

Sustainable and Responsible Investment **Quarterly report**



Therese Niklasson
Head of Governance and
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ESG quarterly report

Summary

This is Threadneedle's second quarterly Environmental, Social and Governance (ESG) report. One of the aims of this report is to demonstrate to the wider community how Threadneedle addresses ESG issues and incorporates them into our investment decision making process. We are active signatories to the UN PRI and this reporting initiative particularly supports Principle 6, which asks investors to commit to 'reporting on activities and progress towards implementing these principles' and this report helps to highlight the progress that is being made.



Cathrine de Coninck-Smith
Governance and
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Analyst

Threadneedle's Sustainable and Responsible Investment (SRI) process focuses on the 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 account of the risks and opportunities arising from these issues and incorporate them into their business strategies will have a better chance of outperforming companies that continue a 'business as usual' approach.

The SRI team engages in research at company, sector and thematic levels, taking into account micro as well as macro variables. In building this pool of specialist knowledge, the SRI team uses a wide variety of research sources including broker research, external ESG rating agency profiles, news, and company meetings and updates. This enables the team to access a unique mix of views and information on different agendas and stakeholders. In addition, continual company engagement and dialogue are key parts of this process. We also collaborate with management organisations and attend conferences to gain a greater insight into specific SRI issues and help disseminate information to the wider community.

This quarter, significant ESG related public policy issues included UK corporate governance developments as well as the Copenhagen Climate Change Summit. Corporate governance recommendations published in the Walker Review, including the Institutional Shareholder Committee (ISC) Code on the Responsibilities of Institutional Investors, were already to a large extent incorporated into Threadneedle policies and procedures. We have, however, updated our policy to formally endorse the guidelines. We continue to vote globally, on a case by case basis, and have engaged extensively with the management of key holdings. Our governance and responsible investment policy can be found online.

The results of our ESG research and engagement on our corporate website are circulated to all of Threadneedle's fund managers and analysts across the equity desks and to the fixed income desks wherever feasible. Development of the integration process is a highly dynamic process and we have already made sure that ESG ratings are included in all stock reviews where possible¹. 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. A factor differentiating Threadneedle from some asset managers is that the SRI team sits alongside the fund managers and analysts on the main investment floor, thereby keeping SRI analysis relevant and facilitating interaction. We believe this has played a key role in helping to promote a greater awareness of the importance of ESG issues at both a company and sector level. The SRI team thus works as ESG consultants across the investment department. This integration is a continually evolving process and involves a cultural change of the investment decision-making process. For more information on how the SRI and Governance team functions at Threadneedle please visit our corporate webpage at www.threadneedle.com

¹Our ESG rating universe is limited to the offering by RiskMetrics (formerly Innovest Strategic Advisors)

Company engagement

The last quarter of 2009 was a busy period with wider ESG engagement resulting in 21 company engagement activities. This was partly due to the being a common time for companies to approach us regarding governance issues ahead of AGM's in early 2010 and partly due to there being a heightened focus on climate change with the meeting in Copenhagen in December.

There had been some concern that the recession would lessen companies commitments to ESG issues. However, our overall level of engagement and interaction during 2009 suggested this was not the case. We believe that companies' awareness of ESG issues will continue to improve, which is good news for active asset managers pursuing integration strategies. This also supports our view that good ESG management is important during periods of economic crisis as it essentially promotes good management quality, accountability and long-termism. In our previous report, we pointed out that in some ways, the credit crisis could be linked to shortcomings in certain ESG areas, particularly governance.

Company Engagement

| Topic | Companies engaged with during Q4 |
|---|--|
| Corporate strategy* | Swedish Match, Scottish & Southern Energy |
| General governance meeting (company update) | Astra Zeneca, BP |
| Transparency | Orpea |
| Succession Planning | Fenner |
| Remuneration Meetings | Shell, Premier Farnell, RBS, Record |
| Correspondence regarding remuneration | Hargreaves Lansdown, ARM, Go-Ahead |
| Ethical Consumerism | Sainsbury's |
| Renewable Energy Companies | PV Crystalox, Renewable Energy Generation |
| Oil Sands (Canada) | Nexen, Amec, Shell, Canadian Oil Sands, Canadian Natural Resources |

Integrated research

Our integration process continues to develop and is a priority for the SRI and Governance team as it is crucial that ESG information gets delivered to the fund managers and analysts so that they can assess and act on this information, if appropriate.

