2021 CLIMATE COMMITMENT

COVID-19

Like climate related insurance risk, COVID-19 has a short tail and a long tail.

There is no doubt that COVID-19 dominated headlines, public policy and financial markets in 2020.

In 2021 the expectation is for vaccination rollouts across the developed world with the goal of controlling global transmission rates. Success could see us moving away from the politics of knee jerk lockdown policy. An optimistic view may include the gradual reopening of global borders within the calendar year. Unfortunately, as the worldwide race to vaccinate entire populations gets underway, dysfunctional systems and inequality will be exposed.

COVID-19 economic fallout in the form of publicly held debt will likely be felt for years to come. Many private businesses have been dealt a similar set of cards, that is, having no alternative than to take on debt to survive.

To put this into perspective, in early January we spoke with an owner-operator of a boutique Pacific Island resort. Over two decades, the operating family has managed a successful debt free operation. Today they estimate the business will be six years behind plan by the time operations normalise. That is a downgrade of magnitude on anyone's terms.

We are looking to a post COVID-19 world or a COVID-19 normal world where we successfully learn to deal with both the short and the long tail impacts of a pandemic. Under such a scenario, collectively, our focus can return to longer-term issues that need to be addressed for a sustainable global future. One where we do better than stumble from global crisis to crisis losing decades of productivity along the way due to entrenched shortsightedness.

Paris

In this note we outline our 2021 climate change initiative, a subset of our ongoing Environment, Social and Governance (ESG) commitment.

Our starting reference point is The Paris Agreement, which came into force in 2016. It is a platform to strengthen the response to the threat of climate change and it has shifted the conversation to a fundamental economic and financial risk return discussion.

The purpose of the Paris Agreement is to hold the increase in global average temperature to 'well below 2°C above pre-industrial levels'. The Paris Agreement also sets an aspirational target of a 1.5°C limit. In addition, the parties to the agreement aim to reach carbon neutrality (i.e. achieve a balance between anthropogenic emissions by sources and removals by sinks of greenhouse gases) by 2050.

The Paris Agreement is grounded in the idea of common but differentiated responsibility. It requires parties to communicate nationally determined contributions (NDCs), which are publicised intended reductions in greenhouse gas emissions, specific to each participating nation.

These NDCs will be reviewed at five-year intervals, enabling parties to demonstrate a progression and increased ambition over time. The Paris Agreement has no mechanism for enforcing compliance against parties – rather it relies on transparency to incentivise ongoing participation in the framework it creates.

Local failure

Australia should be a global leader in this space, but instead our leadership has dithered. We view this failure as systemic. It sits alongside our antiquated taxation platform, shortsighted Research and Development (R&D) policies and our inability to attract and incentivise the technology and science-based industries of the future. Instead, we export talent.

Australia's intended NDC, which the Federal Government published in August 2015 in advance of the Paris Agreement coming into effect in November 2016, committed Australia to implementing an 'economy-wide target to reduce greenhouse gas emissions by 26 to 28 per cent below 2005 levels by 2030'.

Australia has, however, qualified its targets by reserving the right to adjust its target. We have not made a commitment towards carbon neutrality for the second half of this century.

The Federal Government outlined its approach to action on climate change in the Climate Solutions Package, published on 25 February 2019. This is a continuation of its direct action policies and promises investment in low-cost emissions abatement technology and clean energy through a climate fund.

Federal Energy and Emissions Reduction Minister, Angus Taylor has also flagged the development of a technology roadmap, which will guide government investment in clean technology solutions. The focus of which has shifted away from wind and solar, which Angus Taylor now considers to be *"commercially viable"*, to storage and grid integration technologies.

In addition to these policies, the Federal Government is seeking to rely on carry over units from the Kyoto Protocol (the targets for which Australia had managed to exceed). This practice was the subject of extensive negotiation at the Conference of the Parties to the UNFCCC in Madrid in December 2019 (COP25). Several groups of countries opposed the practice which Australia was proposing to adopt, although the issue was not resolved at COP25.

