

The **co-operative**  
asset management

# Responsible Investments Quarterly Review

Autumn 2010





# Section 1 **Engagement Update**

## **Addressing Deforestation in Supply Chain Management**

The Co-operative Asset Management has taken a leading position in engaging on forest supply chain issues. Last year we endorsed and joined the steering committee of the Forest Footprint Disclosure (FFD), a project that aims to capture policy and provide a neutral platform for sharing best practice between companies for the five key forest commodities; timber, cattle, palm oil, soy and biofuels.

With legislation protecting forests gathering momentum this issue is of increasing importance to purchasing managers who have to ensure continuity of supply, reputation managers where concerns of business

impact on forests can damage brands, and boards responsible for oversight. Strong policy correspondingly highlights to investors where companies may have incremental margin opportunities or face risks.

In the third quarter of 2010 our engagement sought to raise awareness of supply chain dependence and impact on forests, centring on those companies in which we have holdings that did not complete the FFD survey last year. In a number of cases this has led to companies agreeing to participate in the survey. The results of some of our communications so far are recorded below. We intend to continue our correspondence with companies to encourage the formation and implementation of appropriate forest commodity policies, including reference to sourcing standards and proportions of certificated products, with targets for improvement and timelines.

<b>Company</b>	<b>Outcome</b>
<b>Tesco</b>	Intends to complete FFD
<b>Royal Ahold</b>	Intends to complete FFD
<b>Avon Products</b>	Intends to complete FFD
<b>Reckitt Benckiser</b>	Intends to complete FFD
<b>TUI Travel</b>	Intends to complete FFD
<b>Home Retail Group</b>	The company recognises the issues and has a suite of policies on forest management. It is currently reviewing whether it wishes to participate in the survey.
<b>Whitbread</b>	Whitbread are appraising their impacts and dependencies across their entire raw materials supply chain to determine priorities and will develop policies accordingly, making these public where appropriate. It is notable that most of the coffee Whitbread sells is Rainforest Alliance Certified™ however it is aiming to move this to 100%.
<b>Proctor &amp; Gamble</b>	The company has acknowledged the issues and has a range of policies on forest management. It will consider participation in future years, but is focusing on providing details for water and carbon at this point.
<b>Croda International</b>	Croda has a solid offering in sustainability, partly due to its strength in sourcing renewable commodities rather than minerals as its chemical feedstock. This includes forest commodities such as palm oil. However, given the time taken to produce its own sustainability reports the company did not wish to dedicate resources to completing an external survey at this time.
<b>Bunzl</b>	The company is currently developing other areas of its CSR strategy, but recognises the importance of forest products particularly in its packaging supply chain. It is likely to turn to this area in the future.
<b>Carnival</b>	Carnival uses a number of forest products including timber for its boat refurbishments and beef in its catering operations, as well as potentially biofuels. Like TUI Travel, eco-tourism is a critical component of the company's offering. However, its biggest environmental footprint is in fuel use, which has been prioritised. Carnival recognised the benefits to developing forest sourcing policies but is not devoting resources to this area at the present time.

## Taking the Gender Agenda Forward

We have continued our engagement on improving gender balance in collaboration with other United Nations-backed Principles for Responsible Investment (PRI) signatories.

Along with US investors Pax World and Calvert, we are leading a group of nine investors engaging with 57 companies in eight countries. The international composition of the collaborative team reflects the fact that gender balance is an issue across the world. Indeed, Governance Metrics International's global study of gender balance at 4200 companies around the world showed only 8.9% of board seats were held by women, in line with the 8.8% finding in our Good Companies Guide 2009 study of the FTSE 350.

We are co-ordinating engagement in the UK and selected a group of companies representing a range of industries. These are Balfour Beatty, Barclays, GlaxoSmithKline, ICAP, Novartis, Reckitt Benckiser, Rotork, Smith & Nephew and Smiths Group. The engagement has been very well received and we have obtained initial responses from all of the companies. As expected, these show a number of different approaches, and reflect varying levels of management sophistication in relation to

the issue. We are benchmarking the responses and will follow them up in the coming quarter, with the aim of agreeing plans with each company on how to progress the gender agenda.

