

Policy on Consideration of Environmental, Social and Governance Issues for Investment Purposes

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1. SUMMARY

Environmental, Social and Governance (“ESG”) issues are a natural component of the Magellan Asset Management Limited (“Magellan”) investment analysis process, as gaining a robust understanding of these issues is a key part of assessing the outlook for future cash flow generation and risks of an investment.

Where appropriate, the investment team should engage with investee (or prospective investee) companies in regard to their ESG policies and their management of ESG risks. The objective of such engagement is to enhance the certainty of long-term cash flow generation we expect from the company.

Institutional investors increasingly require that investment managers incorporate ESG issues into their investment framework. Strong evidence of an investment manager’s commitment to ESG principles is to become a signatory to the United Nations-sponsored Principles for Responsible Investment (“PRI”). The principles provide a framework by which all investors can incorporate ESG issues into their decision-making and ownership practices. The principles are not a prescriptive set of rules, and are to be applied as appropriate within each asset class and investment approach. Magellan is a signatory to the PRI.

For Magellan’s actively managed valuation-based portfolios, ESG issues are reviewed as part of the assessment of Business Risk and Agency Risk completed for the determination of investment grade status. ESG issues are explicitly discussed as part of the research report completed for each company and are reviewed on an annual basis as part of the ongoing analysis of companies. This review of ESG issues is to be evidenced in the research report completed for each company by including an analysis of environmental and social issues as part of the Business Risk assessment and an analysis of governance issues as part of the Agency Risk assessment.

Individual ratings for the Environmental and Social profile and the Governance profile will be awarded to each company on an A, B or C scale. The Environmental and Social and Governance ratings will reflect the issues faced by the industry that the company operates in and the company’s practices. If a stock is to be awarded a Low rating for Business Risk then as a pre-condition the stock must be awarded an A rating for Environmental and Social issues. If a stock is to be awarded a low rating for Agency Risk then as a pre-condition the stock is required to achieve an A rating for Governance issues.

2. INTRODUCTION

This paper seeks to outline for Magellan’s registered managed investment schemes (“funds”) and designated investment mandates (“mandates”):

- How ESG issues are linked to Magellan’s investment analysis framework;
- How ESG issues are incorporated as part of the investment process; and
- How analysis of ESG issues as part of the investment analysis framework should be evidenced.

3. WHY ESG ISSUES SHOULD BE CONSIDERED AS PART OF THE INVESTMENT ANALYSIS PROCESS

There are two key reasons why it is important for investors to explicitly consider ESG issues: the veracity of the investment analysis and the demand for ESG from investors.

3.1. Veracity of investment analysis

Magellan’s actively managed funds seek to identify high quality investments and acquire such investments at prices assessed as representing an appropriate margin of safety. As part of the assessment of a company’s intrinsic value Magellan seeks to consider all issues that it is able to identify that may materially affect the investment outcomes for a company. ESG issues affect the investment outcomes for a company and Magellan specifically considers these issues as part of its analysis of agency and business risks.

The investment objectives of the Magellan managed investment funds are to (a) minimise the risk of permanent capital loss and; (b) achieve superior risk-adjusted returns over time. For its actively managed investment portfolios, Magellan seeks to achieve these objectives by investing in companies that meet Magellan’s investment grade requirements and for whom the share price represents an appropriate discount to the assessed intrinsic value.

The investment grade rating of potential investments are evaluated by the Magellan investment team by applying the following qualitative assessment criteria:

1. **Economic moat** – Magellan seeks companies with sustainable competitive advantages and a consequent ability to generate high returns on capital for a long period of time;
2. **Reinvestment potential** - Magellan seeks companies with the potential to continue to reinvest capital into the business at high incremental returns;
3. **Business risks** – Magellan seeks investments with predictable cash flows and earnings. The assessment of business risk for each company is not an attempt to measure the volatility of the shares, but rather the predictability and strength of the underlying business; and
4. **Agency risk** - A key assumption inherent in a standard discounted cash flow valuation (DCF) is that free cash flows are returned to shareholders or are reinvested at the cost of capital. However, cash is often reinvested by companies at returns below the cost of capital. In these cases businesses can end up being worth substantially less than implied by a DCF analysis. We term the risk surrounding the deployment of the free cash flow generated by a business as "Agency Risk".

