Responsible Investment Policy

March 2020

Introduction

The effect that humanity's activity has on our planet is becoming increasingly apparent. The consequences of our growing consumption of natural resources now threatens the future not just of other species but of our own as well. Many governments have recognised the danger and have begun to implement regulations to try to reverse this trend. Companies, organisations, and individuals are also changing their behaviours, partly in response to new regulation but also to be part of the solution, rather than contribute to the problem.

The investment community has been amongst those addressing the issues. There is a growing number of investment strategies designed to deal with environmental issues, social issues, ethical concerns, or governance structures. There have, of course, been many different iterations of responsible investing going back decades. The difference now is that there is a focus on the consequences to society of the activities of companies into which we, as investors, commit our clients' capital.

At GSI we believe that we have a moral and fiduciary obligation to conduct ESG screening; the Paris Agreement of 2015, signed by global leaders, pledged to keep the increase of global temperatures below 2°C of pre-industrial levels. We can play our part, by investing in companies which prioritise good ESG practice. Given similar levels of risk and return, these companies are also more appealing to investors.

We build portfolios sensibly and systematically, investing in a wide range of companies across global markets with a tilt toward small and mid-cap companies and toward factors such as value and profitability. Research tells us that companies displaying these factors offer the potential for higher returns over the long-term. We also consider a company's approach towards environmental, social and corporate governance (ESG) issues. We review ESG ratings of every company we invest in, which informs our investment decision alongside the other factors we consider.

Factor-Based Investment Strategy

Our goal is to give investors exposure to a range of well-understood factors that are strongly supported by the academic and practitioner literature. The factors that we principally seek exposure to are:

- Market factor - broad exposure to equities across global markets.
- Size factor – smaller company stocks have higher expected returns than larger companies.
- Value factor – stocks trading at lower prices have higher expected returns compared to stocks trading at higher prices.
- Profitability factor – companies generating higher profits, on average, have higher expected returns.
- Momentum factor – this is captured passively.

Each of these factors contributes independently to expected returns. We form a portfolio by first tilting towards smaller cap stocks whilst maintaining sector diversification. All stocks are ranked on a range of value and profitability metrics including book-to-market, EBITDA/Enterprise-Value etc. A composite value/profitability score, which we call a Value Score for simplicity, is formed for each stock based on these metrics. The size tilted portfolio is then tilted towards higher value stocks by increasing or decreasing company weights depending on the Value Score.

An additional feature is that the degree to which we tilt towards our value score is somewhat less for very large stocks and higher for smaller stocks. This way we avoid excessive under-weights or over-weights of very large companies relative to their market weights. It also means that our “active weight” in general is more evenly distributed across the size ranges of the portfolio leading.

We believe in diversification across markets, stocks and sectors, which helps to reduce downside return risks. By paying more attention to diversification, we are able to design portfolios that have better risk/return profiles than market-weighted indices, which tend to be dominated by large-cap stocks and relatively few sectors.

ESG Integration

Assessing a company’s approach to environmental, social and corporate governance (ESG), helps to inform our systematic investment process.

When we research and analyse a company’s factor potential, its ESG rating helps to inform our view. Is a company attempting to reduce its impact on the environment? How does it manage its relationships with employees, suppliers and customers, not to mention the community within which it operates? How is the company led, how are executives paid, and is the business well-audited?
We look at a company’s ESG rating alongside other factors like value, profitability and size. This holistic approach allows us to choose sustainable assets with the highest return potential for our investors.

What is Sustainable Investing?

We define sustainable investing as a long-term investment strategy that incorporates environmental, social, and governance considerations into the investment process. To appreciate the scope of sustainable investing, it is necessary to have some knowledge of the ESG components. Each ESG component - environmental, social, and governance – is made up of several constituent criteria. A company’s management of its ESG responsibilities is measured by aggregating its scores on each of the components. The following are examples of the criteria relevant to each of the ESG components.

