



# SRI Quarterly Report

## April-June 2011 Summary

Our team is always particularly busy during this season, mainly due to the intense 'proxy season'. We vote in 50 markets around the world. We attend approximately 1800 meetings per year, and the majority of these involve voting. This quarter it was 1102. In our view proxy voting is a key part of assessing company governance, which partly drives the equity risk profile. We focus on several areas for this evaluation, such as the company's attention to minority shareholders and how this is reflected in board independence and committees. Remuneration also remains a key engagement point and something the team spends a significant time working on. Usually we receive a large number of letters from companies in the first couple of months on which we need to engage and take a stand on. We will then exercise our opinion through our vote in the second quarter.

During the quarter, the team attended a number of conferences and events, such as the CERES conference for the North American SRI industry, as well as the Sustainable Investment Strategy Meeting organised by IBDG where Therese Niklasson, Head of the SRI team, presented on how to approach ESG engagement in emerging markets.

In the last report we mentioned we attended the EITI conference in Paris. Following that event we wrote a piece on the initiative, which we have chosen to include in this quarter's report. We also produced a "Threadneedle Thinks" piece on ESG and the SRI Industry together with our in-house writing team. It is called "ESG investing: the challenges of a growing market" and can be obtained by contacting [Threadneedle.co.uk](http://Threadneedle.co.uk). The piece looks at terminology, ESG principles and procedures, different SRI strategies, challenges to the future growth of ESG and ESG integration in emerging markets. It is meant to be useful for those who have little or no prior knowledge of the industry, as well as for those who are interested to know how we approach new markets, such as Asia and Emerging markets and what challenges and opportunities it poses in terms of products and research.

## Company engagement

We engaged with 26 companies this quarter, focusing on environmental, social and governance issues. Most of these were related to proxy issues where either we reached out to the company for more information or to raise concerns or where the company contacted us in advance of their AGM to discuss issues. Because of the heavy workload around the AGMs we did not work on as many stock reviews as usual. However we did manage to work through the Asian desk's list of holdings to highlight which companies needed more attention from an ESG perspective. Our interaction with the Asian and Emerging Markets team have really taken off over the past 12 months and we are in the midst of developing a strategy for how our team will interact with the different markets as efficiently as possible in terms of both engagement and research.

Company meetings	
Remuneration engagements	Wincanton, BT, 3i, Intercontinental Hotels, Aveva, Oxford Instruments, Go-Ahead, Kier Group
ESG roadshow	Tesco, BP, Anglo American, Xstrata, Barrick Gold, Aviva, GSK, Unilever, EDF, DSM
Mainstream meeting**	Glencore (IPO), Prysmian, SEB SA, Ingenico, Rubis
Stock reviews	Meggitt, Gazprom, Tesco, Hugo Boss, BASF, Prysmian**

\*\*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.

## Integrated research

This quarter resulted in six stock reviews across the UK, European, Asian, US and Global equity desks. Below are a few examples of companies we have had meetings with or researched as part of our integration and engagement agenda. We have also included highlights from our piece on Asian forests.

### Prysmian

As a cable producer and installation provider they are well placed to take advantage of renewable energy trends. They state that a substantial amount of revenue is related to off shore wind and it is an important part of their pipeline. They have 40% market share in onshore transmission in China post the Draka merger. We have engaged at length regarding disclosure on ESG topics. Their latest environmental report was in 2009 and they are now preparing an SRI report which will be published with the 2011 annual report. They suggest that they have little risk from a health and safety perspective and they have no related litigation action. Their corporate governance is adequate; they have a separate CEO/Chair and have introduced variable compensation for the whole group. We have engaged with them together with our small-cap European fund manager to fully integrate the ESG themes into the investment decision process.



### Tesco plc

This is not the first time we have spoken about Tesco in one of our reports and it is unlikely to be the last. We meet with the company annually to update our fund managers on their ongoing commitment and performance on a range of ESG issues. Tesco's complex business structure with a large supply chain and operations in diverse geographies pose ESG challenges in terms of managing expectations for various groups of consumers. While they are considered one of the best within the UK in terms of ESG policies, they are frank about the challenges to implementing the same high standards in their overseas operations. They are focused on climate change and energy, as it is a key driver for reduced costs and it represents three of their nine key performance indicators for sustainability. Their responsibility extends to their supply chain, which is essential to manage potential negative reputational risks from overseas operations.



