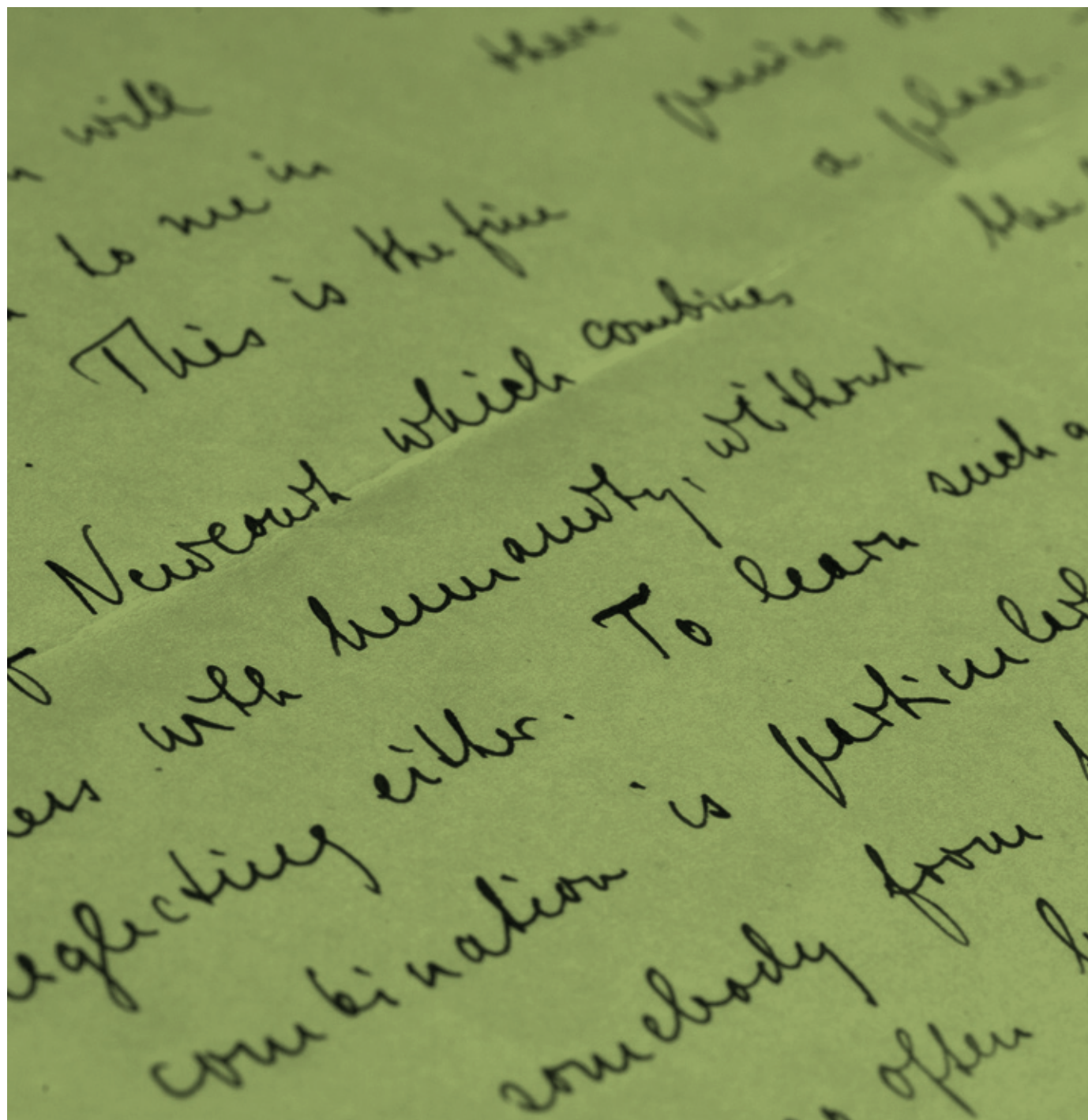


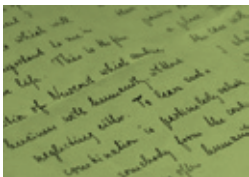
Who cares wins



2018 ESG report

March 2019





Cover image:
Extract from 1926 letter from
Sigmund Warburg to Lionel and
Anthony de Rothschild, thanking
them for teaching him about
business and 'the fine tradition
of New Court, which combines
business with humanity without
neglecting either.' Courtesy of
The Rothschild Archive.

