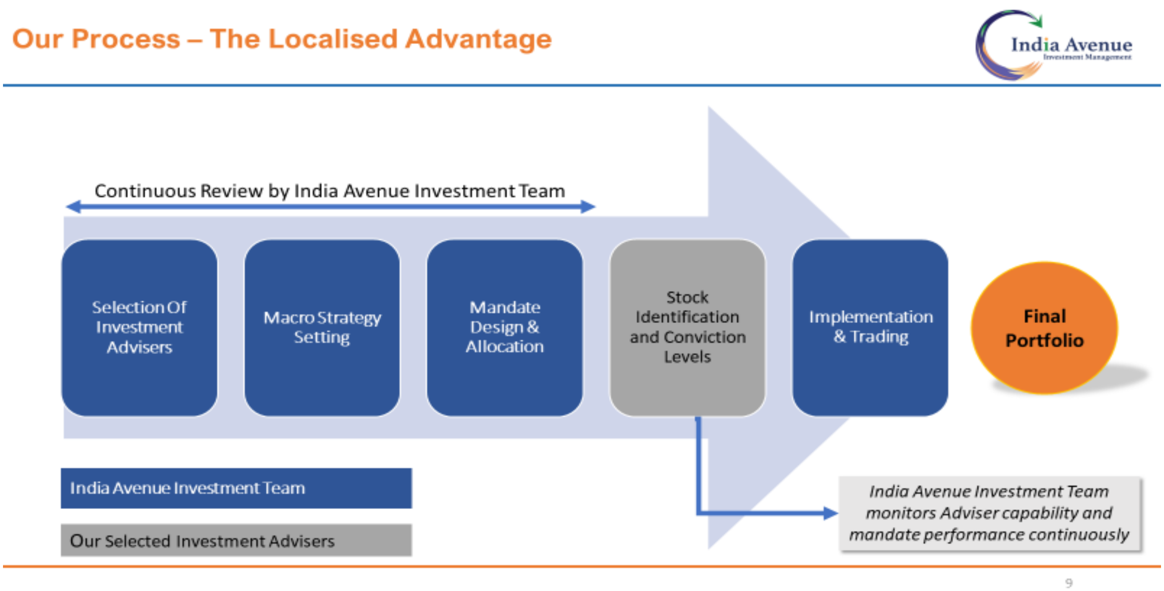
India Avenue's ESG Philosophy

India Avenue's philosophy towards investing

India Avenue Investment Management (IAIM) was founded in 2015 and domiciled in Sydney, Australia to provide investors in Australia and New Zealand the opportunity to benefit from India's strong growth by investing in its capital markets. The first and only investment vehicle to this day is the India Avenue Equity Fund, which invests in 40-60 listed companies domiciled in India. The philosophy of the firm as expressed through this fund is articulated below:

1. India is likely to remain a high economic growth region for the next few decades given its fundamentals are driven by a significant and youthful population and a low GDP-per-capita that is expected to rise given population growth is just over 1%. This will lead to the need for consumption, financial services, technology, and infrastructure.
2. Investing in India should be undertaken with an active investing mindset given the nature of its equity market. Several companies are compounding earnings at a significant pace with their market value being underestimated in a global context. Additionally, several of India's mid and small cap companies are under-researched by broking analysts, who tend to focus on large and liquid companies.
3. To invest successfully in a region like India, it requires local partnerships with fund managers who have successful investment track records and possess a strong understanding of the local ecosystem for each business (suppliers, consumers, distribution agents, competitors etc.). Additionally, corporate governance is a key factor in decision making and this is best understood qualitatively by locally based investors, via their due diligence process.

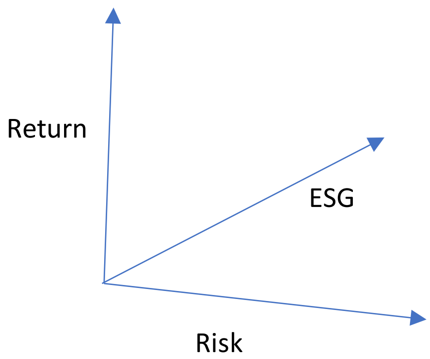
Given the philosophy outlined above our investment process can be illustrated in the following way:



Almost all aspects of the investment process are driven by IAIM. The only aspect outsourced is stock identification and conviction levels. This is governed by an investment mandate given to each of our investment advisers to provide advisory services to IAIM.

