



Sustainable and Responsible Investment **Quarterly report**



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ESG quarterly report

Summary

This report is a new initiative from the SRI & Governance Team at Threadneedle and aims to inform our clients of work that has been undertaken over the past three months in the areas of environmental, social and governance (ESG) issues. This reflects our overall commitment to improve our communication with our stakeholders and raise our standards around disclosure and transparency of activities in the field.

Threadneedle's Sustainable and Responsible Investment (SRI) process focuses on integration of environmental, social and governance (ESG) research into the mainstream investment process. We believe that taking material ESG factors into account is our fiduciary duty, as active owners, and can assist us in making better informed investment decisions. We also believe that on a long-term basis, companies that take into account the risks and opportunities around these issues and incorporate them into their business strategies will have a better chance of outperforming, relative to those who continue according to 'business as usual' strategies.

The SRI team engages in research at company, sector and thematic levels, taking into account micro as well as macro level variables. The research is built on the back of a wide variety of research sources including broker research, external ESG rating agency profiles, news, and company updates. This gives a unique mix of views and data based on different agendas and stakeholders. In addition, continuous company engagement and dialogue are key parts of this process. We also collaborate with non-governmental organisations and attend conferences to contribute to the discussion of SRI issues in the wider community.

Our ESG research is circulated to the wider investment desks, across equity and fixed income assets. Development of the integration process is a highly dynamic process and has started by making sure ESG ratings are included in all stock reviews where possible. More extensive research is included in relevant stock reviews (where material), investment themes meetings and other presentation opportunities. Individual teams then draw on this analysis to form their own views.

This strategy has resulted in substantial dialogue between the SRI analysts and fund managers. The SRI team is often approached by fund managers or sector analysts for information or an update on stocks they are covering, indicating that the understanding of these issues is filtering into the wider team. A differentiating factor for Threadneedle is that the SRI team sits on the main investment floor, keeping SRI analysis relevant and facilitating interaction. We believe this is a key decision. The SRI team thus works as ESG consultants across the departments. This integration is a continually evolving process and involves a cultural change of the investment decision-making process. For more information around how the SRI and Governance team functions at Threadneedle please visit our corporate webpage at www.threadneedle.com

Company engagement

This quarter we continued our engagement with several companies on ESG issues. We believe that this correspondence and interaction are crucial parts of being active investors, providing us with important information and an appreciation of a company's performance which we are able to process and report back to the investment team. As we increasingly take these aspects into account in our fundamental analysis and through our dialogue, we generate accountability to corporate ESG promises and standards.

Company Engagement

Topic	Companies engaged with during the quarter
Corporate strategy*	Drax, New Britain Palm Oil, Michelin
Small cap medical companies & corporate responsibility	Orpea, Diasorin, Rhon-Klinikum
Ethical consumer	Marks and Spencer
Corporate responsibility strategy	Deutsche Bank, Barclays, Vodafone, L'Oreal, Michelin, Burberry, Go-Ahead Group, BG Group
Succession Planning	Tesco, British American Tobacco
Board independence	Record plc, RPS Group
Meetings regarding remuneration	Burberry, Cable and Wireless
Correspondence regarding remuneration	Orpea, Beazley Group, Oxford Instruments, Greene King, Go-Ahead, IG Group plc

*This refers to integrated meetings with mainstream fund managers with stocks that have a fundamental ESG angle to their corporate strategy and where it is seen as helpful to have an SRI specialist included in the meeting and provide relevant material prior to the meeting.

Integrated research

Our integration process continues to develop and is a priority for the SRI and Governance team as it is crucial that the information gets delivered across to the fund managers and analysts so that they can assess and act on the information, if appropriate. This is a difficult process and we have been very open about the areas of challenge for any mainstream house due to existing embedded practices and cultural underpinnings. We are very keen to keep an open dialogue with our stakeholders on this development and have had a number of meetings during the quarter to discuss it with both existing and prospective clients. We expect to keep writing research and updates on this area and will refer to these in upcoming quarterly reports.

During this quarter we have been very active and carried out ESG research for 20 stock reviews where it was deemed a relevant input. Furthermore, we have written monthly thematic research pieces which we consider as key long-term investment themes for picking quality investments. This fits within our idea-generation model of macro developments leading to thematic research and subsequently individual stock analysis.

This quarter's themes focused on innovation, water and the ethical consumer. These themes are chosen opportunistically in terms of what is being discussed in the SRI community and on our own investment floor. The themes will frame and be integrated into our stock analysis. We view innovation as an SRI theme, particularly in these times as companies focus on cost-cutting to the extent that it impacts innovation and long-term sustainability. For the ethical consumer we drew conclusions as to how various UK food retailers would be placed to take advantage of this theme. Finally, we wrote an article arguing that water is a key performance indicator as resource constraints impact companies, local communities and national economic growth.