## Sustainability Consultations

One notable feature of the quarter was an increase in the number of companies proactively seeking investor input on their corporate social responsibility (CSR) and sustainability agendas. We were asked to take part in stakeholder consultations for Johnson Matthey, Compass Group and Spectris, three companies at very different stages of their evolution towards sustainable business.

Johnson Matthey operates in a number of environmental markets and plays directly into sustainability themes. The company also has a strong approach to managing its impacts, with time-bound commitments in the context of a long-term strategy. We fed back that the sustainability report could have made more of the benefits that the company provides, and included a broader discussion about developments in those markets. This could extend to lifecycle analysis; the report would then take on a longer term, more strategic nature.

Compass Group has experienced a chequered history from financial and environmental, social and corporate governance (ESG) perspectives; however, management changes have resulted in significant progress at the business on all fronts in recent years. Nevertheless, the CSR strategy is not yet fully formulated: while some regions of the business have strong policies and monitor progress, there is not yet a methodical approach, and the group’s targets are not aligned to strategic goals. We continue to view progress in these areas very positively, and encourage the efforts. As a catering business, Compass has considerable impacts and dependencies on the environment across long and complex supply chains, and improved management holds a significant prospect of future cost savings and risk mitigation, creating a win-win situation.

Historically Spectris has not made a convincing commitment to CSR; this has been reflected in our voting history and engagement with the company. To some extent the structure of the business as a number of discreet entities with a high level of autonomy does not lend itself naturally to centralised CSR policies. However, many of Spectris’ products in instrumentation, testing and controls help its customers enhance productivity, performance and manufacturing yield. As such, we believe the company may be a significant beneficiary of sustainability-related opportunities. Our view is that an enhanced focus on such business drivers may reveal new strategic opportunities. This realisation could also lead to a better understanding and management of the companies’ impacts.

We welcome proactive approaches by companies to engage their shareholders in dialogue about linking company strategy to sustainability, and hope that this trend continues.

## Sustainable Stock Exchanges

The Co-operative Asset Management collaborated with a coalition of responsible investors, who will write to chief executives of the global listing authorities and stock exchanges, to demand that sustainability reporting becomes embedded within listing rules. The aim is to promote a global listing environment that requires companies to consider how responsible and sustainable their business model is, and also encourages them to put a forward looking sustainability strategy to the vote at their Annual General Meetings (AGMs).

Aside from a few notable examples, such as the Singapore, Johannesburg and Istanbul Exchanges, there has not been a serious commitment from stock exchanges to amend their listing rules to encompass the broader sustainability issues companies face. This initiative will send a strong signal to the stock exchanges, as currently two thirds of them do not provide any sustainability reporting guidance for listing companies.

## Annual Report Voting

We maintained our stance on voting on the Annual Report in relation to the level of disclosure on ESG issues as outlined in the Spring 2010 Quarterly Review. Accordingly, we wrote to 16 companies in the third quarter of 2010, as indicated in the following table in chronological order.

Company	Vote	Topics addressed
<b>Paypoint</b>	For	Climate, Gender, KPIs, Management
<b>WPP</b>	For	Report
<b>BTG</b>	Abstain	Climate
<b>CAP</b>	Abstain	Gender
<b>London Stock Exchange</b>	Abstain	Climate, Gender, KPIs
<b>Telford Homes</b>	Abstain	Climate, KPIs Governance
<b>Helical Bar</b>	Abstain	Climate, Forests
<b>RPC Group</b>	Abstain	Climate, Gender, POPs, KPIs
<b>SAB Miller</b>	Against	Donations
<b>Umeco</b>	Against	Climate, KPIs
<b>Spice</b>	For	Climate, Gender, KPIs
<b>Quintain Estates</b>	Abstain	Climate
<b>Consort Medical</b>	Against	Climate, Gender
<b>Micro Focus</b>	Abstain	Climate, Gender
<b>NCC Group</b>	Abstain	Climate, Gender, KPIs
<b>Misys</b>	For	Climate, Gender, KPIs, Incentives

**Climate** – refers primarily to reporting of Greenhouse Gas emissions.

**Gender** – refers to gender balance throughout the company and at board level.

**KPIs** – refers to whether the company discloses Key Performance Indicators that enable performance on an issue to be assessed.