The Introduction of ESG

Investors have always been interested in economic return when investing in businesses and this will always in our opinion remain their number one priority. However, increasingly investors are seeking to benefit economically from investing in companies, which take their **E**nvironment (climate change, sustainability), **S**ocial ecosystem (diversity, human rights, consumer protection, animal welfare), and corporate **G**overnance (management structure, employee relations, executive and employee compensation) seriously. Ideally, investors seek economic returns (via understanding the risk and return trade-off), but also screen and invest in companies improving on their E, S and G factors.



IAIM started its ESG journey in 2017 by eliminating investments firms with material operations in industries which are commonly and globally accepted as not ideal for the environment or socially. This includes the following industries:

- The manufacture of cluster munitions
- The manufacture or testing of nuclear explosive devices
- The manufacture of anti-personnel mines
- The manufacture of tobacco
- The processing of whale meat
- Recreational cannabis; and
- The manufacture of civilian, automatic and semi-automatic firearms, magazines or parts

Given our process of outsourcing the selection of companies to locally based investment advisers, our method of elimination of investments in companies operating materially in these industries would be via the investment mandates we have in place. However, we acknowledge that in India, screening for ESG factors is still in its nascency and is generally not practiced in a "positive"[1] way. The points made below will illustrate our thinking on this matter:

- Analysts of traditional buy-side firms are unlikely to incorporate questions on ESG factors into their due diligence of a company
- There are only a handful of funds practising ESG screening in India and we suspect some are riding momentum, marketing and "Green washing"[2]. Most are excluding companies via negative screening rather than seeking companies, which screen positively for ESG.
- Company data on ESG factors tend to lack transparency beyond the largest 100 companies

[1] Positive screenings refers to a process where you seek to invest in companies improving from better practices in ESG, rather than negative screening where you seek to eliminate companies who are involved in business which is detrimental to ESG factors.

[2] The term greenwashing is generally used when an organization spends more time and money on advertising that they are "green" or environmentally friendly than on putting into place practices that are environmentally friendly.

- Shareholder activism on ESG factors is extremely nascent. Also given the significant equity ownership by promoters, it is difficult to be activist unless in a positive manner with smaller companies seeking to improve their valuation by a focus on ESG factors.

Our Aim

Given our process of outsourcing stock selection we seek to implement ESG awareness in our own unique way:

1. We seek to migrate the India Avenue Equity Fund towards a greater focus on ESG factors by paying attention to issues more specific and important in India, rather than simply applying a negative screen on generic globally recognised "harmful" industries.
2. We seek to achieve this by embedding additional screening aspects into our investment mandates with our advisers
3. We adopt a "Red-Orange-Green" categorisation process whereby industries listed as Red are screened out for investment. Conglomerate companies with more than 20% of their revenue generated from this Industry are also screened out
4. Orange categorised industries are currently acceptable for investment but need to be monitored for developments, attitudes and practices. We monitor Orange industries through our network (underlying advisers, other advisers, broker relationships and the Refinitiv quantitative tool).
5. Companies with Orange or Green industries can be excluded if they contravene acceptable practices in an E, S and G context.
6. We expect factors pertaining to G to be screened by our investment advisers, given they are in the best place to make a qualitative analysis of the company. However, we cross-check this amongst our broader network.
7. We do not aim to select advisers purely who are managing ESG focused funds as we feel this is still in a nascent stage of development in India.

ESG in practice today

What is ESG?

ESG stands for Environmental, Social and Governance factors used to measure the ethical impact and sustainability of investment in a company. When an investment process is ESG aware it focuses on investing in companies that are either making a positive impact in the areas of E, S and G and/or screens out companies, which may have a harmful impact on E, S and G factors.

ESG investing grew out of investment philosophies such as Socially Responsible Investing (SRI). SRI typically uses value judgements and negative screening to decide which companies to invest in. ESG investing is often termed as sustainable investing or mission-related investing[3].

Global acceptance of ESG investing

ESG is considered the next growth frontier for the asset management industry. The focus for managing non-financial operating risk is growing amongst institutional investors. ESG investing grew

[3] www.cfainstitute.org/en/research/esg-investing

to more than US$30tn and is estimated to surpass US$50tn in the next two decades. It is most popular in Europe, with Australia and the US showing strong momentum. In 2019, funds based on ESG themes attracted four times the money it attracted in 2018[4]. As investments, which are aware of ESG issues, increase, companies improving their ESG ranking can be expected to carry a valuation premium and create a positive feedback effect. ESG investing is expected to witness a similar revolution as experienced by ETF/passive investing in the last decade[5].

