



# AVARON ASSET MANAGEMENT

**RESPONSIBLE INVESTMENT REPORT  
FOR THE YEAR 2016**

**CONTENTS**

AVARON OVERVIEW..... 3  
SUSTAINABILITY IN AVARON .....4  
SOCIALLY RESPONSIBLE INVESTING IN AVARON ..... 6  
    INTEGRATION .....6  
    ACTIVE OWNERSHIP .....7  
    COLLABORATION AND INDUSTRY INVOLVEMENT .....9  
    COMPLIANCE WITH UNPRI.....10



## AVARON OVERVIEW

Avaron Asset Management is a fund management company that mainly manages UCITS funds and institutional investor managed accounts investing in listed equities and high yield bonds in Emerging Europe region. The Company started its business activities in 2007 as its first investment funds were launched on April 23<sup>rd</sup> 2007. Asset class wise our focus is on listed equities and fixed income in Central and Eastern Europe. We follow the principles of value investing and evaluate every investment case on a standalone basis. Portfolio construction is based on stock-picking, thus fully bottom up. We invest only in listed instruments and the whole idea generation is proprietary, driven by our in-house bottom-up research. Our investment universe includes 236 entities, which are under close observation of our eight-member investment and analyst team. In total Avaron employed 14 talented people as of end-2016. We are proud to be an independent, management-owned boutique committed to delivering strong risk-adjusted investment returns to our clients.

As of end of 2016, the Company managed €548mil AUM of which our core Emerging Europe listed equity strategy accounted for €529mil. Out of total AUM only 2% was invested in fixed income instruments. We manage three investment funds registered in Estonia, including one equity fund (Avaron Emerging Europe Fund), one fixed income (high yield) fund (Avaron Eastern Europe Fixed Income Fund) and one closed-end asset allocation fund (Avaron Flexible Strategies Fund). In addition to investment funds registered in Estonia, Avaron provides sub-investment management services to third party funds and managed accounts. Investment management services to professional investors in the form of third party funds and managed accounts have been an increasing business line for us over the past years and account now for a substantial part of the AUM.

## SUSTAINABILITY IN AVARON

Avaron is committed to sustainable business practice that is embedded into our corporate identity. We review sustainability under the categories of People, Community, Environment and Investing (please refer to Socially Responsible Investing section on page 6).

### PEOPLE

At Avaron we recognize that the skills, experience and commitment of our team together with a robust, repeatable and long-term focused investment process are integral to deliver superior investment returns to our clients. In order to attract and retain the best people we aim to make the working environment enjoyable, flexible and dynamic. We promote equal opportunities and highly value transparency together with mutual trust. Being part of our small but ambitious team should provide excellent opportunities for people that strive for excellence and are passionate about investing. We have developed effective hiring and on-boarding processes to ensure that we find talented people and are able to integrate them successfully into our team. We will not discriminate because of age, disability, gender, marital status, pregnancy and maternity, race (including color, nationality and ethnic or national origins), religion or belief, sexual orientation or any other factor. It is our belief that long-term success is created via an environment in which difference and diversity are respected and welcomed.

Staff numbers	2014	2015	2016
Full time employee	15	15	15
% of female	50%	56%	56%
% of male	50%	44%	44%
Turnover	20%	14%	13%

The average tenure of our staff as of end 2016 was 5.6 years.

### COMMUNITY

We encourage our staff to take an active role in the community for the benefit of both our business and society. In this we put emphasis on education and youth development. Over the years our staff has held lectures on investment topics at Estonian universities. Since 2014 we have been participating in the “Back to School” initiative (<https://tagasikooli.ee/>) as guest teachers. “Back to School” initiative has the objective to strengthen the cooperation between Estonian schools and the rest of the society by inviting guest teachers to schools to carry out lessons and share their experience. In addition, from November 2015 to May 2016 we carried out a virtual investment game for 5<sup>th</sup> graders in one school with an objective to teach them about saving and equity investing.

### ENVIRONMENT

We acknowledge and aim to measure our environmental impacts and take action to improve wherever possible. As an office-based business our direct environmental impact is relatively limited. We have identified four main impact areas from our operations: energy consumption, water use, paper use and travel. We are committed to reducing these through cultivating sustainable business culture optimization of

our working practices. In Avaron we have a policy to avoid bottled water and use tap water for drinking. Annual electricity and paper consumption are tracked since 2014 and over these last 3 years we have managed significantly to reduce paper consumption by taking more advantage of electronic sales presentation possibilities. Electricity consumed by our operations has increased 1% p.a. during this period.

