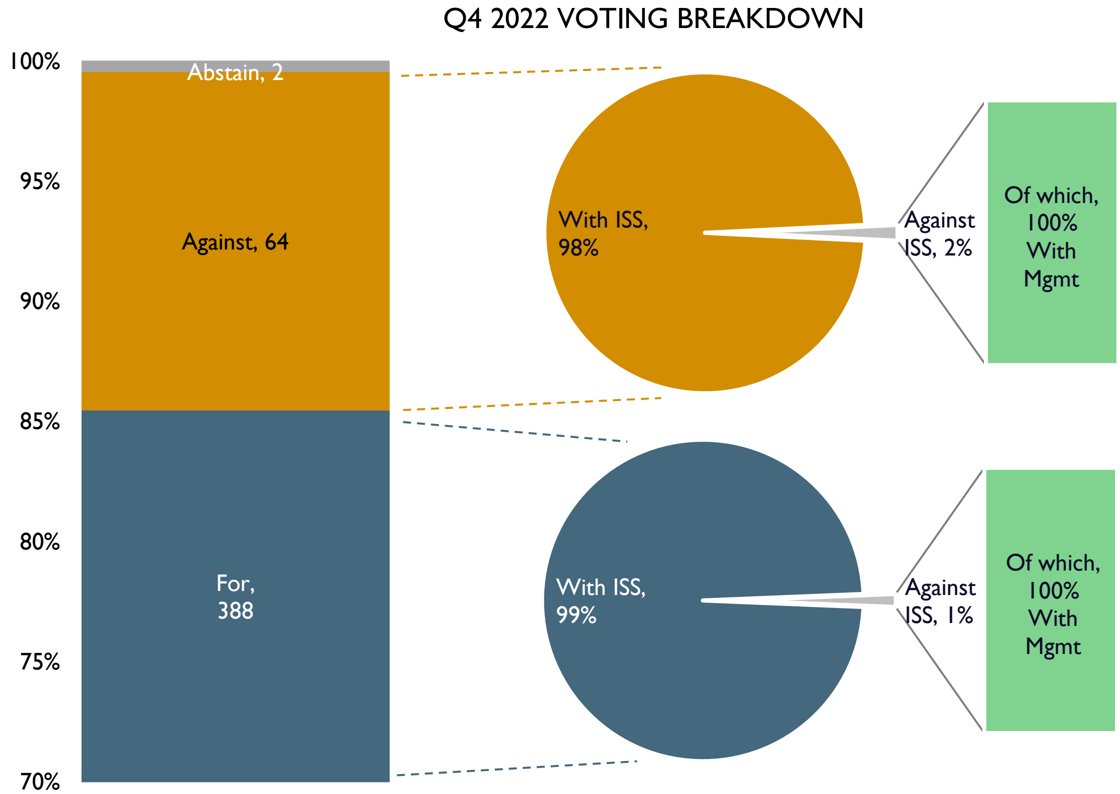
The turning of the tide is underway. As the regulators stir, our industry is beginning to question the oversimplified version of the world in which it has found itself. Increasingly, we see our peers adopting the sort of nuanced, pragmatic approach to ESG integration that we have long championed. As we move forward we hope this approach will not only help to steer sustainable capital flows in a more effective manner, but also continue to weave fibres into the mandate that remains our golden thread: delivering long-term outperformance for our clients.

References

References for any data or quotations included in this article and elsewhere in this report are available on request.

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.



