BUILDING STRONGER PORTFOLIOS

Investment stewardship

Promoting sustainability through investment-led stewardship

February 2020

J.P.Morgan
Asset Management

“We believe effective investment stewardship can materially contribute to helping build stronger portfolios over the long term, for our clients.”

George Gatch

CHIEF EXECUTIVE OFFICER
J.P. MORGAN ASSET MANAGEMENT

Foreword

At J.P. Morgan Asset Management, creating value for our clients is central to everything we do. For more than 150 years, our fiduciary commitment has meant we consider the impact of each decision we make on client portfolios and performance.

We believe that sustainability is a vital part of this commitment. Sustainability factors are those that can have an impact on a company's ability to operate, today or in the longer term. When we take into account the full range of risks and opportunities – including those related to environmental, social and governance (ESG) practices – in our research, and promote sustainability through our engagement and voting, we strengthen our understanding of how companies will perform in the future, and contribute to stronger outcomes for our clients.

At the heart of our approach lies a close collaboration between our portfolio managers, research analysts and investment stewardship specialists to engage with the companies in which we invest. We call this "investment-led stewardship."

Regular engagement with our investee companies has been vital to our active heritage. We continue to exercise active ownership through regular and ad hoc meetings, and through our voting responsibilities. At the same time, we recognize that our approach needs to adapt and evolve to remain relevant in an ever-changing landscape.

In this paper, I am pleased to introduce our approach to reinforce and enhance our global investment stewardship model. Leveraging the expertise of more than 1,000 investment professionals working directly with companies, we are building on the foundation of our longstanding corporate engagement practices to focus strategically on a defined set of stewardship priorities that we believe can play a critical role in creating value for our clients.

Investment-led, expert-driven investment stewardship will not only enable us to recognize significant risks, identify new opportunities and better generate attractive risk-adjusted returns, but it should also help us to build stronger and more sustainable portfolios for our clients.

Jennifer Wu
Global Head of Sustainable Investing
J.P. Morgan Asset Management

Our investment stewardship philosophy

As a fiduciary of our clients' assets, we understand that performance is paramount. We believe that ensuring our investments are sustainable is vital to that goal.

We have worked to create an investment stewardship approach that aims to improve long-term, sustainable value. We believe that the companies in which we invest should be focused on responsible allocation of capital and long-term value creation.

For us, investment stewardship is not about adhering to one set of norms or limiting our scope to one collection of standards. Nor is it about arbitrarily extending the time horizon of our portfolios. Rather, we strive to understand how factors impacting sustainability are financially significant to companies over time, understanding that the regions, cultures and organizations in which we invest differ greatly.

Identifying whether a risk or opportunity is substantial enough for us to act upon it is a key element in our approach to investment stewardship. Due to the global breadth of our investment universe, we cannot apply the same metrics or standards across the board. Instead, we need to judge securities, assets and situations in context, and decide how significant a particular event or circumstance may be, given that context. This allows us to gauge the financially material elements of a sector, industry or business model from a sustainability perspective, now and into the future.

Our focus is on future cash flows or duration of business. We view purposeful leadership at the top of a company, supported by strong corporate governance, as the key to achieving these goals. Where such attributes are lacking, we will actively engage with investee companies to improve governance.

We integrate financially material ESG factors into our active investment frameworks across asset classes. Combining our ESG research capability with the experience and skill of our investment teams and the expertise of our investment stewardship specialists gives us a deep understanding of the risks and opportunities facing different sectors, industries and geographies. By integrating this expertise onto a global common platform, we seek to maintain a consistently high standard of engagement, considering the myriad nuances a responsible investor needs to embrace.

Our approach provides for broad flexibility as data, regulations and outlooks change, while focusing on the best prospects for sustainable financial returns.

Our five investment stewardship priorities

We have identified five main investment stewardship priorities that we believe have universal applicability and will stand the test of time. Within each priority area, we have identified related themes that we are seeking to address over a shorter timeframe. These themes will evolve over time, as we engage with investee companies to understand issues and promote best practice.

This combination of long-term priorities and evolving, shorter-term themes provides us with a structured and targeted framework to guide our investors and investment stewardship teams globally, as we engage with investee companies around the world.

Governance	Strategy alignment with the long term	Human capital management	Stakeholder engagement	Climate risk

Governance

Companies that get their governance right tend to get other sustainability issues right.

We believe it is vital to encourage the highest governance standards in the companies in our portfolios. Every company is different, but they all share some exposure to sustainability risks. We aim to ensure that board members and senior management teams are fully focused on their own responsibilities as leaders of people and stewards of investor capital.

