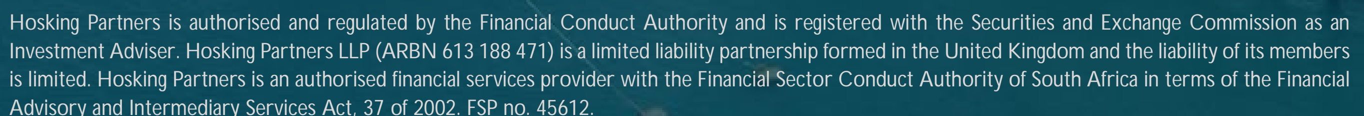
# ESG and Active Ownership Report

## Q1 2024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# Foreword

Our unconstrained, diversified portfolio of over 350 stocks stretches across the investable universe, encompassing sectors, geographies, market caps, and business models.

This quarter, our lead article focuses on one particular area of the Hosking Partners portfolio. It is an area which has outperformed our benchmark (ACWI) in recent years, and which is at the intersection of several evolving global trends. It is the shipping industry.

Considered 'difficult to own' by many investors – not least those with an ESG focus – the shipping industry nevertheless represents a critical part of the global economy. Our article explores why our supply-focused approach, combined with a holistic view of ESG, sees opportunity where others see challenge.

Elsewhere in the report, recently promoted Hosking Partners portfolio manager Omar Malik discusses how the alignment of incentives contributes to the investment case in portfolio holding Tiny. Aligning incentives with shareholder interests is not only a central part of good corporate governance, but also a critical behavioural element which we study carefully as part of our long-term approach.

The report also contains the usual collection of voting and engagement examples. As ever, please do be in touch with your questions.

**Roman Cassini**
Head of ESG

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| VOTING SUMMARY | Q1 | 2024 |
|---|---|---|
| Meetings Voted | 37 | 37 |
| Proposals Voted | 397 | 397 |

| ENGAGEMENT SUMMARY | Q1 | 2024 |
|---|---|---|
| ESG | 42 | 42 |
| Total Direct (1-on-1) | 101 | 101 |
| Total Indirect (Group) | 28 | 28 |
| Conference | 15 | 15 |

# Shipping: A bigger splash?

- The shipping industry is central to the world's economy, carrying 80% of global trade
- Nevertheless, it is sometimes considered a 'hard to own' sector by long-only investors
- Applying a supply-focused lens to the dual trends of deglobalisation and the energy transition suggests hidden upside for the sector

*"What is comfortable is rarely profitable."*

Robert D. Arnott

**Back in 2017, we wrote a Hosking Post which highlighted our growing exposure to the shipping industry** ("What shall we do with the drunken sailor?"). Seven years later – over which period the portfolio's shipping holdings have outperformed our ACWI benchmark by a considerable margin – we return to the high seas once again to discuss this fascinating but often overlooked area of the equity market.

**We have written in previous Active Ownership Reports about how the energy transition is unlikely to unfold in quite the way many expect** ("The maze to net zero", "A diverse world"). We have also written about how oversimplified approaches to ESG may be leading to capital misallocation ("Embracing complexity"), and how these two issues are connected ("Only dead fish swim with the stream"). The shipping industry provides a neat case study that brings this to life, and demonstrates how our capital cycle approach allows us to see the world from a differentiated perspective, unlocking opportunities others find difficult to access.

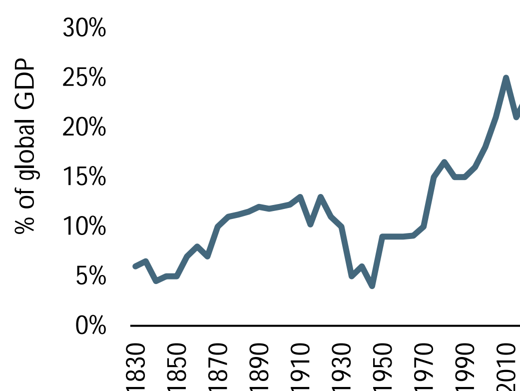
**In this piece we will explore three reasons why shipping appears 'difficult to own' for long-only investors**, and how Hosking Partners' capital cycle lens and holistic approach to ESG finds opportunity where others see challenge. In overview, we will cover: (1) the role shipping plays in a fragmented global economy; (2) its environmental profile and the role it plays in the energy transition; and (3) the inherently cyclical nature of the industry. We will conclude by discussing Hosking Partners' exposures, and their performance in recent years.

## Is deglobalisation a threat or an opportunity?

**The history of commercial shipping traces back almost 9,000 years**. The oldest known sea route appears to have run across the Aegean Sea, transporting obsidian from the volcanic island of Milos towards the southern Balkans where it was refined into blades. Over time, advances in shipbuilding, navigation, and trade expanded global shipping networks. The advent of coal-fired steamships in the 19th century and then containerisation in the 20th revolutionised the industry, facilitating faster and more efficient transportation of goods between continents. Today, shipping remains a cornerstone of the global economy, with circa 80,000 commercial vessels (counting all non-passenger classes over 100 gross tonnage) carrying 80% of international trade by volume. Without shipping, the modern world as we know it would grind to a halt.

**Unsurprisingly therefore, geopolitical factors weigh on the industry.** Tit-for-tat US-China frictions and sanctions on Russian energy that have incentivised a 'shadow fleet' of uninsured vessels are symptoms of the broader trend towards deglobalisation. This has been accelerated by the Covid supply shock and geopolitical insecurity arising from the Russia-Ukraine war, but data suggests it has been over a decade in the making. Global trade as a percentage of GDP grew steadily through the 19th century, before stagnating and then shrinking in the interwar period. Post-1945, it reaccelerated sharply until around 2010, growing from 5% to 25% of global GDP. That moment, coming out of the WTO consensus and rise of China, marks the high watermark of globalised

**Figure 1:** World trade as a share of global GDP



trade. Since 2010, it has stopped growing and been range-bound between 20-25% (see figure 1, previous).