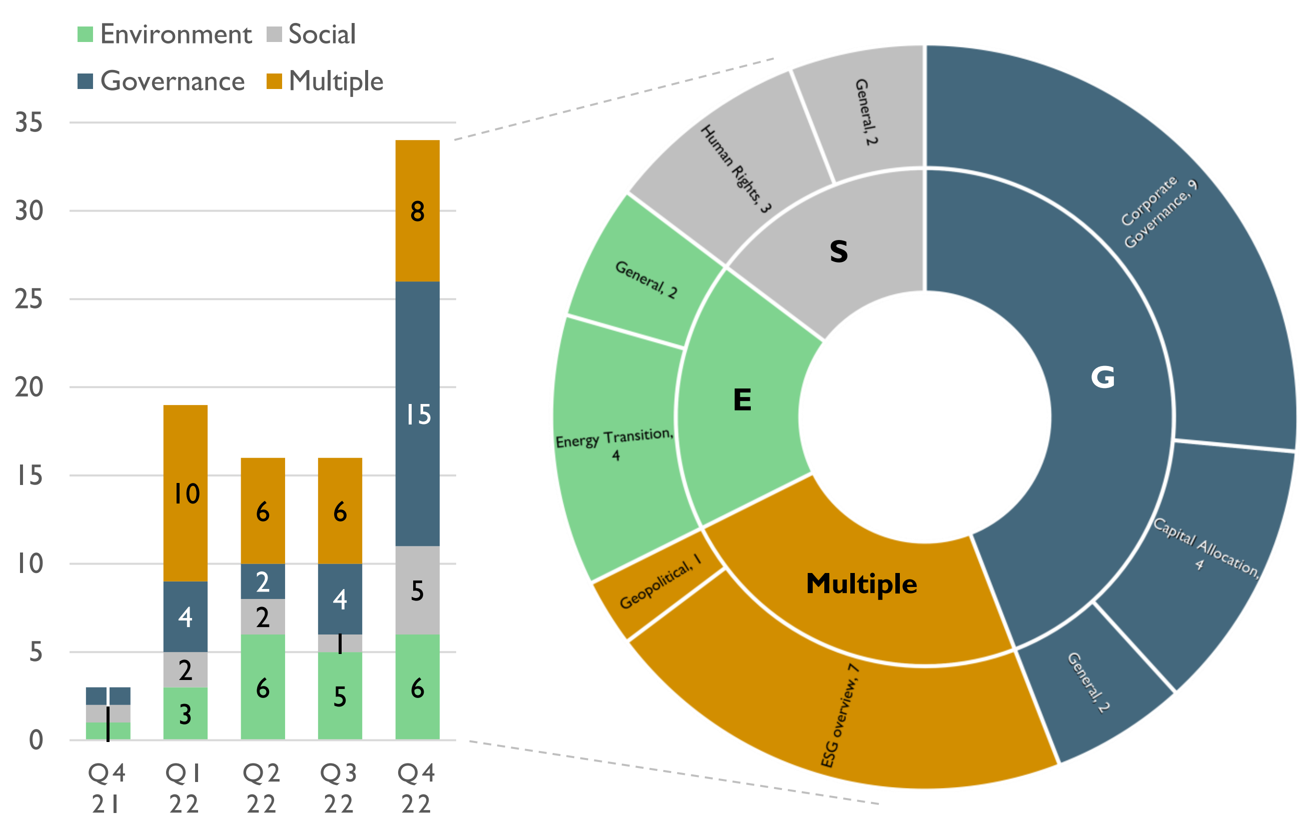
2022 FULL YEAR THEMATIC BREAKDOWN	FOR		AGAINST		ABSTAIN		AGAINST ISS	
	Total	% share-holder	Total	% share-holder	Total	% share-holder	Total	% share-holder
Director related, elections etc	3,123	<1%	280	12%	70	7%	67	21%
Routine/Business	1,157	<1%	50	18%	2	-	4	50%
Capitalisation incl. share issuances	515	-	55	-	-	-	10	-
Remuneration & Non-Salary Comp	542	<1%	88	5%	-	-	23	-
Takeover Related	132	-	8	-	1	-	1	-
Environmental, Social, and Corporate Governance	28	57%	60	98%	1	100%	19	95%
Other	42	14%	25	92%	1	-	14	86%
Total	**5,539**	**<1%**	**566**	**23%**	**75**	**8%**	**138**	**33%**

* Between Q3 and Q4 ISS updated their voting themes/categories. The new categories are reflected in this table, retrospectively applied to the entire year. We have also amended the table to show the percentage of each voting position that were shareholder proposals, which we believe is more informative than simply translating the totals into catagorised percentages.

