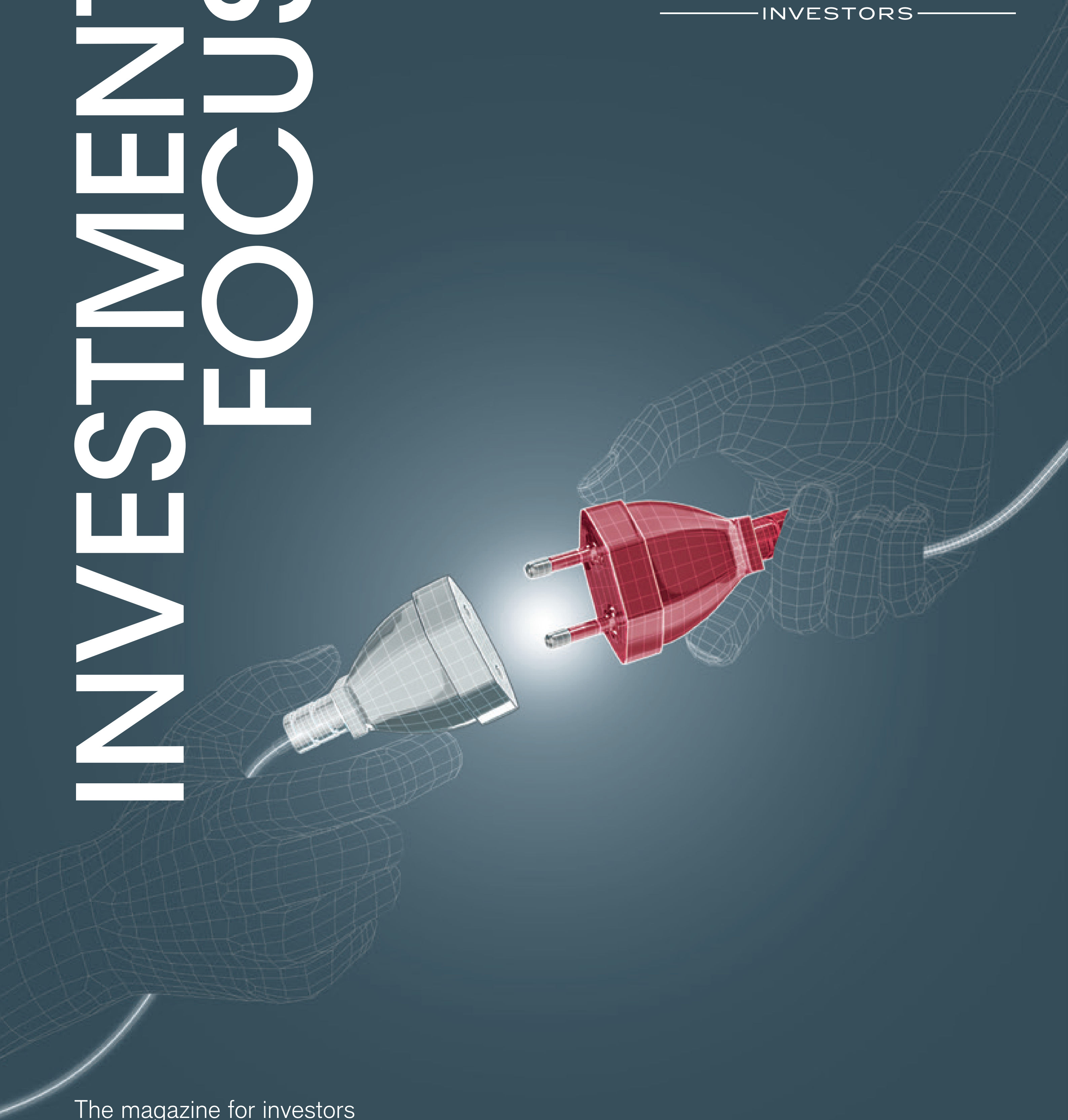
INVESTMENT FOCUS

Janus Henderson
INVESTORS



The magazine for investors
with Janus Henderson

Issue 20
Winter 2018-2019

Inside: Engagement – direct connections between managers and investments

For promotional purposes

Simon Hillenbrand
Head of UK Retail

WELCOME

You trust us to invest your money. This comes with responsibilities – to know what we are investing in and to hold those companies to account on your behalf.

Have you ever wondered what fund managers do beyond buying and selling investments? If so, then you will appreciate this issue of Investment Focus, which has 'engagement' as its central theme. What do we mean by engagement? It is the process of connecting with the companies we invest in, whether that is meeting companies directly, voting on proposals or actively agitating for change.

Engagement can take many forms. For bond investors, it plays a role in determining the yield (interest rate) that a bond when launched pays to investors. It is also a two-way process as John Pattullo, Co-Head of Strategic Fixed Income, explains on page 10, since engagement helps fund managers gain a stronger understanding of the conditions in which companies are operating, in turn helping to join the dots in formulating a broader macroeconomic view. For equity investors, as shareholder owners of the business, there is the opportunity to vote on proposals, support or question management and raise concerns with a company's executive. On pages 6-7, portfolio managers within our global technology team explain how they are ensuring that parental anxieties about the social impact of video games are being heard and acted on by gaming companies.

Making connections

Much of the research on investments has to be done at arm's length. In part, because it is not always physically feasible or cost-effective to engage with companies. Typically, fund managers aim to maximise efficiency by meeting company executives at conferences or directly at Janus Henderson's offices but when they do go on research trips valuable insights can be gleaned as Charlie Awdry reveals on a trip to China on pages 8-9. Other subjects covered include dealing with plastic pollution and a topical look at the transformation within retail in the property sector.

I do hope you find this edition of the magazine engaging. All that remains is for me to thank you for your ongoing investments with us and to wish you a happy, healthy and prosperous 2019.

Simon Hillenbrand
Head of UK Retail
Janus Henderson Investors

Investment differs from trading — it is about truly understanding a business and acting as owners.

NEWS IN BRIEF

Role model

Investment management is still an industry where women are under-represented at a senior level. Janus Henderson is committed to helping women progress in the industry so it was especially pleasing to see Alison Porter, who co-manages our technology funds, winning the award for Fund Manager of the Year (large firm) at the Investment Week Women in Investment Awards 2018, which were held in late November 2018.

Record payout

Global dividends paid out by companies rose 5.1% year-on-year to generate a record third quarter payout of US$354 billion in Q3 2018 according to the Janus Henderson Global Dividend Index. Each quarter we release information on aggregate dividends paid by the world's largest firms; this widely-followed study allows investors and the media to gain insight into global dividend trends. For the latest quarterly update visit **hgi.co/global-dividend-index**

Past performance is not a guide to future performance. The value of an investment and the income from it can fall as well as rise and you may not get back the amount originally invested.

CONTENTS

MARKETS

WORLD OVERVIEW

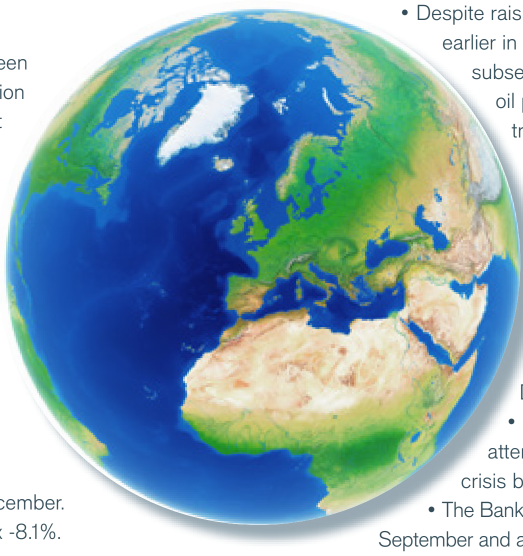
Global equities fell in the second half of 2018 as markets contended with a heated geopolitical climate. Brexit negotiations lumbered on, and a potential trade war between the US and China troubled both developed and emerging markets. A tanking oil price from October was another cause for concern.

