SPHERIA
ASSET MANAGEMENT

ESG REPORT 2022

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ESG Market Developments

2022 presented some challenges to the ESG sector as well as welcome developments towards the standardisation of non-financial reporting requirements and mandated meaningful ESG disclosure.

The war in Ukraine and related Russian weaponization of energy supply to Europe disrupted markets and caused sustained energy price hikes. Renewed focus on energy security will favour renewables in the long term; in the short term though, investors who had excluded hydrocarbons from their universe had a hard time outperforming. The profit boom caused by energy price increases bolstered the balance sheets of coal, oil and gas companies, further reducing the effectiveness of ESG strategies based on disinvestment and de-financing. Despite that, the number of financial institutions restricting investment and finance to hydrocarbon companies is increasing.

Higher energy prices and restricted access to Russian oil & gas intensified the debate on the shape of a just transition to a net-zero economy, particularly the role of gas a transition fuel and – to a lesser degree – the role of nuclear for zero-emission electricity generation firming renewables. COP27 stressed the importance of "low emission energy" (e.g. gas) and both China and Germany signed sizeable 20-year LNG contracts with Qatar, signalling that both countries believe they need gas in the medium to long term.

The investment challenges brought by higher energy prices reignited the debate on the role of corporations and whether long or short investment horizons were to be used. In the US, some Republican States introduced regulations against ESG investment styles that emphasize the long-term.

Vanguard (~US$7trl FUM) withdrew from the Net Zero Asset Managers (NZAM) initiative arguing that passive funds management is not compatible with net-zero alignment.

Covid restrictions and related economic activity, alongside geopolitical tensions (and war), disrupted many supply chains. Those developments – together with modern slavery legislation and extreme weather events – focussed corporate attention on provenance, chain of custody, and strategies to de-risk access to key inputs.

Stricter regulation on carbon emissions and ecosystem protection sparked farmers' protests in both Holland and New Zealand. Proposed changes to the Australian Safeguard Mechanism drove domestic carbon credit prices higher but were favourably received by the business community, for their positive environmental impact and - likely - for their role in providing regulatory certainty and in avoiding carbon-tariffs being imposed on our exports.

Biodiversity loss and ecosystem collapses gained increasing prominence as urgent environmental challenges. The dual imperative to protect ecosystems and provide sizeable and affordable carbon sinks is driving agriculture practices towards regenerative farming. Several food multinationals stated in a report to the UN published in 2022 that: "The rate of growth of regenerative farming needs to triple to reach 40% of global cropland by 2030"[1]. Australia

1 The Sustainable Market Initiative Agribusiness Taskforce – Scaling Regenerative Farming: an Action Plan, Nov 2022

signed the Global Methane Pledge, which aims to reduce global methane emissions by 30% by 2030. Reducing livestock methane emissions will be key in achieving that target.

Stricter regulation on plastic, packaging reduction, and the circular economy have been proposed and entered into force both domestically and abroad. Private and public investments towards circular economy processes and systems may spur innovation in this field.

The debate (and upcoming referendum) over the introduction of a First Nations Voice to Parliament is focussing attention on Aboriginal relations in all areas of society, including corporate. The design and composition of the voice to parliament - if introduced – will determine its influence on corporate behaviour and will likely impact new projects' approvals, particularly those that affect land use, like new mines.

ESG investors' focus in 2022 was squarely on carbon emissions: disclosure, green claims, evaluating corporate net-zero pathways in hard to abate sectors, adaptation plans and exposure to weather and regulatory risk.

Reports presented at last year's COP27[2] provide welcome guidance to investors evaluating corporate paths to net-zero emissions and green credentials and the upcoming finalization by the IPCC (part of IFRS) of their accounting standards for sustainability and carbon disclosure (and likely endorsement by regulators in many jurisdictions) will move significant sections of ESG disclosure towards being mandated.

De-risking supply chains, and the impact of modern slavery regulation introduced both domestically and overseas drew attention to disclosure, remediation readiness and the financial risk posed by complex and obscure supply chains. Modern slavery does not just represent a brand risk, the financial implications of mishandling modern slavery in a company's supply chain are potentially high if legislation like the US's Uighur Force Labour Prevention Act (UFLPA) is strictly implemented and similar regulation is adopted by other jurisdictions.

Governance, diversity, and OH&S practices were mainstays on the ESG agenda. Cybersecurity gained even more prominence due to several high-profile breaches in Australia.

