Responsible Investment Report

Q1 2023

Contents

Responsible investment at Ruffer

AT RUFFER, WE ARE COMMITTED TO BEING GOOD STEWARDS OF OUR CLIENTS' ASSETS.

To do that, and to generate good investment performance, we need to analyse environmental, social and governance (ESG) issues. They represent both sources of value and investment risks. Incorporating these considerations into our investment approach forms part of our responsibility to our clients.

Whether it's climate change or indigenous rights, executive pay or workforce safety, we believe our considered approach helps us make better investment decisions.

To the advantage of our clients' portfolios.
For the benefit of the companies we invest in.
And to the good of the environment and society.

HOW WE DO IT

INTEGRATION

ESG risks and opportunities are considered as part of our investment process.

ENGAGEMENT

Directly engaging with companies is a part of our investment process.

VOTING

Equity investing comes with rights and responsibilities.

We take this seriously.

We are signatories and supporters of

PRI Principles for Responsible Investment | IIGCC | Climate Action 100+ | Transition Pathway Initiative | CDP | IFRS Sustainability Alliance | RACE TO ZERO | UK STEWARDSHIP CODE

Overview of the quarter

THE MARKET RALLY WHICH BEGAN LAST OCTOBER HIT THE BUFFERS IN FEBRUARY AND MARCH AS CORE INFLATION PROVED STICKY AND THE COLLAPSE OF SILICON VALLEY BANK SPARKED CONCERNS ABOUT THE WIDER FINANCIAL SYSTEM. BONDS AND GOLD ROSE IN VALUE AMIDST A FLIGHT TO SAFETY, BUT OIL WEAKENED, WITH RECESSION FEARS ECLIPSING EXPECTATIONS OF INCREASED DEMAND FROM CHINA.

The last time global inflation was this high, US athlete Edwin Moses was winning an astonishing 122 consecutive races in the 400m hurdles, taking Olympic and World golds and setting four world records between 1977 and 1987. Clearly, Moses had no trouble clearing the hurdles.

Sadly, the same cannot be said for some corporate projects designed to provide innovative solutions to climate change and other problems. Given the elevated economic uncertainty, many companies are raising their hurdle rates for such plans. Investors currently appear to prefer fossil fuel projects offering more clear-cut returns. In this report, we explain why it's important to scrutinise hurdle rates that are based on stale or dismissive views of climate policy and the treatment of externalities.

One fossil fuel company we engaged with over the quarter was BP. We were reassured that it intends to meet oil and gas demand triggered by the war in Ukraine by extending the life of existing machinery and fields in both a resource and energy efficient way.

We also engaged on a variety of topics with a wide range of companies. These included a Swedish operator of independent schools which had encountered negative attention from politicians, a Greek cement producer seeking innovative ways to meet its long-term decarbonisation goals and a Japanese electronics conglomerate which eased our concerns about its alleged links to Uyghur detention camps in China.

Stewardship activities in brief

COMPANY	SUMMARY
ACADEMEDIA	A meeting with management to encourage continued emphasis and communication on the company's social licence as an independent school operator, despite the political contention around privately run schools.
BANK OF IRELAND	A meeting to discuss governance factors, such as remuneration, audit quality and board director tenure, and to encourage interaction between the company and ESG rating agencies.
BP	A meeting following last quarter's results to discuss the company's strategic update and subsequent negative media reports about its low-carbon strategy.
CASTINGS	A discussion about the ongoing role of the former Chair of the board and the strategy of the business under its new leadership and to encourage the company to increase its return on capital.
DASSAULT AVIATION	A brief conversation on the company's stance on engaging with ESG ratings providers, encouraging Dassault to communicate with these agencies and improve its ESG score.
MUSIC MAGPIE	Initial conversations to understand the company's business model, whether more capital is needed and how the company would benefit from consumer trends towards more sustainable consumption.
NEC	Having discussed the issue for many years, we applauded the company for shifting from a traditional Japanese kansayaku board to a three-committee board structure.
NEXUS INFRASTRUCTURE	A meeting to discuss the board's effectiveness in preparing the new management team, given a change in the corporate structure of the company.