UK

- Brexit dominated headlines; a number of key players resigned their posts and the EU rejected a deal proposal in September.
- Tentative agreement was reached in November, although Prime Minister Theresa May faced a vote of no confidence, which she won. A vote on the deal was delayed.
- The Bank of England raised rates in August but lowered projections for Q4 growth in December.
- FTSE All-Share Index -11.0%.

Europe ex UK

- The ongoing disagreement between Italy and the European Commission surrounding the country's budget took a toll on the euro.
- Problems in the Turkish banking system led to fears of a knock-on effect throughout Europe.
- Exacerbated by Brexit, these concerns contributed to the feeblest growth rate in more than four years.
- The European Central Bank (ECB) maintained its 0% interest rate and confirmed that its bond-buying scheme would end in December.
- FTSE World Europe ex-UK Index -8.1%.



US

- Despite hitting record highs in the autumn, equity markets were brought low by a major sell-off in the technology sector and trade war rhetoric.
- Nevertheless, consumer confidence rose to 98.3 in December, although business confidence fell sharply to 54.1 that month, the largest monthly drop since October 2008.
- The Federal Reserve continued its tightening path, raising interest rates in both September and December.
- S&P500 Index -3.4%.

Japan

- Japanese markets fell as GDP expansion plummeted to -6% in Q3 2018, due partly to a run of natural disasters.
- US President Donald Trump threatened high tariffs on automobile exports to the US.
- Shinzo Abe was re-elected as head of his party and the Bank of Japan left policy unchanged.
- FTSE World Japan Index -8.1%.

Asia ex Japan

- Asian equity markets were down, with concerns over the China-US trade war the overarching theme.
- Chinese GDP growth was disappointing as year-on-year expansion in the three months to end September was lower than expected.
- South Korean stocks plummeted on global worries and a mass exodus of foreign investors.
- Australia's benchmark index recorded its worst yearly performance since 2011.
- Despite raising its key interest rate to 6.5% earlier in the period, India's economic data subsequently stalled on lower food and oil prices and mounting international trade tensions.
- FTSE World Asia Pacific ex-Japan Index -5.1%.

Emerging markets

- Emerging Markets generally fell, with the exception being Brazil, whose Bovespa index surged to an all-time high in early December.
- Argentina's central bank attempted to combat its currency crisis by raising interest rates to c. 60%.
- The Bank of Russia raised rates in September and again in December.
- MSCI Emerging Markets Index -4.9%.

Bonds & commodities

- Core government bond markets were largely up, with yields falling in the US, Germany and the UK.*
- Yields fell in the US on trade war rhetoric and depressed oil prices.
- Worries surrounding a no-deal Brexit scenario sent 10-year gilts to their lowest level in the period ahead of the Conservative Party's vote of no confidence, rising later.
- Corporate bond markets fell in local currency terms on worries about rising US interest rates and an economic slowdown.
- The price of Brent Crude spiked in October but fell swiftly by the end of the year as Saudi Arabia's output increased.
- The gold price rose over the six months.

Source for all index performance: Thomson Reuters Datastream, 1 July 2018 to 31 December 2018, total return indices in sterling unless otherwise stated.

*Bond yields move inversely to prices.

Past performance is not a guide to future performance.

Gross Domestic Product (GDP): a measure of economic activity.

Q3, Q4: third quarter, fourth quarter.

Paul O'Connor
Head of the UK-based Multi-Asset Team

Outlook: Expect surprises

2018 was a transition year for financial markets, away from the unusually benign investing conditions of the previous couple of years, to a more complicated and uncertain market environment. A central theme of the year was the repricing of risk. Investors were optimistic about equities and other risk assets at the start of 2018 (see chart), having enjoyed two years of strong returns and low volatility. However, they spent most of the year adjusting their expectations to acknowledge emerging risks on the growth, policy and political fronts.

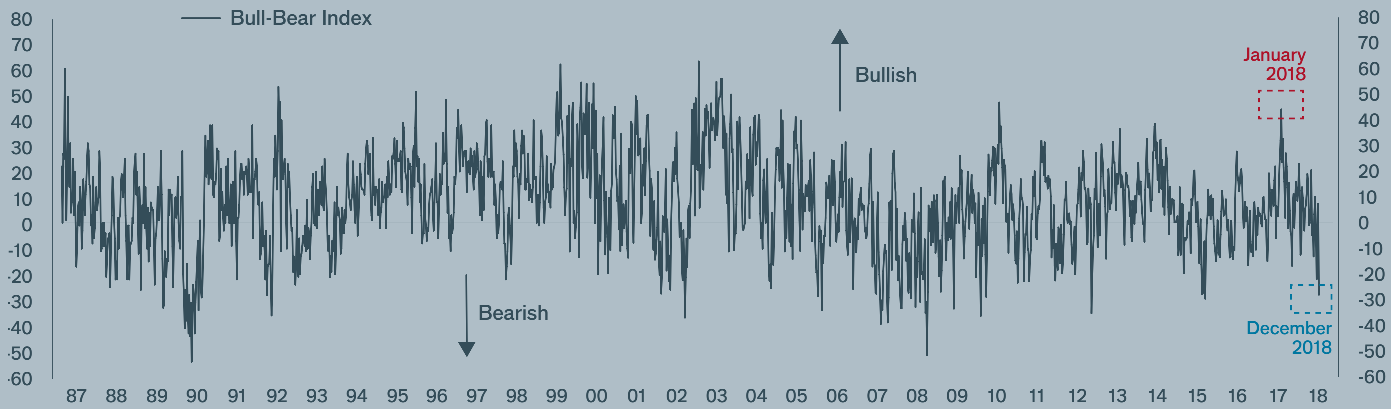
Whereas this widespread investor complacency at the start of last year made us wary of the market outlook then, we enter 2019 encouraged by the fact that many key risks are now more fully priced in to financial markets. While there are plenty of uncertainties overshadowing the outlook, our base-case scenario for global macroeconomic fundamentals is still fairly market friendly. We see no reason yet to abandon our expectation of an extended period of economic growth, which should sustain increasing company earnings and maintain a low level of defaults on corporate borrowing. A belief that inflation prospects remain low in the major economies, which should maintain unusually suppressed interest rates for the foreseeable future, is a key assumption underpinning this view of a long market cycle.

Away from central banks, the other big policy question overshadowing 2019 is whether global trade tensions will ease before economic confidence is damaged. We feel that market concern on this topic is close to a peak, given that a lot of bad news has already been factored in and that progress has been made recently to de-escalate trade tensions in a number of important areas. Beyond trade, we see plenty of other potential sources of political flare-ups in 2019, with developments in Italy and the UK looking most likely to generate market-moving headlines in the early months of the year.

