



AVARON ASSET MANAGEMENT

**SUSTAINABILITY REPORT
FOR THE YEAR 2017**

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AVARON OVERVIEW

GENERAL INFORMATION

Avaron Asset Management (the “Company”) is a fund management company established in 2007. Avaron holds a license from the Estonian Financial Supervision Authority to manage investment portfolios and funds, and is also a registered Investment Advisor with the US Securities and Exchange Commission. The Company manages UCITS funds and institutional investors’ managed accounts investing in listed equities and fixed income in Emerging Europe region. Asset class wise the core focus is on regional listed equities.

As of end 2017 Avaron managed 488 million euros, out of which the core Emerging Europe listed equity strategy accounted for 475 million euros. Fixed income investments accounted for 1% of the total assets under management. The Company manages two mutual funds domiciled in Estonia, which are open to any investor that has a European bank account. Avaron Emerging Europe Fund is focused solely on Emerging Europe ex-Russia listed equities. Avaron Flexible Strategies Fund is an asset allocation fund combining predominantly Emerging Europe cum-Russia listed equities, fixed income and money market instruments but is not bound to the specific region according to the fund rules and can invest globally. Total assets under management of Avaron’s mutual funds in the end of 2017 amounted to 94 million euros, out of which 81 million euros was in Avaron Emerging Europe Fund and 13 million euros in Avaron Flexible Strategies Fund.

In addition to the Estonian domiciled mutual funds, 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 the Company over the past five years and accounts now for 80% of the assets under management. The total size of institutional investors’ mandates in the end of 2017 was 389 million euros. Besides that Avaron also manages 5 million euros worth of portfolios for high net worth individuals.

We follow value investing principles and evaluate every investment case on a standalone basis. Portfolio construction is based on stock-picking, thus fully bottom up. Idea generation is proprietary, driven by the in-house bottom-up research. Our investment universe includes 272 entities, which are under close observation of our ten-member investment team. In total Avaron employed 17 talented people as of end-2017. We are proud to be an independent, management-owned boutique committed to delivering strong risk-adjusted investment returns to our clients.

GOALS AND VALUES

Our mission is to be the most suitable partner for institutional investors catering for their needs in investing into Emerging Europe listed equity and fixed income asset class. We seek to offer positive risk weighted long-term return to our clients through value based and responsible investing. To achieve this, we adhere to our bottom-up value focused investment process. Our investment team has a key role in achieving this objective, which is why the Investment Managers and key investment team members are also the Company

shareholders. Investment Managers have worked in Avaron for 10+ years, while the employment of Head of Research and two key Analysts extends from 7-10 years. Today our research team, purely dedicated to the Emerging European region equity analysis, comprises 10 investment specialists and is one of the largest among our peers.

Avaron has a strong corporate culture where integrity, passion for investing, diligence, flexibility and sustainability is highly valued. Integrity is the foundation of long-lasting success in asset management industry. To build client's trust we are honest, open, ethical and fair. People trust us to adhere to our word and we are accountable for our actions. Passion for investing is a key characteristic we look for during our employee selection process as we consider it to be essential for self-development and long-lasting job satisfaction. In order to keep excelling one has to have a strong drive. Without it we would lose our competitiveness. Success in investing relies on disciplined, careful and persistent work. Adhering to the set investment process and strategy in long-term enables us to achieve our goals. As a boutique asset management house flexibility, both towards its clients and employees, is something that sets us apart from the competition. We offer tailor-made solutions to our clients and opportunities for personal growth for our employees.

At Avaron we recognise that our business and investment practices have an impact on environment and society. We are committed to carry out our business activities in a sustainable manner to ensure diverse ecological environment and vibrant cultural, social and economic base for future generations. Our perception of sustainability is of something not being harmful to people, communities, environment or depleting natural resources, and thereby supporting long-term social and ecological balance. As asset managers we also believe that environmental, social and corporate governance issues are important contributors of long term performance of investment portfolios.

