ACTIVE OWNERSHIP
REPORT 2019

Active Ownership

Flossbach von Storch

Flossbach von Storch Invest S.A. presents the Active Ownership Report published once a year from our Fund Manager Flossbach von Storch AG, Cologne.

Flossbach von Storch AG Cologne acts as the responsible fund manager for the investment funds managed by Flossbach von Storch Invest S.A. and in this capacity is responsible for the exercise of voting rights and the ongoing exchange with companies held in the portfolio. The Active Ownership Report is therefore a report from the responsible fund manager on the voting rights and participation activities in 2019.

"Sustainability is not new to us, but it is rather an essential characteristic of a long-term investor and thus of a long-term investment strategy. A company can only operate successfully and sustainably over the long term if it serves its customers well; motivates its employees; treats its business partners fairly; invests sufficiently; pays taxes, and does not cause any environmental damage. This is why we not only deal with business models and company balance sheets, but also with the people behind a company."

Dr Bert Flossbach
Co-Founder and Board Member of Flossbach von Storch AG

ACTIVE OWNERSHIP
=
ENGAGEMENT
+
VOTING

As **active owners**, we see ourselves as a constructive sparring partner for the companies of our holdings, and a responsible trustee for our clients. In an ongoing **exchange** (engagement) we discuss social, relevant and critical issues for companies. By exercising our **voting rights**, we enforce our position.

Foreword

Ecology, economy and social issues are not opposites, they are mutually dependent.

Sustainability is one of the major social trends and has now found its way into almost all areas of life. In the world of finance, too, the issue and the handling of so-called ESG factors (environmental, social and governance) play an important role. In this discussion, special attention is paid to the rights and duties of shareholders as active owners.

At Flossbach von Storch we are aware of our responsibility as trustees of our clients' and investors' assets. We see ourselves as an active (non-activist) investor who makes appropriate publicity about irregularities in companies in which we have holdings. We pay particular attention to long-term corporate management in our companies. Because only if a company is well managed (governance) can it be successful in the long term and thus safeguard the interests of all stakeholders, especially the shareholders.

This is why we want to know what makes the managers of a company tick, what drives them, what they work for, where they are headed, what is important to them, what they want to avoid. Dealing with ESG issues also plays an important role. We make sure that a company serves its customers well, motivates its employees, treats its business partners fairly, invests sufficiently, pays taxes and does not cause any environmental damage. In short, ecology, economy and social issues are interdependent.

ESG The acronym ESG stands for Environment (E), Social (S) and Governance (G). It is at the heart of the discussion on sustainable finance, which is intended to encourage investors to integrate environmental and social issues and questions of good corporate governance into their investment process.

Active Ownership Process

Divest

PHASE 1

Analyse
Identification of ESG conflicts that permanently impair the value of the company

PHASE 6

Vote
Exercising voting rights or selling the holding if the target is not met

PHASE 2

Prioritise
Prioritisation of ESG conflicts according to the strength of their impact on the company value

PHASE 5

Evaluate
Evaluation of the changes achieved

PHASE 3

Elaborate
Development of a meaningful roadmap for resolving ESG conflicts

PHASE 4

Engage
Constructive discussion of the roadmap with the Executive Board

Source: Flossbach von Storch, data as at December 2019

Focus on active shareholders

We are independent in our thoughts and actions – this strengthens our role as active owners.

At Flossbach von Storch, the exchange with the management of our holdings and the exercise of our voting rights is firmly anchored in our investment philosophy. We do not outsource the responsible handling of our rights and duties to a staff unit, because the issue is simply too important for that. Our analysts and portfolio managers act as an active corrective and take responsibility for all measures from a single source.

As part of our active ownership process, we constantly monitor and analyse the performance of our portfolio investments. This enables us to identify potential problems affecting their business development at an early stage – including serious ESG conflicts. We discuss any critical issues with the management. We see ourselves as a constructive sparring partner who makes sensible suggestions and supports the management in implementing them.