A key starting point is appointing the right people to take on board-level responsibilities. A board must assess the skills it needs to oversee the company and make board appointments transparently. Assessing the performance of individual directors, committees and the board in aggregate is key to the ongoing functioning and refreshment of the board.

As an active investor, we demand high standards from company directors, particularly around their interaction with investors, and encourage a strong corporate culture to foster long-term value. We require candid and open communication, access to independent directors as well as executive management and a clear articulation of the board's thinking on long-term strategy.

Current theme: Board and management diversity

We believe diversity – of gender, sexual orientation, disability, and ethnic and religious background, as well as of perspective and skill sets – promotes stronger thinking and enhances decision-making. While it may be too simplistic to reduce this to a numerical target, we believe that boards function better when there is a diversity of viewpoints around the table.

While progress has been made in this area in many markets, there is still a long way to go. For example, a 2019 survey carried out by Equileap found that only 10% of companies globally had gender-balanced boards.[1] The UK government-backed Parker Review, launched in 2017, reported in early 2020 that 37% of FTSE 100 firms still had no ethnic minority representation on the board, with the number much lower for FTSE 250 companies.[2]

[1] Gender Equality Global Report & Ranking, Equileap, 2019.
[2] https://www.ey.com/en_uk/news/2020/02/new-parker-review-report-reveals-slow-progress-on-ethnic-diversity-of-ftse-boards

Current theme: Capital allocation

In a survey from the National Association of Corporate Directors in the United States, the majority of directors cited board oversight of strategy development (61%) and execution (63%) as areas for improvement in 2020.[3]

The board of directors plays an important role in providing oversight of the capital allocation process over competing priorities and multiple time horizons. Capital allocation has increasingly come into investor focus in recent years, becoming one of the leading drivers of activist campaigns against boards. As long-term investors, we encourage company leadership to consider extended time horizons when approaching capital allocation and other strategic business decisions. Planning needs to be long term and should take into consideration the views of a wide variety of stakeholders, as well as the potential for economic, societal and regulatory change, given the potential implications of these factors for company performance.

[3] https://www.nacdonline.org/about/press_detail.cfm?ItemNumber=66872

Strategy alignment with the long term

We believe long-term thinking leads to sustainable business models.

The role of management and board is to manage the business for long-term outcomes. While a company's purpose generally doesn't change, corporate strategies often do, in response to technological, competitive, societal and regulatory change. This can make strategic alignment with the long term challenging. At the same time, over-focusing on the short term clouds long-term thinking. By taking an extended view, company leadership can formulate strategies that should see them ready to react to – if not lead – disruption in their own sector and help them to navigate unexpected shocks. We understand this is not a simple task. A 2020 survey by the National Association of Corporate Directors in the United States found 68% of directors felt they could no longer count on extending their existing strategy over the next five years.[4]

We encourage boards to dedicate more time to long-term value creation, starting with the company's purpose, culture and strategic roadmap. This requires an internal focus on pushing toward the same future goal – and logging improvements along the way.

Current theme: Executive remuneration

We expect the businesses in which we invest to be managed for long-term outcomes. However, this task is made difficult when combined with short-term remuneration policies.[5] Even when executive remuneration is explicitly tied to performance against sector averages, it can have little effect on reducing "pay-for-luck."[6]

As a long-term investor, we will work with boards and management to appropriately align remuneration packages over the long term. At the very least, we believe this should help improve the transparency of the remuneration process and demonstrate how multiple facets of performance can contribute to an overall result.

[4] https://www.nacdonline.org/about/press_detail.cfm?ItemNumber=66872
[5] Executive Compensation: A Survey of Theory and Evidence, A. Edmans, X. Gabaix, D. Jenter, 2017.
[6] CEO Pay and the Rise of Relative Performance Contracts: A Question of Governance? B. Bell, S. Pedemonte, J. Van Reenen, 2018.

Human capital management

Effective management of human capital is critical to an engaged and productive workforce.

Purposeful leadership is critical to defining and developing the right conditions to drive workforce productivity growth. We encourage management to create an environment in which employees at all levels feel valued and can bring their own experiences and perspectives to bear. The attraction, development and retention of personnel with key skills are critical to the successful execution of strategy. The Securities and Exchange Commission has issued recommendations on how companies should report on their specific human capital programs,[7] and we believe human capital reporting has the potential to become a regulatory area of focus.

Diversity of thought, skills and background is as important to most aspects of human capital management as it is to optimal decision-making for boards. We work with investee companies to help them recognize diversity as a key element of recruitment and promotion practices. Employee training and development programs are central to a company's longevity and are an effective way of raising productivity and adding value.