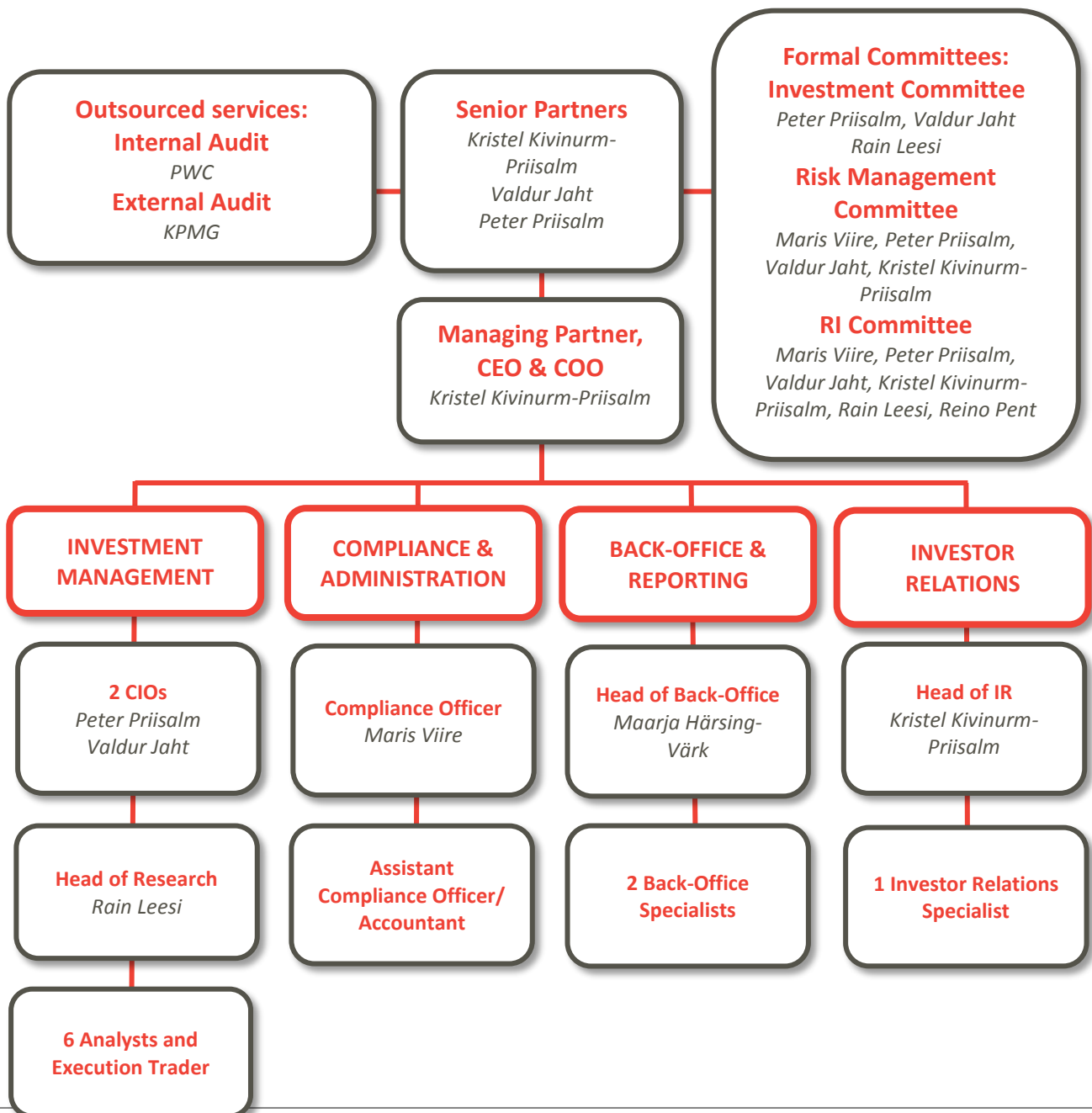
OWNERSHIP AND MANAGEMENT STRUCTURE

Avaron is owned by its employees and the Company has no institutional investors. 82.41% of Avaron belongs to Avaron Partners OÜ. 33.33% of Avaron Partners shares belong to Drusba Investments OÜ, which is equally owned by Valdur Jaht and his wife Maris Jaht (not active in the business). 66.67% of Avaron Partners belongs to Princo OÜ, which is equally owned by Kristel Kivinurm-Priisalm and Peter Priisalm. In the end of 2016 Avaron issued preferred shares, which were acquired by senior investment team members of the Company – Rain Leesi (6.85%), Piotr Jurga (5.86%) and Reino Pent (4.88%).