State governments, by contrast, have made more aspirational commitments, with all states and territories adopting a target of net zero emissions by 2050. Similarly, the Federal Labor opposition has adopted a 2050 goal of net zero emissions, a position supported by the Business Council of Australia and the Australian Industry Group. Third party research institutes, including Climate Action Tracker, have rated Australia's commitments as being incompatible with a 1.5°C or 2°C limit.

From a regulatory perspective, Australia has seen heightened engagement, supervision and recommendations from the RBA, APRA, ASIC, Australian Accounting Standards Board (AASB) and Auditing and Assurance Standards Board around response to and obligations related to the financial risks of climate change.

Selector ESG

Global institutions are making progress. This time last year we outlined the position being taken by Blackrock. In Australia, our largest super funds have developed constructive policies and are similarly taking leadership. We have referenced material from two of these institutions in this note.

SFML sits in a unique position as a small business. We have been entrusted, by our clients, with part or all their superannuation and lifesavings. Collectively they represent a diverse range of employed and retired Australians, blue collar and professional, either directly or via institutional investors. This grouping also includes all the members of our team. On behalf of all our stakeholders, it is incumbent on us to champion increased transparency, better disclosure, good governance and strong risk management. We see this as a common-sense approach to long-term investment.

In addition, we believe 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.

It starts with culture

Environmental, Social and Governance (ESG) considerations are fully integrated into our portfolio construction process and evolves as we learn. It is adapted to ensure it adds value to the process and remains relevant to our long-term goals.

We have long believed culture and ESG are intertwined. We consider them both integral to our assessment of a business.

We have focused on people and culture as a key driver of long-term sustainability since our inception in 2004. We believe the culture of a business ultimately drives attitudes towards business sustainability. This includes the board and management teams' disposition towards disclosure, transparency, the short and long-term horizons, R&D, capitalisation of expenditure, use of debt, issuance of equity and the broad risks attached to ESG. Effectively all the 18 elements of our investment roadmap.

Over past decades the focus on Social and Governance issues have no doubt won out ahead of the Environmental considerations. This is likely due to the greater difficulty of tackling this issue. As part of our ESG journey and to better address Environmental issues, we are building out our climate commitment in 2021, which we discuss below.

The recap

First let us recap where we stand today on ESG and what was achieved in 2020.

Our investment process currently includes three important aspects. Firstly, we employ mandate exclusions, sometimes referred to as a negative screen. Secondly, we have a strong program relating to company engagement. Thirdly, we have a structured in-house voting program. These three elements are explained in more detail below.

The mandate exclusions, 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

Our cultural assessment of a business or potential investment, has been driven by our company engagement program since inception. This is a foundation of our investment process. We engage with board members and management teams, attend AGMs and undertake site visits.

This is essentially a risk out process. We are aiming to take as much risk off the table before we invest in a business, by determining that a business meet our four requirements of stock selection. As many of our investors understand, we are seeking businesses with leadership qualities, run by competent management teams, underpinned by strong balance sheets, with a focus on capital management. The goal is to capture as much real earnings per share growth as possible over the long run.

Through our company engagement 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 payout ratio that allows ample reinvestment for future earnings growth. None of this is earth shattering or rocket science, it’s just a common-sense approach.

Importantly we vote as long-term owners of a business and we attend AGMs in person where possible, although in the year just past this has been virtual. In relation to voting, we have adopted a structured program of work that dovetails with company engagement program. We review, vote and document each company resolution put to shareholders within our portfolio. This is a substantial piece of work undertaken by the portfolio managers and the investment team.

Alongside our company engagement program, we believe this proactive approach to voting drives a 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.

ESG 2020

When we look back on 2020, we believe we made progress in our ESG endeavours.

