

Blue Oceans Capital

ESG Policy for Internal Governance

Introduction

Blue Oceans Capital recognises its responsibility to act appropriately in its business activities and towards those whom its actions affect.

As an investment manager, we strive for a high standard of business conduct, as well as a responsible approach to environmental, social, and governance issues (ESG). We believe these standards make good business sense and enhance investor value. Attention to and excellence in ESG criteria have been linked to improved corporate financial performance (Friede, Busch, & Bassen, 2015).

This ESG Policy focuses firstly on Blue Oceans Capital as a business and the principles that guide us. The second part compiles our approach to ESG issues as an investment manager. It is an integral part of our management practices to stay abreast of industry-wide ESG standards and to review those standards as compared to internal practices regularly.

The following guiding principles communicate our interpretation of ESG responsibilities and their practical application in the day-to-day running of our business.

Part One

BLUE OCEANS CAPITAL GUIDING PRINCIPLES

- Minimal travel-related activities. Analysts in our Bangalore office live and work in the one campus cutting out the need for any work-related day-to-day commuting. This eliminates all commute-related emissions. In our Australian office, the daily commute to work is taken by train, reducing carbon emissions.
- All internal communications are electronic where possible.
- Minimal office footprint. At both our Bangalore and Brisbane offices we work in a shared workspace environment. In this way we minimise our share of electrical load with electrical usage efficiency per person being maximised (Maximum use of shared facilities, no idle facilities or infrastructure).
- Maximum usage of software and automated data processing at every friction point. This minimises manual tasks reducing or eliminating physical presence and the environmental load that comes with that physical presence.
- Cloud data services. Wherever possible we run software on cloud servers in preference to

- our own on-site servers maximising electrical efficiency and minimising required floor space.
- Shut-down computers at night minimising electrical load.
- Recycling of all recyclable usables.
- Purchase recycled office stationery where possible such as recycled paper.

SOCIAL - WE HAVE DEVELOPED A UNIQUE HUMAN CAPITAL MANAGEMENT FRAMEWORK

Employee wellbeing has been well documented to correlate with work-related performance (Eisenberger, Fasolo, & Davis-LaMastro, 1990). Our human capital management is paramount to executing our business strategy, growth, innovation, continuity, and is a key area of our attention.

- Principles of investment management have been codified into processes and systems that structure a formal set of checks and balances in filtering for, and analysis of, every stock under consideration and currently in the portfolio. These systems, where possible, are replaced by or assisted by software data processing. Manual processes follow a given framework that ensures each element of analysis is covered both in a set standard for all companies and also with company specific considerations.
- Given a concrete framework to work within, analysts are otherwise free to manage their own time in how they meet and exceed performance requirements and also which businesses they devote their time to analysing. Providing this flexibility in both time management and ability to focus on companies of their choice ignites employee engagement and curiosity and leads to the uncovering of very exciting business models.
- Remuneration is via a fixed salary and investment component. The fixed salary is a base amount on average with industry standards. The investment component involves an initial investment allocation that is then redeemable in 3 years' time and linked to the performance of the portfolio over that time. The investment amount represents over 90% of the analyst's liquid wealth. This combined with the moderate fixed salary amount balances the future prospects of the analyst with the performance of the portfolio. In this way everyone working at Blue Oceans Capital is incentivised just the same as our investors. The investment amount also receives a significant bonus portion should the portfolio increase by an average of 15% per annum or more over the three year period (our target return).
- Voluntary turnover rates - We incurred a voluntary turnover rate of 16% in FY2018. 0% in FY19.
- Professional development - Analysts are required to regularly undertake during and after hours study. In addition, 8 weeks of personal development was dedicated to each analyst in FY2018.
- Remuneration levels for male and females are exactly the same.
- Culture. We foster a culture of transparency, integrity, respect, and fun. You can view an interview with one of our junior analysts here: <https://www.instagram.com/p/BmNtQPfl44F/>

ACCOUNTABILITY TO OUR INVESTORS

We take our responsibility of care to our investors very seriously. Consideration to this responsibility is inherent in everything we do.

