The “principal agent problem,” also known as the “agency problem,” has existed since the dawn of civilisation. There is a fundamental issue when the ‘agent’ is authorised to make decisions on behalf of the ‘principal’. In many cases, from shareholders (principals) vs. corporate managements (agents) to voters (principals) vs. politicians (agents), this problem persists. It can come in many forms and it leads to what economists call moral hazard or a conflict of interest.\(^1\) As asset managers, we face the agency problem when allocating our clients’ capital. We have taken steps to ensure full transparency and strong alignment through co-investing with our clients, as well as appropriate incentive structures and a long-term mindset. We believe strong alignment is a very important mechanism in ensuring pain and success are mutually shared. When we invest in companies, we use this same mindset, looking for an alignment of interests with the management teams and owners of these businesses.

\(^1\) Defined as a situation in which one party gets involved in a risky event knowing that it is protected against the risk and the other party will incur the cost. It arises when both the parties have incomplete information about each other.

The value of investments and any income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

Investing in emerging markets is generally considered to involve more risk than developed markets.
Before we delve further into how we think more broadly about alignment, it is important to highlight some of the key characteristics of our investment universe. Two types of majority shareholders are prevalent in emerging markets (EM) listed equities: families and governments (we will refer to them as State Owned Enterprises, or SOEs). In Indonesia, for example, family-controlled companies make up 50% of the MSCI listed equities, and a further 42% are SOEs, according to Morgan Stanley. This picture holds true across the majority of the emerging markets, with some differences such as China having a larger proportion of SOEs and South Korea being dominated by family-owned “chaebols”, etc. In contrast to the EMs, family-owned businesses make up only one-third of the S&P 500 Index. For the Responsible Global Emerging Markets strategy, family-owned businesses make up more than 50% of our holdings, and 80% of our total holdings have a steward with a significant shareholding in the businesses.

For us, investing is about being shareholders in real businesses – not a flashing Bloomberg ticker on a screen but actually partly owning businesses with employees, assets and stakeholders, where we aim to partner with those in charge. This means we aim for our interests (as minority owners) to be aligned with those of the majority owners, whether families or governments. Both types of owner carry different merits that we find attractive, and we are also fully aware of the risks involved in partnering up with a controlling shareholder.

**Family businesses**

Family businesses are known to deliver consistent profitability, more so relative to non-family-controlled peers. Credit Suisse research on the topic has demonstrated that family-owned companies have managed to outperform broader equity markets by 4% per year since 2006.1

At LGM, we find that certain qualities in family businesses fit well with our investment approach. Families typically aim to retain and grow their businesses for many generations to come. Often, a family’s main source of wealth sits with the listed company, creating a strong and tangible alignment of interest with minority shareholders that also have a long-term mindset. We believe the family businesses we invest in demonstrate characteristics that go beyond pure entrepreneurship to involve perseverance, ambition, passion, and importantly, integrity.

In order to ascertain whether a business has the above-mentioned qualities, we undertake extensive due diligence on the owners. We seek to understand the reasons for their success, including whether this is largely linked to political connections rather than leadership, entrepreneurialism and good management. Political connections can generate value, but are a risky and potentially circumstantial intangible quality that we do not think can be sustainable, especially when political winds change. We like businesses that do well regardless of the prevailing political backdrop.

Another element we analyze carefully is family relationships. Conflicts in families are unavoidable and family businesses can compound these challenges even further. Therefore, we evaluate approaches to communication and conflict resolution when it has arisen, formal governance structures, and succession planning.

We also assess related party transactions (RPTs) to make sure material RPTs do not disadvantage minority shareholders; ideally, companies will have fully independent audit committees that responsibly ensure that such transactions are conducted based on arm’s-length valuations. We recommend that each company disclose any shareholdings that its controlling owners may have in other companies or investment vehicles that have a material interest in the company. Some companies tend to have overly complex structures that at times can look a lot like a disorganised spider web – we avoid companies with these structures given the significant governance risks involved.

