STEWARDSHIP REPORT 2016

CONTENTS

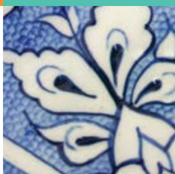
FOREWORD....3

CONTROLLING EXECUTIVE PAY....4 - 5

ENGAGEMENT....6 - 7

CASE STUDIES....8 - 9

THE TEAM....10



FOREWORD

This is our second Stewardship Report, covering the twelve months to the end of June 2016. During this period, we have continued to build on our commitment to act responsibly as asset owners on behalf of our clients and to develop our internal guidelines on voting; this latter point has meant refining our criteria in certain aspects of good governance and formalising our voting policy for the first time into a document to be made public. This and other developments have taken place against a fascinating backdrop for investors in the UK stock market given the increasing attention being paid to executive remuneration and the question of whether institutional investors are doing enough in this area.

The period since our inaugural report has seen a number of highlights for our stewardship efforts; first and foremost was the addition to our investment team of Kate Hewitt. Kate joined us as a graduate recruit following the completion of her degree in Biology at Newcastle University and a successful internship on our investment desk. Part of her studies included a focus on the science of conservation and as a result, environmental issues have become increasingly important to her. Allied to a keen interest in the investment world, this drives her motivation to help develop better business practices through responsible investing and in particular, the use of voting and engagement to encourage companies to adopt best practice. Kate has significantly enhanced our stewardship resource and when it comes to agreeing the implementation of our guidelines, she typically provides the analysis of company resolutions to note contentious issues and suggests voting decisions in light of them. Furthermore, Kate has been instrumental in drawing up our formalised voting policy and in helping produce this report.

Since the first report, we have also changed our external screening source. We had historically used EIRIS to provide our screening system and gained significant knowledge from the efforts of the well-resourced team there. However, we met with Ethical Screening and were impressed with their approach, subsequently deciding that we would sign up to use their services. The Ethical Screening team continue to look for ways to enhance their offering, with one example being their work at present to refine their Human Rights screening criteria in order to allow investors to hone in on different aspects of the risk this topic poses in different market sectors. We have also benefited from our interaction with them on specific companies or ethical topics. As a result of this change, our Castlefield B.E.S.T Income Fund also now benefits from Ethical Screening's system as a key part of its investment process.

Following on from the publication of our inaugural report, we submitted it to the Financial Reporting Council (FRC) as evidence of our reporting against their Stewardship Code. The Code is voluntary and works on the principle of 'comply or explain', while the FRC is seeking to improve the quality of such reporting in order to allow managers to be assessed more clearly on their approaches to stewardship. One development this year has been to publicly place signatories to the Code into tiers, with Tier 1 representing those companies exhibiting best practice or the closest to it and Tier 3 those companies with significant improvements required. We have been assessed as a Tier 2 signatory. The FRC has provided us with an appendix of what we do well and where we could do better in our reporting and we aim to use this information to help us improve our future submissions.

Good stewardship is a continuous process in our eyes. In 2017, we aim to continue increasing our level of engagement activity with companies alongside the implementation of our new voting policy, in particular with regards to executive pay. A key area of focus during the year will be to examine the structure of Long Term Incentive Plans (LTIPs) as part of remuneration packages, with the intention of identifying both whether they are fair and challenging in their design and appropriate in the context of overall pay. We look forward to reporting back on this in due course.

Simon Holman
Partner

CONTROLLING EXECUTIVE PAY

Responsible stewardship helps to promote good corporate governance. Holding company boards to high standards encourages them to do business better which is not only beneficial for the company and its shareholders but for society as a whole. One governance concern that often reaches the media is excessive executive pay. Putting an exact figure on what is "too much" is tricky. One of our challenges when writing our revised Castlefield Voting Policy was deciding where the line should be drawn. What is the "tipping point"?

The median gross annual salary in the UK in 2015 was £27,600. The lowest paid on the national minimum wage earn around £12,000 and the lowest earning 10% of the population receive c.£15,000. The average FTSE 100 CEO total pay figure was £4.3 million a year in 2015[1] (although quoted as high as £6.0m in some reports)[2] while the pay ratio between such CEOs and the average total pay of their employees in 2015 was 129:1. Compared to the pay of the average UK worker and not just their own employees, this ratio rises to 183:1[3] This is a sizeable mismatch in and of itself, yet these ratios do not account for the outliers at the extreme ends of the pay spectrum highlighted above. The pay gap is particularly hard to justify in times of economic uncertainty and mixed corporate performance.