Current theme: Diversity in the workplace

Inequality in the workplace has been recognized as a possible constraint to the growth of the global economy[8] and therefore as a drag on investment returns. While a lack of diversity can have negative effects on employee morale and stifle innovation,[9] a workforce that is representative of its customer base and the wider population should help a company further understand and realize its broader potential.

It has been demonstrated that a working environment that is more accepting of a diverse range of skills, backgrounds and outlooks is more productive.[10] Therefore, we encourage companies to strengthen their corporate culture and adjust their employment practices to create a welcoming and diverse workplace.

There is evidence of existing good practice. Some of the world's largest companies have implemented policies to transform their structures and working environments to allow people from all backgrounds to thrive. Best practice goes beyond ensuring gender diversity to attracting staff from a range of backgrounds (including religious, ethnic, sexual orientation) to achieve broad inclusivity.

As a global investor, we encourage companies to focus on their hiring, retention and promotion policies to improve diversity. We believe this can unlock growth potential, including, in some cases, through improved economic prospects for the communities in which such companies operate.

[7] https://www.sec.gov/news/press-release/2019-148
[8] Relationship Between Female Labor Force Participation Rates and GDP, U.S. Council of Economic Affairs, 2019.
[9] https://www.accenture.com/gb-en/services/communications-media/inclusion-diversity
[10] https://hbr.org/2015/12/proof-that-positive-work-cultures-are-more-productive

Stakeholder engagement

Generating long-term sustainable returns requires managing the interests of stakeholders.

Companies do not operate in a vacuum; their sustainability depends on other stakeholders beyond their investors and employees. To be sustainable and productive over the long term, a company's leadership needs to take into account the broader network of relationships in which they operate. This includes suppliers, customers and surrounding communities.

The risks that fall within this area touch all links in the stakeholder chain, from climate change and environmental risks, through data privacy and cyber security issues, to product liability and safety concerns for customers, employees and the surrounding community. According to the National Association of Corporate Directors in the United States, while many of these issues are currently viewed as discretionary rather than mandatory concerns, companies are increasingly likely to see them as "mission critical."[11]

The willingness to do the right thing is crucial. We believe that a respectful corporate attitude can foster goodwill, which, in turn, is vital to help create and sustain value. Engagement of all stakeholders both within and around a company will be increasingly critical to long-term success.

Current theme: Cyber security

Cyber security is part of the way a business protects its customers, and is a key enterprise risk, requiring board-level oversight of technology, data security and data privacy policies. Yet despite the potential impact of a breach or other cyber event on a company's valuation, this remains a neglected risk for many boards. While more than four in 10 UK businesses (43%) experienced a cyber security breach or attack in 2017, fewer than three in 10 (27%) have disclosed formal cyber security policies.[12]

In our view, cyber security is a priority issue for investors, and disclosures on cyber risks and strategy on risk management should be included in corporate reporting. We encourage boards to appoint directors with relevant expertise, or create sub-committees with a direct reporting line to boards, to advise on this evolving issue. We also promote best practice around preparation, protection and prevention issues. Managements and boards need to review and evaluate their approaches to cyber security risks on a regular basis and ensure that risk mitigation programs receive the appropriate level of attention at the board level.[13]

[11] https://www.nacdonline.org/analytics/survey.cfm?ItemNumber=63801
[12] Cyber Security Breaches Survey 2018, Department for Digital, Culture, Media & Sport.
[13] Stepping Up Governance on Cyber Security. What Is Corporate Disclosure Telling Investors?, UNPRI, 2018.

Climate risk

Climate change is a global challenge that investors cannot afford to ignore.

The changing climate needs to be placed high on every corporate agenda as it poses both wide-ranging risks and opportunities that could impact company operations and investment valuations. Physical changes to the environment, technological disruption through resulting innovation, and regulatory risks all pose threats, with the United Nations claiming delays in tackling the issue could cost companies around the world almost USD 1.2 trillion over the next 15 years.[14]

Every company needs to be alert to how the changing climate may impact its business in the future and to its own contribution to climate change, even if such risks may seem distant at this time. Governments, agencies and regulators have begun to put in place policies that will limit greenhouse gas emissions or penalize entities that do not comply with new standards. It is vital for a company's long-term sustainability to understand the risks posed to its business model by such legislation – compounded by a potential for withdrawal of investor support. As a long-term investor, an understanding of exposure to climate risk is imperative in our assessment of investee companies in our active portfolios.