In 2019 we were in regular direct contact with over 200 companies. The primarily personal discussions at executive-board level focused in particular on corporate governance issues. However, environmental and social aspects were also intensively discussed. We use our voting rights to emphasise our concerns. At every stage of the process, we are independent of third-party sources and base our approach on our own analyses and direct exchange with the companies. This strengthens our role as active owners.

Exercise of voting rights extract 2019

1. Reckitt Benckiser Slough, United Kingdom

Annual General Meeting on May 9, 2019

- We voted against the remuneration report as we felt that the bonus and, above all, the long-term share-based remuneration seemed inappropriately high.
- We also opposed the re-election of a member of the Supervisory Board.

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2. Bpost Brussels, Belgium

Annual General Meeting on May 8, 2019

- After detailed examination, the remuneration system did not have enough defined key figures, so we expressed our concerns by abstaining.

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3. Newmont Mining Corporation Greenwood Village, USA

Extraordinary General Meeting on April 11, 2019

- We approved the capital increase for the acquisition of Goldcorp by Newmont Mining Corporation after thorough review.

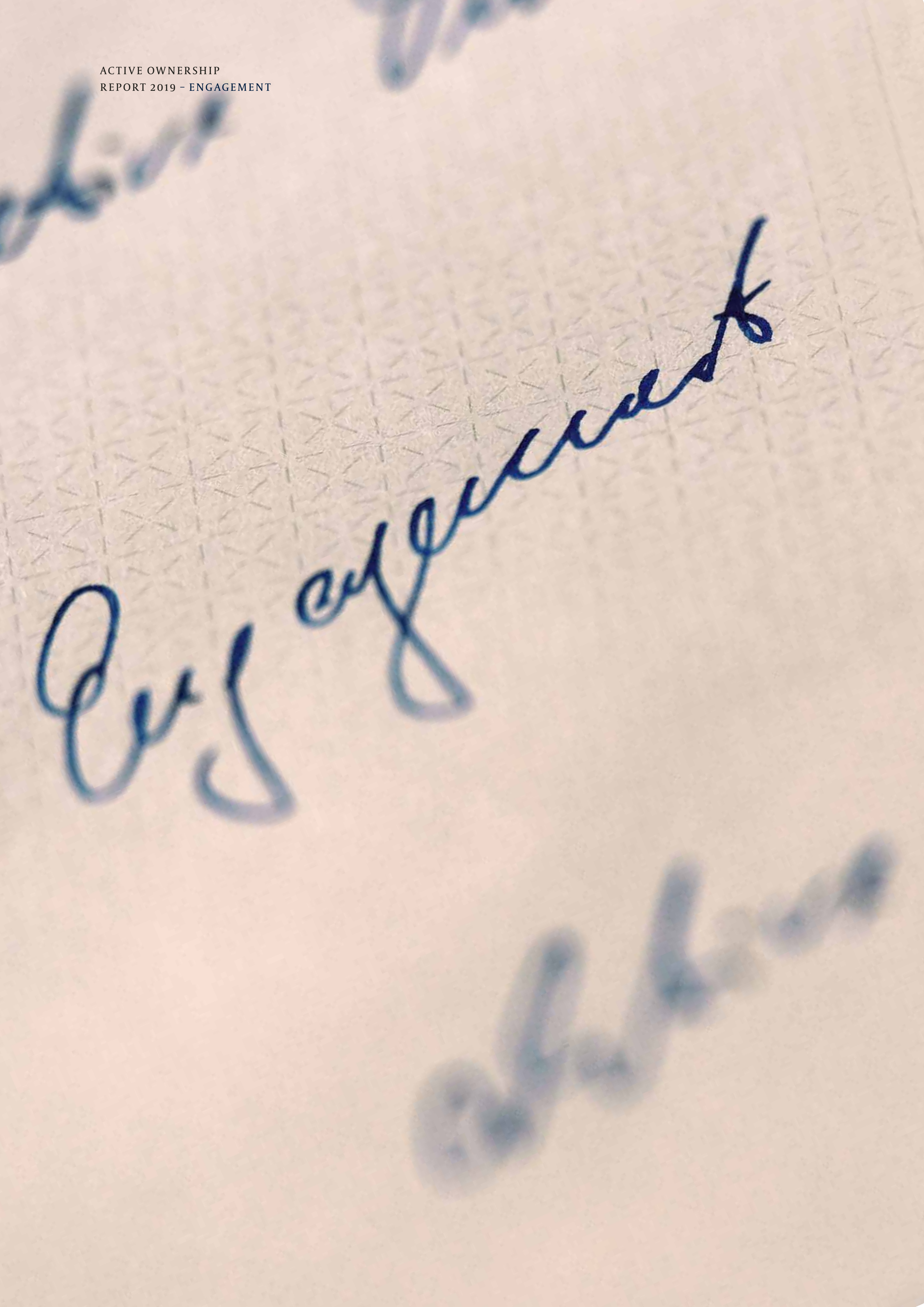
Representing interests

The right to vote is a powerful instrument that must be used responsibly.

We are trustees of nearly EUR 50 billion. This steadily growing investment volume makes us one of the largest bank-independent asset managers in Europe – and gives us a voting volume with clout.

Flossbach von Storch has undertaken to exercise the voting rights independently and exclusively in the interests of the shareholders. All items on the agenda are examined in detail by our analysts in advance. This process is carried out in line with our investment philosophy and is based on our "Guidelines on the Exercise of Voting Rights". In our portfolios we focus on carefully screened and hand-picked securities. We only use third-party data for plausibility checks. Recommendations from proxies can provide useful information, but can never replace our own analysis.