- We highlight the performance of given stock indexes and compare to our performance.
- We communicate to investors the benefits of index investing and the benefits in terms of

return and fees should those indexes outperform our portfolio net of fees.

- Strict adherence to investment principles. Our investment systems and procedures are designed with layers of checks and balances that either make it impossible for an omission or we have imposed a double check procedure to ensure that they have been covered and have been covered correctly.
- Minimising our fees - We structure our business in such a way to minimise the cost required to pass on to our investors. We do this by:
 - a. Recruiting talent in countries with a significant cost arbitrage. Developing talent in-house through development of training modules and the analysis framework which takes out the need to purchase high-level talent. We have codified those processes where possible to need as few high-trained analysts as possible.
 - b. Office leases are a significant portion of our expenses. We minimise this expense by working in co-working spaces which offer the benefit of shared expenses and by holding the bulk of our analysis and IT function in countries that hold a currency conversion benefit.
 - c. All salaries and bonuses are modest.

GOVERNANCE

Blue Oceans Capital is a small boutique fund manager with few staff. However, we have still developed a governance framework that facilitates success. We adhere to the best-practice guidelines as set by the ASX where relevant to our organisation.

Foundation of management and management oversight.

Roles of the manager:

- To ensure accurate and complete application of systems and procedures to cover all aspects of analysis.
- To regularly review and update those systems and procedures.
- To develop and retain in-house analytical talent.
- To develop and implement analyst incentive plan that aligns completely with sustainable portfolio returns over the long term.
- To ensure the fund is at all times compliant with regulatory requirements.
- To report to investors the accurate performance of the fund.
- To report to investors risks of the fund and any concerns of future performance.
- To ensure all expenses related to management of the fund are minimal.
- To participate in the promotion and improvement of ESG standards both within this organisation and those of companies we invest in.

Management oversight is obtained via:

- Review by our appointed accountants
- Review by our investors
- Adherence to regulatory framework

Promotion of ethical and responsible decision-making

Is promoted by:

- a. The integration of ESG standards into our analysis process.

- b. Adhering to our analysis process.
- c. Adhering to the regulatory framework.

Remunerate fairly and responsibly

We do this by:

- a. Ensuring wages for both staff and director match or are higher than industry award.
- b. Bonus incentives are tied to outperformance of the fund as compared to global benchmark.

Recognise and manage risk

We do this by:

- a. Adhering to our analytical principles and procedures.
- b. Maintaining a diversified portfolio.
- c. Closely monitoring and analysing current investments.
- d. Monitoring and analysing competitors to current investments.
- e. Monitoring economics of countries our companies draw revenues from.
- f. Seeking advice from special council.
- g. Regularly improve education of staff and apply learnings to our procedures.

Part Two

BLUE OCEANS CAPITAL INVESTMENT MANAGEMENT APPROACH TO ESG ISSUES.

ESG analysis factors have been integrated into our business as outlined in the Principles of Responsible Investing (PRI) framework as issued by the United Nations Finance Initiative (UNEP FI, 2018).

1. We have incorporated ESG issues into our investment analysis and decision-making process.
2. We are active owners and integrate ESG issues into our ownership policies and practices .
3. We seek out relevant and comprehensive ESG disclosure in entities we are invested in.
4. We promote acceptance and implementation of the PRI within the industry.
5. We work together in an effort to improve our effectiveness in PRI implementation.
6. We report on our progress in implementing, adhering to, and progressing the PRI framework.
7. We have incorporated ESG issues into our investment analysis and decision-making process.

Progress to date has been made in qualitative analysis, quantitative analysis, and making the investment decision.

QUALITATIVE ANALYSIS - INVESTMENT PROCESS AND PHILOSOPHY

Industry and Business Model - In deciphering industries and business models we ask ourselves three important questions.

1. How does this business add value?
2. What mechanism/s does this business use to create revenue?
3. Is this industry and business one we can confidently apply a growth projection to?

