

Global Matters

ESG at 4D

February 2020

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Introduction

Sustainability and associated ESG issues are becoming increasingly important in global investment analysis.

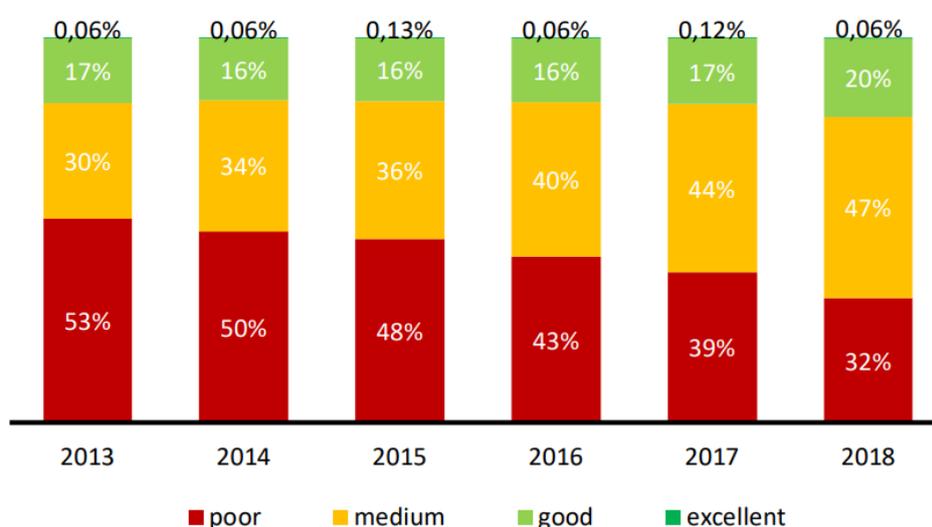
At 4D Infrastructure, ESG assessments have always and will continue to play a key role in our investment process. We have a unique integrated process for investment, whereby country risk analysis is combined with individual stock analysis in a single analytical cycle. Put simply, a stock cannot find its way into our portfolio unless we are also happy with its country of origin as defined by its listing locality and/or primary sources of income. Because of this two-step integrated process, we complete ESG reviews at both a country and individual stock level. ESG analysis is conducted in house, with Institutional Shareholder Services Inc (ISS) providing an external data feed into our analysis.

In this article, Sarah Shaw (Global Portfolio Manager & Chief Investment Officer) looks at: (1) the current state of play with Environmental, Social and Governance (ESG) issues around the world; (2) corporate controversies that defined 2019; and (3) our approach to incorporating ESG factors into our investment process, demonstrating why ESG is so important to 4D.

(1) The current state of play with ESG around the world

ESG continues to grow in importance across global capital markets as sustainable investing gains increasing favour. Institutional Shareholder Services Inc's (ISS) 'ESG Review 2019: The State of Play of Corporate Responsibility' identifies that the share of companies with 'good' or 'excellent' ESG performance saw an unprecedented increase in 2018 reaching an all-time high of 20.4%, up from just over 17% in the previous year (see chart below). Together with 'medium' assessed companies, the group rated with 'better-than-poor' performance exceeds 67.5%. Similar patterns can be observed among companies incorporated in emerging markets (EM), but on a lower level.

Sustainability performance of major international companies incorporated in developed countries (DMU)



Source: ISS ESG

ISS identifies the drivers of this increase in accountability as varied, but regulation features prominently:

- in March 2018, the European Union's (EU) Action Plan defined 10 actions on sustainable finance;
- in May 2018, the European commission (EC) published four legislative proposals relating to taxonomy, fiduciary duties, and disclosure (ESG integration), low-carbon benchmarks, and ESG as part of financial advice (amendments to MIFID and IDD directives); and
- a Technical Expert Group on sustainable finance (TEG) was also set up.

Voluntary initiatives are also important drivers of change. The Task Force on Climate-related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board (SASB) reporting standards continue to grow in importance.

The Paris Agreement: driving cultural change

The Paris Agreement is an agreement within the United Nations Framework Convention on Climate Change (UNFCCC) dealing with greenhouse-gas-emissions mitigation, adaptation and finance, signed in 2016. The language was negotiated by representatives of 196 states and adopted by consensus on 12 December 2015.