Having worked on this strategy for some time the ESG team felt it would be a useful exercise to engage with the investment team and see what they felt about the process and usefulness of ESG integration. We therefore circulated a brief questionnaire to our UK and Pan-European teams which was completed by fund managers and analysts. The answers proved useful for the ESG team in understanding what had worked in terms of integration and highlighted areas where more work needed to be done.

Below we have outlined some main conclusions from this survey. The section includes company case studies and an update on our integration work.

Integration Questionnaire

Examples of questions asked

- To what extent do you agree with our internal ESG policy statement that ‘well governed companies will outperform over time’? Well governed here means appropriate management of material ESG factors
- Do you ever consider these issues in your stock selection or portfolio?
- Do you think the ad hoc addition of ESG research to the traditional research data is: (very useful – not useful)?
- What is your perception on integration of ESG (into stock reviews, themes meetings etc)?
- Do you think proxy voting and governance engagement is; (very important – not important)?

Summary of feedback

- All respondents agreed that there had been an increase in the attention given to ESG issues over the past 2 years by mainstream investors and that they occasionally consider ESG issues in the stock selection process.
- The majority answered that integration of ESG issues are useful (when material) in stock reviews, themes meetings etc. Some wanted to be more involved in meetings with companies and the ESG team as they felt companies did not include it in main stream meetings when material to a satisfactory level. On the flipside, we often hear that companies do not include it because fund managers do not ask. This highlights the need for us to facilitate a bridge in communication by extending an invitation to the fund managers to attend Threadneedle ESG meetings.
- With regards to governance, all of the fund managers wants to get their shares voted, believing it’s a vital tool to exercise active ownership and influence companies. Similarly everyone believed engagement across ESG issues is important and something they want to participate in occasionally.

On the back of this feedback, we have suggested a few changes and additions to the integration process which we will start carrying out in 2010. The focus will continue to be on engagement, transparency and an improved dialogue between companies and the investment floor on material ESG issues.

We believe that this was a very useful survey and an important step in improving the integration process. In many ways, the integration of ESG issues is just starting to take meaningful shape within the mainstream asset management community. In developing this process we feel it is important to do so in manageable chunks with sensible breaks. We keep an open dialogue with the investment team, and are prepared and receptive to constructive criticism as well as praise.

Company Case studies

During the quarter we were very active and carried out ESG research for 18 stock reviews where it was deemed a relevant input. Furthermore, we have written monthly thematic research pieces on topics we consider to be 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 oil sands, renewable energy and climate change.

We wish to highlight the following case studies, Nexen, Orpea and Sainsbury’s, which were part of our ESG integration strategy either as part of a long-term engagement theme, an individual company engagement or analysis as part of a stock review.

Nexen

We met with Nexen as part of a wider investment group researching the Canadian oil sands in Alberta, Canada. Nexen is a global energy company that explores for, develops and produces crude oil, natural gas and other products around the world. The majority of its wells are in Canada, in the Athabasca oil sands region.



This is a key growth area for the company and we engaged with the management on a number of ESG risks relevant to the industry such as increased operational costs (environmental and social), labour issues and health and safety considerations. The company is responsible for projects such as Long Lake, an in-situ project where the energy requirements are higher because more power is needed to separate the bitumen. This said, the company is addressing the energy supply issue (generally gas) by producing a synthetic gas through upgrading the technology used. The company is open about its strategy to expand in the region and the associated risks relating to responsible land access and royalty negotiations. The company is delaying some of its projects due to regulatory uncertainties arising from the Canadian government's environmental legislation. However, the company has actively invested in carbon capture and storage (CCS) research which most operators consider to be the main technological solution to tackling the increased levels of emissions.

Overall, we were very impressed by Nexen's dialogue with us and the management were open about their plans and how these related to ESG issues. We would definitely regard the company as a leader in this specialist field from a 'best in class' perspective. It is clear that the company is expanding into the region with a full appreciation of the risks that need to be addressed and that ESG measures will be integral to their business strategy. More information will be available on this company in our extensive oil sands piece due to be released very shortly.