Environmental	Social	Governance
Climate change and carbon emissions	Gender and diversity	Board composition
Air and water pollution	Human rights	Executive compensation
Energy efficiency	Labour standards	Audit committee structure
Waste management	Employee engagement	Bribery and corruption
Water Scarcity	Customer satisfaction	Lobbying activities
Biodiversity and deforestation	Community relations	Political contributions

Source: ESG Components Source: “What’s in a name? The Many Dimensions of Sustainable Investing”, Morningstar 2017.

Current ESG components cover a wide range of areas, some of which are less relevant to one company versus another. For example, air and water pollution will be an important element in measuring the environmental impact of a power-generation utility. The same element will have less bearing on a technology company. Nonetheless, the broad scope of all the constituent elements means that current ESG coverage is relatively comprehensive.

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The three main approaches to sustainable investing are (a) Themed investing; (b) Exclusion/inclusion-based investing; and (c) ESG integration. Each approach captures sustainable investing differently and, consequently, each has a different outcome.

We believe that an approach that uses ESG integration, while carefully managing the key factors and characteristics that drive expected return and risk, we can deliver a sustainable investment strategy that is appropriate for investors' core exposure to global developed equity markets.

Responsible Investment Approach

We employ a proprietary systematic approach to investing, which determines the companies in which we invest and the amount to be invested in each company. The systematic approach used by us employs current equity prices and fundamental company data sourced from independent data providers. Using this data, we take into consideration each company's valuation characteristics, which include its price-to-book ratio, a composite measure of relative profitability, and net distribution-to-price ratio, when determining the eligibility of a company and the amount to be invested in that company. In addition, we categorise a company based on its market capitalisation, the relative size of the company's sector, and the country in which it is listed.

We also bias our investments towards companies that are assessed to have higher scores with respect to environmental, social and governance (ESG) criteria in determining the weight of that company in a portfolio. The ESG criteria cover companies' exposure to and management of the following:

- Environmental issues: such as climate change and carbon emissions, air and water pollution, and energy efficiency;
- Social issues: such as gender and diversity, human rights, and labour standards; and
- Governance issues: such as board composition, executive compensation, and audit committee structure.

The ESG scoring process addresses environmental, social and governance issues across a range of topics selected for their relevance from a business and sustainability perspective. The ESG rating from 0-100 is based on a set of underlying cross-industry and industry-specific indicators. Each indicator is scored from 0-100 and weighted according to an industry-specific weight matrix. These include 60-80 cross-industry and industry-specific indicators covering different ESG topics across four pillars:

- Preparedness: An assessment is made of how each company's management systems and policies are designed to mitigate material ESG risks. Examples include: health and safety programmes, programmes and targets for hazardous waste;

- Disclosure: Assessment of the degree of company transparency on material ESG issues towards investors and other stakeholders. Examples include: tax transparency per country and scope of greenhouse gas emissions;

- Quantitative Performance: Evaluation of a company's ESG performance based on targets and quantitative commitments. Examples include: employee turnover rate, carbon intensity and number of fatalities; and

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- Qualitative Performance: Monitoring and assessing a company's involvement in incidents and controversies, which may highlight inadequate company preparedness to manage its ESG risks.

Where a comprehensive range of ESG indicators is not available, ESG ratings will be derived from the information available. Not all information is equally useful, so ratings will be based on the information that best represents a company's ability to manage key ESG issues. Raw ESG ratings are adjusted for regional, sector and size effects. This way, after ESG scores have been integrated with companies' value characteristics, a portfolio will retain its target exposures to regions, sectors and smaller companies.

ESG data and scores will be sourced from one or more specialist third party ESG data providers and may be supplemented by internal research. From time to time, events concerning a specific company may happen faster than can be incorporated and delivered by a third-party provider. In these circumstances, the we may modify the ESG scores to reflect current events which have yet to be reflected in the data provided externally.

Reporting

We provide stock-level data and portfolio returns to Morningstar who publish fund analysis on their website. This analysis includes detailed sustainability scores for each of the funds it analyses.

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