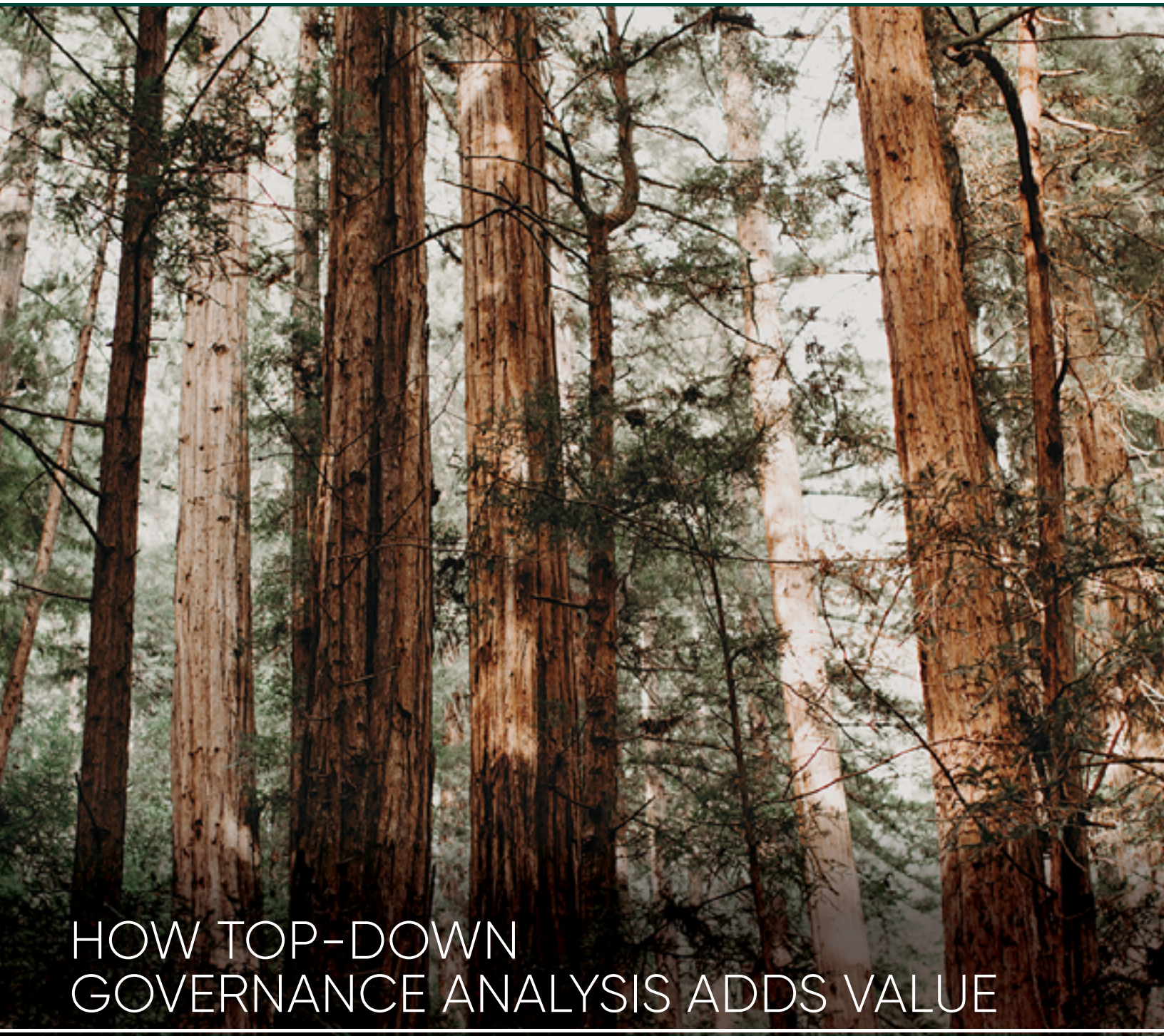
FISHER INVESTMENTS EUROPE™



HOW TOP-DOWN GOVERNANCE ANALYSIS ADDS VALUE

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TOP-DOWN VERSUS BOTTOM-UP

Overwhelmingly, investment professionals today utilise an investment process generally known as "bottom-up" investing. A typical bottom-up investor emphasises equity selection and researches an assortment of companies, attempting to pick those with the greatest likelihood of outperforming the market based on individual merits. The investor mixes the selected securities together to form a portfolio; however, country and sector exposures are often simply residuals of security selection.