Orpea

We engaged with Orpea as part of our greater focus on ESG issues at key smaller companies. Orpea is a French company that builds and operates its own care homes. We identified the operational costs of the business, community impact and brand reputation as areas where positive ESG management would have a material role in creating a competitive advantage for the firm. Furthermore we were concerned about the lack of transparency and ESG management aimed to improve this through engagement with the company. The company revealed impressive data around environmental management in terms of energy consumption, and incorporating high energy efficiency into the planning of new care homes. The company also publishes an ethical charter but no community focused initiatives. Finally, we succeeded in achieving agreement that future reports and accounts are produced in English, as well as with time, more transparency on ESG initiatives to be publicly available. This is indicative of a successful engagement which will help us to make better informed investment decisions.



Sainsbury's

As the UK economy slowly moves out of recession, it has been apparent during this quarter that consumer patterns are changing and consumer spending patterns are mixed. As part of our general theme of the ethical consumer, we engaged with Sainsbury's, the largest UK retailer of fair-trade (primarily due to bananas, coffee and tea). Currently ethical products, including fair-trade, organics and animal welfare products constitute approximately 5% of sales², but animal welfare products (eg. RSPCA chickens) and fair-trade products grew at 100% year on year. The company stated that this trend will continue with the slow economic recovery, where consumers are squeezed, yet may resort to small pleasures: The so-called "lip-stick" effect. To this end, Sainsbury's also had very good sales figures in the latest trading statement, not least due to champagne sales.



²Company IR Meeting, October 2009.

Update on long-term engagement themes

Oil sands

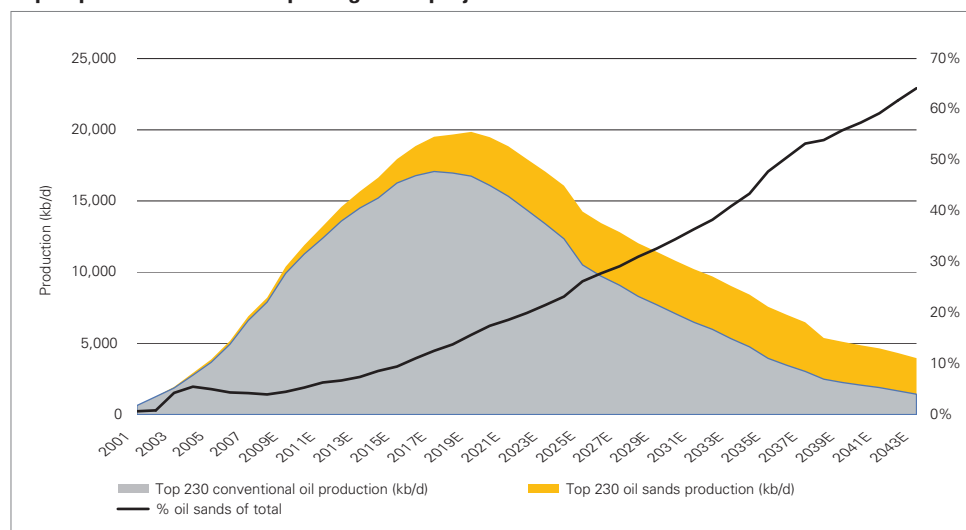
The oil sands have continued to be a dominating theme for this quarter with a research trip to Canada and the Alberta region. The trip was organised through a London Broker (Goldman Sachs). It brought together a number of asset managers as well as asset owners predominantly from the UK but also from Sweden and the Netherlands. The trip was highly successful and highlights the commitment Threadneedle has taken towards research in ESG issues. Some main conclusions are highlighted below awaiting the finalisation of our extensive oil sands piece.

Oil sands in Canada represent a huge reserve in term of global oil and gas. Leaving aside the analysis of how much the demand and supply curves will change for crude going forward it is clear it will remain part of the energy mix in the future. The figure below put together by the GS Sustain team shows their forecast of oil sands percentage of the total energy mix over the next 40 years. The nature of the process (both mining and thermal) means that there will be both significant risks associated with costs, social implications and the environment. The good thing is that governments and companies are all realising this at an early stage and work towards integrating these externalities as soon as possible.

