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Plenary Session: Investing for the future

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In his speech, Ross Youngman, Chief Executive Officer of Five Oceans Asset Management, discusses some of the major questions facing the investment community today and more specifically how Five Oceans Asset Management are addressing these issues.

Good morning everyone

I would like to share with you my view on investing for the future which comes about as a result of views I have formed during my time in the industry, over the years and additionally from the position of having established from scratch a boutique asset management business in Five Oceans Asset Management, with Chris Selth. Five Oceans specialises in the management of international equities.

When you set up a business you have an opportunity to reflect on the industry, draw from previous experience and position the business in your preferred way for the future. In essence you have the luxury of basically starting with a blank sheet.

The world is constantly changing in a variety of ways, and I believe strongly that for a number of reasons the demands and requirements of the investment community are going through a major change currently, the likes of which we haven't seen for many years, and that this has come about through a confluence of events.

The new landscape of Corporate Share Ownership

Today beneficial owners of large corporations are no longer the wealthy privileged few but increasingly on a global scale they are working people who have their pensions and other savings invested in shares of the world's largest companies. The savings impact felt in Australia under the Super Guarantee regime has been replicated around the world from South America to the US to Europe. If investment is about meeting the needs of the owners of capital, then the responsibility of investors of this capital will be not only to meet their return objectives, but also to consider the long-term viability of their societies and environments.

In effect this trend of broader share ownership means that this larger pool of beneficial owners becomes more at one with society in general. This has resulted in pressure on company management to broaden their focus from solely maximising shareholder returns to additionally taking account of other stakeholders who are influenced by a company's action.

At the extreme, this is the concept of the triple bottom line which relates to expanding the traditional reporting framework to take into account environmental and social performance in addition to financial performance. But it also means that environmental, social and corporate governance (ESG) issues are now increasingly coming to the fore within the mainstream investment community.

Wal-Mart is a case in point where management's hard nosed approach to driving profitability, in a society where their shareholders, employees and clients have significant overlap, had the effect of damaging their reputation. It is also fair to say that for Wal-Mart now the penny has to an extent dropped and they are now making strides to improve their approach across environmental, social and governance areas.

Climate Change

We have heard today from Dr Tim Flannery about the daunting issue of climate change that we are facing. This is an issue that we have felt very strongly about as global citizens, parents and business proprietors, from the onset of Five Oceans. Personally, I feel strongly about the fact that the world is a fragile ecosystem and we have a responsibility to do our best as the current guardians of the planet to hand this over to the next generation in as good a shape as possible.

We also know this issue is of growing concern to the broad populace as people like Tim, Sir Crispin Tickell (who spoke at the launch of Five Oceans) and Al Gore, to name a few, seek to educate the population at large on this issue. We are now also

seeing this manifest itself in the voting patterns at local and state elections and in federal polls that take the electorate's temperature. We also know this by virtue of the sudden interest of the politicians, some of whom seem to have all of a sudden got religion in this area!

I also hear from time to time from the so called 'climate sceptics' who, although they generally seem to agree that the world is warming and greenhouse gas levels in the atmosphere are climbing, will argue that this is a natural phenomenon isolated from the impacts of man.

To be honest I don't have a lot of time or patience for this argument because firstly I believe the evidence is unassailable that man has played his part in all this and secondly, whatever the actual combination of causes for climate change, we should always be seeking a better way to do things and if there is a way to live and prosper as global citizens without producing as much pollution and waste then we should be striving to do this and so simply at a minimum, sceptic or not, if global warming is the catalyst for providing an impetus for us all to create an environment in which we can live and prosper with less pollution then that is a good thing!

Corporate Governance

We also know that society wants more from its corporate citizens. We saw the stark reality of this in the fallout from the post Enron and Broadcom collapses with major fallout for shareholders, societies, and employees. Many Enron employees 'having drunk the Kool-aid' had invested and lost up to 100% of their retirement savings in the 'company stock' option of their 401(k) retirement plans.

In general, pension funds and superannuation investors are in for the long haul. They want corporate executives to work to build businesses for the benefit of shareholders in ways that will ensure the long-term viability and sustainability of the business franchise. They are not interested in get rich quick schemes.

Research has shown a very strong relationship between governance and company value.

Now post these issues we saw regulators tighten their oversight of corporates and markets in a classic 'close the gate after the horse has bolted' approach. Sarbanes Oxley has, for example, dramatically increased the administrative burden on corporates without any strong evidence that it will protect against the next blow-up. We have also seen a version of this in Australia over the past few years with changes and a tightening up through the AFSL regime. This is not to say that these initiatives have not been well intended but over time it is much more than a set of

rules that is needed to drive business in a sustainable way into the future as evidenced by recent finance company failures in Australia.