We are personally present at important annual general meetings or general assemblies. In some cases, we also grant proxies, who are guided and controlled by us through specific individual instructions. Up until the end of 2019, we exercised our voting rights as soon as more than one per cent of the share capital of a target company was held, or when major items on the agenda were up for decision. We will intensify our exercise of voting rights from 2020 and will make use of our voting rights above a threshold of 0.5 per cent.


Engagement

Packaging & recycling

Pioneers needed

Sustainably successful companies understand that they must be part of the solution.

Digitalisation, changing consumer habits and climate change are enormous challenges. They demand foresight and flexibility from entrepreneurs. The innovative power and the will to face the changing circumstances will decide on long-term success and failure.

Rapidly changing markets threaten traditional business models and force entire industries to change radically. Digitalisation, globalisation, population ageing and climate change have enormous potential for disruption. Climate and environmental policy are the subject of more controversial public debate and polarise like almost no other topic. However, panic and emotions are not good advisors when it comes to solving complex problems. Instead, innovations and new technologies that combine ecological and economic progress and a policy that creates the necessary framework conditions and incentives are called for.

Sustainably successful companies understand that they must be part of the solution. Even manufacturers of consumer goods for daily use, which are sometimes considered particularly crisis-proof, have to deal with the challenges of changing consumer habits and climate change.

Recognising and acting on opportunities

Consumer goods manufacturers who contribute to a reduction in meat consumption or increase their recycling rates with alternative offers open up new sales potential and improve their image. Because above all, most people equate “sustainable” with “green”. Sustainability in people’s daily activities has thus developed into a trend towards conscious consumption.

The social focus is primarily on packaging plastics. In recent years, plastics have come under increasing criticism. Its manufacture is resource- and emission-intensive, and disposal and recycling is still a major problem. New, recyclable packaging materials must be developed and processes must be optimised.

