

WaveStone ESG Report

Quarter ending December 2022

ESG Sector Spotlight – ESG Metrics in Executive REM

Public pressure and changing expectations are driving greater adoption of ESG linked remuneration outcomes in executive pay. In this quarter’s ESG report we take a look at what ESG metrics have been included in the remuneration hurdles for the ASX200 in FY22 and how this has changed over the last year.

Sustainability has a positive impact on profitability and valuations. The actual and perceived positioning of a company on environment, social and governance outcomes has the potential to impact both the short- and long-term profitability, and thus valuation of a firm. At WaveStone, we strongly believe that responsibly managed companies are more likely to achieve Sustainable Competitive Advantage (SCA) and provide strong long-term growth. We approach ESG from both a risk and an opportunity perspective with a view that integration of ESG into our analysis can reduce overall portfolio risk and improve returns.

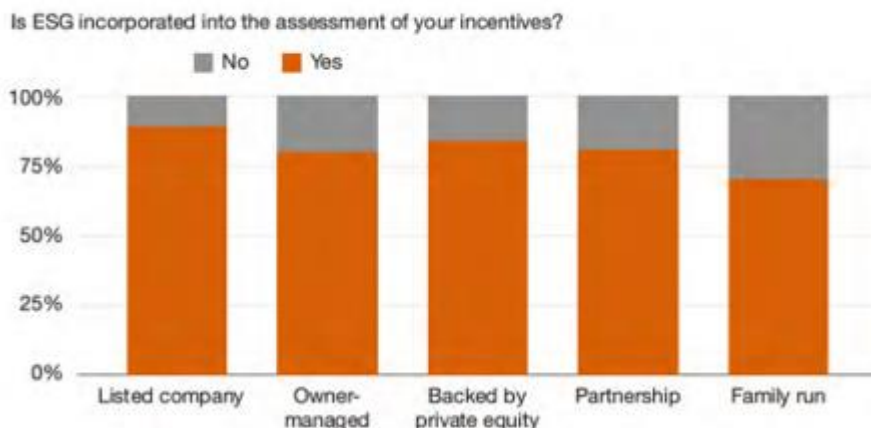
By improving our understanding of company ESG issues, with a focus on REM structure to ensure strategic alignment, we hope to achieve our aim of generating above average, long term sustainable returns.

The majority (80%) of ASX 200 companies now link REM to some form of ESG

We have examined the links to ESG outcomes within executive remuneration for the ASX 200. In FY22, 80% of the cohort included some form of ESG outcome within remuneration. This is up from 73% in FY21, signalling ESG is an increasing priority. A total of 13 companies introduced ESG measures into their management scorecards in FY22, including some of our portfolio names, CKF, DMP and FPH. The Macquarie ESG team performed a similar analysis, estimating 64% of companies within the ASX300 have now tied their variable remuneration to ESG.

This Australian data compares favourably to similar analysis performed offshore, with The Conference Board’s analysis determining 73% of the S&P 500 were tying executive compensation to some form of ESG performance in FY21 (up from 66% in 2020) (Linking Executive Compensation to ESG Performance (conference-board.org)). PWC did a similar study looking at remuneration practices amongst listed and unlisted companies globally. Their 2022 review (Paying-for-good-for-all.pdf (pwc.com)) found that 82% of senior leaders have ESG targets in their pay with listed companies the most likely to adopt ESG measures (89%). Given the level of public scrutiny on listed companies, it is not surprising the use of ESG metrics is highest in this cohort.

