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Long-term review required for long-term investor

Company/ASX Code	Argo Investments/ARG
AGM date	Monday 26 October 2020
Time and location	10 AM ACDT online
Registry	Computershare
Webcast	Yes-virtual meeting
Poll or show of hands	Poll on all items
Monitor	James Hahn assisted by Bob Ritchie
Pre - AGM Meeting?	Yes, by phone, with Chair Russell Higgins

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

Summary of ASA Position

<u>Governance and culture</u>

As we said last year, Argo does not have a large social or environmental presence. However, it is the custodian of $5.2 billion of Australian shares and therefore has an obligation to engage in best practice corporate governance so as to set an example. It is with this theme in mind we would like to draw attention to a practice that we believe could be improved: to put the MD's performance rights to a vote at the AGM.

<u>Financial performance</u>

Argo announced a 2020 profit of $199.5m compared to $297.7 last year and dividends of 30cps compared to 33cps last year. Earnings declined from 41.1 cps (36 normalised) to 27.8 cps. With a decline in share price from $8.12 to $7.19 this gave shareholders a negative return of -11.4%.

We were surprised initially by a paucity of comparative performance information in the annual report. Study of a unidirectional trend in reduction of such information over the past decade led us to seek more comprehensive comparative information about long term performance of this long-term investor.

This year, the annual report gives 20-year averages for:

- the S&P ASX 200 Accumulation Index, which does not take into account any costs or tax,
- Argo's compound return per annum, as measured by the movement in net tangible asset backing (NTA) per share assuming dividends paid are reinvested,
- Argo's total shareholder return (TSR) based on the share price over the same 20-year period
- Argo's total shareholder return (TSR) based on the share price over the same 20-year period including the franking credits attached to the dividend payments.

The first two of the measures above have been the traditional comparison to benchmark which Argo has used. Previous to the 2019 report, 15-year averages were used. In a much earlier eriod, a 20-year average was used.

To obtain a long-term perspective on Argo's comparative performance, ASA requested a copy of the twenty-year data sets used to calculate the four averages given in the annual report on page 11. To obtain twenty-year averages over twenty years, we also sought extension of the first two data sets back to 1980. Argo provided information back to 2000 but was unable to provide information back to 1980. Therefore, our methodology is a comparative annual histogram overlayed with a 3-year moving average (Figure 1).

At our pre-AGM meeting, we provided a set of four figures, changing the starting date in each case, showing how a difference in the picture occurs as starting date or number of years averaged are changed.

The two paragraphs reproduced below are the difference we have detected between the Argo 2020 Annual Report (page 13) and the 18 September letter to shareholders headed 'Shareholder Update for the year ended 30 June 2020', page 3. The letter contained new information; namely that Argo's comparative benchmark, the S&P ASX200 accumulation index returned -7.7% for the year. This information allowed a calculation of the difference in performance: 2.4% in absolute percentage points by which Argo underperformed its traditional benchmark.