We undertook a program of reviewing the corporate governance documents and board charters of companies we invest in and we provided feedback to board members and management. The highlights of this program include change, which were adopted by the companies that we engaged. We had successes on several fronts here. Chiefly in gaining insights into how companies operate and the deployment of internal resourcing. Secondly, we encouraged the updating of documents, corrected missing links and this arguably promoted better disclosure. We encouraged others by offering up examples of what we considered to be best in class governance disclosures.

Our ESG roadmap was integrated into our company financial modelling program. Like our quantitative and qualitative roadmap that we adopted at inception in 2004, we set out to develop an ESG roadmap in late 2019. This was integrated into our models in 2020 and is scored each time a company reports financial results.

The premise is, if the right questions are asked at regular intervals and recorded, then we are well placed to observe trends over time, be they positive or negative. The ESG roadmap consists of three categories: Environmental, Social and Governance (our original roadmap has two, Quantitative and Qualitative), with 12 subcategories that prompt the evaluation of multiple questions. A simple 1 or 0 scoring system is applied. We do not obsess on the scores generated; we are looking for trends over time.

The intention is the ESG roadmap will evolve to ensure relevance and value add. For instance, after a year in use we have determined that two categories can be merged. Simple, repeatable processes are often more effective.

In 2020 we undertook 480 company engagements. Each one represents a cultural review of a business, where both qualitative and quantitative areas of the business are examined. We consider each engagement to be a page in our book of knowledge that develops over time. Two portfolio managers attend each meeting and notes are recorded and stored. A subset of these engagements was specific to ESG related matters.

We also established an ESG Resource Centre on our internal workflow platform, Monday. Again, this is not groundbreaking news. It does however bring together all the ESG related material and public documents relating to our portfolio into one location. This important digital hub drives significant efficiency for our internal investment team. It has become the foundation of our voting program.

In 2020 we considered, debated and recorded our views, and voted on 183 resolutions put to shareholders. A portion of resolutions were referred to the boards, from which they originate from, for clarification. We also actively ask our companies to engage with us on any matters that proxy advisors are pushing back on.

In the period, we abstained from a small handful of resolutions that related to approval of equity raisings that we participated in. Our process is hands on and labour intensive, involving a contribution from our investment team and principally the portfolio managers. This retains the granularity of information that would otherwise be ceded if this process is to be outsourced.

In 2020 we discussed ESG matters in our Quarterly Newsletter. Several of our long-term investors have shown an increased interest in what we are doing behind the scenes and we have upped our communications in response to these requests.

Finally, on 30 June 2020 we completed our Inaugural (2019) carbon measurement. A 100% carbon offset was achieved and certified. We have communicated this in previous newsletters.

Climate 2021

Across our portfolio of holdings, in 2021 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. We believe we can have far greater impact via our company engagement program and our voting program.

Our advocacy will extend to the principals of the Task Force on Climate Related Financial Disclosure (TCFD), for which we have recently applied to become a signatory. This advocacy is discussed below.

Limitations

There are of course limitations in what we are trying to achieve and it is important to understand these also. Reporting is not uniform across companies and not all are reporting on climate related matters.

Many factors are at play here. At the extreme end, some businesses are not resourced nor have the expertise to provide data. Some simply have not seen the writing on the wall. At some point these businesses may find these attitudes, if entrenched, limit capital availability.

Others have large, entrenched carbon footprints, such as heavy industry, which take considerable time to address in a meaningful way.

Of course, many companies are reporting climate related data, including emission levels and renewable targets. Rarely is this data directly comparable. The information gaps are significant, and they will likely remain that way for some time to come. We believe a simple unified approach across financial markets will go some way to addressing this.

Finally, at SFML, we are generalists not experts; we learn as we go and adapt. We see this as a journey we will all collectively benefit from in the form of sustainable future portfolio returns.

Why Paris and TCFD

The financial risks associated with climate risk are very real and many examples can be drawn upon.