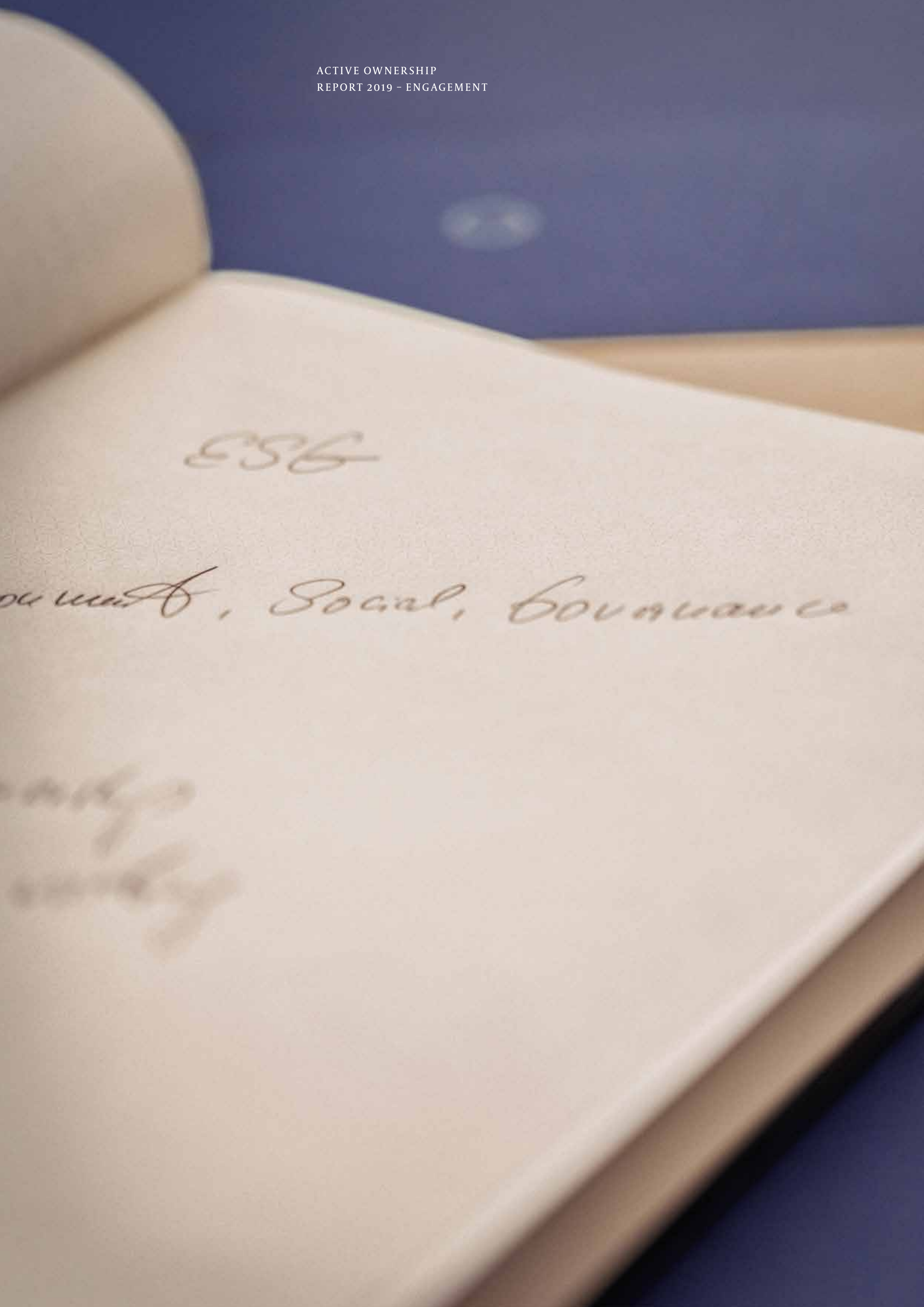
Environmental protection as a driver of innovation

In the recent past, we have clearly addressed these problems in discussions with business leaders from the consumer goods sector and have thus been able to contribute to the implementation and better communication of concrete measures. Nestlé, for example, has defined important environmental goals. The world's largest food company has committed to making its packaging 100 per cent recyclable or reusable by 2025. In addition, a research and development centre was established in 2019 to drive innovation.

We are engaged in an intensive exchange with companies on ESG issues. We have thus become an important and constructive sparring partner.