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.

Q4 2022 ESG ENGAGEMENTS BREAKDOWN



This quarter's marked uptick in ESG-related engagement, particularly in governance, reflects two factors, one strategic and one procedural. Firstly – and the explanation for the uptick in governance-focused meetings – is the portfolio's increasing exposure to Japanese equities. The underlying thesis for this strategic shift is closely linked to shareholder activism and improving corporate governance in Japan, so many of our meetings have focused on this important area.

Secondly, from Q4 onwards we have slightly widened the net for how we record 'ESG Engagements' to include those conducted by the wider investment team. This policy is better aligned with our philosophy and indeed our process – as discussed in our lead article – that from an investment point of view ESG factors are primarily a subset of long-term, intangible value drivers relevant in varying degrees to all companies. We continue to differentiate between an 'ESG engagement' and regular 'company meeting' in the same way as before. The former has a particular focus on an ESG-related issue, and/or involves a two-way dialogue with a company in which Hosking Partners encourages a particular course of action related to E, S, or G factors. These output-focused engagements are managed by our Head of ESG. Less targeted meetings aimed at updating or initiating a relationship with an investment or prospect are recorded as company meetings, and are not included in the analytics provided on this page. Given the overall number of meetings has risen since the three analysts joined in late Spring 2022, it is unsurprising that the frequency of the ESG engagement subset has also increased.

A focus on… ESG-linked remuneration

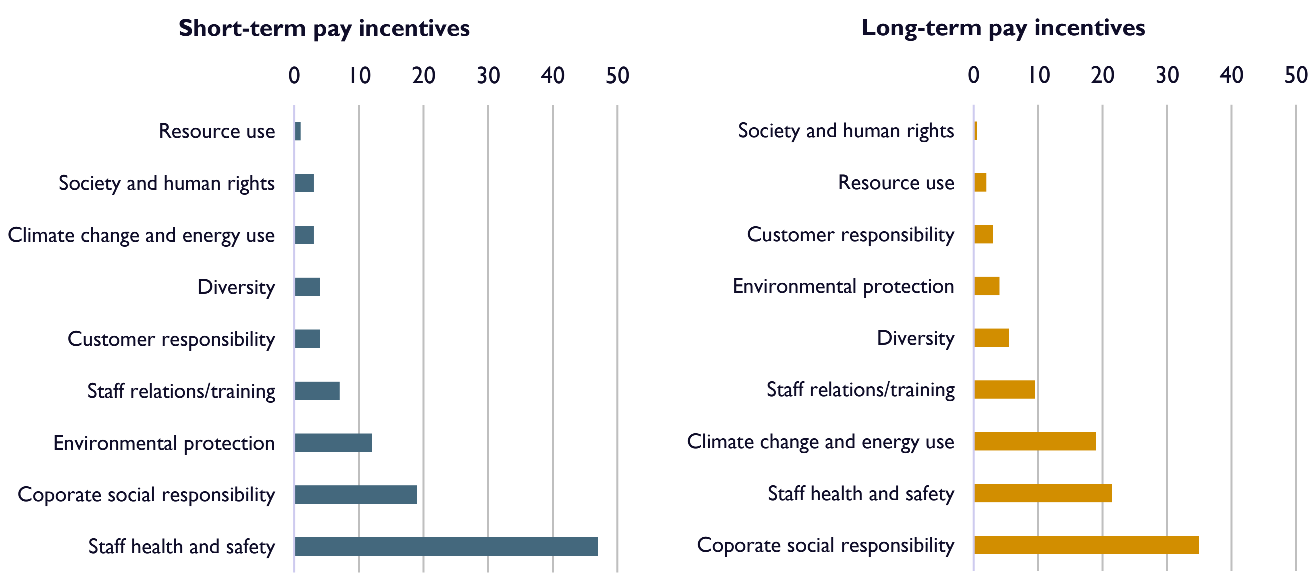
- The integration of ESG metrics into executive remuneration is gaining global momentum
- However, the assessment and reward of ESG matters is steeped in complexity
- We believe the best incentives align to corporate strategy and encourage long-term perspective