The Paris Agreement's central aim is to strengthen the global response to the threat of climate change by keeping a global temperature rise this century well below 2 degrees Celsius above pre-

industrial levels; and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius. Additionally, the agreement aims to increase the ability of countries to deal with the impacts of climate change, and to making finance flows consistent with a low GHG emissions and climate-resilient pathway.

The Paris Agreement requires all parties to put forward their best efforts through '*nationally determined contributions*' and to strengthen these efforts in the years ahead. The Paris Agreement opened for signature on 22 April 2016 and entered into force on 4 November 2016. Since then 186 Parties (of 196 to the Convention) have ratified the agreement.¹

New disclosure to be required from fund managers on ESG

Common reporting requirements are being developed under the Paris Agreement, and are to be available for review by the end of 2020. While the formats have yet to be finalised, set out below are illustrative examples of what potential reports may look like (as developed by ISS) together with comments on recent developments in GRESB – the investor-driven global ESG benchmark for the infrastructure sector.

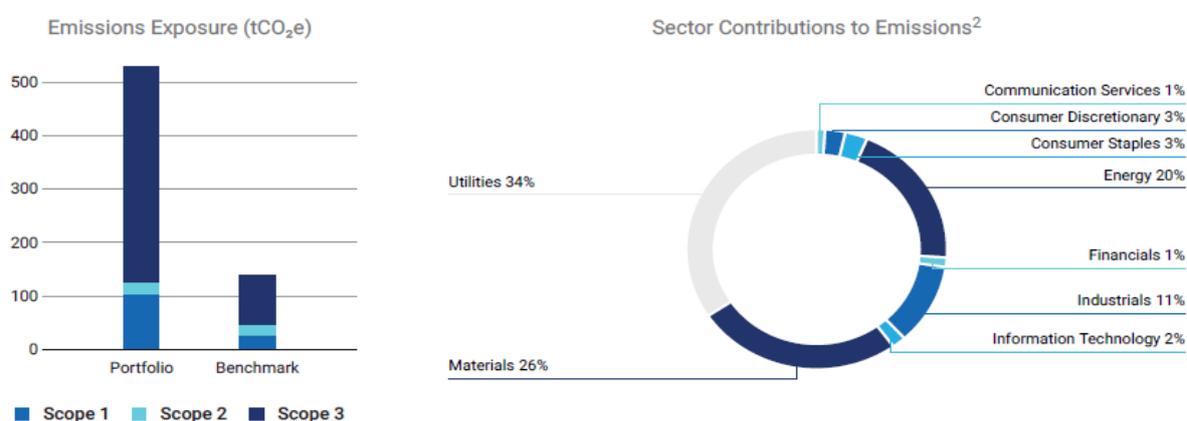
- **Portfolio overview versus a benchmark**

This report provides a comparison of a fund manager's portfolio on emissions grounds against a benchmark.

Portfolio overview

Disclosure Number/Weight	Emission Exposure tCO ₂ e			Relative Emission Exposure tCO ₂ e/Mio USD Revenue		Climate Performance Weighted Avg	
	Share of Disclosing Holdings	Scope 1 & 2	Incl. Scope 3	Relative Carbon Footprint	Carbon Intensity	Weighted Avg Carbon Intensity	Carbon Risk Rating ¹
Portfolio	59% / 80.8%	126	529	128	218	233	33
Benchmark	93.3% / 98.5%	44	137	45	84	114	45
Net Performance	-34.3 p.p. / -17.7 p.p.	-183.9%	-287.5%	-183.9%	-159.3%	-104%	–

Emission Exposure Analysis



¹ Note: Carbon Risk Rating data is current as of the date of report generation.

² Emissions contributions for all other portfolio sectors is less than 1% for each sector.