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Foreword

Awareness of ESG (environmental, social and governance) investing has grown rapidly in recent years and increasingly investors, our clients included, want assurance that their portfolios are being managed responsibly and sustainably. This is our third annual report, and the first we are sharing with all our clients.

For readers less familiar with ESG, in the context of businesses the 'E' looks at a company's impact on the environment; 'S' relates to labour practices and human rights issues; and 'G' is concerned with issues such as executive pay and shareholder rights. Increasingly, evidence suggests companies that manage their ESG issues successfully will deliver more attractive long-term investment returns.

We're not alone in adopting sustainable investment practices. In 2004, the United Nations Global Compact published a study called *Who Cares Wins*, which explores how the financial industry can integrate ESG issues.* (We've borrowed the title for this year's report.) Today, professional asset managers around the world are increasingly integrating ESG factors into their investment processes as investors become more aware of the benefits of sustainable investing.

We have a distinct investment philosophy and process and are constantly seeking to improve how we embed sustainable investment principles in our investment decision making. We hope you enjoy reading this year's report, where you can find out more about the progress we've made in 2018 as well as our plans for the year ahead.

As always, we welcome your feedback and look forward to continuing the conversation with you about investing for a sustainable future.

A handwritten signature in black ink, consisting of a series of loops and a long horizontal stroke at the end.

Helen Watson

CEO, Wealth Management UK

*www.unglobalcompact.org/library/218

A responsible approach

Incorporating ESG into our investment decisions is part of our ongoing commitment to investing sustainably

The idea of investing sustainably has always underpinned our approach to building and managing long-term portfolios. Whether investing directly or through external managers, we believe the best way to identify high-quality investments that can deliver attractive returns over the long term is to consider ESG factors as an integral part of the investment process.

Over the past year, we've been busy improving our processes and putting more structure around what we do – in other words, how we approach sustainable investment. For example, for all our direct equity holdings we have defined the key ESG issues that affect each company and have assessed how well these issues are being addressed.

In addition, we've continued to develop our ESG policy, which explains how we consider sustainability issues when making investment decisions. We've also joined two initiatives designed to improve the quality of engagement between investors and companies for better long-term risk-adjusted returns.

The first is the UK Stewardship Code, which sets out areas of best practice to which the Financial Reporting Council (FRC) believes investment managers should aspire (see box 'Enhance and improve'). The FRC awarded Rothschild & Co the highest of three tiers, which reflects our ability to provide a clear and transparent description of our approach to stewardship.

Investing with principle

The second is the United Nations-supported Principles for Responsible Investment (PRI), which we joined in March 2018. This membership-based organisation promotes responsible investing globally and encourages investment managers to focus on and incorporate ESG factors into their decisions. Signatories commit to the six principles of the PRI and are subject to a mandatory annual filing to report on ESG processes and activity (see box 'A global initiative').

We are encouraged by the introduction of minimum criteria this year, meaning that investment managers cannot simply sign up and pay lip service. As an absolute minimum, signatories need to have a formal ESG policy in place, which in turn they must apply to at least

50% of the assets they manage for their clients. (Criteria we already fulfil.)

To further our commitment in 2018, our investment team joined two PRI events. The first was *PRI in Person*, which took place in San Francisco, bringing together PRI signatories and other investment professionals to learn, network and collaborate over several days. Attracting a diverse audience, it offers something to attendees at all stages of the responsible investment journey, giving them an opportunity to discuss topical issues, share experiences from their own organisation and reason with peers from around the world.

The second was the *PRI Climate Forum*, which took place in London in November. This conference is part of a popular new global series of events focusing on key climate topics with practical advice for investors. Topics included how to invest in the low-carbon transition and

Enhance and improve

In order to enhance the quality of engagement with companies and improve long-term risk-adjusted returns, the UK Stewardship Code says institutional investors should:

- Publicly disclose their policy on how they will discharge their stewardship responsibilities.
- Have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed.
- Monitor their investee companies.
- Establish clear guidelines on when and how they will escalate their stewardship activities.
- Be willing to act collectively with other investors where appropriate.
- Have a clear policy on voting and disclosure of voting activity.
- Report periodically on their stewardship and voting activities.

Source: Financial Reporting Council.

the latest updates from the Task Force on Climate-Related Financial Disclosures (TCFD).

Measuring sustainability

Investing sustainably is much more than a crusade against climate change and supporting the green economy. It involves considering not just how companies are managed but other issues too – from the way they are governed to the way they treat stakeholders.

