Environmental,

Social and

Governance,

ESG Policy 2021

ACN 102 756 347 | **AFSL** 225 316
Level 8, 10 Bridge Street, Sydney NSW 2000
+61 2 8090 3610 | www.selectorfund.com.au

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Digital references

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selector

Introduction

Selector Funds Management Limited (SFML) acknowledges the importance of an integrated and consistent approach to Environmental, Social and Governance (ESG) risk factors across each aspect of our investment decision making process.

We extend this consideration to our own business activities. We place the highest priority on the wellbeing of our team – their safety, work life balance and financial security – the strength of our governance program, where we complement our internal process with external oversight and expertise, and finally our environmental impact, including measuring and offsetting 100% of the carbon footprint that we generate each year.

While our carbon footprint is small at 100 tonnes of carbon emissions in 2019, and vastly lower in 2020 as COVID-19 restricted our ability to travel, it remains important to offset all our emissions as a message to our team, their children, and our stakeholders.

We have achieved this offset through a partnership with Carbon Neutral to support their Yarra Yarra Biodiversity Corridor initiative. This Australian Native Reforestation project aims to restore habitat loss and deforestation in the Northern Wheatbelt of Western Australia. Carbon Neutral is certified by The Gold Standard, which ensures projects achieve genuine outcomes that deliver with as much impact as possible.

We are planning more ambitious projects for the future.

When we consider our investment process from an **environmental (E)** perspective, the research is compelling. At the extreme, some assets will become stranded by the impacts of climate change, while other companies may become uninvestable, due to a set of business risks that can no longer be quantified.

Yet we believe standardised reporting across our investment universe remains some way off. For this reason, SFML is a supporter of the Task Force on Climate-Related Financial Disclosure (TCFD) Asia Pacific region, which promotes the pursuit of leadership and responsibility in this endeavour, across the global financial community.

Our key environmental climate related agenda at SFML is promoting transparency and consistency of reporting on financial targets. We believe that when financial targets are set, the complex task measurement can start.

SFML seeks to understand the many and varied **social (S)** factors affecting a company's financial performance from both short and long-term perspectives. Areas of focus are human capital management and specifically remuneration and the behaviours it drives. Management of supply chain risk and end customer relations are areas of importance that drive or reduce market share. In assessing these examples and others, we are attempting to distinguish one off or short-term noise from longer term structural issues that inevitably erode shareholder returns.

Corporate **governance (G)** involves a set of relationships between a company's management, board, shareholders, and external stakeholders. Clearly SFML has a role to play here. We have a structured process for voting on each resolution that crosses our table. We believe this approach means our collective voice (representing you – our client) is heard over the long term. Here we can be responsible for meaningful change.

Executive Summary

Our confidence in tackling this broad agenda stems from our belief that Environmental, Social and Governance consideration is embedded at the centre of each of the four elements of our stock selection process: **people**, **business**, **balance sheet** and **capital management,** a proxy for real earnings per share (EPS) growth. ESG is not simply tacked on as a final question before closing a meeting, or a tick of the box exercise.

Companies with superior cultural behaviours are better disposed to responsible management of ESG issues. They increase shareholder wealth through higher staff engagement and retention (people), they pursue business leadership through consistent reinvestment (business), and they are better managers of financial risk (balance sheet), including cashflows and earnings (capital management).

In our experience, given time, superior culture drives real earnings per share growth. This meets our long-term requirements, while contributing positively to the development of society and the communities in which our selected businesses operate. This reflects responsible* business practice.

Conversely, companies unwilling (**people** or **business**) or financially unable (**balance sheet** or **capital management**) to sufficiently support an internal culture that factors in ESG issues, risk delivering diminished investment returns over the longer term. If they are lucky enough to remain a going concern this is irresponsible business practice.