Another key part of our analysis involves understanding how families have behaved in past crises. This provides us with a good picture of attitude towards risk and how they treat minority shareholders when it matters the most.

**State Owned Enterprises (SOEs)**

We are generally very cautious about investing in SOEs as these structures add a layer of governance challenges on top of those that any listed firm already faces. These challenges often arise when the alignment of interest between value

---


creation and “national service” gets blurry (which is more common than not). By “national service”, we are referring to states’ political, economic and social agendas, e.g., securing an election, fostering local enterprises or keeping unemployment low. While we don’t impose a blanket ban, when we find an SOE company we like we spend a lot of time researching and understanding where we stand as minorities and whether we will benefit from the success of the company.

We find that SOEs are of mixed quality across Asia. On one extreme we observe companies staying loyal to the state regardless of cost. An example is one of the largest Asian oil and gas (O&G) companies (part of the MSCI EM Index), which controls almost two-thirds of the mid-stream gas infrastructure and is mandated to ensure abundant domestic supplies, even if doing so means selling gas at a loss. There certainly are beneficiaries of such operations, but we feel minority shareholders will not always be one of them.

On the other side of the spectrum, we have our holding China Resources Gas (CR Gas), which distributes natural gas to households and industries across China (“downstream” in O&G jargon). We feel this company is strongly aligned to minority shareholders as well as to the Chinese government. As China continues to invest in trying to improve air quality by using alternative sources of energy instead of coal, CR Gas has pledged to connect houses, businesses and factories to the natural gas grid. In order to attract investments, it offers fair contracts to private and public companies and, as a result, is positioned favourably to reap the benefits from the clean energy transformation as one of the largest natural gas distributors in the country. It generates very large and growing free cash flow and, as a result, its dividends and pay-out ratio have increased every year. It is also reasonably valued, justifying risk and reward. While our research gives us ample comfort in investing in CR Gas, we are also wary that policies can change, and not always in favour of investors. Therefore, we have decided to ensure our exposure is moderate, with around 1.5% of the strategy currently invested in CR Gas.

Engagement Update

Managing environmental and social risk

Banks are exposed to credit, reputational, legal, operational and market risks driven by environmental and social (E&S) issues that affect their clients and customers. Identification and management of these risks as part of their credit risk appraisal processes is, therefore, important for banks to manage their exposure to overall risk. This quarter we engaged with several of our holdings, including Bank Mandiri, HDFC Bank, Kasikornbank and Public Bank, to encourage them to strengthen their E&S-specific procedures, assessment tools and internal capacity allocated to managing these risks. In particular, we asked them to identify and report on portfolio-level E&S risks, monitor clients’ E&S performance and require them to implement mitigation measures for identified E&S risks, and develop specific guidance on industries with potentially high E&S impacts, e.g., extractives, coal-fired power generation, agriculture.

Several studies point to the significant impact on global greenhouse gas (GHG) emissions caused by the forecasted growth in milk consumption in China: according to one study4, global emissions from Chinese dairy production alone could increase by 35% and the land needed to feed cows for China would have to increase by 32% in the next 30 years.

Our holding, Yili, is China’s largest dairy company and now amongst the top 10 globally. During the quarter, we had a productive discussion with the company, during which we expressed our support for several initiatives it has taken over the past couple of years to mitigate GHG emissions along the entire value chain. These initiatives, which include energy efficiency measures and cooperation with farming partners to implement sustainable dairy farming practices, led to an 8% reduction in carbon emissions per ton of product between 2016 and 2018. At the same time, we encouraged Yili to step up its efforts to collect, measure and report emissions, and engage with suppliers and other stakeholders to drive increased efficiencies in milk production in China.