Let's put these figures into context. In the 1920s, J.P. Morgan himself insisted on a limit of 20x the lowest-paid employee, a ratio which apparently held until 1965, while now, the John Lewis Partnership works on a figure of no more than 75x.[3] In the US, inflation-adjusted executive pay increased by almost 1000% between 1978 and 2014, while the average worker's pay increased by only 11%, a stark illumination of divergent fortunes.[4] Closer to home, here in the UK the ratio of FTSE 100 CEO pay to average employee pay in 1998 was 47:1 – but by 2015 was the 129:1 figure noted above.[3] Current levels of executive pay are purely a modern phenomenon.

As well as being socially divisive, the disparity between CEO pay and that of the average worker is completely nonsensical for shareholders. Evidence suggests that executive pay has increased out of all proportion to corporate performance. Long Term Incentive Plan (LTIP) rewards and shareholder returns are no longer related, with some executives being rewarded for mediocre performance. This suggests that executives are overpaid and underperforming. A 2014 study found evidence that CEO pay is negatively related to future stock returns for periods of up to three years. The researchers responsible believe that their results are driven by high-pay related CEO overconfidence that leads to shareholder wealth losses from activities such as overinvestment and value-destroying mergers and acquisitions.[5] These findings are supported by a 2016 MSCI study that showed there is a negative relationship between total 10-year CEO pay and shareholder return. Given the results of these recent studies and the level of disparity between CEO pay packets and those of a UK worker, we discussed what guidelines should be put in place to attempt to use our voices as shareholders to express our displeasure at excessive remuneration.[2]

When drafting our guidelines, we decided that resolutions proposing measures that we deem inappropriate will be voted against. We will also vote against a company's Remuneration Report if any of our guideline conditions are not met. If we intend to vote against a resolution to approve a remuneration policy or report, we will also consider not voting for the re-election of the Remuneration Committee's Chairman. If concerns over remuneration packages persist, we may escalate this to voting against all committee members.

The main points we consider when deciding which way to vote on resolutions concerning pay are:

- Executive compensation should be in line with performance.
- There should be a reasonable explanation provided for any increase in salary.
- Any increases in executive base salary should be consistent with salary increases across the company.
- Salary or bonus increases should not be justified on the sole basis of size or presence in a particular index (e.g. the FTSE 100). Over the past 18 years, CEO salaries for the top 100 companies in the UK have risen from £1m in 1998 to £4.3m in 2015.[1] If the justification for a salary increase is "companies of similar sizes are doing it" then the upward drive in executive pay will continue.
- The ratio of executive pay to the average and/or median salary across the company/the UK will be considered to see if it is proportionate. Whether a company is or is not a Living Wage employer will also be factored in. This relates to the "real" Living Wage rather than the Government's "National Living Wage".
- Variable pay schemes (LTIP and bonus schemes in aggregate should not amount to greater than 300% of basic salary.

- Executive bonuses should be based on delivery of good long term performance, the targets should be aligned with the strategy of the business and the performance criteria should be stretching.

- Executives should not be rewarded for achieving less than median performance.

- The quantum of variable pay determined by this performance measure should be taken into account when voting.

- All discretionary payments should be transparent and justified.

Excess is, of course, subjective, but what is clear is that the ratio of CEO pay to employee earnings has extended beyond what is justifiable and this is a failure of governance. CEO remuneration has breached our definition of "excessive" in many cases and is poorly linked to performance. Shareholder engagement helps to counteract this ever widening gap and we hope that the guidelines we use when determining what is and is not acceptable will serve to realign performance and pay.