Investing in well-managed companies that have a positive impact on society and the environment makes good financial sense for everyone involved. We acknowledge that there is no such thing as a perfect business. Yet increasingly we are focusing on identifying ‘win-win’ businesses. They tend to be companies with a real purpose, which benefit all their stakeholders, including employees, customers and suppliers as well as shareholders and senior managers.

Our starting point when assessing any potential investment is to determine the financial strength and durability of the underlying company. Evaluating the sustainability of its business model along with its practices is integral to this approach.

One way to evaluate potential investments against measures of sustainability is to use the ESG ratings provided by leading research providers, such as Bloomberg, MSCI, Morningstar and Thomson Reuters. However, we believe these ratings are a blunt tool to capture sustainability in a single number. Instead, we think that each ESG factor represents a different amount of risk or opportunity to each company. Therefore, we prefer to focus on those factors that could materially impact (both negatively and positively) an investment’s performance over the long term (see box ‘Materiality matters’).

In many cases these factors are qualitative and require subjective assessments. We believe that reducing such a broad range of complex factors to a single ESG rating is not the best way to assess individual companies.

Our research partner

We had been working with independent, third-party ESG research provider Vigeo-EIRIS since 2016.

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A global initiative

By signing the United Nations-supported PRI, investors commit to the following six principles:

- Incorporate ESG issues into investment analysis and decision-making processes.
- Be active owners and incorporate ESG issues into our ownership policies and practices.
- Seek appropriate disclosure on ESG issues by the entities in which we invest.
- Promote acceptance and implementation of the Principles within the investment industry.
- Work together to enhance our effectiveness in implementing the Principles.
- Report on our activities and progress towards implementing the Principles.

Source: PRI.

After an extensive review in the first half of 2018, we decided to switch providers to Sustainalytics.

Sustainalytics is a global leader in ESG and corporate governance research with 25 years of experience. Today, the firm has more than 500 employees globally with offices in 17 cities and supports hundreds of the world’s foremost investors who incorporate ESG and corporate governance insights into their investment processes.

Sustainalytics conducts extensive research, which we use to complement our own proprietary research on the companies we own in our portfolios. Its research also helps us assess our indirect equity holdings through the external funds we own in client portfolios. The firm’s tools help us to identify any potentially controversial issues surrounding our investments as well as providing consultancy services when we need them.

Looking forward

As part of our ongoing commitment to investing sustainably, we’re planning several initiatives for the year ahead. They include a strategic review of our investment process in collaboration with an independent consultant. Within this review, we’ll be evaluating our processes of incorporating ESG into our investment decisions and establishing best practices.

Another area we began work on in 2018 is calculating the carbon intensity of our portfolios. This project will help us understand the risks and opportunities that climate change presents to

Materiality matters

To help us identify which ESG issues are relevant or significant, we've developed what we call a materiality map for each company in our portfolios. This map provides an overview of the material ESG factors that can affect the company. Issues that present the greatest risk are red and those that are the most positive are green, with eight shades in between. We then use these maps to monitor how companies are addressing these issues and engage with them.

For example, one of our holdings is Middleby, an American manufacturer of commercial cooking equipment. Our assessment highlights a range of risks and mitigating factors.

Environmental. Kitchen equipment tends to account for the largest part of a restaurant's water and energy consumption. Yet Middleby focuses on innovation that helps restaurants

reduce their environmental footprints, through water and energy-saving initiatives.

Social. Although Middleby makes frequent acquisitions and sometimes needs to reduce headcount, it pays appropriate severance packages. Meanwhile, kitchen equipment can cause accidents and lead to problems with food safety. Yet the firm helps its customers comply with food safety standards, and focuses on making its products easy and safe to use.

Governance. Middleby pays its executives variable compensation according to one-year performance measures, which can lead to short termism. However, long-term incentives are only vested if minimum performance hurdles are achieved and payouts are capped. In addition, the CEO has invested a significant proportion of his own money in the company.

Our assessment of key ESG factors for Middleby



our portfolio holdings. We will provide an update on our progress in next year's report.

We're also committed to continuing the work we've started on materiality maps (see box 'Materiality matters'). As well as providing detailed information on direct equity holdings, we intend to produce heatmaps on the actively managed funds we own.

Fixed income is an asset class where we have little progress to report. While interest rates and credit spreads remain very low, we have minimal exposure to longer-dated bonds or credit risk, with the majority held in short-dated government bonds such as UK Treasury Bills or supranational issuers such as the European Investment Bank. In time, as interest rates normalise, we expect ESG considerations to be of greater relevance. This remains on our 'to-do' list for the time being. We aim to increase consideration of ESG in our bond selection process, particularly corporate bonds.