In this document:

- We explain how our **investment process**, including our historic focus on culture and sensible financial outcomes, lends itself to strong ESG outcomes. This is based on our belief that strong culture drives strong ESG outcomes.
- We outline our **mandate exclusions**, or negative screen, which increases the ESG quality of our stock selection process. We also summarise how our investment **universe** is reflective of our approach to driving better ESG outcomes.
- We discuss how our **Roadmaps** provide the consistent and repeatable framework used to execute our strong **corporate engagement** and **quantitative programs,** both of which we believe drive superior ESG outcomes.

In recent years we have taken progressive steps to better understand Environmental risk and we are actively seeking better financial disclosure from the companies we invest in. This is addressed in our **Climate Focus.**

Finally, we review our **structured approach to voting** in our adjoining **voting policy.**

Investment Process

All research is undertaken in-house by the Portfolio Managers and investment team. This is an intensive, granular and in-depth approach to continuous learning. We seek businesses with leadership qualities, run by competent management teams, underpinned by strong balance sheets and with a focus on capital management. This approach lends itself to strong ESG outcomes. Our approach is to fully integrate ESG into each of these four areas.

This is a risk out process. We are trying to take as much risk off the table as possible before we invest. The key areas of risk we focus on are board and management competency and the culture they are responsible for, business qualities, balance sheet and capital management. We believe a common-sense approach holds that a net cash balance sheet carries lower risk and more optionality than an optimised or extended balance sheet. We ultimately compare equity risk to a risk-free rate.

Before we invest, we seek to understand which risks a business can control verse those outside its control. For this to be possible, risk must be reported in a consistent and transparent fashion, so as to avoid any surprises.

Risk sits in each bucket of E, S and G. Our program of corporate engagement has aided our understanding of risk in the S and G buckets since inception. In more recent years we have taken progressive steps to better understand Environmental risk and today, we are actively seeking better financial disclosure from the companies we invest in.

Our conviction in this process generates a concentrated portfolio of our best ideas, or our highest quality stock picks. The aim is to capture as much real earnings per share growth as possible over the long-term.

Our approach has been consistent since inception. It is framed by our Roadmap, which is both qualitative and quantitative in nature. Our Roadmap provides a repeatable framework that drives our corporate engagement program, our quantitative program of financial modelling including our stock universe data screen, and our structured voting program. Each of these programs are discussed below.

These areas of work however are not rigid, they evolve over time as we continuously seek to incorporate better solutions. By way of example, today we employ more human capital, with more diversity of thought, have better external and internal business systems, use and develop more technology and automation, and we have more robust compliance systems aided by external expertise, than was the case in the first year of operations 17 years ago.

This consistent reinvestment in our business, over time, has driven continuous improvement of the investment process.

Mandate Exclusions

The mandate exclusions or negative screen, which have been adopted across all our portfolios, include:

- Business generating >10% revenue from thermal coal;
- Business that manufactures or sell munitions or weapons; and
- Tobacco related businesses.

We are transparent in acknowledging our investments in the gaming sector. We have high expectations of these companies in relation to S, social responsibility.

We expect these companies to play a leadership role, global where possible, in responsible gaming initiatives including addressing problem gambling. We will divest when this hurdle is not met.

A Universe that drives better ESG outcomes

- In general, we have sought ideas from the ASX 300.
- Our focus is on industrial companies.
- In the past 10 years we have not owned, Real Estate Investment Trusts (REITs), Banks, General Insurers, Resources, or Junior Miners.
- We do not own Energy.
- Our universe will typically have a lower capital intensity and lower carbon footprint as a result.
- While hundreds of models have been built since inception, +90 models are currently up to date, per reporting period, and feed our stock universe data pool.
- Inclusions from outside this index and select competitors are added (for example, we may include a business with a capital structure where the free float may not meet Index requirements).
- Our universe is subject to change and is reviewed after each reporting season for relevance.
- Based on our four areas of focus, (people, business, balance sheet capital management) that our universe is a higher quality subset of the ASX 300.
- We rank our universe by buyout, Roadmap score, yield.