The company explains that climate solutions are key to reducing operational costs in the long term and so far commitments to reduce carbon emissions have saved over £150m per annum in energy costs. They are also focusing on building energy-efficient stores, as well as introducing a "carbon label" to over 500 products in the UK and 33 in Korea.

On supplier relationships, they say that it is essential to establish a flexible business and prevent negative publicity from poor supply-chain practices. Positive scores have improved (80% of the supplier's surveyed believe they have a good relationship with Tesco, yet this was only based on responses from 54% of all their suppliers). The focus is on building longer-term relationships and extensive audit programmes. They also spoke of their commitment to source 100% certified sustainable palm oil by 2015 – a difficult target, as there is not currently enough certified palm oil to satisfy their requirements, still this commitment is a positive trend in the industry.

### BASF

BASF is an example of a company operating in a highly regulated yet exposed industry in terms of ESG issues. These issues are dealt with from a board level, which in turn has a sustainability council that reports in to it. The company has demonstrated continuous improvements across a number of areas and there is an overarching strategic goal to reduce emissions. In 2010 they had reduced greenhouse gases by 28.9% from a 2002 baseline. They have also cut by significant amounts emissions of a number of substances into water: notably an 82.3% reduction in nitrogen; a 71.5% reduction in organic substances; and a 58% reduction in heavy metals.



There is an overall strategic goal to improve energy efficiency, which should also have a positive effect on the company's operational costs. So far they have improved specific energy efficiency in the production process by 23.7% against a 2002 baseline, which is very encouraging. In addition to this, the primary energy savings from the group has been 2.7 million tons of oil equivalents per annum, which equates to almost US\$1bn.

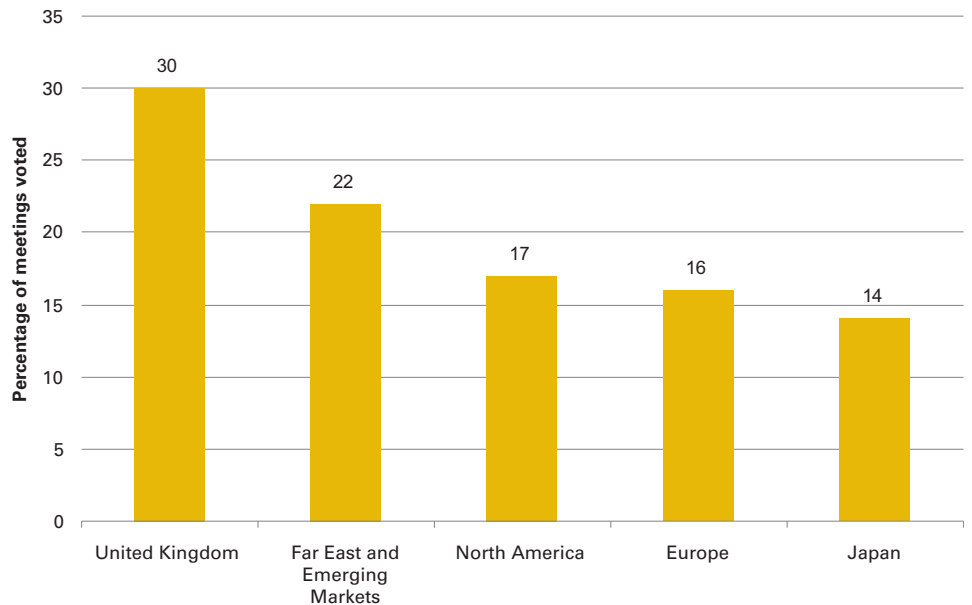
BASF looks closely into what kind of sustainability issues are actually material for their business on an ongoing basis. Key issues selected were energy/climate, water, product stewardship and personnel development. They focus heavily on R&D and sustainable development plays a key role in this. About 1/3 of BASF’s research expenditures are invested in energy efficiency and climate protection. Overall we were very impressed after studying the company’s strategic commitment to ESG areas, both in terms of efficiency and improving the operational side of their company, but also in terms of managing risks as well as tapping into potential markets where innovation is centred on these themes.

## Proxy voting – A tool to promote good governance

In Q2 we voted at 1102 meetings across 43 different markets. The majority were UK, Far East and US meetings. We opposed resolutions at 821 meetings (74%) and abstained at 54 meetings (5%). The percentage of meetings in which we decided to oppose at least one resolution may seem unusually high this quarter, but this is mostly related to the high number of votes in the Far East and North America where our policy routinely results in opposition to issues such as non-independent auditors, large equity raisings without pre-emptive rights and approval of board members without any information.