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Reaching for the highest investment standards

We launched the Exbury Fund towards the end of 2018. This multi-asset class strategy has the flexibility to seek out opportunities across all global regions and asset classes, and follows the same investment philosophy and process behind our core investment strategies. It incorporates additional selection criteria by applying a higher threshold to certain sustainability and ESG issues, covering both equity and fixed income securities.

As with all our investments, we do not invest in companies that engage in illegal or morally unacceptable activities, that breach internationally recognised protocols, or those that cause significant harm to society or the environment. We will not own bonds issued by governments that are subject to financial sanctions or abuse human rights.

Additionally, the fund incorporates some of the most common ethical exclusions expressed by existing clients. We will not invest in businesses that derive more than 10% of their revenue from products or activities that are socially or environmentally harmful, including but not limited to:

- the manufacture or sale of tobacco, armaments, alcohol, pornography or gambling;

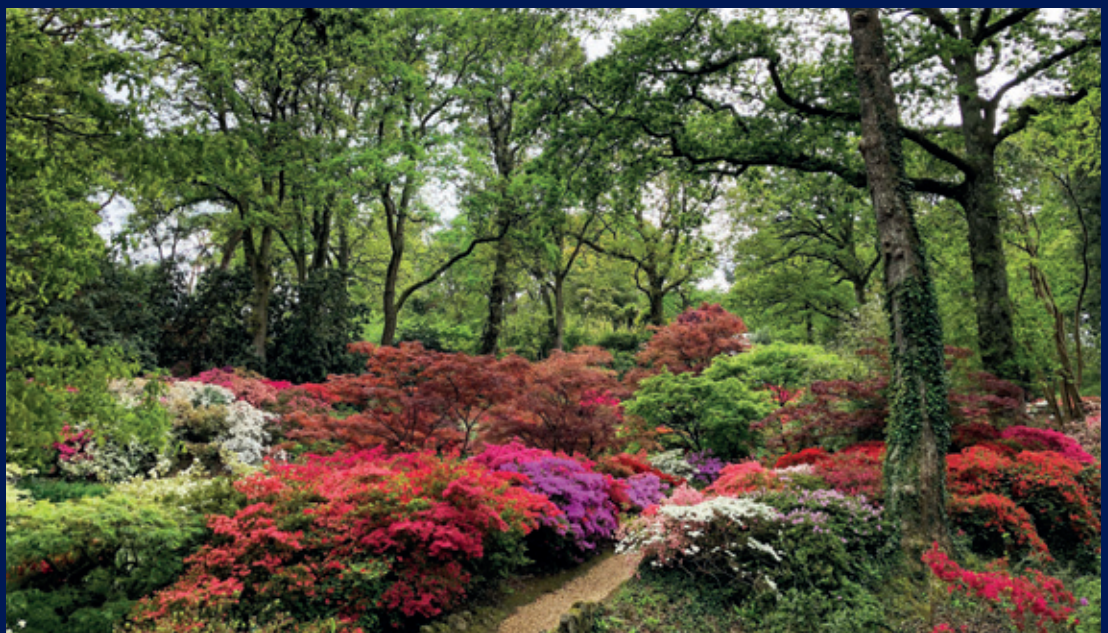
- mining thermal coal or tar sands;
- surface mining; and
- the manufacture or sale of cosmetic products that are tested on animals.

A flexible approach

We can also apply the investment process that's behind the Exbury Fund to segregated portfolios. This flexibility is ideal for clients who would like the same approach but where it may not be efficient to move their assets away from their existing portfolio.

We named the fund after Exbury Gardens in the New Forest in southern England, which was the inspiration of Lionel Nathan de Rothschild. He bought the Exbury Estate in 1919 and created his garden during an era when explorers were bringing back seeds of previously unseen plants from remote areas of the Himalayas and Southeast Asia.

Please get in touch if you'd like to find out more about investing in the Exbury Fund or incorporating this approach.



Azaleas and acers in bloom during the spring at Exbury Gardens.

Engaging and voting

We think it's important to engage with companies and funds and hold them to the highest standards

Engagement is an essential part of our investment process and provides a direct way for us to influence behaviour and have a positive impact. We engage with companies in two ways. First, we meet management teams regularly to discuss any areas of concern, and below we provide two examples of how we've engaged with companies in the past year. Second, we use our shareholder votes to hold them to high standards (see Figure 1: 2018 voting summary).