ESG is used in pay across company types, but especially listed companies



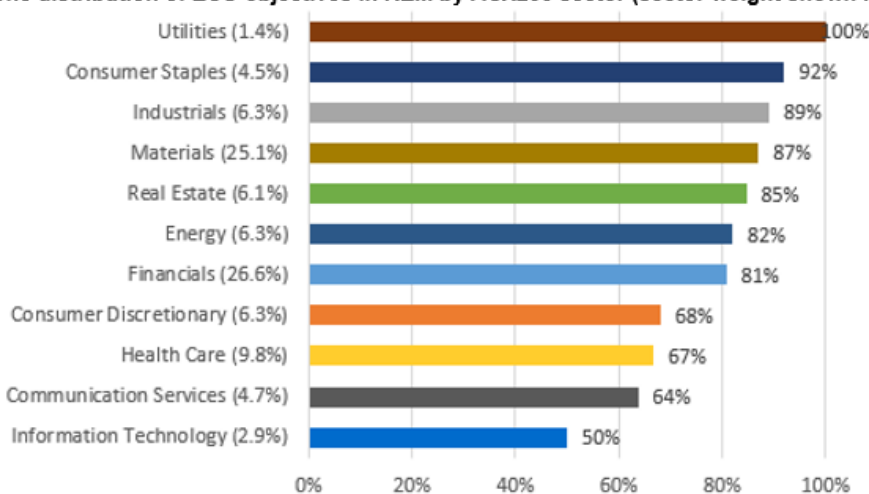
There are significant differences between sectors when it comes to the use of ESG in REM

While at least 50% of companies in each sector include some form of executive REM linkage to ESG performance, there are significant differences between sectors in the breadth of application. All companies (albeit only 3: ORG, AGL and APA) in the utilities sector, 87% of materials and 82% of energy companies have included ESG measures in REM, compared to only 50% and 64% of companies, respectively, in the IT and Consumer discretionary sectors.

When viewed along sector lines it is not surprising that industries with a larger carbon footprint or greater OH&S risk, are signalling ESG is a priority via the use of these metrics in compensation. We are confident that the increased scrutiny is driving this outcome.

Overall, we found companies were more likely to link compensation to human capital management goals (such as safety, people & culture) and less likely to use environmental goals. The use of environmental metrics was also biased toward heavier emitting and more disruptive industries, consistent with the use of ESG metrics overall.

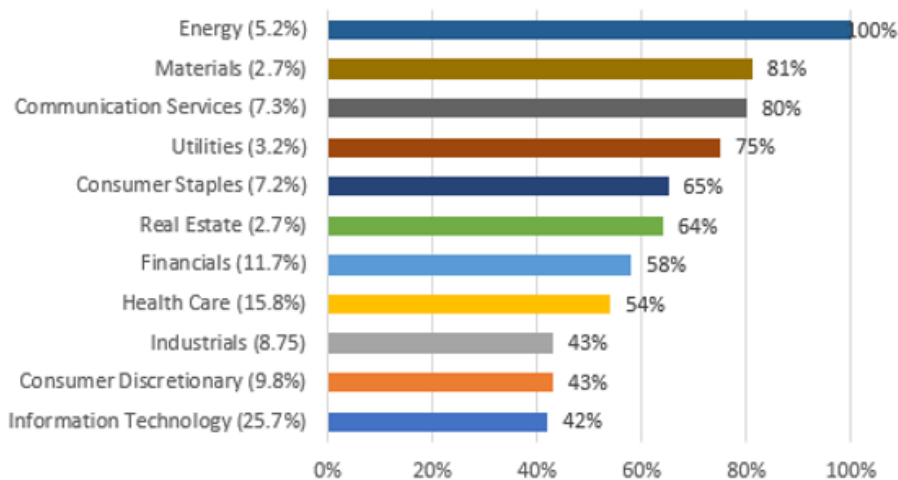
The distribution of ESG objectives in REM by ASX200 sector (sector weight shown in brackets)



Source: Company reports, FactSet.

A study undertaken by Glass Lewis on the US market showed a similar distribution in the use of ESG metrics by sector to what we found in Australia.

The distribution of ESG objectives in REM by S&P 500 sector (sector weight shown in brackets)



Source: [E&S Metric Usage in S&P 500 Executive Compensation: Glass Lewis Special Report - Glass Lewis](#).

ESG is predominantly included in short term incentive plans

Interestingly, although corporate ESG objectives are typically long term, the majority of ESG performance metrics were tied to short-term as opposed to long-term incentive measures. Of the 159 companies with an ESG metric, only 21 (13%) included an ESG hurdle in the long-term incentive plan.