No meetings were missed during the quarter. As usual, we engaged with a large number of companies among our holdings to protect our assets and conform with our internal policies, as well as external ones, such as the Stewardship Code in the UK for example.

Proxy Voting by geography April to June 2011



## Participation in the SRI community

### Threadneedle attends The Extractives Industries Transparency Initiative (EITI) conference in Paris – the future of development transparency

There is no doubt that the extractives sector plays a critical role in resource-rich countries as well as the global economy. According to Revenue Watch and Transparency International, “petroleum and its derivatives account for 15% of world trade, and resource related sovereign wealth funds – with some \$2 trillion in assets – are major players in global financial markets” (Revenue Watch Index, 2010). Industrial and emerging economies are heavily dependent on imported minerals, and the robust demand of recent years has led to a significant increase in exploration activity across both geo-political and environmentally sensitive regions. According to the same report, mineral resources accounted for 24% of Africa’s GDP growth between 2000 and 2008.

The Extractive Industries Transparency Initiative (EITI), launched in 2003, is a global standard designed to ensure more transparent management of natural resources around the world. Essentially, it is a methodology whereby company and government payments (including taxes, duties, royalties and bonuses) for natural resources such as oil, gas and various mineable substances are reconciled. The process is implemented by governments while emphasising participation by companies and civil society. Threadneedle signed up as a supporter of the EITI during the initial investor round in 2005, and in March this year we attended our first EITI Global Conference. Our decision to become a supporter was linked to our internal policies concerning ESG integration and the call for transparency on these issues as they relate to an improved investment environment.

Azerbaijan
Ghana
Liberia
Mongolia
Timor-Leste
<i>The Central African Republic</i>
<i>The Kyrgyz Republic</i>
<i>Niger</i>
<i>Nigeria</i>
<i>Norway</i>
<i>Yemen</i>

The EITI is a relatively young initiative but its progress has been impressive. The former UK prime minister Tony Blair announced the initiative at the 2002 UN Johannesburg Summit, and in 2007 the first five candidate countries were welcomed. During this year's global conference EITI representatives referred to the heart and soul of the EITI as the consolidation process (reporting) and the dialogue facilitation between companies, civil society and governments. To become an EITI candidate a country must meet four sign-up indicators, including the development of a work plan documenting how it intends to achieve EITI status (EITI Progress Report 2009-2011). To achieve EITI compliant

status a country must complete a further 16 indicators and undertake an EITI Validation.

The 'validation' is an independent assessment of the progress achieved and identifies what measures are needed to strengthen the process. Currently the countries shown to the right are compliant (those in italics are newly compliant).

The call for better transparency through initiatives such as the EITI is just one example of a changing international environment for both governments and companies. The US Dodd-Frank Act (signed in July 2010) is a recent development, which implements financial regulatory reforms and also contains three provisions that will impose additional disclosure requirements relating to the extraction and use of natural resources. Section 1502 of the Dodd-Frank Act requires disclosure relating to the activities of issuers who use "conflict minerals" originating in the Democratic Republic of Congo or adjoining countries. Section 1503 introduces enhanced safety disclosure for issuers engaged in the operation of mines and section 1504 requires disclosure of certain payments made by natural resource companies to governments for the commercial development of oil, natural gas or minerals. This effectively means that any company listed in the US (regardless of domicile) will have to disclose under these sections. This may present a difficult situation for companies operating in host countries which prohibit disclosure.

Momentum is also building across the EU to replicate the corporate transparency enforcements contained in the Dodd-Frank bill, with a draft proposal expected by November. The replication could require fuller disclosure of money flows between companies and governments. In addition to this, the UK Government has launched a new Bribery Act (to be enacted in 2011) to provide a more modern and comprehensive scheme of bribery offences. The act is supposed to be more stringent than any other similar regulation on bribery across the world, and this poses a number of challenges for companies. For example, directors of companies may be liable to prosecution for failing to maintain adequate procedures and companies may face criminal, rather than civil, prosecution and be banned from bidding for public contracts and face debarment under the 2004 EU Procurement Directive.

