DODGE & COX®
WORLDWIDE FUNDS

Evaluating Environmental, Social, and Governance Factors as Active Owners

APRIL 2018

EXECUTIVE SUMMARY

Environmental, social, and governance issues, collectively called ESG, have become significant factors in investment decision making, especially over the last decade. However, investors' approaches to ESG vary, ranging from the systematic integration of material ESG factors to portfolios constructed solely of investments in companies promoting social good. Some investors also run screens that help them avoid investing in companies they deem to have a negative impact on the environment (e.g., energy or manufacturing companies) or society (e.g., tobacco, alcohol, or gaming businesses).

At Dodge & Cox, we have operated with the same investment philosophy for over 85 years: we seek to identify well-established companies that have attractive long-term earnings and cash flow prospects not reflected in the current security valuation. To select investments, we employ a consistent and disciplined approach that focuses on intensive bottom-up research, a long-term investment horizon, and a strict price discipline.

As part of this investment process, we assess many factors, including ESG factors, on a company-by-company basis, for their potential to materially impact a company's risk/reward profile. As active owners, we pay particular attention to a company's governance structure and practices as well as risks and opportunities associated with environmental and social factors, when applicable. We proactively engage with the board and management teams of companies in which we choose to invest, especially when a particular issue is significant to our investment thesis. We also vote proxies, including those addressing ESG-related issues, consistent with our approach as long-term investors.

OUR APPROACH TO ESG: FOCUSING ON MATERIAL FACTORS

We look at the mosaic of ESG factors and evaluate them in terms of their potential impact on a company's earnings and cash flow prospects. When we deem these factors to be *material*, we will incorporate them into our investment analysis and decision-making process. To emphasise our commitment, we became a signatory to the United Nations Principles for Responsible Investment (UNPRI)[a] in 2012. Dodge & Cox remains committed to considering the investment implications of ESG issues, when appropriate and consistent with our fiduciary duty.

Several academic studies support our approach, affirming that "materiality" matters when incorporating ESG factors in the investment process. For example, Harvard Business School researchers Mozaffar Khan, George Serafeim, and Aaron Yoon[b] found that "firms with good ratings on *material* sustainability issues significantly outperform firms with poor ratings on these issues. In contrast, firms with good ratings on *immaterial* sustainability issues do not significantly outperform firms with poor ratings on the same issues." This suggests that focusing on material sustainability issues can enhance shareholder value. The authors examined ESG issues that were material or immaterial at the industry level, and measured the stock performance of companies with high and low ESG ratings on material ESG factors.

ESG exposures may also convey information about future risks that are not captured by statistical risk models. In their paper *Assessing Risk Through Environmental, Social and Governance Exposures*[c], Dunn, Fitzgibbons, and Pomorski investigated the relationship between companies' ESG exposures and the statistical risk of their equity. They found a strong positive relationship: "Stocks with poor ESG exposures tend to have higher total and specific risk and higher betas, both contemporaneously and as far as five years into the future."

INTEGRATING ESG INTO OUR INVESTMENT PROCESS

Through our bottom-up approach, we evaluate investment risks and opportunities on a company-by-company basis.

Analysis of ESG factors has been an important element of our investment review process for many years. Each Fund's portfolio composition is a result of individual security selection, which takes these and many other factors into consideration.

STEP 1: Due Diligence

Rigorous research and due diligence are the foundation of our investment process, enabling us to develop a thorough understanding of each individual company and issuer under consideration. Our global industry analysts visit companies across the globe and meet with senior management teams in our office. We often attend industry conferences and talk with competitors, customers, and suppliers to develop a well-rounded view of a company's fundamental strengths and weaknesses.

ESG-related issues may be material to the long-term sustainability of a particular company's competitive advantage. Such issues may present unique challenges or opportunities for companies and industries that could impact long-term investment performance. Therefore, as part of our due diligence process, we consider various ESG factors, including:

Environmental

- Chemical safety
- Emissions, pollution, contamination
- Management of environmental risks
- Raw material sourcing
- Supply chain management

Social

- Community relations
- Customer satisfaction
- Employee and union relations
- Human health impacts
- Safety practices

Governance

- Board structure
- Capital allocation
- Company bylaws & articles
- Management incentive structures
- Shareholder and bondholder rights

Due Diligence

ESG is considered when conducting research, speaking with company management, and visiting company facilities.