2 "Integrity Matters: Net Zero Commitments by Businesses, Financial Institutions, Cities and Regions", High-Level Expert Group on the Net Zero Emissions Commitments of Non-State Entities, Nov 2022
"SMI Energy Transition Task Force: Framework for transitioning companies", Sustainable Market Initiative, Nov 2022

ESG at Spheria

Spheria's ESG process has been embedded within the investment process since day one and is continually evolving. In early 2020, we expanded our approach to ESG to incorporate the outcomes of a 31-point ESG questionnaire into our valuations to form a broader view of ESG risks and opportunities. While we don't exclude individual companies or sectors from our investment universe, a premium or discount is applied to the stocks' valuation based on proprietary ESG scoring. Our integrated approach to ESG involves formally engaging with companies on the themes highlighted in their ESG scoring system. Both our stock analysts and ESG specialists participate in engagement meetings with the results of our discussions informing investment decisions. We believe our ESG research and proactive corporate engagement strategy positions our portfolios for long-term success. Our close relationship with management teams thanks to long holding periods, coupled with an array of substantial holdings, gives us a competitive advantage when it comes to corporate engagement with our investee companies. Through corporate engagement, we strive to challenge management to achieve best practice and drive positive ESG outcomes, as well as superior performance. Investing responsibly is particularly important in the small and microcap sectors that we focus on, in which many companies do not face the same level of scrutiny as their large cap peers. We believe that our research and engagement make positive contributions not only to our performance but to our investee companies and we are proud of it.

4 Key Pillars of Responsible Investing

We are committed to investing responsibly as we believe environmental, social and governance risks are investment risks and that these ESG factors have material impact on returns.

1. ESG Risk Integration

2. Stewardship and Active Engagement

3. Advocacy

4. Transparency

Environment

- Climate change
- Carbon emissions
- Scope 1, 2, 3 analysis
- Water use
- Packaging and recycling
- Energy use

Social

- Social license to operate
- Supply chain transparency
- Diversity
- Human rights and labour standards
- Data protection and cyber security

Governance

- Board structure and composition
- Remuneration
- Corruption and bribery
- Board skills
- Lobbying

Future Considerations

In many jurisdictions, legislation is moving from vague environmental aspirations to more effective regulation backed by financial penalties and incentives. We expect protests from affected interest groups to become more vocal and the debate over ESG to intensify. Addressing climate change requires democratic governments to convince their electorates to embrace lower living standards. Achieving that while retaining the political mandate will prove a fine balancing act, and a considerable challenge.

The dual imperative of addressing the collapse of ecosystems and establishing sizeable carbon sinks – together with the debate over establishing a First Nations Voice to Parliament – will radically affect the way we "use" land: how we produce food, how we extract materials, and – if an El Niño follows two consecutive years of wet weather – how we conserve and allocate water.

Spheria 2022 ESG Highlights

In 2022, Spheria completed 17 corporate engagement meetings with investee companies and continued focusing on climate change (risk exposure, TCFD disclosure, and net-zero pathways), modern slavery (instances found, remediation practices, demonstrable supply chain knowledge, disclosure quality), OH&S and Governance (particularly leadership teams' diversity). In order to inform our investment decisions, we sought to learn about material ESG risks and opportunities our portfolio companies are exposed to, provided feedback, and shared best practice examples, whenever appropriate.

We joined the cooperative engagement initiative Investors Against Slavery and Trafficking (IAST) and actively participated in the Pinnacle ESG Working Group's activities.

To address greenwashing and prepare for stricter ESG disclosure requirements, we tweaked our proprietary ESG scoring system and capped disclosure scoring to neutral. In our investment process, companies can be penalised for poor disclosure but cannot improve their ranking through good disclosure, which is now considered the norm.

We have analysed our portfolios using carbon information provider Emmi focusing on our top emitters' track records and paths to net-zero. In these particular engagements, we have argued for more granular information on CAPEX, enhanced efforts in R&D, and disclosure in line with TCFD guidelines. We continue to believe that divesting hard to abate sectors is not an effective strategy to either maximize risk-adjusted return or address climate change.

Spheria also undertook the exercise of calculating our operations' carbon emissions footprint. Spheria's scope 1 and 2 carbon emissions for FY22 totalled 65.82 tonnes of CO2. Our small footprint reflects the nature of our funds management business, the size of our team, and the efforts taken to reduce our impact (e.g. energy efficient premises, use of videoconferences, when possible, flexible work options, etc.).