**It remains to be seen whether growing geopolitical instability leads to a prolonged retrenchment in trade**. Some experts have drawn concerning parallels between the pre-WWI years and today. If we are indeed entering such a period, then there will inevitably be impacts on the world's shipping industry as the primary carrier of that trade. But as we will see, a supply-focused lens shows that it is not necessarily a wholly negative picture for investors. Furthermore, this deglobalisation trend must be considered alongside the energy transition. These are – in many ways – two sides of the same coin (as we discuss in "A diverse world"). Fuel cargoes constitute 36% of shipborne trade alone, but this excludes broader category 'energy-derived' products such as food, chemicals, plastics and so on. The flow of all of these will be affected by changes to the world's energy mix and distribution patterns. Meanwhile, the world is moving towards more volatile energy sources. The output of wind and solar assets varies by ±3.5% each year due to their intermittent nature. As these energy sources ramp from 5% to 30% of the useful energy mix, the standard error in global energy balances may double. In turn, that means ±2% swings in energy balances due to abnormal weather events could become 250x more likely in 2050 than today. This volatility will be even more extreme at the local level, as weather events affect regions differently. So it seems likely that the energy transition – whatever its final shape – will increase energy price volatility as long-established patterns are upturned, the global energy ecosystem reorders, and intermittent energy sources are built out.

**As capital cycle investors, we see the world through a lens that observes supply rather than tries to forecast demand**. We can observe the impact this collective uncertainty is having on supply, where shipping orderbooks have reached multi-decade lows and average vessel age is rising (see figure 2, below). The dual trends of deglobalisation and the energy transition are likely to constrain future supply as uncertainty across several fronts suppresses new vessel orders into the 2030s. Deglobalisation – or perhaps more accurately – 're-localisation' may lead to less efficient shipping routes, lower fleet utilisation, and thus lower supply. Meanwhile, commodity price volatility – driven by both trends discussed above – favours shipping as the industry enables cross-border arbitrage by transporting energy and other goods from areas of surplus to areas of deficit.

## Do simplistic ESG approaches conceal an energy transition winner?

**The shipping industry accounts for about 3% of global CO2 emissions**. This is about a sixth of the 20% or so attributable to transport as a whole, three quarters of which is road transport. Stripping out light passenger vehicles to focus on freight, in gross terms shipping sits second to trucks (5%), but ahead of aviation (2.5%) and rail (0.5%). This physical reality makes shipping the target of environmentalists – and by extension – ESG-focused investors. In brief, it is a 'hard-to-abate' sector. Ships are large, heavy objects and require energy-dense fuels to operate. Accordingly, oil-based fuels meet over 99% of

**Figure 2:** Tanker orderbook (left) and average age (right)

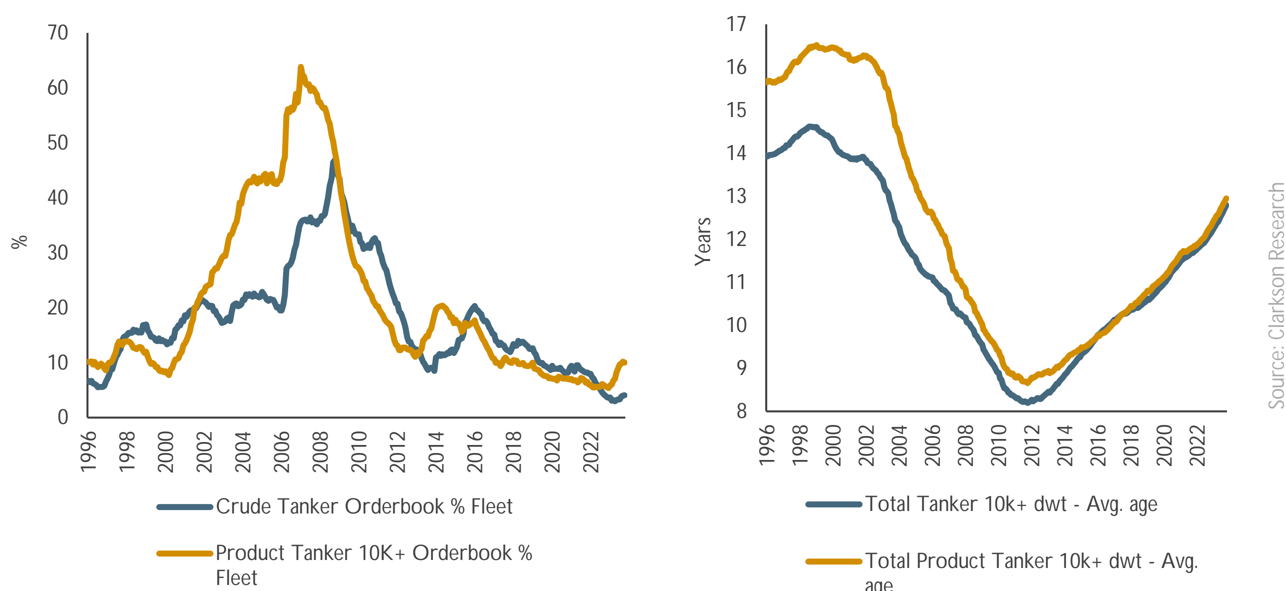
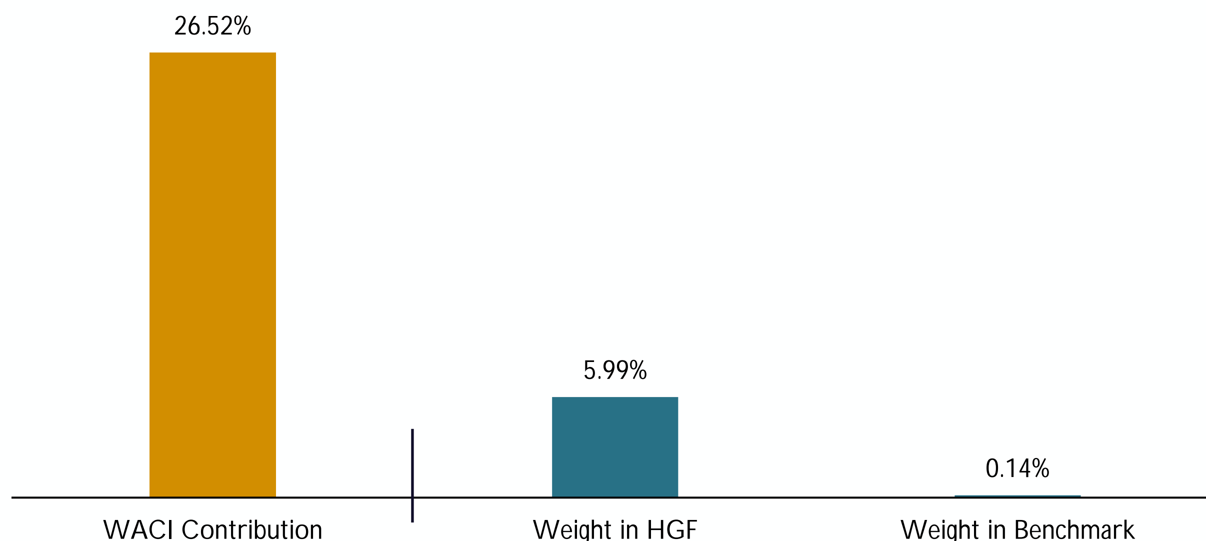