On a micro-view, we wish to highlight a few case studies of our integrated ESG stock reviews including Michelin, the Go-Ahead Group and Tesco. We highlight these to give a flavour of the line of thinking we are using when analysing companies from the ESG perspective and the message we try to convey to the investment managers.



Michelin

Michelin's sustainability initiatives are linked to the strategic business case through the competitive advantage of being well placed to respond to increasing regulations on car fuel economy and CO2 emissions, as well as a differentiating factor for customers demanding high quality products.

Michelin produces high quality, premium products that are sold at a 10-15% premium. 72% of its tyres are sold as replacements in passenger cars, making customer education and brand awareness key. Michelin products are sold for their grip, lifespan and rolling resistance. Sustainability factors are integrated within each of these core selling points, such as product safety, longer duration (resulting in less replacement), and fuel efficiency.

Key areas impacting growth include a strong brand and being able to keep costs low. During the downturn the company has seen a 13% reduction in sales, yet an increase in free cash flow. This is primarily due to material cost reductions of €600 million. In order to keep premium prices competitive, a global media campaign will be launched in early 2010, focusing on the total cost of ownership of the product. This aims to educate the customer base about the additional fuel efficiency and quality of product that pays back the initial premium paid. Despite the emerging markets being the key growth areas, the company is spreading a consistent message as Michelin believe that its customers globally are willing to purchase ethical products.

Following up from this meeting, the information was distributed to the relevant analyst and the SRI fund manager.



Go-Ahead Group plc

Go-Ahead Group has a competitive advantage due to excellent energy management. The key driver of the company's energy management programmes is an opportunity to increase passenger numbers and reduce operating costs. Go-Ahead views climate change as an opportunity to increase its passenger numbers. Based on the long-term trend towards a lower carbon economy, the company is well placed to be a potential beneficiary with more than 20% of earnings related to the theme in 2008. The company's energy management programme gives it a licence to operate as local councils create low emission zones. Furthermore, energy costs have a direct impact on operating profit (est £5 million cost savings 2008-2009).

The UK transport fleet generates 25% of carbon emissions so public transport must be part of the effort to reach government carbon reduction targets of 80% from 1990 levels by 2050. With 21% market share, Go-Ahead recognises that it has a big influence on emissions.

Go-Ahead is the only UK operating transport company (so far) to have achieved carbon accreditation. This gives it a competitive advantage going forward, particularly in the initial stages of the UK carbon reduction commitment (CRC). While all competitors co-ordinate energy management, Go-Ahead Group's accreditation will give it the external verification needed to distinguish its programmes.

These findings were distributed to the UK investment team as a case study of where ESG issues have a material impact on investment decisions.

Tesco

Tesco is a case study of a firm where the governance issue of succession planning was highlighted as a potential risk to the company's corporate strategy. The Chairman, David Reid has been at Tesco for 25 years and Chairman since 2004. The CEO, Terry Leahy has been at Tesco since 1979. The close link between the management can be a concern for the sustainability and continuity of the firm's growth and innovation. We were encouraged by our engagements that these issues are understood by the firm and we will continue to monitor corporate governance closely. Succession planning is a general theme that we address more broadly through our work with the Association of British Insurers (ABI).



This engagement followed several meetings with Tesco during the course of the year regarding broader Corporate Social Responsibility (CSR) issues. We have seen the company twice in our offices, once with the Chairman and once with the SRI team. We also hosted an event for SRI investors, where Tesco presented its new CSR report. The meetings discussed CSR initiatives more broadly, but also the UNITE resolution, and the implications of the Employee Free Choice Act.

The outcome of this long-term engagement has been an appreciation by Tesco that shareholders are taking these issues into account and appreciate how it relates to the business case from a sustainability point of view. Furthermore the meetings have factored into our thematic research process on the ethical consumer and supply chain risk management, which is an increasing concern for supermarkets as they are outsourcing practices and face greater scrutiny.

Update on long-term engagement themes

Oil sands

We have carried out extensive engagement around the issue of oil sands. We believe that involvement in the oil sands poses several risks, particularly due to uncertainties around environmental regulation and the high price of oil required to sustain such projects.

Oil sands are oil reserves that are trapped within shale and sand. The extraction method either involves mining or steam-assisted gravity drainage (SAGD). SAGD involves heating up the oil, making it fluid and easier to extract. Both methods have serious environmental implications in terms of habitat destruction, disruption to indigenous communities' livelihoods and water pollution. The most significant immediate cost is the cost of carbon. These processes are between three and five times more carbon intensive than traditional methods.