To support our clients navigating the carbon net-zero debate and choosing an approach that aligns with their requirements, objectives, and culture, we have published an article outlining a carbon net-zero framework for asset owners, where we explain the reasons behind our chosen path and the risks and opportunities related to different approaches (https://spheria.com.au/a-framework-for-thinking-about-carbon-net-zero-commitments/).

We have discussed carbon credits and circular economy efforts with our food and agriculture companies, particularly livestock methane emission abatement strategies, and the business opportunity of offering net-zero carbon food products.

Remediation provision, community relations, staff well-being, diversity and safety featured prominently in our conversations with miners and their contractors.

Our investee companies demonstrated varying degrees of maturity, when addressing supply chain issues: some had diversification strategies in place and deep knowledge of their suppliers beyond tier 1, others seem to believe that buying inputs in Australia was enough to ensure a secure supply chain and the absence of modern slavery. Most companies' knowledge seemed limited to tier 1 suppliers. None of our portfolio companies reported finding modern slavery instances, which – considering the endemic nature of modern slavery - raises doubts about the thoroughness of their investigations. The implementation of the Uyghur Forced Labour Prevention Act (UFLPA) has not impacted companies in our portfolio, yet. We remain vigilant about instances of US Customs seizing goods in the sectors our investee companies with sizeable US export businesses operate.

Like the rest of the ESG sector, we made our maiden submission to the PRI (the UN's Principles for Responsible Investment) under their new scoring mechanism, and we were pleased to be awarded four or five stars in all the categories applicable to Spheria's work (five stars being the maximum score possible).

In 2023, we look forward to a convergence of the ESG "alphabet soup" of alliances, groups, and compacts towards widely accepted (and mandated) disclosure standards. We believe that moving towards granular integrated disclosure models that include both financial and non-financial information will contribute to "internalising externalities", as an economist might put it, and paint a fuller corporate picture for investors wanting to maximize risk-adjusted returns, particularly for those interested in longer term horizons and sustainable earnings.

Engagement Examples

Blackmores (AU:BKL)

Last year, we met twice with the Blackmores team to discuss ESG and were impressed with their efforts to de-risk their supply chain and their work on modern slavery. We continue to be concerned about their cost-structure though, which was reflected in our voting decisions.

Adbri (AU: ABC)

Adbri's sizeable carbon footprint and hard to abate activity makes it a key target for our engagement activity (both for Spheria's team alone and as part of CA 100+). While we were pleased with their carbon target setting and their link to management remuneration, we would have preferred more information on the cost involved with switching energy source and future CAPEX requirement. A larger commitment to R&D would also seem appropriate, considering the size of the challenge. We are planning and look forward to more engagements this year.

City Chic (AU:CCX)

We discussed US' Ughur Forced Labour Protection Act (UFLPA) and modern slavery more generally with City Chic, who consistently demonstrates deep knowledge of their supply chain. We look forward to their progress in product circularity design.

Flight Centre (AU:FLT)

Spheria engaged with Flight Centre (FLT) with focus on carbon emissions. Prior to the meeting, Spheria had the view that FLT did not disclose enough with regards to ESG and sought to raise this with management. Spheria were pleased to learn that FLT created a new sustainability role to support their long-term ESG goals. Spheria discussed with FLT their focus on the environment, given the nature of their business. FLT have signed up to the science-based target initiative and will submit their first report this year. As part of this initiative, FLT calculated their carbon footprint and will use 2019 as a baseline to measure reductions going forward.

A2 Milk Company Ltd (AU:A2M)

Spheria engaged with a2 Milk (A2M) with focus on carbon emissions and sustainability. Prior to the meeting, Spheria were eager to understand more on their plans to be GHG neutral by 2030 and what initiatives the company had in place to achieve that goal. A2M CEO was able to outline the technical reasons behind the timeline for the switch to an electric boiler at their MVM plant and gave us details of the design for the asparagopsis trial they are planning. Asparagopsis is a methane-reducing farm animal food additive that - if successful - could greatly reduce A2M scope 3 carbon emissions. We remain concerned about the geopolitical risk that doing business in China carries. While A2M has a well-articulated in-country business strategy that might mitigate such risk, geopolitics remain outside company control. We continue monitoring developments in this area. We are planning and look forward to more engagements this year.