**Figure 3:** Shipping's contribution to portfolio carbon intensity



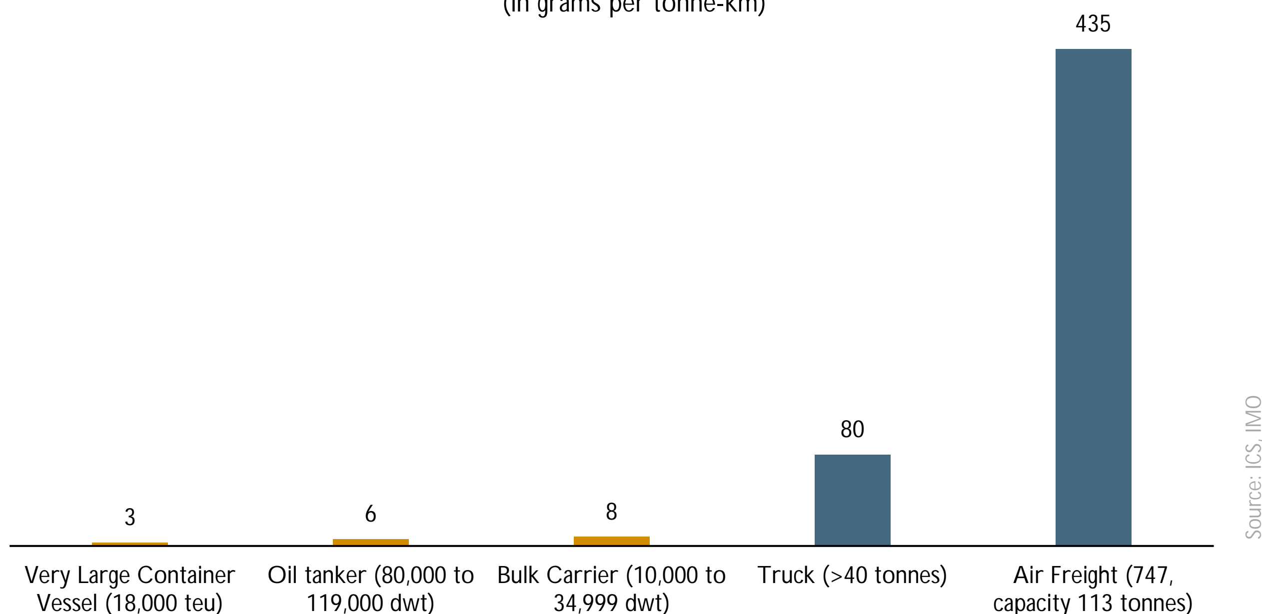

their energy demand. For the sector to decarbonise meaningfully, these fuels must either be replaced with a lower carbon alternative – biofuels, LNG, methanol, etc – or the emissions must be captured and stored (or some mixture of the two). Unfortunately both options – replacement and capture – remain either technologically immature, prohibitively expensive, or both. Because of shipping's fundamental role in a growing global economy, gross emissions from shipping emissions are growing rather than falling. Meanwhile, uncertainty over which technology will win out means shipowners are delaying allocating capital to newbuilds. After all, who wants to commit $250 million on a hard asset with a lifespan of 20+ years if it is unclear whether it will be able to operate in a few years' time?