The largest reserves of oil sands are held in Northern Alberta, Canada. The reserves are second only to those of Saudi Arabia. The oil sands activities have lasted for approximately 40 years but have received increased opposition recently due to greater focus on climate change. Furthermore, the sharp drop in the oil price in 2008 caused many projects to be stalled or postponed as the costs became economically unfeasible.

This raises concerns for investors over the sustainability of returns generated from such projects. Increasing environmental regulation and mounting social opposition raise costs that are already significantly higher than traditional methods, making the projects even more vulnerable to fluctuations in the oil price. Furthermore, there have been suggestions of demand erosion and discussions around an additional tax in the US on oil from such carbon intensive sources. While the latter rise remains to be seen, we have identified the area as a key risk to involved oil majors in the longer run.



We have engaged with oil majors through several avenues. We have seen executive management in individual meetings focusing on this issue, some being more open and frank about the risks relating to uncertainties than others. We have also been part of a collaborative campaign, organised through the UN Principles for Responsible Investment (UNPRI) Clearinghouse and United Kingdom Sustainable Investment and Finance Association (UKSIF). The letters requested information regarding the stance and approach taken to tackle the environmental and social risks of oil sands.

Nearly all companies involved responded and we believe that a continuous request to make companies accountable will encourage the highest standards and prudent investment decisions. For example, we were able to ask the oil majors what cost of carbon they were assuming and were assured that this was factored into the costs assessment of projects.

We have fed back the information to the investment floor through a research note and a presentation in the monthly themes meeting. We continue to follow this theme and will attend a site visit in November 2009, with related flight emissions naturally being offset. Improving the level of information regarding the risks of these issues allows our fund managers to make informed investment decisions. Expect more research from the SRI team on this going forward.

US Employee Free Choice Act

The US Employee Free Choice Act (EFCA) is a highly political act that proposes changes to the current system of union elections in the United States. The current method of unionisation involves a company being targeted by a union; they then carry out a card check where if it reaches 35%, they authorise an election; campaigning follows and subsequently voting through secret ballot.

The changes would take away the election provided that the card check returns a result of 50% of employees wanting to be unionised. There would then be a mandatory arbitration after 90 days if the Union and the company could not come to terms with the package.

There is broad consensus that the EFCA will be implemented in some form, yet possibly slightly amended. Regardless of the terms, the changes are likely to lead to greater unionisation. This poses risks for companies that are not adequately prepared. Furthermore, it is an additional aspect for foreign firms to consider when expanding into the US.

Threadneedle has taken part in two collaborative engagement activities. The first was with the UN PRI Clearinghouse, targeting the S&P 100 and asking them for information regarding their labour practices and how they were preparing for potential changes to the labour laws in the US.

The second engagement activity was with UK Sustainable Investment and Finance Association (UKSIF) and a group of nine investors that identified large UK companies with significant exposure in the US. We each took responsibility for a few companies and have shared the responses.

We will continue working with these companies and taking the EFCA into account when analysing the competitive position. Once we have received all responses, we will share these in a report to the US equity desk.

Proxy voting – A tool to promote good governance practice

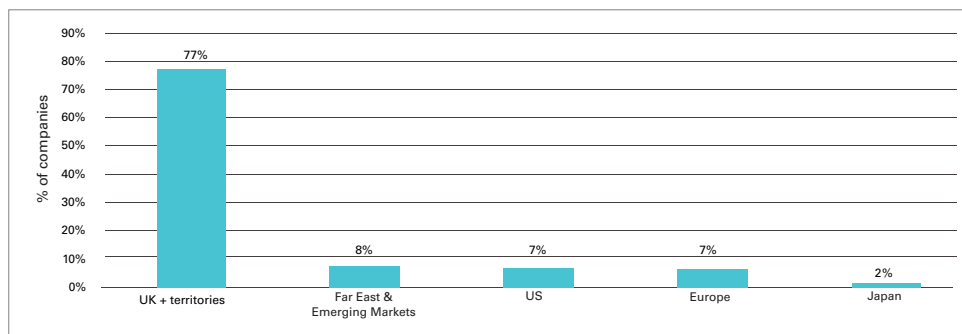
Threadneedle uses proxy voting as a governance tool to support good governance practices, which we believe are a cornerstone to long-term shareholder value. Equally we aim to express our concerns when appropriate. We refer to market corporate governance best practice codes along with a comply-or-explain approach. We continue to monitor companies with particular issues.