One thing we can observe through these swings and roundabouts is that good companies with strong leadership will prosper independently of the 'rules' often through different cycles, because its not just about the rules, but rather it is about the culture, leadership and morality of a business and in no small part it is the expectations of the society, investors, community and government surrounding a business that will also influence this corporate behaviour. This is where asset managers and superannuation funds have a strong part to play in communicating their expectations to management.

Longer-term investors want their executives to show broad leadership, to understand they have a responsibility to shareholders and also to society. They don't want to hear that an investment decision has been taken without a full analysis of the future environmental and social impacts to communities going forward that may result in short-term gains, but then be followed by years of environmental clean-up. We saw that with Ok Tedi.

Labour and society

I believe again that there has been a fundamental change to the way society sees these areas. Part of this relates to the attitudes and demands of youth. A lot has been written about the attitudes of Gen X and Y; part of this is the more flexible and transient nature of the global workforce but also the sustained period of global growth has meant that employees have been generally dealt a stronger hand.

Attitudes to employees and relations with community are issues that again are critical to the long-term sustainable growth of business. In a tight job market the costs of a poor approach to workplace relations are highly evident in increased turnover and the inability to hire and retain good people. Increasingly job applicants want to know and understand the cultural position of a business before they accept a job.

So we have a turning point which I believe will drive a different investment environment in the future. The investment world is moving from one where Socially Responsible Investment once sat at the edge of mainstream investing using a range of blunt negative screens to narrow the universe to one where today Responsible Investment is rapidly moving to the mainstream to be incorporated into the core of the investment process.

This is no longer about voting with your feet but rather the various players; super funds, asset managers and companies

forming a dialogue to develop a common understanding of the issues because investment is about the long term and the longer-term participants in the industry can not shy away from dealing with these issues but rather must engage to solve them. To this end significant progress has been made and the marketplace is mobilising!!

So how is Five Oceans as a business and group of individuals approaching these issues?

Well firstly I'm not standing up here to hold Five Oceans out as having cracked the code for determining the nirvana of best practice for future investing or to say that personally I am at the forefront of moral and environmental correctness. These are very dangerous positions to take in this day and age!!

This was evidenced by the criticism Madonna received when performing at the Live Earth Concert recently. Apparently her charitable Ray of Light Foundation has a diversified share portfolio and some of these companies have made it onto a list of the worlds largest polluters.

Madonna declined to comment. But Live Earth founder Kevin Wall defended her, saying she had demonstrated commitment to the project. 'Today we're not focusing on what she or any of the artists may have done in their past; it is about the future.'

And I think that sums up our position which is about modifying behaviour for the future and being an agent for change where possible... there is an element of breaking new ground here.

In essence at Five Oceans we have thought long and hard about our approach both personally and as a business and we are working hard to develop a leading edge approach in this area.

Obviously we are also driven by what our clients want and there is significant evidence now that this is important to clients. From the investor viewpoint it is now apparent that institutional investors, super funds and individuals are increasingly concerned about environmental, social and corporate governance issues and increasingly they are looking for managers who are treating ESG considerations in a mainstream way.

Phil Stathis of the Australian Council of Super Investors ACSI states, 'having a care for the environment, society, and for fair dealing with employees, customers and suppliers would seem to be natural and intrinsic elements of good corporate governance. Some companies will do these things because they are moved by the moral and ethical imperative to do the right thing. Others will do all or some of these things because to avoid

them involves material risks to their company's prospects. Managing these risks is the duty of the company board and its executive management. Being satisfied that the board and management are on the case is an issue for investors, particularly large institutional investors as super funds have become.'

Hesta, Vision Super, Vic Super, Unisuper to name a few are all taking an active lead in this regard.

So what are we doing at Five Oceans...??

Essentially the view that Chris and I had was that concepts of business sustainability including environment, social and corporate governance considerations need to be incorporated into the mainstream of our investment process. Not to have these issues sit out to the side of what we do but rather be embedded in the core of our fundamental process. In a way we see this as a natural evolution in the industry from the days of stand-alone ethical funds that operated with negative screens.

To do this effectively we needed to hone our investment approach and more importantly get the buy in of the rest of the team to ensure that culturally everyone was onboard.

We have spent a lot of time internally discussing these issues and establishing a modus operandi.

Basically we see an understanding and management of business sustainability considerations as a good barometer of corporate management and a way for companies to minimise reputational risk, protect their franchise and sustain long-term competitive positioning.

Sustainability issues can affect a company's ability to generate long-term returns, through a lack of understating of potential risks to a business or a failure to embrace future opportunities.