The trip demonstrated how improving technologies are both lowering costs as well as environmental impacts. Given the scale of the operations pilot projects are of such size, that they could provide the base for commercial scale feasibility tests.

The meeting with the Premier of Alberta in Edmonton, did not suggest that major environmental regulatory changes were around the corner. The main regulation that currently applies to operators is a tax of 15 CAD per tonnes of CO₂. This price is likely to rise and many of the companies we met used higher prices in their calculations. It was also clear that there will not be a one size fits all solution to the environmental issues and technological challenges due to the variation in ore consistency, location and geology of the mines in the regions.

Liquid production of the Top 230 growth projects



Source: Company data, Goldman Sachs Research.

Post Copenhagen – An update

The general feeling after the Copenhagen Climate summit was one of disappointment. Many have concluded that this outcome was expected. Sir David King, Scientific Advisor on Climate Change to UBS, has suggested that the great expectations to the meeting were unfounded. The consensus suggests that a legally binding agreement cannot be reached before the US has clarity on its national policy.

Some are hopeful for the COP in Mexico in 2010, but great uncertainty remains. The Copenhagen Accord, while disappointing in its lack of detail, is a key building block for future discussions and is evidence of a transformation in global environmental policy that has happened at unprecedented speed. The accord has been endorsed by key countries including US, Brazil, India, China and South Africa, Japan, the EU and Australia. Yet the UN process is such that all countries must agree unanimously for a treaty to be passed and small island states, such as Tuvalu and the Maldives, raised objections as they want an agreement that commit to 1-1.5 degrees Celsius of warming, rather than the suggested 2 degrees Celsius. The supporting countries have until 31st January 2010 to pick a national number, which will form part of the appendix of the Copenhagen Accord and there is a review process in 2015. We will wait and see the outcome and whether countries will deliver on this promise.

Countries that do deliver are likely to develop strategies to meet such targets. This could include such targets as set in the EU, that are more relevant to investors as they generally entail specific targets on a sector basis, eg. electric vehicles, energy efficiency and renewable energy sources. This is the path taken in the UK, which has introduced the Climate Change Act, committing to an 80% cut in CO₂ by 2050. While there are concerns over financing, the act itself has led to increased support for wind power, nuclear, hybrid vehicles, carbon capture and storage as well as new wave technologies. Furthermore there is a focus on adaptation through improving energy efficiency in residential homes and flood protection technologies.

We believe that the key negative outcome of Copenhagen for investors and corporations alike is the lack of a clear carbon price signal. The failure of Copenhagen to deliver a legally binding agreement, or address the reform of the clean development mechanism (CDM) that is badly needed, caused the carbon price to crash. Speaking to corporations, primarily transport and infrastructure, utilities and oil services companies that have built a business strategy around a low carbon future, the failure of a strong carbon price signal introduces uncertainty into key investment decisions for such firms. Similarly, stock picks under the climate change theme have potentially weakened slightly in conviction.

The lack of a clear carbon price signal does not mean that the momentum for a low carbon economy is completely stalled, and there is a great debate over the benefits of the cap and trade versus a carbon tax. The European Union trading scheme is fixed and will continue until 2020 but business and investors are arguably potentially better off with a carbon tax. A tax would generate the clarity needed around investment decisions yet it is politically unfeasible at this point in time. Consequently, the carbon markets must be improved in future, firstly by lowering volatility by regulating similarly to interest rates, via perhaps a central bank. And secondly, by thoroughly considering the windfall impacts on pollution and the real transfer of wealth to developing countries, as the markets sometimes have perverse effects, benefitting polluters.

The Copenhagen Accord shows that governments are supportive of a greener economy and going forward, the US and China play crucial roles in providing strong leadership. The failure to pass a Climate bill in the US senate would result in default regulation through the EPA. While this is similar to a carbon tax, the split nature of the regulations would likely create inefficiencies and and bureaucracy.

In summary we must wait and see what happens and responsible investors and greener companies are unlikely to completely change paths. News flow is likely to be solid throughout 2010 and may influence market movements of individual technology related to mitigation of and adaptation to climate change. We continue to focus our ESG research and investment ideas around the themes of energy efficiency and security of energy supply.