While solutions to the challenge of climate change will require action by governments and regulators on policy and carbon taxation, we encourage companies to be proactive in assessing their exposures to both physical and transitional climate-related risks and opportunities. Business models may be impacted by future legislation or by shifts in societal opinion. The risk can be existential; some business models may be rendered obsolete as risk assessments evolve. We expect managements to engage with investors, and to articulate how the company intends to navigate the risks and opportunities posed by climate change and the oversight provided by the board on progress of implementing such plans.

Current theme: Climate risk disclosure

Carbon emissions disclosure has become the principle measure of a company's environmental impact, and the potential risk to its future sustainability. According to CDP (formerly the Carbon Disclosure Project), the number of companies disclosing on emissions has increased dramatically since the organization was founded in 2004.[15] From around 300, mostly European, companies reporting annual greenhouse gas emissions to CDP in 2004, the number has reached nearly 7,000 companies, based all around the world, today.

However, some regulators have claimed that disclosing emissions data is insufficient to adequately gauge climate-related risks.[16] For example, out of 3,610 companies claiming to have an emissions reduction target in place, only 67% (2,407) disclosed sufficient information for these targets to be validated. We therefore encourage companies to publish and regularly update a report as outlined by the Task Force on Climate-related Financial Disclosures (TCFD). Not only will compliance with TCFD establish a company as a leader in its field, but also it will enable leaders to proactively influence the sustainability debate, as it evolves.

[14] Changing course: A comprehensive investor guide to scenario-based methods for climate risk assessment, in response to the TCFD, UNEP Finance Initiative, 2019.

[15] Global Climate Change Analysis 2018, CDP.

[16] Institutional Investors' Views and Preferences on Climate Risk Disclosure, E. Ilhan, P. Kreuger, Z. Sautner, L. Starks, 2019.

We recognize that no company has the same starting point when disclosing on climate-related risks. Different industries and sectors have different degrees of carbon intensity and therefore different levels of potential risk to investors. There are also variables that investors must consider when assessing these risks, including changes in carbon prices over time and the duration or longevity of specific emission-generating assets.

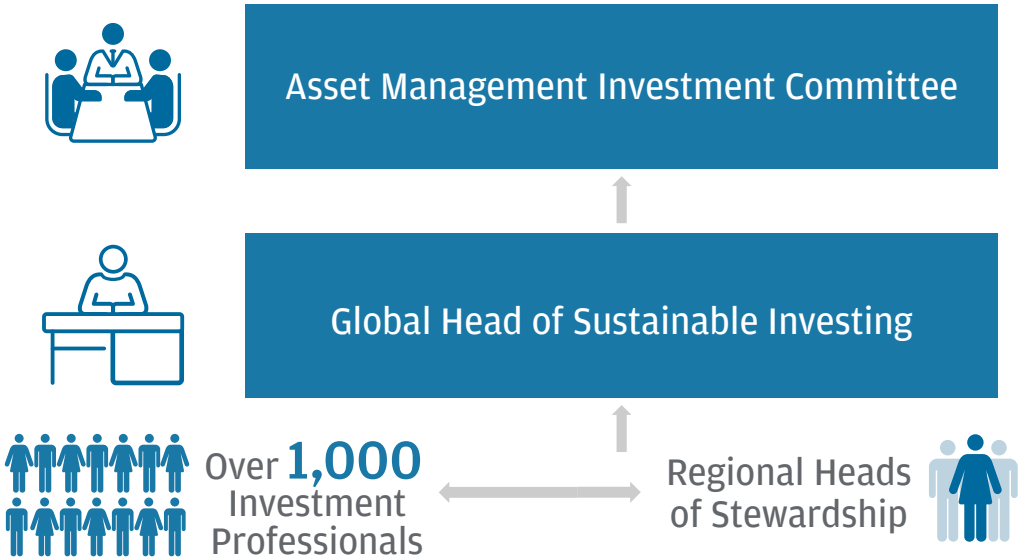
With this in mind, we are developing new ways of identifying and processing relevant information from unconventional, alternative data sources to understand corporate climate-related efforts and how progress is being measured and monitored.

Our team and approach

Locally focused, globally accountable

We are global investors who take a local approach. Our heritage of active investment has taught us that one size rarely fits all and, to create outperformance by picking long-term winners, local knowledge and understanding is key.

Around the world, including in New York, London, Hong Kong and Tokyo, our regionally based investment teams work closely with our sustainable investing and investment stewardship specialists to select, reject or engage with companies to enhance long-term performance. Together, these teams use our proprietary investment-led, expert-driven investment stewardship framework to establish benchmarks that are relevant and reliable, based on their local and sector-based context. Direct engagement and shareholder voting are all carried out at a local level, with guidance from our regional and global investment stewardship teams.