Analysis

ESG research is incorporated into our investment analysis and addressed in our internal research reports.

Weigh Valuation

We weigh valuation against risks and opportunities, including ESG factors, for each company.

Investment Decision

Among other considerations, material ESG factors are incorporated in our decision-making process.

In addition to our own analysis of ESG issues, we review reports from MSCI ESG Research and other third-party providers to help alert us to any significant related issues pertaining to the companies and issuers we are evaluating. While taking this research into consideration, we ultimately make an independent evaluation of the material ESG factors for each company.

STEP 2: Written Analysis

Our global industry analysts develop three- to five-year growth, earnings, and cash flow projections, along with a detailed assessment of the risks and opportunities, to derive a range of potential investment returns over our investment horizon. They analyse the past drivers of the business and determine the materiality of selected ESG issues. Our analysts present their findings in thorough written reports that represent formal buy and sell recommendations based on the combination of a wide range of analytical inputs.

Analysts systematically integrate ESG considerations into their research reports and provide a qualitative overview of the significant ESG risks and opportunities they have examined. The qualitative ESG overview is recorded in an ESG Risks and Opportunities Checklist (see Appendix) that is included as part of the analyst's recommendation report. If we have engaged with a company on ESG issues, the company's responses will also be incorporated into our report.

STEP 3: Weighing Valuation Is Essential

As bottom-up, value-oriented investors, we weigh a company's valuation against its risks and opportunities. Our emphasis on value often leads us to find opportunities where other investors have become overly pessimistic about current challenges. We may decide to invest in a company that has a significant ESG issue if we believe the company is making progress in resolving the issue or we conclude that the issue is exerting an unwarranted impact on the valuation.

STEP 4: Investment Decision-Making Process

Our analysts' written analysis is subject to peer review by Sector Committees, whose members rigorously vet analyst recommendations, stress test assumptions, and identify areas for additional research. The Sector Committees will consider material ESG issues as part of their role in advising the Investment Committees on intra-sector relative value.

Our Investment Committees then review analyst and Sector Committee recommendations and consider a particular investment's risks and opportunities before approving new investments or changes in the size of existing holdings.

WHY GOVERNANCE MATTERS TO VALUE-ORIENTED, LONG-TERM INVESTORS

We believe governance factors—defined as the system of rules, practices, and processes through which a company is directed and controlled—are material for every company. Strong governance is expressed in the way a company makes decisions and balances the interests of all of its stakeholders, including shareholders, bondholders, employees, management, customers, suppliers, and the communities in which it operates.

As investors with a three- to five-year investment horizon and low portfolio turnover, we closely analyse a company's governance structure and monitor related issues. We look for core attributes of an effective corporate governance system, as shown in the diagram below[d]. We seek to understand how the company makes decisions and assess whether management is truly running the company for the benefit of its long-term owners. Management's past behaviour, in particular how they balance stakeholder interests, can provide valuable insights.

We also assess risks pertaining to business ethics, ownership structure, board composition, financial accounting and reporting practices, regulatory interventions, and litigation. For example: *Has the company adopted takeover defences or issued share classes with different voting rights that unduly favour incumbent management? Are board members qualified? Is there an independent majority on the Board?*

Core Attributes of an Effective Corporate Governance System

- Delineation of the rights of shareholders and other stakeholders
- Clearly defined manager and director governance responsibilities
- Identifiable and measurable accountabilities
- Fairness and equitable treatment in all dealings
- Complete transparency and accuracy in disclosures

Source: Clayman, Fridson, and Troughton. "Corporate Finance: A Practical Approach."

We spend considerable time gathering information and corroborating our findings with a variety of sources, which may include:

- Speaking directly with a company's management and board members;
- Cross-checking assertions of corporate management teams (e.g., holding in-depth conversations with providers of finance);
- Talking with industry consultants, brokerage firm analysts, credit rating agency analysts, macro economists, competitors, and customers;
- Reviewing information in trade periodicals and business publications as well as various database services; and
- Enlisting legal counsel to research and evaluate corporate structures and legal entitlements.