Do not lose the connection

If framework conditions change, for example due to a change in customer demand or production costs associated with the climate debate, the effects on a company's business model and competitive advantage must also be examined. After all, sustainable success also includes ecological and social sustainability. If a company falls behind here, its competitive position and profitability can suffer in the long term. For us, therefore, the innovative power and foresight of management play an important role. It ensures the sustainability of the business model and is therefore decisive for our investments.


ESG
Social, Governance

Pension deficits

In the interest-rate trap

Despite low interest rates, pension funds still invest a large part of their funds in nominal investments. It is therefore hardly surprising that the gap between pension obligations and pension assets is growing at many companies. This has serious long-term consequences for the companies and their owners.

The pension burdens of many corporations can become an existential problem for them in view of the low interest rates.

Offers for company pension schemes are popular with many employees. Many companies today make so-called defined contribution plans with their employees, which only require the employer to make regular payments of pension fund contributions – nothing more. In the past, however, so-called defined benefit plans were used. Under these agreements, the employer guaranteed employees fixed amounts to be paid out on retirement – the classic company pension.

These "old contracts" are increasingly becoming a burden, as the low interest rates make it difficult for pension fund managers to generate sufficiently high returns to meet the guarantees once given on retirement. In other words, the gap between pension obligations and pension assets is growing alarmingly at many companies.

Pension burdens threaten the substance of companies

Many companies therefore have to permanently close gaps – with financial resources that would be much better invested elsewhere, for example in research and development. Ultimately, the growing expense for pension funds threatens the future viability of many companies. For years we have been approaching the pension funds of DAX companies to reduce pension deficits by shifting parts of the pension assets into higher-yielding investments. Given the long-term investment horizon of a pension fund, this would not only be advisable but also obvious.

Unfortunately, this still looks different in practice. According to our own calculations, bonds still account for more than 50 per cent of pension assets on average, while equities account for just 19 per cent.

The example of General Motors shows what steadily growing pension deficits can lead to.

This year we addressed the issue at three DAX companies. However, the feedback was restrained. For example, one CFO was unable to provide precise information on the allocation of plan assets. Proposals to increase the equity allocation were ignored, citing the strong fluctuations in the stock market and the obligation to report quarterly. Temporary fluctuations in plan assets are far better than having to add money on a permanent basis.

Incidentally, the problems of pension funds are not a purely German phenomenon, but are widespread, for example in the USA. One of the best-known examples was the bankruptcy, under American law (Chapter 11), of General Motors in June 2009, an example of the burden that steadily growing pension gaps place on the future viability of a company.

The earlier this risk is recognised at management level and countered accordingly, the better the prospects of getting the problems under control in the long term. As committed owners, we will not tire of pointing out any undesirable developments.

Executive remuneration

The right incentives

The quality of the management team is crucial for the long-term success of a company. This makes it all the more important to retain good managers – and to give them the right incentives.

In the long term, the quality of management determines the success of the company.

Hardly any fund manager fails to emphasise the importance of company quality as an important selection criterion for the shares in their portfolio. In most cases, this is done by highlighting easily measurable variables: the profit margin, for example, cash flow, growth or debt.

In addition, the assessment of a company's economic moat, which is intended to ward off intruding competitors. In football, one could speak of a chain of defence that is difficult to penetrate. But this alone does not make a first-class team. Only the right strategy leads to success – i.e. the formation, allocation of securities, tactics and motivation. After all, the quality of a team is more than the simple addition of the "player material".

It is about more than professional competence and experience

The same applies to companies. The quality of the management team determines the company's success in the long term. Accordingly, its assessment should not be a mere "rounding off" criterion, but should, in our view, be placed at the centre of the company analysis.

Top management, in particular the chief executive officer (CEO), is responsible for company strategy, in particular for the allocation of company resources (physical and human capital). Especially in a time of very low interest rates and comparatively low growth rates, the right allocation of capital is crucial for the long-term success of the company.

Ideally, a manager thinks and acts like an owner – in the long term. Always only looking at quarterly targets and subordinating everything to them is the wrong approach and ultimately damaging. In contrast, a sustainable value system for the entire company based on personal responsibility and integrity is indispensable.

False incentive turns executives into high-paying employees, not owners.