Much has been written in recent years on the shift from shareholder primacy to stakeholder capitalism. The central premise focuses on the failure of unregulated free markets to adequately create inclusive and equitable economies for all, including future generations. Indeed despite the Finance industry's proclivity towards the quantitative, economists and market participants alike have struggled to price externalities, be they positive or negative. Indeed, as mentioned in our opening article, externalities are commonly described as market failures because the equilibrium price of the product associated with them does not accurately reflect the total societal cost. As renowned theorist Stafford Beer has written, "we cannot regulate our interaction with any aspect of reality that our model of reality does not include." Recently there have been numerous efforts to address this problem, many of which are linked to the ESG movement. The combination of Say on Pay regulation, increasing scrutiny of executive remuneration packages by shareholders, and more recently the introduction of ESG key performance indicators (KPIs) in compensation proposals, represent one example of a potential avenue to tackling this problem.

The momentum in this space is significant. Over 50% of large US corporates and 45% of UK firms now integrate ESG KPIs into remuneration, a level which has increased dramatically in the past three years. However, while aspirationally admirable, a closer look at the reality of implemented plans and a healthy dose of scepticism leads us to observe that many examples of ESG-linked remuneration add even more complexity to an already opaque situation, rather than truly incentivise executives to address externalities.

A reasonable question is to ask why we would include non-financial considerations alongside more traditional metrics in remuneration packages at all? While the competing voices vary in intensity, a comprehensive study of the research suggests there is no decisive empirical consensus on either side. Despite a range of well-researched studies, it ultimately remains unclear whether these ESG practises are positive for either the corporate bottom line or value creation, especially in the near-term. A less idealistic argument may well be that sustainability considerations have historically been deprioritised relative to growth, profitability and share price, and therefore the inclusion of more

Type of ESG-linked pay metric adopted by companies (%)



Source: ISS

sustainability-oriented metrics provides a way to focus the minds of hereto non-compliant executives. The practical reality is that increasing regulation and ultimatums from the investment community alike provide little wiggle room or opportunity for companies to avoid including ESG KPIs in prospective remuneration packages for executives. This is a direction of travel that seems unlikely to abate in the years to come.

> *"Show me the incentive, I'll show you the outcome."*
>
> Charlie Munger

As boards increasingly look to distil ESG considerations into executive remuneration, the issue of complexity or multi-dimensionality looms large. Imagine a hypothetical consumer business with a design teams across the US and Europe, a manufacturing base across South East Asia, stores in all major global shopping districts, and a multi-platform digital presence. Quite simply, how can one distil the ESG considerations inherent to that company to just a handful of metrics? While carbon reduction may seem a logical focus for oil & gas companies faced with the rising tide of energy transition – for example, Shell have recently added emissions reduction targets into their LTIPs – for many businesses such a narrow focus appears rather blunt. Furthermore, how should a firm strike the balance between measuring, setting targets, and rewarding performance for ESG inputs, versus ESG outputs? As demonstrated in the example of Sibanye-Stillwater discussed elsewhere in this quarter's AOR, health and safety metrics are a critical consideration for mining companies. However, should remuneration focus on proactive metrics tied to training and organisational structure, and thus incentivise the avoidance of accidents before they occur, or rather take a more reactive approach which measures safety outcomes retrospectively and forfeits executive compensation in punishment for underperformance? It seems obvious the former system is conceptually preferable, but it is much harder to implement because it implicitly requires measurement of a counter-factual (i.e. how many accidents would have occurred in some hypothetical baseline scenario).