COMPANY	SUMMARY
ORIX	An opportunity to encourage more ambitious targets for gender diversity at management and board level, given 2030 targets have almost been met already.
ROHM	A meeting that touched on progress being made on board diversity and to encourage the company to consider appointing an outside director as Chair.
ROVI	An introductory meeting to understand the long-term vision of the company and discuss future succession planning, given the family-owned structure.
RUBIS	Despite recently divesting, we met with the company to discuss its capital allocation strategy and whether our concerns were being addressed.
SHELL	A letter to the CEO, focusing on the transition plan, to gauge the prospects for return on capital through decarbonisation.
SHIN-ETSU CHEMICAL	A discussion on the tenure of board directors, given our concerns around particularly long tenures, and the pace of cross-shareholding reductions over recent years.
SIMPLEX	A conversation on the structure of the board of directors, specifically focusing on female representation and director independence.
SONY	A response to our query about human rights abuses in the company's supply chain, confirming no suppliers are involved in the use of forced labour from the Xinjiang Uyghur Autonomous Region.
TITAN CEMENT	A comprehensive discussion on the company's transition plan and how we propose to analyse and track Titan's progress against its targets. A number of topics were discussed, including capital allocation, internal carbon pricing, policy incentives and the wider value chain.
UPM	A meeting to discuss the company's emissions reduction targets, to communicate which metrics we plan to monitor progress against and to understand how the company is addressing bottlenecks.

COMPANY	SUMMARY
VAN ELLE	A discussion on potential acquisition activity in the industry, given the company's desire to scale.
VIVENDI	A meeting that covered a number of ESG-related topics, including the company's ESG rating, its commitment to disclosing to CDP, the approval of science-based targets, labour rights in the supply chain and the independence of its audit and remuneration committees.
YARA INTERNATIONAL	An opportunity to provide input on the company's remuneration policy, in light of the Norwegian government's proposal to restrict the variable component of compensation.
VARIOUS	A collaborative letter sent to a number of companies, which we co-signed as a member of the IIGCC, encouraging development of a Net Zero transition plan consistent with Net Zero Investment Framework alignment criteria.

Engagements in focus

BP

We met with BP at the beginning of February, primarily to discuss the previous quarter's performance and full year results for 2022. However, when the company announced its results, it also gave an update on strategic progress that garnered a lot of negative media attention. Reports claimed that the announcement represented a row back on renewables and a shift towards oil and gas production, casting doubt over whether the company was really committed to moving towards a low-carbon world.

As long-term shareholders of this energy major, we felt obliged to learn more about the seemingly mixed messages on BP's strategy and the role renewable energy will have to play. We spoke to BP's chief financial officer and the newly appointed executive vice president of gas and low carbon energy. They confirmed that the company is aiming to marginally extend the life of its existing oil and gas assets to meet demand triggered by Russia's invasion of Ukraine but is doing so in a resource and energy efficient manner by using existing machinery and fields, rather than investing in intensive new projects.

Overall, the announcements suggest to us that BP is taking a pragmatic and flexible approach to achieving its reiterated goal of a Net Zero transition. The transition will require a significant amount of energy, much of which will unavoidably be fossil fuel based, and the flexibility to react to external events and adjust accordingly will be crucial to delivering a value accretive, and therefore sustainable, transition. We think the events of the past year have highlighted how important such characteristics will be to achieving decarbonisation in an increasingly volatile world.

SONY

In 2020, the Australian Strategic Policy Institute published a report that identified 82 brands allegedly linked to so-called labour transfer programmes of Uyghur and other ethnic minority citizens. These companies had ties to factories across China that are believed to have used forced Uyghur labour transferred from state-sponsored 'vocational education and training centres', which some describe as detention camps. When the report was released, we contacted a number of companies that we held in our portfolio to gain clarity on their supply chain policies.

We asked Sony, one of the names listed in the original report, to clarify its response to the allegations. As a founding member of the Responsible Business Alliance (the largest industry coalition dedicated to corporate social responsibility in global supply chains), Sony performed an initial assessment to confirm the report's findings but did not identify that any supplier was involved in the use of forced labour from the Xinjiang Uyghur Autonomous Region. Sony also reiterated its explicit prohibition of trafficked and forced labour in its supply chain. Should a supplier be confirmed to have committed a major violation of the code such as the use of forced labour, Sony will take appropriate countermeasures including requesting the implementation of corrective actions and terminating its business with the supplier. We were satisfied with this response and intend to monitor the situation.