With both policy and political uncertainty looking set to be unusually high in 2019, faith in the constructive view for a long market cycle is likely to be frequently tested during the year. We expect most of the major asset classes to deliver better performance in 2019 than in 2018 but we believe that the next few years are generally going to see global markets delivering lower and more volatile returns than those enjoyed in the era of central bank quantitative easing.

While buy-and-hold investing was the optimal approach when markets were strongly trending higher, the more turbulent market regime that we anticipate will demand a greater emphasis on volatility management and adjusting asset allocation to suit market conditions. Actively managed multi-asset funds should have plenty of appeal in this sort of environment, given their broad opportunity set, flexibility and diversification.

Investor sentiment: US Bulls vs Bears through market cycles



Source: Bloomberg, December 2018.

Actively managed:
An active investment approach relies on an investment manager's skill in making active decisions about which and what proportion of assets to hold, often with the aim of outperforming a specific index. The opposite of passive investing.

Bull vs Bear:
Bull describes optimism and rising markets. Bear describes pessimism and falling markets.

Buy-and-hold:
An investment strategy where a long-term view is taken, regardless of short-term fluctuations in the market.

Inflation:
The rate at which the prices of goods and services are rising in an economy.

Macroeconomic:
Relating to themes that affect an economy at large, eg, supply and demand, growth, unemployment and inflation.

Quantitative easing:
An unconventional monetary policy used by central banks to stimulate the economy by boosting the amount of overall money in the banking system.

Repricing of risk:
A reassessment of the risk attached to a given investment, leading to re-pricing that adjusts for perceived changes to its risk profile.

Volatility: the rate and extent of price moves up and down.

These are the manager's views at the time of writing and may differ from those of other Janus Henderson portfolio managers. The information should not be construed as investment advice. No forecasts can be guaranteed.

DIGITAL HEALTH: SALES VERSUS SOCIAL IMPACT

Janus Henderson's Global Technology team is actively engaged with its existing holdings on a range of criteria in order to promote sustainable growth. Here, the team discusses how they were one of the first asset managers to engage with companies on the issues facing the video game industry.

Video game sector: attractive investments but with a need for active engagement

The Janus Henderson Global Technology team has been invested in a number of video game developers and publishers (including Activision Blizzard, Tencent and Electronic Arts) in recent years. The team is attracted by the growing ubiquity of gaming as an entertainment form, driven by a strong demographic tailwind, as well as the diversity of gamers in the millennial generation. Strong player engagement with games, the importance of content, higher-margin digital distribution, the opportunity in mobile gaming, increasing monetisation of time spent on games and the improved management of video game stock – as well as an increasing focus on a smaller number of hit franchises – has enhanced the industry's attractiveness to investors. As part of a wider focus on the sustainable growth of our investments, however, we are actively engaged with these companies given some of the issues facing the industry.

Sustainable growth: preserving digital health will preserve long-term profits

The video game industry has enjoyed phenomenal growth over the years, evolving from the PC era, through console, to today's thriving mobile games ecosystem. Video games have also become a key entertainment medium for younger demographics via the games themselves as well as by watching other gamers play via streaming platforms such as Twitch. This has exacerbated wider, longer-term concerns around excessive screen time, violence and questionable monetisation tactics like 'loot boxes' and 'play-to-win', which encourage gambling and addiction. While the vast majority of gamers continue to play video games in a responsible way, there is a minority at risk. This led the World Health Organisation to list 'gaming disorder' as a mental health condition for the first time last year, defining it as a pattern of persistent or recurrent gaming behaviour so severe that it takes "precedence over other life interests". The longer-term sustainable growth of the video game industry requires an appreciation of the risks related to digital health.

The video game industry has enjoyed phenomenal growth over the years, evolving from the PC era, through console, to today's thriving mobile games ecosystem.

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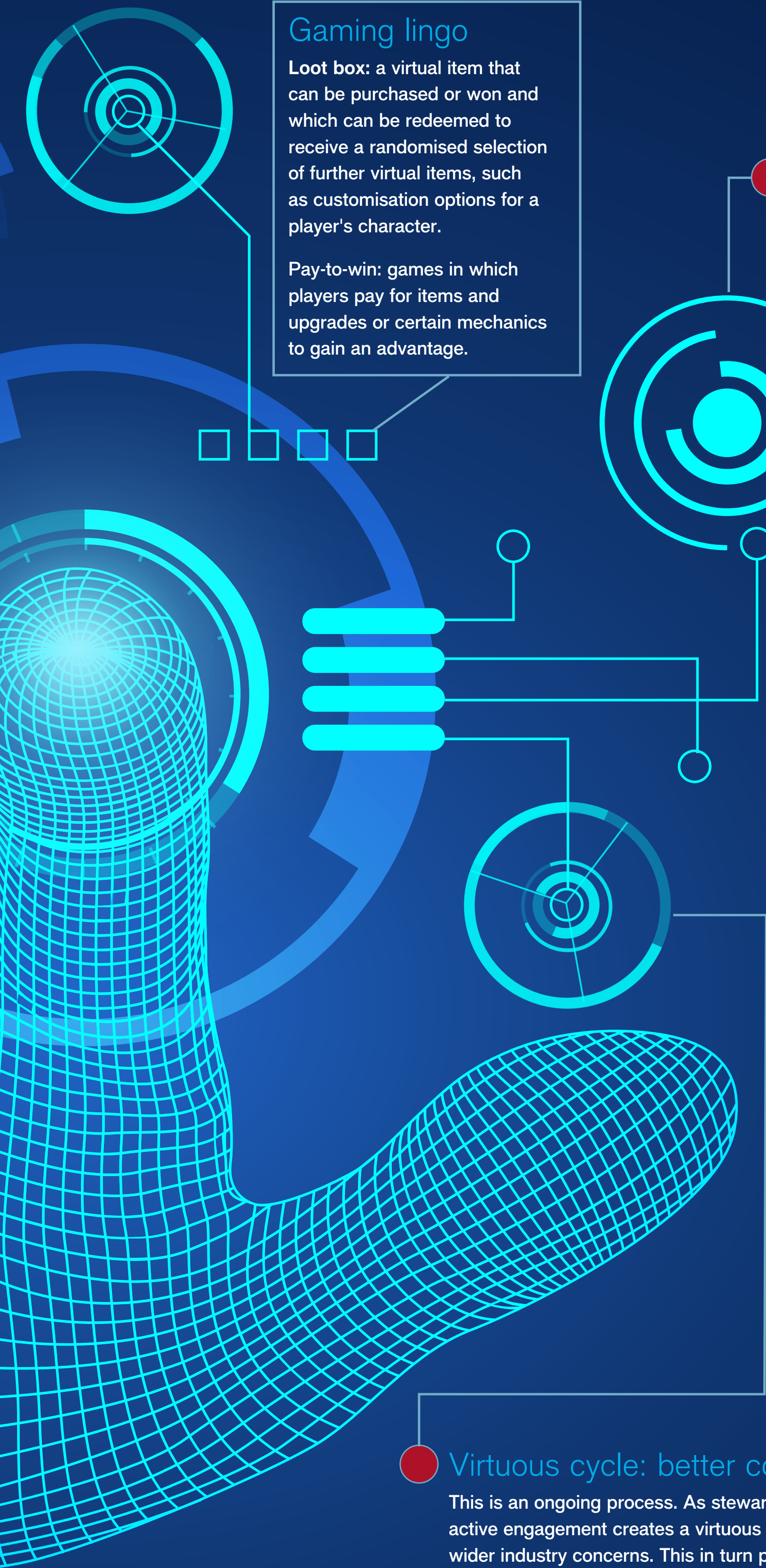
Graeme Clark, Alison Porter and Richard Clode
Janus Henderson Global Technology Team



Gaming lingo

Loot box: a virtual item that can be purchased or won and which can be redeemed to receive a randomised selection of further virtual items, such as customisation options for a player's character.