We understand the limitations of our analysis. To that end we avoid the following businesses for the following reasons:

Commodity derived revenues - We do not have the analytical ability to predict future prices of oil, wheat, or copper. Predictions surrounding international demand and supply, rainfall, and geopolitical tensions lie outside of our capability.

Contract winner - This company must continually tender for, and win, contracts to carry out and increase business. Typically in the construction industry, the company comes unstuck in two ways - Inability to accurately cost new projects and the willingness of new competitors to under quote. Examples generally include:

- Apartment high-rise builder
- Infrastructure builder of government initiatives - e.g. roads, bridges, tunnels, ports.
- Office tower builder
- General government procurement such as marketing, engineering, logistics, defence equipment, building construction, consulting)

We don't believe we have the analytical ability to predict or future chances of this contract winner to:

- a. To continue to win more and more contracts
- b. To continue to accurately quote these contracts and maintain margins
- c. To avoid material liquidated damages

Manufacturer - This company is engaged to manufacture products for various brands. It takes raw materials and brings them together to produce given outputs. The classic example is the textile manufacturer who produces clothing for different retail brands. Ones we avoid are low in the value chain.

Examples include:

- Autos
- Food
- Steel
- Chemicals
- Power Cables
- Chain
- Plastics
- Wafer Silicon
- Copper wire

Logistics Provider – This is a capital intensive operation that uses physical warehouses and transport to move goods around. Examples include third-party logistics provider and traditional transit solutions over land and water. We also include airlines in this category.

We avoid the logistics provider because:

- Logistics solutions are a commodity with vast numbers of competitors mainly competing on price
- Material changes to profit subject to the price of oil, a commodity we can't predict the future price of:
 - a. High labour costs consistently increasing
 - b. High depreciation expense
 - c. High lease expense

Real Estate Developer – This entity raises funds to develop land, usually into apartments. They purchase land, engage a construction company to build apartments, and then sell the apartments. Here the developer is subject to movements in interest rates, broader economic performance, and market sentiment subject to change over the project life cycle.

Here we may be able to offer insight into likely interest rate and economic changes over the short term, however we would avoid the real estate developer because of:

- a. Inherent requirement for large debt loads
- b. Inability to scale at speed
- c. Reliance on domestic economy with frequent inability to grow internationally.
- d. Reliance on very specific local economies

Researcher – This company is generally in the business of biological innovation. They will create, manufacture, and innovate drugs or other health promoting agents. They compete on having the most effective treatments and so constantly research and innovate to stay ahead of the competition. These are often pharmaceutical companies.

We do not invest in researcher based business models because we do not have the analytical ability to:

- Confidently understand the revenue streams enough to be able to identify the competition
- Understand the intricacies of the treatment in how easily it might be replicated or superseded
- Be aware of current research that may compete with or supersede this treatment

QUALITY OF MANAGEMENT

The quality of management will be recorded in the financial record of the company. However we do analyse management separately and give analysis thereof special attention when the company in question has a short or no historical record to judge it by.

In assessing the quality of management we consider:

- a. The historical record before they started with the current organisation.
- b. A company's executives should do what they said they would do. We read the past annual reports to see the forecasts the managers made and if they fulfilled these or fell short of them.

- A manager should admit their failures and take responsibility for them.
- c. Executives should not be over paid as compared to competitors and industry norms.
 - d. No evidence of accounting manipulation or emphasis of misleading metrics.
 - e. Company should not be reissuing or repricing stock options constantly.
 - f. Managers should spend most of their time managing in private, not being in the media promoting the company's stock.

QUANTITATIVE ANALYSIS - FINANCIALS AND MODELS

We are fundamental, value based investors. We find investments by filtering through every stock on a given exchange. We do this through careful selection of sector financial metrics combined with rigorous financial statement analysis and notes to financial statement analysis. We specialise in finding small cap investments that exhibit a rapidly scalable business model with global reach. We only invest in businesses that have an exceptional financial record and where we believe our analysis capability can be confidently applied.