"Top-down" investing reverses this process. A top-down investor first analyses such macro factors as economics, politics and sentiment to forecast which investment categories are most likely to outperform the market. Only then does a top-down investor begin looking at individual securities. Top-down investing is inevitably more concerned with a portfolio's exposure to broad investment categories than any individual security. Thus, top-down is an inherently dynamic mode of investing because investment strategies are based upon the prevailing market and economic environments (which change often).

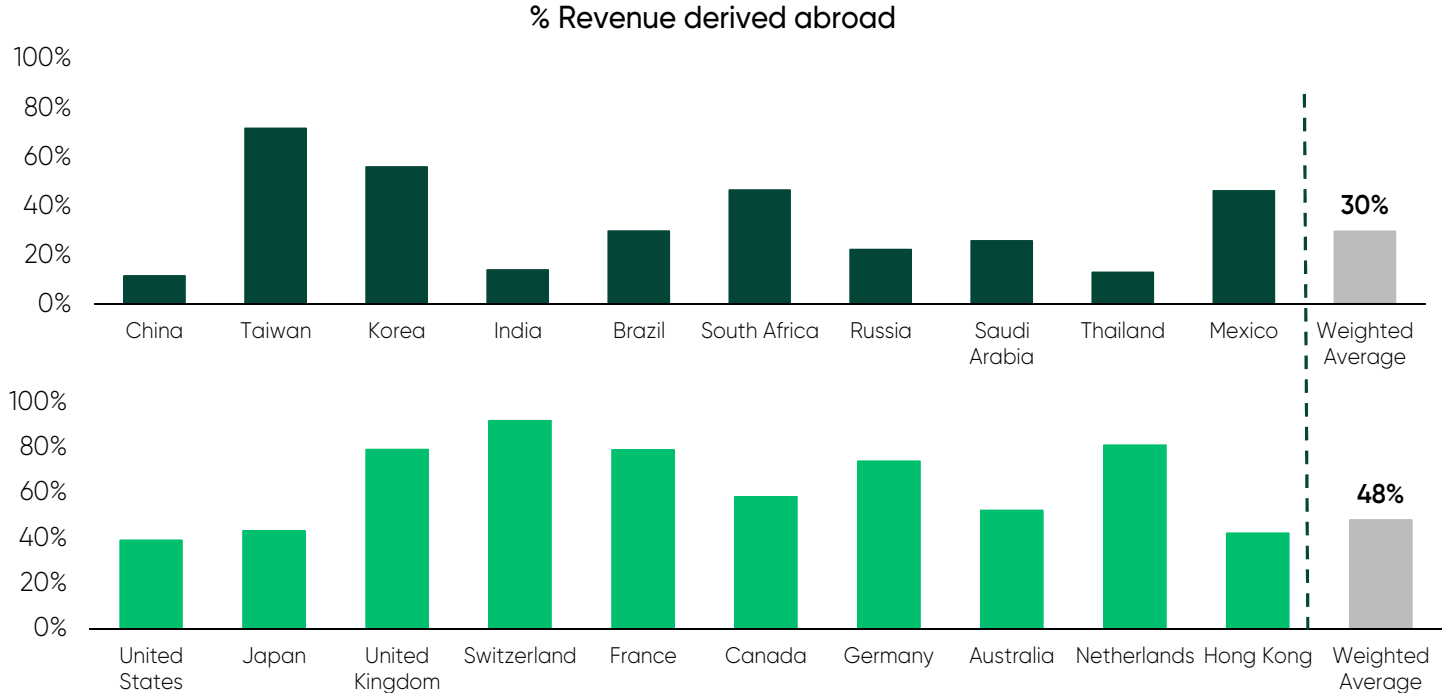
TOP-DOWN IN AN ESG FRAMEWORK

Top-down research is highly complementary to ESG analysis. In a world of global supply chains and multinational corporations, implementing ESG considerations in the investment approach requires global insights. Over 48% of revenue of MSCI World constituents and 30% of revenue of MSCI EM constituents is derived from abroad (Exhibit 1).

Top-down investment management is all about considering factors (risks and opportunities) outside the scope of traditional financial statement analysis. This is also the main goal of ESG integration. For example, understanding the political/legislative/corporate norms of a country can help avoid environmental or regulatory risks securities in any given country may be exposed to. To summarise: Good top-down decisions already demand ESG considerations.