In its 2018 Climate Report, Oil Search presented scenario testing that demonstrated the viability of its asset base. While the Alaska North Slope assets stands up under scenario testing, the asset value may also be affected by the ability to fund development by raising new debt. As US institutions have become increasingly wary of climate advocacy, some have stated they would avoid funding North Slope development. For Oil Search, as a direct result of this shrinking pool, the cost of funding via syndicates, while still available, will likely be higher. The future opportunity to refinance debt may become harder, or they could face reduced tenor of borrowing available to the organisation. As a result, returns and asset values will be lower.

Clearly one of the most heavily exposed industries is insurance. It is feasible that insurance underwriters, with both short and long tail books, may be holding risk that is no longer quantifiable. Sitting alongside them, in this high-risk category, are those with physical assets that stand in the way of extreme weather events.

The damage done to coastal property from single large swell events can be astounding. In recent years, close to home, we have seen public and private property destroyed. Examples include freak swell events that hit Manly's Marine Parade in 2016, sleepy (often no surf) Collaroy Basin in February 2020 and Byron Bay's Clarkes Beach in December 2020. But the risk is not limited to these extreme events. While Sydney Airport does not face storm surf events, its runway that juts out into the calm waters of Botany Bay is at risk of a rising sea level. We don't have portfolio exposure to these examples.

Service industries and technology-based business have very light carbon footprints and lower climate related risk profiles by comparison. It is equally important these businesses understand they have a role to play. Recycling, natural lighting, energy efficient workplaces and renewable energy targets are equally viable approaches to climate policy. Our intention is to be on the front foot advocating and communicating this message.

The Paris Agreement targets have an important role to play here. They link the unequivocal science (see appendix) to the economic and financial risk argument. As a result, this is the starting point we have adopted.

One of the essential functions of financial markets is to price risk. Every investment has risk attached. Essentially when we invest, we target a return that compensates for the equity risk we take. This premise only holds if we understand the risks at hand. As discussed above, we aim to take as much risk off the table as possible before we invest. Our focus on balance sheet strength and sustainability of earnings is testament to this.

The financial crisis of 2007-2008 is an important reminder of the repercussions that weak corporate governance and risk management practices can have on asset values. Without the right information, long-term investors may incorrectly price or value assets, leading to a misallocation of capital.

A significant, and perhaps one of the most misunderstood risks that organisations face today relates to climate change. While certain insurance and physical assets may become uninvestable or even stranded, studies have shown that much of the impact on future assets will come through weaker growth and lower asset returns across the board.

From 2021, SFML has undertaken the process to become 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.

The TCFD was established by the Financial Stability Board (FSB) in 2015, at the request of the G20, to create a framework based on the Paris Agreement that could address the limitations, some of which we discussed above, and the complexity of the risks associated with climate change. The result was a set of recommendations or guideline for consistent *"disclosures that will help financial market participants understand their climate related risks."*

Our goal for 2021 is to adopt the aspects of this voluntary guideline that makes sense within the context of our investment process. This will enhance and strengthen our ongoing approach to ESG.

In 2021, we believe each and every company we invest in will be approaching the Environmental component, or the environment they co habit, including climate change issues, in a responsible fashion. Some for the first time and others with a greater understanding of the risk and opportunities they face. This journey is unique to each business and we will treat them as such. We know from experience that when we adopt a clear relevant framework, which can be applied consistently as part of our bottom-up stock selection process, the process is enhanced. Like our attempts to tackle ESG over the years, through our company engagement and voting programs, our approach will not be rigid, it will adapt as we learn. ***SFM***