Roadmap

SFML Roadmap

Qualitative			Quantitative		
Management Qualities	Owner Qualities	Focus	Growth	Business Franchise	Balance Sheet
Individuals we can trust	Material equity holding	Business point of difference	Reinvesting in business R&D	Financial Metrics Working Cap	Low debt levels
Organic business focus	Common bond ordinary shareholder	Core Business	Capacity to grow EPS organic	Pricing Power within industry	Simple structure
Clear articulation strategy	Track record Inc ESG	Not react to share market pressure	Free cash flow	ROCE	Maintenance Cap Ex

Roadmap scorecard
18 filter Quantitative and Qualitative score card applied to each business
Minimum score of 10 / 18 sort for portfolio inclusion

The purpose of our Roadmap is to enable us to operate under a consistent framework that is repeatable.

The Roadmap was developed when SFML was established, 17 years ago, and is a qualitative and quantitative business score card. Businesses are scored on 18 attributes. This score is integrated into our financial model and is reviewed at the half and full year results. One of these attributes is the company's ESG track record, which directly addresses ESG factors within a business.

In addition, we consider seven of the remaining 17 roadmap qualities to be directly related to ESG on the basis that they are measuring cultural elements within the business. We believe Culture and ESG are intertwined. We consider them both integral to our assessment of a business. Ultimately, we are seeking a higher quality subset of businesses that can deliver real EPS growth over the long term.

The seven elements include:

- Individuals we can trust – relates to ESG.
- Clear articulation of strategy – relates to ESG.
- Common bond with ordinary shareholders – relates to ESG.
- Not reacting to share market pressure – relates to Governance.
- Core business – relates to ESG.
- Free cash flow – relates to ESG.
- Low debt levels – relates to ESG.

ESG 2.0 Roadmap

The ESG 1.0 Roadmap, developed in-house in 2019, defines ESG issues that may impact companies and applies a score of 1 or 0 for each area under consideration. The ESG 2.0 Roadmap iteration was created in 2021, with changes integrated into our portfolio models thereafter.

SFML ESG 2.0 Roadmap

Consideration			
Environment	Climate Targets	Renewable targets	Progress against target
Social	Human Capital Management	Community (including MS*)	Best Interests
Governance	Board effectiveness	Shareholder interests	Risk & Litigation

Roadmap scorecard
9 filters applied to each portfolio business

*Modern Slavery (MS)

The following is a breakdown of each consideration:

- Climate targets – Assessment of the company's plans relating to carbon neutrality, Paris commitments, scientific targets, or emission targets. "0" rating for no effort.
- Renewable targets – Assessment of the company's documented use of renewables mix or implemented targets for renewable energy.
- Progress against targets – Measuring progress made against announced targets. "0" rating for no effort.
- Human Capital Management – "Is there a history of human rights violations, workplace and IR disputes, discrimination and harassment claims?"
  Rating of the company's employee engagement, turnover and productivity. Compare the company's work, health and safety (WHS) standards against peers, including their recording and track record of incidents.
- Community – Rating of the company's community engagement and social licence to operate. Consider whether the company has a framework on social issues across its supply chain, including labour standards, child labour, health & safety, discrimination, and harassment.
- Best Interests – "Is the company behaving in a manner that is in the best interests of stakeholders."
- Board effectiveness – Assessment of the board including industry experience, independence, age, diversity, tenure, equity ownership and capacity.
- Shareholder interests – Assessment of the remuneration structure, shareholder communication, corporate disclosure, and reliability of financial statements. Test the factors against the company's corporate strategy and whether they are in line with shareholder interests.
- Risk & Litigation – Rating of the company's internal risk and control framework.

Corporate Engagement Program

Our Corporate Engagement program is a foundation of our investment process. We engage with board members and management teams, attend Annual General Meetings (AGM), and undertake site visits. Two Portfolio Managers attend these meetings which can occur in office, onsite and at interstate or international locations of interest. In addition, we have the highest quality technology systems deployed in all conference areas to aid this program where travel is not permitted.

We engage with management to understand the culture of a business, the reason it is in existence and its prospects for the future. We do this because we believe culture is the most important driver of future business success.

From these engagements, notes are produced and recorded. We consider each meeting as a page in the book of understanding an individual business and its culture. This work is a key plank of our understanding of the three categories of ESG.