Pay-to-win: games in which players pay for items and upgrades or certain mechanics to gain an advantage.

Active engagement: ensuring portfolio companies make the right choices for the long term

The video game industry is highly successful and profitable, but to sustain this in the longer term, video game companies must be responsible stewards of their industry. Otherwise, they run the risk of negative media coverage, parental and gamer backlash and ultimately regulation. Over the years, the companies we invest in have demonstrated a willingness to respond to these challenges, for instance, implementing age restrictions on games and limiting playing time for minors. As investors, we continue to actively engage with our investee companies to ensure that they are making the right choices to sustain longer-term growth and profits in a fast-evolving industry. This also forms a core part of our formal investment process in assessing growth prospects and risk.

We were one of the first asset managers to talk to industry management about the social impact of their products. As part of our ongoing active engagement and due diligence with Activision Blizzard we have discussed the company’s philosophy on consumer digital wellbeing and how that is integrated into games as part of our assessment of the quality of its franchise. Taking this further, we have engaged on the culture and compensation structures of its in-house studios, and what types of overarching central direction exist in terms of design framework to ensure company-wide adherence. We have also looked into the types of telemetry the company gathers from its games and whether or not there are mechanisms that would trigger an action if problematic behaviour was identified. Finally, we have probed its monetisation strategies and actively argued for better practices; again to promote sustainable growth and to reduce risk.

In China, regulation has been more austere. Game approvals were frozen in early 2018 as part of a wider ministerial restructuring and the government announced policies to combat excessive game playing by minors, which it believed in some cases was resulting in social breakdown and health issues like myopia. New games are now screened more stringently for inappropriate content. In response, technology conglomerate Tencent has tightened its existing restrictions on game time for minors, as well as introducing national ID registration to ensure enforcement. We have actively engaged with the company to encourage it to be more proactive on these issues, and to look beyond minors to gaming addiction in adults given the significant amount of time and money Chinese smartphone users spend playing games. We believe this will help strengthen Tencent’s long-term gaming outlook and reduce regulatory risk.

Virtuous cycle: better companies, better investments, better world

This is an ongoing process. As stewards of client capital, our identification of these wider issues and our active engagement creates a virtuous cycle of ensuring our investee companies are proactive in addressing wider industry concerns. This in turn promotes longer-term sustainable growth and reduces the risk of regulation and other challenges to a company’s earnings power; making for better investments.

NOTES FROM THE ROAD

Charlie Awdry, China equities portfolio manager, gives a first-hand insight into the culture, company dynamics and consumer trends experienced during his recent research trip to China.

Meeting with baijiu distributors

We met with distributors of baijiu — a range of strong, transparent Chinese liquors made from grain, which literally translates as 'white alcohol'.

The distributors we met act as the middle men between retailers and established baijiu brands so their profitability is determined by managing fluctuating demand and margins that are dependent on the difference between ex-factory and wholesale prices.

2018 was a tough year for the industry, which is being squeezed by a campaign to reduce levels of debt, limiting sources of funding for business growth. Ex-factory prices[1] are also rising just as retail demand is softening. The extreme cyclicality of retail pricing can hurt both distributors and retailers.

Unlike almost all other retail segments that have been fundamentally altered by the rise of e-commerce and smartphones, baijiu remains a relationship business with an unreformed and undisrupted supply chain. Our discussions, therefore, focused on the management, sales strategy and pricing at key baijiu companies, particularly on the change of leadership at one of these companies and the hope for improved business relationships in 2019.

Lunch at a branch of Pizza Hut

The aim of our visit was to understand how a western brand continues to adapt to regional preferences. The answer seems to be to keep the consumer interested and engaged with regular changes to the menu. The latest success story in spicy cuisine in Chengdu is a prawn and chilli pizza.

The managers here are pleased that they do not face competition from other western brands, such as Domino's and Pizza Express, unlike their colleagues in more developed eastern cities like Shanghai.

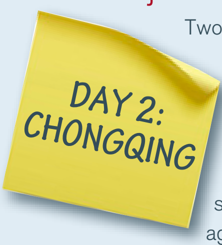
As e-commerce has taken share, shopping malls have filled their empty shop space with more food and beverage offerings, so competition is fierce. Outlets must be price competitive and preferably offer plenty of voucher-driven discounts. As an example of this in action, discount vouchers are thrust into our hands by a McDonald's employee as we stand outside KFC!

Visit to a hypermarket operator

On our visit to a hypermarket operator, the management was very positive on the new business trends driven by joining forces with an electronics retailer and leading e-commerce player Alibaba. The deal increases their local online businesses significantly and allows them to use their warehousing infrastructure more efficiently. Our experience with the company contrasts with a much more 'local' supermarket operator, where our meeting was conducted in a crowded office next to their poorly stored inventory.

The day finished with a four and a half hour drive to Chongqing, arriving at the hotel at 11.30pm. Why we didn't take the high speed train I don't know...

Further due diligence on the baijiu industry



Two more distribution meetings followed; it was interesting to meet with people who work for different brands and note the contrasts in strategy. What they did all agree on, however, is that low-end consumers are trading up and spending more money.

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Charlie Awdry
Portfolio Manager, China Equities

We spent two days meeting companies and visiting retail outlets… We ate in a very popular hotpot restaurant chain that is newly listed on the Hong Kong Stock Exchange.

Meeting with a local beer executive

We met a local beer executive to explore the impact of a merger and acquisition deal that has allowed a Chinese company to introduce Heineken more aggressively into the local market. The company will be competing against Carlsberg, which has built up a very strong market position over many years.

The meeting allowed us to gain a better understanding of promotional activity and how the beer market is segmented between consumers. In China, beer is generally not consumed at home and cans have only recently been introduced. If the consumer can be persuaded to move from bottles to cans, logistical costs should fall dramatically and this would boost profitability.

The day ended with a flight to Zhengzhou in Henan province. Never heard of it? Well it is where 400,000 workers assemble iPhones, and its government is keen to promote growth through free trade zones.

Visit to a pork product company

DAY 3: ZHENGZHOU

We spent the day in the company of an executive from a pork product company. We discussed food safety, consolidation in the industry, pricing opportunities driven by their national scale and the limitations of transporting live hogs versus food products. We saw the entire animal dispatch and meat treatment process. We also viewed, and sampled, their new product portfolio. Afterwards, the executives hosted an excellent lunch, showcasing local cuisine.

We then flew to Beijing.

Interactive dining

DAY 4 & 5: BEIJING

We spent two days meeting companies and visiting retail outlets, during which time we ate in a very popular hotpot restaurant chain Haidilao, which is newly listed on the Hong Kong Stock Exchange.

The company has taken the traditional hotpot cuisine concept and given it a modern twist, with robots helping to deliver plates, extremely high levels of customer service and some fantastic dining room settings. Animations of solar systems and paintings – including The Starry Night by Van Gogh – were projected onto the walls and ceilings of our restaurant.

The company has a rapid national expansion plan and a highly incentivised management structure.