ACADEMEDIA

AcadeMedia is Sweden's largest operator of independent schools, with operations across Europe. It educates people of many ages, from pre-school to adults. Privately operated schools are a politically contentious subject, and the party widely expected to win last year's Swedish general election vocally demanded the abolition of for-profit independent school operators. The negative media attention served as a catalyst for investor sell-offs, depressing the share price to multi-year lows, even though the Social Democrats did not in fact win the election.

We met with the company's management and discussed the importance of emphasising AcadeMedia's social licence to operate, which we believe is compelling. AcadeMedia operates at a higher level when benchmarked to the national average, and its services are appreciated by parents of pupils attending these schools. It is one of the few school operators investing substantially in additional school places and education technology. This focus on operating efficiency and meaningful capital investments is driven by its profit motive and ultimately benefits wider society. We have consistently supported and encouraged management to continue their engagement with the political establishment on independent educational reform. We have also spoken to local investors to seek alignment on how to communicate this more widely.

TITAN CEMENT

The path to a Net Zero economy is not likely to bypass cement. The International Energy Agency (IEA) Net Zero by 2050 scenario has annual cement production increasing from around 4 billion tonnes in 2020 to some 4.3 billion tonnes in 2030 before heading back to the 2020 level by 2050. Cement is used to make concrete, needed to support population growth, economic development and the infrastructure critical to addressing climate risk. No doubt substitutes will emerge in certain applications – such as cross-laminated timber – but it is hard to imagine complete disruption from any combination of materials at present.

That said, we should certainly expect significant changes in the way cement is created. In the same IEA scenario, carbon dioxide emissions from cement production fall from roughly 2.3 billion tonnes in 2020 to 133 million tonnes in 2050. To achieve this rate of decarbonisation, cement producers will need to tackle thermal emissions and process emissions in full force. Grid decarbonisation, improved energy efficiency and the use of alternative fuels are quick fixes, but there will also need to be an acceleration of clinker substitution, carbon capture and the development of novel cements. Strong and stable policy support will be vital. Regulation and public sector procurement will help to smooth out uncertainty, which in turn should drive investment towards green solutions.

In our view, cement producers may be able to harness decarbonisation to promote differentiation. If customers begin to value environmental credentials, carbon leadership – coupled with traits like durability – might lead to stronger pricing power. With this backdrop in mind, our engagement with Titan Cement has focused on capital allocation, capacity to innovate and exposure to policy developments.

Titan has medium and long-term decarbonisation targets: to reduce specific net Scope 1 emissions by 2030; and to deliver carbon neutral concrete by 2050. To achieve its intermediate goals, Titan plans to boost energy efficiency, accelerate the use of alternative fuels, optimise the mix of raw materials and increase the proportion of clinker substituted by cementitious materials with lower carbon intensity. To get emissions all the way down towards zero, these conventional levers will need to be supplemented by more innovative approaches, spanning novel cements, hydrogen technologies and carbon capture, utilisation and storage (CCUS).

The company says it has identified a list of over 90 decarbonisation projects that will carry it towards its 2030 targets. These projects are expected to drive cost savings and open up growth opportunities, whilst decarbonising cement production. Furthermore, Titan uses internal carbon prices to stress-test the economics of these projects – a key method we look for in analysing companies' transition plans.