	2014	2015	2016
Paper usage, # of sheets	22 257	17 548	14 652
change, %		-21%	-17%
Electricity consumption, kWh	17 954	18 187	18 341
change, %		1%	1%

Most significant environmental impact of our business operations is related to the greenhouse gas (GHG) emissions from our air travel. Mid-2016 we put in place processes to track our travel related emissions with an aim to start reporting our carbon footprint (Scope 2 and Scope 3 emissions) from 2017.

## SOCIALLY RESPONSIBLE INVESTING IN AVARON

Since 2011 Avaron follows responsible investment practices and is a signatory of UN Principles for Responsible Investment (UNPRI). As an institutional investor, Avaron has a duty to act in the best long-term interests of its beneficiaries. In this fiduciary role, we believe that environmental, social and corporate governance (ESG) issues can affect the performance of investment portfolios to varying degrees across companies, sectors, regions, asset classes and over time. Given our main aim of generating alpha to our clients via stock picking it is necessary to have ESG analysis integrated into our investment process. When making investment decisions our in-depth knowledge of listed companies is considered as a key ingredient in delivering strong returns to clients. Our investment team has been following vast majority of our current listed equity universe for a decade, which serves as an important strength in assessing the companies' future potential. In order to have an extensive knowledge base of the companies in our universe we have taken a strategic decision not to outsource ESG analysis to third party providers but rather educate our research team and add an ESG specific layer within our research process.

In Avaron we believe that the stock returns are primarily driven by the underlying fundamental potential of companies, while ESG issues may add to or subtract from it. Thus, the ESG layer in our investment process serves as a risk management tool to detect possible important risks related to ESG. While the ESG factors considered mainly aim to reduce investment risk, Avaron also recognizes that applying these principles may better align investors with the broader objectives of society. Improved ESG practices should help to create an environment of higher standards of business conduct, increased market efficiency, sustainable environmental management, and thus ultimately a more cohesive and fairer society. Even though such indirect benefits may not contribute immediately to Avaron's investment performance, these should over time translate into higher and more consistent overall returns.

## INTEGRATION

Avaron seeks to integrate the consideration and thoughtful management of ESG issues into its investment process by undertaking ESG due diligence on all prospective and existing investments. We aim to ensure that our Investment Managers and Investment Analysts understand:

- i. to which ESG risks and opportunities the investment is exposed to;
- ii. how material the ESG issues are for the business, taking into account the industry and individual company exposure;
- iii. how are ESG risks managed and what is the likelihood of these risks materializing;
- iv. what kind of impact the ESG issues are likely to have on the value, earnings and future prospects of the investment.

Avaron has built two ESG layers into its investment process aiming to ensure that ESG issues are consistently taken into account when making investment decisions.

- i. Sector and/or country exclusion in order to not exceed acceptable levels of involvement in sectors considered to be controversial such as weapons, alcohol, tobacco, gambling, adult content and coal, and activities in oppressive regimes. Our tolerance level dependent on the specific

consideration ranges from 0% to 30% of company’s revenues or operating profit.

- ii. Compliance check of investee companies with the main principles laid out in the United Nations Global Compact for social and environmental criteria, and separately with governance criteria set in-house. The main aim of this exercise is to filter out companies that have significantly and repeatedly breached the key principles, and assess any potential notable risks related to the long-term business outlook. When detecting incompliance cases we follow “engage or exclude” action.

As of end 2016 our Emerging Europe listed equity coverage universe had 236 companies (2015: 243). Based on the ESG analysis we had additional 45 companies in the restricted list (2015: 35). It has to be noted that our investment process is set up in a way that the first decision on the overall suitability (business model, management quality, governance issues) into our investment universe is taken usually after the initial meeting with the management without undertaking the detailed ESG analysis. Thus, over the years we have had cases whereby based on governance issues we have rejected the company. Such companies do not get reflected in the restricted list. The latter is rather a reflection of the number of companies that have been excluded from our investment universe.