Sources

[1] Department for Business, Energy & Industrial Strategy Green Paper (2016) Corporate Governance Reform

[2] Chris Philp (2016), Restoring Responsible Ownership: Ending the ownerless corporation and controlling executive pay

[3] EdenTree Investment Management (2016), Amity Insight: Corporate Governance

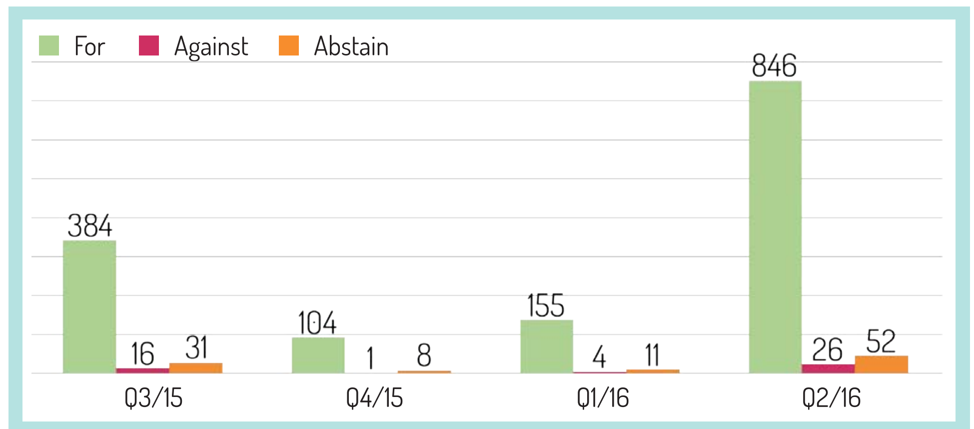
[4] Economic Policy Institute (2015)

[5] Michael J Cooper. Huseyin Gulen. P.Raghavendra Rau (2014) Performance for pay? The relation between CEO incentive compensation and future stick price performance

ENGAGEMENT

RESOLUTIONS		
Number of Resolutions where votes were cast for	1,489	(90.9%)
Number of resolutions where votes were cast against	47	(2.9%)
Number of resolutions where votes were abstained	102	(6.2%)

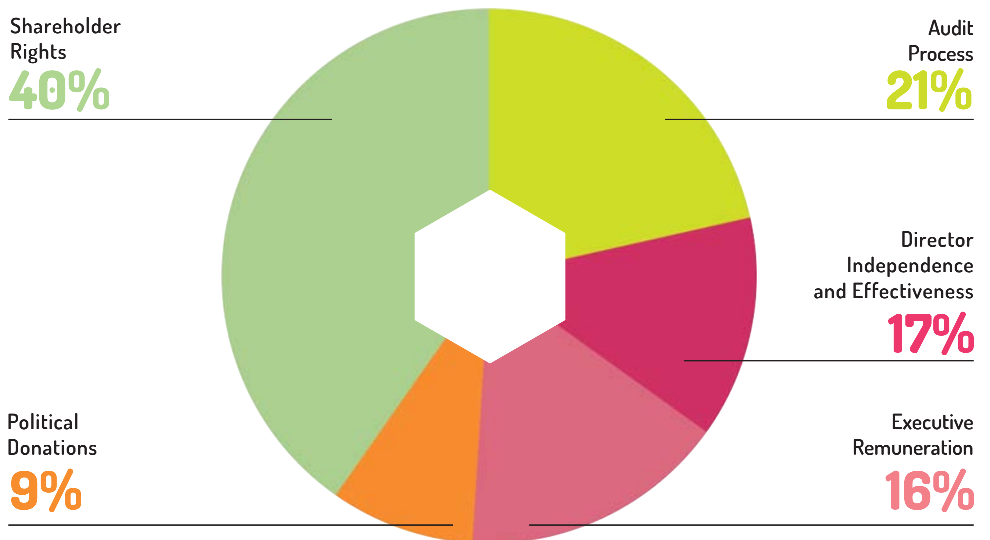
In the twelve-month period from the end of June 2015 to the end of June 2016 we voted on a total of 1,638 resolutions. The following chart shows the number of votes that were made with management (For), against management (Against) and the number of abstentions (Abstain).



When we vote at company meetings we record our decisions and rationale. This allows us to monitor our stewardship and hone our approach.

The chart below shows the reasons why we decided not to vote with management but rather abstain or go against their proposals during this period:

VOTES NOT CAST WITH MANAGEMENT OVER PERIOD



The **audit process** refers to auditor independence which may be compromised if the auditor has been in place for a long time and no tendering process has been undertaken. Auditor independence can also be called into question if the fees for non-audit services are greater than 50% of the fees for audit services.