Avaron's Supervisory Board consists of Peter Priisalm (Chairman, CIO), Maris Viire (Compliance Officer and Head of Administration) and Priit Sander. Mr. Sander is an independent Supervisory Board member and has no other function in Avaron. The Management Board consists of Kristel Kivinurm-Priisalm and Valdur Jaht. The Company is audited by KPMG and internal audit is carried out by PwC. Compliance functions are internalised.

Avaron functions as a partnership, which is being managed by the three partners: Kristel Kivinurm-Priisalm, Valdur Jaht and Peter Priisalm. Kristel Kivinurm-Priisalm is responsible for general management, investor relationship management and operations management. Valdur Jaht and Peter Priisalm are the Company’s Investment Managers, who are responsible for the investments made by the funds and managed accounts as well as the smooth running of the investment team’s work.

Figure 1. Organization structure



SUSTAINABILITY IN AVARON

Avaron as a company is committed to sustainable business practices, which are embedded into our corporate identity. We review sustainability under the categories of People, Community, Environment and Investing (please refer to Responsible Investing section on page 9).

In 2017 Avaron became a member of the [Responsible Business Forum in Estonia](#), a non-profit organization with an aim to inspire and support furthering corporate social responsibility (CSR) in Estonian society through being the centre of competence building and communication on CSR. We also participated for the first time in Estonian Responsible Business Index and received the highest gold level quality label. The Index aims at assisting Estonian companies to define, evaluate and monitor their economic, social and environmental impact. The quality label is given to organizations that show high performance and systematic approach in responsible activities towards local community, environment, workplace and marketplace. We are proud to have scored the highest among the small enterprises, proving that our efforts in adopting responsible business and investment practices are bearing fruit. The label is valid for two years.

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 value transparency together with mutual trust highly. 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 an effective hiring and onboarding 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 colour, 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	2017
Full time employees	15.3	14.5	15.0	16.2
% of female	50%	44%	43%	35%
% of male	50%	56%	57%	65%
Turnover	13%	7%	13%	25%

The average tenure of our staff as of end 2017 was 4.8 years, similar among male and female employees.

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 guest lectures on investment topics at Estonian universities. Since 2014 we have been participating in the [Back to School](#) initiative 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 2017 we held internal training tutored by a Back to School leader for our employees with respect to this program to further engage and motivate them to take active part of this initiative.

During 2017-20 Avaron backs the foundation [Youth to Olympics](#) that is dedicated to supporting 18-25 year old Estonian athletes in their pursuit of excellence. During the four years Avaron contributes €40,000 to the foundation. “Youth to Olympics” provides long-term support to prospective young Estonian athletes that have the potential to become ambassadors of active lifestyle for the whole Estonian society and youth in particular. Avaron Partner Valdur Jaht is the founder of the Youth to Olympics foundation.

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. We avoid paper towels and use washable cloth towels instead. Used paper is collected for recycling.

Annual electricity and paper consumption are tracked since 2014 and it has helped us to optimize our consumption. We are taking advantage of electronic sales presentation possibilities whenever possible.

	2014	2015	2016	2017
Paper usage, # of sheets	22,257	17,548	14,652	17,319
change, %		-21%	-17%	18%
Electricity consumption, kWh	17,954	18,187	18,341	19,875
Per FTE, kWh	1,177	1,254	1,223	1,229
change, %		7%	-3%	1%

The emission factor of electricity sold in Estonia based on the composition of production according to the national grid operator Elering is 926.34 g/kWh. In 2017 the greenhouse gas (GHG) footprint (Scope 2) from this was 18.4 tCO₂e (1.4 tCO₂e per FTE). Another important environmental impact of our business operations is related to GHG emissions from travel. Since mid-2016 we are tracking Avaron’s carbon footprint from travel (Scope 3). Emission factors used to calculate the footprint are 0.10173 kgCO₂e per km for pan European flights (short-haul international), 0.24234 kgCO₂e per km for taxi, 0.13552 kgCO₂e per km for bus, 0.07659

kgCO₂e per km for train and 0.13788 kgCO₂e per km for maritime transport. In 2017 our business travels reached 115 thousand kilometres of which 95% were pan European flights. Carbon footprint from business travel in 2017 was 11.9 tCO₂e (0.74 tCO₂e per FTE). Given the nature of Avaron's business that entails regular client visits and sales trips we have not set any targets related to reducing carbon footprint.

