Herald Investment Management Limited
Stewardship Approach and Policy

Stewardship

Stewardship is the process by which Herald Investment Management Limited ('Herald') protects and manages its clients' investments by actively monitoring investee companies. This includes engaging with company management on strategy, performance, governance, risk management and their treatment of employees, as well as safeguarding of clients' assets and monitoring of clients' service providers. We endeavour to apply our approach to stewardship in a proportionate way to all companies in which we invest on behalf of our clients.

Our approach to governance, sustainability and stewardship is consistent with the overall aims of Herald which are:

- to provide good long-term performance for our clients;
- that our exercise of stewardship should always meet client expectations; and
- to maintain the good reputation that Herald has established among investee companies, investment professionals and the wider public since its foundation in 1994.

From the start we were drawn to investing in emerging technology, a sector creating wealth, added value jobs and sustainable benefits for the economy and society as a whole

Herald's original founding purpose - to invest in smaller companies - arose from our belief that they offer greater potential for growth than larger companies because they often provide greater entrepreneurialism when addressing new markets created by technological developments. This conviction led Herald to focus on investing in smaller quoted companies in the areas of telecommunications, multimedia, and technology ('TMT'). These companies create added value employment and have the potential to become the next generation of large companies, thereby generating attractive returns for shareholders.

Many of these companies required equity capital from supportive long-term shareholders to realise potentially exciting growth. As many of these companies were at an early stage, developing new and untried products and services, there was also a high degree of stock-specific risk and limited liquidity, making it difficult for professional investors and retail investors alike to gain exposure to these opportunities.

It seemed appropriate to address this exciting investment opportunity with a closed-end collective vehicle, so that the illiquidity and stock-specific risk could be diversified over many holdings. In addition, focused specialist management would enable stock selection with a higher success rate. To make this investment opportunity available to investors, Herald Investment Trust plc was listed on the London Stock Exchange in February 1994.

Herald Investment Trust's success in providing access to smaller technology companies

The approach is to construct a diversified portfolio through the identification of individual companies which offer long-term growth potential, typically over a five-year horizon or more. The portfolio is actively managed is not modelled on any comparative index. With a remit to invest in quoted TMT companies globally with market capitalisations generally below $3bn, there tends to be a correlation with the performance both of smaller companies and the technology sector. Herald Investment Trust ('HIT') has provided a vehicle for a wide range of investors to gain access to this market in a diversified way.

Since its inception in 1994, HIT has supported hundreds of company fund raisings. Although HIT has itself raised less than £100m of equity capital from its shareholders, through investment, realisation of profits and reinvestment, it has provided approximately £500m of growth capital to small companies in the TMT sectors. Over more than 25 years, the equity capital deployed in investee companies has contributed to the growth of hundreds of small technology businesses, contributing to economic growth and job creation whilst delivering strong returns to investors.

Exploiting the scale up of smaller companies

In 1998, we launched the Herald Worldwide Technology Fund ('HWTF') with a remit to invest in larger capitalised TMT companies, making use of the knowledge obtained whilst investing in smaller TMT companies and the ability of some of these companies to scale dramatically. HWTF is structured as an open-ended investment vehicle as the larger capitalisation focus means liquidity is not an issue for the fund for the foreseeable future.

We retain our belief in technological innovation as an engine of growth…

Herald's TMT sector focus continues. Our intention remains that by specialising in and targeting these dynamic and high growth sectors of the economy, Herald's funds can be deployed in an expert manner in companies that are capable of growing quickly, creating value for shareholders, and providing high quality value-added jobs for employees, with the beneficial side-effect of accelerating the growth of the wider economy.

…and the target sector has demonstrable benefits to the environment

Our focus on the newer sectors of the economy means that, in aggregate, our investee companies assist in improving the world environmentally. The largest component of the portfolio is software, which provides efficiencies for enterprises, governments, and consumers. Other sectors of the portfolio often provide and improve the enabling supply chain.

Technology also provides energy efficient communications, entertainment and more; and we firmly believe that capitalism and technological innovation combined are the central requirements to address the environmental challenges we face. This is in contrast to the environmental impact of the older parts of the economy such as transport, extractive industries, or heavy industrial sectors where we do not invest. Most investments in the technology and media sectors have a low carbon footprint and the carbon emissions of the portfolios are estimated to be a fraction of those of the constituents of the large companies' indices in the UK and US. Furthermore, much of the world's most advanced technology and intellectual property tends to reside in the wealthiest and most advanced economies, which themselves have strict environmental standards.