While ESG factors are of significant importance, in this paper, we will focus exclusively on the added value of analyzing governance considerations through a top-down lens.

EXHIBIT 1: REVENUE DERIVED FROM ABROAD BY COUNTRY



Source: FactSet as of 18/05/2020.

THE PITFALLS OF QUANTITATIVE GOVERNANCE SCREENING

One common approach in 'best in class' ESG strategies is for managers to quantitatively screen out low-rated companies by total score or by individual pillar scores (E,S,G). While applying a common risk framework (ESG score screening) may be appropriate for environmental and social considerations, it is inappropriate for governance review.

NO SHORTCUTS TO SECURITY-LEVEL GOVERNANCE ANALYSIS

Broad common externalities (e.g. carbon regulation, consumer preferences) primarily drive environmental and social risk. A common risk framework (ESG score screening) thus may reasonably help managers assess security-level environmental/social risks. However, while key governance-related externalities need to be considered (e.g. government influence, country reforms), internalities unique to an individual company's structure, management team and business/industry primarily drive security-level governance risks. In analyzing governance risks, therefore, a common risk framework like ESG score screening may not sufficiently help managers.

CORPORATE GOVERNANCE ANALYSIS INTEGRATION

Instead of applying a one-size-fits-all common framework for governance analysis, Fisher Investments evaluates governance factors at multiple stages throughout the investment process. It does this at both the top-down level (with Capital Markets Analysts and the Investment Policy Committee developing country, sector and thematic preferences) and at the bottom-up/security-level (with Securities Analysts conducting fundamental analysis and engagements.)

TOP-DOWN GOVERNANCE PROCESS

In a top-down investment process, sector, country, style and thematic decisions contribute materially to relative performance. As such, identifying factors likely to contribute positively or negatively to country/sector performance requires significant effort. At the country level, for example, governance analysis primarily includes the degree to which a country's political/regulatory structure and trends (e.g. reforms) may influence business results or investor preference for that country relative to alternatives. Top-down governance factors considered when determining country and sector/industry allocation include governmental influence on public companies, regulation, social policy, and market reforms impacting private property, labour or corruption.

BOTTOM-UP GOVERNANCE PROCESS

FI's Securities Analysts perform fundamental research on prospective investments to identify securities with strategic attributes most consistent with the firm's top-down views and with competitive advantages relative to their defined peer group. Governance analysis at the security level involves assessing a company's risks (e.g. ownership concentration, share class structure, proxy fights) and its ability to mitigate such risks (e.g. through board structure, independent auditor activities or managerial quality assessment). When security-level concerns present an inordinate risk to a company's operational or financial performance, or the firm believes they present undue headline risk to share price performance, FI would choose not to invest in that company.

Engagement and proxy voting are also important parts of FI's governance analysis. FI engages with companies as part of its fundamental analysis and to clarify or express concerns over potential governance issues. FI also interacts with company management on proxy voting issues, particularly when our proxy voting services provider, Institutional Shareholder Services, Inc. (ISS), disagrees with company management. FI's broader Engagement Policy is available upon request.

The importance of independent and detailed governance analysis cannot be overstated. As discussed, there are no shortcuts to governance risk assessment, as internalities unique to an individual company's structure, management team and business/industry primarily drive security-level risks. Using a quantitative screening approach relying on third-party (e.g. MSCI ESG Research, Sustainalytics, ISS, etc.) could lead to individual missed opportunities or a restriction of large swaths of the investment universe, such as Chinese ADRs using the Variable Interest Entity (VIE) structure.

TOP-DOWN GOVERNANCE ANALYSIS EXAMPLES

Some of the most important decisions for top-down managers occur on the country and sector level. Top-down governance analysis can help isolate countries and sectors that are poised to underperform— pulled down by negative ESG characteristics. Following are several examples describing how country-level corporate governance can be one of several factors potentially impacting performance.

