Australian Shareholders' Association

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Franking fear assists a record year

Company/ASX Code	Australian Foundation Investment Company Limited/AFI
AGM date	Tuesday 8 October 2019
Time and location	Zinc at Federation Square Melbourne at 10:00 am
Registry	Computershare
Webcast	No
Poll or show of hands	Poll
Monitor	Jason Cole assisted by Dennis Shore
Pre AGM Meeting?	Yes, with Chair John Paterson, Managing Director Mark Freeman and Company Secretary Matthew Rowe

Item 1	**Consideration of accounts and reports**
ASA Vote	No vote required

Australian Foundation Investment Company (AFI) aims to provide shareholders with attractive investment returns through access to a growing stream of fully franked dividends and growth in capital invested over the medium to long term in quality Australian and New Zealand equities.

Governance and Culture

AFI has advised that for the 2019 Annual General Meeting, the business of the meeting will be conducted by a poll. Traditionally AFI has conducted voting on a show of hands. ASA has often had a substantial number of undirected proxies that aren't reflected in a show of hands vote and we welcome this move that will now allow ASA's position to be reflected in the voting results, as well as more accurately reflecting the voting of the shareholders which is one share equals one vote.

Financial Performance

This year AFI delivered a record profit of $406.4m, a 45.6% increase on the $279 million profit recorded in 2018. Several one-off factors contributed to the recorded profit result including the receipt of special dividends, participation in off-market share buy-backs for Rio Tinto and BHP and a dividend from the Coles demerger from Wesfarmers.

Portfolio performance for the year resulted in a return of 11.4% against the S&P ASX 200 accumulation index return of 13.4% for the same period. Both results assume that investors can fully utilise the benefit of franking credits, but it is important to note that the AFI result is calculated after expenses and tax, whereas the index returns do not take these items into consideration.

As at 30 June 2019 the AFIC portfolio investment by sector was closely aligned to that of the S&P/ASX 200 Accumulation Index. However, major sector disparities are within the Industrial sector where AFI is considerably overweight and Property Trusts where AFI is underweight in comparison to the index.

In voting intentions for the past three years the ASA has flagged that AFI has outperformed the index over the long-term (10 years), but that this was converging to similar levels as the index due to underperformance over short-term (1 year) and medium-term (5 years) timeframes. The convergence has now materialised with AFI 10-year returns being 11.5% against the index 10-year return of 11.7%.

The 10-year performance return was raised by ASA monitors at the meeting with company representatives. AFI representatives consider that the disposal of around 20 stocks from the portfolio over the previous year has resulted in a better-quality portfolio. This being due to now being more highly invested in the companies that they favour. Additionally, outperformance is more likely to be delivered in downward markets which have not been the prevailing conditions over this time period

AFI also operates a small trading portfolio and this recorded a loss of $4.7m compared with a gain of $0.3m in the previous year. An explanation is provided on page 4 of the Annual Report and AFI representatives clarified that this is primarily due to a function of accounting standards.

Total shareholder return for the year was 9.2%, whilst shareholder equity increased from $6.34 billion to $6.62 billion. Dividend for the year was 32 cents per share, up 8 cents due to the payment of a special dividend in anticipation of proposed changes to the franking credit system, should a Labor government have been elected.

Key Board or Senior Management Changes

Mr John Paterson was elected as Board Chair with effect from the conclusion of the previous AGM held in October 2018.

In addition to the change of Chair, Jacqueline Hey retired as director on 18 January 2019 and was replaced by Rebecca Dee-Bradbury who will stand for election at the AGM (Item 4). As an aside Ms Hey was subsequently announced as Chair-elect of Bendigo and Adelaide Bank (BEN) effective 29 October 2019.

2019 ASA Focus Issues

Board composition is one of ASA's 2019 focus issues and AFI's compliance in this area is at odds with the guidelines set by ASA. The current 8-member board contains 2 female directors (25%) which is below the target sought by ASA of at least 30% female and 30% male directors. Whilst the newest board appointment is female, the only other female director (Catherine Walter) has also been on the board for 17 years and is not considered independent by the ASA.

