Amati Global Investors

Environmental, Social and Governance Issues

Introduction

As institutional investors in small cap equities, broadly defined as companies which represent the bottom 10% of the stock market by market capitalisation, plus AIM, we will in some cases become significant shareholders in investee companies. In addition, as VCT managers, we are involved with funding companies directly, at very significant points in their development. At these moments we have the ability to make a difference to them and the dialogue between fund manager and company executive tends to be at its most open. We take seriously our responsibility to be a positive influence on the companies in which we invest, expecting high standards of corporate governance and social and environmental responsibility from executives, which we believe are in the best long term interests of shareholders.

While corporate governance has been well codified in the UK Corporate Governance Code published by the Financial Reporting Council (previously known as the Combined Code) and Amati's engagement with this is evident through being a Tier One signatory to the Stewardship Code (see Amati's "Response to the Stewardship Code" statement), matters of social and environmental responsibility are much more difficult to codify or reach a consensus over. Although the funds that we manage have no specific criteria in relation to these matters, we believe that our investment process should take into account the broader social and environmental impact of the companies in which we invest. Because the issues raised are highly complex, and judgments formed are mostly subjective and involve taking an overall view on the balance of many different factors, we do not believe that a formulaic or box-ticking approach produces worthwhile conclusions, and hence we are reluctant to make any strong claims about our ability to form such judgments. However, we deal with such considerations with the utmost seriousness, and seek to engage in dialogue with our clients about issues raised by the stocks in which we invest.

One of the aspects of investing in UK small companies that we value the most is that the work is very much done face to face. The lines of communication between end investor and underlying investee company are somehow shorter and simpler than with almost any other investment product. This goes against the current of ever increasing financialisation across the investment landscape, which works to remove underlying investors from any understanding of the impact that their investments make. Nearly all of our underlying clients will experience some of the companies in which we invest directly as customers, and many others indirectly, and so can participate in forming views as to their societal impact.

We seek in this document to provide investors with an insight into the broad principles we work with.

Corporate Governance

Amati is supportive of the principles and procedures laid out in the UK Corporate Governance Code ("the Code"), and it is not the purpose of this document to recapitulate these. The Code is drawn up with FTSE 350 companies primarily in mind, and in certain points, such as the annual re-election of directors, specifically excludes its requirements from smaller companies. Strong corporate governance is often a greater challenge for smaller companies, partly because it represents proportionately a greater cost, and partly because there tends to be a greater overlap between management and ownership of companies, which can accentuate one of the abiding problems that corporate governance structure needs to address, namely the potential conflicts of interest between management and shareholders.

Moreover, at Amati we are active investors in AIM, which operates looser reporting requirements than those which apply to premium listed companies on the main market. AIM is in part a success because it recognises that small companies don't require the same governance and reporting procedures as much larger ones. But this can in some cases breed a poor attitude towards corporate governance in which shareholders interests can be ignored. As investors, the main focus of our concern with corporate governance is to ensure that directors remain attuned to creating value for shareholders, and that their interests are aligned with those of shareholders. We also take part in regular discussions over governance issues with other small cap investors, and parties interested in the AIM market, such as the Quoted Companies Alliance and members of ShareSoc.

We recognise that there are many cases where small quoted companies have to compete for management talent with private equity backed companies, and that in some circumstances remuneration needs to reflect this. However, we are critical of incentive schemes that rely heavily on share options, because the interests of option holders will always differ from those of shareholders. It is also the case that the structures used in private equity are such that equity type rewards for managers only emerge after the bulk of the capital invested has achieved a high level of return. This is rarely mirrored in option schemes for the management of quoted companies. Unfortunately the tax regime in the UK gives very favourable treatment to approved option schemes, so we recognise that their use will remain pervasive, but we don't see this as the best form of incentivisation, and believe that directors and analysts are far too willing to add back the share based payments charge (which is almost always related to the grant of options) to earnings figures. We would always prefer an incentivisation mechanism which has rigorous performance criteria, giving priority to a base level of equity return to investors, takes into account total returns (i.e. includes dividend payments made, unlike option schemes), and which results in the management owning shares rather than derivative instruments. We do not support awarding share options to non-executive directors.

We believe it is important for directors to be shareholders in the companies that they manage, and prefer situations where management own 10-20% of the equity. Beyond 20% issues emerge over management having too much control, issues which are hugely increased where an individual on the board, or a set of related individuals control more than 50%. Shareholders in this situation need to recognise that the dynamics of corporate governance are then completely different, relying in large measure on the willingness of the controlling party to safeguard the interests of minority shareholders.

Issues concerning Social and Environmental Impact

It is normally in the long term interests of investors to pay careful consideration to the social and environmental impact of the companies in which they invest, but it is often not in their short term interests, as short-cuts may give much more rapid results in the short term. This sets up a complex dynamic for fund managers. At what point should matters of principle over-rule the possibility of short term advantage? How should those points of principle be defined?

In our view this is not just a question for funds which set out to label themselves as "ethical" or "sustainable" because they have defined a process which they believe can form desirable judgments about these questions. Rather we regard these questions as important to every investor. The fact that we don't chose to label our funds in this way reflects our belief that the issues are too complex, and too much a matter requiring personal judgment to be usefully wrapped up into a pre-defined process.