**POPs** – refers to Persistent Organic Pollutants and whether the company is taking steps to manage them out of operations or the supply chain.

**Management** – refers to the structures the company is using to manage social, environmental and ethical (SEE) risks and find opportunities.

**Incentives** – refers to whether remuneration provisions relate to environmental or social performance.

**Donations** – refers to whether a company makes political donations.

**Governance** – indicates those situations where the AR vote has been used to express disapproval of board composition overall.

**Report** – we wrote to complement WPP on putting its corporate responsibility report to the vote.

# Section 2 Corporate Governance

## Compliance with the Stewardship Code

The code was conceived in the wake of the financial crisis, when many institutional investors were criticised for not monitoring more closely the management of companies they owned. We fed into the Financial Reporting Council's (FRC) consultation process on how investors can act as responsible owners; we have long advocated incorporating responsible investment policies in our investment products and, when the Stewardship Code was launched in July 2010, we were very supportive. We ask for transparency to evaluate the companies we invest in, so it is only right that we demonstrate the same ourselves. We hope other investors will pick up the gauntlet the FRC have thrown down in this Stewardship Code.

In August 2010 we were one of only two asset managers who were fully compliant with the Stewardship Code\*.

## Engagement Round-up

As we moved into the third quarter, the prevailing story of activism in the market had been one of decreased levels of votes against, compared with the 2009 post financial crisis backlash. Companies have seen more than a 65% drop in opposing votes up to 1 July 2010 compared to 2009. This likely reflected a combination of companies being slightly more responsive to shareholder concerns, and shareholders lacking scrutiny as the market recovered. As we've noted previously, our motto of all-weather principled stewardship means that The Co-operative Asset Management applies scrutiny at all times.

The third quarter was a story of consolidation: having survived the storm and remodelled their businesses to new market realities, many companies were looking to review the link between strategic goals and pay structures, as well as the composition of expertise on the boards. This inevitably meant that some companies enhanced their practices, increasing shareholder confidence, while others unfortunately took backward steps.

The quarter began with an Annual General Meeting (AGM) of note, as Tesco faced investor backlash for awarding substantial bonuses for performance in the US by its Fresh & Easy subsidiary. Given that we had not been able to support its remuneration report since 2006, we entered into discussions with Tesco almost a month before the meeting in an effort to effectively convey our concerns. The year under review had represented a peak in concern with problems identified in areas such as the US Director Tim Mason's salary and bonus awards, discrepancy in the calculation of performance metrics, repeated application of discretion to advantage the directors, underwhelming degree of stretch incorporated into performance targets, and executive contracts that had reward-for-failure provisions.

Although the dialogue with Tesco had been helpful, it was not sufficient to assuage our concerns. We maintained our opposition to the report and on the day 32% of investors concurred, with a further 15% abstaining. With a combined protest vote at 47%, the company must now realise significant re-appraisal is required. It was rather telling, therefore, that as part of board succession planning a new chairman of the remuneration committee, Stuart Chambers, was formally introduced at the AGM. Our corporate governance team had anticipated the level of shareholder dissent and attended the meeting specifically to convey the importance of re-appraisal to the new chair of the remuneration committee. Due to our dialogue with the company, The Co-operative Asset Management will be part of a significant consultation process to review the remuneration arrangements this winter.

There was a similar story at WPP where we had opposed the remuneration report previously. We therefore, again, initiated early dialogue with the company in an effort to facilitate mutual understanding. While WPP is able to demonstrate some market leading practices, in other important areas of corporate governance it is a shame there appears to be a disconnect between the levels of executive pay and performance. Ultimately, shareholders registered a combined protest vote of 22% against WPP's remuneration report.

We had identified concerns at Robert Wiseman Dairies over the composition of the board, which clearly lacked independence, in combination with a concentration of power: the chairman being the holder of some 15% of the shares. We were therefore unable to support the re-election of various non-executive directors whose tenure on the board had exceeded nine years, which made them non-independent according to the UK Corporate Governance Code. Lack of independence on the board can act to dilute effective challenge of strategy. At the AGM 21% of shareholders voted against one such director, sending a clear message that board refreshment was in order.