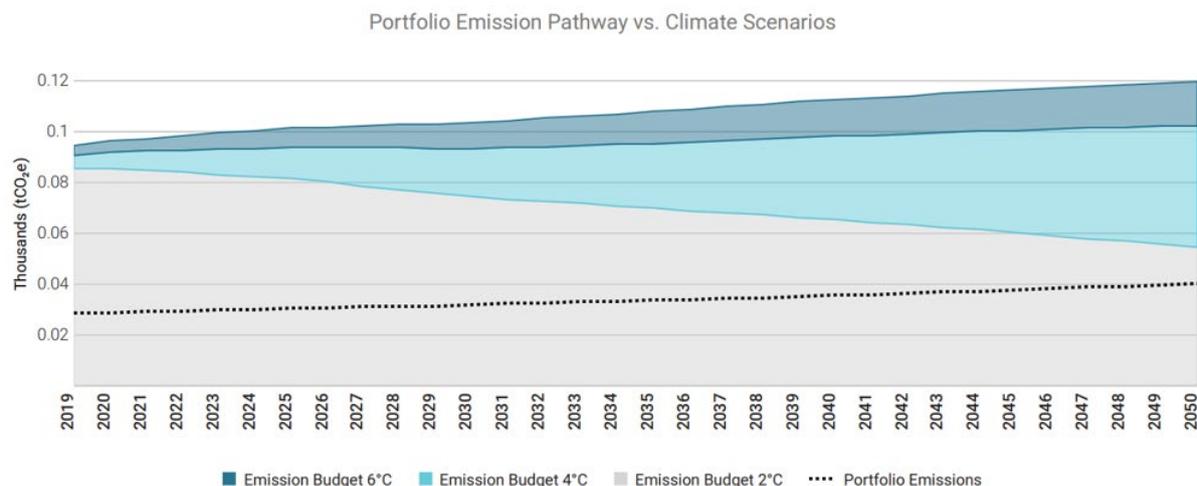
Source: ISS ESG

¹ United Nations Framework Convention on Climate Change (UNFCCC). Source ISS ESG

- **Ongoing portfolio compliance against the 2 degree target**

This ISS report looks at a portfolio's compliance with the 2 degree target. In the example below, it shows that a portfolio of 609 companies, rated as 'Prime'² by ISS on ESG grounds, would comply with the 2 degree target out to 2050.

CLIMATE PERFORMANCE OF 609 PRIME COMPANIES



Source: ISS ESG

- **New GRESB infrastructure public disclosure dataset**

In 2019, GRESB released a new Public Disclosure dataset measuring the level of material ESG disclosure by the listed infrastructure sector. The dataset's initial coverage will enable investors to evaluate ESG transparency levels across the entire global listed infrastructure universe.

The GRESB dataset collection is unique in that GRESB originally gathers the information and subsequently provides each company with the opportunity to review and amend/correct the data.

(2) Corporate controversies that defined 2019

In January 2020, ISS published a paper 'Corporate controversies that defined 2019' in which they identify the five most exposed industries to ESG controversies.

Mining accidents in Brazil and the ongoing opioid crisis in the United States were two of the most serious controversies during 2019. These resulted in a high density of negative news revolving around steel and pharmaceutical companies.

The table below ranks industries according to the number of negative news items they generated during 2019, broken down according to different ESG categories. The human and environmental costs associated with dam collapses in Brazil contributed significantly to the high number of negative news items for the steel industry, which ranked as the most controversial industry.

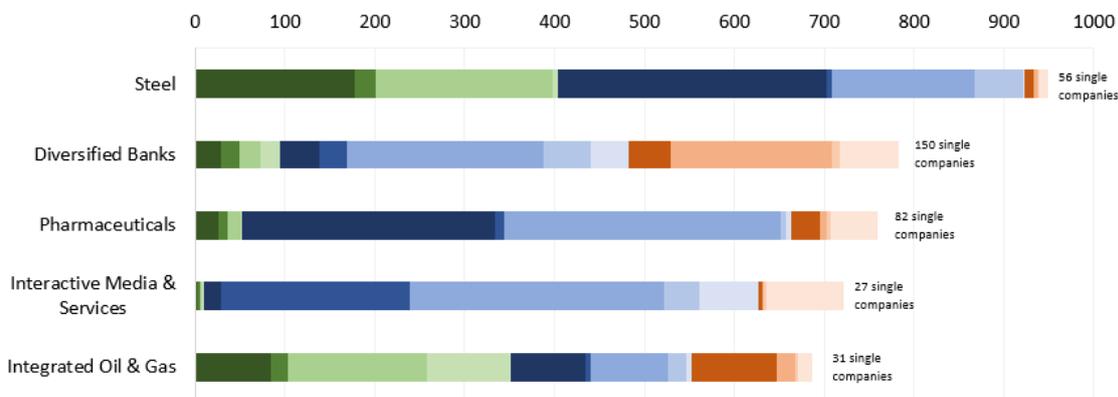
The banking sector faced heavy media scrutiny during 2019 as several European banks were linked to money laundering schemes. The so-called Troika Laundromat scandal was among the most prominent cases, one which implicated several banks that are alleged to have laundered billions of dollars out of Russia. The case, which came to light in March following a data leak of 1.3 billion banking transactions, is estimated to have been responsible for funnelling US\$4.6 billion into Europe