WE ENGAGE WITH COMPANIES AS ACTIVE OWNERS, NOT AS ACTIVISTS

There is an important distinction between being an *activist* investor and an *active* owner in a company. Activist investors may purchase shares in a public company and/or try to obtain seats on the company's board with the short-term purpose of creating a major change in the company. Active owners expect management teams to run their businesses with a focus on creating long-term value.

As active owners, we seek to build constructive long-term relationships with boards and management teams, rather than filing shareholder resolutions or joining public campaigns. We engage with the management of a company when we believe their decisions are not aligned with the best interests of long-term shareholders. These may include decisions that provide short-term benefits but ultimately harm company stakeholders in the long run.

When we have concerns that we believe have not been addressed adequately to protect the long-term value of the company, we may choose to sell our position or express our views through our proxy votes on management and shareholder proposals.

Engaging Directly With Management

We believe that undertaking and maintaining a dialogue with management is an important aspect of investment analysis and critical to building our understanding of management's priorities and strategies. We seek to understand management's views on key issues that are important to its business. These could include capital allocation, investment decisions, cost structures, quality of workforce, environmental considerations, diversity of management, diversity of board, and a host of other issues. We do not have opinions on everything a company does, but when we do, we want to be able to share our views with management when merited. Conversely, management teams have sought our input on various issues, including capital allocation, remuneration practices, governance structure, and board composition.

Expressing Our Views Through Proxy Votes

Proxy voting is an effective mechanism to express our views about ESG issues. Our policy is to vote proxies in a way that we believe best serves the interests of our clients as long-term shareholders of a company, which includes voting on issues with ESG implications. We vote securities for which we have full proxy voting authority consistently across

Engagement: Akzo Nobel

Based in the Netherlands, Akzo Nobel is a leading producer of paints, performance coatings, and speciality chemicals. By May 2017, the company had received three acquisition offers from PPG Industries, the world's largest coatings company by revenue, each at a significant premium to its share price.

Citing an internal strategy to drive an increase in value, Akzo Nobel's management declined all three offers and denied shareholders an opportunity to vote on PPG Industries' offer. We engaged directly with the management team and the Chairman of the Board to express our point of view.

Akzo Nobel has an anti-takeover defence provision in place that makes it very difficult to vote out the company's supervisory board. While some shareholders went to court to try to remove the Chairman, we wrote the court a letter defending the essential shareholder right to vote. Akzo Nobel won the lawsuit, but the judge indicated in the ruling that the company needed to improve its relationship with shareholders.

After thoroughly reviewing the company, we decided to continue to hold Akzo Nobel because we believe the company's discounted valuation relative to industry peers does not reflect the opportunity for revenue and earnings growth. Moreover, we are encouraged by recent steps taken by the board to improve Akzo Nobel's governance practices.

all of our portfolios in accordance with the Dodge & Cox Proxy Voting Policies and Procedures, which can be found on our *website*.

Just as we thoroughly research each investment, we also diligently evaluate each proxy initiative. In addition to undertaking our own analyses, our proxy team reviews research provided by Institutional Shareholder Services (ISS) and Glass Lewis prior to voting. Once the team has recommended a vote and the global industry analyst has ratified the decision where applicable, the proxy voting team implements the voting decisions.

While we do not vote proxies to conform to specific ESG criteria or an ESG mandate, the Proxy Voting Policy does address ESG issues. We evaluate each proposal on a case-by-case basis and vote in a way that we believe will best preserve the long-term value of our clients' shares in the company.

When items are not covered by our Proxy Voting Policy, the global industry analyst recommends a vote, and the proposal and the analyst's recommendation are then evaluated by one or more members of the Dodge & Cox Proxy Policy Committee.

Proxy Voting: Hewlett-Packard

When evaluating Hewlett-Packard (HP), governance played a significant role in our thinking. In 2011, HP's decision to acquire Autonomy, a UK-based software company, for $11.7 billion—a 79% premium over market price—led us to be concerned about capital allocation. HP had paid a high valuation for several other deals that had reduced its financial flexibility and ability to conduct large share repurchases.

