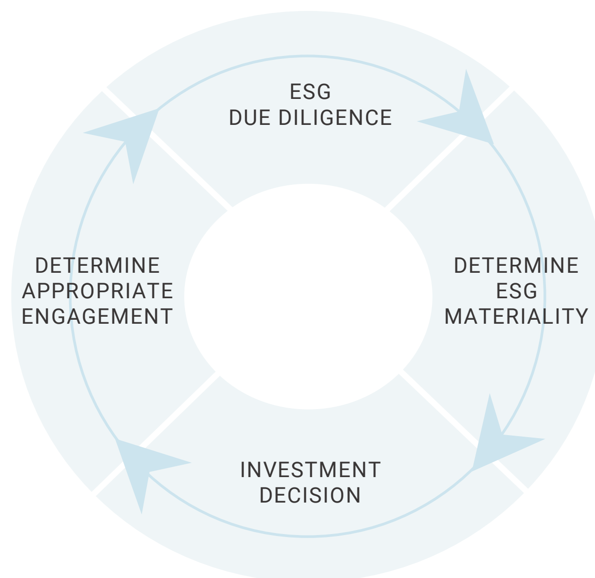
H&W ESG PHILOSOPHY AND PROCESS

ESG PHILOSOPHY

Hotchkis & Wiley's investment approach is predicated on several important pillars:

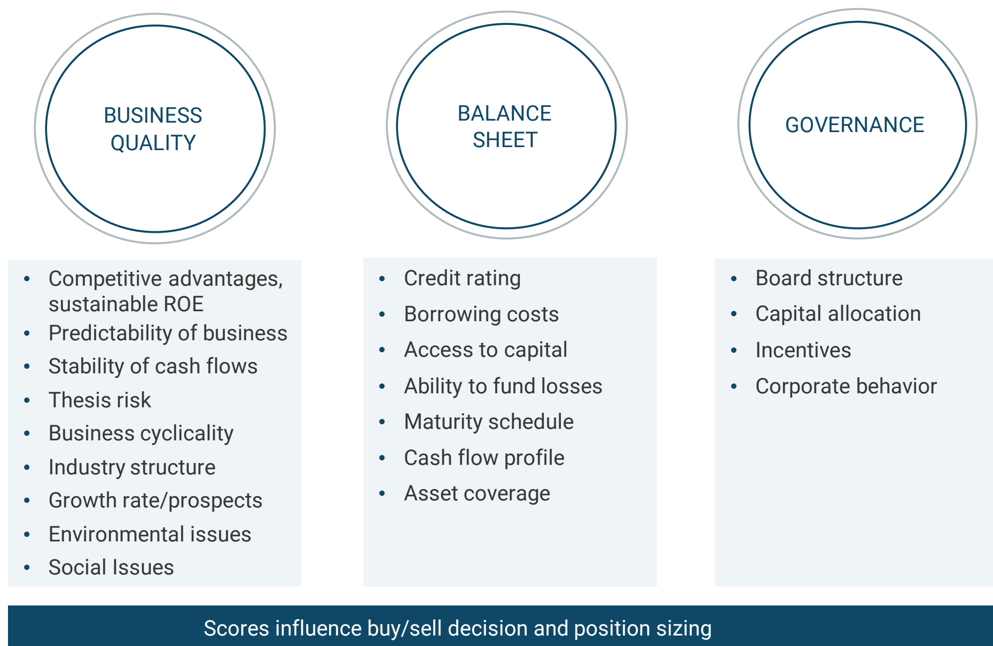
- We are long-term, fundamental investors
- Valuation is the beacon that guides us
- All investment decisions weigh risk and return

A comprehensive understanding of ESG factors strengthens each of these pillars. We recognize that material ESG factors can influence the two most important merits of any potential investment: intrinsic value and risk. As long-term fundamental investors, we must understand whether a company's assets, business practices, and cash flow streams are sustainable. To reflect this belief, we became signatories of the UN Principles for Responsible Investment ("PRI") in 2013.



ESG PROCESS/INTEGRATION

ESG factors have long been contemplated during the normal course of our research process—even before the widespread use of the term "ESG". While the spirit of our approach has remained largely unchanged, our process for integrating ESG factors into our analysis has been progressively formalized/enhanced over the years as ESG awareness, data, and disclosures have proliferated.



