AB INTERNATIONAL HEALTH CARE PORTFOLIO

ENGAGEMENT REPORT: 1H 2021

During the first half of 2021, AB portfolio managers and analysts engaged with the senior management and/or boards of directors of companies held by the AB International Health Care Portfolio. Summary reports of engagements with UnitedHealth Group, Vertex Pharmaceuticals, Intuitive Surgical and Mettler-Toledo International during the period follow.

Research is the core of investing at AB, and we firmly believe that ESG integration drives better research and outcomes for investors. It's essential to engage directly with company management to understand the ESG factors a company faces and incorporate them into the risk/return assessment for every security we analyze. As active investors, we also use engagement to encourage firms to advance their business activities and practices.

EXAMPLE ENGAGEMENTS ON ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES

+ **UnitedHealth Group** (health care). During the period we met with the chief human resources officer (CHRO) and a member of the board. We came away impressed with programs under way around human capital development.

The CHRO—who was recently appointed a named executive officer (NEO)—is just two years into the role and has transformed the company's talent process, which is centered around an "employee experience index" (EE Index). The EE Index processes active and passive touchpoints and creates a range of potential actions: from adjusting pay to targeting leaders for development programs to identifying replacement headcount to analyzing productivity. Perhaps even more important is a more granular tool that allows management to zero in on a local team and/or an individual employee's experience. While the quality of some output of the EE Index appears aspirational, early results, in our opinion, are tangible: productivity is up, retention increased 20% and attracting new talent increased 12%.

We learned that 10,000 employees received stock options, which management would like to expand, perhaps even double in the next year with a focus on Optum employees. An analysis project is planned for later this year to better understand value and incentives and where to put compensation dollars, among other priorities. In terms of executive compensation, the company increased the weight of operating income, decreased the weights of revenue and cash flow and added a stewardship element. There are value-based care metrics in NEO and other leadership compensation plans, although we believe they are somewhat discretionary versus quantitative. Internal pay equity and wealth accumulation analysis have been added to the compensation process. UnitedHealth Group's Net Promoter Score was down slightly year over year, a key metric that management monitors closely.

Our overall ESG assessment for UnitedHealth Group remains strong: the company continues to be an industry leader in terms of people programs, is increasing its orientation around value-based care and is thinking thoughtfully about how it uses compensation dollars.

+ **Vertex Pharmaceuticals** (health care). During the period we met with the heads of human resources and compensation to learn more about the company's recently completed wage/benefit/development value analysis program. The company also completed a comprehensive employee feedback survey and expects to roll out new initiatives this summer that are team and role based. Management indicated these efforts will allow them to understand the value add of every compensation dollar, increase retention and attraction metrics, and reduce (costly) external talent hires where possible. The company also plans to launch an internal career hub that uses artificial intelligence to pair employees with career opportunities and recommend, track and measure professional development progress. New, more comprehensive professional development paths have been

identified for research and development employees, which while positive, makes us wonder if management is solving for a problem rather than enhancing what current programs offer; this will be monitored.

In terms of compensation, we calculate that median pay for employees remains 7% higher than the biotechnology industry more broadly and is much higher than compensation at direct peer companies, even though compensation at Vertex decreased 5% year over year. The 20% increase in stock-based compensation was due to head-count growth (bringing median pay down). Turnover was down 30%, which is likely due to COVID-19. The company's pivot away from options is complete for executives and most employees.

Our overall ESG assessment improved based on improved and unique people programs and overall cultural strength, however executive compensation still lags. We continue to push for stronger financial goals, performance measurement metrics, improvements to political disclosures and demonstrated improvement in cybersecurity risk preparedness and disclosure.

+ **Intuitive Surgical** (health care). During the period, we spoke with the chair of the compensation committee and shared our views on how to improve the company's executive compensation plan to better align with our philosophy, be an example for others and introduce value-based goals. Although the compensation plan uses high levels of discretion and adjustments, we give management credit for doing a lot right. Unquestionably, executives are underpaid on a granted basis versus their market value. Indeed, Intuitive Surgical does something that almost no other company does: it accounts for the realized executive compensation experience when deciding about how much to award NEOs going forward. In addition, there is a focus on rotating compensation from the top to the next two tiers of talent, as well as an emphasis on succession and innovation. Management makes a fair point that GAAP-driven compensation metrics can be difficult given imperfections of the Black-Scholes model. While the board member could have been better on certain details, he was genuinely receptive and focused on the connection between compensation and culture.
We will continue to monitor future developments in this area and are encouraged the engagement narrative with management continues to paint a strong cultural picture.

+ **Mettler-Toledo International** (health care). We came away from a recent engagement call with the chairman of the board disappointed in terms of the company's governance practices.

The company's board composition remains a concern. The chairman (and former CEO from 1993 to 2007) and the lead independent director have both served on the board for 25 years and collectively hold five of six board leadership roles. Two former CEOs sit on the board and are non-independent, in our view. The board chair receives an unusually high salary: he is paid four times what other company directors are paid and 20 times the median employee pay, which during our engagement was rationalized based on his level of activity (but it remains unclear what differentiates his work from other board chairmen.)

Turning to matters of governance consistency and best practices, we learned that the new CEO (appointed in April 2021) will not be appointed to the board, one of the few, if only, unboarded CEOs in the S&P 500 and Russell 1000 Index. This is in stark contrast to the company's most recent CEO (from 2008 to 2020 and appointed to the board in 2009), who retains "marketing and organizational support leadership" responsibilities but is no longer an executive at the company. The CEO before that, now chair, was appointed to the board three years after rising to the position. We question such inconsistent governance maneuvers.

Executive compensation is mostly options with smaller tranches devoted to relative total shareholder return, earnings-per-share and cash-flow targets. During our discussion there appeared to be little interest in changing and enhancing targets. And while we were pleased to learn that compensation targets didn't change during COVID-19, we learned that 50% of all equity grants go to the top five NEOs, an extremely high concentration of equity grants. On a positive note, employee retention, supply-chain program plans, environmental stewardship and disclosures have all improved.

We remain cautious and will continue to engage for impact on governance matters with management and the board of Mettler-Toledo.

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