On the radar

Ryanair is a successful budget airline that is often in the headlines – and not always for the right reasons. Back in 2013, Ryanair provoked passenger safety concerns after announcing it was restricting the amount of fuel on planes in an attempt to cut costs. More recently, cancelled flights due to pilot strikes over issues ranging from seniority and promotions to pay and labour contracts affected around 50,000 passengers in August 2018 alone.

We met CEO Michael O'Leary to talk about a range of issues – from industry consolidation and capital allocation to relationships with airports and labour relations. We also attended the AGM and had a separate small group meeting with the non-executive Chairman David Bonderman and Senior Independent Director Kyran McLaughlin to discuss board tenure and composition. We are also monitoring the impact of Brexit on the business and shareholders (including voting rights).

While we acknowledge the issues that some investors raised about the board's independence and objectivity, in our view Bonderman's deep knowledge of the aviation industry has been extremely valuable for Ryanair's board, particularly during what has been a challenging period for the company. Therefore, we've been more comfortable with him as chairman than some investors, despite his long tenure.

Through our discussions with management it was clear that the company has been thinking long and hard about succession planning, not just in terms of who would replace Bonderman and McLaughlin when the time comes, but also the eventual departure of O'Leary.

Subsequently, the company used its first earnings report of 2019 to announce the intention of both Bonderman and McLaughlin to step down by September 2020. Bonderman will be replaced by Stan McCarthy, who has been a board member since 2017 and is the former CEO of Kerry Group.

Ryanair has also been working hard to improve labour relations. Its pilots are now among the best paid in Europe and the company has been investing in the rostering team to reduce the risk of problems associated with taking holidays. It is also making progress with unions and willing to agree to all reasonable demands providing they don't risk the low-cost model.

Our view remains that Ryanair's management is trying to balance fairness to its employees with commercial pragmatism. We are comfortable that the company's labour policies are in line with best industry practice, but this is an important issue and something that we will continue to monitor and engage with management on.

Banking on change

Meanwhile, a scandal at Wells Fargo first made headlines in September 2016 when federal regulators revealed that the bank's employees had secretly created millions of unauthorised bank and credit card accounts in order to meet aggressive sales targets. In addition to federal and regulatory investigations, the board of directors launched its own investigation into sales practices, and the findings were released in April 2017.

Engagement is an essential part of our investment process and provides a direct way for us to influence behaviour and have a positive impact.

Voting case studies

Pershing Square Holdings

In 2018 we abstained in the vote to re-elect Nicholas Botta as Director of Pershing Square Holdings (PSH), an investment company dedicated to long-term investments in North American companies. Although the board recommended voting in favour, we held discussions with the Chairman about how the trust was managing the discount to net asset value (NAV) and the effectiveness of its oversight.

Given Mr Botta's role as CFO of Pershing Square Capital Management and Director of PSH, we believed the way he was managing the discount was unsatisfactory and abstained from voting. The resolution was passed 98% to 2%. We have divested from the fund since then.

Charter Communications

Charter Communications is an American communications and media company. We voted in favour of a shareholder proposal to allow the nomination of directors by a shareholder, or group of shareholders, that have owned at least 3% of the company's shares for at least three years. The board

recommended voting against this proposal. However, we felt that this level and length of shareholding was an appropriate hurdle for nominating board members. The resolution was not passed after receiving just 20% support.

Unilever

We voted in favour of a corporate structure resolution regarding Unilever, a British-Dutch consumer goods company. The resolution proposed to approve the simplification of the holding company to a single Dutch-domiciled entry. We reasoned that this resolution should reduce bureaucracy and duplication of administrative expenses and would also make share-based transactions easier.

The voting power of ordinary shareholders would be increased under the proposal due to the cancellation of preference shares, and a lack of inclusion in UK indices is not a concern for us as global investors. There was however a significant amount of pushback from UK investors who would be forced to divest as the company would have dropped out of the FTSE index. This EGM was subsequently cancelled.

The report set out what went wrong and detailed the company's plans to rebuild customer trust. Led by their new CEO, Wells Fargo has committed to a number of initiatives. They include:

- changing the compensation structure for branch employees;
- shifting the focus away from the number of products sold to a combination of business targets and customer satisfaction metrics; and
- regular mystery shopper checks to make sure the changes are taking effect.

In addition, the company has dismissed several senior executives and ensured the forfeiture of remuneration.

We have made our own assessment, using the report together with extensive discussions with the company (including the CEO and Head of Consumer Banking), competitors and other industry experts.

