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Not much joy for investors here

Company/ASX Code	Challenger Limited/CGF
AGM date	31 October 2019
Time and location	9.30 am Wesley Centre, 220 Pitt Street, Sydney
Registry	Computershare
Webcast	No
Poll or show of hands	Poll on all items
Monitor	Elizabeth Fish assisted by Lewis Gomes
Pre-AGM Meeting?	Yes, with Chair Peter Polson and Stuart Kingham

Item 1	**Consideration of accounts and reports**
ASA Vote	No vote required

Summary of ASA Position

Having outperformed the share market in the past, Challenger has had two very difficult years. During 2019 Financial Year (FY19) the share price dropped from $11.83 to $6.64, resulting in a total shareholder return of negative 41%. Statutory net profit of $307.8m was down 5% on FY18. Life annuity sales were at $3.5b (billion), also down 11.4% on 2018. Funds under management (FUM) increased by $1b to $79b although net income to Fidante Partners and Challenger Investment Partners decreased by $1.3m due to reduced performance and fee income. The net outflow from the Funds Management segment was $2.4b and included $3.9b from the loss of a major Australian Superannuation Fund.

At the pre-AGM meeting we asked the Chair why there has been such a drop in share price. He said he thought that perhaps the company had been overvalued on the share-market and the share price was rather a function of expectation than reality.

We asked if the Board had any thoughts regarding changing or adding to the single long-term incentive (LTI) target, presently, total shareholder return (TSR) of 10%. The TSR calculation relies heavily on an increasing share price as well as dividends received. Mr Polson said that the board considered TSR was the best method of aligning management interests with that of shareholders, and he did not expect that that measure would change. The ASA considers TSR is a good measure but believes an additional hurdle linked to the company's long-term goals should be part of an LTI scheme.

Challenger's FY19 annuity sales were reduced by 4% on FY18 figures. Management blamed this reduction primarily on disruption to the financial advice market by findings of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (RC). As a result of the RC findings, Challenger is evolving a service model where an increased proportion of financial advice will come from independent financial advisors, rather than those affiliated with the major financial institutions. At the 2018 AGM, a shareholder asked if the Chair expected the RC findings would have an impact on Challenger's business. At that time, the Chair's response was that he did not anticipate any of the Commissions' findings would affect the business.

At the 2019 pre-AGM meeting, the monitor asked the Chair if he had been aware of the ongoing fee arrangements, grandfathered commissions and lack of disclosure that applied to many of the affiliated advisors who also marketed Challenger's products and he said he had been unaware of the situation. He added that Challenger had paid commissions to advisors until 2014 when they were banned on new sales. Where business was written prior to 2014 Challenger now requires the client to confirm that the advisor still provides a service to them. If not confirmed, the commission is paid to the client rather than the advisor.

The FY19 annuity sales from the Japan business dropped down 54% on FY18 and 56% on FY17. At the pre-AGM meeting, the Mr Polson explained that as a consequence of the FY19 strategic relationship agreement with Japanese insurance company MS&AD, starting from July 2019, the Japan annuity business is guaranteed to deliver sales of $700m per annum (pa) based on current exchange rates, over the next five years.

In addition to annuity sales, Challenger has moved into the fund management business in Japan. Japanese asset management licences were granted during the year. Challenger has commenced managing some property assets and is working toward distributing some Fidante Partners boutiques in Japan. The financial performance of the Japanese business is included in Funds Management and it is not expected the Japanese funds management business will be reported on separately.

As part of new reinsurance arrangements, MS&AD has announced its intention to increase its shareholding in Challenger to over 15% of issued capital and seek representation on the Challenger Limited Board. On 30 June 2019, MS&AD held 16% of Challenger's issued capital. A representative from MS&AD joined the Challenger Board in August 2019. Caledonia (Private) Investments increased their holdings from 12 to over 15% in the year.

There were no material acquisitions or disposals of controlled entities during the year, apart from disposal of Oikos Storage a bulk fuel and storage infrastructure business in the U.K. This disposal resulted in a goodwill impairment of $14.3m.

The retirement of Mr Brian Benari the company CEO was announced at the 2018 AGM. Mr Benari transferred to a non-key management personnel (KMP) role on 2 January 2019 as transition to retirement and left the company on 30 June 2019. The new CEO Mr Richard Howes has held a number of executive roles since joining Challenger in 2003, the most recent being Chief Executive, Distribution, Product and Marketing. We are pleased to see a female joining the list of KMP as Ms Angela Murphy steps into Mr Howes' vacated position.

Challenger has set diversity target for women in management of 38% to 40%. At 30 June 2019, 37% of management roles were held by women. Two of the seven Non-Executive Directors (NEDs) are women bringing overall female representation on the board to 28.7% which is a little lower than ASA's recommended minimum of 30%. Headcount at 30 June 2019 was 687 fulltime employees. According to Challenger's Diversity Policy, women in all roles, the company is targeting an FY20 target of at least 45% of women in all roles with 40% in management and 30% on the Board. In contrast, BHP has set a target of achieving a 50% female workforce by 2025 – a challenging target that might be harder to achieve considering the biases and limitations particular to the mining and resources sector.