Another important point to make as to why countries have become increasingly incentivised is that loans by the World Bank Group, the International Monetary Fund (IMF) and the African Development Banks increasingly come attached with anti-corruption "conditionalities". A diverse range of African nations now make fighting corruption a key priority in managing their resources and attracting foreign investment.

The fifth global EITI conference, held in Paris at the OECD (Organisation for Economic Co-operation and Development), was a very interesting event that brought together some high profile delegates and speakers. The programme boasted presidents from the Kyrgyz Republic, Central African Republic, Tanzania, Mozambique and Togo, as well as chief executives from Total, Shell and Standard Life. There were also a number of other high profile political figures from around the world and several civil society bodies and NGOs such as Global Witness and Publish What You Pay. The wide variety of representation made for a very lively and, at times, heated event. The level of engagement was somewhat unexpected, but certainly encouraging for the topic.

The outgoing EITI chairman, Peter Eigen, set the tone by highlighting the growing attention on transparency and raising the standard for governance in the extractives sector. Peter Voser, CEO at Shell, talked about the importance for companies and how they believed the dialogue between civil society, governments and business was key for companies' licence to operate. The new EITI Chair, Claire Short, will aim to take the initiative beyond compliance and increase transparency and accountability.

The EITI has been both praised and critiqued over the years. There are several benefits from the initiatives, such as the opportunity to curb corruption and rent seeking, improvement of a country's access to capital, improvements to the investment climate and the opportunity to build capacity and empower civil society. The criticism has mostly focused on whether the EITI's minimum disclosure standards and its focus on material payments between governments and the extractive companies are sufficient. Others argue that the EITI takes for granted that a strong and independent civil society, including a free media, already exists in the countries implementing the initiative. With many valid points on both sides it is important to note that the initiative is still young and that it is not the sole mechanism being used to combat corruption.

The EITI reminds us of themes, such as the "resource curse" and theories by political economists that nation states which rely on oil, gas and mineral revenues may be particularly prone to mismanagement, corruption, authoritarianism and conflict. There are also limitations to relying primarily on external actors to build transparency and public oversight if local societal actors and institutional safeguards are limited. It is clear that government officials and other key players have a mutual interest in promoting transparency and cracking down on corruption. Finally, international and national actors must be able to hold officials accountable. These three conditions are fundamental to fostering transparency and accountability.

The involvement of investors in the EITI is critical as commodity-related sectors are crucial components of global investment universes, representing 15% of global equity markets and in the UK 30% of equity markets. Currently over 80 global investors have signed on as supporters for the initiative, with different opportunities and interests in being actively involved. Fundamentally the initiative encourages transparency, which helps foster political stability and limits the opportunity for corruption. Recent events in the Middle East demonstrate that a lack of transparency can create political and social tensions which threaten financial stability.

We know from experience that conflict areas and unstable regimes lead to project disruptions, increased operational costs (both upstream and downstream) and reputational damage with an increasingly active and inquisitive shareholder base. For some companies it is crucial to be able to demonstrate what is paid in fees to governments and to have this reconciled by the actual governments. This process then puts pressure on the governments to make sure revenues are distributed and allocated fairly in terms of development.

Without underrating the importance of companies' corporate responsibility programmes, it is important that we allow for governments to oversee and manage key economic and social developments, such as schools, infrastructure and healthcare. Supporting initiatives such as the EITI and the push for better transparency will help minimise the risk in the future for political and social unrest, undoubtedly incurring costs and disruptions to our investments. However, with transparency also comes great responsibility, which means that it is unlikely that governments will be free of criticism after revealing their accounts. Although the risk of corruption may be decreased, citizens and stakeholders may still have a strong voice around the revenues derived from companies and how these are spent.

Over the next 20 years around 90% of hydrocarbon production is expected to originate from developing countries and the vast majority of this will be owned and managed by state-owned companies. The struggle for better and more meaningful transparency around the management of these resources is therefore urgent. After years of patience and hard work, the EITI has demonstrated that the push for transparency is gaining momentum and it is a positive development to see 11 validated countries, including Norway. The pressure on other developed nations to join will increase. Meanwhile, expectations for linking the EITI to development factors and other extractive areas, such as forestry and perhaps water, are also on the table.

Finally, initiatives such as these can be important for greater charters, such as the UN Millennium Development Goals where poverty, hunger and other basic conditions are highlighted. Transparency and corruption is one way to steer development in the right direction and help foster prosperity for a wide range of stakeholders, including companies.