Visiting new retail formats

Our visit endorsed the view that e-commerce is moving into a new highly competitive stage, with a penetrated customer base and powerful social media channels. Costs have come full circle and e-commerce tools are now returning to offline stores, but in new retail formats. Maybe Alibaba's Jack Ma is right about the convergence of retail into new retail and omni-channels.

An interesting example of the new formats was a sports clothing company that has incorporated workout areas upstairs in an effort to generate a more intimate brand experience. Such brands are becoming more fashion-orientated and are bringing in a contemporary 'London Shoreditch-style' image that they never discount – this is very unusual in China.

DAY 6: SINGAPORE

We then flew to Singapore to spend time with colleagues in Janus Henderson's office there, before flying home to London.

[1] Ex-factory price: the cost a manufacturer charges for distributors or other buyers to purchase its products, excluding shipping or taxes.

MACRO SIGNALS — EARLY SIGNS OFTEN COME FROM THE GROUND

John Pattullo, Co-Head of Strategic Fixed Income, explains how the team arrive at a decision to include a particular bond in their portfolios.

We continue to analyse the companies 'long-distance' and prefer not to get emotionally attached to any one name.

Investing in bonds is a fairly complex process; bonds tend to be bought and sold in a closed world of experienced insiders and experts, but as with any good investment, extensive research is needed before the decision to purchase.

Gathering information about the entity issuing a bond is a lot easier for government bonds than for corporate bonds, as the former market is much more liquid and transparent, with issuer information more easily available for analysis.

Buying a corporate bond is analogous to buying into the business

In order to invest in a corporate bond, detailed scrutiny of the issuer's business is vital to get a better understanding of how it functions, who its competitors are and its position within the industry and the economy as a whole. As investors, we need to be sure that the company can produce free cash flows regularly, giving it the ability to meet interest payments (coupons on the bonds) and to repay the debt at maturity.

This involves the examination of the issuer's business through many avenues, which can include company filings (if it is a public company), research material, broker analysis reports, news and, at times, meetings and calls with the company itself.

As strategic bond investors, we are actively on the lookout for opportunities to invest across developed economies in both government and corporate bonds. Our macro asset allocation decisions determine the tilt of the portfolio towards the fixed income asset class most likely to benefit given where we are in the prevailing economic cycle. Government bond purchases are made based on our views of their economies, central bank policies and where inflation and interest rates are heading. Overarching industry views further help the asset allocation to corporate bonds. Individual corporate bond purchases are made after we complete our bottom-up company and security analysis.

Evaluating corporates – the information sources

While information on any one business is not always easily available to the general public, as fund managers we can draw on valuable sources to get the necessary input for our analyses:

EQUITY MEETINGS: companies can raise capital via stocks or bonds. If they have issued public equity there will be a plethora of reports and analysis on their business. Our equity analysts have many meetings each year with both companies and industry analysts. The latter group visit companies on a regular basis, and share their information with other market participants, including us. This information is then shared internally with all investment professionals.

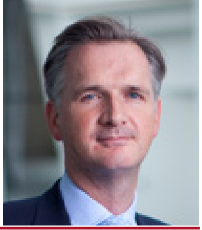
CONFERENCES: each year, numerous conferences are held covering macroeconomics, fixed income (eg, high yield), industries and sectors (eg, technology) and equity-related subjects. As fund managers we have a long list of invitations to attend these, which we do selectively. The forums can be very informative on current issues as well as on future trends.

ROADSHOWS: investment banks bringing new bond issues into what is known as the 'primary market' often organise 'roadshows' to invite prospective buyers, including us, to meet the company and its management and provide up-to-date information on its business. The roadshow helps gauge interest in the bond, and our response (and those of other investors) can help to determine the bond price.

THIRD-PARTY BROKERS: through meetings and conference calls they disseminate current information about corporations (and governments) as well as bonds in the 'secondary market' where they are traded after issue, via regular reports and analyst meetings.

CREDIT RATING AGENCIES: if a company has a credit rating in place or has issued bonds, the agencies will continue to monitor it, providing regular reports on the entity with whom they meet to gain an informed view of the company (they also cover governments).

John Pattullo
Co-Head of Strategic Fixed Income



An ear to the ground

While not strictly necessary for any single bond purchase, we selectively meet with a diverse number of companies over the course of the year, whether we hold their bonds or not. This can unearth information and often confirms macro signals at the ground level. For example, with regard to where inflation might be heading, what are companies saying about raising prices? Will they raise them? If not, what is stopping them? Hard facts such as these can paint a clear picture of the economy. Furthermore, optimism or pessimism is typically betrayed by companies when we meet them face to face making this type of direct engagement potentially helpful in our active management of the portfolios. In fact, some of our top-down asset allocation decisions can come from directly meeting with companies.

Once a bond is issued, a further resource for our continued monitoring is the issuer’s quarterly investment calls, where investors get to hear about the current state of the business alongside the official reports that it has to file for the regulators. The live Q&A session is often the most revealing part of the call.

Continuous monitoring is vital

As active fund managers, we continuously monitor the markets and the holdings within our portfolios using the resources mentioned. After we buy a bond, it can stay in the portfolios while it is performing, unless a better opportunity presents. However, if the issuer’s credit story changes or there is a material deterioration to the business, then we act swiftly to sell. We continue to analyse the companies 'long-distance' and prefer not to get emotionally attached to any one name.

We said at the start that macro considerations define our asset allocation decisions. Currently, we believe that markets and economies are definitively in their late-cycle stage and that growth and inflation have peaked; quantitative easing has faded and the short-term cyclical impulse to propel growth over the last two years (such as ill-conceived tax cuts in the US) is also disappearing.

Hence, we continue to be highly selective when adding bonds to the portfolios, looking for defensive, non-cyclical businesses with longevity — or a reason to exist, as we like to call it.

Where to look now?

Given where we are in the cycle, it is becoming increasingly challenging to find credit positive stories, but new pockets of opportunity are always emerging and we spend our time using our resources to seek them out.

As examples, currently we like tower companies and data centres. Why? Towers are critical communication infrastructures, with great revenue visibility. Mobile companies need to lease space on towers to build their networks, which means that tower companies can lock in long-term customer contracts.

Data centres are like a modern day utility. Once again, there is strong demand to lease space in data centres. The demand initially came from connectivity providers, such as BT or AT&T, and then from platforms, such as Amazon. In the future, more demand should come from companies across multiple sectors looking to transition their IT infrastructure from in-house to the cloud in order to save costs, giving data centres a stable base of contracted, recurring revenues.