Changes to the Board of Directors included Mr Graham Cubbin, a NED resigning. Mr Cubbin had been on the board since 2004. Mr Benari stepped down in January 2019 and was replaced by Mr Howes. Ms M Willis, Mr D West and Mr J Green were elected to the Board as NEDs at the 2018 AGM. An executive of MS&AD, Mr Masahiko Kobayashi, joined the Board in August.

The company has had a policy in place for some years to assure alignment with shareholders interest by requiring NEDs to hold shares equivalent to one year's base fees after a qualifying period. It is disappointing to see that at least two NEDs still do not meet this requirement. The matter has been raised with the Chair on several occasions but dismissed as unimportant. ASA does not understand why an organisation implements a policy to fulfil a particular aim then allows it to be ignored. Challenger should ensure all NEDs comply with the policy.

Summary

(As at FYE)	**2019**	**2018**	**2017**	**2016**	**2015**
NPAT ($m)	307.8	322.5	397.6	327.7	299.0
UPAT ($m)	396.1	406.1	384.9	361.7	334.0
Share price ($)	6.64	11.83	13.34	8.63	6.72
Dividend (cents)	35.5	35.5	34.5	32.5	30.0
TSR (%)	-41%	-8%	58.6%	37.6%	-.56%
EPS (cents)	50.9	54	70.7	58.5	54.8
CEO total remuneration, actual ($m)	5.4	11.6	7.2	9.3	8.9

For 2019, the CEO's total actual remuneration was **62 times** the Australian Full Time Adult Average Weekly Total Earnings (based on May 2019 data from the Australian Bureau of Statistics).

While, the CEO's 2019 remuneration does appear to vary significantly from that paid in 2018, it should be noted that Mr Howes commenced his CEO role in January 2019. Further, the Board have set the CEO's fixed pay to $1.275m pa and short-term incentive (STI) has been capped at 200% of fixed pay.

Item 2 (a)	**Re-election of Peter Polson as a Director**
ASA Vote	**Against**

Summary of ASA Position

Mr Peter Polson was first appointed to the Challenger Board in November 2003 and has held role of Chair since 2004. He holds a Bachelor of Commerce (Witwatersrand University, South Africa), Master of Business Leadership (University of South Africa) and has completed the Management Development Programme (Harvard Graduate School of Education). He has international experience in banking, insurance and funds management having held senior executive positions with the Commonwealth Bank and Colonial First State Limited. Mr Polson is Chair of the Nominations Committee and is also a member of the Group Risk Committee, the Group Audit Committee, the Group Audit Committee and the Remuneration Committee. He holds one other non-executive directorship as Chair of IDP Education Limited.

In the notice of meeting, Mr Polson has advised that should he be re-elected, he does not anticipate seeking a further term. He expects that in this next term he will complete the Board renewal process. Mr Polson made a similar statement regarding re-election in 2016. At the pre-AGM meeting he said that if elected he may not complete the full term.

Mr Polson holds 122,000 shares the value of which at 30 June 2019 is more than the minimum shareholding guidelines for Chair of $525,500 or one times base fees. There are 8 other NEDs on the Board and one Executive Director and a representative from MS Primary. The last two are not considered to be independent and if we were to support the proposed re-election that would mean three non-independent board members. The ASA will not support Mr Polson's re-election to the board given his period of tenure.

Item 2 (b)	**Election of Mr Masahiko Kobayashi as a Director**
ASA Vote	**Undecided**

Mr Kobayashi holds an executive position with MS Primary, a subsidiary of MS&AD, as Director and Managing Executive Officer (Corporate Planning Risk Management and Finance). He has held several executive positions for Japanese companies in Singapore and the United Kingdom. He holds a Bachelor of Law from Kyoto University and an MBA from the Questrom School of Business, Boston University. Mr Kobayashi joined the board in March 2019 as a result of MS&AD increasing its Challenger shareholding to over 15% of issued capital.

He will sit on the nominations subcommittee but is not considered to be an independent director. This means there are now two non-independent directors on this board. We have not been told which particular skills Mr Kobayashi brings to the board. We hope he will speak to the meeting and help ASA decide how we will direct open proxies.

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

Summary of ASA Position

The remuneration report is mostly clear and easy to understand. Changes to the methodology used in earlier years are as follows: extension of the vesting period of STIfrom 2 to 4 years: Extension of the vesting period for LTI from 3 to 4 years. Use of VWAP (volume weighted average price) to calculate the number of LTI HPSRs (Hurdled Performance Share Rights) awarded. Dividends no longer paid on unvested HPSRS. For all KMP maximum STI award is set at 200% of fixed salary and maximum LTI at 225%.

None of the tables shown in the AR 19, reflect actual take home pay as advocated by the ASA. Following is a table showing actual remuneration which includes equity awards that vested in FY 19 and distribution of dividends on unvested shares, that is Deferred Performance Share Rights (DPSRs). Vesting DPSRs and HPSRs are valued at the VWAP in the five days prior to the grant in September 2017 of $10.37.