² ISS uses a broad 'Prime/Non-Prime' approach to rating countries and companies in terms of ESG as well as individual entity gradings on an A-D basis.

and the US from questionable Russian sources. In Australia the Banking Royal Commission attracted a high degree of publicity. Separately, the banks are also being challenged by stakeholders for neglecting to assess their exposure to human rights violations and environmental damage through their investments.

Importantly, what you don't see amongst the largest controversies for 2019 are infrastructure names or sub sectors within this space, despite the ongoing spotlight on climate change.

STEEL COMPANIES FACED HIGHEST NUMBER OF CONTROVERSIAL NEWS IN 2019
The five industries with the highest volume of negative news



Source: ISS ESG

Environment	Social	Governance
Poor environmental due diligence	Health impact	Bribery
Depletion of biodiversity	Infringement of privacy	Money laundering
Pollution	Poor human rights due diligence	Accounting Fraud
Climate change	Poor labour standards	Anti-competitive behaviour
	Discrimination	

(3) 4D's approach to ESG: integrated at the country and stock level

4D's investment process involves an integrated macro (*Country Reviews*) and micro (*Stock Reviews*) approach.

- **Country Reviews: ESG assessment is an integral part of the process**

4D's Country Review process involves assessing each country based on the four key sovereign risks identified below.

4D sovereign risk assessment

 Financial Risk	 Economic Risk	 Political Risk	 ESG Risk
<p>➤ including country debt levels, credit ratings, credit default swap spreads</p> 	<p>➤ including GDP growth, inflation, budget deficit/surplus, current account position</p> 	<p>➤ including political system & government stability, internal and/or external conflicts</p> 	<p>➤ includes ESG risks not considered in other 3 risk assessments and also incorporates ISS research</p> 

Source: 4D Infrastructure

Within an ESG context, our key considerations are set out below. While it is the ‘E’ in ESG that currently attracts the most attention and publicity, as shown below in our Country Reviews we place equal importance on the ‘S’ and ‘G’. For example, Governance is key to our reviews as it goes to the quality and reliability of infrastructure concession contracts, and how strong the judicial system is in supporting the sanctity of those contracts. Similarly, levels of corruption are also important together with how well the judiciary is tackling the issue. For example, in Brazil the so called ‘Carwash’ corruption investigation has been ongoing and far reaching, but this is exactly what has helped us get more comfortable with that sovereign. No one is denying that a degree of corruption exists, but the judiciary has been persistent and diligent in its pursuit of wrongdoing at all levels of society.

We also subscribe to dedicated ESG research from ISS and incorporate that into our Country Review process. ISS ESG research conclusions are reflected via a ‘Prime’ or ‘non-Prime’ country rating. Note while this research is an important part of our process, we may not always agree with the ISS view. This is illustrated in the UK Country Review summary page shown below. The UK is rated ‘Prime’ by ISS, but we disagreed with some of their criticism.