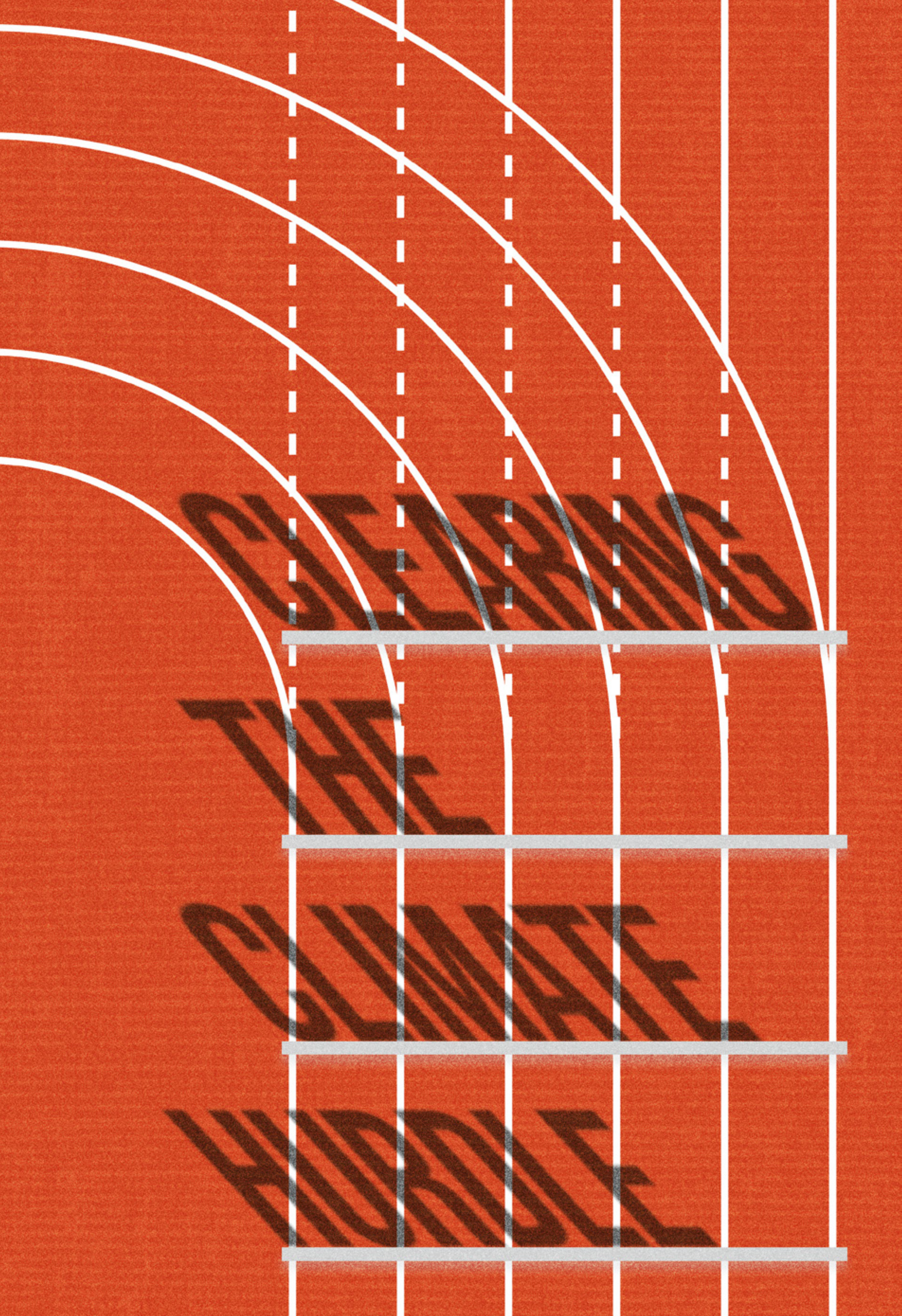
We suggested to the company that investors might benefit from a marginal abatement cost curve. That would help us visualise the potential for emissions reductions of each abatement lever and the associated cost. We would then be able to evaluate prospects for value creation, in the context of the company's cost of capital and prevailing carbon prices. We look forward to engaging on this topic in more detail in the future.

Another consideration is the technological uncertainty that 2050 targets will have to contend with: the economics of complete decarbonisation will depend on technology that has not yet been proved at scale and on the policy environment into which these technologies are deployed. To execute its decarbonisation plans, Titan will need to increase research and development expenditure, as well as innovation-related capital and operating expenditure. It will also need to embed digital expertise across the organisation. The company nearly doubled annual investment in research and innovation between 2018 and 2021 and plans to double this again beyond 2025.

As we continue to engage with the company on its innovation roadmap, we plan to explore its human capital strategy. In particular, we will track access to key skills and the strength of employee engagement. The company points out that “existing processes to recruit, develop and retain talented individuals and promote their mobility may not be sufficient, thus potentially giving rise to risks of employee and management attrition, difficulties in succession planning, and an inadequate pipeline of future talent, potentially impeding the continued realisation of high operational performance and future growth.” How effectively the company manages these human capital risks will determine the rate of innovation and, therefore, the rate of decarbonisation.

Given the carbon intensity of cement production and the significant innovation required to get to Net Zero, companies with European facilities will be closely watching developments in the EU Emissions Trading System. As free allocation of allowances gives way to the Carbon Border Adjustment Mechanism, we will evaluate the industry’s ability to handle direct exposure to the carbon price, as well as to evolving export-import dynamics.