We believe culture and ESG are intertwined, with the former driving the later. We have focused on the culture that drives the social and governance process within a business since inception.

This granular approach in understanding the culture of each business aids our evaluation of the short and long-term remuneration structures tied to non-financial outcomes. This is described in our voting policy.

We have extended our Roadmap, in recent years, to address specifics such as Climate. We support TCFD in promoting consistency and transparency of financial reporting in this area. Our ESG Roadmap scoring system is integrated into our financial models alongside our original Roadmap.

Climate Focus

Around the globe, regulation and legislation is starting to tackle the large, systemic and structural changes that limiting climate change will require. The Paris agreement of 2016, a platform to address and minimise rising global temperatures, has shifted the conversation to a fundamental economic and financial risk return discussion.

SFML believes all companies and organisations have a responsibility to consider the risks of climate change and to ensure their business is resilient in a low carbon future.

Alongside our program of direct corporate engagement, SFML digests information from annual reports and climate change statements where available. Not all companies are reporting and for those who are, company reporting is often not directly comparable.

Across our portfolio of holdings, we will advocate for the recognition, establishment and inclusion of Paris based targets and or science-based climate targets, emissions targets and/or renewable energy targets. Once these base targets are established, progress can be tracked.

We are also monitoring our companies for no efforts, no accountability. We are not proposing to exit investments based on our climate policy, this will not solve problems as we note in our concluding remarks. We believe we can have far greater impact via our corporate engagement program and our voting program.

In 2021, SFML became a supporting party to the Task Force on Climate Related Financial Disclosure (TCFD) and its principles, in pursuit of greater transparency on these important issues. We have adopted the aspects of this voluntary guideline that make sense within the context of our investment process. This will enhance and strengthen our ongoing approach to ESG.

Quantitative Research Program

Our quantitative approach is centred on financial modelling also undertaken in-house. Individual company models are built using a consistent repeatable template. Information is taken from multiple annual reports and other publicly available documents. No information dumps occur as we prefer the granular approach of extracting and understanding the individual numbers behind the multiyear trends that are drawn out of this work.

While over 50 financial ratios are calculated in addition to our buy-out ratio, which we compare to a risk-free rate, it is the longer-term trends that hold our attention. While hundreds of models have been built since inception, >90 are continuously up to date, per reporting period, and feed our stock universe data pool.

This granular approach to understanding financial drivers of each business aids our evaluation of the short and long-term remuneration structures tied to specific financial outcomes.

Decisions about executive pay can have an indelible impact on a company. When compensation is managed carefully, it aligns people's behaviour with the company's strategy and generates better performance. When it is managed poorly, the effects can be devastating: the loss of key talent, demotivation, misaligned objectives, and poor shareholder returns. Given the high stakes, it is critical for boards and management teams to get compensation right.

This is described in our voting policy.

Voting Policy 2021

Introduction

The depth of our corporate engagement and quantitative research programs provides the groundwork for our structured voting program.

Executive Summary

SFML has developed a cloud based ESG resource centre, which collates all the relevant public documents required by the Portfolio Managers and Head of ESG in reviewing the activities, processes, targets, and commitments made by the businesses we own. The centre includes annual reports, sustainability reports, AGM documents, corporate governance documents, relevant policies, and charters. It also includes our working notes.

Through our corporate engagement program, we can exert influence for change on a business. Undoubtedly this is stronger when we have an aggregate holding within the top 20 shareholders of a business. That said, arguably we have more influence when we have a long-term professional relationship with a public company, its management team and board.

Areas we have long championed include, having the optionality of a strong cash balance sheet, writing off all R&D in the year it is incurred and a sensible dividend pay-out ratio that allows ample reinvestment for future earnings growth. None of this is earth shattering or rocket science, it is a common-sense approach to investment and one that we apply to our own business and which extends to our voting policy.

In relation to voting, we have adopted a structured program of work that dovetails with our corporate engagement program. Importantly, we vote as long-term owners of a business and we attend AGMs in person where possible.