4D ESG considerations at a country level

Key Considerations	Examples																														
<p>Environmental</p> <ul style="list-style-type: none"> Exposure to certain types and use of specific natural resources Risk of environmental incidents Biodiversity and conservation management Water Resources and management General environmental policies, renewables integration, attitudes of government towards environmental protection <p>Social</p> <ul style="list-style-type: none"> Access to and level of healthcare and education of population Income inequality, social welfare Gender equality Board experience, diversity and election frequency <p>Governance</p> <ul style="list-style-type: none"> Rights of citizens Legal protections Strength of legal system / judiciary and recourse actions / government interference with judiciary Corruption Corporate disclosure requirements 	<div style="text-align: center;"> <p>UK Country Review: 5 August 2019</p> <table border="1"> <thead> <tr> <th>Rating / Outlook / Date</th> <th>Preliminary Grade</th> <th>Final Grade/Trend</th> </tr> </thead> <tbody> <tr> <td>Standard & Poor's AA / Negative / April 2019 (Max Portfolio Weight)</td> <td style="background-color: #92D050;">Grade 1 (75-100%)</td> <td style="background-color: #FFD700;">Grade 2 / Negative (75-100%)</td> </tr> <tr> <td>Past Grades</td> <td colspan="2" style="background-color: #92D050;">2015/16/17/18</td> </tr> <tr> <td>No. CIU Stocks: 10</td> <td colspan="2" style="border: 2px solid red; text-align: center;">ISS ESG Rating: B (Prime)</td> </tr> <tr> <td>12mth catalysts:</td> <td colspan="2">Brexit outcomes, possible election or 2nd referendum</td> </tr> <tr> <td>Next Election</td> <td colspan="2">Last election May 2017 / ??</td> </tr> <tr> <td>Other ratings</td> <td>Moody's: Aa2 / Stable</td> <td>Fitch: AA- / Negative</td> </tr> <tr> <td>Info: Country Rankings</td> <td>Preliminary Grade 1</td> <td>Preliminary Grade 2</td> </tr> <tr> <td>S&P's Rating</td> <td style="background-color: #92D050;">AAA – BBB (investment grade)</td> <td style="background-color: #FFD700;">BB</td> </tr> <tr> <td>Sources include</td> <td colspan="2">BBC, Bloomberg, BIS, Brokers, BOE, CNBC, Economist/EU, Euromoney, Fitch, Focus Economics, Forbes, ISG, IMF, ISS, Moody's, S&P, Trading Economics, RBC, Wolfe Research, OECD, World Bank, The Heritage Foundation (Index of Economic Freedom)</td> </tr> </tbody> </table> </div> <p>Extract from Country Review:</p> <p><i>“ISS rank the UK a ‘B’ or ‘Prime’ on ESG grounds (a B- ranking is their Prime threshold). They comment that there are no gross human rights violations recorded in the United Kingdom or on its behalf. Yet, the massive surveillance on anti-terrorist grounds is an unproportionate intervention in individual’s privacy. 4D disagrees with this view given the number of terrorist attacks and innocent lives lost in the UK over the past decade, as such we feel that surveillance measures are a prudent response by the government to help mitigate the risk of any further attacks on UK citizens</i></p>	Rating / Outlook / Date	Preliminary Grade	Final Grade/Trend	Standard & Poor's AA / Negative / April 2019 (Max Portfolio Weight)	Grade 1 (75-100%)	Grade 2 / Negative (75-100%)	Past Grades	2015/16/17/18		No. CIU Stocks: 10	ISS ESG Rating: B (Prime)		12mth catalysts:	Brexit outcomes, possible election or 2 nd referendum		Next Election	Last election May 2017 / ??		Other ratings	Moody's: Aa2 / Stable	Fitch: AA- / Negative	Info: Country Rankings	Preliminary Grade 1	Preliminary Grade 2	S&P's Rating	AAA – BBB (investment grade)	BB	Sources include	BBC, Bloomberg, BIS, Brokers, BOE, CNBC, Economist/EU, Euromoney, Fitch, Focus Economics, Forbes, ISG, IMF, ISS, Moody's, S&P, Trading Economics, RBC, Wolfe Research, OECD, World Bank, The Heritage Foundation (Index of Economic Freedom)	
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Based on our assessment of the four risks above, countries are then given a grade (1-3) and a traffic light status (*green/yellow/red*) as depicted in the chart below. The relative country grading determines the maximum portfolio exposure to stocks from that country grade.

Based on their Final Grade country Portfolio Guidelines are as follows:

Country Grade & Portfolio Guidelines		
Status	Final Grade	Maximum Portfolio Holding
Green	Grade 1	100%
Yellow	Grade 2	25%
Red	Grade 3	0%

Source: 4D Infrastructure

As shown in the table below, developed market (DM) countries ranked green by 4D have very strong ISS ESG rating profiles. Of DM countries with stocks in the 4D Global Infrastructure Fund (GIF), 80% are rated Prime by ISS, with that percentage increasing to 87% in our broader Core Investible Universe (CIU). Similar results occur for our yellow ranked DM countries where 100% of the Prime rated countries come from DMs.