Exclusions based on type		Excluded companies by country	
Ethical considerations	12	Bulgaria	3
Environmental	15	Czech Republic	3
Social	0	Estonia	5
Governance	18	Greece	3
		Poland	7
		Romania	2
		Russia	13
		Turkey	9

In order to align our responsible investment approach with the climate change and energy policy targets of European Commission Avaron decided in Q1 2016 to stop financing coal-based business models. This entailed excluding the following companies from our investment universe: 1) mining companies that derive 30% or more of their revenues or operating profits from mining thermal coal; 2) utilities that derive 30% or more of their generated electricity or heat from thermal coal. This change resulted in 11 companies being excluded from our internal investment universe. As of end-2016 our portfolios fully comply with the set new restriction.

More detailed description of the ESG integration can be found in our Responsible Investment Policy ([http://avaron.ee/files/docs/2016.05.11\\_Avaron\\_RI\\_policy\\_revised.pdf](http://avaron.ee/files/docs/2016.05.11_Avaron_RI_policy_revised.pdf)).

## ACTIVE OWNERSHIP

### Engagement

One way Avaron manages and protects the value of its clients’ investments is via being an active owner, exercising the shareholder rights and engaging with managements of the listed companies. Avaron takes an active approach to communicating its views to companies and seeking improvements where there are

shortcomings in performance, or a company has failed to apply appropriate standards, or to provide adequate disclosure. Should the company breach Avaron’s ESG criteria, engagement would be the preferable option over exclusion in order to thrive towards better ESG awareness and policies. A dialogue with the company is maintained over an extended period if necessary. Escalation of the engagement activities will depend upon the company’s individual circumstances. Actions may include communications through the company’s brokers, direct engagement with the management board or joint intervention with other shareholders, and where appropriate, voting against board proposals.

Meetings with company executive and non-executive board members are one of the key ingredients of our investment process. Besides the upside to our internal target prices the portfolio construction is also driven by company quality for which we have a specific scorecard. Such qualitative assessment can only be done by combining publicly available information with meetings with company representatives. During these meetings we have also the opportunity to bring forward our concerns on ESG issues and ask for proper following action from the company.

No of meetings	2014	2015	2016
1on1 meetings	85	109	127
1on1 calls	17	17	9
Group meetings	24	72	27
Quarterly group conference calls	320	315	304

In our experience the most common challenges to overcome in Emerging Europe continue to be governance related. In most cases companies do evaluate ESG risks as part of the operational risk management process, however, very few of them disclose information on it. Reasons for proper disclosure are related to limited demand for such information from stakeholders and lack of best practice disclosure guidance.

Besides the limited ESG disclosure there are a few corporate governance related issues of minority shareholder rights protection that we often come across. For example, lack of independent board members, no separation of function of Supervisory Board Chairman and CEO roles, high turnover in the management board, poor management access etc. This tends to result in cases of outright minority ownership rights abuses. More than 60% of our governance based exclusions relate to historical minority mistreatment cases. These issues are also the most often discussed topics during company meetings.

### Voting

A key part of being an active owner of listed equities is using voting rights in an informed way at company meetings, including but not limited to shareholder resolutions on ESG performance issues. Key principles of Avaron’s voting policy have been set in Avaron’s Exercise of Voting Rights Strategy ([http://avaron.com/files/docs/2016.05.11\\_Exercise\\_of\\_voting\\_rights\\_strategy\\_revised.pdf](http://avaron.com/files/docs/2016.05.11_Exercise_of_voting_rights_strategy_revised.pdf)).

Avaron normally participates in shareholders’ meetings on behalf of the managed portfolios where it holds the right to exercise ownership rights taking into account the level of advantage that this participation would bring as well as for the opportunity to affect decisions. We participate in all shareholders’ meetings where the portfolios that carry ownership rights in aggregate hold 5% or more of the company’s share

capital. If the set limit is not exceeded, then participation and voting rights shall be exercised if required by the need to safeguard the interest of the clients. Given the above the level of participation in shareholder meetings has fluctuated over the years.

Voting activity	2011	2012	2013	2014	2015	2016
Meetings	1	9	7	8	20	13
Resolutions	9	52	101	65	210	94
For	9	43	84	54	183	91
Against	0	6	17	11	17	2
Abstained	0	3	0	0	10	1

In 2016 Avaron decided to exercise voting rights in 13 shareholder meetings of 5 portfolio companies. In terms of percentage of average assets that we were eligible to exercise the voting rights these 5 names accounted 19% of average equity allocation over 2016.