---

4 “Global environmental costs of China’s thirst for milk”, Zhaohai Bai Michael R. F. Lee Lin Ma, Gerard L. Veldhof, et.al, Wageningen University and Research, February 2018
Voting

This is a new section that we have introduced into the quarterly report. As readers will know one of the core pillars of our investment process and philosophy is active ownership, i.e., engagement and voting. On the latter, we believe that we have a duty as shareholders to use our votes to send a clear message to the boards of the companies that we own about improvements they can make in their corporate governance practices.

We start with the high-level numbers, and then move onto some case studies. Over the quarter, there were 28 company meetings where we were asked to vote, and we voted at all of these meetings. Out of the 330 resolutions we voted on, we voted ‘For’ management on 76% of these, ‘Against’ management on 17%, and ‘Abstained’ on 7%. Regarding the ‘Abstained’, this was mainly because of insufficient time or a lack of information given concerning the vote. We do think communication is important every time we vote against management and we do write to them explaining the reasons why we do this.

We would like to highlight three companies this quarter.

Universal Robina Corporation

We have been engaging with Universal Robina Corporation (URC), a large consumer food and beverage product company in the Philippines, for several years. We believe URC can be recognised as a world class consumer company and we think having an appropriately balanced board (with a greater proportion of independent non-executive directors) will help them to achieve this goal. We wrote to management in July 2018 expressing this view, and expected URC to utilise the opportunity to restructure its top management and refresh its board in the 2019 AGM; however, as this did not happen, we did not support the re-election of some of the executive directors. We wrote to URC to share our vote intention and to explain that a stronger, better-balanced board will benefit all stakeholders in the long term. We will again convey this message when we next meet management.

Magnit

The second case study is Magnit, a large Russian food retailer. We have spent a lot of time engaging with Magnit over the past twelve months and we have had several meetings with senior management and members of the board of directors.

We directed all our votes at this year’s AGM to the two independent directors nominated by minority shareholders, whom we believe have the necessary experience and drive to challenge management. We will seek to establish a close relationship with these independent directors so that we can have a better grasp at how the board functions.

Shortly before quarter-end, Magnit announced unexpectedly that the CEO, Olga Naumova, would be stepping down, after just a year in the role; Magnit’s President, Jan Dunning, has assumed the CEO role. The message from senior management is that nothing has changed, and they remain focused on the turnaround strategy that they have outlined to address their consumer shortcoming in the marketplace.

Magnit remains a priority company for us to engage with over the coming 12-24 months.

Unilever PLC

The third case study we want to discuss is Unilever PLC, where we voted against the remuneration report because of our concerns of the impact of the change from base salary to a consolidated “fixed pay” structure proposed during 2018’s AGM. The change, met with significant dissent (34% of shareholders voted ‘Against’), could potentially lead to increased fixed pay and annual bonus payments.

This year we engaged with the company to express our concerns and suggest improvements; however, no changes were made. We, therefore, voted against the remuneration report.

We would like to highlight three companies this quarter.

Universal Robina Corporation

We have been engaging with Universal Robina Corporation (URC), a large consumer food and beverage product company in the Philippines, for several years. We believe URC can be recognised as a world class consumer company and we think having an appropriately balanced board (with a greater proportion of independent non-executive directors) will help them to achieve this goal. We wrote to management in July 2018 expressing this view, and expected URC to utilise the opportunity to restructure its top management and refresh its board in the 2019 AGM; however, as this did not happen, we did not support the re-election of some of the executive directors. We wrote to URC to share our vote intention and to explain that a stronger, better-balanced board will benefit all stakeholders in the long term. We will again convey this message when we next meet management.

Magnit

The second case study is Magnit, a large Russian food retailer. We have spent a lot of time engaging with Magnit over the past twelve months and we have had several meetings with senior management and members of the board of directors.

We directed all our votes at this year’s AGM to the two independent directors nominated by minority shareholders, whom we believe have the necessary experience and drive to challenge management. We will seek to establish a close relationship with these independent directors so that we can have a better grasp at how the board functions.