What are the key issues, which apply globally?

Globally the key issues for asset managers are dependent upon the horizon. While long-term issues do not change often, short-term issues tend to focus on the near term. For example, in 2019, issues confronting asset managers were climate change, regaining trust in the banking sector, access to medicine, modern slavery etc. Short-term issues are often a subset of a longer-term thematic at play. According to German financial services firm Allianz, five ESG trends to watch in 2020 are climate change, water management, biodiversity, supply chain exploitation and governance issues[6].

Integrating ESG

ESG screening is a tool that allows investment managers to build a portfolio that is consistent with their principles. The strategies used to implement ESG investing have changed based on asset manager's philosophies, increasing industry acceptance and awareness over time. Some common methods used either in isolation/combination by fund managers around the globe are[7]:

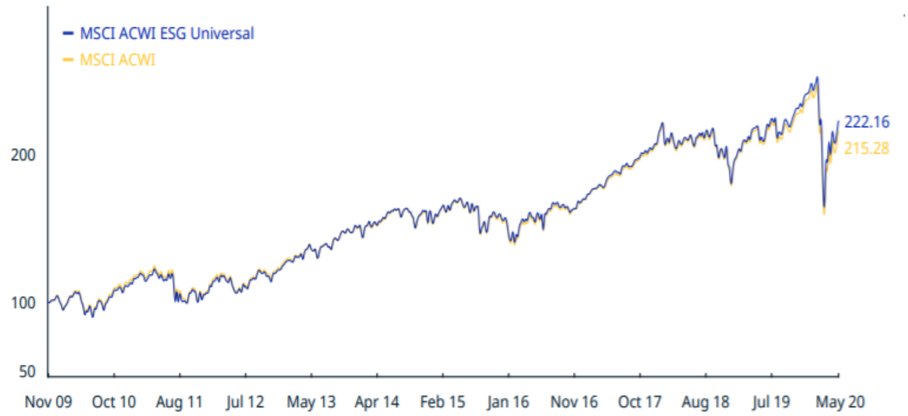
Method	Implementation	Est. US$tn[8]
Negative/exclusionary screening	Eliminating the companies in industries or countries deemed to operate in objectionable business	15
Norms-based screening	Eliminating companies, violating some set of norms set out by globally recognised organisations e.g. Ten Principles of the UN Global Compact etc.	6
Positive/best-in-class screening	Selecting companies with strong ESG performance	2
Sustainability-themed investing	Selecting companies based on sustainability-related theme e.g. clean water or renewable energy etc.	0.5
ESG integration	Including ESG factors while analysing the fundamentals of a company	11
Active ownership	High level of engagement between the portfolio companies	9
Impact investing	Selecting companies that make a positive impact on an ESG issue while still generating alpha	0.5

Validation thus far

A research carried out over a period of 10 years between May 2007 and November 2017 found that high ESG rated companies were more profitable, paid higher dividends and commanded slightly higher valuation multiples. In addition, high ESG rated companies are found to be exposed to low

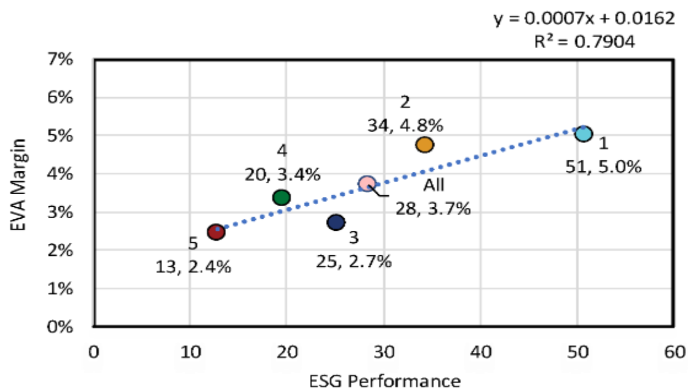
[4] cnbc.com/2020/01/14/esg-funds-see-record-inflows-in-2019.html
[5] etfstream.com/features/moody-s-esg-is-next-growth-frontier-for-asset-managers/
[6] agcs.allianz.com/news-and-insights/expert-risk-articles/grd-esg-trends.html
[7] hbr.org/2019/05/the-investor-revolution
[8] Edelweiss, Seeking Growth the ESG Way, GSIR 2016

systematic risk i.e. risk affecting the broader equity market[9]. Another research carried out from 2015-19 on the MSCI World Index and MSCI Emerging Markets (MSCI EM) Index proves that companies with high ESG score have lower cost of capital as compared to companies with a lower ESG score. This differential is even higher in the MSCI EM Index[10]. The findings of both the researches corroborates with the Capital Asset Pricing Model (CAPM), where lower systematic risk implies lower cost of capital.



