Australian Shareholders' Association

Australian Shareholders' Association Limited
ABN 40 000 625 669
Suite 11, Level 22
227 Elizabeth Street, Sydney NSW 2000
PO Box A398, Sydney South NSW 1235
t (02) 9252 4244 | f (02) 9071 9877
e share@asa.asn.au

Steady Dividend in Unsteady Times

Company/ASX Code	Australian Foundation Investment Company Limited / AFI
AGM date	Wednesday 14 October 2020
Time and location	10:00 am – Virtual Meeting via Lumi AGM app or via telephone
Registry	Computershare
Webcast	Yes
Poll or show of hands	Poll on all items
Monitor	Jason Cole assisted by Dennis Shore
Pre AGM Meeting?	Yes, with John Paterson (Chair), Mark Freeman (Managing Director), Andrew Porter (Chief Financial Officer) and Matthew Rowe (Company Secretary)

Please note any potential conflict as follows: The individuals (or their associates) involved in the preparation of this voting intention have no shareholding in this company.

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

Australian Foundation Investment Company (AFI) is a Listed Investment Company (LIC) which 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.

<u>Financial performance</u>

AFI this year delivered a profit of $240.4m, which was down 40.8% on the previous year. Last year's result was influenced by several one-off factors and AFI had indicated that this would not be repeated in 2019/20 financial year. Excluding 2019 one-off items, profit was down 12%, largely due to a fall in dividend income caused by several companies deferring or reducing their second half year dividend.

The AFI dividend was maintained at 24 cents fully franked. The final dividend was kept at 14 cents after AFI drew on reserves due to the fall in income in the second half of the year. Last year's dividend included a special dividend of 8 cents.

AFI have previously stated that their portfolio is more likely to outperform in downward markets and this year's performance resulted in a return of -3.1% against the S&P ASX 200 accumulation index (AXJOA) return of -6.6%. 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.

Performance over 5-years remains under the AXJOA (6.7% v 7.5%), whilst over 10-years the results are nearly identical (9.3% v 9.4%).

Discrepancies with the AXJOA by sector occur in banks and materials, where AFI is underweight, and healthcare and industrials in which it is overweight as at 30 Jun 2020.

AFI operates a small trading portfolio which this year delivered a $9.7m profit after a previous year loss of $4.7m.

Total shareholder return for the year was 2.9%, whilst shareholder equity declined to $6.24bn from $6.62bn the previous year.

2020 ASA focus issues

Risk Management

AFI employs 20 staff and the extent to which it has been impacted by Covid-19 is primarily through its exposure to other companies via volatile equity markets.

The two main areas of risk identified by the company are investment risk and operational risk. The ASA questioned company representatives as to the success of their existing risk framework and any learnings that may have been gained because of the pandemic.

AFI were pleased with the responsiveness of their existing risk framework and the smoothness with which they were they were able to transfer all required functions to a home-based environment. AFI stated that their preparedness for remote access is tested regularly and that an external audit had identified that their controls had stood up well.

AFI has stated that as a long-term investor, Environmental, Social and Governance (ESG) analysis is integrated into their investment framework and ASA sought more detail on this with respect to evaluation of holdings. In short, AFI consider that as a long-term investor they are interested in the sustainability of the business model for companies they invest in and therefore are considerate of the potential for these issues to have impact on businesses. AFI prefer to seek management changes to companies involved in ESG issues rather than disposing their equity in those companies.

A comprehensive guide to risk is available in AFI's Risk Management and Policy Framework.

Directors and Boards

The composition of the AFI board continues to be at odds with ASA guidelines for Independence and diversity.

The current 8-member board consists of 2 female directors (25%), below the target sought by the ASA of at least 30% male and 30% female directors. AFI had stated an objective to have at least 30% of each gender represented by the end of June 2020 and advised in its corporate governance statement that despite significant progress in the selection process for an additional female director, it would be unlikely to meet this objective.

The ASA raised this in discussions and the chair considered this to be one area of disappointment for the board. AFI identified a shortlist of potential female directors early in the year and had been in preliminary discussions with a suitable candidate. The onset of Covid-19 caused a halt to those discussions due to the extra time the identified person needed to devote to her existing commitments. Due to the impacts and uncertainty of Covid-19, AFI do not consider it productive to have conversations regarding board appointments at present.

ASA guidelines consider that boards should have an independent chair and a majority of independent directors. The chair, who has been in the role for 2 years, is not considered independent due to a 15-year tenure on the board. In total, only 50% of the board has served less than 12 years and meet ASA criteria for independence on tenure.

AFI regard board continuity as a critical factor in the board's approach to being a long-term investor and the board has a strong view, outlined in the corporate governance statement, that length of tenure is not an indication of lack of independence.

The ASA has traditionally taken a more lenient approach to this guideline due the nature of this company being one who invests in other companies and the importance of the board's role in managing those investments and providing oversight into the investment process.

The above issues are relevant to two of the directors seeking re-election this year and a discussion on the ASA position for each of them is available later in this report.