Shortly before quarter-end, Magnit announced unexpectedly that the CEO, Olga Naumova, would be stepping down, after just a year in the role; Magnit’s President, Jan Dunning, has assumed the CEO role. The message from senior management is that nothing has changed, and they remain focused on the turnaround strategy that they have outlined to address their consumer shortcoming in the marketplace.

Magnit remains a priority company for us to engage with over the coming 12-24 months.

Unilever PLC

The third case study we want to discuss is Unilever PLC, where we voted against the remuneration report because of our concerns of the impact of the change from base salary to a consolidated “fixed pay” structure proposed during 2018’s AGM. The change, met with significant dissent (34% of shareholders voted ‘Against’), could potentially lead to increased fixed pay and annual bonus payments.

This year we engaged with the company to express our concerns and suggest improvements; however, no changes were made. We, therefore, voted against the remuneration report.
Country visit – India

Whatever you can rightly say about India, the opposite is also true.

Joan Robinson, British economist

During the quarter, the team visited India – an exciting time to visit the country after recent elections. As our readers will know, we have large exposure to Indian equities in the strategy. We believe the quality of local businesses is very high. Many of these businesses, often run by families, have managed to build very strong competitive advantages through their operations in what has been a dysfunctional democracy with a lot of bureaucracy around it.

Upon landing in Mumbai airport, much urban change is evident in a city whose population has more than doubled since 1991. Seven metro lines are under construction, various highways above street level have decreased traffic substantially, and we observed many more high rises being built.

World’s largest democracy – One cannot visit India without taking a view on Prime Minister Narendra Modi. Is he the great leader that will change India for good or just another populist on the rise? We think he is a bit of everything.

Modi, a mastermind in political rhetoric, has managed to get a very strong mandate after the recent elections. Since Modi took office in 2014, we have seen elevated valuations, implying high expectations for growth from the Indian equity markets. The reality has been slower growth, whether we look at GDP figures or consumer numbers from the frontlines. It is no surprise that markets tend to overestimate change, and expectations of Modi are a good example of this. While he has been successful in reforming some parts of economy (Good & Services Tax (GST), insolvency code, central registration, medical insurance), he has failed in making radical decisions that would transform India (reforming state banks and labour laws, improving air quality, agriculture, federal structure). If during his second term, Modi can bring about socioeconomic change in a fiscally disciplined manner while creating long-term sustainable competitiveness through education and investment in production of goods and services, India is likely to do well. We remain hopeful that India will be better off at the end of Modi’s second term based on what we have seen from his first term.

The climate factor – The common thread of our discussions with those we met during our trip was the amount of tremendous opportunities companies have to grow their businesses by tapping into a vast domestic market where consumers’ income and purchasing power are expected to continue to grow. But, given the numerous and costly climate-related events India has had to deal with in the past year alone, we cannot help but wonder how such events, which are only set to become more frequent as the climate continues to change, can impact living standards and thus the potential for growth.

During our visit, local newspapers reported on how the fourth largest city, Chennai (estimated population of 10 million), was grappling with acute water shortages as the reservoirs upon which it depends had dried up. Furthermore, a report produced by three ministries suggested that 21 major cities, including megacities like Delhi and Bangalore, are expected to run out of groundwater as soon as 2020, putting food and water security at risk for over 100m people. One of our holdings, Colgate Palmolive India, has been putting a lot of effort in water conservation across its manufacturing operations as well as its customer base through targeted education campaigns.

With regard to efforts to curb growing carbon emissions, we were positively surprised to learn that solar and wind makes up close to 20% of the installed power capacity mix. Solar tariffs have come down by around 90% since 2010, and today India ranks 4th and 5th globally in installed capacities for wind and solar power respectively. Many of the companies we spoke with have started buying solar or wind energy for their operations to bring down their emissions profile as well as to drive down overall electricity costs.