RESPONSIBLE INVESTING IN AVARON

Since 2011 Avaron follows responsible investment (RI) 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 not to 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.

The list of oppressive regimes is based on the latest Economist Intelligence Unit (www.eiu.com) Democracy Index, which measures the state of democracy in 167 countries. Oppressive regimes have been defined as countries with 2.0 or lower score on a scale from zero to ten of the Index. Additional country based investment restrictions may be set by the Avaron Responsible Investing Committee based on the European Union sanctions within the framework of the Common Foreign and Security Policy (CFSP) and the list of sanctioned countries of the UN Security Council. In case of discretionary mandates from non-EU clients Avaron will follow the sanctions list of respective non-EU countries and make exclusion decisions based on that in collaboration with the client.

- 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.

In 2017 we started to develop a new ESG analysis tool that would replace the existing compliance check and will be implemented in the first half of 2018. The main purpose of the change is to provide a more comprehensive and rigorous analysis mechanism for our investment team. Current compliance check comprises 13 broad principles that are being assessed, while the new tool includes around 90 criteria that will be separately scored enabling us to start ranking companies we cover according to their ESG performance.

<u>Exclusions based on type</u>		<u>Excluded companies by country</u>	
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

As of end 2017 our Emerging Europe listed equity coverage universe had 272 companies (2016: 236). Based on the ESG analysis we had additional 45 companies in the restricted list, unchanged during the year. 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 since implementing our Responsible Investment Policy.

Minority shareholder rights protection most often raises our concerns in relation to governance topics and to which we are especially sensitive to. More than 60% of our governance based exclusions relate to historical minority mistreatment cases.

More detailed description of the ESG integration can be found in our [Responsible Investment Policy](#).

On annual basis we measure how our ESG approach has impacted the financial performance of our investment portfolios by comparing 1, 3 and 5-year volatility and risk-adjusted returns (Sharpe ratio) of equally weighted portfolio of excluded companies and compare it to Avaron Emerging Europe Fund and its benchmark.

	Total return			Volatility			Sharpe ratio		
	1-year	3-year	5-year	1-year	3-year	5-year	1-year	3-year	5-year
Avaron Emerging Europe Fund	17%	24%	56%	7%	10%	9%	2.59	0.80	1.03
MSCI EFM CEEC ex RUSSIA Index	30%	27%	22%	12%	16%	15%	2.52	0.55	0.27
ESG exclusion list ex Russia	34%	45%	28%	10%	14%	15%	3.57	1.01	0.43
ESG exclusion list cum Russia	24%	55%	23%	10%	15%	16%	2.59	1.14	0.36

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 companies' quality for which we have developed 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 further corrective actions from the company.

# of meetings	2014	2015	2016	2017
1on1 meetings	85	109	127	154
1on1 calls	17	17	9	20
Group meetings	24	72	27	22
Quarterly group calls	320	315	304	362

One of the most common challenges to overcome in Emerging Europe continue to be governance and disclosure related. In our experience listed companies do evaluate ESG risks as part of the operational risk management process but offer limited disclosure on it. Driven by increased investor demand for such information and emerging best practice guidance we are witnessing slow but steady improvements. Our aim here remains to actively advocate and promote implementing proper ESG policies and disclosure.

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](#).

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 rights in Avaron are exercised internally i.e. our investment team reviews the agendas of shareholder meetings of the companies we are invested in. Voting proposals are put forth by the Analysts that cover the companies, approved by Investment Managers and then forwarded to our global custodian or directly sent to the companies.

Voting activity	2011	2012	2013	2014	2015	2016	2017
Meetings	1	9	7	8	20	13	16
Resolutions	9	52	101	65	210	94	158
For	9	43	84	54	183	91	119
Against	0	6	17	11	17	2	19
Abstained	0	3	0	0	10	1	20

In 2017 we voted in 16 shareholders' meetings of 5 companies in the Fund portfolio out of 96 meetings held. On 12% of agenda points we voted against the management proposals and on 13% we abstained. Starting from 2018 we have committed to systematically exercise our voting rights on most shareholder meetings.