Additional policy support for green innovation may also have implications for Titan’s access to capital and cost of capital, and ultimately the rate of decarbonisation. On CCUS in particular, the company highlighted that progress would depend on the nature of funding and incentives. In this context, we discussed the relative merits of the US Inflation Reduction Act and the EU Green Deal Industrial Plan, touching also on the EU Innovation Fund and Horizon Europe. Though the quantum of incentives may be comparable, the US model appears more streamlined, which may be a factor in drawing capital away from Europe in the near term. We will continue to engage with the company on how regional policy differences may or may not influence strategy and the rate of decarbonisation across assets.


CLEARING
THE
CLIMATE
HURDLE

The first rule of making money is to get more out than you put in. In business, a project must generate a higher return than it costs. Rather than thinking about how much an ice cream machine costs when deciding whether to start an ice cream business, companies think in terms of how much the money to buy the machine is going to cost. This cost of capital can be broken down into the risk-free rate (the minimum return on an investment that seemingly carries no risk) and the corporate risk premium (to compensate for business risk). Any project that can earn more than the cost of capital is golden – it returns an economic profit and is therefore viable.

However, another layer of return is often required on top of the cost of capital. This additional margin, which is set by the company, acts as a buffer or a safety net in case the project yields less profit than expected. Together, these three elements make up a company's hurdle rate – the magic number a project's prospective return on capital must hit in order to be considered by management (Figure 1).

Figure 1

COMPONENTS OF THE HURDLE RATE

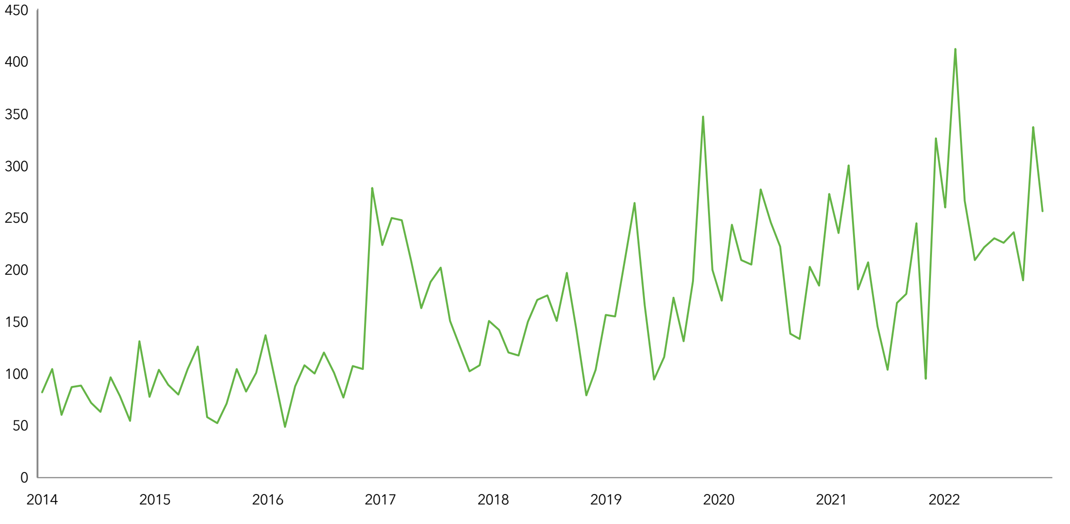
Source: Ruffer

It is important to understand the hurdle rate if we want to get a sense of how a company is allocating capital. The risk-free rate has risen meaningfully over the last year, and the other two components are being forced up by uncertainty and risk aversion.

Market uncertainty is high, whichever way you measure it. The VIX volatility index remains elevated as markets guess where inflation is going and how the Federal Reserve will respond. Meanwhile, indices based on newspaper coverage of policy-related economic uncertainty and disagreement among economic forecasters also indicate uncertainty. If we zoom in on climate policy specifically, this upward trend in uncertainty is clear (Figure 2). If companies can't be sure how much they can expect in the way of green subsidies or tax breaks, they are unlikely to pursue projects whose profitability depends on such support.