Given these factors, over the years Herald has therefore found little requirement to engage actively in resetting the environmental standards of companies within the portfolio as they typically operate well ahead of, and in some cases lead, the environmental standards of the countries in which they operate. In particular, we will not insist small companies with a low environmental impact submit formal Environmental, Social and Corporate Governance ('ESG') reports, because they must first concentrate on creating a sustainable business. Herald therefore primarily focuses its monitoring and stewardship activities in the areas of social and governance issues. We believe it is important to converse with management and review publicly available information. A number of the larger companies in the sector have been leaders on ESG issues globally.

Our long-term approach to investment management and stewardship

The long-term perspective of Herald is evident in the low portfolio turnover and our efforts to understand a company's business prospects over the next decade, and not just to forecast the next set of results. To do this requires the identification of well-managed companies that can thrive in their sector and meet the expectations that shareholders, employees and society place upon them. We believe that the Herald approach, being questioning but supportive of management and building up a good relationship and understanding of companies over many years, is the correct one for our clients and their beneficiaries.

The investment focus on growth companies, and particularly in earlier-stage companies, means that historic financial statements, while an important analytical tool, are insufficient to value a company's potential. It is an essential part of the investment process to meet management in person; sometimes we do so several times prior to investing, and regularly thereafter as part of our endeavour to understand the long-term prospects. We frequently contribute to delivering the ambitions of the company with the support of our clients' capital.

We believe that effective stewardship creates long-term value

Herald takes pride in endeavouring to help emerging companies grow. We encourage management to explain any long-term investments which may adversely affect short-term profitability. Theoretically, efficient markets should discount the long-term potential. However, even though the share price may be adversely affected in the short term, we generally encourage management to maximise value over the long term. The danger is that this approach can leave companies vulnerable to a take-over bid, and we typically resist takeover approaches which might give a short-term uplift in value, but do not appropriately reflect the long-term wealth-creation potential of the company.

We believe in the importance of fundamental analysis incorporating consideration of ESG factors

The investment team takes a fundamental approach to investment and a significant amount of time is spent meeting with companies to better understand company strategy and investment risk and to assess performance. Herald believes that a company's ESG practices are integral to this investment process. Well managed companies will have sound ESG policies and performance, which are a measure of how professional their management is. Strong management leads to strong long-term company financial performance.

Our expectations of reporting standards vary according to investee company size and location

Investing in small and often immature companies in many different countries with different approaches to disclosure, governance and regulation does bring its challenges. The quality and level of disclosure of ESG reporting for small companies in many countries is often very limited and well below that found within fully listed large companies in some more mature markets. There is, rightly, a distinction between the corporate governance and reporting standards demanded of a large fully listed company that has many thousands of employees and has been established for decades, and those for a very small company traded on a junior stock market that may have fewer than 50 employees, only a few million pounds of turnover and may be loss-making due to investing heavily in developing new products. Clearly Herald's approach, and its expectations of reporting and governance, will differ greatly between these extremes.

We favour a non-prescriptive approach to stewardship due to the nature of the remit

Given the wide range of company sizes and the variety of governance and regulatory environments we do not believe that it is possible to enforce prescriptive policies and rules. Furthermore, such an approach may well prove to be damaging. For example, smaller companies can find it challenging to attract appropriate non-executive directors and Herald will not necessarily vote against a board without diversity if we consider that its members possess suitable commercial and governance skills. Herald aims to understand the companies in which it invests well and to back management teams and boards that are endeavouring to balance the interests of the different stakeholders in an equitable manner. We recognise that there are often difficult judgements to be made and that it is often only with the benefit of hindsight that success in these endeavours can be judged. Where we do not think management of an investee company are acting appropriately and where we believe that we can initiate improvement, we will engage in discussion with the company. We also recognise the limitations of our influence as a minority shareholder and in cases of strong disagreement our ultimate action may well be to sell the investment.