13% of companies included ESG metrics in LTI

ESG in STI only = 138

ESG in STI & LTI = 18 LTI only = 3



159 Companies had ESG Metrics in their REM

Source: Company reports, [WaveStone](#) analysis.

While Environmental metrics feature strongly in LTI, Social metrics still dominate

Only Environmental = 4

Environmental & Social in LTI = 8

Social metric in LTI only = 9



21 Companies had ESG Metrics in their LTI

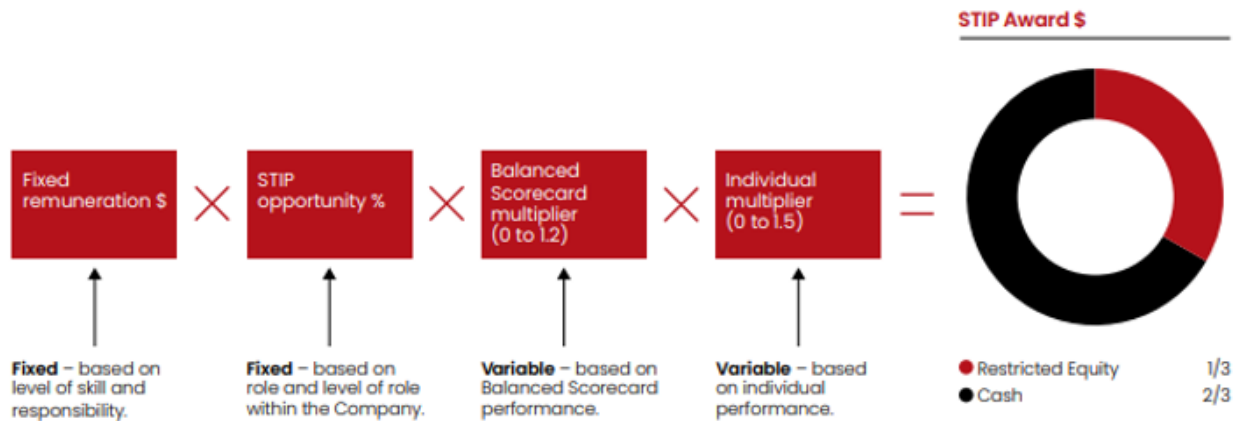
Source: Company reports, [WaveStone](#) analysis.

Lack of standardisation and the inclusion of ESG goals within broader culture and strategic REM buckets frustrated our analysis

The lack of standardisation made our attempt at comparative analysis difficult, with ESG metrics often included within broader social and governance categories. One particular problem we had was trying to establish the weight of an ESG metric within a broader strategic or non-financial bucket. For example, Cochlear's (COH) management STI is awarded based on both Financial (60%) and Strategic (40%) measures. While there are ESG metrics within the strategic allocation, there are also plenty of non-ESG metrics too. With no disclosure of the relative component weightings within the strategic category, it is difficult for us to accurately report the % weighting of REM to ESG. Allocating the entire 40% will undoubtedly overstate the representation and estimation of the proportion introduces the risk of bias - it could also be inaccurate. Another problem we encountered was determining how to weight policies with multipliers such as Treasury Wine (TWE) which has a Balanced Scorecard overlay to financial measures with outcomes ranging from 0 to 1.2x.

These nuances highlight the need for analysts to engage with corporates to gain a better understanding of remuneration policy. While our work recorded the full percentage allocation to each bucket of REM with an ESG metric, for the purposes of this report, we have looked at the measure more simply – “has the corporate included a metric for ESG outcomes, or not?”.