> At the end of an extraordinary year, Argo's investment portfolio had returned -10.1% after deducting all costs and tax (measured by the movement in NTA assuming dividends paid are reinvested) and Argo's share price performance returned -7.8% for the financial year, with the share price at a slight discount to NTA after trading at a premium for the first few months of the COVID-19 crisis. (Annual Report 2020, page 13 of 78.)
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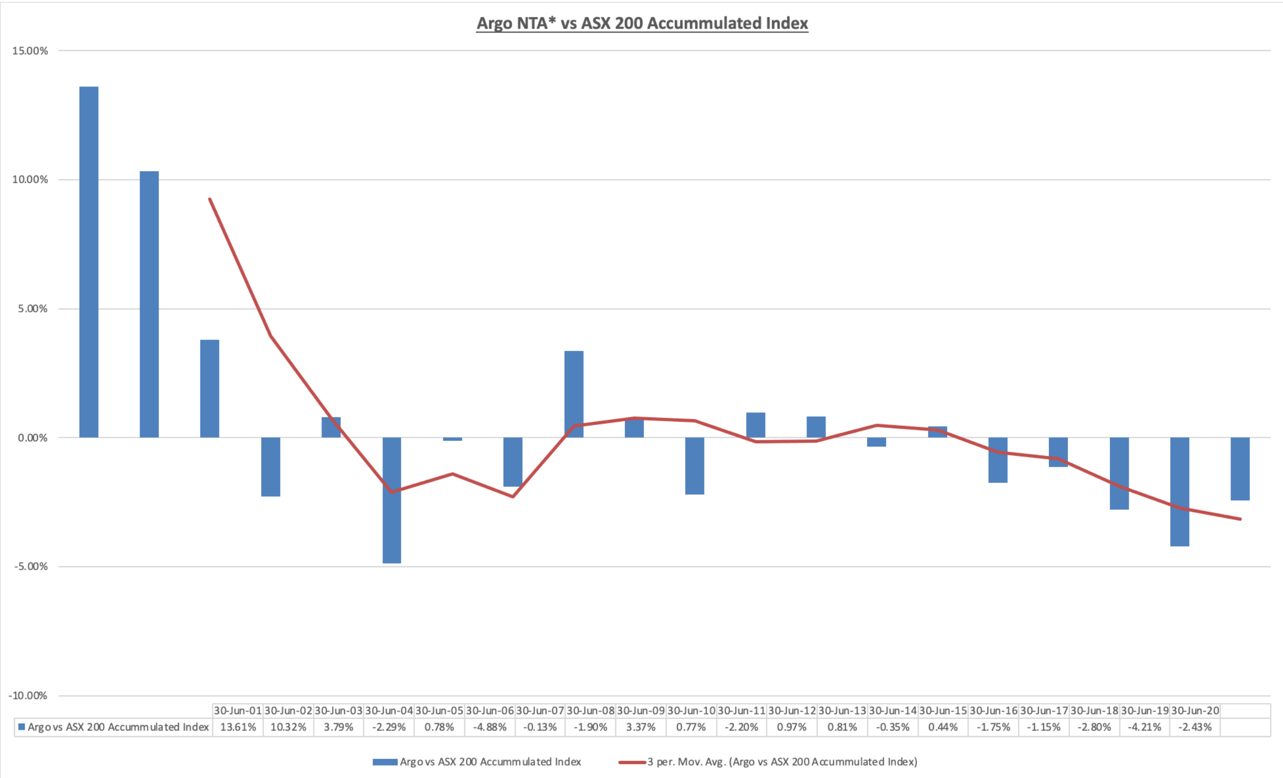
> At the conclusion of a highly volatile and unprecedented year for shares, Argo's investment (NTA) performance returned -10.1% after all costs and tax. This compares with the benchmark S&P/ASX 200 Accumulation Index which returned -7.7%, without making any allowance for costs or tax.
>
> (18 September letter to shareholders, headed 'Shareholder Update for the year ended 30 June 2020', page 3.)

In Figure 1 blue columns are the absolute percentage point difference between Argo's performance and the S&P ASX200 accumulation index for each year and the red line is their three-year moving average. We think this display is more meaningful than a single 20-year average given for this comparison on page 11 of the annual report; calculated as 0.6% absolute percentage point in Argo's favour. The moving average has been in decline for the last five years and has been below the benchmark for six of the last seven years. For the last three years, we have raised the question with the board as to whether this decline is cyclic or structural. At our pre-AGM meeting we asked whether the board has given serious consideration to this question. We will repeat this question for public answer at the AGM, as further noted below on the re-election of Mr Higgins.

Figure 1



	30-Jun-01	30-Jun-02	30-Jun-03	30-Jun-04	30-Jun-05	30-Jun-06	30-Jun-07	30-Jun-08	30-Jun-09	30-Jun-10	30-Jun-11	30-Jun-12	30-Jun-13	30-Jun-14	30-Jun-15	30-Jun-16	30-Jun-17	30-Jun-18	30-Jun-19	30-Jun-20
Argo vs ASX 200 Accummulated Index	13.61%	10.32%	3.79%	-2.29%	0.78%	-4.88%	-0.13%	-1.90%	3.37%	0.77%	-2.20%	0.97%	0.81%	-0.35%	0.44%	-1.75%	-1.15%	-2.80%	-4.21%	-2.43%

*Argo NTA is measured by the movement of NTA per share assuming dividends paid are reinvested. This return is after payment of all costs and tax.

Future measurement of NTA (adjusted) will be a measure before tax or fees instead of adding franking credits. Except for the tiny fees amount, this adjustment would be neutral whenever pau-out ratio is exactly 100%. The calculation will be in Argo's favour when pay-out ratio is less than 100% and otherwise when more than 100%.