However, symptomatic of EM countries generally not being as strong on ESG issues, only 25% of our green ranked EM countries are Prime according to ISS. This is not surprising, and we expect that as these countries evolve and migrate towards DM status their ESG ratings will improve accordingly.

4D Country Rankings & ISS ESG Rating							
ISS Rating	Green		Yellow		Red		
	GIF (%)	CIU (%)	GIF (%)	CIU (%)	GIF (%)	CIU (%)	CIU (%)
Prime	5 50%	15 54%	2 50%	2 33%	0 0%	0 0%	0 0%
DM	4 80%	13 87%	2 100%	2 100%	0 0%	0 0%	0 0%
EM	1 25%	2 17%	0 0%	0 0%	0 0%	0 0%	0 0%
Not Prime	4 40%	12 43%	2 50%	4 67%	0 0%	3 75%	3 75%
DM	1 20%	2 13%	0 0%	0 0%	0 0%	0 0%	0 0%
EM	3 75%	10 83%	2 100%	4 100%	0 0%	3 100%	3 100%
Not Rated	1 10%	1 3%	0 0%	0 0%	0 0%	1 25%	1 25%
DM	0 0%	0 0%	0 0%	0 0%	0 0%	0 0%	0 0%
EM	1 100%	1 100%	0 0%	0 0%	0 0%	1 25%	1 25%
Total Countries	10	28	4	6	0 0%	4	4

Source: 4D Infrastructure

- **Stock Reviews: individual company ESG ratings**

At 4D, we assess *stock quality* and *value* quite separately. Our company quality grading involves assessing each company based on the following broad criteria:

- Industry Structure;
- Asset Quality; and
- Management Performance

Our stock ESG assessment is part of the Management Performance assessment and an individual score is assigned to ESG factors as one of the four subcategories within the management assessment.

At a stock level we assess each stock based on the following ESG considerations. We also again employ independent ESG research from ISS to help determine our ESG company score.

4D ESG considerations at a stock level

	 Environmental	 Social	 Governance
Key Considerations	<ul style="list-style-type: none"> How focused are they on environmental sustainability and policies to be environmentally neutral If relevant what targets do they have for carbon emissions, greenhouse gas emissions etc How good is their disclosure on environmental policy – ISO certification? Strategy to leverage a greener future eg rise of electric vehicles The proportion of energy from renewable sources eg PPAs to provide and/or procure How do they compare amongst peers in the sector/wider market? Policies on waste disposal? 	<ul style="list-style-type: none"> What commitments has the company made to <u>labour</u> standards and human rights? Relationship and engagement with local and indigenous <u>communities</u>? How focused are they on employee health and safety? What has been the trend in workplace incidents/accidents? What sort of learning / development /training programs are provided to employees? 	<p>Security ownership</p> <ul style="list-style-type: none"> Who are the key shareholders? What are their motivations? Shareholder <u>influence</u> over management? Minority protection? <p>Board Structure</p> <ul style="list-style-type: none"> Does the board structure benefit shareholders? Is there ample separation of powers? Board experience, diversity and election frequency <p>Remuneration</p> <ul style="list-style-type: none"> Compensation structure Is executive remuneration aligned with shareholder outcomes?

Source: 4D Infrastructure

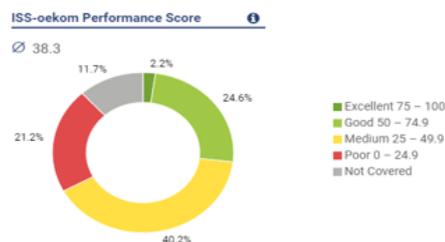
As is the case with our Country Reviews, we place great importance on the ‘S’ and ‘G’ as well as the ‘E’ in our Stock Reviews. The key considerations in these assessments are set out above. For example, under Governance we look closely at Board and management compensation structures to ensure an alignment with shareholders’ interests.

- ESG at an Investment Committee/Portfolio Manager level**

Finally, ESG is reviewed at the Investment Committee/Portfolio Manager level as summarised below.