Summary

(As at FYE)	**2020**	**2019**	**2018**	**2017**	**2016**
NPAT ($m)	240.4	406.4	279.0	245.3	265.8
UPAT ($m)	240.4	406.4	279.0	245.3	265.8
Share price ($)	6.09	6.25	6.16	5.81	6.12
Dividend (cents)	24	32	24	24	24
TSR (%)	2.9	9.2	10.3	8	-4.4
EPS (cents)	19.88	34	23.6	21.3	23.8
CEO total remuneration, actual ($m)	1.125	1.079	0.957	1.166	1.241

For 2019-20, the CEO's total actual remuneration was **12.23 times** the Australian Full time Adult Average Weekly Total Earnings (based on May 2020 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	.867	59.1%	.867	59.1%
STI - Cash	.21*	14.3%	.21+**	14.3%
STI - Equity	.21*	14.3%	.21+**	14.3%
LTI	.18	12.3%	.18+**	12.3%
Total	1.467	100%	1.467+	100%

The amounts in the table above are the statutory amounts that are envisaged in the design of the remuneration plan. *Target remuneration is sometimes called budgeted remuneration and is what the company expects to award the CEO in an ordinary year, with deferred amounts subject to hurdles in subsequent years before vesting.

* 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 21 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 reasonably well aligned with ASA guidelines. Both actual and statutory remuneration outcomes are disclosed.

The fee for non-executive directors (NEDs) increased by $2500 to $97,500 whilst the chair's fee rose $5000 to $195,000. Total remuneration to NEDs is $780,000, well under the fee cap of $1,250,000 per annum which was approved at last year's AGM.

AFI seek to set total remuneration at the upper or second quartile of the sectors in which they operate, and most executives received inflationary increases in their Fixed Annual Remuneration (FAR).

The percentage of FAR for the managing director was increased by 2% to 59%, with the Long-Term Incentive (LTI) being reduced by the same amount. This reduces to 41% the percentage of potential pay that is at risk, which is less than the ASA guideline of 50%. For other executives, the split is 69% FAR / 31% at risk.

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 (STI) 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.

Performance measures were generally met when measured over 1 and 3 years, but not met when measured over the extended periods. This resulted in 54% of the annual incentive being paid to the managing director.

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 (TSR) measured against the index over a thirty-day period and Total Portfolio Return (NTA) compared against an industry benchmark of funds. Only outperformance is awarded, vesting is after 4-years and there is no retesting. The 2015 award was available for vesting but was forfeited in its entirety due to hurdles not being met.

Some changes to the remuneration structure with effect from the financial year ending 30 June 2021 have been implemented. In summary these are

- TSR will no longer be used as a metric for the STI. However, the ELTIP will move from being 50% grossed up TSR and 50% NTA accumulation vs peer group to 100% grossed up TSR.
- For the STI, investment return, NTA gross return and operating EPS growth will remain and the growth of the dividend paid will be considered.
- The Reward to Risk return measure benchmarked against peers will be removed from the STI.

The ASA discussed the motivations for the changes and was advised that AFI felt the reward to risk peer comparison was not a fair one, as it was measuring AFI's post tax returns against pre-tax returns of peer company investment funds.

ASA guidelines require LTIs to be based on at least two hurdles, one of which is TSR. The new remuneration structure is based on only one hurdle, that being 100% grossed up TSR. AFI consider that the ELTIP will continue to have a good alignment with shareholder interests through the TSR performance condition and they way in which this relates to the NTA through AFI share price movements.

There has been 100% forfeiture of the ELTIP for both hurdles in the past 3 years, so the reduction to only one hurdle does not appear unnecessarily advantageous.

Whilst the ASA will continue to monitor any effect of this change closely, it is considered that the remuneration structure still aligns well with the objectives sought by the ASA and will be supported this year.

Item 3	Re-election of Mr John Paterson as a Director
ASA Vote	For

Summary of ASA Position

Mr Paterson was appointed to the board in June 2005 and as Chair in 2018. He is appropriately qualified and is also Chair of the Investment and Nomination Committees along with ASX listed Djerriwarrh Investments Limited (DJW). His workload is considered manageable.

Having now served 15 years on the board, he is no longer considered independent under ASA tenure guidelines. In these circumstances, ASA require that companies must have a clearly explained and demonstrably independent process for appointment and ongoing evaluation of directors. Comprehensive information regarding the performance assessment process for NEDs and the chair, along with succession planning is outlined on pages 4-6 of the corporate governance statement.

Given the demonstrated compliance with this requirement and the structure of the company as discussed earlier, ASA supports the re-election of Mr Paterson for another term.

Item 4	Re-election of Mr David Peever as a Director
ASA Vote	For

Summary of ASA Position

Mr Peever was appointed to the board in November 2013, is appropriately qualified having been Managing Director of Rio Tinto from 2009 – 2014 and is currently Chair of Brisbane Airport Group Pty Ltd. Mr Peever is also a member of the Foreign Investment Review Board and Naval Group Australia. His workload is considered manageable.

Prior to last being elected, Mr Peever was chair of Cricket Australia before resigning in November 2018. It is not considered that the reasons for that resignation should preclude ASA support for his re-election.

Item 5	Re-election of Mrs Catherine Walter AM as a Director
ASA Vote	For

Summary of ASA Position

Mrs Walter was appointed to the Board in August 2002 and is appropriately qualified with a law background. She has a manageable workload, being chair of two non-listed organisations and a director of another non-listed entity.

She has now served 18-years on the board and the ASA has previously supported her re-election beyond the 12-year tenure guideline for independence. As one of two female directors she contributes to ASA objectives for gender diversity on boards and her meeting attendance record over the previous term has been impeccable.

AFI representatives indicated that Mrs Walter brings a strong governance focus to the board and that this remains as strong as ever.

For these reasons, along with those previously outlined for Mr Paterson, ASA support her re-election for another term.