Quarterly results are not decisive

In the USA the "slavish quarterly thinking" is increasingly coming under criticism – and rightly so. After all, a sustainable growth strategy cannot be pursued if at the same time profit forecasts are to be met to the cent. In an emergency, quarterly results are then massaged until they meet the expectations of the financial markets. In Europe, the custom of setting precise profit targets is less widespread, but the interests of company owners are often not sufficiently taken into account – a shortcoming particularly in the case of large corporations.

In many boardrooms of large corporations there has been a lack of "skin in the game" for decades. Only a few top managers own shares of their "own" company to any significant extent. Instead, they receive bonuses and stock options, which leads to an asymmetrical distribution of opportunities and risks. If things go well, the managers earn magnificently, if they go badly, they earn a little less magnificently. The incentive systems of the banks during the financial crisis have shown where this can lead. The possibility of risk-free profits at the expense of third parties is the breeding ground for false incentives.

Incentives for the management boards of the companies in which we hold shares are an important issue for us. After all, fully comprehensive insurance for the board of directors, which tolerates mediocre management and hardly sanctions bad management, harms the company and all its stakeholders. Thus, at several annual general meetings last year, we voted against raising the remuneration of the management board (the generous bonuses). This kind of incentive turns board members into highly paid employees or "Me Inc." corporations – not owners.


Know your Companies

Investor initiative

Investing responsibly

The issue of sustainability is not new to us, but has always been part of our investment philosophy.

Many institutional investors have committed themselves to promoting international sustainability standards, which they regard as general benchmarks for their investments. We support this dynamic by actively discussing the issue of sustainability not only with our clients, but also with politicians, initiatives and through press releases, interviews, etc., and by providing constructive and critical support.

This includes the investor initiative PRI – Principles for Responsible Investment – in partnership with the UNEP Finance Initiative and the UN Global Compact. We signed the PRI Principles for Responsible Investment in 2019. They commit all members to integrate environmental, social and governance (ESG) issues into their investment process. This objective is in line with our investment philosophy: sustainable investing should be a matter of course for every active, long-term investor.

PRI Principles for Responsible Investment

Sustainability is an essential characteristic of a long-term investor.

Conclusion

Sustainable investment begins with people – they shape businesses, the economy and markets.

Sustainability is more than an ecological fig leaf and cannot be measured by rigid templates. It must be lived and understood by companies and all stakeholders alike. That is why sustainable investment must also start with people, especially those who make important decisions for a company and shape the corporate culture and value system.

For us, sustainability is nothing new. It has always been an elementary component of our investment philosophy, which was designed for cross-generational investment. Long-term corporate governance based on integrity is of paramount importance to us. We are concerned not only with the business models and balance sheets of companies, but also with the people who are responsible for them. An intensive exchange with the management of our companies helps us to represent the interests of investors with a long-term orientation and to play our role as a constructive corrective.

We are convinced that an intensive exchange with business leaders and active voting are important prerequisites for successful and sustainable investing. The responsible handling of our rights and obligations plays a central role in our investment process and thus influences the quality of our investments. We will therefore continue to expand our position as an active owner.

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Stanislaus Thurn und Taxis is responsible for ESG research activities at Flossbach von Storch. In addition to this activity, Thurn und Taxis is an analyst for the consumer staples sector. This dual function reflects our comprehensive ESG approach. With seven years of professional experience and various positions in the capital markets business, Thurn und Taxis has the necessary practical knowledge to support and further develop ESG activities in the interests of our owners and investors. Thurn und Taxis holds a Master of Science from the London School of Economics and Political Science and a Bachelor of Science from the University of Maastricht.

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Since October 2019 Frederike von Tucher has been project manager in the Corporate Communications department of Flossbach von Storch. At Flossbach von Storch, von Tucher is responsible for the sustainability strategy and the company's commitment to the internationally recognised UN Principles for Responsible Investment (PRI). Over the past 13 years, the cultural-manager graduate has spent her professional career in various positions and sectors in the field of communication.

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