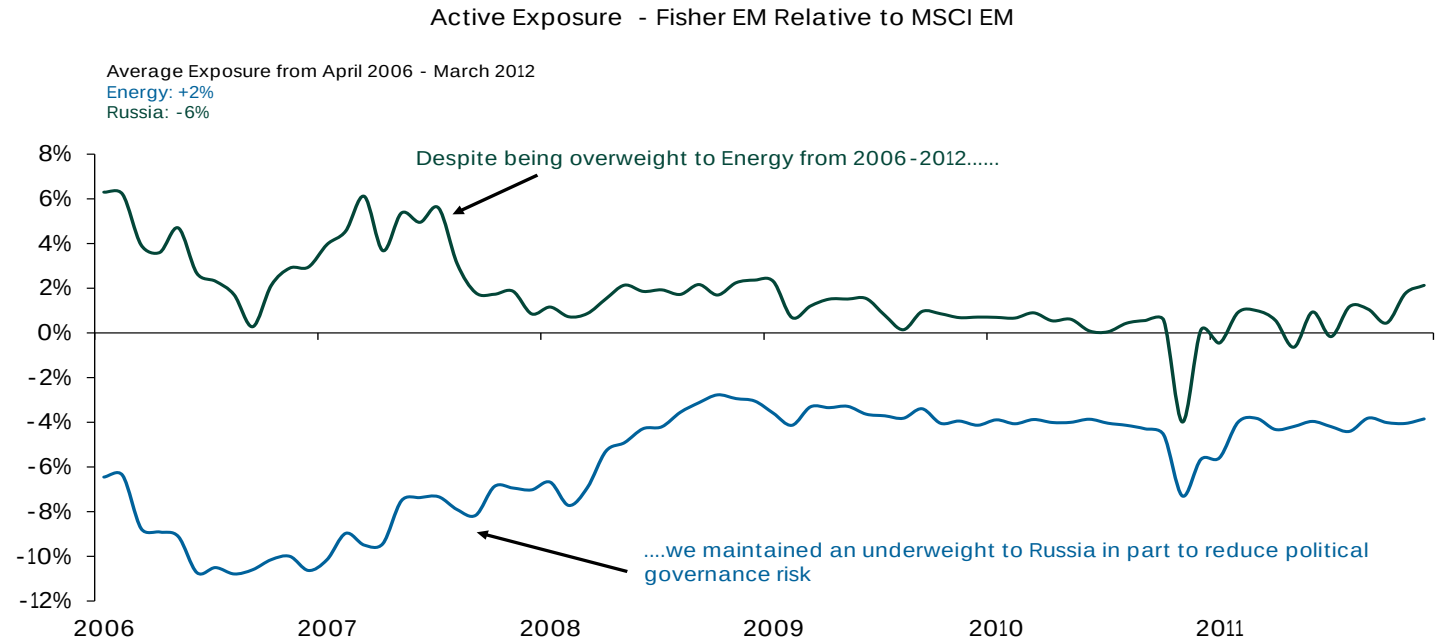
RUSSIAN CORRUPTION

Country-level corporate governance is one of many factors that help us determine the gap between reality and expectations and expected risks in the portfolio. We hold no bias in favour or against any specific country, but we consider top-down governance considerations particularly important in Emerging Market countries like Russia—where there are less-rigorous mechanisms to prevent public and private sector corruption.

Russia has a history of nationalisations that raise concerns over property rights, such as the one conducted on energy company Yukos. The CEO was arrested, the company was forcibly broken up and pushed into bankruptcy for unpaid taxes. International courts ruled that the government abused their power to illegally seize the company's assets.

Although there was a high concentration of Energy companies in Russia from 2006 – 2012 and we remained overweight to the sector in our EM strategies, high-level ESG considerations led us to seek Energy exposure in other areas with significantly less political risk (Exhibit 2).

EXHIBIT 2: ACTIVE EXPOSURE TO ENERGY AND RUSSIA OVER TIME



Source: Fisher Investments Emerging Markets active weights to Energy and Russia relative to MSCI Emerging Markets. Barra Portfolio Manager from 01/04/2006-31/03/2012.

SOUTH AFRICAN REFORMS

Another country-level governance analysis example involves South Africa. This analysis heavily influenced the Investment Policy Committee's (IPC's) decision-making within Fisher Investments' Institutional Emerging Markets Equity Fund. Specifically, it led to the IPC's decision to underweight South Africa vs. the MSCI Emerging Markets Index.

