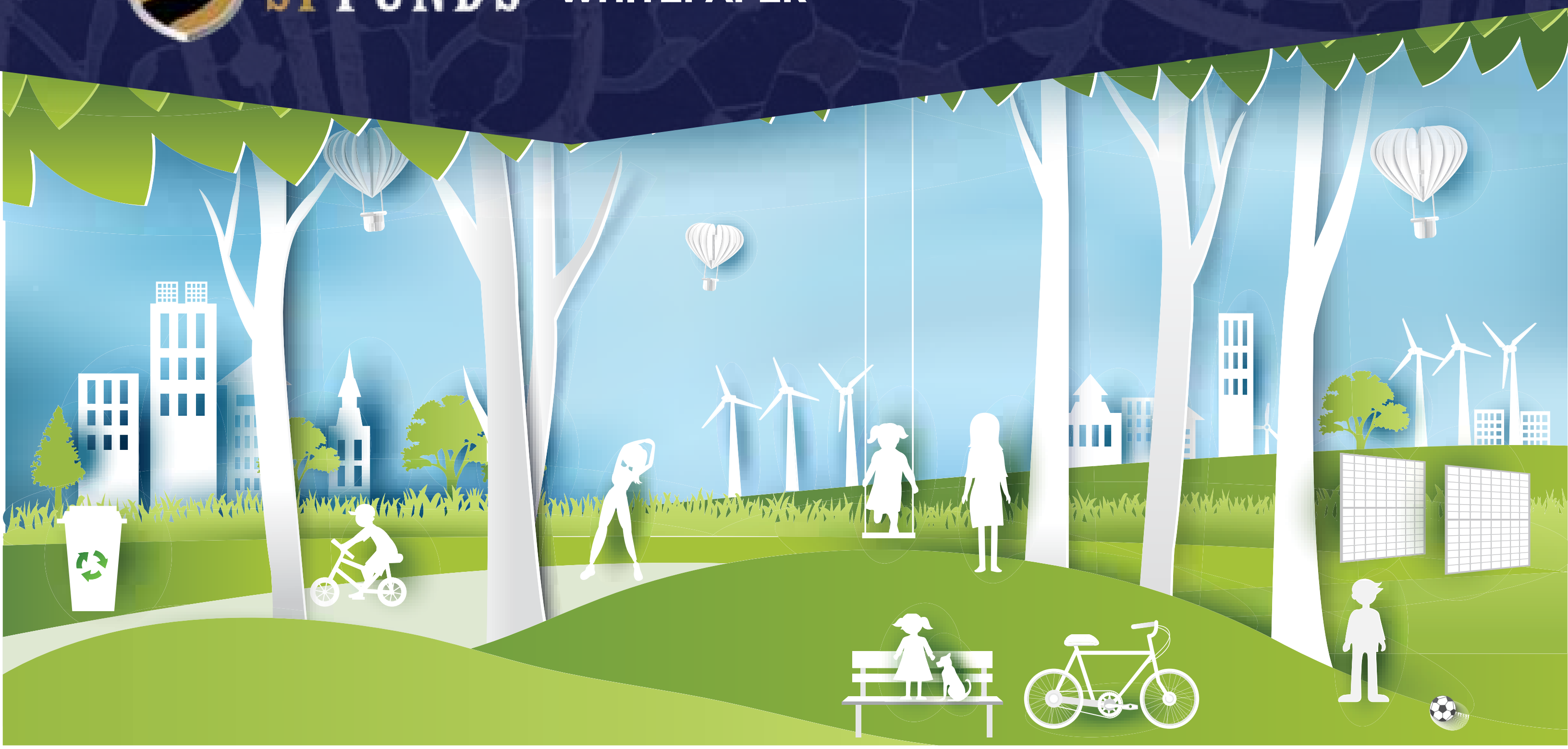
SP FUNDS WHITEPAPER



Environmental, Social and Governmental (ESG) Investing

By Irfan Chaudhry, Portfolio Manager, SP Funds

At SP Funds, our approach to responsible investing is based on consciousness of the fact that investors trust us in helping them to achieve their financial goals according to the principles of value-based investing without compromising their personal values.