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 key to long-term shareholder value. This quarter two important documents were published, namely the Walker Review of governance practices in the financial sector, as well as the Institutional Shareholder Committee (ISC) Code on Responsibilities of Institutional Investors. We work closely with the investment community, particularly through the Association of British Insurers (ABI), to translate these guidelines into our own practices. Our governance practices already comply with the ISC recommendations, but we will maintain the same high standards and are experiencing greater willingness by corporations to engage in constructive dialogue. We continue to operate a comply-or-explain approach and we monitor companies with particular issues.

The Walker Review was a useful review of corporate governance practices and has prompted much discussion in the investor community. We have participated in discussions with the ABI and RiskMetrics; a few conclusions can be drawn from this research. During the credit crisis, some investors who engaged in capital risk were ignored as the banks were caught in the risk bubble or felt that investors were wrong. This illustrates the need to change the effectiveness of engagement practices. Yet it would be a mistake to limit any changes to the banks. The key areas addressed by the Walker Review, including board structure and independence, governance of risk and remuneration are important for all investors. There is an understanding that effective governance practices rely on the integration of governance teams and governance analysis into the mainstream investment research and engagement process.

Going forward, Threadneedle is responding to calls for greater transparency. Furthermore, taking politics into account in bank valuations will be essential, while maintaining a focus on shareholder interests and material issues. The Financial Stability Board has announced a global governance oversight of a list of banks and insurance groups that carry systemic risk. This trend could spread more widely, for example as Europe is trying to strengthen its corporate governance frameworks with the Shareholder Rights Directive.

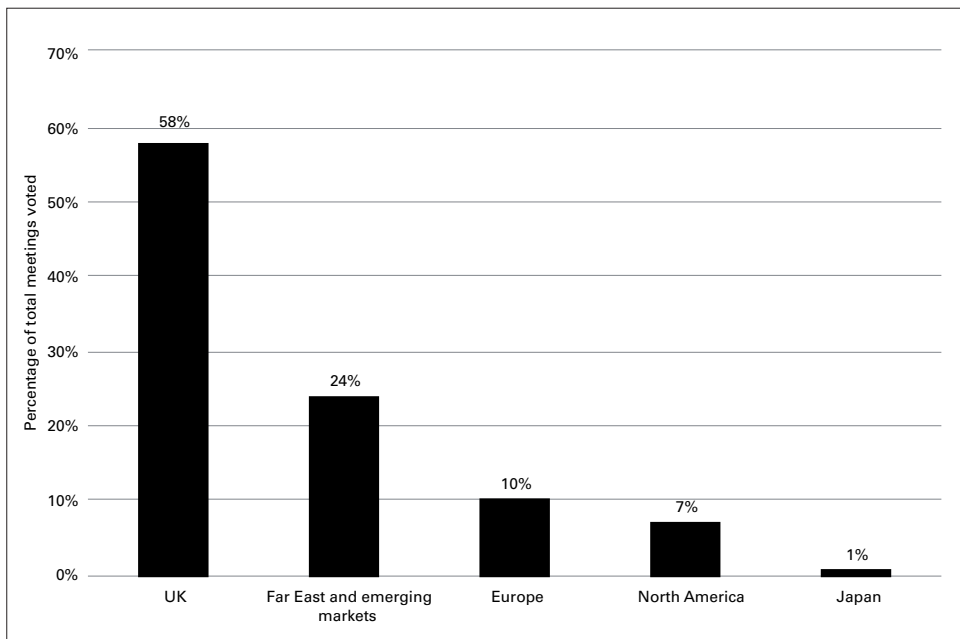
This quarter we voted on 255 company meetings. The majority were UK companies (58%) and the remainder in the Far East and emerging markets, US, Europe and Japan. We opposed or abstained on resolutions at 19 meetings and on seven meetings with significant holdings (stocks where we hold more than 0.5%). The points of contention was evenly split between remuneration concerns and board independence. Threadneedle is particularly strict on audit committee independence.

