SRI
Quarterly Report
October – December 2011
Information for Investment Professionals

SRI Quarterly Report

October – December 2011 Summary

We have taken the opportunity this quarter to focus on broader ESG engagement. Keen to expand the global reach of our activities, the Governance and Responsible Investment team has been particularly active in engaging with Asian and European companies.

ESG analysis of Far East companies is becoming increasingly formalised and we spent time this quarter gaining first-hand experience of the region. We arranged a research tour of Hong Kong and Shenzen, which involved attending the annual Asian Corporate Governance Association (ACGA) conference and study tour, an HSBC water conference, and meetings with brokers and with ASrIA (Association for Sustainable and Responsible Investment in Asia), of which we are also members. The study tour and several private meetings allowed us to make contact with representatives of 15 companies that encompassed technology, retail, energy and conglomerates. We also met the Hong Kong and Shenzen securities regulators. The aim of the trip was to investigate the potential of ESG trends making an impact on Chinese growth, as well as on individual companies. We also wished to observe the culture and the current trend of ESG development, as well as to gauge the level of interest within our peer group of investors and other stakeholders. We examined the development of corporate governance guidelines and regulation, the strategic importance of environmental trends such as water scarcity and climate change, as well as wage and labour welfare. The trip has been an invaluable learning experience that will feed into investment theme discussions with our Far East and Global desks, as well as shape our governance engagements in the region.

We are also pleased to announce that we have adopted a non-investment policy for controversial weapons, as a response to the UN Convention on Cluster Munitions. This policy is a prudent reaction to the Convention and we believe that it demonstrates our commitment to responsible investment practices.

Company Monitoring and Engagement

We engaged with 48 companies this quarter, focusing on environmental, social and governance issues. We devoted 75% of the engagements to ESG issues and 25% specifically to proxy voting or remuneration issues. We skewed our engagement focus this quarter towards Asian and European companies, reflecting our commitment to boosting Threadneedle's global engagement efforts.

The Asian research trip gave us insight into energy management via CLP and GCL-Poly, and sustainable supply chains in the Asian context through Li & Fung Ltd. We also engaged with Hutchison Whampoa in order to encourage the corporation to take a more pro-active stance on ESG disclosures. The central discussion with the technology companies concerned labour practices. The common response was to cite cases where the companies had invested in their local community which is slightly avoiding the issue of labour relations within their operations.

We have also met representatives of a number of European companies, in order to discuss their sustainability agendas. In many cases, these small cap companies were engaging in SRI conversations with investors for the first time. We have identified this area as interesting from an ESG perspective, in the sense that engagement can add particular value and create scope for new opportunities.

Company meetings and engagements	
Remuneration engagements	GSK, Hunting Plc, Credit Suisse, AstraZeneca, Optos, Wolfson
ESG road show	Tesco, GCL-Poly, CLP Holdings, Hutchison Whampoa and Yantian Port, Huawei, Tencent, Mindray Medical, China Wireless Technologies, Li and Fung, Bank of China, Roche, L'Oreal, Henkel, Sainsburys, HSBC, AMEC, Standard Chartered, Seikisui Chemicals, Air Liquide, Umicore, Imtech, Colruyt, Telenet, Lloyds Banking Group
Mainstream meeting**	Glencore, N Brown, British Sky Broadcasting, Mothercare
Stock reviews	IG Group, Premier Oil, Balfour Beatty, CLP, Hutchison, Tencent, Ambev, Femsa, ICT, Genting, Formosa Plastics, CNOOC, AngloGold Ashanti, ITC, Mondi, AZ electronics, DiaSorin, Wacker Chemie, Tele2, CP All

**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 20 ESG stock reviews across the UK, European and Asian equity desks. The research is incorporated into mainstream analysis, in order to facilitate a greater understanding of risks and opportunities.

UK Banks: Standard Chartered, HSBC, Lloyds Banking Group

UK banks' increasing efforts to incorporate environmental and social issues into their operations appear to stem primarily from the damage done to the reputation of financial institutions combined with a growing recognition of ESG rewards. It would appear that banks are identifying an enhanced environmental and social ethos as a building block towards regaining the trust of employees and the public.

The approach taken by each bank may differ, but the underlying message remains the same: environmental and social risks present opportunities, and managing ESG issues contributes to value creation. Nevertheless, while banks are aware of the advantages, they are still struggling to quantify cost savings or to define the opportunities that can be realised.

Governance remains a contentious issue within the UK banking sector, with the media highlighting excessive executive pay over the past few months. The adoption by HSBC of a somewhat controversial 'balanced scorecard' for executives' long-term incentive plan – that rewards financial and non-financial incentives – has been an interesting development.
In general, we consider that incentive schemes should be as transparent as possible and that non-financial incentives must be suitably stretching.