We discussed these concerns with HP's board and management team, and we ultimately decided to vote against certain board members who were strong advocates of the Autonomy transaction. The HP-Autonomy merger turned out to be one of the worst technology deals of all time. After conducting an internal investigation, HP accused Autonomy's founder of fraud and ended up incurring an $8.8 billion loss on the transaction. Management later invited our input on board composition and governance initiatives.

Hewlett-Packard has since split into HP Inc. and Hewlett Packard Enterprise. We continue to actively discuss governance and capital allocation concerns with their management teams.

CONCLUSION

In our opinion, ESG issues do not lend themselves to hard and fast rules or metrics. In fact, some ESG factors may be more salient than others in certain situations or for specific companies or industries.

At Dodge & Cox, ESG considerations are embedded in each phase of our investment due diligence and decision-making processes. Material ESG factors are important considerations when assessing the range of investment risks and opportunities. Our task as active owners is to identify whether the company is addressing issues we deem material or the market is overly pessimistic about the risks. As a value-oriented manager, we may invest in a company that has a significant ESG issue if we believe that the company is making progress or if the issue is overly discounting the company's valuation. We invest for the long term and look for companies with sustainable franchises.

Examples of Dodge & Cox's ESG Integration

Environmental Factors: Engie

For companies that face significant environmental risks, we consider how they manage these risks to reduce impact over time and prevent large-scale disasters. Environmental risks can lead to various direct and indirect financial liabilities, including regulatory fees and fines, litigation and remediation costs, or loss of customers due to damage to the brand. We also evaluate whether the company is taking advantage of environmental opportunities, such as renewable energy and resource-conserving technologies.

Environmental factors played a significant role in our evaluation of Engie, a multinational electric and gas utility domiciled in France. Like many utility companies, Engie is exposed to environmental risks through power generation from coal, natural gas, nuclear, and renewable sources of energy. Our global industry analysts discussed environmental concerns with Engie's management, reviewed the company's environmental safety and social responsibility reports, and used numerous third-party ESG resources. We believe Engie's management has a long-term view and is actively working to moderate and reduce environmental risks. Engie is also capitalising on opportunities to reduce regulatory and resource risks through its focus on low-emission energy sources.

In addition, Engie has taken steps to diversify its portfolio through an increasing emphasis on renewable energy. The company has invested in low-emission energy sources, which provide a hedge against regulatory and resource risks while providing reasonable investment returns in diversified markets. We see upside potential from Engie's renewable energy production and expansion into emerging markets, and view the reduced environmental and regulatory risks favourably.

Social Factors: Axis Bank

Social factors are material to our investment thesis for Axis Bank, one of India's largest banks. India has a fast growing economy and a young population (more than 65% of the population is below the age of 35); however, a significant portion of the population has limited access to banking products. It is common for people in India to save in cash and gold, and to borrow from informal moneylenders, who charge high rates of interest. Over the past several years, the Indian government has pursued a number of policies to push a greater portion of the population into the formal banking sector. One example is a financial inclusion campaign called Pradhan Mantri Jan-Dhan Yojana (PMJDY), which is designed to ensure access to affordable financial services, including checking and savings accounts and remittance, credit, insurance, and pension products. Axis Bank offers PMJDY accounts and has partnered with other organizations to implement several other financial inclusion initiatives, including microfinance and financial literacy programs.

In addition, state-owned banks control approximately 70% of the market in India, but generally provide a lower level of service than private banks. Over time, as more people are able to access bank products, private sector banks such as Axis have an opportunity to continue to take market share from state-owned banks and improve the level of service the end customer receives.

We believe Axis Bank has a positive social impact in India by providing better financial resources to underbanked populations. We consider the bank's social impact to be a material part of our investment thesis, as the growth potential for Axis Bank lies in financial inclusion and making banking resources accessible to a larger population.

Governance Factors: Kinder Morgan

One significant consideration in our investment process is whether a company is balancing the long-term interests of all stakeholders, including bondholders. While we were mindful of the environmental and social factors associated with being an operator of oil and gas pipelines, governance played a particularly notable role in our evaluation of Kinder Morgan's debt securities. When we initiated a position in Kinder Morgan's bonds in 2014, we focused on the implications of the large equity ownership and active role of long-time CEO (now Chairman) Richard Kinder, as well as the company's proposal to dramatically simplify its legal structure. Based on several meetings with senior management and our analysis of their track record (including bondholder-friendly aspects of their 2006 leveraged buyout), we believed the company's long-term focus was highly aligned with creditors' interests. This belief was confirmed in December 2015 by the company's decision to reduce its dividend by 75% to strengthen the balance sheet and defend its investment-grade rating in an environment of heightened commodity price volatility.