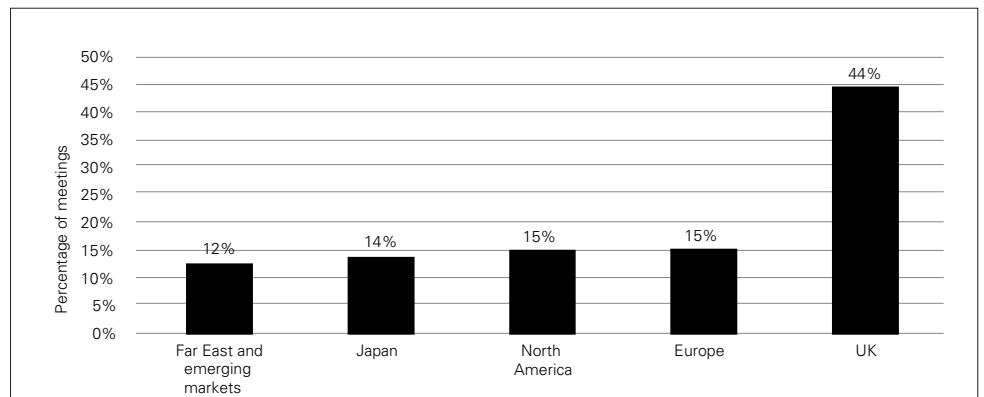
We engaged extensively with the management of several key holdings to continuously hold the corporations accountable and to strive for higher governance standards. We rank

the following items as grounds for engagement (If this fails, we act with the wider voting community to jointly requisition a resolution on the AGM or call for an EGM):

- Low board independence (implies weak transparency and accountability)
- Lack of effective board structure
- 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 rights

Proxy Voting by geography October to December 2009



Proxy Voting 2009 (Jan-Dec)

As it was the last quarter of the year we are able to share some data on how we voted in 2009. A separate report will be published soon and available on our website but some key points are:

- We voted at 1377 meetings in more than 40 markets
- The majority of votes and meetings were UK-based
- We opposed resolutions (at least one) at 17% of meetings

Participation in the wider SRI community

November is usually a busy month for SRI conferences around Europe and this year was no exception. We attended the TBLI ESG Conference in Amsterdam which over the course of two days looked at issues such as the integration of ESG research into portfolios, followed by 20 different workshop opportunities of which the participants had to attend four. Overall, it was a well attended event with a mix of attendees from around the world from asset owners, asset managers and research service providers.

Another important event in November was the National Ethical Investment Week (NEIW), co-ordinated by the United Kingdom Sustainable Investment and Finance Association (UKSIF), of which Threadneedle is a member. The campaign aims to ensure that everyone is aware that they have green and ethical options when it comes to their financial and investment decisions. NEIW co-ordinated and brought together advisers, charities and trusts, financial organisations, faith groups, NGOs and community groups to spread the word about green and ethical investing.

Threadneedle took the opportunity to attend several ESG seminars around London as well as promoting internal awareness of SRI. We produced our first quarterly report of an Threadneedle approach to SRI and distributed posters and conducted presentations internally to facilitate awareness.

Finally, RiskMetrics hosted its annual governance event in London which discussed trends and developments in corporate governance. Insights were gained from industry experts, senior corporate board members, financial institutions as well as the Financial Reporting Council (FRC). Several themes were discussed, including overall shareholder responsibility, governance of risk management and a review of executive remuneration. In the context of the Walker Review and the associated Institutional Shareholder Committee Code on Responsibilities of Institutional Investors (ISC Code) the conference highlighted the role of institutional investors as responsible owners and discussed what went wrong during the financial crisis as well as new developments in the UK going forward.

Investment implications of the integrated SRI work

We continuously work towards linking the ESG analysis to financial returns. We focus on material aspects and accept that in some cases ESG factors are not significant to the investment decision. Even when it is recognised that ESG factors should be incorporated into the analysis, the fundamental issue is how ESG corporate initiatives translate into market movements. The long term nature of ESG issues means that shorter-term market movements can be completely separate to longer term ESG trends.

An analysis of our preferred stocks revealed that the majority are rated AAA, as an indicator of our focus on long-term quality investments. Furthermore there is an increasing understanding amongst fund managers that good ESG performance provides further support for a buy recommendation. This has become increasingly evident as we have further developed our stock review process.

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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