However, the evidence is not purely from an investment return front. A report by McKinsey[11]highlights that a strong ESG proposition has been linked to value creation for shareholders in five essential ways – facilitating top-line growth, reduction in costs, reduction in regulatory and legal interventions, increased productivity and more efficient capital allocation practices.

Additionally, a report by Harvard Business[12] school highlights higher ESG performance firms generate higher returns with lower risk. They also tend to have higher valuations afforded to them as a result and are generally good allocators of capital. Typically, these firms tend to be less cyclical in nature and are more than likely in the Technology, Healthcare and Consumer sectors.



Higher ESG performance appears to relate to a higher EVA margin
The data is as at 31/12/2018
EVA Margin = [(ROIC – Cost of Capital) x Invested Capital] / Sales
The five points reflect the five quintiles of performance

Source: Harvard Business Review

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[9] Weighing the Evidence: ESG and Equity Returns, Guido Giese and Linda-Eling Lee, https://www.msci.com/documents/10199/9aec76d8-376f-91ef-a575-b2b0ea65061a
[10] https://www.msci.com/www/blog-posts/esg-and-the-cost-of-capital/01726513589
[11] mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/five-ways-that-esg-creates-value

[12] https://corpgov.law.harvard.edu/2020/01/14/esg-matters/

Applying ESG in India

India's still a nascent market for ESG awareness

Compared to the rest of the world, ESG investing is relatively nascent in India. Only a handful of India ESG funds exist at this stage. However, several asset management firms have now filed draft offer documents and are awaiting approval from the Securities Exchange Board of India (SEBI).

India lags the developed world on ESG parameters, specifically on environment and governance. The Government of India is working relentlessly to catch up with global standards. The Government Think Tank (Niti Aayog) formulated a Sustainable Development Framework, underpinned by the United Nation's 17 SDGs that are becoming the benchmark for many corporates.

In April 2014, company law was amended to make it mandatory for large companies in India to spend 2% of its average net profit over the last three years on Corporate Social Responsibility (CSR). As ESG investing is picking up steam in India, more companies are voluntarily disclosing the information related to ESG parameters. We expect that this will put peer pressure on companies, making them focus on improving ESG outcomes and therefore valuation.

What are the specific issues in India, which we need to pay additional attention to?

IAIM acknowledges that's global awareness of ESG is increasing with rapid pace, with significant investment dollars being directed towards generating investment returns with additional ESG awareness. However, issues more specific to India need to be considered compared to generic global issues. **We believe that improving our awareness of ESG factors in India will lead to investing a greater proportion of capital in businesses that add value to shareholders over time.** This has been the observance globally and we expect it should be even more telling in India, given the substantial slippage that may be occurring.

We aim to do this by identifying industries, which are controversial in India and in our view contravene "best practices" in India, without much effort to change. In our view India has an opportunity to bolster its economic growth further by increasing environment friendly practices, diversifying and skilling its workforce, reducing corruption and modern slavery.

- **Climate change** - 14 of the 20 most polluted cities in the world are in India. According to the UN, in 2018 alone, the economic impact of climate change in India was US$37bn.
- **Diversity** – According to a report by McKinsey Global Institute in 2018, India could add more than 18% to its GDP by providing equal opportunities to women[13].
- **Corruption** - According to the World Economic Forum (WEF), the least corrupt government collects 4% of GDP more in tax revenues compared to countries with high corruption[14]. India ranks 80th in the world (out of 180) according to Transparency International's corruption index and thus has a lot of room to improve[15].