**The industry is also poorly served by some of the simplistic metrics used in ESG portfolio construction**. Shipping benefits from economies of scale, meaning that larger vessels are generally more efficient per tonne of cargo carried. Thanks to this efficiency, revenue per tonne-km (number of tonnes transported multiplied by distance travelled) is lower than in other transport industries. As a result, portfolio carbon metrics like Weighted Average Carbon Intensity (which divides emissions by revenue) structurally disfavour shipping companies. Demonstrably, in the unconstrained Hosking Partners portfolio, shipping accounts for just 6% of portfolio assets but contributes over 25% of the total WACI (see figure 3, above). No other sector comes close to this level of imbalance, which makes the sector literally 'hard to own' if carbon intensity is an exclusionary consideration in portfolio construction. The more concentrated the portfolio, the more extreme the effect.

**These issues make investing in the shipping industry a challenge for some ESG-focused investors**. But the analysis is misleading. While shipping's gross emissions represent an opportunity for decarbonisation, we should not lose sight of the sheer efficiency of carrying freight by sea. When measured by emissions per tonne-km, shipping compares highly favourably to other forms of transport because of the scale advantages of carrying more mass over longer distances. By this measure – which is favoured by the Transition Pathways Initiative – a very large container vessel is about 26x more carbon efficient than a truck, and 145x than a plane (see figure 4, right). Furthermore, while absolute sector emissions are rising thanks to the growing global population and economy raising demand for shipping, emissions per tonne-km are falling steadily. This is due both to gradual progress in alternative fuels and carbon capture, but mainly to a proactive regulatory approach by the International Maritime Organisation and other industry bodies. These rules are targeting the accelerated phasing out of older, dirtier ships alongside speed restrictions designed to increase round-trip fuel efficiency.

**These regulations will help curb gross emissions, but they also have operational impacts**. Engine power limiters result in a one-time permanent reduction in speeds, which will limit the global fleet's ability to speed up to meet short-term increases in demand. The overall effect of slower speeds is to reduce existing shipping

**Figure 4:** Typical CO2 emissions of modes of freight transport (in grams per tonne-km)




capacity, in terms of new capacity. In other words, some of the increase in the industry's fleet size is to compensate the lost efficiency caused by slow steaming. This creates an illusion of growth in capacity when, in reality, it is merely an adjustment to maintain baseline service levels. Concurrently – because of the uncertainty over both regulations and which future fuel technology will triumph – many operators (e.g. portfolio holding **Pacific Basin Shipping Ltd**) have committed not to order new ships until zero or near-zero carbon models are both available and affordable. This constrains 'real' new capacity coming online. This all adds up to a 'tighter for longer' supply picture.

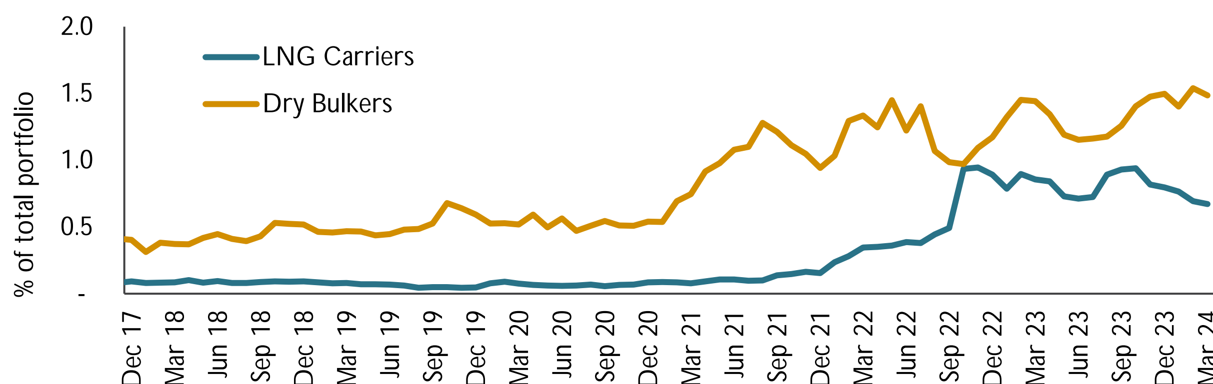
## Do low barriers to entry mean low returns?

**The shipping sector is also affected by a range of other issues which can spook investors**. As we discussed back in 2017, the sector is highly fragmented, so ship owners have limited pricing power. Meanwhile, barriers to entry are extremely low. After all, anyone can cobble together some equity, get a loan from a bank, and order a ship with very little downpayment at the shipyard. These factors have in the past incentivised poor discipline among owners. This time, however, uncertainty over future fuels and the engines to consume them, combined with more expensive capital due to ESG metrics which penalise the sector, mean that the typical supply response to higher time charter rates is delayed. Nevertheless, carefully evaluating the quality of management teams, their level of ownership, and how they are incentivised remains key to avoiding those pirate-operators looking to place 'heads I win, tails you lose' bets with shareholders' funds.

**Taking this supply-focused, behavioural approach allows us to see opportunity where others see challenge**. It is in this context that examining trends like deglobalisation, the energy transition, and even ESG fund flows lends one valuable additional perspective. Many of the factors discussed in this report – technological uncertainty, low capital investment, oversimplified ESG approaches, imperfect emissions regulations, and a tarnished reputation for capital allocators – have combined to place a natural constraint on near-term marginal supply. Over the last seven years, this has led to higher returns on capital and higher share prices across a basket of shipping stocks in the Hosking Partners portfolio.

**This is not a one-size-fits-all approach**. Also required is an understanding of the cycles in each separate class of shipping, and how they interact. We noted earlier how LNG tanker orderbooks have recently swelled, particularly in China. In response, over the last year, we have trimmed our exposure to LNG carriers and recycled it into dry bulk, where in contrast to 2017 the supply picture now looks more attractive (see figure 5, next page). Similarly, there are early signs that product tanker supply is picking up, leading us to moderate our position in **Hafnia**, which has returned 349% in USD terms since we first added in 2019.