All resolutions are documented, considered, and commented on by the Portfolio Managers and Head of ESG, before votes are submitted. While we do not subscribe to any proxy services, our continuous dialogue with clients and the companies we own, enable us to quickly understand any areas of public interest which require our consideration. While this can be circular and time consuming, the granularity of this approach aids our continuous learning about the businesses and their stakeholders.

This is a substantial piece of work undertaken by the Portfolio Managers and the Investment team. Alongside our corporate engagement program, we believe this proactive approach to voting drives better insight and a greater understanding of a business, and the issues and risks it faces, than would occur if we otherwise outsourced our voting responsibilities or simply followed the recommendations of a proxy advisor service.

Voting for Directors

Selector employs a qualitative approach to voting for directors. We do not believe a box ticking approach is sufficient.

Selector's votes are based on outcomes from our corporate engagement program run by our Portfolio Managers. We want to understand how a board and its directors are adding value.

This is a detailed research program that occurs across an entire year, but also benefits from the historic understanding of a business, its board and management that comes with long term ownership.

We believe we are further advantaged in this voting process, by our unique lens, having run our own businesses across decades.

Voting on Remuneration

When voting on remuneration, we take into consideration both qualitative and quantitative achievements of the individual business measured against any strategic goals set by the board and executed by the management team.

The depth of our corporate engagement program informs our voting on remuneration. Individually we will consider leadership, transparency, strategic thinking, responsible conduct, and other attributes of the individual being remunerated. This relates to non-financial components of remuneration.

These non-financial metrics include:

- Reasonable short-term incentive (STI) & long-term incentive (LTI) remuneration structures that are in line with key performance indicators previously outlined by a company.
- Reasonableness of base.
- Component of performance award at risk to non-financial outcomes.
- Culture.
- Business leadership.
- Risk Management and ESG.

The consistency of our quantitative research program informs and aids our voting on remuneration. We consider the relevance of each financial metric, gateway and hurdle that comprises an individual's remuneration and the behaviours it drives in relation to the financial outcomes of the business. We evaluate the reasonableness of the entire remuneration outcome. We consider relevant market conditions for remuneration, which vary across industry and geography.

Our views are balanced by the need to retain and motivate quality leadership. We understand the disruption and dysfunction that goes hand in glove with the failure to achieve a positive outcome, at both management and board levels.

That said it cannot simply be a race to the top in executive remuneration, where all boards want to be just above midpoint. This type of thinking means that the midpoint continues to shift up without alignment to other stakeholders.

There is no best practice that works in all situations.

The financial metrics include:

- Component of performance award at risk to financial outcomes.
- Balance sheet optionality.
- Reinvestment.
- Growth in metrics including real EPS and real DPS.
- Responsible financial conduct of Management.

Voting Procedure

SFML's voting process has been upgraded and systematised to incorporate digital distribution of AGM notices, resolutions, and reporting documents. This process is now cloud-based rather than a manual paper-based process.

The upgraded process enables all resolutions and supporting documents, including the annual report to be reviewed, commented and voted on by both Portfolio Managers and members of the Investment team. This can be undertaken from any mobile device at any location.

Upon notification of a vote, our investment team prepare the necessary information into our report format. This is then distributed to the Portfolio Managers digitally, whereby the respective decisions are made based upon the above information. The actions are then recorded and archived before the votes are lodged via an online proxy portal.

Conclusion

SFML believes it is essential to consider the impact of material ESG risks on the long-term performance of our investments.

SFML's aim is to:

1. Understand, measure where possible, and monitor ESG risk in the context of our equity investments.
2. Make full use of our rights of ownership, on behalf of our investors, by voting on all relevant resolutions. We need to be able to justify our votes. This relies upon our corporate engagement program and our quantitative research program.
3. Drive common sense changes in business practice and financial management that benefit all long-term shareholders and stakeholders.
4. Continue along the pathway of learning across a diverse range of ESG related topics.

Independent research, and our own experience as a long-term investor, indicate that positive ESG outcomes are tied to better financial performance.