To further reinforce culturally our approach to this we have signed on as a signatory to the UN Principles for Responsible Investing. To a large extent these Principles were a direct outcome of work undertaken by the World Economic Forum in 2003 and 2004. In general it has been determined that the investment community, investors and managers, have an important influence on how CEOs and Boards viewed Corporate Citizenship.

Let me briefly summarise the Principles. These Principles state that as institutional investors we have a duty to act in the best long-term interests of our beneficiaries and commit to the following:

1. We will incorporate environmental, social and corporate governance issues into investment analysis and decision making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on Environmental, Social and Corporate Governance issues from the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will report on our activities and progress towards implementing the Principles.

The essence of the Five Oceans fundamental research process relating to international equities is as follows.

We use a variety of screening techniques to narrow the global universe to a research work in process, we analyse the franchise strength, we value the business and we seek the catalyst that will move the company's share price from where it sits today to our target valuation.

To this end environmental, social and corporate governance factors are incorporated within our screening; not in a way that excludes specific sectors or a large chunk of the investable universe, but rather where we perceive there are ESG issues and when there is no discernable improving trend or desire culturally for the company to embrace these issues our radar goes up and in the absence of mitigating circumstances we may pass at this point. Sometimes we have an early call with the company to clarify these issues before commencing detailed research. As a core part of our dialogue with companies we want them to know that ESG criteria is important to us as an investor.

The bulk of our analytic work occurs in our franchise assessment where as part of this process we analyse and summarise the company's ESG approach. What we are looking for is management that has a forward looking strategy for managing these issues or is invoking such a strategy. For us it is not about every company already being at the cutting edge regarding these issues but rather about change and attitude.

Finally if we feel that there are aspects of a company's approach, or lack thereof, to the ESG area that can be quantified we build it into our valuations either by adjusting the discount rates we use in our modelling or applying some other adjustment. For example, increasingly carbon tax scenarios and outcomes are being modelled.

Engagement with companies and management is a significant part of the process. Here we seek to make sure companies understand our views and approach to the ESG area as we clarify issues relating to our analysis. As a small business the power of our engagement with business is limited; notwithstanding we do our best to punch above our weight in this regard. To enhance our leverage we also seek to engage through other means predominantly joining industry groups.

For example, we are a signatory to the **Carbon Disclosure Project** (CDP). The CDP represents \$41 trillion of institutional assets and includes most major pension players including for example CalPERS and Ontario Teachers and aims to seek information on the business risks and opportunities presented by climate change and greenhouse gas emissions data from the world's largest companies. In 2007, 2400 global companies participated.

We are also members of the **Investor Group on Climate Change** (IGCC) here in Australia. The IGCC recognises that the financial return of an investment is impacted by climate change. As such, the IGCC aims to ensure that the risks and opportunities associated with climate change are incorporated into investment decisions for the ultimate benefit of investors. We are also members of **Environment Business Australia** which is a business think-tank and advocacy group that seeks commercial solutions to environmental challenges.

To execute on our investment approach we have engaged with some external service providers who can give us specialist research across these areas.

For example, we use Innovest Research. **Innovest Strategic Value Advisors** is an internationally recognised investment research and advisory firm specialising in analysing and rating companies' performance on environmental, social, and strategic governance issues, with a particular focus on their impact on competitiveness, profitability, and share price performance.

Also for proxy voting we take input from **Institutional Shareholder Services**, who are a global leader in the provision of corporate governance and proxy voting advice and services.

Also the global broking community is now starting to get with the program. Members of our team attended a Citibank Conference on Climate Change last week in Sydney which follows on from one earlier in the year in London. Some of this has been driven by directed brokerage to an extent brought on by the Enhanced Analytics Initiative (EAI) whose members control over \$2 trillion and undertake to direct 5% of their brokerage to brokers who are undertaking what is termed 'extra financial research' covering environmental, social and corporate governance issues. Unisuper was the first Australian fund to join this initiative.

Overall then, we have adopted an approach that we feel comfortable with and that allows us to get on top of the issues and compare companies based on their respective approaches. As discussed we strongly believe that an understanding and management of ESG criteria by corporates will improve their long-term performance. To this end for us it is not just about where companies sit today in terms of their approach to these issues, but rather where they are heading.

In summary then, there is a change going on that is bringing responsible investing to the mainstream. At Five Oceans our approach to incorporating ESG criteria into our investment process will help us make better long-term investment decisions, play a part in influencing corporates to improve their practices in this area, plus culturally creating a work environment, within our well paid and privileged industry, where we feel we are contributing in our small way to making the world a slightly better place.

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