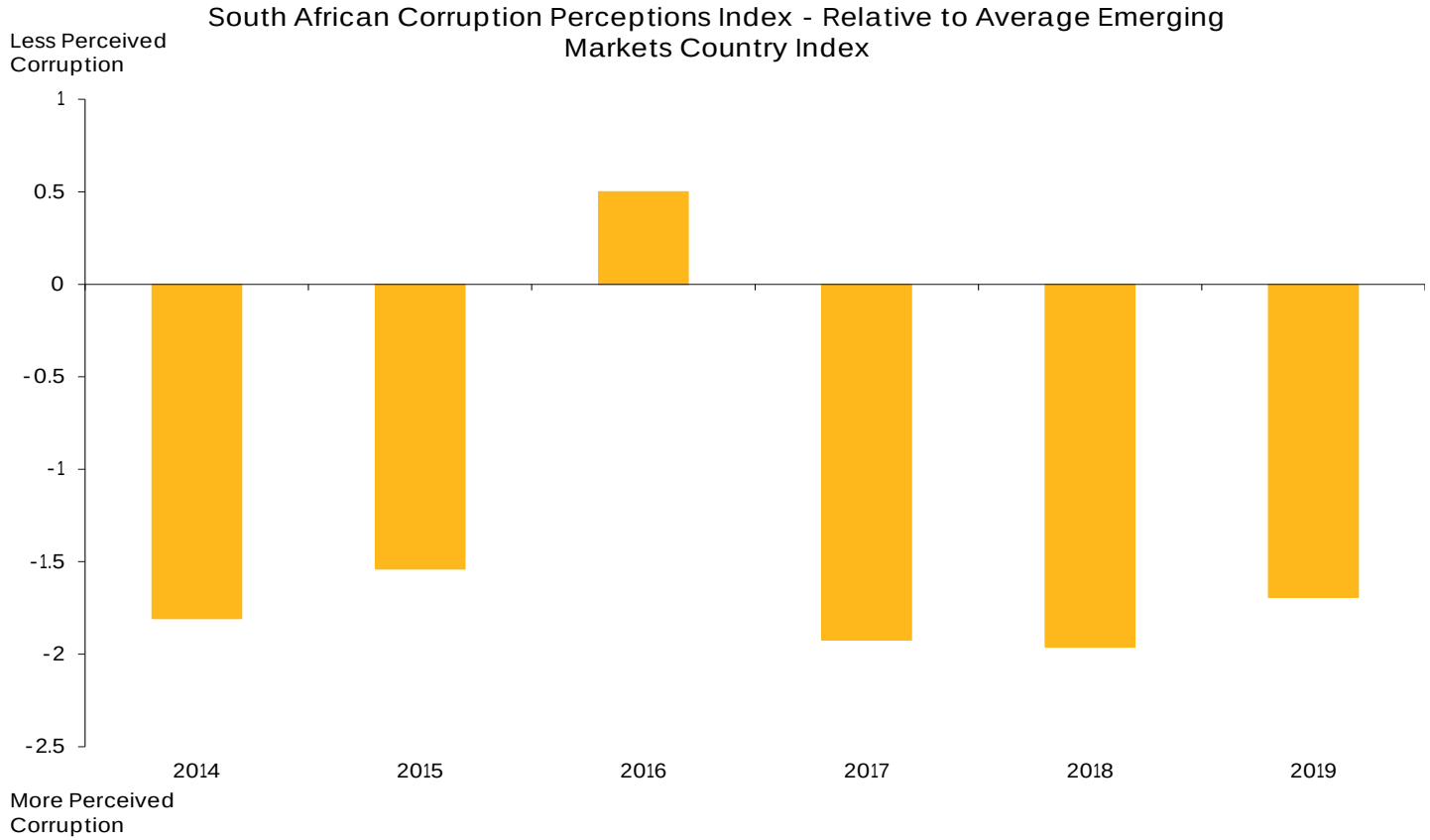
Proposed Land Reform: South African President Cyril Ramaphosa's government has been progressing reform that would expropriate land without compensating current owners. While the goal of this reform, much like prior Black Economic Empowerment programmes, is to improve income and wealth disparity, it does weaken the strong property ownership rights that separate South Africa from other African nations and increases the risk of discouraging foreign direct investment. Additionally, Black Economic Empowerment programmes have been criticised for benefitting only a small portion of the Black population and widening the wealth gap within that demographic. This has a negative impact on the Financial, Real Estate and Materials sectors.

Government Corruption and State Capture: Former President Jacob Zuma is currently facing prosecution for arms deals he facilitated as deputy president and could face additional bribery and state capture charges tied to the Gupta family scandal. While Zuma is out of office, his African National Congress remains in power, and some of his peers and state-owned enterprises could potentially be involved in the scandals.