As part of our dialogue with banks on remuneration, we are keen to gauge the extent to which the sustainability agenda is ingrained in remuneration practices, not just at executive level but throughout the organisation.

Engagement focus list

Having screened our significant holdings last quarter, we are now concentrating our efforts on stock that we believe need further attention. During this quarter, we engaged in depth with two holdings – Nestlé and Melrose Plc.

Nestlé
We initiated engagement efforts with Nestlé on the back of a report produced by our external ratings provider, MSCI, which detailed several controversies. These related predominantly to labour relations and supply chain issues. During a frank discussion, we voiced our concerns to investor relations, health and safety, and labour relations officers.

Our principal doubts related to what appeared to be persistent labour relations issues, despite extensive policies in this regard. Significant anecdotal evidence suggests the outbreak of clashes between Nestlé on the one hand and employees and unions on the other, creating the impression that the company is anti-collective bargaining. The most recent example related to labour unrest in Russia in 2010, the research noted. An appreciation of the operational cost related to the price of such labour disputes in terms of staff turnover, time squandered, disruptions to the supply chain and increases in wage costs, is important to our investment case.

However, the meeting and additional correspondence have boosted our confidence in Nestlé's management of these issues and in its proactive stance to reduce their prevalence. Such steps include a greater emphasis on training, on management, resourcing and on auditing the company's policies.

Furthermore, we note that the company's operational management is strong in water, energy and waste reduction terms, despite the business growing. The company has an innovative supply chain management programme that has served it well in a period of rising commodity prices.

Melrose
Melrose has scored poorly in ESG terms, due to limited disclosure that hinders the assessment of risks. We have been proactive in engaging with the company and have encouraged greater disclosure of environmental and social risks, through a constructive dialogue.

We have found that Melrose is managing and quantifying some ESG elements, as is the case with many of the companies with which we engage; however, these are treated as internal operational issues and are not communicated externally.

We are pleased that MSCI upgraded the company slightly in December, but we will continue to engage on relevant issues and disclosure of policies.

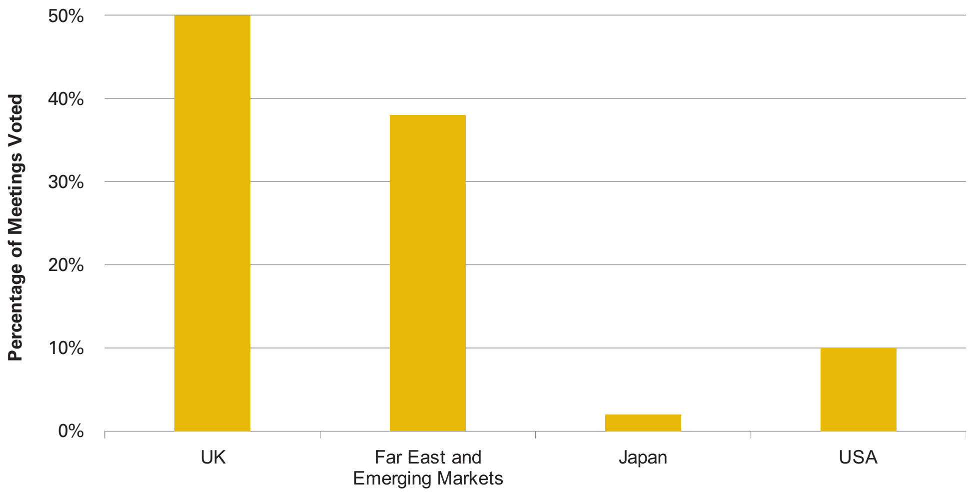
Proxy Voting – a tool to promote good governance

We successfully completed the integration of LV funds into the Threadneedle voting process this quarter. We believe that this will add approximately 400 meetings to our existing annual voting universe of around 1,800 meetings.

We voted 212 meetings across 35 different markets in Q4. No meetings were missed during the quarter. As usual, we have engaged with a large number of holdings to protect our assets and to conform to our internal polices.