KMP Take home Pay	Fixed	Cash STI	DPSRs	HPSRs	Trust Dist.	Total
B Benari	683,490	510,000	1,645,956	4,936,033	56,930	7,832,769
R Howes	995,540	625,000	1,148,038	2,600,912	71,450	5,440,940
A Murphy	335,127	145,833	0	0	7,797	488,757
I Saines	831,136	372,500	789,018	2,599,129	43,677	4,635,460
A Tobin	709,205	425,000	750,719	1,777,856	46,707	3,709,487
C Plater	743,453	494,000	803,968	1,036,313	58,369	3,136,104

To establish the quantum of STI awarded, the Board uses a balanced scorecard, with specific objectives for each KMP (page 31 annual report). There are some changes to the scorecard used in earlier years. In FY 2019 the board used a balanced scorecard however the specific objectives for each KMP is unclear. In the published scorecards, there are three groups of measures; 60% are verifiable financial performance metrics, 20% are based on surveys of risk culture and employee engagement, with the remaining 20% based on strategic distribution initiatives. Two of the four financial performance metrics are measured against normalised rather that statutory measures, which is disappointing as over the last five years normalised profit is inflated by $228.2m due the "investment experience" and the fact of the change in July 2018 to accounting standards, requiring unrealised gains and losses to be included in the company's reported earnings.

The FY19 outcome in each group is measured in terms of full or partial achievement. The financials based on core measures, only partially achieved the target. The remaining groups targets are shown as fully achieved. The ASA expects that the remuneration report should include a table showing % of available STI awarded to each KMP, as was recommended in 2018. Calculations from available information indicate that the CEO was awarded 49% of his STI target, other KMPs were awarded between 45% and 68% of their targets.

STI incentives are granted in September following the June year end, paid partially in cash and partially in equity (DPSRs). The equity awarded is deferred 30% for each of year 1 and 2 and then 20% for each of year 3 and 4. The number of DPSRs granted is determined by the 5-day VWAP of Challenger prior to the September grant date.

From 2019 the long-term equity-based incentive plan, (HPSRs) use a 5-day VWAP methodology to calculate the number of performance rights allocated. LTI has only one hurdle; absolute TSR compounded annually, set at target of 10% pa over 4 years. Prior to 2017, this target was 12% pa. From 2017 onwards 50% of HPSR awards vest at 7%, then on a straight line until 10% is reached. ASA notes from table 4.8 of the Remuneration Report that TSR outcomes for grants made in 2014, and 15 were 100%, 95% respectively. Two thirds of HPSRs awarded are eligible to commence vesting on the third anniversary of the grant the remaining third on the fourth anniversary. HPSRs granted after 2019 will not vest until the fourth anniversary of the grant, and will be subject to retesting on the 5th anniversary. No HSPRs vested to KMP at September 2019 due to deterioration of TSR performance.

Following is a summary of the CEO's maximum remuneration opportunity for 2019. As specific target amounts have not been reported in the remuneration report, the table only includes the maximum opportunity the CEO can earn for FY19. ASA would prefer clearer target definitions to be presented as part of the remuneration report.

CEO	Maximum Opportunity $m	% Total
Fixed Remuneration	1.275	19%
STI Cash	1.275	19%
STI Deferred Cash	1.275	19%
LTI Equity	2.869	43%
Total	6.694	100%

We note that overall KMP take home pay has decreased by 20% over FY18, even though Mr Benari remained as outgoing CEO until 30 June and Mr Howes became CEO in February. Cash STI was down 50% and fewer HPSRs vested in September 2018 (1.2m against 1.36m). Dividends paid on unvested HPSRs are no longer distributed to beneficiaries. The only fixed pay increase for the year was a $50,000 increased to the Chief Executive and Chief Investment Officer Life.

NED board fees have remained the same as in FY18 however two subcommittee (Group Risk and Audit) Chair fees have increased, by $17,000 each. There were similar subcommittee member fee increases in 2018.

Item 4	**Approval of Long Term hurdled performance share rights to the Chief Executive Officer.**
ASA Vote	**For**

Summary of ASA Position

Shareholders are asked to approve the grant to Mr Howes for HPSRs (432,183) to the value of $2.868m being his LTI award for FY19.

From 2019 the long-term equity-based incentive plan is awarded in the form of HPSRs, which represent the right to receive a fully paid ordinary Challenger share for nil consideration, subject to continued employment. A 5-day VWAP methodology is used to calculate the number of performance rights allocated. LTI has only one hurdle; absolute TSR compounded annually, set at target of 10% pa over 4 years. From 2017 onwards 50% of HPSR awards vest at meeting 7% of the target, then on a straight line until 10% is reached. From 2019, the total number of HPSRs awarded is eligible to vest on the fourth anniversary of the grant. There is a retesting provision on the 5th anniversary for any remaining HPSRs.

The individuals involved in the preparation of this voting intention have shareholdings in this company.