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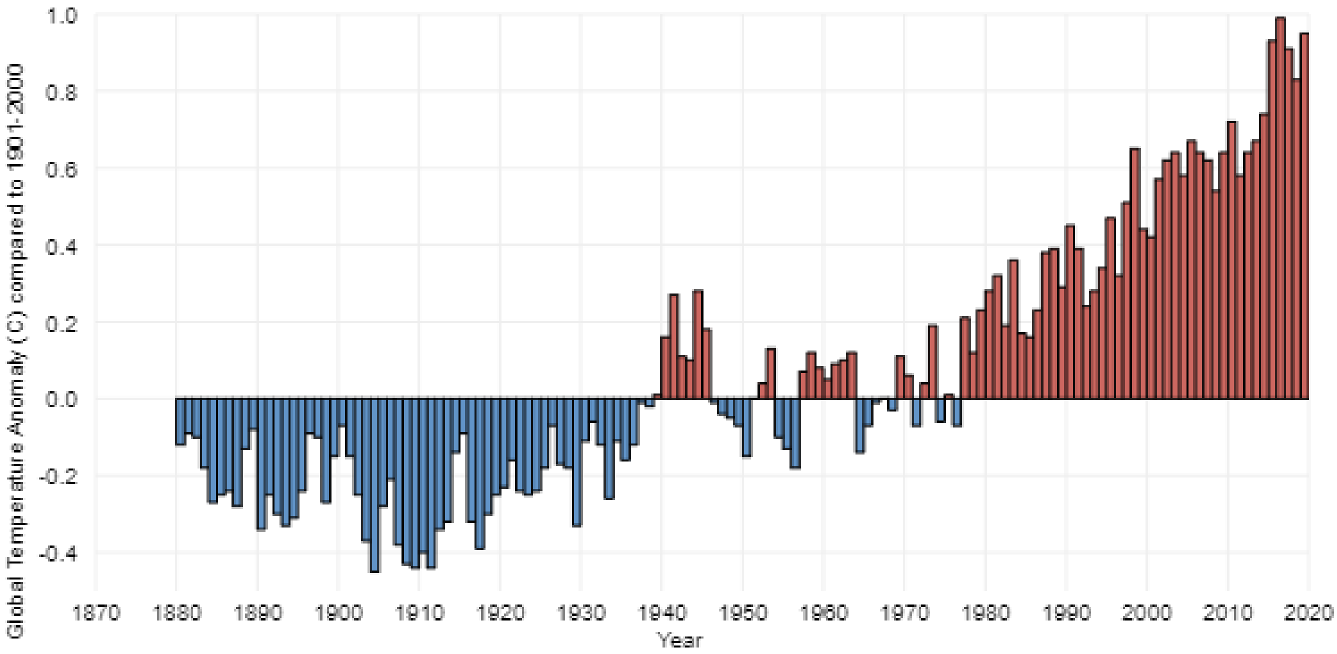
Appendix 1

Evidence of Temperature Warming

- The combined land and ocean temperature have increased at an average rate of 0.07°C per decade since 1880*
- The average rate of increase since 1981 has doubled to 0.18°C
- While warming is not uniform across the planet, the upward trend in the globally averaged temperature shows that more areas are warming than cooling