At FirstGroup we were surprised that other investors did not look to make an example of poor practices. The company had made large recruitment awards to a director which were not linked to performance or continued employment. The director in question has now resigned from the board, and this should form a case-in-point example why such awards ought to, as a minimum, be linked to continued employment. As previously mentioned, The Co-operative Asset Management has identified such 'golden hello' awards as a systemic problem that undermines the incentive and retentive concept of share awards across the market.

At ICAP we were unable to support pay structures that focused excessively on short-term performance, something clearly at odds with the recommendations of the Walker Review and the Financial Services Authority's (FSA) Remuneration Code both designed to combat inappropriate risk taking and promote financial stability. The company eventually saw some 15% of the shares register opposition, which will hopefully send a clear message to the board to balance incentives toward long-term risk-adjusted performance.

\*Our statement of compliance can be found at <http://www.cooperativeassetmanagement.co.uk/advisers/stewardship-code.php>

We had identified the board composition at MITIE as something that could be improved. With a clear independence deficit, we targeted a particular non-executive director who had previously held the role of the chief executive at the company. It became obvious other investors had taken the same approach with 15% opposing and 13% abstaining.

It was only a matter of months ago that the FRC issued the revised Corporate Governance Code, including the divisive recommendation that FTSE 350 companies adopt annual elections for all directors. Finishing this round-up on a positive, we were pleasantly surprised that Northgate adopted the reform earlier than required; particularly impressive given that the company is placed just outside the FTSE 350, and so doesn't actually have to follow the comply-or-explain implementation of this particular aspect.

### Virtual AGM at Symantec

Symantec Corporation proposed holding a virtual-only AGM without a corresponding physical general meeting. Six months earlier, Intel had made the same proposal but received such strong shareholder protest that at the eleventh hour, the company decided to hold a physical AGM to compliment the virtual one.

We called on Symantec to review its decision and hold a physical meeting, as well as investigating ways its AGM could be revitalised to improve attendance. To highlight the worrying precedent that could potentially be set by having virtual only AGMs, we also posted our letter on the PRI Clearinghouse website, encouraging other investors to raise concerns with the corporate secretary of Symantec. We were pleased to subsequently see a significant number of investors and investor bodies joining us in writing to Symantec to challenge its decision. While the company went ahead with its virtual-only AGM this year, despite the shareholder concerns, it has subsequently bowed to pressure and will reinstate the physical AGM in 2011. We continue to believe virtual-only AGMs may have negative consequences, as some companies will likely see virtual meetings as a means to limit shareholder input.

### Green Paper

In September, we made a submission to the European Union's Green Paper on corporate governance in financial institutions and remuneration policies. The Green Paper covered a broad range of topics from risk oversight through to remuneration, incentives and gender balance on the boards. As investors in financial institutions, we have a strong interest in corporate governance, and are keen to contribute to the debate on the lessons that should be learned from the recent crisis. We argued in favour of mandatory vote disclosure to improve investor accountability, as well as advocating annual re-election of directors and closer links between the remuneration committee and the risk committee to strengthen the risk-adjusted dimension of remuneration. Amongst other considerations we further stressed that a mandatory advisory vote (say-on-pay) is fundamental to a robust remuneration policy.

### Reforms in the US

Significant corporate governance reforms have been passed under the Dodd-Frank Act in the US. The Act in its entirety covers a multitude of different areas of importance to the financial system, with issues such as

capital requirements for financial institutions, mortgages, consumer protection, proprietary trading, derivatives, hedge funds, and credit rating agencies all affected by Capitol Hill's sweeping reform. But in a change from the past, corporate governance reforms substantially also made the final cut.

Given the range of topics covered by the bill, and the sheer volume of regulations to be implemented, the full impact of the Dodd-Frank Act will not be known for some time. What is clear, however, is that the regulatory agencies will have much more authority and power to regulate and supervise effectively. Particularly notable corporate governance reforms that made it through House and Senate intact include:

#### **Vote on executive pay and golden parachutes**

It gives shareholders a say on pay with the right to a non-binding vote on executive pay and golden parachutes.

#### **Nominating directors**

This grants shareholders proxy access to nominate directors. Securities and Exchange Commission (SEC) Rule 14a-11 seeks to authorise shareholder groups that have held more than a 3% stake for at least three years to nominate board candidates to appear on management proxy statements. It was important this provision made it through, as the other major reform involving the election of directors was shelved at the eleventh hour. This would have mandated a majority voting standard, so directors would face genuine accountability at the ballot.