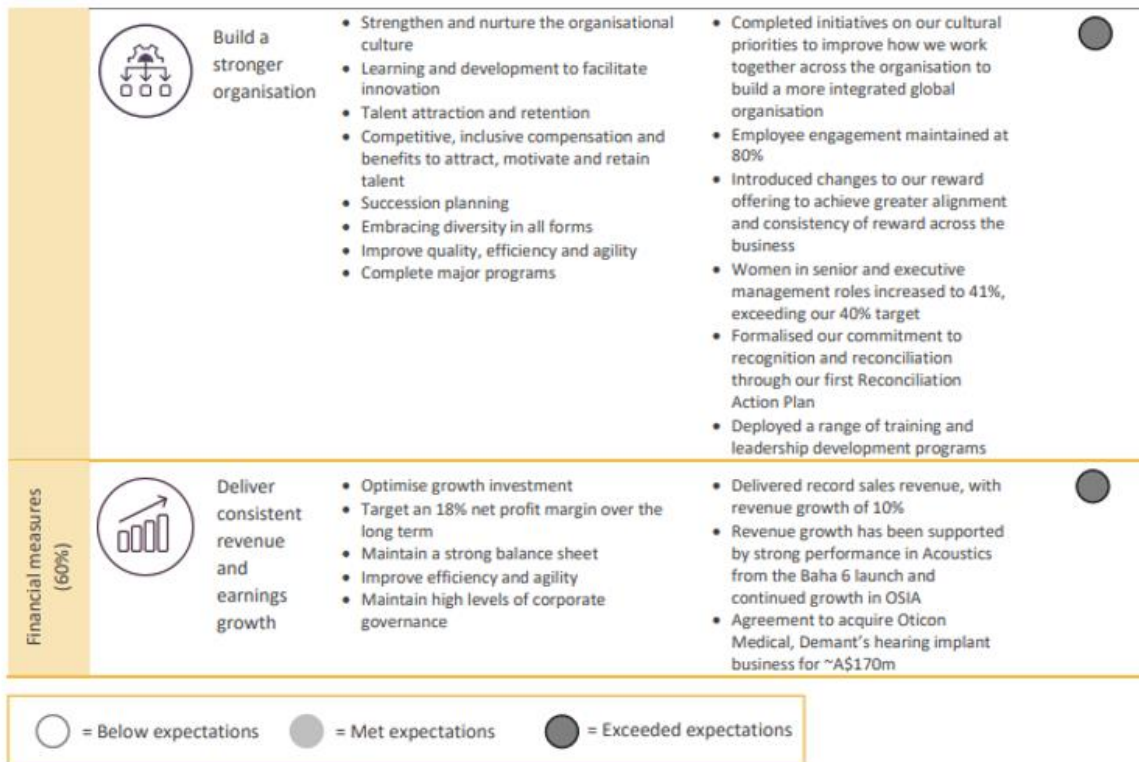
TWE FY22 Short Term Incentive Plan Structure



Source: TWE FY22 Annual Report.

Strategic measures for Cochlear's STI (40% of the award) include both ESG and non-ESG metrics

		Business priority	Commentary on performance	Achievement
Strategic measures (40%)	Retain market leadership	<ul style="list-style-type: none"> Maintain market leadership through growing levels of investment in R&D (targeted at 12% of sales revenue) Innovation focus on hearing implants, sound processing technology, connectivity and clinical and surgical support Introduce new products that provide improved hearing outcomes, functionality, connectivity and aesthetic benefits World-class customer experience Grow connectivity and engagement with recipients Introduce connected care solutions and skills training tools for recipients Introduce sound processor upgrades that provide functional and aesthetic benefits Develop technology solutions that provide greater convenience and confidence to professional customers 	<ul style="list-style-type: none"> Strong market position has been retained or improved in major markets through a very strong product and service portfolio and very good customer service Invested over \$200m in R&D, and achieved good progress in developing new products Achieved milestones on the commercial roll out of Connected Care solutions being the first company to offer app-based Remote Care solutions to both acoustic and cochlear implant recipients Cochlear Family membership grew by 20% to 260,000, with a 60% join rate for new Cochlear™ Nucleus® implant recipients 	●
	Grow the hearing implant market	<ul style="list-style-type: none"> Improve the awareness of cochlear and acoustic implants Broaden reimbursement and improve the indications for cochlear and acoustic implants Support the development of consistent practice guidelines to strengthen the referral pathway for adults Build on the clinical evidence that supports the superior outcomes of cochlear implants over hearing aids for people with severe or higher hearing loss Collaborate with research institutions studying the links between hearing loss and healthy ageing 	<ul style="list-style-type: none"> Direct-to-consumer leads and surgeries exceeded target, driving growth of the business Achieved milestones on referral programs and Standard of Care OSIA roll out on schedule 	●



Source: COH FY22 Annual Report.