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[13] weforum.org/agenda/2018/07/india-could-boost-its-gdp-by-770-billion-by-just-treating-women-better
[14] weforum.org/agenda/2019/04/tackling-corruption-in-government/
[15] https://www.transparency.org/en/countries/india

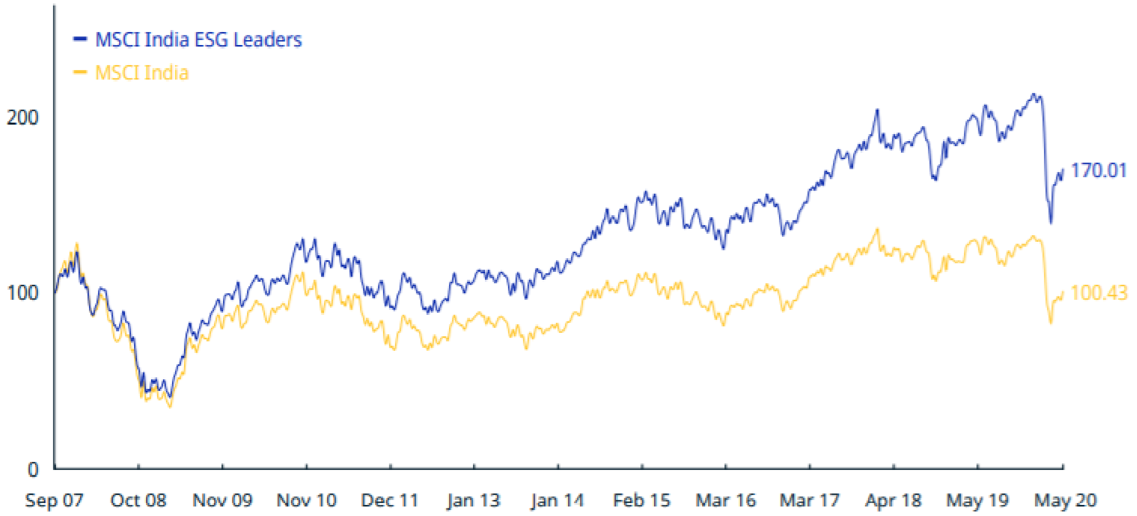
- **Humanity** – The Global Slavery Index 2018 estimates that more than 8 million people lived in modern slavery in India[16].

Existing practices in India

As we highlighted earlier, ESG has emerged as a theme in the last 3 years in India. There are several funds now being launched with ESG awareness. Most funds currently use negative screening or norms-based investing. However, other approaches are now being introduced[17]. Avendus, SBI, Axis and ECube have launched ESG funds in the last 3 years.

Fund	ESG Method	AUM (15-07-20)
Avendus India ESG Fund	ESG Integration	$1,000 M
SBI Magnum Equity ESG Fund	Negative screening and Positive screening	$478 M
Axis ESG Equity Fund	Negative screening and Positive screening	$322 M
Quantum India ESG Equity Fund	Active ownership	$3 M
Unifi Green Fund	Sector specific and Positive Screening	$48m

Validation in India (MSCI India vs MSCI India ESG)



MSCI ESG Leaders Index has outperformed MSCI India Index by 370 basis points annually over the last decade. As compared to the Global comparisons, the wider outperformance by the ESG index can be attributed to predominantly to environmental and governance factors, which may create a divergence in value in a country, like India.

[16] timesofindia.indiatimes.com/india/8-million-people-live-in-modern-slavery-in-india-says-report-govt-junks-claim/articleshow/65060986.cms
[17] ECube Investment Advisors have recently introduced an activist approach to ESG investing. It is India's first truly positive screening approach.

Issue Name	Average Portfolio Weight	Average Benchmark Weight	Average Weight Difference	Portfolio Return	Benchmark Return	Return Difference
			(30/11/2007 – 30/05/2020)			
MSCI India ESG Leaders Index	**100.00%**	**100.00%**	**0.00%**	**216.59**	**69.18**	**147.41**
Energy	19.50%	13.95%	5.55%	147.60	72.34	75.26
Materials	2.90%	8.47%	-5.57%	445.69	1.05	444.64
Industrials	0.98%	6.37%	-5.39%	8.25	-31.34	39.60
Consumer Discretionary	9.09%	7.71%	1.38%	196.44	156.38	40.06
Consumer Staples	7.66%	9.09%	-1.43%	1,040.49	563.17	477.32
Health Care	5.60%	6.21%	-0.61%	314.88	256.76	58.12
Financials	21.28%	24.00%	-2.72%	88.75	36.99	51.76
Information Technology	30.52%	17.29%	13.23%	466.21	354.08	112.13
Communication Services	1.49%	2.59%	-1.10%	38.54	-88.97	127.51
Utilities	0.97%	3.82%	-2.84%	-78.26	-33.89	-44.37
Real Estate		0.01%	-0.01%		-31.18	31.18
Cash & Equivalents		0.00%	0.00%		9.36	-9.36
Other		0.49%	-0.49%		206.73	-206.73