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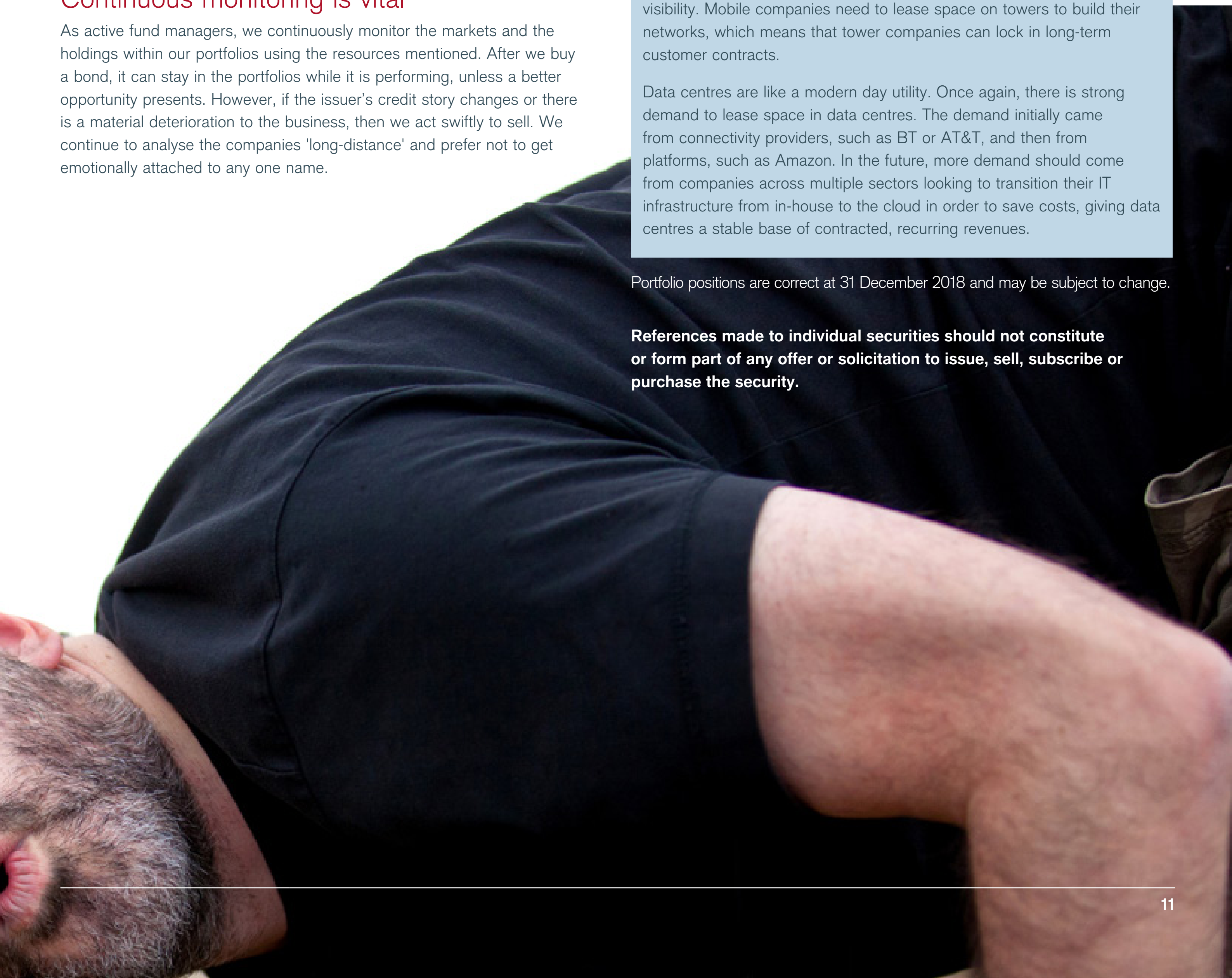


Andrew McCarthy
Fund Manager, European Equities

DOING THE HOMEWORK

European equities manager Andrew McCarthy considers the potential value he sees from engaging with management teams.

Every stock decision inherently has a macro view embedded, but taking a bottom-up view, and getting to know the companies we invest in, brings differentiation.

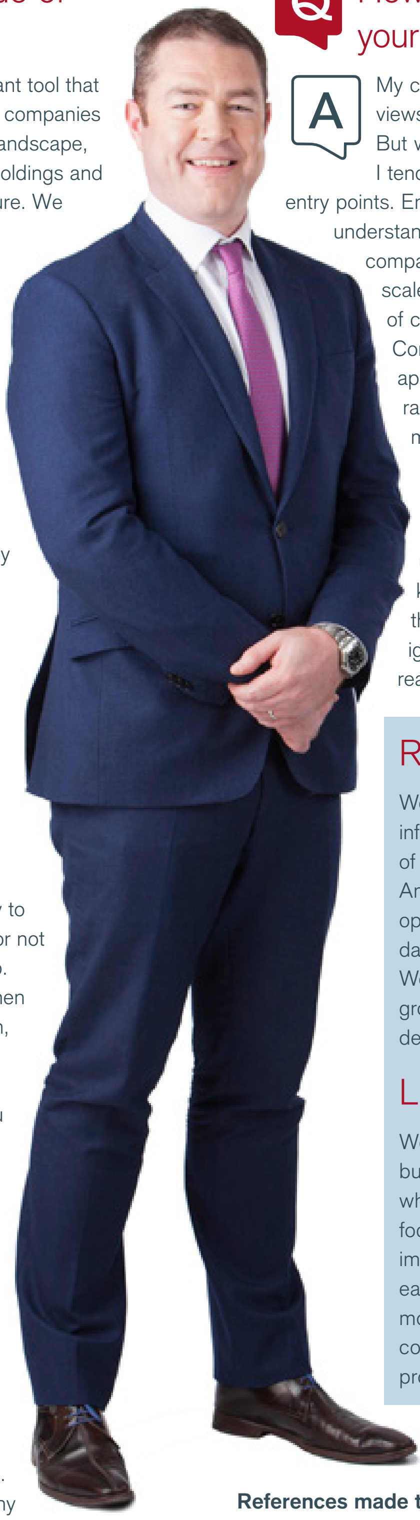
Q What is the value of engagement?

A Engagement is an important tool that we use in getting to know companies in the European equities landscape, both in terms of existing holdings and those that we might consider in future. We value the insight we can gain when meeting with management teams, in terms of understanding their strategy and how it is interlinked with capital deployment. It helps us to more accurately value a company's cash flow, and to make sure we pay the right price for that cash flow. It is the assumption that investors will get a part of that cash flow, but it is up to management as to where the money is allocated. Engagement can help us to understand how well they are spending that money.

Q What insights are you looking for?

A It is our role to assess the value of businesses and meetings are a useful way to gain insight into whether or not a management team is doing its job. They enable us to ask questions when we see a failing on capital allocation, or when a bid gets rejected. If management cannot explain to us why they made a decision, then you have to ask yourself why you would trust investors' money with them.

A lot of what we ask is pragmatic. We want to understand whether management is being realistic in its expectations, relative to history. Does their strategy make sense? Has there been any change in their structure? It is also important to us to know that what they are doing is what it says on the tin – that their strategy is matched by their actions. We are not corporate activists by any means, but it is important to challenge management when appropriate.



Q How does engagement support your investment decisions?

A My co-manager John Bennett and I have similar views on how we should look at businesses. But while he excels at taking a long-term view, I tend to have a bit more focus on timing and entry points. Engagement can really help to improve understanding of a business, particularly with smaller companies. It is still relevant across the market cap scale, however, given the significant amounts of cash that very large companies allocate. Communication with management, where appropriate, can better help us to grasp the rationale behind any decision and what it means for the future of a business.

In our view, corporate fundamentals should come to the fore over time. What we have to do as investors is ensure that our clients understand the time horizon involved in this kind of active management. We need to take the client with us, to be patient enough to ignore the short-term noise and focus on what really matters.

RELX

We met with the management team of information group RELX in the latter stages of 2018, discussing their Risk & Business Analytics division – their fastest growing operation, powered by the development of data analytics across the corporate world. We were encouraged that the fundamental growth drivers for the business remain strong, despite the slowdown in global growth.