Key events

Shareholders contributed $44.9 through the dividend reinvestment plan.

The decline in performance noted above sets a context for questions raised above and for consideration of the following changes which have occurred.

- One of two LTI tranches has been amended, making it easier to gain this incentive bonus
    - The break-even threshold payment is increased from $79,000 to $126,000.

    - Performance to gain $315,000 maximum has been reduced from outperformance by three percentage points to just one percentage point.
    - While a cap of 50% has remained unchanged as a counterweight for negative performance, this cap of $157,500 in the event of negative NTA is paid at one-sixth of a percentage point outperformance when it previously would have required one percentage point outperformance.
- Argo's traditional way of measuring performance against the S&P ASX200 accumulation index benchmark; a benchmark which has been in place since 2000, has been changed. Total portfolio return (TPR), previously grossed up for franking credits, is now adjusted to remove the effect of company tax paid by Argo.
    - While this is a theoretically neutral amendment, we have no information on special circumstances and have no information as to the result of back-testing by the company.
- A new constitution has been proposed.
- Reporting of long-term performance has been amended to focus on a single period: the 20-year average.
    - A 15-year average for a sequence of years was used up to and including 2018.
    - In an earlier period, which we understand was in the 20th century, a 20-year average was used.

Key Board or senior management changes

There have been no changes to management or the board.

ASA focus issue

COVID-19 has had less impact on Argo than most other companies. Meetings with companies in which Argo has an interest have been conducted electronically.

Board composition/director skills:

- Partially compliant – Skills and experience are included in the re-election resolution; directors do address the AGM meeting but the wording of directors' relevancy to the company could be better.
- Compliant – The company has an independent chairman, a majority of independent directors and only one executive director.
- Compliant – The board is comprised of at least 30% female directors and at least 30% male directors.

Remuneration disclosure:

Compliant in issues typically analysed:

- Argo has 4 year long-term hurdles,

- uses market value to calculate LTI grants and
- has a table of actual CEO and KMP remuneration.

Disclosure in reporting performance has been declining in recent years and is specifically noted above.

Risk Management:

Partially Compliant - Being an LIC, risk management would be issues of compliance, solvency and performance. Argo does reasonably well in those areas, but recent comparative performance is being questioned. How the board is or is not dealing with that is also questioned.

Shareholder participation:

Compliant – The company uses proxy voting and shareholders are invited to participate in a dividend reinvestment plan. Also, a $30,000 annual purchase facility is offered to all shareholders.

Summary

(As at FYE)	**2020**	**2019**	**2018**	**2017**	**2016**
NPAT ($m)	199.5	292.7	218.9	211.5	216.3
UPAT ($m)	199.5	256.6	218.9	211.5	216.3
Share price ($)	7.19	8.12	7.98	7.67	7.37
Dividend (cents)	30	33	31.5	31.0	30.5
TSR (%)	-7.76	5.9	8.1	8.3	(3.7)
EPS (cents)	27.8	41.1/36*	31.3	30.7	32
CEO total remuneration, actual ($m)	1.23	1.23	1.25	1.29	0.96

*Excluding Coles demerger dividend.

For 2020, the CEO's total actual remuneration was **13.4 times** the Australian Full time Adult Average Weekly Total Earnings (based on May 2020 data from the Australian Bureau of Statistics).

Item 3	**Adoption of Remuneration Report**
ASA Vote	**Against**

Summary of ASA Position

Intention to make some change to long term incentive (LTI) was briefly announced last year. Change has been made to one of the two tranches. TPR (total portfolio return) has been made easier to get a maximum with outperformance of the benchmark ASX200 accumulation index now being achieved at 1% whereas it previously was an aspirational outperformance of 3 percentage points. The initial payment for equalling the benchmark was increased from 25% of the maximum to 40%. The gate in the event of a negative TPR limiting payment of this tranche to 50% of the maximum was unchanged, as discussed above.

While notice was given last year that there would be changes, the actual changes have not been discussed. Last time a significant change occurred to remuneration policy, ASA was invited to consider the proposal, comment and engage in conversation. Our particular concern going into our pre-AGM meeting was that current changes do not seem to relate to the quest of improving long term performance. They seemed to us to simply be a pay rise (based on performance easier produced). At our pre-AGM meeting this was confirmed. The board's 2019 remuneration review found that the TPR tranche of LTI was not providing the intended opportunity for payment, so it was changed.