Similarly, ASA guidelines consider that Boards should have an independent Chair and a majority of independent directors. The Current Chair, despite being in the role for less than 12 months, is not considered independent due to a 14-year tenure on the board. In total, only 50% of the current board meet ASA criteria for independence.

Whilst retiring directors seeking re-election this year are in accordance with ASA guidelines, the ASA flagged with AFI the potential for implications in future years for directors who do not meet ASA criterion.

AFI reiterated that they consider experience and retention of corporate memory to be a crucial factor in the achieving the company's long-term investment objectives. This is endorsed in their corporate governance statement, which states that the board strongly believe length of tenure is not an indication of a lack of independence.

In responding to the issue of female board representation, Mr Patterson advised that the board had actively sought suitably qualified additional female representation which had resulted in the subsequent appointment of Ms Dee-Bradbury. However, the retirement of Ms Hey had resulted in a status quo.

Summary

(As at FYE)	**2019**	**2018**	**2017**	**2016**	**2015**
NPAT ($m)	406.4	279.0	245.3	265.8	293.6
UPAT ($m)	406.4	279.0	245.3	265.8	261.7
Share price ($)	6.25	6.16	5.81	5.61	6.12
Dividend (cents)	32	24	24	24	23
TSR (%)	9.2	10.3	8	-4.4	2.8
EPS (cents)	34	23.6	21.3	23.8	27.2
CEO total remuneration, actual ($m)	1.081	1.079	0.957	1.166	1.241

For 2018-19, the CEO's total actual remuneration was **12.26 times** the Australian Full time Adult Average Weekly Total Earnings (based on May 2019 data from the Australian Bureau of Statistics).

Item 2	Adoption of Remuneration Report
ASA Vote	**For**

Summary of ASA Position

Statutory Remuneration Structure for Managing Director

	Target $m	% of Total	Max. Opportunity $m**	% of Total
Fixed Remuneration	0.85	57.1%	0.85	57.1%
STI - Cash	.21*	14.3%	.21+**	14.3%
STI - Equity	.21*	14.3%	.21+**	14.3%
LTI	.21	14.3%	.21+**	14.3%
Total	1.49	100.0%	1.49+	100%

* STI split 50/50 however, the Annual Incentive is paid in cash, but 50 per cent of the after-tax amount received is used by recipients to acquire shares in AFIC and the other investment companies which they agree to hold for a minimum of two years.

** Page 18 of annual report states that "Where stretch levels of performance are achieved above target, then higher amounts may be paid. To date, total annual incentives paid to each executive have never exceeded target.

The remuneration structure is comprehensively outlined in the remuneration report, with the medium to long term investment objective of the company resulting in a structure that is well aligned with ASA guidelines. Both actual and statutory remuneration outcomes are disclosed.

Fixed Annual Remuneration (FAR) is benchmarked by external consultants with the 57% of the Managing Director's total remuneration being FAR and 43% being at risk, slightly less than ASA guidelines. The remuneration mix for other executives includes a component of 69% FAR. Across key executives, FAR, increased by around 2% on last year.

Executives participate in both annual and long-term incentive plans, with 27% percent of the incentives determined by the performance outcome of three subsidiary companies (Djerriwarrh, AMCIL and Mirrabooka).

The annual incentive is paid in cash, however 50% of the after-tax component must be used to acquire shares to be held for two years. Quantifiable performance metrics comprise 80% of the annual incentive (Company Performance 43%, Investment Performance 37%) with the remaining 20% based on personal objectives. The quantifiable metrics are assessed against performance hurdles at 1, 3, 5, 8 and 10 years in line with the investment objectives of the company. In almost all hurdles, an unfavourable outcome was realised in comparison to the benchmark and this resulted in over 45% of annual incentives being forfeited by key executives.

The executive long-term incentive plan (ELTIP) grants rights to receive cash that must be used to acquire AFIC shares on market. The performance conditions are split 50/50 between Total Gross

Shareholder Return measured against the index over a thirty-day period and Total Portfolio Return compared against an industry benchmark of funds. Only outperformance is awarded, vesting is after 4-years and there is no retesting. The 2014 award was available for vesting but was forfeited in its entirety due to hurdles not being met.