Climate change is one of the biggest challenges that is going to impact the livelihoods of hundreds of millions of people over the coming years and will be an important area for engagement with our investee companies.
Portfolio actions and considerations

During the quarter, we initiated a new position in Bajaj Auto, a leading manufacturer of two- and three-wheeler vehicles in India. We believe Bajaj has a wide economic ‘moat’ (competitive advantage) with its strong global franchise, able management team and solid balance sheet, and superior profitability ratios. Bajaj has a large presence in India and has built a strong franchise across markets in southeast Asia, Africa and Latin America.

In India, Bajaj has historically been a leading player in the premium segment of the motorcycle market. Over the past eighteen months, the company has reset its domestic strategy in order to increase market share in the entry level and main commuter segments of the market, through new products and more attractive pricing points. This has enabled the company to increase market share, although further progress needs to be made in the main commuter segment. Interestingly, the company is the first major Indian manufacturer looking to launch electric two- and three-wheelers in India over the coming 6-12 months. Given concerns over increasing carbon emissions, we think this could potentially be an interesting long-term growth area for the company.

The key sustainability argument for Bajaj is around mobility. In rural India (or any rural emerging market) public transport infrastructure is often a mix between weak to non-existent. We see Bajaj as playing a key part in helping people’s mobility by providing a cheap and efficient method of transportation. Even in cities, the above statement is true as motorbikes generally don’t require as much fuel nor take up as much space (traffic) as cars. Combined with the fact that the business is strong (net cash), has a decent export element, and is led by a reputable trustworthy family, we feel comfortable in our initial investment.

We also initiated a position in Chile’s Aguas Andinas. Majority-owned by Suez, a leading water and waste management company, Aguas is a regulated water utility company that manages the whole water cycle, including: the catchment of raw water, water production, transportation and distribution, and the collection, treatment and final disposal of sewage. In addition to providing clean water, the company has built a circular economy by setting up a bio factory where the energy recovered from sewer sludge leads to the production of electricity, natural gas, and thermal energy, and bio solids from the wastewater treatment plants are reused as fertiliser to grow food.

The business is very well positioned from a sustainability point of view. It continues to improve efficiency through investments in minimising leakage, invests in improving customer service, and has implemented water management programmes to promote the development and social inclusion of the most underprivileged areas across Chile. In the context of the country’s exposure to increasing water stress from climate change, Aguas’ ability to efficiently provide clean water while also implementing a strategy focusing on the circular economy are key qualities for the long-term health and sustainability of the business whilst ensuring drinking water for the masses at affordable prices.

These purchases were funded from reductions in HDFC Bank, Vitasoy, Bank Rakyat Indonesia and China Resources Gas, and the sale of Western Union, which is facing increased competition in the international payments and money transfer market, including from newly established financial technology companies.

Final note

As it stands, year-to-date to the end of June 2019, our portfolio has caught up with the benchmark and has on an absolute basis managed to grow our clients’ capital by more than 10% in USD terms; the increase in absolute value is what matters for the most part. While valuations remain somewhat elevated we have been finding pockets of interesting long-term ideas. We will keep our investors informed as we dig deeper into the financial and sustainability elements of these companies.

Thank you for your continued support and your alignment with our long-term investment horizon.

Yours faithfully,

LGM Responsible Global Emerging Markets team
Views and opinions have been arrived at by BMO Global Asset Management and should not be considered to be a recommendation or solicitation to buy or sell any stocks or products that may be mentioned.

The Fund is a sub fund of BMO Investments (Lux) I Fund, an investment company of variable capital (ICVC), registered in Luxembourg under No. B 25 570 and authorised by the Commission de Surveillance du Secteur Financier (CSSF). The Prospectus, Key Investor Information Document, Articles of Association, Annual and Interim Reports in German, as well as further information, can be obtained free of charge from our Swiss Representative: Carnegie Fund Services S.A., 11, rue du Général Dufour, CH-1204 Geneva, Switzerland, Web: www.carnegie-fund-services.ch. The paying agent is Banque Cantonale de Genève, 17, quai de l’Île, CH-1204 Geneva. The current prices can be found at: www.fundinfo.com.