This has a negative impact on the Utilities and Financial sectors. Overall, perceived corruption has not been improving in recent years and remains worse than the average of MSCI EM countries, as measured by Transparency International (Exhibit 3).

Further, South African government officials have recently floated proposals to force banks to lend to coal-fired utilities and invest in new coal-fired power plants against their will. This has contributed to underperformance for the banking industry.

EXHIBIT 3: SOUTH AFRICAN CORRUPTION NOT IMPROVING



Source: Transparency International as of 31/12/2019.

BRAZILIAN CORRUPTION

Corporate corruption concerns are most often focused on scandals (e.g. Operation Car Wash in Brazil, South Korean President Park Geun-hye's impeachment) that have caused passive ESG investors to persistently underweight entire countries. Such simple risk-avoidance strategies lead investors to miss out on alpha opportunities that top-down macro managers such as FI don't overlook.

A strategy that simply screens out lower-rated companies could likely exclude an entire country or create a chronic underweight position to areas like Brazil, one of the nations with the worst Bribery and Corruption scores (per MSCI ESG Research). As a top-down manager, Fisher Investments acknowledges the risks in Brazil, but also balances them with the alpha opportunity depressed equity sentiment and fundamental economic tailwinds bring.

Furthermore, by simplistically avoiding Brazil due to fears of corporate corruption, investors also overlook the positive impact produced through the Brazilian banking system. Brazilian banks have a history of lending to low and middle class individuals, helping drive increased credit penetration for the country.

Companies such as Banco Bradesco have used unique approaches, such as riverboats, in order to bring banking to underserved regions of the country.

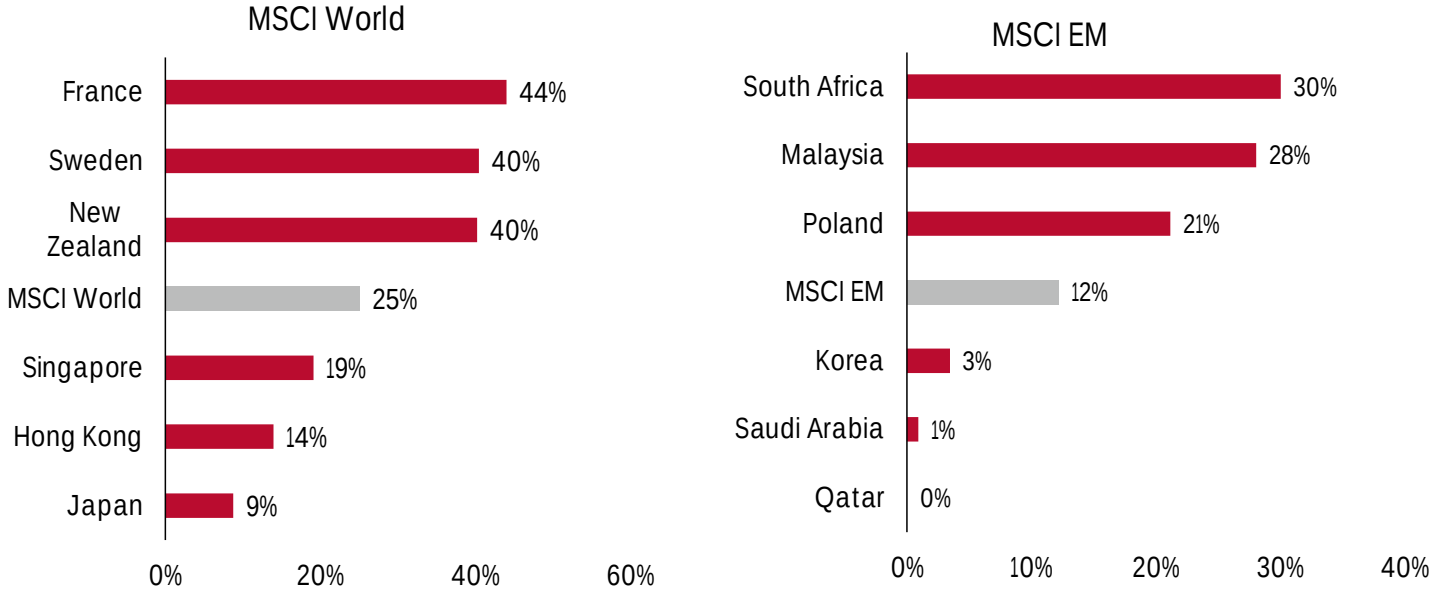
Such investments support UN Sustainable Development Goal #1—"No Poverty". One way for investors to reduce poverty is through investment in banks that provide credit to underserved communities. Investing in Brazilian banks—despite corruption fears—can help achieve that aim.