91% of the 35 WaveStone portfolio companies within the ASX200 have ESG metrics in REM

The WaveStone portfolio holdings compare favourably to this data. 35 of our portfolio holdings sit within the ASX200, of these 32 (or 91%) have an ESG linkage in REM and 10 (or 29%) have ESG included in the LTI. Out of interest we also recorded the presence of ESG gateway provisions in REM. Typically these related to safety (such as fatalities) and risk and compliance outcomes (such as breaches) and were utilised by 27% of the ASX200 and 34% of our applicable portfolio holdings.

While there may be some size bias to the outcome it also reflects our process which looks to identify companies with greater Sustainable Competitive Advantage (SCA). An assessment of the alignment of governance structures to desired corporate outcomes is a component of this process, as weaknesses in these frameworks has often been a contributing factor to poor financial outcomes.

The table below shows a summary of some of the data we collected on ESG metrics in REM for our ASX200 portfolio names. There are a few observations we hope you can draw from this summary.

As we noted earlier, there is a clear preference toward the use of the STI for ESG objectives however it is not always clear what % of the award has been directly attributed to an ESG outcome. In order to differentiate the knowns from the unknowns, we created two separate categories of STI measures, those with a clear percentage attribution to the remuneration outcome and those where we struggled to identify a specific outcome weighting or which had been grouped more broadly with non-ESG related metrics.

While this highlights the progress that has been made, with the majority of companies applying ESG metrics that are clearly attributed, it also shines a light on where there may be weaknesses in remuneration frameworks.

This is the first time we have collated this data centrally. *While the data is a useful tool for benchmarking the portfolio, its primary purpose will be to guide some of our engagement activities in CY23 with the hope of achieving better outcomes.*

ESG Metrics included in REM for WaveStone portfolio holdings (within the ASX200)

ASX Code	Sector	LTI Measure	LTI Factor	Clarity	Clearly Weighted STI Measures	Clear STI Weight	Unclearly Weighted STI Measures	Unclear STI Weight
ALL	Consumer Discretionary	Customer, People, Responsible Gameplay	40%	Unclear			Individual (incl ESG)	30%
ANZ	Financials				People	30%	Customer	35%
ASX	Financials						Team & Culture	1%
BHP	Materials				HSE & Community (Inc Climate), People Social Value	50%		
CAR	Communication Services	Reputation	10%		People & Culture	10%		
CBA	Financials	Culture	25%		Customer, People & Leadership	20%	Strategy (incl Climate)	50%
CHC	Real Estate				People, Strategy & Customer (incl Decarbonisation)	40%		
CKF	Consumer Discretionary				Customer	15%	Esg Inc Emissions	15%
COH	Health Care						Strategic Measures	40%
CSL	Health Care				ESG, People & Culture	15%	Strategy (incl Safety & Sustainability)	10%
CWY	Industrials	Emissions	25%		People & Culture, Safety & Environment	35%		
DMP	Consumer Discretionary						Strategic (incl ESG - intro of SBT)	10%
EDV	Consumer Staples	Responsibility	20%		Safety & Customer	40%		
FPH	Health Care						Non Financial Component (incl some ESG)	20%
IAG	Financials				Culture / Leadership agility	8%	Risk (incl Sustainability)	10%
IGO	Materials	Decarbonisation	10%		Sustainability (incl Decarbonisation), People & Culture	40%		
JHX	Materials	Scorecard (incl Safety, Culture & ESG)	50%	Unclear				
LIC	Real Estate							
MQG	Financials						People, Conduct, Risk & Leadership	75%
NAB	Financials				Customer & People	30%		
NEC	Communication Services							
NST	Materials	ESG	30%		Safety, Environemnt & Culture	30%		
OZL	Materials				Emissions, Community & Employee	50%		
QAN	Industrials				Customer, Safety & Climate	40%		
RIO	Materials				Safety, ESG (incl Climate)	35%	Individual	15%
RMD	Health Care							
RWC	Industrials				ESG, Culture & Leadership	20%	Personal (incl ESG)	10%
STO	Energy				H&S, Environment, Culture, Emissions	25%		
SVW	Industrials				People & Safety & Emissions	20%	Strategic (incl Climate)	30%
TCL	Industrials				HSE, Customer & Delivery, Sustainability, Reputation & Leadership	45%		
TWE	Consumer Staples				Leadership, Inclusion, Equity, Diversity & Sustainability	50%		
WDS	Energy				Sustainability (Inc Emissions)	20%		
WES	Consumer Discretionary	Strategic (incl ESG)	20%	Unclear	Safety & Sustainability	20%		
WOW	Consumer Staples	Reputation	20%		Customer & Safety	40%		
XRO	Information Technology				Customer NPS & Employee Engagement	20%		