We expect companies to create wealth for their investors, whilst appropriately rewarding employees

Intellectual capital and skilled labour are often critical to the success of investee companies. Their management teams generally recognise this, and often compete to attract and retain talent. Typically, we would expect the average working standards and remuneration of employees in the TMT sector to exceed that of the general population in the countries in which they operate. TMT companies will often pride themselves on the quality of their engagement with their workforce and report on the level of employee satisfaction in their annual reports. As the leading technology companies tend to operate in the most advanced economies, the standards of health and safety and legal employee protection are also generally very high, and average pay levels in most investee companies exceed the relevant national average. There are challenging areas for technology companies, such as equal opportunities and diversity. Herald expects investees to address these issues progressively and proportionately as they grow, in line with local standards and laws.

Given the generally attractive remuneration received by employees, they can contribute meaningfully to income tax revenues. In an ideal world, governments would grow their tax revenues not by charging existing top-rate taxpayers twice as much tax through higher tax rates, but by having twice as many top-rate taxpayers, through creating more high-income jobs. No other sectors create new added value jobs in the way Herald's targeted TMT sectors have done, and we are proud that the primary capital we have provided to companies has helped create quality jobs and build valuable skills. In a knowledge-based world, people with skills earn higher salaries because their skills provide the ability to create greater profits for shareholders. This ideological belief has significantly motivated the team at Herald.

There is a challenge in ensuring that investee companies' shareholders receive good returns on their financial capital and that employees are rewarded, but not excessively, for providing labour and intellectual capital. Whilst Herald believes it is in shareholders' interests to attract, retain and reward staff at all levels, we dislike remuneration policies which make it difficult to determine the total costs of running a company. This particularly relates to complex share incentive schemes, often devised by third-party remuneration advisers. We encourage and seek transparency and simplicity.

Ensuring appropriate remuneration structures are in place is an area of focus for Herald's corporate governance efforts. We aim to see that the right balance is struck by seeking out good quality management, discussing incentive schemes, and ensuring that non-executives are competent, sufficiently independent and acting in minority shareholders' interests.

We focus our stewardship effort where it is most needed

Herald aims to be efficient in its governance activities by focusing its monitoring and stewardship efforts where they are most likely to be needed and most likely to be effective. In practice this means the focus is on the companies in our portfolios, or under consideration for our portfolios, where Herald believes that there are any of: governance issues surrounding the approach, composition, and compliance of the board; a failure to meet local governance standards; or where minority shareholder rights are not being protected. Clearly Herald has greater influence and responsibility where it is a significant or leading shareholder. Herald rarely collaborates directly with other shareholders to influence issuers, for fear of breaching concert party or market abuse rules. We will use corporate brokers and advisers where necessary.

In HWTF, Herald invests in some of the largest TMT companies in the world. Often the environmental and corporate governance standards of these large companies will be world-leading but our percentage of voting rights in these companies is very low which limits the need for, and effectiveness of, direct engagement. Nevertheless, it remains Herald's policy to vote all its clients' shares in all investee companies. Herald employs its long-term approach to investing in these large companies and exercises clients' voting rights whilst being pragmatic in understanding that the level of influence we wield is limited in some cases.

We believe that we should contribute to improving the health of the financial system in which we operate

One of the key longer-term systemic risks we have identified is that companies are less inclined to float on public markets, often preferring private funding.

The number of companies in the core markets of the US and the UK is reducing with takeovers far exceeding IPOs. In recent years private equity has gained assets and market share at the expense of the public markets. Private equity investors benefit from reduced regulatory costs, but lack of regulation can pose other risks. In addition, private equity benefits from more efficient tax structures, and often utilises more financial leverage. Financial leverage adds risk for the companies' stakeholders, including their employees, their suppliers, and their underlying investors, as well as for the wider economy. In addition, private equity has short time horizons and offers a form of ownership inferior to the permanent capital that the public markets have offered for extended periods.

Herald participates in market and industry associations, where relevant and effective, to help develop and improve market and corporate practice, regulation, and reporting. A particular focus is to promote the effective functioning of smaller company equity markets and so Herald engages with regulators, governments, and corporate governance bodies to try to ensure the rules and regulations used to govern such businesses are appropriate and proportionate to their scale. Herald contributes to the development of the rules that govern smaller companies through its participation in Quoted Company Alliance (‘QCA’) committees including the QCA secondary markets group and the QCA remuneration committee which produces the guide outlining best practice for UK small companies.