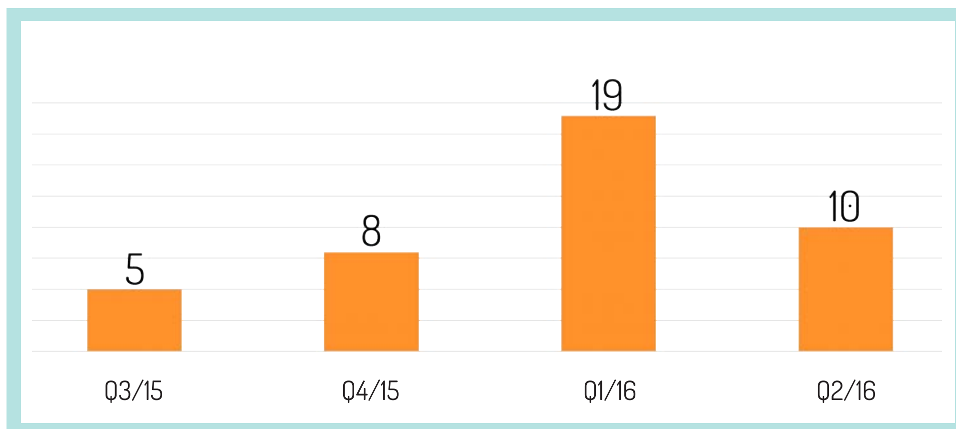
Director independence is an issue often involving Non-Executive Directors (NEDs). NEDs should be independent in order to be effective and if it is found that a NED does not meet the UK Corporate Governance Code parameters for independence then we will typically not vote with the board for the re-appointment of that director. We will also vote against the re-appointment of a director if we feel they have not been particularly effective, for example if they have missed a lot of board meetings.

Executive remuneration is often covered in the remuneration report; if we feel the remuneration package proposed in the report is excessive then we will vote against the board on the approval of the report.

Some companies seek shareholder approval to make **political donations.** Companies will often caveat this request with an expression that they do not intend to use the privilege even if it is granted. We feel that this is an inappropriate use of company money and will vote against resolutions that propose this. We also feel that if a company asks for permission to make donations but have no intention of using the permission, then there is little point in asking in the first place.

Some proposed resolutions may have a negative impact on **shareholder rights.** For example we feel that 14 days is too short notice for a company to hold a meeting as it does not give shareholders who wish to attend in person sufficient time to arrange to go. This criterion also refers to the issuance of new shares which may dilute the stake of existing shareholders.

Another important part of responsible stewardship is regularly meeting company management. Not only do we meet the executives of portfolio companies but the management of companies not currently held. Meeting management allows us to keep up to date with business strategies and get their take on drivers of performance. Through engaging with companies not yet present in portfolios, it allows us better to gauge their suitability for clients.



NUMBER OF COMPANY MEETINGS PER QUARTER FROM JULY 2015 TO JUNE 2016

CASE STUDIES

Wm Morrison

Our interaction with the businesses that make up client portfolios is not restricted to the AGM. Due to our intention to be long term shareholders it is our aim to communicate with companies in order to understand better their business strategies. One example of this was correspondence with the supermarket chain Morrisons following allegations of poor treatment of suppliers. Wm Morrison is widely held across our client base and we have a preference for Morrisons over other supermarkets for a variety of reasons. One of the main draws is a commitment to a number of enhancements to business practices in many areas compared to industry peers, of which we would highlight the following initiatives: reducing emissions from the haulage fleet, reducing water use on the premises, plans to install solar power panels on the rooftops of all new stores, product sourcing policies and the publishing of research into issues such as animal welfare. We are also excited by projects in hand to work on improving the prospects for disadvantaged young people. Finally, we are happy that the company has been certified by Cruelty Free International under the Humane Cosmetics Standard, providing the assurance that own-brand cosmetics and personal care products are not tested on animals. We note that the detailed Corporate Responsibility Review is made available to download and is subject to independent review. The types of policies detailed above are what we should be seeing from one of the UK's larger companies with a broad social and environmental footprint and we expect to see the company deliver on these commitments.

However, breaches of the Groceries Supply Code of Practice raised concerns, as the revelation that suppliers were asked for retrospective lump sum payments not explicitly agreed in the Supply Agreement was met with great unease. We noted that the thorough internal investigation found that 19 of the requests made had not been related to the relevant Supply Agreements and were therefore in breach of the Code and refunds were offered to these suppliers. We also noted that a full investigation was deemed unnecessary by the Groceries Code Adjudicator (GCA) due to the swift action taken by the company.