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. We recognize that in many instances joint action by institutional investors has the potential to be more effective than acting alone. Thus, we have participated in several collaborative initiatives over the past years.

In 2017 Avaron supported the [Global Witness](#) led investor initiative via UN PRI collaboration platform on increased transparency on corporate ownership. Avaron signed the letter that will be sent to the European Council and the European Commission expressing support to amend the fourth Anti-Money Laundering Directive to enable public access to beneficial ownership information. Such transparency is critical for investors like us as it enhances our ability to identify and manage ownership related risks in the companies we invest in.

In addition, we lent our support to a statement that was sent to the representatives of the World Health Organization (WHO) and national health ministers supporting the tobacco control measures already taken by governments and encouraging them to continue their efforts. According to the WHO, tobacco is a primary driver in recent sharp rise in chronic non-communicable disease, killing 6 million people per year. Smoking costs the global economy more than \$1 trillion a year, according to a 2017 joint study by the WHO and the U.S. National Cancer Institute, far outweighing global revenues from tobacco taxes. Since 2011 Avaron has stopped financing business models that derive more than 10% of revenues or operating profit from production and sale of tobacco products.

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. A list of 125 target companies was developed by the PRI using data supplied by Carbon Disclosure Project (CDP), MSCI, South Pole and Trucost. Within the scope of this initiative Avaron took a lead investor role in engaging with the Turkish Koc Holding. Mid-2017 this engagement came to a close. It was established that 5% of companies in the target list already report on Scope 1 and 2 emissions and additional 8% started to report as a direct result of the engagement. 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.

In 2018 we have decided to participate in several collaborative engagements to address the issue of limited carbon emission data disclosure among Emerging European listed companies. Namely we have joined:

- i. [Climate Action 100+](#) that is a new 5-year investor initiative to engage with the world’s largest corporate greenhouse gas emitters to curb emissions, strengthen climate-related financial disclosures and improve governance on climate change.
- ii. PRI-coordinated engagement on climate change transition for oil and gas. It builds on research by Carbon Tracker that illustrates the company-level risks associated with unneeded capital expenditure. This working group is part of Climate Action 100+.
- iii. 2018 [CDP](#) Non-Discloser Campaign aimed at further encouraging companies to disclose carbon data. The campaign focuses on companies that have never responded or have not responded to the CDP questionnaire in recent years. We also remain CDP investor signatory.

GOVERNANCE AND REPORTING

Responsible Investing Committee at Avaron has responsibility for all aspects of Responsible Investing, including philosophy, policies, operational issues relating to the implementation of RI factors across existing portfolios, selection of relevant service providers, proxy voting, engagement, and liaison with external RI organisations and groups. The Committee is made up of senior staff members and is chaired by Executive Board Member and co-CIO Valdur Jaht. The Committee and its Chair have ultimate responsibility to ensure efficiency, compliance and ownership of RI practices in Avaron. Current list of Committee members are:

Key People	Role
Valdur Jaht	Co-CIO, Chair of the Committee
Peter Priisalm	Co-CIO
Kristel Kivinurm-Priisalm	CEO/COO
Rain Leesi	Head of Research
Reino Pent	Senior Analyst, RI Specialist
Maris Viire	Compliance Officer
Kirill Kutakov	Analyst

Avaron reports annually on ESG issues via UNPRI Reporting Framework and Avaron’s Sustainability Report. UNPRI Reporting Framework provides Transparency and Assessment Reports. Transparency Report shows signatory’s responses to the Reporting Framework, and is made publicly available on the PRI website. Assessment Report demonstrates how a signatory has progressed in its implementation of the principles year-on-year and relative to peers, and are not by default public. However, at Avaron we have decided to make our Assessment reports public. On quarterly basis we report on ESG related activities to our clients.

Our annual Sustainability Report includes an overview of sustainable practices on company level as well as our responsible investing practices. All latest reports are made public in the Responsible Investment section on our [website](#).

CONTACT INFORMATION



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