**Figure 5:** Weight of LNG carriers and dry bulkers in the Hosking Partners portfolio




## Conclusion

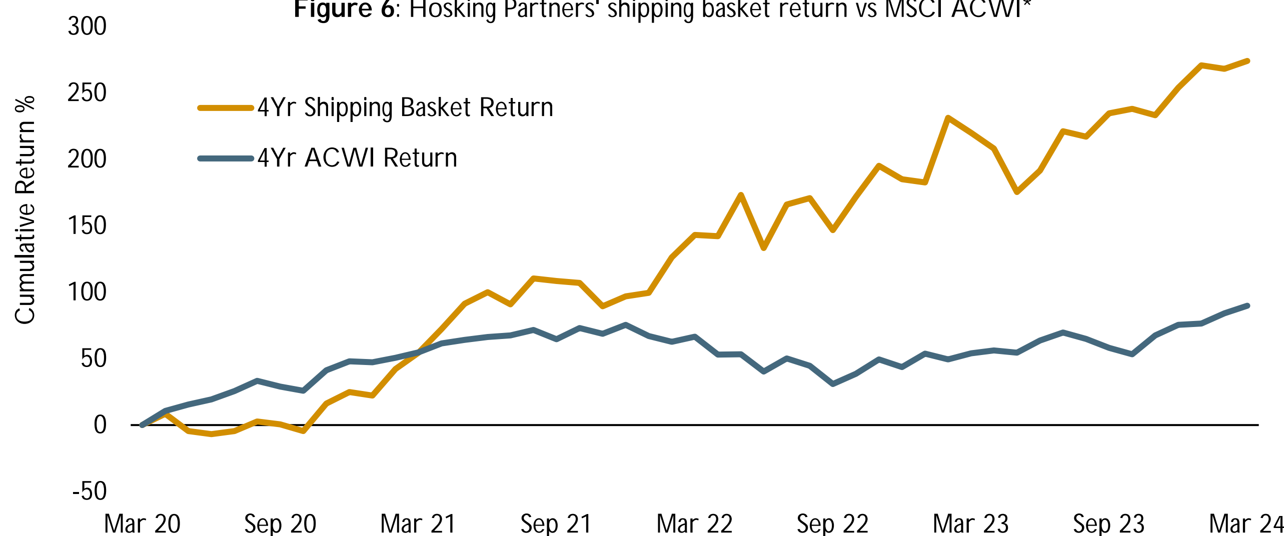
**Since we wrote "What has become of the drunken sailor?" in 2017, Hosking Partners' shipping basket has outperformed the index by about 25%.** This has been driven by particularly strong performance in the past four years, over which period it generated cumulative returns of 274% (see figure 6, below) in USD. As of the date of publication, shipping companies make up about 6% of the Hosking Partners portfolio. This is a significant active bet – the weight in the benchmark is just 0.1%.

**To invest in an industry like shipping, Hosking Partners benefits from being able to take a long-term approach and from our unconstrained remit**. Bottom-up analysis must be paired with a broader appreciation of global trends, where a focus on supply helps distinguish the signal from the noise. Assessing and understanding management behaviour helps us avoid principle-agent conflicts. As we concluded in 2017, investing in this industry is never likely to be plain sailing. But our approach thus far has caught favourable winds, and with due caution and an eye on the horizon, we sense some life remains in this old sea dog yet.

## *References*

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

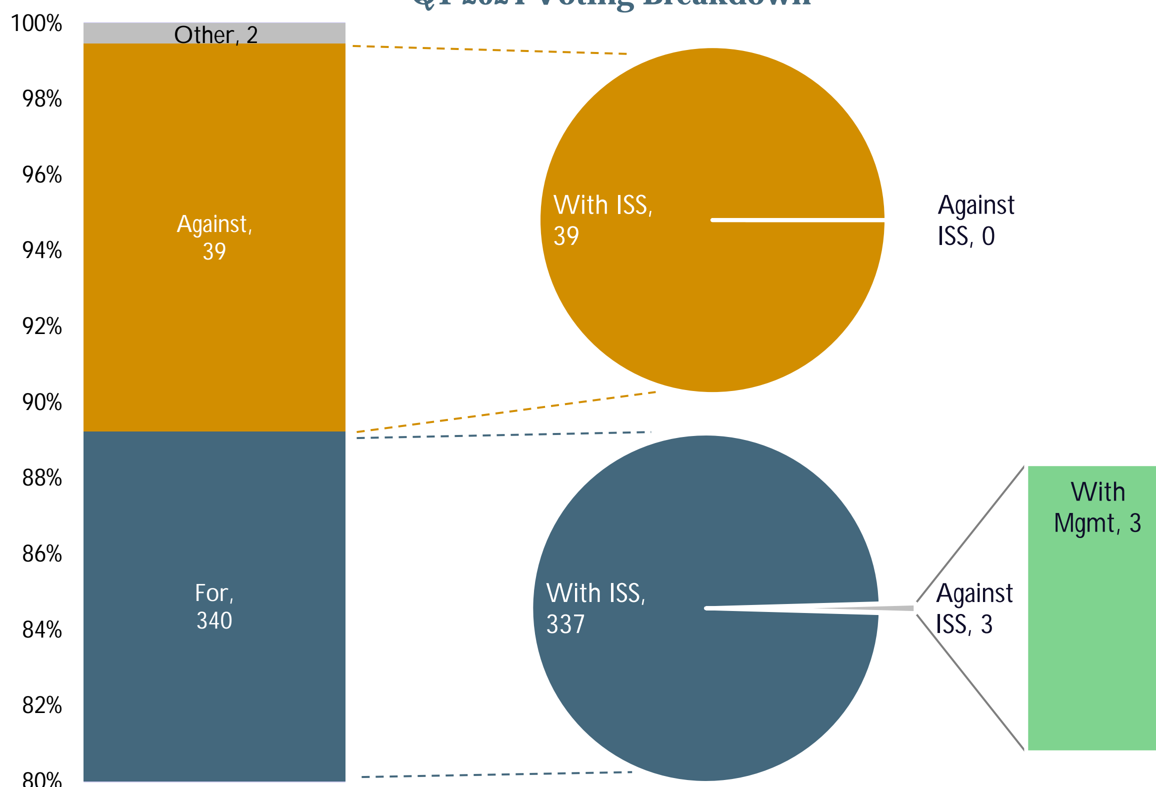
**Figure 6**: Hosking Partners' shipping basket return vs MSCI ACWI*