#### **Independent compensation committees**

Standards for listing on an exchange will require that compensation committees include only independent directors, and have authority to hire compensation consultants in order to strengthen their independence.

#### **Incentivise whistleblowers**

Creates a programme within the SEC to encourage people to report securities violations with rewards up to 30% of funds recovered for information.

#### **Clawbacks mandated for misrepresentation**

This requires that public companies set policies to take back executive compensation if it was based on inaccurate financial statements.

#### **Creation of the investment advisory committee**

A committee of investors to advise the SEC on its regulatory priorities and practices.

#### **Enhanced compensation oversight for financial industry**

This requires federal financial regulators to issue rules specifically applicable to financial institutions.

These provisions are part of a whole gamut of reforms, and while the SEC plans to issue proposed rules on certain governance issues between October and December 2010, others may not be implemented until April and July 2011.

While these are clearly exciting times in the US, we must not bet against further final hour efforts to block important reforms by the business lobby. Only recently it has been announced that the US Chamber of Commerce, and the Business Roundtable, filed a lawsuit that seeks to overturn the proxy access rule.

# Section 3

## Spotlight on Water

As recent events in Pakistan, China and Russia have demonstrated, there can be devastating consequences to both too much and too little water. Yet problems with water are not something that only happens to other people in faraway places – indeed the first six months of 2010 were the second driest for almost a decade in the UK and the hosepipe ban in the North West of England made people acutely aware of the impacts of water scarcity.

Those who still dismiss the talk about water stress in the UK as nonsense, pointing to the plentiful rain the island is famous for, might reflect that the South West of England is already classed as an area of 'extreme stress' in global comparison<sup>1</sup>, with major water shortages likely in the not too distant future unless we change the way it is consumed or find new sources. Further bringing home the reason for even the purely self-interested to be concerned, is the concept of embedded water<sup>2</sup>: in today's interconnected world many everyday essentials we take for granted may well go up in price or become unavailable if they are made in, or imported from, areas suffering water stress<sup>3</sup>.

We use 70% more water than 30 years ago and, with the proliferating appliance uptake and mass consumerism, this trend is set to continue. It is estimated that half of the global population will suffer from water stress<sup>4</sup> by 2025. Combined with population growth the statistics become even more worrying: it is estimated that feeding the nine billion people expected to be alive in 2050 would require twice as much water as used in agriculture today; this in light of the fact that only 2.5% of the world's water resources are fresh, of which two thirds are frozen. The remainder is in aquifers that we are draining much more quickly than the natural recharge rate. Oil is not the only resource we need to worry about running out of – blue is the new black.

<sup>1</sup> [news.bbc.co.uk/1/hi/sci/tech/7821082.stm](http://news.bbc.co.uk/1/hi/sci/tech/7821082.stm)

<sup>2</sup> The water used in growing food and making things

<sup>3</sup> [news.bbc.co.uk/go/em/fr/-/1/hi/sci/tech/8628832.stm](http://news.bbc.co.uk/go/em/fr/-/1/hi/sci/tech/8628832.stm)

<sup>4</sup> The demand for water exceeding the available amount during a certain period or when poor quality restricts its use

Notwithstanding the future challenges, the global community has a pressing one on its hands already. Even without extreme weather events, countless people die unnecessarily every year due to inadequate access to water and sanitation. Indeed, continuing on from sustainable access to safe drinking water and basic sanitation being included among the Millennium Development Goals (MDGs), the UN passed a resolution in July 2010 declaring it to be a fundamental human right, with no countries voting against<sup>5</sup>. This indicates increasing attention being given to the plight of the people, whereby countries will be willing or forced to forgo commercial gains in order to protect the water rights of their citizens. Globally, trade-offs between economic growth and access to clean water are already being made, and regulation is expected to tighten especially in countries where needs of the (growing) population, changing patterns of consumption, business interests and urbanisation, increasingly put pressure on scarce resources.