When taken with the steps outlined in the report, we are more confident the business is on a better course. This progress doesn't negate our disappointment with the behaviour

and corresponding governance failures, and we continue to monitor the company closely.

Separately, at the end of 2018 we discussed the company's loan book exposure to the oil and gas sector. We gained further clarity on its responsibilities as a lender, how it considers the interests of different stakeholders and financing of renewable energy projects.

Setting the bar higher

When it comes to partnering with external managers, we set very high standards, and most don't meet our quality threshold. When selecting equity funds, we like to invest in funds that share our investment philosophy and focus on long-term sustainability through fundamental company research.

We prefer managers with formal ESG policies. Yet we retain the flexibility to invest in those that are still developing their sustainable investment credentials, providing they can demonstrate an ongoing commitment. As part of this, we've expanded our network of external managers that demonstrate a high level of ESG integration in their approach or have investment approaches focused on sustainability themes.

Figure 1: 2018 voting summary

During 2018, we cast more shareholder votes on behalf of our clients than ever before. We decide on how we will vote only after considerable thought and discussion. Of the total 258 votes we made last year, we voted against the board's recommendation in one instance and in another we abstained. This high number also reflects that many of the resolutions are administrative.

Election of directors	Discharge of executive board members	5
	Discharge of supervisory board members	13
	Election of directors	111
	Election to supervisory board	6
Compensation	Advisory vote on executive compensation	8
	Incentive plan	1
	Remuneration policy	3
	Remuneration report	6
Capital structure	Allotment of securities	9
	Changes to authorised capital	1
	Changes to bonds, warrants and or conditional capital	1
	Corporate structure	1
	Disapplication of pre-emption rights	12
	Dividend declaration	1
	Payment of dividend	4
	Repurchase of shares	13
Strategic	Investment objective	1
	Political donations	4
Financial reporting	Receipt of financial statements	10
Audit related	Ratification of auditor	18
	Remuneration of auditor	6
Administrative	Amendments to articles	5
	General meetings	4
Stockholder proposal	Stockholder proposal	15
Total		258

Source: Rothschild & Co.

When we invest in external managers, we continue to monitor their investment processes. We also require all funds to report to us about their investment decisions. One fund manager we have had ESG related discussions with in recent months is Stewart Investors. We had concerns about exposure to a small number of potentially contentious companies.

Through our discussions with the manager, we were reassured about the level of ESG scrutiny they apply when analysing investments. There are still companies in their portfolio that merit further assessment from an ESG perspective, such as Newcrest Mining and United Breweries, and we'll continue to engage with the manager about these investments.

We also had concerns about a palm oil company held within the fund. However, Stewart Investors explained that the company demonstrates good

practice within the limitations of the industry. For example, the government requires all operators to source some supply from small farmers where the risk of slavery is higher. Therefore, if the fund simply excluded the palm oil industry from its portfolio, the overall situation would not necessarily improve. In fact, it may favour the more nefarious operators.

The fund also owns an Indian utility company, which is solving a massive power shortage problem across the country. This particular business is one of the most efficient users of coal, and has also committed to invest no new capital in coal production. The utility also recently divested a subsidiary that supplied battery systems to the Indian army.

Another manager we have had in-depth ESG related discussions with is Cederberg, our China-focused manager. Cederberg is at an inflection

point in its evolution and the team is open to suggestions about how to develop an ESG policy that defines more explicitly how it invests sustainably. They have already committed to implementing a proxy voting policy across their shareholdings.

There are also recent examples of the manager applying its sustainable policy. First, they sold the fund's holding in Chinese search engine operator Baidu on corporate governance concerns. Second, they sold their holding in a traditional Chinese medicine company on questions about the firm's finances as well as its supply chain.

Voting on your behalf

In order to fulfil our stewardship responsibilities, we want to take part actively at the AGMs of the companies in which we invest. Yet we also want

to make sure that when casting shareholder votes on your behalf, you understand what's involved. For example, when voting on company resolutions in some jurisdictions, we're required to disclose information about the beneficial owners of the shares, including full name, address and nationality. This was previously an issue with Nestlé and Unilever's Dutch share class, although we've since sold both holdings and currently don't have any holdings that require this.

While these companies commit to keeping any personal details confidential, we can't be held responsible for how they store data and maintain security. As a standard policy, we'll use your proxy vote and disclose your details unless you tell us you prefer to opt out. Please speak to your client adviser if you would prefer to opt out.

In order to fulfil our ESG responsibilities, we want to take part actively at the AGMs of the companies in which we invest.

Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

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