* Returns are presented net of fees performance, calculated using a single, flat-rate management fee across all accounts as well as reflecting other expenses that may be incurred in the management of the account. The investment management fee schedule used to calculate the net performance for the Shipping Basket is a flat annual rate of 0.375% of all assets.

# 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.*




| 2024 YEAR TO DATE THEMATIC BREAKDOWN | FOR | | AGAINST | | ABSTAIN | | AGAINST ISS | |
|---|---|---|---|---|---|---|---|---|
| | Total | % share-holder | Total | % share-holder | Total | % share-holder | Total | % share-holder |
| Director related, elections etc | 203 | - | 20 | - | 1 | - | - | - |
| Routine/Business | 61 | - | 3 | - | - | - | 1 | - |
| Capitalisation incl. share issuances | 24 | - | 2 | - | - | - | 1 | - |
| Remuneration & Non-Salary Comp | 31 | - | 10 | 20% | - | - | - | - |
| Takeover Related | 4 | - | 1 | - | - | - | - | - |
| Environmental, Social, and Corporate Governance | 5 | - | 3 | 100% | - | - | - | - |
| Other | 12 | - | - | - | - | - | 1 | - |
| **Total** | **340** | **-** | **39** | **13%** | **1** | **-** | **3** | **-** |

*Not displayed in the graph above are 18 non-votable proposals, 16 'Do Not Vote' instructions, and 1 'One Year' instruction.*

# Voting Discussion

| Company | Country | Meeting Date | Meeting Type | % of Voting Shares |
|---|---|---|---|---|
| TOSEI | Japan | 27th Feb 2024 | Annual | 1.3% (as at date of meeting) |

| Proposal(s) | Management Recommendation | ISS Recommendation | Our Vote |
|---|---|---|---|
| Approve Takeover Defence Plan (Poison Pill) | FOR | AGAINST | AGAINST |

One of Hosking Partners' holdings, **Tosei Corporation**, this quarter requested shareholders to approve a poison pill. A Japanese company, Tosei Corp develops and sells residential properties, leases office spaces, and manages real estate investments, predominantly in Tokyo.

A poison pill is a type of takeover defense strategy companies can leverage to deter a would-be acquirer from taking control of the company without the board's consent. This is typically achieved by making the stock more expensive and thus unattractive to the acquirer. There are several types of poison pill which companies may adopt. In this case it would involve issuing warrants to all shareholders except for the offending shareholder, thereby diluting their holding and making it more costly to accumulate a controlling share.

Preventing a takeover can be beneficial to minority shareholders, particularly where a company is temporarily undervalued, as an acquirer could accumulate a controlling share, taking advantage of a temporary price decline, and force out minority shareholders at a value below what might be deemed fair. Although this can be an effective deterrent against hostile acquirers, these strategies can be costly to execute. This cost is ultimately borne by shareholders and can impede potentially positive change by entrenching the current management, who may become less responsive to disempowered shareholders.

Thus, management should ensure that any takeover defense strategy put forward for approval represents "a proportional response to a credible threat". ISS have suggested several benchmarked criteria against which a strategy's "proportionality" can be measured, which should be considered before an assessment need be made of whether a credible threat exists. Measuring the company's plan against ISS' criteria, Hosking Partners had several concerns with the plan, including the excessive 5-year duration and the presence of additional takeover defense initiatives already available to the board. The plan also lacked sufficient independent oversight, characterised by the majority insider board. Combined with a potentially high and unnecessary cost to shareholders, these deficiencies presented a material agency threat, and we believed the balance of cost to benefit was not in shareholders' favour.