ESG issues are part of the suite of issues that affect agency risk and business risk for companies and, accordingly, should be considered as part of the qualitative analysis of a potential investee.

Environmental Issues

In order to fully understand the business risks facing a company investors should consider environmental risks and opportunities that might affect the future operations of a company including issues such as pollution, climate change, resource depletion, ecosystem change, waste disposal, the use of toxic chemicals, the formal license to operate in communities, and other environmental issues.

Magellan believes climate change is a particularly important environmental issue for global businesses and investors to consider. In order to enhance assessments of the company-specific risks and opportunities associated with climate change, Magellan is a Signatory of CDP's climate change program through its parent company Magellan Financial Group. As a Signatory, Magellan is able to access companies' detailed climate disclosures including data on carbon emissions and climate change mitigation activities. Research reports include a discussion of climate change related risks facing companies, including emissions intensity¹, in the environment component of the Business Risk assessment.

Social Issues

Social issues (such as human rights, worker rights, health and safety, labor relations, child labor, community relations/development, indigenous rights, and respect for the rule of law) play an important role in the public's perception of companies. News of a poor safety record or the use of forced labor has the potential to damage a reputation, which can, in turn, adversely affect revenue or prompt new regulatory burdens. The social risks that threaten the reputation and brand integrity of companies is a component of business risk.

Magellan believes that companies engaging in business that undermines the rule of law or that have major detrimental impacts on human health warrant particularly close scrutiny by investors. Such business models may be the subject of future government regulation or changes in consumption patterns, making them a high risk investment from investors' perspective. Magellan excludes companies engaged in "high roller" casino gaming and the production of tobacco from its investible universe.

Governance Issues

Corporate governance is concerned with the way corporate entities are governed, as distinct from the way businesses within those companies are managed on a day to day basis. Strong governance structures, appropriate executive control and high levels of transparency are amongst the factors likely to provide confidence as to the level of agency risk. For further information on the approach to governance issues please see Magellan's Corporate Governance Principles and Proxy Voting Policy.

3.2. Investor demand for ESG analysis

Institutional investors and consultants increasingly require that investment managers incorporate ESG issues into their investment framework. Strong evidence of an investment manager's commitment to ESG principles is to become a signatory to the United Nations-sponsored Principles for Responsible Investment ("PRI").

¹ Emissions intensity is the total Scope 1 & 2 CO2 equivalent emissions of a company in tonnes per million US dollars of revenue (t/\$m). Scope 1 emissions are those produced directly by the company. Scope 2 emissions are those from purchased energy including electricity and steam.

4. HOW ESG ISSUES ARE INTEGRATED INTO THE INVESTMENT ANALYSIS PROCESS FOR EACH STRATEGY

Valuation Based Investment Funds: Global Equity, Global Plus, High Conviction, Select Infrastructure, ESG, Sustainable

For the purposes of these strategies, the attainment of investment grade status for a company requires a research report assessing the company to be completed and approved by the Investment Committee. The quality criteria used by Magellan to assess investment grade status include economic moat, business risk, agency risk and re-investment potential.

As outlined above, ESG issues are relevant to the assessment of Business Risk and Agency Risk and should be reviewed as part of the assessment of Business Risk and Agency Risk completed as part of the research report. This review is to be evidenced in the research report completed for each company by including an analysis of environmental and social issues as part of the Business Risk assessment and an analysis of governance issues as part of the Agency Risk assessment. The template shown as Appendix 1 can be used as a checklist for ESG issues when undertaking investment research. This checklist was influenced by the United Nations' Sustainable Development Goals (SDGs), to identify relevant ESG issues facing companies.