Voting responsibly and engaging for change

Our global network of investment professionals takes a research-driven approach to uncovering opportunities and risks. Analysis of companies and sectors through an ESG lens is a vital component in helping us to assess long-term value.

By examining the ESG profiles of companies within our investment universe, we can establish the risks, and the materiality of those risks, around a specific sector and location. This helps us to identify outliers based on our five priorities and conduct targeted engagements with companies where we believe improvements are warranted. We engage with companies to help us understand the issues they face and support them to adopt best operational and strategic practices.

As our aim is to increase and release sustainable, long-term value, we employ two branches of engagement. Our portfolio managers and investment analysts work with companies on improving elements of their operations and strategy that they deem to have a financially material impact on their profitability over the long term.

Where the issues identified relate to long-term sustainability, our investment stewardship team may conduct additional engagement. When we make an assessment of the future path of a company, we consider existing cultural issues, potential changes in regulation, societal matters and economic shifts. We conduct around 700 dedicated ESG engagements with companies around the world each year, in addition to the regular interaction between our investment teams and company leadership.

A key element to our process is actively voting at shareholder meetings. Effective use of our clients' proxy votes is critically important, and we manage the voting rights of the shares entrusted to us in the same way as we would manage any other asset. We actively vote at approximately 8,000 company meetings each year, in 80 markets around the world. We maintain detailed voting policies in each region, based on a mixture of international standards of corporate governance and local market best practice. Our investment teams and investment stewardship specialists in the relevant region are responsible for implementing those policies, taking into account individual circumstances as well as our investor insights, based on their deep knowledge and experience of the country, sector and company.

Under our enhanced framework, we will apply the lens of our five investment stewardship priorities in our voting decisions, and use votes, where appropriate, as a means to reinforce views expressed through our corporate engagement, in order to vote proxies in the best interest of our clients.

Our investment-led, expert-driven stewardship process has been developed over our extensive history of active management. It is backed by more than 1,000 investment professionals, based around the globe, and overseen by our investment stewardship team, which consistently monitors good practice to ensure we are achieving our aims, and creates feedback loops into our investment process.

Gaining deeper insights through wider data sets

The digitization of the global economy has opened up many new possibilities for collecting and processing data. At J.P. Morgan Asset Management, we have developed in-house technological capabilities to gain insights from a wide pool of unstructured data. Our capabilities include machine learning and natural language processing technology, which make it possible to gather and process multiple data sets into meaningful data at a scale, as well as artificial intelligence.

To highlight an example, our data science team has used natural language programming to pick up key phrases from anonymous reviews of companies by current and former employees on Glassdoor, a human resources website. We have begun to process, evaluate and apply this data to track companies' progress on human capital management and corporate culture. This tool will allow us to employ a forward-looking approach to formulate views on specific companies and sectors, alongside third-party ESG data.

We are excited to be able to generate new ways of finding relevant information from unconventional, alternative data sources, enabling us to build a rounder view of companies and apply it not only for investment research and portfolio construction purposes but also for effective corporate engagement. We continue to develop these capabilities and look for opportunities to apply them to a broader range of strategies.

A FIDUCIARY FOR 150 YEARS+

Commitment to considering the impact of each decision we make on client portfolios and performance

1,000+ INVESTMENT PROFESSIONALS

engaging with companies globally

INVESTMENT-LED EXPERT-DRIVEN

FOCUSED ON FINANCIAL MATERIALITY

ENGAGING

>700 ESG engagements with companies around the world each year

ACTIVELY VOTING

Across 80 markets around the world

Source: J.P. Morgan Asset Management; data as of December 31, 2019.

For more than 150 years, our fiduciary commitment has meant we consider the impact of each decision we make on client portfolios and performance.

John T. Donohue
CEO, Asset Management Americas
Head of Global Liquidity

Jed Laskowitz
Head of Global Asset Management Solutions

Bob Michele
Chief Investment Officer and Head of the Global Fixed Income, Currency & Commodities group

Anton Pil
Global Head of Alternatives

Paul Quinsee
Global Head of Equities

BUILDING STRONGER PORTFOLIOS

At J.P. Morgan Asset Management, collaborating with our clients in an effort to build stronger portfolios drives everything we do.

We are committed to sharing our expertise, insights and solutions to help make better investment decisions. Whatever you are looking to achieve, together we can solve it.

LET'S SOLVE IT.®

RISK SUMMARY

Investing on the basis of sustainability/ESG criteria involves qualitative and subjective analysis. There is no guarantee that the determinations made by the adviser will align with the beliefs or values of a particular investor. Companies identified by an ESG policy may not operate as expected, and adhering to an ESG policy may result in missed opportunities.

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