Our main duty is to invest the funds according to the fund's mandate as outlined in the fund's investing prospectus and reduce the tracking error between the fund and the index. Our funds passively follow the Sharia investing style in an engaged and responsible manner, which replicates in the long term, risk adjusted performance of indexes we follow. This document sets out SP Fund's approach to responsible investing and how it overlaps with Sharia investing style. This includes an interpretation of SRI and ESG principles. It also gives an overall view of how our investment philosophy and resulting investing process integrates and subsumes best practises in environmental, social and governance (ESG) space. This also includes the steps for integration of ESG processes though leading activities.

What is responsible investing?

Sustainable investing is about investing in the companies which are best aligned to achieve evolving social, economic and scientific objectives of conducting business. It is also about aligning and promoting business values in accordance with the shareholders and the stake holders' values. From an investing perspective, environmental, social and governance (ESG) factors are increasingly being considered by the investors to achieve their investment objectives. General terms like "sustainable investment", "socially responsible investment", "responsible investment" and "ESG" refer to this distinct investing style. This will include the factors like employee satisfaction, carbon emission footprint, and reducing the agency affect, while avoiding businesses with higher ESG risk profile like weapon production, tobacco, and gambling in portfolio construction decisions. The United Nations Global Compact is the world's biggest social and corporate responsibility forum. It is a non-binding agreement which has outlined broad principles regarding human rights, labour, environment, and anti corruption for signatories to adhere to and report on. Responsible investment (RI) is an overarching term used to describe a broad range of approaches that can be used to incorporate ESG considerations into the investment process.

ESG Investing and/or Responsible Investing Includes Three Investment Strategies

ESG INTEGRATION

Systematically incorporating ESG factors into investment processes. The goal is to identify potential risks and opportunities and improve long-term, risk-adjusted returns.

SOCIALLY RESPONSIBLE INVESTING

Applying positive or negative screens to include or exclude companies from the investment universe based on a defined set of values.

ENGAGEMENT

Investing in securities of issuers that intend to generate a measurable positive social or environmental impact.

The CFA Institute has summarised ESG factors in its ESG Manual(1) for investors. Although this is not exhaustive, it contains some historic areas of concern to the investors. These areas also offer return and risk opportunities to the investors

Environmental

- Ecosystem change
- Facilities citing environmental risks
- Hazardous waste disposal/cleanup
- License to operate in communities
- Pollution
- Renewable energy
- Resource depletion
- Toxic chemical use and disposal
- Carbon emissions, disclosure/measurement, and reporting
- Climate change; effect on Company/ risk exposure/opportunities

Social

- Animal welfare
- Child labor
- Community relations
- Discrimination
- Facilities, citing social risks
- Genetically modified organisms
- Living wage disputes
- Predatory lending
- Political contributions
- Political risk of involvement in troubled markets, countries
- Sexual harassment
- Shareowner advisory vote on executive compensation
- Slave labor
- Diversity (employee/ Board diversity)

Governance

- Cumulative voting
- Dual class share structure
- Executive compensation (pay for performance, pay equity)
- Majority voting
- Poison pills
- Say on pay
- Separation of chairman/CEO position
- Shareowner rights
- Staggered Boards
- Takeover defenses/ market for control

1 - https://www.cfainstitute.org/-/media/documents/article/position-paper/esg-factors-at-listed-companies-a-manual-for-investors.ashx