Appendix

Environmental, Social, and Governance Risks and Opportunities Checklist

Company:	**Country of Incorp:**
Ticker:	**Country HQ:**
Industry:	**Primary Listing:**

Please answer the following questions based on the MSCI ESG company report, as well as any other knowledge.

- Indicate "Y" if the company has particularly high exposure to the listed risk and provide a brief explanation. For example, an oil company likely has environmental risk exposure, but a financial services company may not.
- Indicate "Y" if a company has had problems managing this risk in the past and provide a brief explanation. Examples may include past oil spills, product safety issues, or evidence of corruption.
- Note if there are any investment opportunities that relate to environmental, social, or governance factors.
- If a risk or opportunity is not relevant to the company or industry, mark "N/A".

	Category	Issue	High exposure to risk? Y/N or N/A	Significant past problems related to risk? Y/N or N/A	Explanation (if additional space is needed, please attach an extra page)
Risks	Environmental	Significant risk of environmental damage or pollution?			
		Significant dependency on scarce natural resources (i.e. water intensive activities in a water-scarce region)?			
		Significant fines, regulatory interventions, or litigation related to environmental problems?	N/A		
	Social	Significant product safety or quality risk?			
		Significant employment or labor risk?			
		Significant cybersecurity and/or privacy risk?			
		Significant human health or safety risks?			
		Significant fines, regulatory interventions, or litigation related to human health, labor, product safety, or security?	N/A		
	Governance	Significant risks related to corruption or business ethics?			
		Significant risks related to ownership structure (i.e. takeover defenses or different voting rights across share classes)?			
		Significant risks related to the company's Board (i.e. not having an independent majority on the Board)?			
		Significant risks related to the company's financial accounting and reporting?			
		Significant issues regarding the alignment between management and shareholder interests?			
		Has the company been subject to fines, regulatory interventions, or litigation related to corruption, mismanagement, and/or fraud?	N/A		

Summarize any significant ESG-related investment opportunities (e.g. investing in clean technology or offering services in underserved markets). If not applicable, please indicate N/A.

Have you conducted due diligence related to these ESG risks or opportunities? If so, please list resources used or describe discussions with management. If not applicable, please indicate N/A.

Are any of the top 3-5 investment risks or opportunities for the company related to ESG factors? Are there any ESG risks not captured above? If so, please provide additional information. If this is not applicable please indicate N/A.

The use of specific examples does not imply that they are more or less attractive investments than the portfolios' other holdings. Akzo Nobel, Axis Bank, Engie, Kinder Morgan, Hewlett Packard Enterprise, and HP Inc. were held in one or more of the Dodge & Cox Worldwide Funds as of 31 March 2018.

Opinions expressed are subject to change without notice. This information should not be considered a solicitation or an offer to purchase shares of Dodge & Cox Worldwide Funds plc or a solicitation or an offer by Dodge & Cox Worldwide Investments and its affiliates to provide any services in any jurisdiction. The views expressed herein represent the opinions of Dodge & Cox Worldwide Investments and its affiliates and are not intended as a forecast or guarantee of future results for any product or service. To obtain more information about the Funds, please refer to the Funds' prospectus at dodgeandcoxworldwide.com.

(a) For more information, see http://www.unpri.org/about/the-six-principles.

(b) Khan, Mozaffar, George Serafeim, and Aaron Yoon. "Corporate Sustainability: First Evidence on Materiality." *The Accounting Review* 91, no. 6 (2016): 1697-1724.

(c) Dunn, Jeff, Shaun Fitzgibbons, and Lukasz Pomorski. "Assessing Risk Through Environmental, Social, and Governance Exposures." AQR Capital Management, LLC (2016).

(d) Clayman, Michelle R., Martin S. Fridson, and George H. Troughton. *Corporate Finance: A Practical Approach.* Vol. 42. John Wiley & Sons, 2012.