4D ESG considerations at the portfolio construction and management phase

 Investment Committee	 Portfolio Manager
<ul style="list-style-type: none"> ESG analysis template is standardized to allow for easy comparison amongst companies in the 4D investment universe Template will include material information relating to each of the ESG components. Analyst will also need to include quantitative data including specialist research provider and disclosure scores (ISS, Bloomberg ESG and Disclosure Scores, etc.) Analyst will include ISS company research (if available) as an attachment for members to read prior to the Investment Committee date Company ESG scores will be assessed on a fundamental basis and then on a relative basis vs sector peers and the 4D core investable universe 	<ul style="list-style-type: none"> PM will monitor aggregate company ESG scores via Bloomberg data and through the ISS portfolio management tool Both PM and analyst will be alerted to changes in external research provider (ISS scores). Material changes particularly those involving controversies will require Analyst to investigate further. If controversy involves a portfolio stock and is deemed significant, the analyst’s assessment and views will need to be discussed in the Investment Committee



Source: 4D Infrastructure

Conclusion

ESG is growing in importance around the world as the next stage of implementation of the Paris Agreement approaches. At 4D we view each of 'E', 'S' and 'G' as a fundamental and critical investment factor that is only going to grow in importance in the future. Accordingly, we have integrated ESG assessment into all stages of our investment process and believe we are positioned to perform well in an increasingly ESG-focused investment environment.

This information is issued by Bennelong Funds Management Ltd (ABN 39 111 214 085, AFSL 296806) (BFML) in relation to the 4D Global Infrastructure Fund and 4D Emerging Markets Infrastructure Fund. The Funds are managed by 4D Infrastructure, a Bennelong boutique. This is general information only, and does not constitute financial, tax or legal advice or an offer or solicitation to subscribe for units in any fund of which BFML is the Trustee or Responsible Entity (Bennelong Fund). This information has been prepared without taking account of your objectives, financial situation or needs. Before acting on the information or deciding whether to acquire or hold a product, you should consider the appropriateness of the information based on your own objectives, financial situation or needs or consult a professional adviser. You should also consider the relevant Information Memorandum (IM) and or Product Disclosure Statement (PDS) which is available on the BFML website, bennelongfunds.com, or by phoning 1800 895 388 (AU) or 0800 442 304 (NZ). BFML may receive management and or performance fees from the Bennelong Funds, details of which are also set out in the current IM and or PDS. BFML and the Bennelong Funds, their affiliates and associates accept no liability for any inaccurate, incomplete or omitted information of any kind or any losses caused by using this information. All investments carry risks. There can be no assurance that any Bennelong Fund will achieve its targeted rate of return and no guarantee against loss resulting from an investment in any Bennelong Fund. Past fund performance is not indicative of future performance. Information is current as at the date of this document. 4D Infrastructure Pty Ltd (ABN 26 604 979 259) is a Corporate Authorised Representative of BFML.

Appendix: Case study in 4D ESG rankings

• **American Water**

American Water – ESG Green Flag



American Water plays a lead role in water quality and conservation, and promotes strong governance and social practices

ESG Ratings			
	10/10		C+ (prime)
			
Environmental	Social	Governance	
<ul style="list-style-type: none"> Reduced Greenhouse Gas emissions by 51% over 10 years Investment in resiliency projects such as floodwalls, to protect against contamination A voluntary member of the EPA's <u>WaterSense</u> Program - aims to raise awareness for conserving water and promotes efficiency products. Consumers have saved a cumulative 1.1 trillion gallons of water since 2006 Participates in EPA's Partnership for Safe Water Program – dedicated to protecting against microbial contamination by optimizing water treatment 	<ul style="list-style-type: none"> Top quartile customer satisfaction compared to other water companies Delivers exceptional water quality - conducts +1 million water quality tests per year with a compliance rate 21x better than peer average AWK strategy involves acquiring municipality networks to finance the upgrading of these underfunded networks Foundation supports employees' charitable endeavors –20,000 hours of volunteer time over 5 years Nearly 80,000 hours of employee safety training in 2018 	<ul style="list-style-type: none"> Supports Universal Declaration of Human Rights including access to clean water and sanitation Code of Ethics is supported through ongoing employee training and annual certification Chairman and CEO roles separated with independent Chair Females represent 50% of the Board members more than majority of other S&P 500 company – including CEO 42% of all employees represent diversity groups Compensation of senior management incorporates operational, safety, and customer satisfaction targets 	

Source: 4D Infrastructure