Source: Company FY22 Remuneration Reports.

ESG Metrics should be tailored, quantifiable, verifiable, transparent, and challenging

While there is a significant groundswell of support for ESG metrics to be incorporated into performance compensation at this stage there is no single set of metrics being recommended as best practice.

Conclusion

In our view, the inclusion of ESG metrics in REM should be nuanced, tailored to suit the positioning and desired strategic outcomes of the company in question. We believe best practice should be the provision of targets that are quantifiable, externally verifiable, transparent and sufficiently challenging so as to encourage a greater push for ESG integration as opposed to allowing a simple uplift in executive pay. Much like the design of more traditional financial REM measures, the ESG metrics applied should be tailored to align to desired stakeholder outcomes. At WaveStone, we strongly believe in Active Ownership and will use this analysis to continue to engage with our investee companies for better alignment in ESG goals and management remuneration outcomes.

Carbon Emission and Intensity Tracker:

WaveStone - Australian Share Fund (WASF)	Carbon Emissions Scope (tonnes CO2e)		
	Scope 1	Scope 2	Total
Portfolio – WASF	18,029	5,601	23,630
Benchmark - S&P ASX 300 Accumulation Index	33,912	10,423	44,335
Difference	-46.8%	-46.3%	-46.7%

Source: MSCI ESG (as at 31/12/2022)

WaveStone - Australian Share Fund (WASF)	Carbon Intensity Scope (tonnes CO2e/sales)		
	Scope 1	Scope 2	Total
Portfolio – WASF	88.53	23.97	112.50
Benchmark - S&P ASX 300 Accumulation Index	109.81	43.20	153.01
Difference	-19.4%	-44.5%	-26.5%

Source: MSCI ESG (as at 31/12/2022)

Engagement

ESG-related Engagements during the Quarter

Company	ESG Category	Topics
NEC	Governance Social	DHG Chair & NEC BOD structure; Director fees & REM; Cyber risk; Implications of buyback
COH	Governance	REM Structure, BOD renewal & succession; Balance sheet & capital allocation.
EDV	Governance Social	EGM regulation and Responsible Service of Alcohol, in relation to Tasmania mandatory pre-commitments on EGMs, and review & recommendations from Responsible Gambling Council of Canada; Remuneration
CAR	Governance	REM, BOD & Management succession & structure; TI acquisition
QAN	Governance Social	Director elections, CEO REM and BOD & management succession; Organisational culture: Regulatory position
CKF	Environment	ESG linked component of STI was removed - we engaged to find the cause which was mainly due to a change in waste collection providers & made like for like comparisons for the waste diversion metric not possible.
LGL	Governance	Discussion with the Chair on the way forward given the IPO wasn't a success and the stock had become illiquid.
KED	Governance	Discussion with the Chair on the way forward given the changed market environment for a high growth company.
TLC	Governance	Remuneration; Capital allocation and governance discussion given it had only recently become a public company.