CORPORATE GOVERNANCE IN JAPAN

Japan currently has the worst corporate governance score (as defined by MSCI ESG Research) of all countries in the MSCI World index. Part of this is due to a lack of independent board members. Often times there are close relationships between big Japanese banks and large corporations. As a result, corporate board members were and still are often insiders coming from a main bank, the corporate group and the corporation itself. Additionally, the country ranks last of all developed countries as it relates to board diversity, with women making up only 9% of the boards of Japanese public companies (Exhibit 4).

However, the Abe administration aims to improve corporate governance and raise ROEs through the creation of equity indices comprised of strong corporate governance firms—aimed to attract government and private capital. Further, the $1.5T government pension fund (GPIF) is allocating funds to encourage better governance standards, female labour force participation and carbon reduction. Many medium and large size Japanese firms are modifying organisational practices as a result of the GPIF emphasis.

EXHIBIT 4: BOARD DIVERSITY (% FEMALE)



Source: MSCI ESG Research, as of 31/12/2019.

HISTORY OF CORPORATE STEWARDSHIP AT FISHER INVESTMENTS

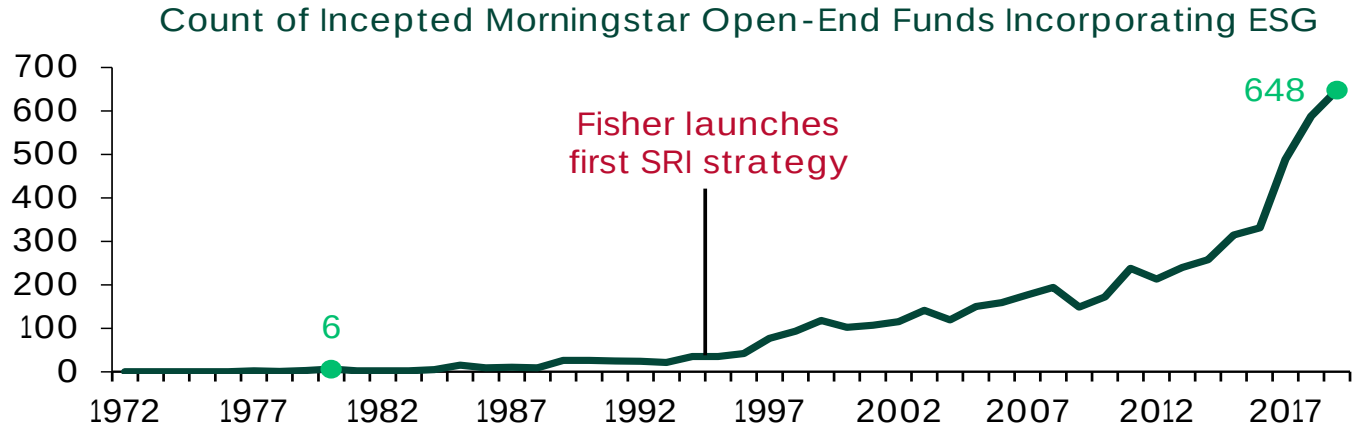
Demand for ESG oriented strategies has grown consistently over the last 50 years, illustrating the importance and value investors put behind considering ESG factors (Exhibit 5). While other managers have rushed to incorporate ESG into their investment strategies, FI has decades of experience actively managing portfolios considering government corruption, environmental legislation, labour developments, human rights and other macro ESG considerations. Each year our ESG program continues to expand and develop, and we are excited to continue building out our ESG capabilities.

CURRENT ESG ORGANISATION MEMBERSHIPS

We are a United Nations Principal for Responsible Investment Signatory, support the U.K. Stewardship Code and are a signatory of the Japanese Stewardship Code. Further, FI is a member of the following organisations.