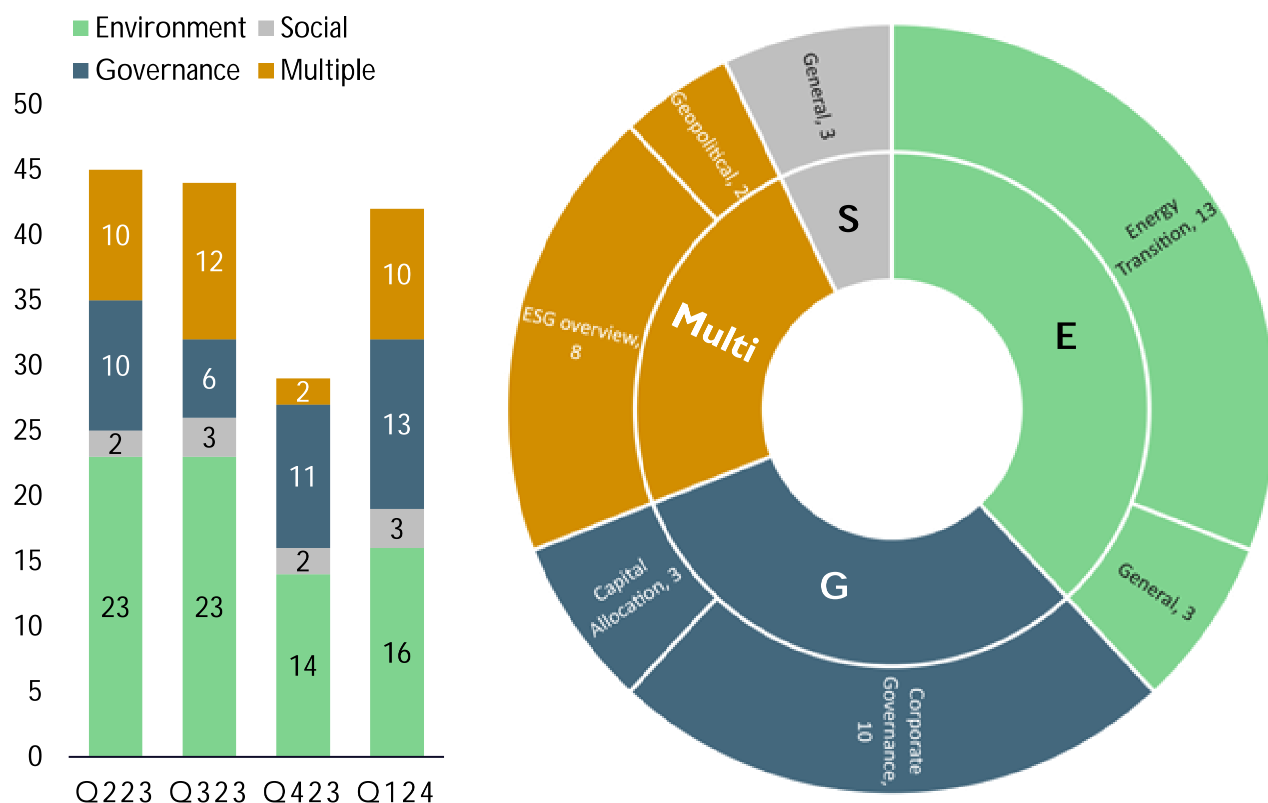
As such, putting aside the absence of a present credible threat, Hosking Partners believed the proposed plan did not reflect a proportional response, leading us to vote with ISS and against Management accordingly.

Source: Hosking Partners, ChatGPT

# Engagement Summary

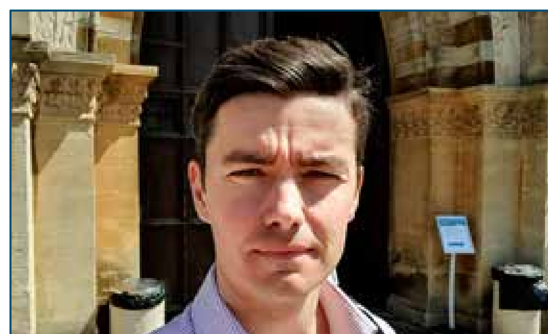
*Corporate engagement is a core component of Hosking Partners' process. As well as engaging in specific situations, we focus on company management, and careful consideration is undertaken by the portfolio managers to assess whether the management teams' time horizons and incentive frameworks are aligned 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.*

## Q1 2024 Engagement Breakdown




## Hosking Partners' Q1 2024 Postcards

Omar and Django stop for refreshments on the way back from the Raymond James Institutional Investor conference in Florida.



Roman on his way into the Oxford Battery Metals Conference, hosted at the Natural History Museum.

# Engagement Discussion

| Company | Country | Engagement Type | % of Voting Shares |
|---|---|---|---|
| AngloAmerican | UK | Letter | 0.15% (as at 1st May 2024) |

In a recent letter to the company, we expressed concerns regarding the incentive compensation schemes for **Anglo American** executives, particularly the $21 million paid to former CEO Mark Cutifani for FY2021 & FY2022.

We questioned the short-term focus of such compensation, highlighting the deterioration in Anglo American's financial health following Cutifani's departure. The letter advocated for a long-term, owner-oriented remuneration policy that aligns with the cyclical nature of the mining industry. Key suggestions included rewarding contrarian capital allocation over decades, focusing on per-share metrics like reserves and production, and maintaining balance sheet flexibility. The letter further questions the effectiveness of current compensation structures, suggesting they contributed to suboptimal capital decisions, such as the missed opportunity to internally fund the Woodside project and potentially retire equity at more favorable prices, thus enhancing long-term shareholder value.

In response to our letter, Anglo American acknowledged the need for remuneration outcomes that are sensitive to both the cyclical nature of the mining industry and shareholder interests. They argued that the current remuneration policy consists of various elements designed to reward management through the business cycle. For instance, the annual bonus is heavily influenced by underlying performance rather than market prices alone, ensuring that high compensation is contingent on sustained performance.

The company further argued that the Long-Term Incentive Plan (LTIP) is structured to focus on long-term performance, including a mandatory two-year holding period post the three-year performance period, which ties executives like former CEO Cutifani to the long-term outcomes of their decisions. Anglo American's Remuneration Committee has also adjusted the compensation package for incoming executives to increase the emphasis on long-term performance, moving from 300% to 350% of LTIP awards.

That said, Anglo American's definition of 'long term' seems plainly inadequate in the context of asset lives with minimum 20-year durations. Furthermore, they did not respond to our request for a per share focus. Nevertheless, this dialogue opens a pathway for further discussions regarding recalibrating executive compensation to better align with the principles of "owner-oriented long termism" as advocated in our letter.

Since our engagement, BHP announced a well-publicised approach for Anglo American – and in particular their world-class copper assets – which was rejected swiftly due to the extremely low valuation premium applied. Despite this, that BHP are proposing the largest mining M&A deal of the century suggests the capital cycle in copper that we wrote about late year ("Where's a copper when you need one?") is alive and well, a boon for our exposure to the sector.