## COLLABORATION AND INDUSTRY INVOLVEMENT

Since 2011 Avaron is a signatory of UN Principles for Responsible Investment (UNPRI) that enables us to stay up to date on industry developments, offers a chance to implement new best practices in the industry and collaborate with other institutional investors and asset owners. Our latest Responsible Investment Transparency Report is available here:

[http://avaron.com/files/docs/\(Merged\)\\_Public\\_Transparency\\_Report\\_AS%20Avaron%20Asset%20Management\\_2016.pdf](http://avaron.com/files/docs/(Merged)_Public_Transparency_Report_AS%20Avaron%20Asset%20Management_2016.pdf). The latest UNPRI Assessment Report is available upon request.

Avaron recognizes that in many instances joint action by institutional investors has the potential to be more effective than acting alone. Thus, Avaron has participated in several collaborative initiatives over the past years. We continue to be signatories to the Carbon Disclosure Project and its different sub-initiatives.

In 2016 Avaron joined the UNPRI-led engagement on corporate carbon footprint disclosure aiming at a select group of listed companies to encourage them to disclose their Scope 1 and 2 emissions. The first phase of the engagement included sending letters to the target companies in July and allowing the companies to respond by September. The second phase of the engagement includes following up with the companies via conference calls or meetings. **Within the scope of this initiative Avaron took a lead investor role in engaging with the Turkish Koc Holding.** We are not invested in the holding company itself but into three of its subsidiaries Ford Otosan, Tofas and Yapi Kredi bank, and have a few others in our internal investment universe. In Q4 we conducted follow-ups with the company as by end-Q3 we had not received a response from Koc Holding to the engagement letter.

Based on the follow-up call the company is open to dialogue and has already taken steps in incorporating climate change issues into its corporate policy. Koc Holding reports carbon emissions on the group level but that does not cover the entire holding. Scope 1 and 2 are not disclosed as only a few of the group companies do have the reporting in place (e.g. Tofas, Arcelik, Ford Otomotiv and Yapi Kredi bank are reporting the Scope 1 and 2 emissions to the Carbon Disclosure Program). Since so far there had not been any stakeholder push towards the issue, this was actually the first time someone had raised this topic, then not a lot of emphasis had been put on it. The company acknowledged the importance in improving the

transparency regarding carbon emissions and said it is committed to go forward, however, the size of the holding (more than 110 companies in the group) poses the major obstacle to overcome. Follow-up to track the progress was agreed for 2Q 2017. The engagement will run until mid-2017 upon which an assessment of outcomes will be prepared by UN PRI in 3Q 2017.

## COMPLIANCE WITH UNPRI

UN PRI Principles	Avaron compliance
1. We will incorporate ESG issues into investment analysis and decision-making process.	<ul style="list-style-type: none"> <li>- Responsible Investment Policy for listed equities in place</li> <li>- Proprietary ESG analysis by the research team</li> <li>- Ad hoc ESG training</li> </ul>
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.	<ul style="list-style-type: none"> <li>- RI Policy for listed equity</li> <li>- Exercise of Voting Rights Strategy</li> <li>- Active engagement</li> </ul>
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.	<ul style="list-style-type: none"> <li>- Regular meetings with the companies</li> <li>- Participation in collaborative disclosure initiatives</li> </ul>
4. We will promote acceptance and implementation of the principles within the investment industry.	<ul style="list-style-type: none"> <li>- Signatory to various bodies promoting ESG</li> </ul>
5. We will work together to enhance our effectiveness in implementing the principles.	<ul style="list-style-type: none"> <li>- Support for several collaborative initiatives</li> <li>- Participation in investor networks</li> </ul>
6. We will each report on our activities and progress towards implementing the principles.	<ul style="list-style-type: none"> <li>- Annual public UNPRI reporting</li> <li>- Quarterly reporting in our monthly newsletters</li> <li>- Client reporting on ESG issues</li> </ul>

## CONTACT INFORMATION

### Valdur Jaht

Avaron Asset Management

Partner, co-CIO

Mobile: +372 5251116

E-mail: [partners@avaron.com](mailto:partners@avaron.com)