LafargeHolcim

We recently met with the management of building materials group LafargeHolcim, where we were encouraged by the continued focus on their Strategy 2022 plan. This improvement project, combined with easing raw material pressures and positive momentum in their end markets, give us confidence in our expectations for strong profit growth.

References made to individual securities should not constitute or form part of any offer or solicitation to issue, sell, subscribe or purchase the security.

Hamish Chamberlayne
Head of Sustainable and Responsible Investment

BREAKING DOWN PLASTIC POLLUTION

The challenge lies in assessing the balance between the benefits of using the material and the costs of designing it out entirely.

The severity of the impact of plastic pollution continues to grow, with the time horizon for consequent irreparable damage drawing ever closer. The responsible use of plastics is an important consideration for evaluating the sustainability of a business and thus increasingly relevant to investors' long-term decision making.

A year of regulatory responses and consumer-driven trends

Last year, Chinese regulation banning imports of any paper or plastic waste came into effect. As China was the destination for approximately 50% of global paper and plastic waste, this legislation had a major impact on governments, businesses and consumers[1,2]. This galvanised an increase in debate on plastic waste; countries around the European Union (EU) set a precedent for plastic-limiting legislation, with bans on plastic microbeads and cotton buds announced in the UK in January 2018, and a French ban on plastic cutlery from 2020[3,4]. The European Parliament has provided further momentum by voting in favour of a ban on 10 types of single-use plastic, covering 70% of marine litter items found on EU beaches[5]. The new EU regulation goes beyond banning products alone to holding manufacturers to account for their impact, embodying the 'polluter pays' principle.

A balancing act

Identifying the primary sources of environmental impact and its most relevant investment risks and opportunities is a complex and ongoing process. Investment risks stemming from changes in regulation and consumer preference will not always align with the greatest sources of environmental damage from plastic pollution. Their full sustainability impact is a result of many interconnected – and often unclear – factors. Responsible use is likely to have a much greater positive impact than the avoidance of all forms of plastic entirely; the challenge lies in assessing the balance between the benefits of using the material and the costs of designing it out entirely.

A 'win-win' for companies and their investors

In 2018, we began to engage with McCormick and Company, a US food company, focusing on their packaging and supply chain, and were impressed by the large amount of detail the management provided on their social and environmental outreach initiatives, both current and in the pipeline. Specifically on the plastics and packaging concerns we raised, we learned that McCormick had reduced the carbon impact associated with its packaging and committed to developing an approach that would take into account the circular economy and reduce plastic waste reaching the ocean. Soon afterwards,

McCormick made a further commitment that 100% of the company's plastic packaging will be reusable, recyclable or able to be repurposed by 2025.

As investors, our discussions satisfied us that sustainability issues are a priority for McCormick, with the pricing and reputational benefits inherent in their approach likely to prove advantageous both to the company's bottom line and to our investors. More importantly, we were also reassured that there is a genuinely long-term mindset in place at the board level, which is precisely where, as socially responsible investors, we expect accountability to lie.

Visit the full 'Breaking down plastic pollution' report at hgi.co/plastic-pollution

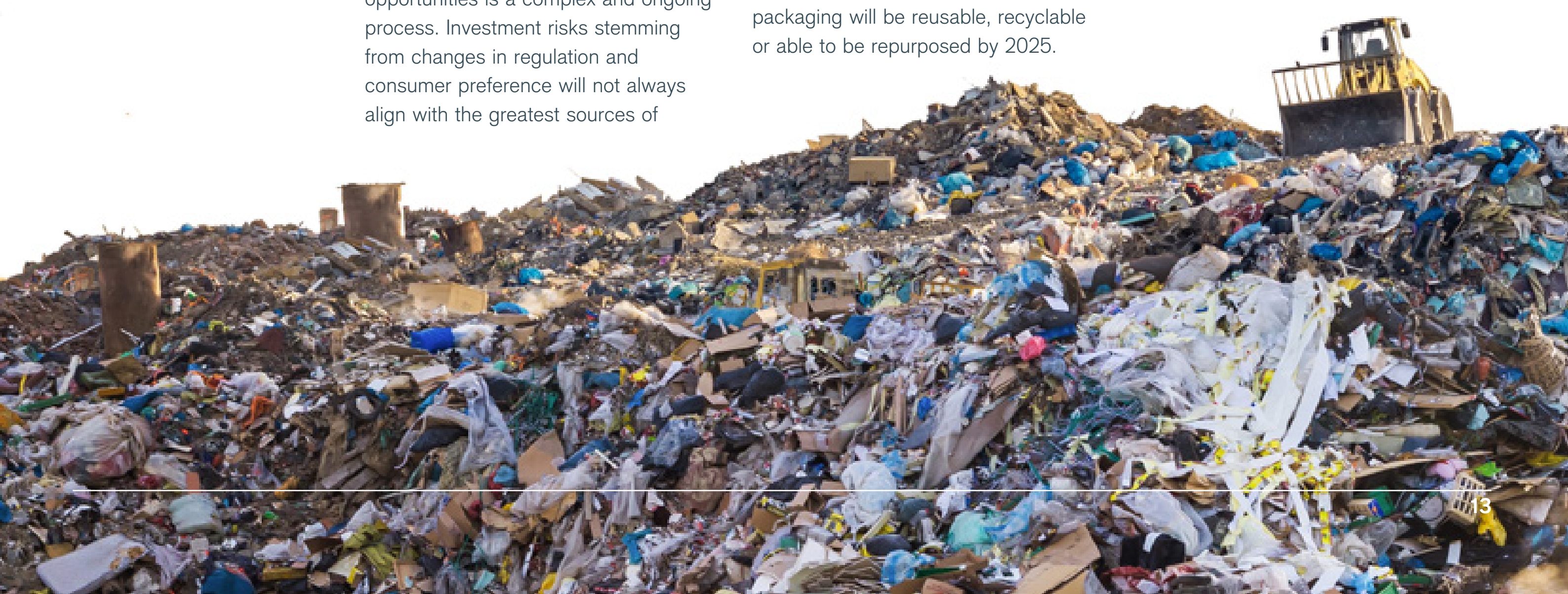
1 UN Environment, "China's trash ban lifts lid on global recycling woes but also offers opportunity".

2 Alice Ross, Unearthed "China's plastic scrap ban threatens 'crisis' for UK recycling industry".

3 Kevin Keane, BBC News, "Scotland ban announced for plastic cotton buds".

4 James McAuley, The Independent, "France becomes the first country to ban plastic plates and cutlery".

5 EU Commission, "Single-use plastics".



RETAIL: ADAPTING TO CHANGE

Ainslie McLennan, Portfolio Manager, UK Commercial Property, examines the structural changes taking place within retail and the impact on physical bricks and mortar stores.

The UK retail sector saw falling investor sentiment and negative headlines throughout the course of 2018, driven by economic and political uncertainty, a trend which is likely to continue in 2019.

While the wider retail industry has been impacted by structural declines, footfall in retail parks with warehouse style assets has been the most resilient amongst major retail formats in recent years.

Adapting to changing consumer behaviour

Our long-held view has been that the retail sector, particularly traditional retailers and high street assets, would come under pressure.

Structural changes continue to see a shift away from the high street towards online sales. Back in January 2008 internet sales accounted for 5% of all UK retail sales but the growth in ecommerce has led to this figure rising to 18% according to the Office for National Statistics as at August 2018. Some retail-based businesses have responded well to managing this change by engaging with customers and changing the experiences and services that they offer. Others have struggled and this has led to an increase in tenant bankruptcies and company voluntary arrangements (where new terms are agreed with creditors to help them to continue to trade).