H&W Fundamental Risk Ratings

All investment decisions compare the discount to intrinsic value with the risk profile. To help quantify the risk profile, we have adopted a proprietary scoring methodology—fundamental risk ratings. Investment risk is scored on three factors: 1) business quality, 2) balance sheet strength, and 3) governance. Scores range from 1 (best) to 5 (worst). Environmental and social factors are incorporated into the business quality score, and as you would expect, governance factors are incorporated into the governance score. The scores are determined by sector teams after thorough debate. We use third party ratings/research as a reference and source of information (primarily MSCI's ESG Manager platform), but we reserve the right to disagree with vendor ratings and create our own independent decisions. The rare company that receives a score of 1 under all three factors would represent a premier franchise that was well-capitalized and well-managed; a company that receives a score of 5 under all three factors would represent a disadvantaged business with a distressed balance sheet and dishonest management. The "1/1/1" company is likely to be a large position if it trades at a discount to its intrinsic value; the "5/5/5" is unlikely to be purchased at any valuation.

Environmental Factors

Material environmental issues will impact a company's business quality score within our fundamental risk rating framework. Examples of environmental factors that would positively affect its score include products/services/investments in clean technology, low emissions and/or initiatives to reduce emissions, and efforts to manage/limit natural resource use. Heavy polluters without initiatives to improve would score poorly.

Social Factors

Material social issues will also impact a company's business quality score within our fundamental risk rating framework. Examples of social factors that would positively affect its score include constructive labor relations, supportive community involvement, dedicated diversity initiatives, and progressive product safety programs. Controversial companies making unsafe products with strained employee relations would score poorly.

Governance Factors

Material governance issues will impact a company's governance score within our fundamental risk rating framework. Examples of governance factors that would positively affect its score include diverse/staggered/skilled boards, appropriate/aligned compensation programs, prudent capital allocation, and ethical corporate behavior. Companies with non-diverse, controlling boards, with misaligned incentives, and unethical corporate behavior would score poorly.

MATERIALITY

Determining whether an ESG issue is material to a company is a critical element of effective ESG integration. Some ESG factors, like capital allocation policies, executive compensation, and board composition are material to most, if not all companies. Other ESG factors are material to all/most companies in one industry but may be immaterial to all/most companies in a different industry. For example, greenhouse gas emissions are likely to be a material factor for utility companies but likely to be immaterial for many tech companies. Conversely, data privacy practices are likely to me more material for a tech company than a utility.

ENGAGEMENT

We meet with management teams across the globe, in our offices, at conferences, and virtually. We do not take a uniform approach to interviewing company management because each company and each management team is unique. If we determine that an ESG factor influences a company's intrinsic value or risk profile, we will address the issue with management. We consider ourselves active owners but not activist investors. We do not make an investment with the intent of obtaining a board seat, starting a proxy fight, or altering the strategic direction of the business. Instead, we take more cooperative approach by working with management and encouraging action that is in the best interest of shareholders, which often come in the form of environmental, social, and/or corporate governance issues.

Proxy Voting

We vote proxies on our clients' behalf unless explicitly directed otherwise. We have a formal proxy voting policy that outlines voting guidelines and procedures, including explicitly addressing ESG issues. The essence of our guidelines state that we shall vote in a manner that is in the best interest of shareholders and that each proxy should be considered individually. As it relates to ESG items, our approach to proxy voting replicates our approach to integrating factors into our research process—if the ESG item up for vote has a material effect on the sustainability of the business, we will vote accordingly. To facilitate consistency, our proxy voting procedures dictate that voting responsibility resides with the research analyst covering the company. To assist in this effort, we have engaged third party research from Institutional Shareholder Services ("ISS"). The research analyst responsible will consider the recommendations of both the board and ISS before independently submitting the proxy vote.

Proxy voting allows us to demonstrate our opinion as it relates to management actions, including ESG related items. We will vote against management's recommendation if we believe the proposed items are not in shareholders' best interests. ESG related factors are among the most common items where we express our opinions that oppose management—voting against excessive/misaligned executive compensation and the (re)election of ineffective directors are among the most frequent. We have also voted in favor of shareholder proposals that encourage ESG related improvements, including items related to employment diversity, global warming, etc.

RESPONSIBILITY

ESG factors are systematically integrated into the core of our research process. Effectively integrating these factors into our process requires a full team effort. We believe the analyst conducting fundamental research, and the pertinent sector team and portfolio managers are best equipped to judge the materiality of ESG issues and potential ramifications, and in determining if/how to engage management. To supplement these efforts, an investment team member runs quarterly screens on all portfolio holdings which is disseminated to the entire team. Trading, compliance, and operations all play roles as well.