Environmental and social issues are reviewed in the research report for a company as part of the analysis of Business Risk issues with each company under review receiving a specific rating for its Environmental and Social profile. The rating for the Environmental and Social profile will be A, B or C. The rating will reflect the Environmental and Social issues faced by the industry that the company operates in and the company's environmental and social practices. If a stock is to be awarded a Low rating for Business Risk then as a pre-condition the stock must be awarded an A rating for Environmental and Social issues.

Governance issues are reviewed in the research report for a company as part of the analysis of Agency Risk issues with each company under review receiving a specific rating for its Governance profile. The rating for the Governance profile will be A, B or C. The rating will reflect the Governance issues faced by the industry that the company operates in and the company's governance practices. If a stock is to be awarded a low rating for Agency Risk then as a pre-condition the stock is required to achieve an A rating for Governance issues.

As part of the ongoing analysis of companies, ESG issues will be explicitly reviewed on an annual basis. The focus of this analysis will be whether and how ESG issues affect the potential distribution of future cash flow generation and, accordingly, whether the qualitative ratings for the company appropriately reflect underlying risks.

Non-Valuation Based Investment Funds: Core Infrastructure

As a non-valuation led, highly-diversified strategy, the constituents of Magellan's Core Infrastructure portfolio are not required to be approved by the Investment Committee and therefore constituents do not undergo explicit ESG scoring as described above.

In determining eligibility of companies for inclusion in the Core portfolio, Magellan does consider significant ESG issues that pose a material threat to the investment fundamentals (such as the future cashflow expectations of the business). Namely:

- Companies must meet acceptable governance standards, with the particular focus around the holding structure and alignment of minority shareholders. Companies that fail to meet acceptable governance standards may be excluded from Magellan's approved universe; and
- Material Environmental & Social risks are assessed and monitored. Companies may be excluded if these risks are considered by Magellan to significantly impact the investment fundamentals. Examples of risks may include exposure to environmental damages or safety standards in operations.

Further, approximately half of the portfolio (as at 31 December 2018) has been approved by the Investment Committee.

Proxy voting and engagement of the Core portfolio are conducted in line with our Proxy Voting Policy and Corporate Governance Principles, consistent with other strategies.

APPENDIX 1 - CHECKLIST FOR ESG ISSUES

ESG ISSUES CHECKLIST**Environmental****Climate Change**

- Clean energy
- Greenhouse gas emissions
- Energy Efficiency
- Ecosystem change
- Changes in physical climate parameters
- Insuring Climate Change Risk

Natural Resource Consumption

- Sustainable use of land and water
- Biodiversity on land and water
- Natural resource use, depletion and degradation eg water scarcity
- Environmental efficiency - minimising waste and managing demand for water and energy
- Sustainable sourcing
- Deforestation
- Clean water and sanitation

Waste Management

- Toxic material use and disposal
- Packaging material and waste
- Hazardous waste disposal/cleanup
- Electronic waste
- Pollution

Social**Labour and human rights**

- Labour relations and standards
- Use of child and indentured labour
- Discrimination
- Diversity
- Gender equality
- Sexual harassment
- Living wage disputes
- Education and human capital

Health and safety

- Tobacco
- Drug addiction
- Workplace health and safety
- Consumer health and safety
- Product safety
- Genetically modified organisms
- Privacy and data security
- Food security

Poverty

- Economic growth and employment
- Industry, innovation and infrastructure
- Sustainable financial systems
- Predatory lending

Social - Other

- Rule of law
- Gambling
- Community relations
- Animal welfare
- Political contributions
- Political risk of involvement in troubled markets, countries
- Peace, justice and institutions
- Sustainable and inclusive development

Governance

Shareholder rights

- Cumulative voting
- Dual-class share structure
- Majority voting
- Poison pills
- Takeover defenses/market for control

Board composition and independence

- Separation of chairman/CEO position

Executive compensation

- Say on pay
- Shareowner advisory vote on executive compensation

Corporate accountability structures

- Compliance
- Bribery and Corruption
- Conflicts of Interest
- Accounting and audit quality