We acknowledge significant challenges exist in our ability to add value across an agenda as broad as ESG. Therefore, our approach to ESG needs to continue to evolve and we need to embrace continuous learning as individuals and as an organisation. We must fight our own bias in this process and while we continue to focus on bottom-up stock selection we also need to be mindful of the bigger picture.

"Unintended consequences…. [can occur if] we fixate on one small part of a complex system, and in so doing come up with solutions to the wrong problem. ESG measures can perpetuate this behaviour, especially when the measures and investor rewards remain tied to individual firms. At an individual level, for example, BP can take credit for reducing its emissions by selling its petrochemicals business. But that business and its emissions, of course, have not gone away."[1]

Following in the footsteps of others, as we learn, we have tried to use our words carefully in this document. The use of the word "sustainability" was replaced with "responsible", at the end of our twelfth paragraph.*

From The responsible company[2] we learnt that sustainability *"is a legitimate term that calls on us not to take more from nature than we give back…We have no business applying the word sustainable to business activity until we learn how to feed, clothe, and enjoy ourselves – and fuel the effort – without interfering with nature's capacity to regenerate*". Obviously with this context, we cannot make that claim.

Chouinard & Stanley outline some of the key issues that responsible companies will face over the next 50 years, in relation to Shareholders, Employees, Customers, Communities and Environment (Nature). They are interesting discussion points as we frame our view of the future.

Shareholders:
Accounting will become more complex. As ESG becomes mainstream companies will have to financially account for their impact on the environment. If not, they risk a shareholder revolt following a sudden rise in the price of carbon or drop in availability of fresh water. The United Nations has weighed in with the adoption in 2012 of an agreed method to account for the ecosystem value of natural resources like minerals, timber, and fisheries.

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[1] Harvard Business Review: https://hbr.org/2021/01/esg-impact-is-hard-to-measure-but-its-not-impossible?autocomplete=true
[2] The responsible company, Chouinard & Stanley (2016) Published by Patagonia Works.

Employees:
There has been a fifty-year trend towards automation (technology), moving jobs offshore, improving wages in developing countries and a flattening of wages in advanced countries. The next fifty years will be marked by pressure to restore the living wage. It was assumed as late as the 1960's that the annual pay of one wage earner (usually male) should support his family. The new more modest goal has a worker paid one half of what it takes to support a family of four. To meet this goal will require further increases in productivity, most of which will come from automation (technology), which further depresses employment rates. More workers will be better paid, yet more people will be out of work.

Customers:
As things become more expensive, customers will become choosier and buy less. They will increasingly demand to know whether products qualify as healthy and humane. Any gaps will be easily exposed on social media.

Communities:
Responsible business will be required to accept its supply chain as part of its own, in relation to improved working conditions and environmental harm. Third party verification will become more important, and more companies will benchmark against social and environmental standards while working to raise the bar.

Environment:
As customers and clients learn more about the consequences of taking from the natural world at our current pace, they will pressure companies to do more, more quickly. Expenses will rise for natural resources (especially energy and water) and for waste disposal. Financial pressures will mount for those with weaker cashflows and balance sheets. To compete, a company will have to at least be as responsible as its competitors.

Fifty years out, it will be the leaders in these five categories of shareholder, employee, customer, community, and environmental engagement, that will prevail. These areas align closely with our own views on the importance that culture and its relationship with ESG will have on any given business.

We believe that ESG will increasingly be accepted as mainstream investing. We have confidence that our investment process, which promotes continuous learning via our work programs across corporate engagement, quantitative research and our structured approach to voting will add value in this space.

The journey at SFML started with extremely humble foundations, and today we hold on to these roots. It is just as well, because the reality is that investing itself can be a very humbling experience. We have long accepted the challenge of becoming better investors. To achieve this, we will continue to invest in human capital and our business, and we will maintain a cash balance sheet that supports this reinvestment.

On behalf of our team, we look forward to sharing further developments with our clients, investors, shareholders, and stakeholders in the future.

Tony Scenna | Portfolio Manager
Corey Vincent | Portfolio Manager
Kari Humphrey | Head of ESG