At the heart of ESG-linked remuneration is the need to include metrics that are both relevant and material, and achieve consensus on the correct methods of measurement. Implicit is the need to satisfy multiple stakeholders. But in practise, who is to judge the materiality of ethnic diversity for a hypothetical business located in a community with historically low diversity levels? Alternatively, while we can all agree as to the materiality of demographic diversity in industries such as financial services, what is the most appropriate metric by which to target, measure, and judge progress? After all, much has been written about the inability of ESG rating agencies themselves failing to agree on what best practise actually looks like. This is further complicated when proxy voting agencies such as ISS begin to adopt default positions universally, even when certain types of remuneration scheme are more appropriate for some sectors, geographies, and corporate governance structures than others.

Frameworks such as SASB's Materiality Map provide helpful reference tools for company and industry considerations, but the question remains as to what percentage of remuneration should be allocated to ESG KPIs. The average observed by bodies such as the UN PRI today stands at around 15% of variable pay, while some in the investment community have commented publicly that 20% feels "about right." However, with evidence showing that non-financial targets in variable compensation have a higher payout than financial KPIs, it's not surprising that the consensus feels rather like the wisdom of crowds.

> *"Not everything that counts can be counted."*
>
> William Cameron

At its worst, the introduction of ESG-linked remuneration metrics can be argued to be simply crowd-appeasement (i.e. 'greenwashing'), or alternatively a distraction from what might really matter. For example, with the much-documented focus on carbon emissions amongst the investment community in recent years, numerous capital-lite businesses have made self-proclaimed 'bold commitments' to achieve net zero – a strategy encouraged by investors and index-providers alike. Conveniently, such declarations ignore the physically realities associated with their often already structurally constrained emission footprints (see our discussion of carbon intensity on page 7). Linking emissions reduction targets to pay in such cases could actually incentivise the lengthening of a decarbonisation pathway. After all, why decarbonise aggressively if you are being paid each year to hit more moderate targets over a longer period? This may sound slightly cynical, but nonetheless it does illustrate the basic behavioural importance of ensuring remuneration is linked to issues with a demonstrable connection to performance rather than/as well as social externalities. Elsewhere, labour-intensive companies seeking to include a social-oriented KPI in remuneration have tended towards demographic diversity amongst their workforce, however often ignoring alternative but relevant social considerations such as CEO-to-worker pay balance, a metric that has been deteriorating broadly across geographies like the US.

In the cases we have observed where ESG-linked remuneration looks most sensible, it is both strongly-aligned with group strategy and demonstrates prudent long-term thinking. **Alcoa**'s early-mover approach to tie LTIP remuneration to safety and environmental stewardship back in 2013 demonstrated a sensible recognition of maintaining license to operate as a matter spanning strategic, financial and non-financial objectives. **Suncor's** prioritisation of the representation of indigenous peoples on their board, as well as targets for inclusion within management, highlights an understanding of, and commitment to the communities in which they primarily operate. Similarly, **Philip Morris**' allocation of 30% of variable compensation to what they define as 'Transformation' – the progress they make towards smoke-free products as a percentage of total group revenues – not only reinforces group commercial strategy, but also speaks to a strategic orientation towards harm reduction that is materially incentivised at the highest levels. We have been vocally supportive of these schemes in our engagement with these companies, because their implementation is aligned with the creation of sustainable, long-term value.

At Hosking Partners our capital cycle-led investment approach seeks neither to reflect optimism, nor pessimism towards an ideal, but rather aspires to recognise reality. We do not look to company initiatives to say the 'right thing,' likely reflective of the zeitgeist or latest fad to captivate commentator attention. Rather we seek values and value that we can understand. First principles thinking leads us to believe that long-term, well-aligned incentives focused on value creation tend to bear fruit for owners of businesses, not renters of stocks. However, we also recognise that executive remuneration plans appropriately considered are instructive flags as to less favourable outcomes for minority shareholders – a nod to the infamous quote by Charlie Munger above. Recognising the challenges and limitations of linking remuneration to ESG considerations, we seek not to dismiss nor discard, but rather to identify and embrace the complexity where it emerges. After all, therein lies opportunity.

Source: Google Images

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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