- Preference on small to medium-sized businesses.
- Global coverage but with investments in stable economies and emerging economies undergoing rapid economic expansion with sound fundamental economic drivers.
- Preference on rapidly scalable business with early free cash flow.
- Low portfolio turnover.
- Use of computing for repetitive, codifiable analysis calculations.

LONG-TERM INVESTMENT HORIZON

We are not traders. We perform detailed analysis on the current status of the financials, the business model, and industry. We prefer companies that are excelling in industries undergoing structural change and businesses we invest in are often leaders in that disruption. As such, these are fast growing businesses however the resulting share prices at times lag as market participants may overlook these business in the short term, either due to neglect or prejudice. This is often the reason the investment case arose in the first place. Over the long term however, stock prices always revert to intrinsic value and it is this reversion coupled with our long-term focus that yields results.

The difference in our thinking is that we would rather look hard and long to find an undervalued extraordinary company that than to easily find an undervalued ordinary company. In this method we look for a company that has exceptional growth characteristics coupled with good financials at a price that gives us a margin of safety.

How we think about this - In finding potential investments we must first sift through every stock. To filter a universe of some 100,000 + stocks we consider the following factors.

Detailed Financial Statement Analysis.

This analysis covers some 42 data points and also draws on insight gained from specific interrelations of these data points. The data points relate to metrics and analysis drawn from the income statement, balance sheet, cash flow statement, and notes to financial statements.

Calculating intrinsic value vs market price and filtering for required rate of return.

The market will often make prices that have no basis in a company's current or possible future earnings often far overestimating earnings ability. This creates a price which is too expensive or simply overlooking a sound company with good prospects leaving its share price undervalued. Therefore, we must make our own independent valuation of a company's worth. We call this intrinsic value.

In calculating intrinsic value we consider the following quantitative and qualitative elements:

Quantitative

- a. Capitalisation
- b. Earnings and dividends
- c. Assets and liabilities
- d. Operating statistics
- e. The discount rate

Qualitative

- a. Nature of the business
- b. Relative position of the individual company in the industry
- c. The company's physical, geographical, and operating characteristics
- d. The character of management
- e. The outlook for the company, the industry, and business in general

The longer we hold a stock, the greater chance we give our original analysis to be proven correct.

Accounting manipulation checks and balances

In this section we cover a series of checks and balances that uncover signs of accounting manipulation.

This process accounts for some 140+ data points and interrelations between those data points found within management discussion, financial statements, and notes to those financial statement. Past annual reports must also be analysed to gain insight into how these metrics are trending and to highlight any abnormalities that may be indicative of suspicious behaviour.

INVESTMENT DECISION

After collating all the information above and comparing it to all investment options that also meet the above criteria we are ready to make the investment decision. A decision is made based on:

- a. How well the company fits into our preferred investment criteria
- b. What its expected return is over a 5 year horizon
- c. Its attractiveness compared to other options meeting the above criteria
- d. Its attractiveness compared to existing stocks in the portfolio

Under those considerations the decision is made to:

- a. Buy
- b. Hold
- c. Sell

d. Avoid

ACTIVE OWNERSHIP

In this area we have more room for improvement. Currently our efforts involve:

- Voting.
- Analysing company proposals and remuneration at AGMs.
- Continually checking for evidence of accounting manipulation or attempts to mislead investors and communicating those findings to management.

References

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Gunnar Friede, Timo Busch & Alexander Bassen (2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies, *Journal of Sustainable Finance & Investment*, 5:4, 210-233, DOI: 10.1080/20430795.2015.1118917

United Nations Environment Programme Finance Initiative (2018)., *Principles for Responsible Investment, A Practical Guide to ESG Integration for Equity Investing*, <http://www.unepfi.org>

Who is Blue Oceans Capital?

Fundamental, value based investments.

Blue Oceans Capital is an investment fund driven to achieve exceptional results with meaningful purpose through dedication to uncovering truth and applying our understanding of what is known and not what is forecasted. We invest in listed equities across the globe.

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