After contacting the investor relations department at Morrisons we were told that measures were in place to ensure that such unfortunate incidents will not be allowed to happen again. The key points are:

- Morrisons has a good working relationship with the GCA and her team. They meet face to face for general discussion at least every 3 months.
- The GCA did not view this as an issue worth investigating or taking specific action on because existing procedures dealt with the matter swiftly and effectively.
- There is a dedicated team across legal, internal audit and corporate services that now actively monitors and controls compliance.
- Swift action is taken on any non-compliance.
- There is strong governance with reporting up to both the Executive Committee and CCR (Corporate Compliance and Responsibility) Committee.

We were pleased to learn of these points and pleased that the effective response was sufficient for the Adjudicator.

Lakehouse

Another example of our continuing engagement is with Lakehouse. Lakehouse is an asset and energy support services group that constructs, improves, maintains and provides services to homes, schools, public and commercial buildings with a focus on the UK public sector and regulated markets. The business is split into four areas: Regeneration, Compliance, Energy Services and Construction. The Regeneration business is in part driven by demand from the Housing Revenue Account, which provides funding for the provision of local authority social housing. Lakehouse's offering here consists of electrical rewiring, insulation, disabled adaptations, heating systems and more. Compliance, meanwhile, is focused on protection and offers services that are legal obligations for landlords, such as gas service and maintenance, emergency lighting, fire suppression systems and water tank refurbishment and cleaning. The Construction business has a niche market in the refurbishment, remodelling and extension of primary schools, primarily in the London area where pressure to meet the anticipated growth in pupil places is most acute. Finally, the Energy Services division tackles domestic insulation, smart metering and renewable energy as key areas. Here, the company sees demand from Housing Associations and Local Authorities as well as from the major utility companies. This latter demand is generated by the legal requirement for the utility companies to save a proportion of carbon emissions, which they achieve in practice by buying their share from Lakehouse's installation of such systems. The Energy Services division grew substantially following the acquisition of the Scotland-based company, Everwarm. We participated in the 2015 flotation of the company as we felt the inherent focus on sustainability-related activities of the group was attractive.

Following a profit warning at the end of January 2016 shareholders became wary of the direction that management were steering the company. Investors registered their concerns with Lakehouse and ultimately, Slater Investments Ltd and Steve Rawlings (the late founder of the company) served a notice under sections 168 and 303 of the Companies Act 2006, requiring the Company to convene a General Meeting. This meeting was called in April where resolutions to remove three of the Non-Executive Directors were proposed due to governance concerns. The board were against these resolutions as they felt that they would risk further destabilising the Company, creating potentially damaging uncertainty in relation to its future direction and undermining its reputation with customers, suppliers, employees and other partners and stakeholders. They also felt that it constituted an unnecessary distraction to the Company's executive management team as they sought to focus on getting the business back on track.

We spoke with a firm representing the management and also with a representative of Slater Investments, allowing the latter to explain what their concerns were. After careful consideration of the views of both management and the dissenting investors, we concluded that we would vote for these resolutions and go against the wishes of the Lakehouse Board. We decided this because we felt that a change in the non-executive Directors would improve the governance structure and add shareholder value and felt that the concerns raised over the Board's effectiveness were legitimate.

The majority of shareholders voted against the Board at the meeting and changes to the Board were consequently agreed, whilst the CEO stood down as a result. The Board ultimately appointed Bob Holt OBE as a Director and Executive Chairman of the Company. The Castlefield Voting Guidelines state that typically we disapprove of the merging of the roles of CEO and Chairman. However, in this case and in light of the absence of a CEO and the Board upheaval, we deemed the appointment appropriate and voted for this resolution. Bob Holt has extensive experience in the sector from his 20-year involvement with Mears plc - a company he floated on the stock market and has grown substantially – and we felt that his expertise will prove invaluable in restoring Lakehouse's fortunes. His appointment included a remuneration package beyond what we normally view as appropriate. Again though, given the circumstances and the high hurdles he has to meet to earn his full rewards, we voted for the package.

THE TEAM

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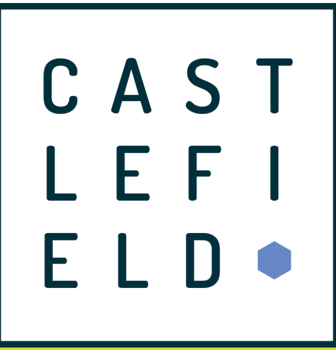
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