LIC	Governance	Governance on BOD succession
DMP	Governance Social	Remuneration & CEO-succession; Cyber security; BOD renewal; Wage underpayments
EDV	Governance Social	Responsible gaming & regulation
QAL	Governance	Governance around compensation as a public company
PXA	Governance	Governance & succession
TCL	Environment Governance Social	BOD skill mix and succession plans; Gender diversity & 40:40 Vision; Capital allocation; Market communications in light of FY23 DPS guidance surprise at FY22 result
TWE	Governance Social	Sustainability & governance
ALL	Governance Social	Responsible game play with cashless gaming; Other regulatory reforms in Aus & the US regarding social casino
WDS	Environment Governance Social Industry Engagement	Sustainability goals & new energy technology.
CKF	Governance	CEO tenure & remuneration
STO	Environment Social	Sustainability & regulatory risk of new projects
ASX	Governance Industry Engagement	Regulatory risk around CHESS replacement

MSCI ESG Ratings*

Portfolio
WaveStone Australian
Share Fund

MSCI ESG RATINGS



Benchmark
S&P/ASX 300

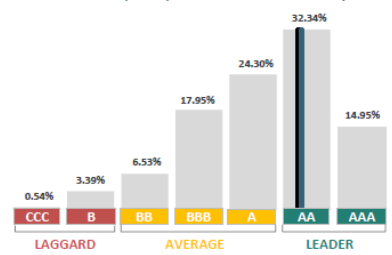


How the MSCI ESG Rating is calculated

	Portfolio	Benchmark
Weighted Avg ESG Score	7.41	7.32
Adjustment		
+ ESG Trend Positive	9.49%	15.33%
- ESG Trend Negative	6.51%	8.84%
- ESG Laggards	0.00%	0.83%
Adjustment Total	2.98%	5.65%
Score Adjustment	0.22	0.41
ESG Quality Score	7.63	7.73
ESG Rating	AA	AA

Distribution of MSCI ESG Fund Ratings Universe

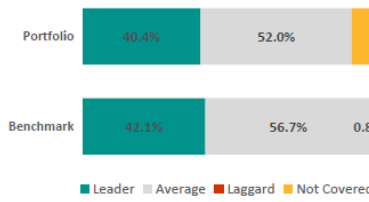
Colored bars correspond to portfolio and benchmark ESG Quality Scores



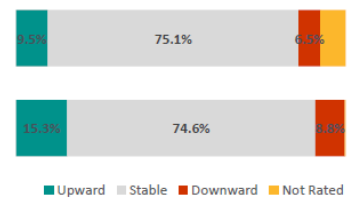
PORTFOLIO ESG RATING SUMMARY

ESG Quality	Leader 1.3% below benchmark
ESG Ratings Distribution	Leaders 1.7% under benchmark Laggards 0.8% under benchmark
ESG Ratings Momentum	Upward momentum 5.8% under benchmark Downward momentum 2.3% under benchmark

ESG RATINGS DISTRIBUTION

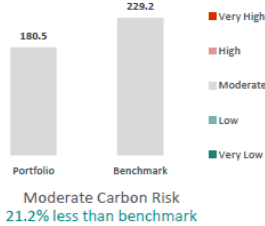


ESG RATINGS MOMENTUM



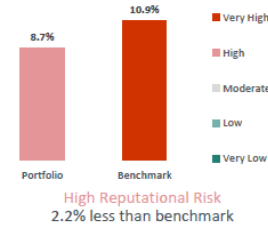
Carbon Risk

(T CO2E/\$M SALES)



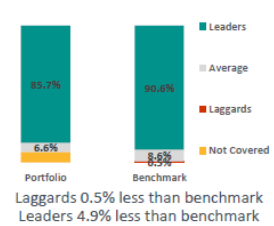
Reputational Risk

(Very Severe Controversy Exposure)



Governance Risk

(Global Percentile)



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Memberships and initiatives

- Principles of Responsible Investment (PRI)
- Climate Action 100+
- 40:40 Vision

Links to WaveStone Policies

- ESG Policy: **WaveStone ESG Policy**
- ESG Activity Report: **WaveStone ESG Activity Reports**
- Proxy Voting Policy: **WaveStone Proxy Voting Policy**
- Proxy Voting Records: **WaveStone Proxy Voting Records**
- Engagement Policy: **WaveStone Engagement Policy**
- **WaveStone PRI Transparency Report 2020**
- **WaveStone PRI Assessment Report 2020**

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