Being active investors in AIM creates an added dimension of difficulty in this regard, because the universe of stocks on AIM includes companies operating in almost every region of the world, under widely differing legal jurisdictions, with management teams from the widest possible range of cultural backgrounds. The most international sector on AIM, namely natural resources, has also become by far the largest, and illustrates the issues more sharply than any other. Clearly the mining and oil and gas industries often have a huge impact on the countries in which they operate. The problem, particularly acute in Africa, known as 'the curse of oil', where countries with massive oil wealth remain blighted by poverty and are ruined by war, highlights how much is at stake from the behaviour of such companies. Whilst bank lending to mining projects in emerging economies is now often being shaped by practices developed by the IFC, and encapsulated in the Equator Principles, a voluntary code of conduct which is being increasingly adopted by international banks, such issues are generally less well considered by equity investors, reflecting in part the fact that much less information is generally made available to them. We have a strong preference for mining companies which have secured project financing from banks which have adopted the Equator Principles, because this is the best benchmark we have for good practice.

However, over more recent years, as a result of Prof. Leif Wenar's work, we have realised that this doesn't go far enough, and that the "curse of oil" phenomenon is far more destructive and self-perpetuating than we realised (see Leif Wenar, *Blood Oil: Tyrants, Violence and the Rules that Run the World*, 2016). As a result we have been working with Prof Wenar to establish an approach to investing in natural resources companies where we have established criteria for avoiding investing in resource cursed countries where such investment is likely just to prolong the agony of an oppressive regime, and where the offsetting positive impacts cannot reasonably be expected to mitigate this.

As a matter of outlook, we are supportive of international investment in emerging economies, believing that this is the most powerful mechanism for creating more widespread prosperity and opportunity. However, experience has also taught us to be very wary. In the UK we are used to the fair application of the law, to high standards of corporate governance, to consumer protections, and to complex and sophisticated regulation. It is a huge cultural mistake to expect to find these in equal measure in every other part of the world. We take strong views on specific regimes and legal systems around the world, and this influences our propensity to invest. These views are not fixed, but respond to the ways countries develop. Where we invest in companies operating overseas, we prefer to invest in companies with UK management teams.

The issue of corruption is one of the hardest which UK investors have to consider in relation to companies operating in emerging economies. Corruption is relatively absent in the UK, and since the introduction of the Bribery Act in 2010, UK companies have operated under one of the strictest regimes in the world. But corruption, and its subtler form, clientelism, remains pervasive in many countries, and as a result we tend to underestimate it. We are generally suspicious of companies which gain prize assets too easily, or sail through a permitting process too fast. Despite the obvious frustrations which can result, we are committed as investors to backing companies which have strong anti-corruption policies, but add the warning that our knowledge will only ever be partial in this regard.

The issue of modern day slavery has risen to prominence over recent years. For UK companies this issue mostly arises as one buried within supply chains. There is a link here to the resources curse, as the regions of the world which tend to propagate modern day slavery are generally those worst impacted by the resources curse. We seek to ask searching questions of our investee companies where they have obvious supply chains in developing economies, but acknowledge that we have more work to do on this topic.

In terms of sector considerations, there are no sectors in which we are not willing to invest. There was at one stage a view held by ‘ethical’ funds that the defence, tobacco and alcohol sectors should be avoided. We have always viewed this kind of approach as facile. Most quoted defence companies play a crucial part in supplying equipment to our armed services. To adopt a policy of refusing to invest in them is to take the view that either we shouldn’t have a defence force, or that if we do, it should not be well equipped. We subscribe to neither view. However, were we to invest in a defence business, we would want to be satisfied that they were not also in the business of arming oppressive governments. The tobacco and alcohol industries likewise present complex questions. We feel it is for governments to regulate the use of and sale of these products, from which they derive substantial revenues, and we don’t wish to adopt a stance which suggests that they should be outlawed. However, for tobacco companies (which are all too big for us to consider anyway) there are serious questions to answer in relation to the use of their financial strength to stop governments in developing economies from adequately informing their populations about the health risks or constraining their marketing messages, and for this reason we would be unlikely to want to invest in them. For alcoholic drinks companies the questions are more about whether they encourage the irresponsible use of their products. In relation to the gambling industry we see a fine line to be drawn between offering a leisure service, designed to enhance the enjoyment of a sporting event for example, and seeking to exploit addictive behaviour amongst vulnerable groups. We would seek to avoid investing in the latter type of business.

Concerning climate change, we have been active investors in renewable energy technologies and projects, and see this as an area which will continue to grow in the future.

Amati Global Investors charitable donations policy

Amati has a transparent formula for the split of profits that will be distributed as bonus to staff and profits for the benefit of Amati’s shareholders, either as dividend distributions or retention for investment in the business. The general principle is that there is an equitable balance in any financial year between rewarding staff for their efforts, providing income to partners, and retaining sufficient profits in the business for investment.

Where it is decided that an element of profit payable to shareholders should be distributed by way of a dividend, Amati provides that 10% of these profits are paid to a United Kingdom registered charity. The choice of charity rests with each shareholder with payments made pro rata to their ownership of the business. As a result Amati has supported a wide variety of charities over the years since its inception in 2010.