Faith Based Investing as a Branch of ESG and SRI

Faith based investing based on a value system, on the other hand, is considered a part of sustainable or socially responsible investing. Consequently, in accordance with different religious standards, faith-based investment institutions reveals a considerable positive attitude with respect to environmental, social and governance (ESG) topics, or considering Corporate Social Responsibility (CSR)**(2)**, and with United Nations Social Development Goals (SDGs)**(3)** launched in 2015 and to be reached by 2030. The relation between faith and economics behaviors can be outlined by references to sets of principles in Islam, Christianity, and Judaism regarding use and possession of wealth. These principles among many others include avoiding usury, slavery, and gambling. The maximization of shareholder's wealth had been primary objective of traditional finance. The first faith-based fund in the US was the Pioneer Fund, launched in 1928 and the third oldest fund in the US. It kept away from investing in gambling, tobacco and alcohol companies lately known as "sin stocks". The purpose of Sharia finance is to improve living conditions and wellbeing, establish social equity, and prevent injustice in trade relations. The environment is also considered under the tenet of Islam that says man must play the role of steward over divine creation. In its application, waste and useless or superfluous consumption are deemed unacceptable. These elements closely resemble those of SRI: a keen focus on sustainable development, creation of wealth for society, and improvement of overall quality of life. The first Muslim equity mutual fund was created in 1963, by the Malaysian government. From the 1970s to 1990's, the rules of interest rejection and capital protection were combined with the will to earn a return. In the last decades, and especially after great financial crisis of 2008, faith-based investments have become a growing niche in the domain of ESG investing style. Resilience shown by faith-based investments during the sub-prime crisis has drawn increased attention of investors. The SP Funds**(4)** is one of the pioneers in the space of Sharia Investing. It launched an exchange traded fund, SPUS**(5)**, which follows the Sharia-compliant broad market index (S&P 500 Shariah Industry Exclusions Index**(6)**).

SP Fund's approach to responsible investing

While traditional finance has always been driven by an effort to maximise risk-adjusted returns, investors in Islamic finance and SRI have the additional goal of ensuring financial market activity is compatible with investors' ethics, and that they promote social welfare. Both sets of investors seek not only financial returns, but also societal returns. Shariah compliant stock investing differs from conventional investing because of a prohibition in receiving and paying interest and investing in "unethical" companies such as alcohol producers, and casinos. At SP Funds, we believe that:

- Being an engaged and responsible investor empowers us to enhance the long-term, sustainable performance of our Sharia-compliant funds.
- We believe that the companies passing Sharia screen helps us to identify environmental, social and governance (ESG) risks and opportunities by the companies in which we are invested is critical to strengthening the overall performance of our portfolios. ESG factors are integrated in our process through Sharia-compliance.
- Our investment process implicitly manages material ESG risks and opportunities
- Our commitment to integrate ESG factors through Sharia-compliance into our investment process is firm wide.
- Initiatives that increase transparency and foster fair and efficient markets benefit all investors and clients globally
- Collaboration with like-minded investors may give us greater influence on issues that are material to our investments

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2- https://www.investopedia.com/terms/c/corp-social-responsibility.asp
3- https://sustainabledevelopment.un.org/?menu=1300
4- https://sp-funds.com/
5- https://www.sp-funds.com/spus
6- https://www.spglobal.com/spdji/en/indices/equity/sp-500-shariah-industry-exclusions-index/#overview

Our RI Investment Strategies

Although there is no official standard process for selecting companies which rank high on ESG parameters, the table below outlines different responsible investing strategies, which follow those developed by the CFA Institute**(7)**. These same strategies were highlighted by why and how institutional investors use ESG information.

Screening:

- Negative screening: The exclusion from a portfolio of certain sectors, companies, or practices based on specific ESG criteria.
- Positive/best-in-class screening: Investment in companies selected for positive ESG performance relative to industry peers.
- Norm-based screening: Screening of investments against minimum standards of business practice based on international norms.
- Thematic: Investment in assets specifically related to sustainability (e.g., clean energy, green technology, or sustainable agriculture).

Integration:

- The systematic and explicit inclusion of ESG factors into financial analysis.

Engagement:

- Individual: The investor's internal staff using shareholder power to influence corporate behavior, including through direct corporate engagement (i.e., communicating with senior management and company boards) and filing shareholder proposals.
- Collaborative: The conduct of corporate engagement, as defined above; however, it is undertaken jointly with other investors.
- Internal voting: The use of proxy voting guided by ESG guidelines where the voting decisions are undertaken internally and not outsourced to an external service provider.