Figure 1: History of global surface temperature since 1880



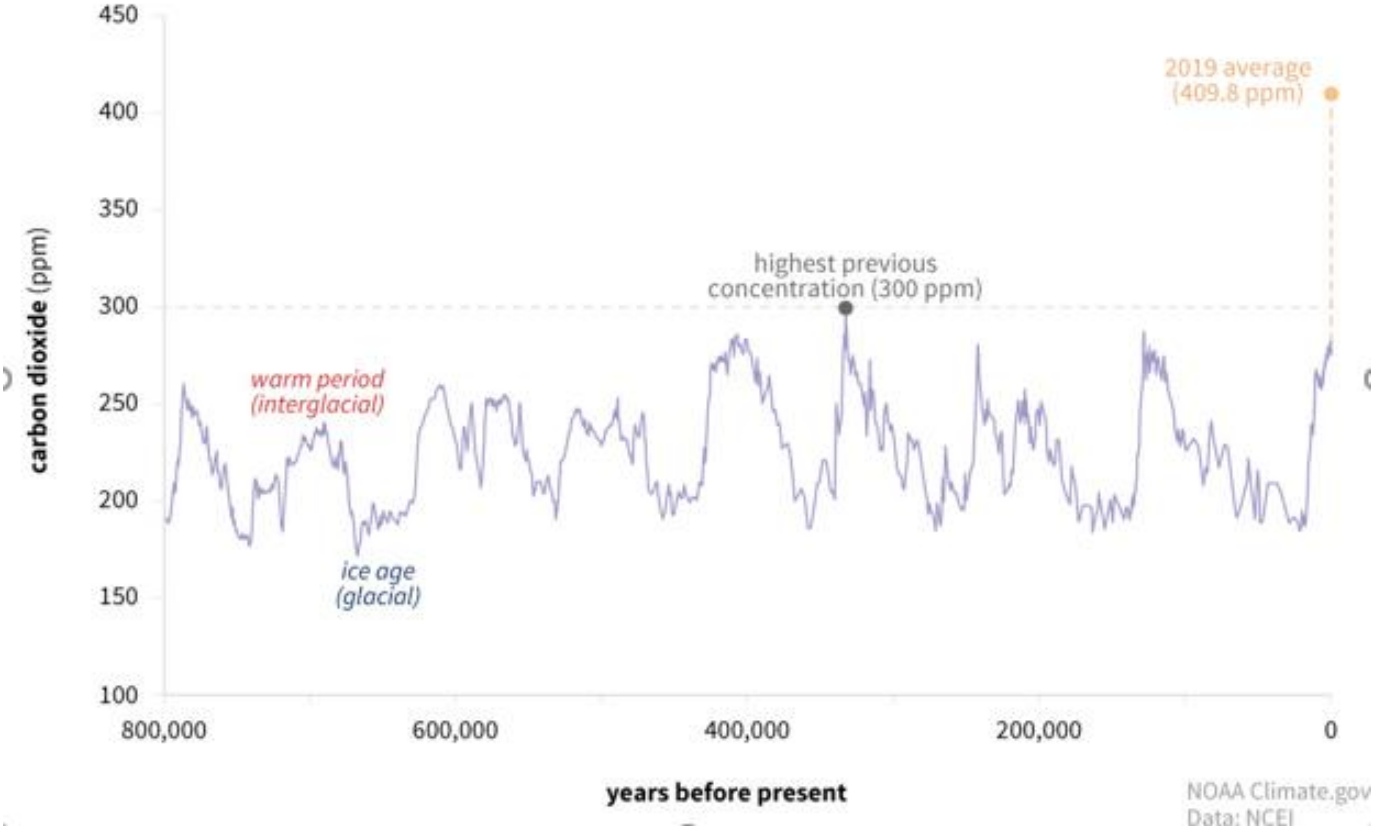
Source: Ncdc.noaa.gov. 2020. Global Climate Report - Annual 2019 | State Of The Climate | National Centers For Environmental Information (NCEI). [online] Available at: https://www.ncdc.noaa.gov/sotc/global/201913

Appendix 2

Evidence of Increase in C02

- The global average CO_2 levels in 2019 was 409.8 parts per million (ppm), the highest in 800,000 years
- The annual rate of increase in C02 over the past 60 years is 100 times faster than at the end of the last ice age 11k -17k years ago
- CO_2 amounts were last this high over 3 million years ago, when temperature was 2°–3°C higher and sea level was 15–25 meters higher
- CO_2 concentrations are driven by fossil fuels that people burn for energy

Figure 2: Carbon Dioxide over 800,000 years



Source: Ncdc.noaa.gov. 2020. Global Climate Report - Annual 2019 | State Of The Climate | National Centers For Environmental Information (NCEI). [online] Available at: https://www.ncdc.noaa.gov/sotc/global/201913