REDUCING CARBON EMISSIONS – CUMMINS, INC.

Cummins, based in Columbus, Indiana, manufactures diesel engines, electric power generation systems, and engine-related components. Its products serve the following businesses/ industries: heavy duty trucks, marine, power generation, oil & gas mining. The company was founded in 1919, has more than 60,000 employees, and trades under the ticker "CMI" on the New York Stock Exchange.

The company's stock price declined during 2008/2009 recession to a level that appeared to be potentially attractive. The more research we did, the more confident we became in the overall quality of the business and the more optimistic we became in its long-term investment prospects. Central to our investment thesis is the company's history of, and continued commitment to manufacturing technologically advanced, reliable, and efficient engines that reduce carbon emissions. Through decades of reliability, Cummins has cultivated extremely high brand loyalty with its customers. Meanwhile, increasingly stringent regulations designed to curb emissions and improve fuel economy drive additional customers to Cummins. The company is the only full system engine and components supplier that is positioned in every major market and able to address new regulatory hurdles. The cost to keep pace with these requirements is substantial and rising, which makes Cummins' offerings a better economic return to its customers, with less risk, than developing the required technologies internally. Even customers that choose to develop engines internally often rely on Cummins components. Regardless, Cummins' content per vehicle rises significantly with each new government mandate, providing a meaningful opportunity for growth as environmental consciousness intensifies.

Additionally, Cummins has spent considerable time and investment in new electric and hydrogen propulsion systems. This has yet to produce a meaningful economic return, but it reinforces the company's commitment to cutting-edge technological advancement designed to reduce carbon emissions—an opportunity for growth in a transitioning global market. In addition to the growth opportunities in clean-tech products, the company has been well-managed, executed prudent corporate governance, and has a very good balance sheet—all qualities that should command a premium valuation in the marketplace.

THE IMPORTANCE OF EMPLOYEE RELATIONS – ALCOA

In the late 1990s, Hotchkis & Wiley analyst JP Flagler flew to Pittsburgh, PA to meet with Alcoa's CEO, Paul O'Neill (unfortunately, Mr. O'Neill passed away in April 2020 at the age of 84). O'Neill was unique in that his top priority was to improve upon and ensure the ongoing safety of his workers. At the time he was appointed CEO, the company's safety record was generally viewed as adequate by the standards of the time. They were in no way satisfactory to O'Neill; however, and his policies to address the issues stretched well beyond what was considered normal for the time. From JP's perspective, O'Neill demonstrated his commitment by starting every one of his meetings with a review of safety-related procedures for meeting participants (JP's own meeting with Mr. O'Neill began with a compulsory review of the emergency evacuation plan), and every one of Alcoa's performance presentations began with a review of the company's safety statistics. O'Neill firmly entrenched this philosophy in the firm's culture, emphasizing the value that he and the rest of Alcoa's leadership placed on its workforce including, of course, those represented by unions. This, in turn, fostered improvements in employee morale, collaboration, and productivity.

Shortly thereafter, JP traveled to meet with one of Alcoa's direct competitors. As he was shuttled to the meeting, he was greeted by an angry group of striking union workers. The shuttle bus had protective metal screening installed to prevent injuries caused by thrown objects. Upon arrival, the company's CEO apologized for the scene in front of the plant and made comments that reinforced his combative stance with the workforce. The contrast with Alcoa was stark. Years later, that company filed for bankruptcy, and its inability to resolve its labor disputes was considered a key driver of that outcome.

Meanwhile, Alcoa thrived, as both its financial results and its share price rose. The primary takeaway, which was well understood by O'Neill, is that a safe, respected, and motivated workforce is essential to the success of a business and therefore its shareholders. We also understand and appreciate this distinction, which is one of the many important factors that we consider when evaluating an investment opportunity. It is part of our well-established and thorough due diligence process, developed long before the ESG acronym was coined.

Company examples were specifically selected to illustrate ESG considerations as part of the firm's investment process and are not investment recommendations. No assumption should be made that all investments in the firm's strategies have the same ESG considerations. Each investment has different factors and considerations. The examples are based on either a past and/or current investment in the company and may not be reflective of H&W's current view of the company. The company information is based on a point in time and, therefore, may not be indicative of the company's current situation, nor indicative of the company's future situation. H&W is not responsible for providing updated information on the companies. There is no assurance that the investments in the companies were or are profitable. The company examples do not represent all investments made for H&W's advisory clients.

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