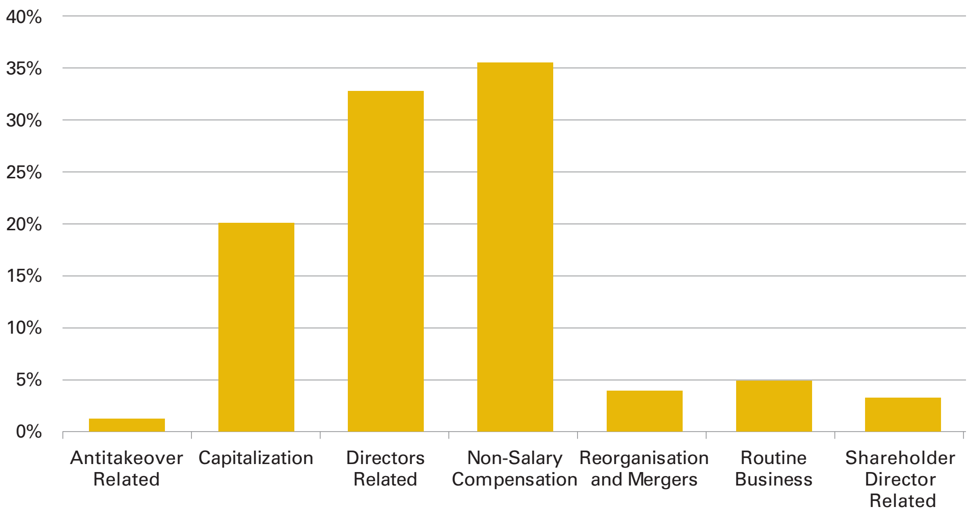
UK voting continued to dominate this quarter, accounting for 50% of meetings. Australia and Hong Kong voting accounted for the majority of Far East and Emerging Market votes.

Proxy Voting by Geography October to December 2011



We opposed resolutions at 46 meetings (22%) and abstained at 16 meetings (8%). We engaged with holdings where we considered the issue significant enough or where we had a significant interest. Remuneration and insufficient independent director representation remain the most contentious issues globally. We have also voted against a significant number of anti-takeover schemes in Hong Kong, China, the Cayman Islands and the UK.

Resolutions Voted Against Management Q4



Investment relevance of ESG trends in Asia: Conclusions from research trip

Impact on GDP growth: Separate the Macro from the Micro
The World Bank had been planning to issue a report on the costs of pollution in China; however, the publication has now been cancelled and only an executive summary highlighted. This states that health and non-health impacts of water and air pollution in China will **cut GDP by 5.5%**.

The broker community (HSBC, Goldman Sachs, CLSA) agrees that high levels of environmental pollution, as well as social trends, can impact growth negatively. However, it believes that the stimulus created by Green Industries growth, under the auspices of the 12th 5 year plan, is big enough to counter the negative effect. Indeed, it considers this a "green stimulus" package, which supports energy saving technologies, next generation IT, bio technology, high-end manufacturing, new energy, new materials and clean energy vehicles. **The package is expected to represent 5% of GDP by 2015 and 15% by 2020**.

This view appears to correlate with the significant energy and water sector reforms that have been announced. **The measures will result in greater consolidation of the power sector and important investment in water treatment, resulting in increased and more efficient output together with economies of scale**. Alongside agriculture, energy and water are the major areas contributing to environmental pollution. Beijing experienced severe smog at the end of October, for example, and instances of extreme water shortage have occurred across the country. Yet environmental regulation is tightening in response and the public voice is becoming stronger. These present key risks and opportunities and are relevant to the investment decision on a sector and individual company basis.

We conclude that we must separate the micro and the macro pictures in investment terms. While no clear evidence exists that environmental and social issues will be allowed to have a direct impact on GDP growth in the short term, more rigorous environmental regulation certainly affects individual companies. The data suggests that new regulation and stricter enforcement do affect operating costs and/or capex. For example, Mindray is shifting factories inland to avoid wage inflation on the coast. GCL Poly has invested in a new recycling factory, which is the sole reason for its current status as lowest-cost producer of poly-silicon, as it can re-use some of the waste material in its processes. JP Morgan in turn mentions Catcher Technology's Suzhou manufacturing plant and Meiko Electronics' Wuhan plant, both of which have been suspended due to environmental pollution. These are sound reasons for further integrating ESG considerations within the Far East research.

Governance developments: An 'East meets West' dialogue
Governance is a very broad concept in the Asian context, encompassing corporate, environmental and social governance. As regards accounting and regulatory developments, we were given the opportunity to meet the China Securities Commission, Shenzen Branch, the Hong Kong Securities regulator and Hong Kong Stock Exchange representatives, as well as hearing from Forensic Accounting Asia to gauge the extent of accounting fraud.

In addition, the Asian Corporate Governance Association (ACGA) conference featured many senior speakers with board experience at several major corporations, including the Bank of China, the State-owned Assets Supervision and Administration Commission (SASAC), and independent directors of Samsung Electronics and Aon Corporation.