The incentive plan for the investment team, which differs slightly from other executives, is outlined in the remuneration report.

The fee for non-executive directors (NEDs) increased by $2,500 to $95,000 whilst the Chair's fee rose from $185,000 to $190,000, pro-rata between both holders of the Chair role during the year.

Item 3	**Non-Executive Directors' Fee Cap**
ASA Vote	**For**

Summary of ASA Position

This resolution seeks an increase in the maximum aggregate remuneration which may be paid to the NEDs of the Company for their services for each financial year commencing on 1 July 2019.

It is proposed that the maximum fee cap be increased from the current amount of $1,000,000 to $1,250,000 per annum. The current maximum limit was approved by shareholders in 2007.

The total remuneration for NED's in 2019 was $758,155 which is below the current maximum and less than the 2018 amount of $787,500.

In discussing the rationale behind the proposed increase, the company stated that it was to assist with succession planning and to allow for scope should an additional director need to be appointed, an outcome consistent with the board's aim to increase female representation.

A comparison with peer company, Argo Investments Limited (ARG), shows that annual limit for NED remuneration for that company is $1,100,000 which was approved in 2015, whilst the remuneration paid by Argo in 2019 was $806,533.

Given the twelve-year duration between fee cap increases, the acceptable results achieved by the company over that time and a comparable structure to peer company Argo, ASA considers the proposed increase to be reasonable and will vote FOR the resolution.

Item 4	**Election of Rebecca Dee-Bradbury**
ASA Vote	**For**

Summary of ASA Position

Ms Dee-Bradbury is the most recent addition to the board having been appointed on 6 May 2019. She is appropriately qualified having held several senior executive roles and currently being a Non-Executive Director of listed companies BlueScope Steel Limited (BSL) and Grain Corp Limited (GNC). She is also a director of EnergyAustralia Holdings Ltd. Ms Dee-Bradbury does not currently have any holdings in AFI. This however is understandable, given the short period of time that has elapsed since being appointed. Ms Dee-Bradbury is considered independent under ASA guidelines and her election to the board is supported

Item 5	Re-election of Peter Williams
ASA Vote	**For**

Summary of ASA Position

Mr Williams was appointed to the board in 2010 and is considered independent under ASA guidelines. He is Chair of the Audit Committee and a member of the Investment Committee and Nomination Committee.

He is suitably qualified with executive experience locally and internationally in insurance and trustee management. He has no current directorships with listed companies, but does have directorships (including 2 Chair roles) across several non-listed business, not-for-profit and sporting organisations. As the extent of this workload is not obvious it was raised in the Pre-AGM meeting. AFI advised that these roles are largely non-corporate and that as a Melbourne based director Mr Williams is readily accessible to the company.

Mr Williams' attendance Board or Committee meetings over his previous term has been impeccable, so the ASA is satisfied that his workload is manageable.

Mr Williams has shareholdings well above the ASA minimum shareholding guideline. The ASA supports his re-election for another term. This will be the final term, due to length of tenure, in which ASA considers Mr Williams to be independent.

Item 6	Election of Stephen Mayne
ASA Vote	**Against**

Summary of ASA Position

Mr Mayne is a former director of ASA, and we have considered our position carefully given that relationship. ASA lifted board composition to the top focus issue for 2019, highlighting the importance of the detailed skills the director brings to the board of the company at that time, and how those skills meet the requirements of the board in the coming years. Mr Mayne's directorial skills and experience include graduation from AICD director course and experience in corporate governance associated with seeking fair treatment of retail investors.

The notice of meeting didn't include the reasoning for Mr Mayne's nomination. According to the Mayne Report, 29 August 2019, it was that AFIC should publicly release its voting record on its major holdings in ASX-listed companies, and had the board agreed to do that, he would have withdrawn the nomination. ASA acknowledges institutional investors releasing voting records on an annual basis to be good governance, however the link to the requirements of the board in the coming years is missing in this candidature, and we will vote against his election.

The individuals (or their associates) involved in the preparation of this voting intention have no shareholding in this company.