Voting

Proxy Voting Summary

Micro-cap Portfolio

	Management Proposals		Shareholder Proposals		All Proposals	
	Total	Percent	Total	Percent	Total	Percent
Votable Proposals	182		0	0.00%	182	
Proposals Voted	182	100.00%	0	0.00%	182	100.00%
FOR Votes	150	82.42%	0	0.00%	150	82.42%
AGAINST Votes	32	17.58%	0	0.00%	32	17.58%
ABSTAIN Votes	0	0.00%	0	0.00%	0	0.00%
WITHHOLD Votes	0	0.00%	0	0.00%	0	0.00%
Votes WITH Management	153	84.07%	0	0.00%	153	84.07%
Votes AGAINST Management	17	15.93%	0	0.00%	29	15.93%

Smaller Companies Portfolio

	Management Proposals		Shareholder Proposals		All Proposals	
	Total	Percent	Total	Percent	Total	Percent
Votable Proposals	259		0	0.00%	259	
Proposals Voted	259	100.00%	0	0.00%	259	100.00%
FOR Votes	217	83.78%	0	0.00%	217	83.78%
AGAINST Votes	42	16.22%	0	0.00%	42	16.22%
ABSTAIN Votes	0	0.00%	0	0.00%	0	0.00%
WITHHOLD Votes	0	0.00%	0	0.00%	0	0.00%
Votes WITH Management	221	85.33%	0	0.00%	221	85.33%
Votes AGAINST Management	38	14.67%	0	0.00%	38	14.67%

Opportunities Portfolio

	Management Proposals		Shareholder Proposals		All Proposals	
	Total	Percent	Total	Percent	Total	Percent
Votable Proposals	223		4		227	
Proposals Voted	223	100.00%	4	100.00%	227	100.00%
FOR Votes	191	85.65%	0	0.00%	191	84.14%
AGAINST Votes	32	14.35%	4	100.00%	36	15.86%
ABSTAIN Votes	0	0.00%	0	0.00%	0	0.00%
WITHHOLD Votes	0	0.00%	0	0.00%	0	0.00%
Votes WITH Management	192	86.10%	4	100.00%	196	86.34%
Votes AGAINST Management	31	13.90%	0	0.00%	31	13.66%

Global Opportunities Portfolio

	Management Proposals		Shareholder Proposals		All Proposals	
	Total	Percent	Total	Percent	Total	Percent
Votable Proposals	426		8		434	
Proposals Voted	426	100.00%	8	100.00%	434	100.00%
FOR Votes	369	86.62%	6	75.00%	375	86.41%
AGAINST Votes	56	13.15%	2	25.00%	58	13.36%
ABSTAIN Votes	1	0.23%	0	0.00%	1	0.23%
WITHHOLD Votes	0	0.00%	0	0.00%	0	0.00%
Votes WITH Management	369	86.62%	8	100.00%	377	86.87%
Votes AGAINST Management	57		0	0.00%	57	13.13%

Spheria exercises all its voting rights. Proxy voting consultant ISS advises us but the final decision on AGM resolutions rests with us (unless we receive specific instructions from our clients on how to vote their shares). We vote in ways that are consistent with our over-arching goal of maximising risk-adjusted returns and welcome conversations with our investee companies' leadership teams on AGM resolutions and the reasons behind the way we vote.

Spheria ESG Alliances

PRI Signatory

Spheria has been a signatory of the United Nations Principles for Responsible Investment (UNPRI) since 2019. The principles promote the inclusion of ESG issues into investment analysis and decision-making processes and is used by Spheria as a blueprint in their ESG investment processes.

TCFD Supporter

In November 2020, Spheria became an official supporter of the Task Force on Climate-Related Financial Disclosures (TCFD).

CA 100+

In September 2021, Spheria joined Climate Action 100+ and their working group in Adbri.

Investors Against Slavery and Trafficking Asia Pacific

The Investors Against Slavery and Trafficking Asia Pacific (IAST APAC) initiative is an investor-led, multistakeholder project. It was established in 2020 to engage with companies in the Asia-Pacific region to promote effective action in finding, fixing and preventing modern slavery in operations and supply chains.

Portfolio Emissions

Based on FUM size

Spheria Australian Micro-cap Fund

- Scope 1 - 12,367 CO2 tonnes
- Scope 2 - 11,304 CO2 tonnes

Spheria Australian Smaller Companies Fund

- Scope 1 - 40,316 CO2 tonnes
- Scope 2 - 12,804 CO2 tonnes

Spheria Opportunities Fund

- Scope 1 - 42,548 CO2 tonnes
- Scope 2 - 15,858 CO2 tonnes

Spheria Global Opportunities Fund

- Scope 1 - 378 CO2 tonnes
- Scope 2 - 222 CO2 tonnes