We believe in exercising the voting rights of our investors

Herald reviews the stewardship principles regularly with the independent boards of its clients and Herald exercises those clients’ votes. Voting decisions are made by investment managers and reflect all the knowledge they have on the industry, company and management as well as incorporating input from specialist information sources. We annually disclose a summary of our voting publicly and will, on request, disclose our detailed voting to the independent boards of our clients. We will not publicly disclose our detailed voting, on a company-by-company basis, as that may negatively impact our clients’ underlying investments.

Putting our belief in the value of good stewardship into practice – what we look for

Herald believes that good governance of a company will be key to helping deliver value creation for its clients. So, what do we mean by this and what do we look for?

A **simple capital structure**: we generally look for companies without financial engineering and encompassing good protection of minority shareholder rights. Entrepreneurial management and founder-led businesses have often created significant value in the TMT sector, and we welcome management holding significant equity stakes and encourage companies to require minimum shareholdings for executives. The use of preferential voting rights to sustain management control has mixed results for minority shareholders and we will evaluate such structures on a case-by-case basis. We are defenders of shareholder pre-emption rights and believe they are a fundamental shareholder protection. We are generally not in favour of poison pill takeover defences as they run the risk of entrenching weak management and believe that strong management will usually prevail in fending off a takeover approach at an unattractive valuation.

Focus on the **long-term creation** of value and not on manipulating near term profits. We are suspicious of companies that massage their earnings either by exotic accounting, financial engineering or by reducing investment.

Entrepreneurial and highly motivated executive management are key to a company's success and are best assisted in their endeavours by a strong, knowledgeable, and independent board. The board should have the capacity to challenge executives when required and equitably represent and balance the interests of minority shareholders and other stakeholders.

Remuneration should be focused on the achievement of long-term objectives and aligned with the interests of long-term shareholders. The reporting of management pay and incentives should be clear and where share-based incentives are used that dilute shareholder interests, the shareholders should have the opportunity to vote on such schemes. Whilst we recognise the importance of skilled, knowledgeable employees in building their company, we are wary of excessive dilution from share-based incentives.

The **governance** approach of companies should reflect their size, the stage in their corporate development and the expectations and limitations imposed on them by the societies and jurisdictions in which they operate. There is no single right answer and the approach to governance a company adopts should be to balance the interests of the various stakeholders to ensure that it thrives and succeeds in the long run. What works in practice is more important than what works in theory.

Longevity and sustainability of the companies in which we invest is critical for delivering long-term shareholder value and we believe that companies should comply with the letter and spirit of all regulatory, environmental, and legal guidelines in the jurisdictions in which they operate. We believe the long-run success of a business is only sustainable if a company considers its impact on society and the environment, and it should consider what information and plans for improvement they disclose publicly.

The articles of incorporation, country of incorporation and country of listing have a significant impact on the governance of a company, the influence of minority shareholders and the availability of minority shareholder protections. Some jurisdictions are clearly superior and some deficient in these governance areas and when investments are made in less favourable **jurisdictions** the scale of the expected reward needs to be sufficient to compensate for the risks of a relatively weak governance regime.

Summary

We believe that corporate governance and investment performance are inextricably linked

Herald considers and engages on corporate governance and stewardship as it believes that there is a strong link between good corporate governance and long-term investment performance. Herald invests in very small to very large companies across a broad range of geographic jurisdictions with varying standards of governance. Herald's percentage of voting rights, and hence influence, varies dramatically. We believe that a one size fits all or tick box approach to corporate governance is impractical. In many cases, what is an unconventional approach may prove to be the most effective and boards and companies that score highly, based on a tick box approach, may prove to be the least effective.

The quality of the boards and management teams of the companies in which we invest is a critical element in the quality of stewardship that Herald's investors receive

Herald's views on corporate governance are incorporated into its investment views on whether to buy, sell or hold clients' investee companies. Herald's opinions on the quality of corporate governance at different companies and whether it is improving or declining also influences how we vote and engage with management or the board of directors. The ideal is that we can rely on effective, responsible company management governed by a strong independent board and we believe that this is the primary protection of our clients' interests as long-term shareholders.