Challenges

We have highlighted research which point to more highly rated ESG companies having a positive impact on performance on risk-adjusted basis. We do understand that there are some challenges with the empirical data. These challenges are listed below:

1. **Data Integrity**

   Different ESG data providers have different ways of classifying data depending what they think is more important. This can lead to conflicting results between two different data providers.

   ESG data providers rely heavily on data that is voluntarily disclosed by the companies. There is no regulatory requirement to audit this data. This can lead to inaccurate ESG results. Until there are government regulations that mandate ESG data to be audited, data integrity may remain challenging.

2. **Limited Investment Universe**

   In India, there was little to no regulation for companies to disclose ESG information. It is predominantly the largest 100-150 companies by market cap which attempt to provide ESG data. However, this is about to change as SEBI has recently mandated for top 1,000 listed companies to prepare a Business Responsibility Report (BRR) starting in 2020[18].

3. **Idiosyncratic Factors**

   An analysis of MSCI India ESG Leaders Index by IAIM has revealed that one of the reasons for outperformance has been due to the ESG Index having significant weighting towards Information Technology and individual stocks such as Reliance Industries (as of July 31st 2020 has a weight of 23.42%). Idiosyncratic effects can distort the cause and effect when analysing data.

Implementation within the India Avenue Equity Fund

We seek to identify sectors which we seek to exclude based on the environment and social related issues with relevance in India. We have identified this in the matrix below and classify them according to the impact they make.

For example, we classify Tobacco, Alcohol and Gambling as problem issues in India given the low GDP per capita and the social issues that come with these activities. India's smoking rate is over 11% which is close enough to that of Australia's 15% and US 17%[19] despite having a far lower GDP-per-capita. This may imply that businesses involved in production of cigarettes are taking advantage of India's significant population and lesser education around the harm caused by tobacco (particularly amongst the poor). Similar linkages can be drawn to alcohol and gambling.

We have also excluded sectors such as Paper, Coal, Nuclear and Defence industries. As mentioned earlier, pollution is a significant issue in India and has an impact on the life expectancy of its citizens. The balance that needs to be struck here is that India's significant population still requires energy to power its economy. Whilst solar, wind and clean forms of energy are being developed, they remain relatively expensive relative to fossil fuels like oil and coal. Coal is the most significant polluter, so we exclude it, however we have placed other fossil fuels on review (orange sector) rather than exclude as needs must be met somehow.

Whilst Nuclear and Defence are not related to what we mention above, they bring humanity related issues into the picture. It is our view that they are avoidable given the consequences they bring. Whilst every country must have some funding associated to defence, it is our view that it should not be on the primary agenda for India given the level of poverty in the country.

[18] https://www.thehindubusinessline.com/opinion/columns/slate/all-you-wanted-to-know-about-esg-funds/article30965272.ece
[19] World Health Organisation (2016)

Matrix for exclusions and the issues listed above:

	Climate Change	Pollution & Waste	Humanity	Social issues
Paper	✓			
Tobacco				✓
Alcohol				✓
Gambling				✓
Coal	✓	✓		
Nuclear		✓	✓	
Defence			✓	

Additionally, we list the following sectors as orange – to be monitored for development