We will continue to engage actively with Anglo American – on both remuneration and its approach to a prospective merger or takeover – as the year unfolds.

# A focus on… **Incentivising long-termism**

- Incentive structures too often prioritise the maximization of short-term metrics over generating long-term shareholder value
- At Hosking Partners we advocate for incentive systems that encourage management to act like owners
- Companies such as portfolio holding Tiny demonstrate what this can look like in practice

**Under the analytical framework of the capital cycle, management incentives play a key role**. The capital allocation decisions made by a company's leadership – for example about capital expenditure and acquisitions – determine the denominator in the calculation of return on capital. When a long-term investor buys shares in a company, they outsource future investment decisions to the current management team. Management incentives influence behaviour generally, and capital allocation in particular. Not only can they ensure that optimal investment decisions are made, but they are also useful for revealing to investors the ways in which management is likely to exercise the discretion it has been given to manage the company's balance sheet.

**Despite this opportunity to optimise outcomes, incentive structures often exacerbate behavioural weaknesses** rather than aligning the interests of the management team with those of the company's owners. They may be tied to excessively short-term metrics (for example, sales) or performance metrics which exclude consideration of capital deployment (earnings per share being the obvious example). Such incentives ignore the long-term consequences of today's decisions and instead privilege growth over return on capital, which in the long run is the key driver of shareholder returns. At Hosking Partners, we believe that incentive arrangements promoting long-term share ownership best focus management on the true drivers of value because when interests can be broadly aligned between management and shareholders, this raises the likelihood of intelligent capital allocation. When management already own significant equity, and share the interests of minority shareholders, so much the better.

**Such alignment is often the exception rather than the rule.** The challenge comes when analysing companies where equity ownership is diversified, and executives are hired without skin in the game. In these situations, boards' remuneration committees typically engage

Source: Hosking Partners, ChatGPT

consultants to implement "industry best practice", leading to standardised incentive packages. These arrangements often include an attractive base salary, an annual cash bonus set as a multiple of their base salary based on short-term key performance indicators (KPIs), and annual equity grants through stock options or performance-based long-term incentive plans (LTIPs).

**Even when annual bonuses are designed thoughtfully, they may place too much weight on short-term financial metrics.** This serves to distract management from their task of long-term value creation. Temptations arising from this might include costly acquisitions or the deferral of necessary investments. To compensate for this, more companies include return on capital as a key performance indicator to encourage better capital allocation. Even this is not wholly perfect, however, as it may be distorting to focus solely on a single year's return, especially in capital-intensive industries where assets have long useful lives. Although metrics based on a combination of the income statement and the balance sheet are intended to promote an all-round approach, if schemes are not devised carefully then company leaders can achieve generous bonuses by focusing on just a few KPIs at the expense of the rest. We advocate for longer measurement periods and multi-year phasing of benefit awards to promote strategic thinking.

**Despite being strong believers in the importance of share ownership by management, we are wary of equity grants to management** as we do not believe they align with shareholders' interests in the way that is hoped. Often little more than 'lottery tickets,' these grants reward management on the upside, which may be the result of factors beyond their control. Such awards can serve merely to transfer costs from the income statement to shareholders, boosting profits but diluting returns. LTIPs may not be much better, as we find they frequently award high payouts even when performance lags corporate targets. Gifting equity, whether by share grants or via LTIPs, is an inadequate way of replicating the effect of an owner putting their personal wealth at risk in owning a share of an enterprise. There is a chicken-and-egg challenge here – what to do when management have not yet got to a position where they been able to acquire an ownership interest which is meaningful in relation to their own circumstances?

**We are drawn to companies that have addressed this principal-agent dilemma thoughtfully**. Although no perfect solution exists, we find several schemes worth remarking on. Notable examples include **Tiny Ltd** (held in the Hosking Partners portfolio) and Constellation Software (not held). At these companies, the founders align closely with public shareholders, forgoing base salaries and bonuses in favour of significant equity stakes. However, other senior managers, also critical in capital allocation but without the same level of prior ownership, have a different arrangement. Their compensation includes an industry-average base salary and an annual bonus based on return on capital and revenue growth in their segments. Constellation Software states, "The objective of our annual incentive bonus is to reward employees for working towards our goal of increasing shareholder value. We believe that shareholder value is created by managing two financial components over the long term: profitability and growth."

**Using more than one metric helps reduce the risk of manipulation**. Managers at Tiny receive no bonus if the ROIC falls below a certain threshold. Importantly, at both Tiny and Constellation the annual bonus is paid in cash, with the requirement that a large portion (40-80% across both companies) is used to purchase shares in the open market. At Constellation Software, these shares are held in escrow for a minimum of four years.

**Such an incentive arrangement emphasises key metrics for value creation and promotes long-term thinking** by requiring managers to invest a significant portion of their compensation in company shares. Executives at Tiny and Constellation Software only do well if the share price appreciates, in stark contrast to the norm at many public companies where executives are able to enrich themselves regardless of shareholder outcomes.

**Well-designed incentives do not automatically guarantee good share price performance**, and poor incentives do not necessarily lead to shareholder value destruction. But incentives are nevertheless important as they make clear which outcomes management teams are being asked to prioritise, and this shapes their behaviour. A company's board of directors, elected by shareholders, puts in place these incentive arrangements and it is vital that we, as shareholders, advocate for and support good incentive systems in our portfolio companies. We recommend that boards start from first principles rather than relying on standard practice, with the aim of creating simple incentive schemes that encourage management teams to act more like owners.

# 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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