The dialogue clearly reflected the on-going 'East meets West' learning process. The speakers and regulators were conscious both of Asian culture and of the Western governance model's imperfections, citing financial crises and Enron as corporate failures. Nevertheless, they accept that they are at a learning stage and are working towards developing corporate governance guidelines and improvements. Accounting fraud remains a concern and the China Securities Regulatory Commission (CSRC) wishes to strengthen regulation without interfering too much in actual practices. Indeed, regulation seems to be tightening, despite the Shanghai and Shenzen exchanges competing with Hong Kong. The Hong Kong Stock Exchange has just issued a new guideline document that requires director training, disclosure of CEO remuneration and monthly management updates. The latter is a key tool for reducing insider trading. The Singapore Stock Exchange has just updated its corporate governance code and the Tokyo Stock Exchange is reviewing its practices following the Olympus scandal.

Asia's ownership culture was an interesting sub-theme. Discussions with family-owned and family-controlled companies, such as Li & Fung and Hutchison Whampoa, suggested a strong ownership culture in Asia. Minority shareholders are often at risk but the management is heavily aligned with the major shareholder base, as they are one and the same. Given discussions concerning the UK Stewardship Code and "absent landlords" in Britain, Asia's strong ownership culture is potentially a lesson that the East can teach the West.

Variable Interest Entities (VIEs) were a key concern that featured in many discussions. There is a risk that the government will tighten regulation of companies involved in these structures, although the regulator has hitherto disclosed little concrete information. We took this lesson back as an important issue to assess across our portfolios.

Investors have had limited input regarding proposed changes to accounting regulation in China, and key accounting risks remain, particularly in asset heavy industries, in agriculture and throughout China in general.

Key factors to consider: (source: Capital Group):

- Non-compliance with laws (how much do parties owe the Government?);
- Organizational structures (e.g., VIE – China prohibits foreign ownership and foreign investors can invest only in the holding company);
- Audit committee lacks highly experienced financial analysts;
- CFO lacks accounting background;
- Excessive margins without cash-flow info;
- Inadequate disclosure of key estimates used in financial statements;
- Poor communication by management;
- Related party transactions;
- Non-compliance with the Sarbanes Oxley Act; and
- Low senior management share holding

Lessons for engagement and dialogue: Just ask!

There is a common misconception that companies in Asia facing 'ESG' questions put by investors are likely to respond in a hostile manner. In reality, the firms that we visited were proud to show us their facilities and very willing to talk to investors. They recognise that they are learning how to interact with investors and how best to combine responsible business practices with sustainable growth. The key points for investors are always to explain the background, to outline the relevance of the question, and to pose a relatively direct question on one subject matter. Open-ended questions will usually receive rather vague answers.

A common feature in all regions was the reluctance of some rather than other companies to discuss ESG issues. Generally speaking, answers lacked precise data; hence, the first step towards improvement will be better disclosure of key facts and the introduction of information from management and KPIs concerning ESG issues.

Our tour has been an incredible learning experience, and an essential, progressive contribution to our engagement processes. We have also exploited the results of our research within thematic reports that serve to generate new investment ideas.

Investment Implications of the Integrated ESG research

Controversial Weapons Non-Investment Policy
In November 2011, we implemented a Controversial Weapons non-investment policy, a measure introduced to comply with legal restrictions in certain jurisdictions on direct investment in companies producing such weapons. We see this as a prudent move to protect our clients and our own interests. The policy reads as follows:

The UN Convention on Cluster Munitions came into force on 1 August 2010. This Convention prohibits all use, stockpiling, production and transfer of cluster munitions. Threadneedle Investments acknowledges the importance of the Convention and actively screens companies for evidence of their corporate involvement in not only cluster munitions but also in controversial weapons more generally (defined as anti-personnel mines, cluster munitions, biochemical weapons and depleted uranium ammunition and armour). Where a company is verified to undertake such activities, Threadneedle's policy is not to invest in the securities issued by that company. We reserve the right to take short positions in such securities.

Mark Burgess, Chief Investment Officer at Threadneedle, commented: "We are active investors committed to maximising our investment returns through the pursuit of good governance and responsible investment practices. The controversial weapons non-investment policy adopted by Threadneedle demonstrates our belief that the management of ESG issues is a critical component of long-term value creation and is central to our investment approach."

The non-investment in controversial weapons policy is a negative investment approach and a response to an international convention with legal as well as reputational implications. However, our ESG research process is primarily based on the best-in-class approach, focused on adding value as part of the holistic consideration of a company. We believe that ESG research is a feature of efficient risk control, of fundamental enhanced information of risks and opportunities related to portfolio companies, and of an overall view of the portfolio exposure to ESG risks.

For more information

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

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