The issue of polarisation continues with economically-resilient retail locations getting stronger and weak areas no longer viable as retail destinations. Therefore, the identification of prime locations, positive demographics and due diligence on occupiers remain key. For a number of years we have been diversifying away from traditional areas of the market as we seek to maintain an appropriate, broad mix of assets that we believe to be best suited to the conditions ahead.

A physical presence

While the wider retail industry has been impacted by structural declines, footfall in retail parks with warehouse style assets has been the most resilient amongst major retail formats in recent years, as shown in the chart opposite. This trend is not uniform across all assets, but go past any well-located retail warehouse park and it is clear that many of these assets have benefited from having a convenience offering and the growth in 'click and collect', which allows savvy retailers to remain located in stores that are internet compatible.

Footfall in out-of-town supermarkets has also benefited from the convenience and accessibility for shoppers. Food remains a relatively defensive sector, with many supermarket chains having experienced robust in-store sales growth during a period when the clothing and footwear segment of the market saw sluggish growth.

There are, however, challenges facing supermarkets. The ongoing price war between the 'big four' and the discounters (such as Aldi and Lidl) is likely to exert downward pressure on inflation, thus hitting nominal sales growth.

- **Retail** is typically classified as standard retail (which includes traditional high street assets and public houses), supermarkets, retail warehouses, shopping centres or more brand-orientated outlet malls.

Ainslie McLennan
Portfolio Manager, UK Commercial Property

UK store footfall growth (% change year-on-year)

Source: BRC, Q3 2018, figures are calculated using 3-month moving average data.

Survival through evolution

Retail will survive but not as we know it. Successful town and city locations are likely to be multi-use, combining retail with residential and leisure facilities, such as gyms, cinemas and restaurants, which factor in wellbeing and sustainability. Fewer shops in the future will force retailers and stores to be far more engaging and interactive to attract consumers and personalise their shopping experience. Landlords will need to take account of these requirements to attract the next generation of retailers.

Artificial intelligence (AI) is one example of retailers adding value through a physical presence. Clothing retailers may soon be embracing AI-based technology such as installing 3D virtual fitting rooms with touch screen digital mirrors that allow customers to 'try on' different colours and styles without changing garments.

AI is also likely be used in future to increase efficiency and space by tracking customer behaviour in shops by analysing aisles or promotions that are attracting shoppers and what is not. Meanwhile, Amazon, the e-commerce specialist, plans to take market disruption full circle by expanding into physical grocery retailing in key inner city locations with cashless and cashier-free free stores. Motion-tracking AI would be used to record and charge customers' accounts for what they have taken from the store.

Technology is key to the future or failure of retail and companies that are successful in tomorrow's world are likely to be the most adaptable to change.

Purley Way, Croydon, is a large retail warehouse park in South London and an example of how engagement with retailers and local authorities can add significant value for investors:

- The portfolio owns approximately nine acres of land adjoining Purley Way, with retail units let to John Lewis and Currys.
- Planning application submitted to develop 35,000 square feet of retail warehousing on a vacant site situated between the John Lewis and Currys units.
- Proposed development 90% pre-let ahead of securing planning permission.
- Inflation-linked lease agreements signed with Aldi (25 years) and Smyths Toys (15 years) to occupy the completed development.
- Additional 2,500 square feet of development for which planning permission is expected to be granted in the first half of 2019.
- Significant valuation gain from an otherwise redundant portion of the site providing further portfolio diversification.

Source: Nuveen Real Estate, 31 December 2018.

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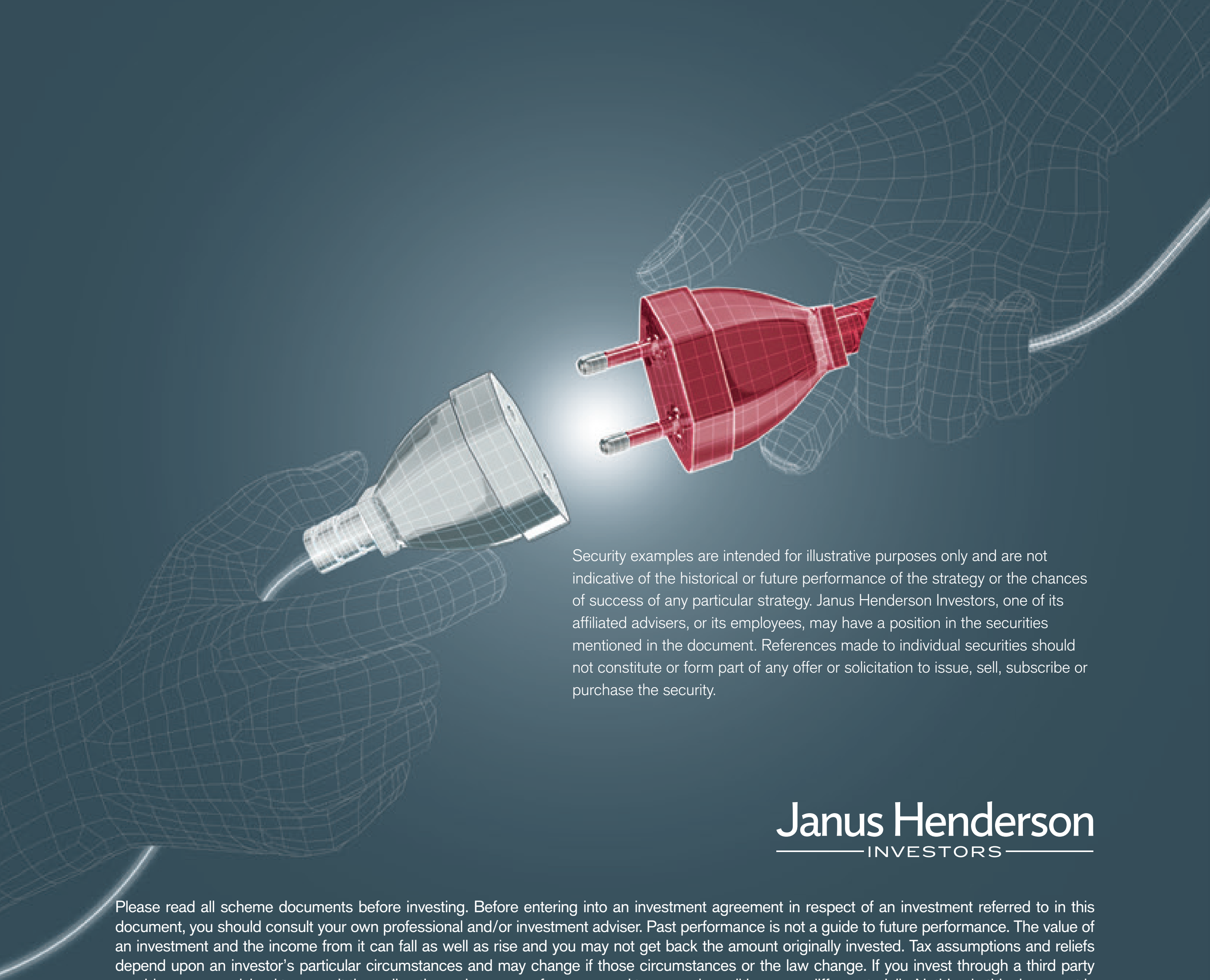

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