- **UN Global Compact Participant:** The UN Global Compact is a voluntary initiative based on company commitments to implement universal sustainability principles and to undertake partnerships in support of UN goals.
- **CDP Signatory:** CDP runs the global environmental disclosure system. Each year CDP supports thousands of companies, cities, states and regions to measure and manage their risks and opportunities on climate change, water security and deforestation.
- **Climate Action 100 Signatory:** Climate Action 100 is an investor initiative to ensure the world's largest corporate greenhouse gas emitters take action on climate change. The companies include 100 'systemically important emitters', accounting for two-thirds of annual global industrial emissions, in addition to 60 companies with high opportunity to promote clean energy.
- **Task Force on Climate-related Financial Disclosure (TCFD) Supporter:** The FSB TCFD creates voluntary, consistent climate-related financial risk disclosures for firms to provide for investors, lenders, insurers, and other stakeholders.
- **Conservation International Supporter and Emerald Circle Member:** Conservation International works to highlight the critical opportunities that nature provides to humanity. They work to protect more than 2.3 million square miles of land and sea across 70+ countries.

EXHIBIT 5: EVOLUTION OF ESG DEMAND



Source: Morningstar Direct. As of December 2019. Based on 5,537 observations. Fisher's SRI strategy was US Small Cap Capabilities ESG and was seeded February 1995.

DISCLOSURES

Fisher Investments Europe Limited (FIE) is authorised and regulated by the Financial Conduct Authority. It is registered in England, Company Number 3850593. FIE is wholly-owned by Fisher Asset Management, LLC, trading as Fisher Investments (FI), which is wholly-owned by Fisher Investments, Inc.

Fisher Investments (FI) is an investment adviser registered with the securities and Exchange Commission. As of 31 December 2019, FI managed over $120 billion, including assets sub-managed for its wholly-owned subsidiaries. FI and its subsidiaries maintain four principal business units – Fisher Investments Institutional Group (FIIG), Fisher Investments Private Client Group (FIPCG), Fisher Investments International (FII), and Fisher Investments 401(k) Solutions Group (401(k) Solutions). These groups serve a global client base of diverse investors including corporations, public and multi-employer pension funds, foundations and endowments, insurance companies, healthcare organisations, governments and high-net-worth individuals. FI's Investment Policy Committee (IPC) is responsible for investment decisions for all investment strategies.

For purposes of defining "years with Fisher Investments," FI was established as a sole proprietorship in 1979, incorporated in 1986, registered with the US SEC in 1987, replacing the prior registration of the sole proprietorship, and succeeded its investment adviser registration to a limited liability company in 2005. "Years with Fisher Investments" is calculated using the date on which FI was established as a sole proprietorship through 31 December 2019.

FI is wholly owned by Fisher Investments, Inc. Since Inception, Fisher Investments, Inc. has been 100% Fisher-family and employee owned, currently Fisher Investments Inc. beneficially owns 100% of Fisher investments (FI), as listed in Schedule A to FI's form ADV Part 1. Ken and Sherrilyn Fisher, as co-trustees of their family trust, beneficially own more than 75% of Fisher Investments, Inc., as noted in Schedule B to FI's Form ADV Part 1.

FIE delegates portfolio management to FI. FI's Investment Policy Committee is responsible for all strategic investment decisions. FIE's Investment Oversight Committee (IOC) is responsible for overseeing FI's management of portfolios that have been delegated to FI. Matters arising pursuant to FI's portfolio management policies are elevated to the IOC.

The foregoing information has been approved by Fisher Investments Europe.

Investing in financial markets involves the risk of loss and there is no guarantee that all or any capital invested will be repaid. Past performance neither guarantees nor reliably indicates future performance.

The foregoing information constitutes the general views of Fisher Investments and should not be regarded as personalised investment advice or a reflection of the performance of Fisher Investments or its clients. Investing in financial markets involves the risk of loss and there is no guarantee that all or any capital invested will be repaid. Past performance is never a guarantee nor reliable indicator of future results. Other methods may produce different results, and the results for individual portfolios or different periods may vary depending on market conditions and the composition of a portfolio or index. The value of investments and the income from them will fluctuate with world financial markets and international currency exchange rates. If you have asked us to comment on a particular security then the information should not be considered a recommendation to purchase or sell the security for you or anyone else. We provide our general comments to you based on information we believe to be reliable. There can be no assurances that we will continue to hold this view; and we may change our views at any time based on new information, analysis or reconsideration. Some of the information we have produced for you may have been obtained from a third party source that is not affiliated with Fisher Investments. Fisher Investments requests that this information be used for your confidential and personal use.