The concept of development in Islam has three dimensions – self, Earth, and society – and all three dimensions assign heavy responsibility on individuals and society. If balanced development is defined as progress, positive or impact screening could open many new doors for the Islamic investor by uniting investments that generate measurable positive social impacts. Sharia investing integrates environmental, social and governance criteria (ESG) into financial analyses. This strategy ushers' various ethical criteria into the mainstream financial industry and helps close the gaps between conventional and SRI investments. Negative screening, the most common strategy of SRI is the simple avoidance of businesses that fail to meet the investors' ethical and moral standards, is similarly used in Sharia investing for avoiding activities or structures prohibited by Sharia. In the last decade, though, SRI investors have actively explored positive 'impact screening' techniques – an active search for businesses that have proven their beneficial social or environmental impacts.

Unlike what may be the case for SRI, Islamic finance does not explicitly exclude issuers guilty of the worst social and environmental practises. Nevertheless, a report by OWW Consulting**(8)** , a CSR (corporate social responsibility) and SRI consulting firm in Southeast Asia, highlighted the compatibility between the tenets of Islam and those of the United Nations (UN) Global Compact . The UN Global Compact**(9)** is a strategic policy initiative for businesses that are committed to aligning their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment, and anti-corruption. These principles draw on the standard references in these areas, including the Universal Declaration of Human Rights**(10)**, the International Labour Organisation Declaration on Fundamental Principles and Rights at

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7- https://www.cfainstitute.org/en/advocacy/issues/esg-sustainable-investing

8- https://www.sri-connect.com/index.php?option=com_comprofiler&task=userProfile&user=1030327&Itemid=4

9- https://www.unglobalcompact.org/

10- https://www.un.org/en/universal-declaration-human-rights/

Work(11), the Rio Declaration on Environment and Development(12) and the UN Convention against Corruption(13). It should be noted that the Global Compact does not enforce any regulation, nor does it measure or review the practices of signatories. OWW Consulting's report describes how the tenets of Islam comply with each of these principles, despite being based on different sources and motivations and often stricter ethical standards.

SP Funds investment process integrates ESG criteria within the investment process through Sharia screens on a confluence of research and performance. The same process is used to screen the companies to be included in the passive ETF, the SP Funds S&P 500 Sharia Industry Exclusions ETF (SPUS), which scores higher in ESG. ETFdb.com(14), which uses similar ESG criteria to rank ETFs compliance to ESG parameters, ranks SPUS as 86.02% global percentile and 93.66% peer percentile

How Our Investment Process Overlaps With ESG
Overall, SRI and Shariah compliant stock investing seem to be driven by roughly the same (micro) factors. However, there are other factors like leverage, and operating leverage which implies higher business quality and income sheet quality may affect the valuation of Shariah compliant stocks behaviour during varying market cycles. This also endows them with better defensive characteristics. The discussion above shows that Shariah compliant stock investing is part of SRI, not only, exclusion-based SRI but also social, and governance-based parameters. Thus, research on SRI might also give insights into Shariah compliant stock investing. However, given the diversity of SRI strategies and given that perception that Shariah compliant stock investing typically only uses exclusion may cloud that comparison.

Social Value Creation: Islam may be considered a system of standards based on moral and ethical values. The purpose of Islamic finance is to improve living conditions and well-being, establish social equity and prevent injustice in trade relations. This is precisely the reasoning behind the prohibition of usury and its replacement with a system whereby profits and risk are shared more equally. This purpose resembles that of SRI as it has developed in recent years, with its focus on sustainable development in its economic and social principles – creation of wealth for society and improvement in the quality of life. Islam restricts the ability of Muslims to invest only in Shariah compliant stocks. Sharia-compliant investing style excludes some businesses from inclusion in the portfolios. These include businesses based on loan and interest charges on loans like banks, credit card companies etc., alcohol, gambling, defense, and weapon production. This would discourage predatory lending, speculation, wars, conflicts, exposure to countries with troubled background, health concerns.

Governance Value Creation: Corporate governance is as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." There always has been a fundamental principal–agent problem, commonly referred to as the separation of ownership and control. The classical examples include executive perks, such as corporate jets "empire-building", or enjoying the benefits of a so-called quiet life. There is an extensive evidence of agency costs and differences in corporate governance systems around the world related to the level of legal protection of investor rights. Increase in debt vs equity had been used as a mean to counter the agency problems. This may act as a disciplinary measure on the management and stop them from empire building or frivolous new projects. Further reduction of the cash on the balance sheet is helpful in combating the management wasteful activities, which goes to the heart of corporate governance. Sharia investing's screens against more levered companies (>30% debt/mkt cap) and higher cash companies (less than 33% pf total assets) should be inherently biased against selecting the companies who has governance issues, which in this case is being represented by higher leverage and higher balance sheet cash. This effectively will result in selecting those companies which are better at the "G" part of ESG.

