COMMENTARY

May 11, 2018

Dear clients and colleagues,

Last October we talked about the increasing interest in Environmental, Social and Governance (ESG) factors and reported on our portfolio's annual carbon footprint. We have been proactively improving our responsible investing practices since then and are now pleased to provide a report on the progress we have made so far and on some events we recently attended.

ESG Events

The Western North American Network

This week we attended the Western North American Network organized by The Principles for Responsible Investment (PRI). Attended by more than 70 asset owners, investment managers and service providers from the west coast of United States and Canada, the two-day meeting updated us on the recent trends within responsible investing and provided guidelines on how we can move our practice one step forward.

The PRI is an independent organization that encourages investors to use responsible investment to enhance returns and better manage risks. It engages with global policymakers and is supported by the United Nations. Global Alpha has been a signatory to UNPRI since 2012.

It was commonly agreed by the speakers and discussion panelists that responsible investing should be integrated into the investment process instead of being a "Checklist Washing" practice. As investors, we should consider ESG risks along with macroeconomic, geopolitical and other risks when making investment decisions. Responsible investing is an inevitable trend and requires a high level of collaboration. We were pleased to see that many asset owners, investment managers and industry associations were willing to share their thoughts and practices.

Climate Risk Reporting and HLEG Recommendations Webinar

This webinar was provided by ISS-Ethix Climate Solutions. The discussion was focused on different climate-related reporting regimes. Europe has been leading the way on climate-related reporting. European companies are encouraged to adopt the Task Force on Climate-related Financial Disclosure (TCFD) for more transparent and consistent climate-related financial risk disclosures. The adoption of TCFD is currently voluntary, but European regulators are seeking to make the disclosure mandatory. For investors, in 2015, France became the first country to introduce mandatory climate change-related reporting for institutional investors with the adoption of Article 173 of the French Energy Transition Law. It requires investors to disclose how they factor ESG criteria and carbon-related aspects into their investment policies. Other countries are working on similar laws.

We also attended the *Engaging Clients around Responsible Investment* seminar organized by the Responsible Investment Association (RIA), where we saw increasing interest in responsible investment from both institutional and retail investors, and the *Integrating ESG into Passive, Active and Factor Portfolios* seminar organized by MSCI on how ESG ratings have a material financial impact on stock returns.

Our ESG Approach

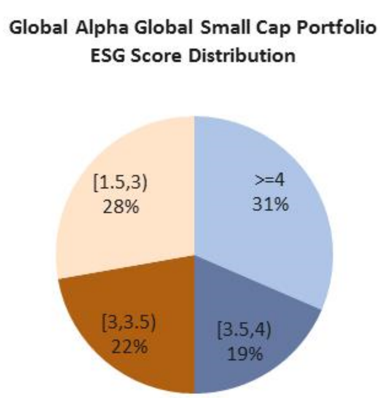
At Global Alpha, we value responsible investment and proactively seek ways to integrate ESG factors into our fundamental analysis in a meaningful way, not just ticking boxes. Here is how we implement ESG considerations into our investment process:

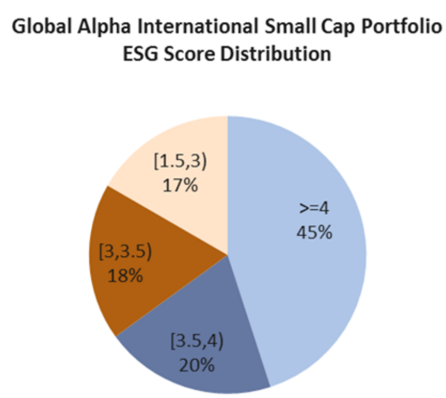
ESG Score

Because small caps are not well covered by ESG service providers such as MSCI or Sustainalytics, we collect raw ESG data by ourselves, through company websites, reports and meetings with management, and calculate an ESG score for each company. For all portfolio holdings, such information is held in a centralized database and is accessible by the entire investment team.

There are five categories in the ESG score (Reporting, E, S, G and Recognition). The maximum score in each category is 1; therefore, the maximum total ESG score is 5. The minimum ESG score required for our holdings is 1.5, with at least 0.5 in the E, S and G categories. We score companies relative to their industry peers.

As of March 31, 2018, the Global Alpha Global Small Cap portfolio has an average ESG score of 3.45, and the International Small Cap portfolio has an average ESG Score of 3.74.





Discount Rate Adjustment

This score is used to adjust the discount rate in discounted cash flow valuations. A high ESG score means low ESG risk, and vice versa. Depending on the ESG score, the discount rate is adjusted in a linear manner. A 5%-10% premium over the original discount rate will be given to companies that scored lower, and a 5%-10% discount will be given to ones that scored higher. No adjustment is needed for companies with scores between 3 and 3.5.

The rationale behind this is that a company with better ESG performance will have a higher risk-adjusted return. In an article published on the MSCI website (www.msci.com) — *Has ESG Affected Stock Performance?* by Guido Giese — the author examines three transmission channels through a DCF model, namely the cash-flow channel, idiosyncratic risk channel and valuation channel. First, in the cash-flow channel, according to the study, "high ESG-rated companies are more competitive and can generate abnormal returns, leading to higher profitability and dividend payments" due to their more efficient use of resources and human capital. Second, in the stock-specific channel, high ESG-rated companies "have a lower probability of suffering incidents that can impact their share price" because they employ better risk management systems. Third, in the valuation channel, high ESG-scored companies have lower exposure to systematic risk factors, which leads to a lower cost of capital and higher valuations. We believe our ESG-adjusted valuation provides a better reflection of a company's intrinsic value.

After the decision is made to invest in a stock, we will send the company two documents that we developed last year: the ESG Questionnaire and CEO Remuneration Guidelines. Our aim is to engage with companies about their ESG practices and our views on key ESG issues. The CEO Remuneration Guidelines is also available on our website.

Our weekly update ends here, but our attempts for a better responsible investing approach continue. We are currently working on establishing our own proxy voting policies and will keep you updated.

Have a great weekend.

The Global Alpha team