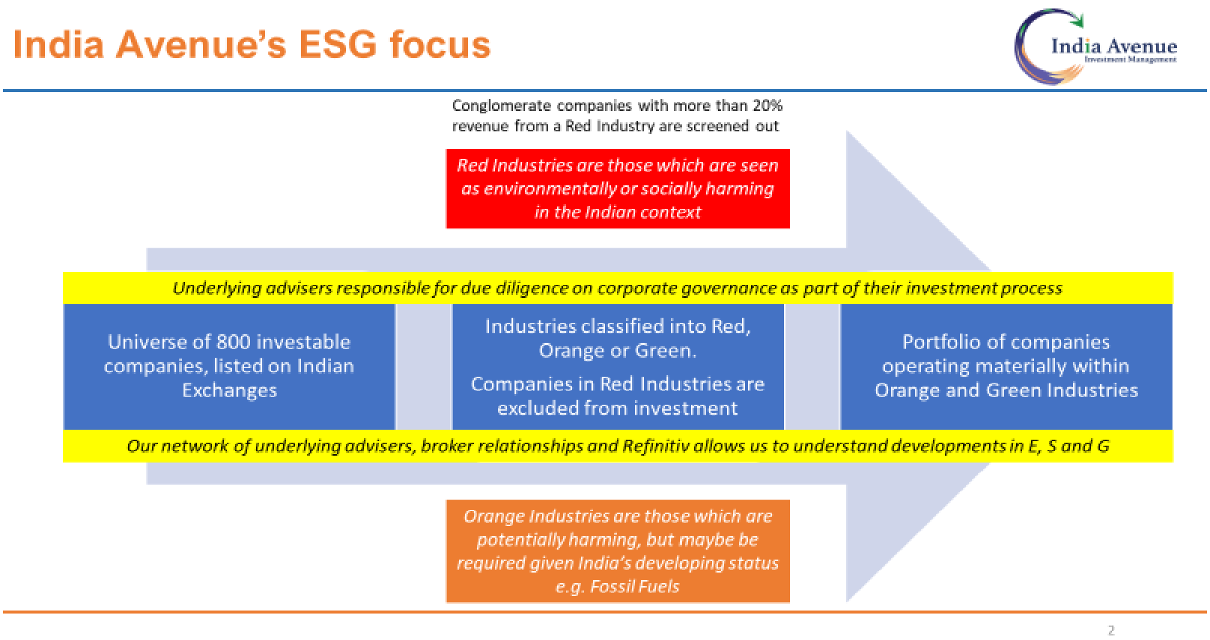
- Automobiles and Ancillaries
- Basic Resources
- Chemicals
- Construction and Materials
- Consumer Products and Services
- Energy
- Food and Beverage
- Industrial Goods
- Insurance
- Media
- Personal Care, Drugs and Groceries
- Real Estate
- Retail
- Telecommunications
- Travel and Leisure
- Utilities

How do we seek to implement an ESG philosophy into our portfolio?

Existing: Negative screening of companies within industries listed as likely to do harm environmentally and socially on a global basis. These include tobacco, nuclear weapons manufacture, cluster ammunition, fossil fuels.

Additionally, investment adviser mandates highlight the need for advisers to exclude companies which commonly breach E, S and G factors as part of their due diligence process.

Proposed:



A. Negative screening of companies within industries listed as likely to do harm with a specific focus on India's key problem areas, whilst being cognisant of global sustainable goals. These "Red" sectors are screened out. Conglomerate companies with revenue from a "Red" Industry will be screened from a materiality perspective.
B. Sectors which are classified Orange are those which need to be monitored closely for developments. Green classified sectors are far less likely to contravene on the E & S front.
C. Investment adviser mandates continue to highlight the need for advisers to exclude companies which commonly and knowingly breach E, S and G factors as part of their due diligence process. Our due diligence process when seeking investment adviser partners in India will also incorporate the advisers' philosophy on ESG awareness.
D. On a quarterly basis, we submit to our advisers a list of screened out sectors (classified as red) and companies (orange or green sectors, but contravening best practices)
E. IAIM monitors and reviews its portfolio on a quarterly basis by using its network as a qualitative overlay (our network includes incumbent and other investment advisers, broker community and Refinitiv (Thomson-Reuters tool)).
F. Our goal is to continue to improve the ESG awareness and ESG score of our portfolio over time. Whilst we recognise the limitations of a quantitative approach, when data reporting is not consistent, it does provide us with a relative measure for monitoring improvement.

Concluding remarks

It is our aim to continue to increase our awareness of ESG in our portfolio. We accept that in a multi-adviser framework (the India Avenue process) we cannot control the stock selection decision, except by way of exclusion. We also feel that India is too nascent in the ESG path to adopt a positively screened approach to selection of companies (given analyst capabilities and company reporting on ESG).

Therefore, we have chosen the path detailed in this report as the most appropriate one in building our capability and awareness towards an improving '***ESG rated***' portfolio. The most important development for our capability will be our own due diligence function (through our network of incumbent advisers, other advisers, brokers with ESG capabilities and company management and reporting). Apart from purely identifying "red" sectors for exclusion we also seek to exclude companies which continuously contravene with our view of the best ESG practices in India.