11- https://www.cfainstitute.org/en/advocacy/issues/esg-sustainable-investing
12- https://www.sri-connect.com/index.php?option=com_comprofiler&task=userProfile&user=1030327&Itemid=4
13- https://www.unglobalcompact.org/
14- https://www.un.org/en/universal-declaration-human-rights/

Environmental Value Creation: The environment is also considered in Islamic finance – one of the tenets of Islam is that man plays the role of steward over divine creation. God's creation, which encompasses not only nature and the environment but also humans and society, belongs to God and is entrusted to man, who is vested with the duty of maintaining and managing the earth on God's behalf. The application of this principle is often that wasteful and useless, superfluous consumption are unacceptable. Although Sharia stock selection does not expressly include any environmental factors. However most of the companies in the higher carbon emission foot print space seem to have higher debts on their balance sheet and tend to retain cash, which instead being used to invest for value creation is returned to share holders through buy backs or dividends. This may result in those companies passing Sharia screens which have lower carbon footprint and hence environmentally safe. This is one of the most discussed and important characteristics of environmentally friendly businesses

Quality, Performance and Risk
Most of studies on SRI found a nonnegative relationship between ESG and financial performance. These results are consistent with the existence of societal norms against funding "sin" activities. As mentioned previously, the intuition is that the reduction in demand resulting from investors being unwilling to hold companies with poor ESG exposures translates into lower stock prices. There is an active debate on the performance of funds focused on SRI/ESG investing. ESG advocates and firms that offer sustainable financial products sometimes claim that ESG investing can enhance returns because of markets underpricing non ESG information. As mentioned previously, the intuition is that the reduction in demand resulting from investors being unwilling to hold companies with poor ESG exposures translates into lower stock prices.

Sharia investing is seen as the extension of responsible investment, as it highlights the importance of due diligence and transparency of investment structures, processes, and reporting, and has clear understanding of the underlying risks, structures, and cash flows. Sharia investing also is designed in a way that ensures the quality of its portfolios through its prudent elements, to avoid high and undue risks. Islamic portfolios have outperformed during bear market conditions. This proposition was tested during the recent financial market crash of 2008/2009 and COVID related swoon, and it was apparent that Islamic ETFs outperformed conventional benchmarks during these turbulent times. Moreover, while recovering from COVID 19 bear market, Sharia-compliant exchange traded fund SPUS outperformed broad market indices. As the global economy continues to face the challenges of a high-risk environment, SP Funds ETF promises a bright future and represents a compelling proposition. Relative to strategies that involve traditional SRI only, Sharia based ethical investing not only avoids high financial risks but has the potential to deliver and enhance long-term risk-adjusted returns, which is a key factor for investors. This represents a diversified investment option that allow people who lack the knowledge, skill, or time to manage their own wealth and prosper from the returns of equity markets.

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Before investing you should carefully consider the Fund's investment objectives, risks, charges, and expenses. This and other information is in the prospectus. A prospectus may be obtained by clicking here. Please read the prospectus carefully before you invest.

Investing involves risk including loss of principal. As with all ETFs, Fund shares may be bought and sold in the secondary market at market prices. The market price normally should approximate the Fund's net asset value per share (NAV), but the market price sometimes may be higher or lower than the NAV. The Fund is new with a limited operating history.

Islamic religious law commonly known as Sharia has certain restrictions regarding finance and commercial activities permitted for Muslims, including interest restrictions and prohibited industries, which reduces the size of the overall universe in which the Fund can invest. The strategy to reduce the investable universe may limit investment opportunities and adversely affect the Fund's performance, especially in comparison to a more diversified fund.

Equity securities, such as common stocks, are subject to market, economic and business risks that may cause their prices to fluctuate.

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