This quarter we voted on 245 companies. The majority were UK companies (77%) and the remainder in the Far East, US, Europe and Japan. We opposed one or more resolutions at 14% of the meetings and abstained on one or more resolutions at 9% of the meetings. We opposed the remuneration report of five of the stocks where we hold more than 0.5% of issued share capital. We contacted the companies in all instances to highlight our concern.

We rank the following items as grounds for engagement (and perhaps, if this fails, join the wider voting community to act jointly, through adding an extra item on an upcoming agenda or call for an extra EGM):

- Low board independence (implies weak transparency and accountability)
- Combined CEO/Chairman (considered on case by case basis)
- Aggressive remuneration practices (that do not align the interest of management and shareholders)
- Anti takeover devices
- Pre-emption rights (important safeguard to dilution)
- Disproportionate voting right

Proxy Voting by geography July to September 2009



Participation in the wider SRI community

Threadneedle received two SRI recognitions during the quarter. We were voted “Best UK ESG Asset Manager” by the World Finance Magazine. The awards panel used a wide range of criteria to inform its decision over the most pertinent categories to include in the 2009 awards, and to establish criteria for voters to consider. These included innovation, originality and quality of research. We were also pleased with being ranked fourth in this year’s Thomson Reuters Extel SRI and Sustainability Survey. The survey is based on the views of more than 300 investment professionals from 19 countries, making it the most extensive assessment of SRI in the European investment community.

We participate in industry conferences and seminars to encourage debate in the SRI community and to keep on top of this rapidly evolving industry. We have attended several seminars, including those on financial regulation following the G20 announcements, the developments of Green Bonds, and the marketing of ethical funds.

In September we attended the DVFA-EFFAS 3rd ‘Taking ESG into Account’ in Frankfurt on ESG Mainstreaming. This brought together a mix of investment professionals from both the buy and the sell side, corporates and ESG services industries from all over Europe. It was an incredibly well attended event, with speakers clearly moving beyond the traditional discussions of ESG rationale to debates reflecting performance and practicalities. It was presupposed that corporate managing, measuring and disclosing ESG is the default. Likewise the event presupposed that taking risk factors (and thus ESG factors) into account is the default for recognising fiduciary duties in making asset management decisions, and consequently the default of an industry delivering service for asset managers. This conference centred around the frustrations that investment managers and asset owners have with finding concrete examples of how ESG is integrated into the investment process.

Investment implications of the integrated SRI work

An area of much debate within SRI and integrated ESG research continues to be the link to investment performance and the need for metrics to quantify and measure as well as attribute the real financial returns or even the environmental and social returns. Unsurprisingly this is very difficult, largely due to the subjectivity issues around what ESG is and how it should be approached. Intangible values associated with environmental, social and governance (ESG) issues and the long time horizon of the issues also contribute to this dilemma. Furthermore, it is difficult to separate ESG drivers of outperformance from other factors, such as market specifics and management.

To give an example of a clear link, energy and waste reduction have a direct impact on operational costs for a range of companies so that excellent eco-management can generate a competitive advantage and outperformance due to better cost-management. This issue is key in energy or waste intensive businesses (see Go-Ahead Group as an example).

Other SRI areas, such as retention of labour, general ethical values and good supply chain oversight, however, have benefits largely in risk-management in long-term value creation. As Ivo Knoepfel, managing director at consultancy onValues in Zurich, states: "...broad ESG strategies are more about managing downside risks than about generating outperformance in the short term". (Environmental Finance article 22.10.2009)

This philosophy governs SRI at Threadneedle. We look for the risks or opportunities associated with material ESG factors across our holdings, on a longer term basis. Engagement and proxy voting are clear examples of how active owners exercise their responsibilities and are part of the process of identifying ESG risks or opportunities. These risks and opportunities will form part of our assessment of potential investments and can be a key factor to the overall investment analysis behind a stock buy or sell.

We do not currently operate an 'SRI-linked' retail product but try to integrate the ESG analysis across the investment floor. We believe that this is part of being better informed in our investment decisions, and can help to reduce risk and potentially generate opportunities for outperformance in the long term. This approach benefits all funds, not just designated SRI funds.

We do, however, manage a segregated global fund on behalf of an external client that is positively, environmentally screened against three themes: environmental risk, sustainability and eco-management. This product is an absolute return portfolio with an attached swap application. The stock selection process within the rated universe benefits from the interaction between the fund manager and the SRI analysts to ensure that the integrated aspect of longer-term themes is also factored into the process. The fund has outperformed its benchmark by 3.4% since inception (September 2008) and only holds stocks that have positive environmental performance.

All figures as at 30.09.2009 unless otherwise stated.

For more information

For more information on SRI Product opportunities or our approach to integrating SRI, please contact your local sales office or visit threadneedle.com for details.

Important information

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