Figure 2

CLIMATE POLICY UNCERTAINTY INDEX



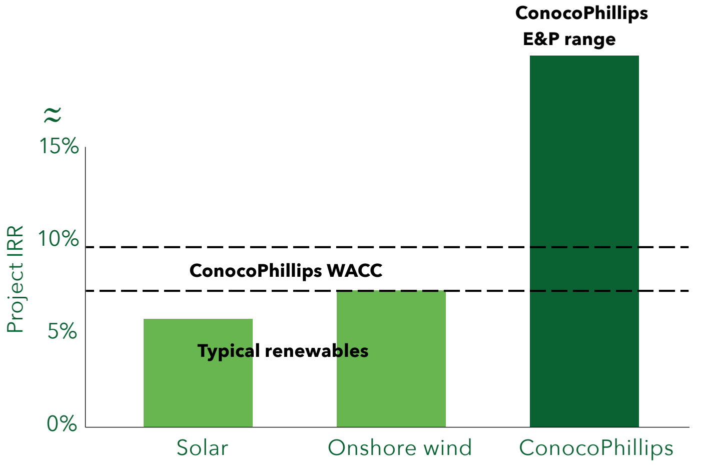
Source: Gavriilidis (2021), Measuring Climate Policy Uncertainty

Uncertainty brings risk aversion in business, as in every walk of life. As a result, the hurdle rate imposed when assessing potential value creation projects is stubbornly high. Whether this is a good or a bad thing depends on the company in question.

High hurdle rates can have negative ramifications for important innovative or transformational solutions, notably to the climate crisis. Simply put, returns from renewable energy are far lower than those from fossil fuels. A US oil and gas exploration and production company (E&P) makes this point in its plan for the Net Zero energy transition (Figure 3). And consider the market's reaction to BP's announcement that it was dialling back on targets to slash oil output: the stock price jumped to its highest in four years. It seems investors are rewarding a renewed focus on fossil fuels, with their higher profit margins. Indeed, there is a clear valuation gap between oil majors that won't consider pivoting to renewable energy and those making the change (Figure 4, page 15). The market wants near-certain returns, and it wants them now.

Figure 3

RETURNS ON RENEWABLES VERSUS FOSSIL FUELS



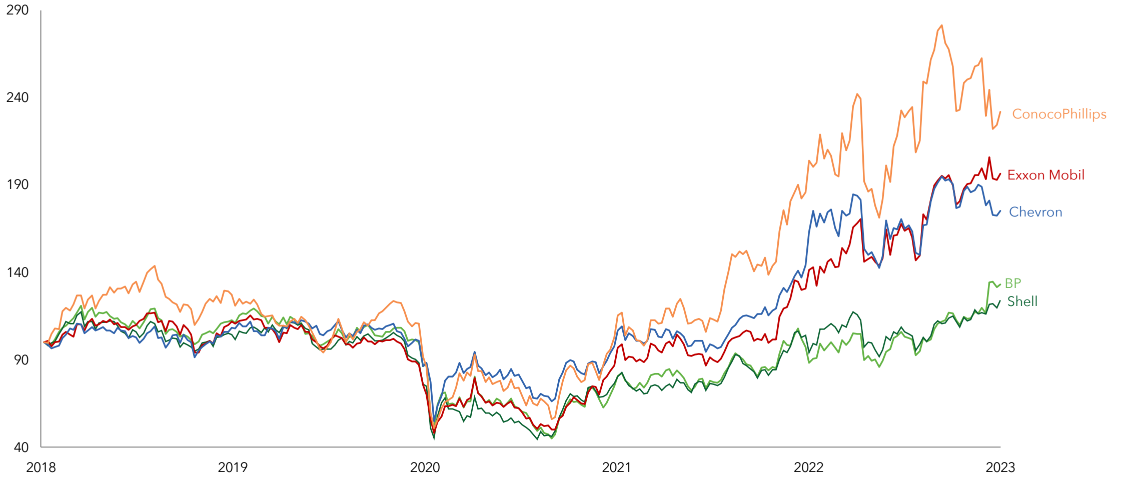
Source: ConocoPhillips, Bloomberg, WoodMac

On the other hand, high hurdle rates can offer some reassurance that a company is only pursuing the highest quality projects. Put another way, a higher required rate of return may force a company to return cash to shareholders via buybacks or dividends, rather than spending on new projects. This may be especially relevant when considering companies in high-emitting industries. If you were an environmentally minded investor in a company that has doubled down on fossil fuels, calling for a high hurdle rate or directly demanding that capital is returned might be an effective strategy.