We accept the argument that adjustment of TPR by not counting franking credits but now not counting company income tax should produce a better way of comparing Argo's TPR performance with the S&P ASX200 accumulation index. It is appropriate, in our opinion, to include both TPR comparative measures in annual reports for the next decade.

CEO rem. framework	Target* $m	% of Total	Max. Opportunity $m	% of Total
Fixed Remuneration	0.7	48.6%	0.7	37.6%
STI - Cash	0.25	17.4%	0.25	13.4%
STI - Equity	0.28	19.4%	0.28	15.0%
LTI	0.63	14.6%	0.63	34%
Total	1.86	100.0%	1.86	100.0%

The amounts in the table above are the 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.

Our history of Argo's remuneration policy extends back to 2010; a period longer than any current non-executive director. Easier payment under the TPR half of LTI therefore was perceived by us to be a significant policy shift from the rationale we were given by previous chairman, Ian Martin, whereas present board members understand the change as making a simple income adjustment.

It is a combination of current factors which lead to our intention to vote against adoption of the remuneration report:

- the PRT change in LTI
- reduction in good comparative information on performance, coming to a head with shift from 15-year to 20-year without explanation and clearly indicating better outcome viewed over 20-years than 15

- tension between competing goals of current dividends and future value which we believe have not yet been resolved satisfactorily in strategy or remuneration policy.

Our negative vote this year is meant as a wake-up call.

Item 3	**Re-election of Mr Russell Higgins as a Director**
ASA Vote	**For**

Summary of ASA Position

Mr Higgins joined the board in 2011 and as such will, in ASA classification, be in his final term as an independent director. He is presently Chairman of the board and a member of the Remuneration Committee. Also, Mr. Higgins is Chairman of Argo Global Listed Infrastructure Limited and Telstra Foundation.

We believe his extensive background in senior government positions and ASX listed boards enables him to bring valuable skills to the company.

There is an issue, however, as to whether as chairman of the board Mr Higgins has provided sufficient leadership in addressing the question of whether the board is satisfied with the company's performance over the last half-decade or more and whether goals, priorities and strategy are now adequate. This is a matter we have addressed in pre-AGM conversation and will repeat for a public answer at the AGM. Based on our conversation with Mr Higgins, we expect his answer at the AGM will give a clear explanation of the tension created by competitive goals of current dividends and future value. In anticipation, our present intention is to vote for his re-election.

Item 4	**Re-election of Mr Roger Davis as a Director**
ASA Vote	**For**

Summary of ASA Position

Mr Davis joined the board in 2012 and as such will, in ASA classification, be in his final term as an independent director. He is currently Chair of the Board's Remuneration Committee. With his extensive career in global senior management position in investment banking his expertise is valuable to the board.

Given his special responsibility for remuneration, we intend to seek confirmation at the AGM that changes to LTI were not designed to improve the company's long term performance; rather to adjust what seemed to be an unfair pay scale. We also will ask if back-testing was undertaken on the effect of changing adjustment for tax and payroll tax in measuring PRT performance.

While our final decision will depend on the answers to our questions, it is in anticipation of good answers that we indicate our present intention to vote for the re-election of Mr Davis.

Item 7	Adoption of new or amended constitution
ASA Vote	**Against**

Summary of ASA Position

The current constitution was adopted in 1999. Given changes in legislation, ASX listing rules, societal values and the effects of the COVID-19 pandemic, amendment of a constitution would generally be appropriate.

Some of the changes proposed are inappropriate in our opinion; in particular:

- it will be more difficult for shareholders to nominate a director
- it will be constitutionally more difficult for shareholders to call a poll (although present policy of the board is to conduct all voting on resolutions by poll).

As all amendments are on the agenda without prior notice or opportunity for conversation which could lead to change, and there is no time for the board to advance any amendment, we encourage the board to leave this item on the agenda for conversation at the AGM but withdraw the motion, to bring it forward next year and create an opportunity for conversation with shareholders in the meanwhile.

Item 8	Renewal of proportional takeover provisions
ASA Vote	**For**

Summary of ASA Position

This is a normal and beneficial resolution.