## Threadneedle attends IMA release of Stewardship Report

The IMA calls it “the most comprehensive survey to date of UK institutional investors engagement with the companies they invest in”, entitled “Adherence to the FRC’s stewardship Code”. It was launched at the end of May at the IMA and was well attended by a range of prominent regulatory and investment figures including the CEO of the FRC (Stephen Haddrill), the chairman of the NAPF (Lindsay Tomlinson) and the chairman of the IMA (Douglas Ferrans). The panel consisted of David Jackson, company secretary of BP, Elizabeth Tijssen, national expert from the European Commission, Eric Knight from Knight Vincke and David Pitt-Watson, Chair at Hermes Focus Asset Management. The survey reveals the widespread adherence by 50 UK institutional investors to the best practice set out in the FRC’s Stewardship Code:

- Over 90% of major institutional investors now vote all or the great majority of their shares in UK companies; nearly two thirds now publish their voting records.
- At the time the survey was conducted, 43 out of 50 respondents had published a statement on adherence to the Code, and another six did so subsequently.
- Over 1,300 people focusing on stewardship activities are employed by 43 of the respondents to the survey.
- The report includes in-depth case studies showing how institutional investors dealt with six controversial issues:
  - M&S: combined CEO and chair
  - Barclays: disregard for pre-emption rights in capital raising
  - Shell: oil sands resolution
  - Prudential: failed acquisition of AIG
  - Tesco: remuneration
  - Lloyd: rescue deal for HBOS (merger)

In over 80% of cases, institutional investors believed they had achieved their set objectives in engaging on the issue. The report can be found on <http://www.investmentfunds.org.uk/research>.

We believe that although a survey of this kind was very welcome and we participated in it, we are not entirely convinced that much came out of the study, partly because it is still early days. Although the FRC chaired the steering committee for the survey there is an element of the industry auditing itself. It was mentioned during the event that perhaps the companies themselves should conduct their own study about their views on the engagement processes they are faced with from investors. We would really welcome that study and think it will be useful to investors looking to improve the engagement process.

## Threadneedle hosts UKSIF/ EUROSIF event on the Green Paper on Corporate Governance

UKSIF and Eurosif held an event at Threadneedle on the ongoing consultation on European Corporate Governance issued by the European Commission led by Michel Barnier. This is the follow-up to the Green Paper on Corporate Governance and Remuneration Practices in Financial Institutions, which was published last summer. The questions in the paper are relatively open by nature, allowing many different views and solutions to be proposed.

The paper focuses on three key areas:

- The composition and effectiveness of the board of directors,
- Shareholders, particularly how to encourage greater engagement and a long-term focus,
- How to improve the effectiveness of the “comply or explain” approach.

Like many other organisations, we are working through the questions and will participate in collective debates around our views and issues. During the event a number of views were expressed and an interesting discussion was held over ‘comply or explain’ as well as diversity. At Threadneedle, we believe in the explain approach but also recognise that the information and explanations from some companies need to improve. We also support the suggestion of making say on pay mandatory across the EU. The term short-termism is frequently referenced in the paper, but what is defined by this and why it is a bad thing according to the commission is less clear. The paper will have to trail through numerous views and interpretations of what it is intending to do and it will be some time yet before we have something substantial coming out of the commission on this front.

As a final note we wish to highlight that Miss Niklasson is to leave Threadneedle at the end of July. Until a replacement is found the team will be covered by Miss Cathrine de Coninck-Smith, who is currently an ESG analyst.

## Investment implications of the integrated SRI framework

Our focus and the aim of our ESG research is to add value to the investment process. To do this we need to understand the relationship between sustainability, ESG, price and value. We focus on material aspects and accept that in some cases ESG factors are not material or significant to the investment decision. The integrated framework constantly changes so that ESG analysis is a part of the holistic assessment of the investment decision. The long-term nature of ESG issues means that shorter-term market movements can be completely separate from longer-term ESG trends.

We are seeing more client requests for an overlay of our integrated capabilities and reporting on our engagement. In addition, proxy voting requirements have always been common and are becoming a standard requirement.

### **For more information**

For more information on SRI product opportunities or our approach to integrating SRI, please contact Cathrine de Coninck-Smith at [cathrine.deconinck-smith@threadneedle.co.uk](mailto:cathrine.deconinck-smith@threadneedle.co.uk) or **+44 (0) 20 7464 5211**.



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