If climate change is one of your top priorities, your initial reaction to Figure 3 might be despair. But despair should be balanced with rationality. A major challenge for us ESG proponents is not confusing what we want to see in an ideal world with the reality we face. Although growth in renewable generation has been impressive, it has nonetheless been insufficient to meet the world's growing demand for energy – to keep the lights on in schools and hospitals and enable growth and a better standard of living in poor nations. At least in the short term, therefore, demand for oil and natural gas will continue. E&Ps will be vital in delivering reliable and affordable energy in a responsible manner to meet this

Figure 4

RELATIVE TOTAL RETURN PERFORMANCE OF OIL COMPANIES



Source: FactSet

demand, and they will have a significant role to play in decarbonising the global economy, as long as production becomes less carbon intensive. A holistic perspective on the energy trilemma – security, affordability and sustainability – has never been more relevant.

This reality feeds into our fundamental view on the impact China's emergence from three years of covid lockdowns will have on the market for oil. This view is reflected in our increased allocation to energy stocks. But we do not believe this contravenes our commitment to promoting decarbonisation. Through investment and engagement, we want to understand the project economics and, where relevant, argue for a change in methodology that could close the returns gap and put renewables on a more level playing field.

For energy majors, one catalyst for promoting the push into renewables is bringing down the hurdle rate that restricts investment in riskier or potentially lower-yielding projects. Clarity on policy will be a major tipping point. America's Inflation Reduction Act, which will funnel $369 billion into clean technology investment, is the first domino to fall, triggering the crystallisation of incentives in Europe, China and beyond. The combination of subsidies and lower thresholds for returns should make a compelling case for investing in projects that could have a meaningful impact on global decarbonisation.

Coming at the problem from another direction, the idea that fossil fuel returns are artificially inflated by ignoring most of their environmental and social costs is moving into the mainstream. For example, Duncan Austin, a guest contributor in this year's Ruffer Review, talks about the market's invisible hand being connected to an unmentionable foot. Fossil fuel projects overwhelmingly exclude the full extent of their contribution to climate change. Pricing in a social cost of carbon to reflect environmental damage might change the equation, making returns from renewables look more attractive in many instances.

A prominent feature of E&P Net Zero transition plans is advocating a carbon price. While the US does not have an explicit federal carbon price, some states have implemented their own, and the EU's Emissions Trading System has been effective at reducing carbon emissions. As investors, we want to know how E&P companies are using this carbon price in their own returns calculations. Is the carbon price used akin to the social cost of carbon? Are these companies modelling what effect such a carbon price will have on the end-user demand for their product? At what point does the returns profile for oil and gas begin to look unattractive?

Part of our investment analysis and stewardship commitment includes building a robust understanding of the economics of a company's capital allocation. This work is not limited to the oil sector. Over the past quarter, we have engaged with companies such as Titan Cement and UPM, a forest products company, on the implementation of an internal carbon price and the framework they use to allocate capital to projects that span timeframes and risk profiles. As we drive towards Net Zero, it is important to understand technological bottlenecks that might hinder progress. But it may be just as crucial to scrutinise self-imposed capital constraints in companies that are setting hurdle rates based on stale or dismissive views of climate policy and the treatment of externalities.

ELEANOR MORIARTY

Responsible Investment Associate

About Ruffer

OUR AIM IS TO DELIVER GOOD POSITIVE RETURNS – WHATEVER HAPPENS IN FINANCIAL MARKETS.

To invest well, we need to take on risk. With risk comes great responsibility. Our preoccupation is with not losing money, rather than charging headlong for growth. It's by putting safety first that we have made good money for our clients. Through boom and bust. For over 28 years. If we keep doing our job well, we will protect our clients' capital – and increase its real value.

We believe that investing responsibly will lead to better long-term outcomes for our clients.

ESG factors form one part of our fundamental analysis. We have a collaborative research process between the research analysts, members of the responsible investment team, and responsible investment specialists. To fulfil our duty to act as responsible stewards of our clients' assets, we use our judgement to determine when to engage and how to vote at shareholder meetings to best protect the economic interests of our clients, while remaining cognisant of the impact on all stakeholders. Engagement with the companies we invest in not only gives us an opportunity to deepen our understanding of the business, but also is an effective tool to achieve meaningful change.

OUR RESPONSIBLE INVESTMENT FRAMEWORK