As water is literally a matter of life and death, the tensions over access to shared supplies will not always be solved through a compromise or national regulation but will in some instances lead to an escalation of hostilities. For companies, quite aside from potential pressure over their license to operate, such unstable operating environments will cause difficulties in their own right. The emerging 'water wars' – whether between groups or countries – and the related population movements may in turn have serious implications for global security.

This all points to an urgent need to address the fast growing environmental crisis water availability and purity issues present. However, where there is a challenge, there is also an opportunity, and those developing solutions to water stress may well make a substantial return on their investment. The market for water-related products and services today is estimated at over \$480bn<sup>6</sup> and set to increase rapidly.



## Business Case for Water Management

Water, critical to many processes, is usually a non-substitutable resource, the availability of which may have significant implications to business continuity and growth. Although water scarcity is generally considered a local problem, many companies in today's global system have manufacturing and supply chains in water-stressed areas, exposing them to various operational, reputational and regulatory risks.

Not only does the mere presence of a water-intensive industry where there is not enough water for everyone jeopardise these companies' licence to operate, but any mismanagement or pollution of scarce resources will also likely antagonise the local population (and authorities) and attract hefty fines. Moreover, it will put the often invaluable brand at risk. For instance, when Pepsi was accused of using excessive amounts of groundwater in India – whose emerging consumer class is among the company's key priorities – and further alleged to allow pesticide residue to get into locally made soft drinks, its sales fell by double digits even without any guilt being proven<sup>7</sup>. This is but one example of a backlash against multinational companies consuming scarce natural resources; particularly objectionable when exporting both the products and profits out of the country, and leaving few benefits to the local communities.

Whether because of outstaying their welcome, or because of running out of supplies, some companies may be forced to rethink their procurement or relocate operations to areas where appropriate amounts or quality of water is available. Many more are likely to be affected by rising raw material and production costs (cotton, paper and rubber, to name but a few, are very water-intensive), and more expensive imports if national/regional water management leads to price increases. Experts in China, for instance, expect water prices to increase up to four fold to cover the costs of managing supply and sewage treatment in the country where water shortages are responsible for direct economic losses of \$35bn every year. Further making a compelling case for proactively monitoring water usage and disposal is China's 2008 Water Pollution Prevention and Control Law that has provisions for levying fines of up to 50% of income on individuals working in offending companies<sup>8</sup>.

## Water Winners and Losers

Water utilities companies are clearly in the front line on this issue and, with sensible regulation, are likely to benefit from the scarcity. They can find new reservoirs, update infrastructure, fix leaks, and install water meters to encourage customers to use less, and explore technologies such as desalination. In order to ensure the appropriate measures are taken, authorities will have to allow water businesses to make acceptable returns on these additional investments – for example, increase the size of the regulatory asset base and, consequently, the absolute level of profits.

Another sector where water cannot be substituted is the beverage industry – something that became only too evident to Diageo when raw material shortages, especially water, required the production schedule to be reprioritised in Ghana, leading to volumes falling by 8%<sup>9</sup>. Accordingly, beverage companies are among leaders when it comes to water management, understanding the related business implications, and engaging with those affected on location.

Water issues affecting other industries may be more hidden but no less essential for business continuity, or indeed for realising the visions contrived for the future of our societies. To illustrate, nuclear power has been hailed as a cleaner option to coal, if only as an interim solution to tide us over while the renewable sources are further developed, yet nuclear power plants use up to 83% more water per megawatt than other types<sup>5</sup>. The blueprint for meeting the future energy demands tends to concentrate on CO<sub>2</sub> emissions while largely overlooking water considerations; however the latter can drastically affect the intended output.

The indirect impacts can be even more surprising: coinciding with the expanding Internet penetration and general digitalisation of processes, many companies have adapted their business models to better cater for the demands and opportunities of the 'e-era'. Countless data centres are needed to keep the Internet, computers, call centres and applications running, and many more will be required going forward – partly to support the move to a low-carbon economy in which information and communication technology (ICT) will play a crucial part.

Yet many office or online-based companies do not account for the vast energy needs of their 'low impact' (ICT collectively emits as much CO<sub>2</sub> as aviation globally) operations, and fewer still realise that a 1MW data centre operating water cooled chillers and cooling towers can consume 18,000 gallons of water daily, to dissipate the heat generated by the IT equipment. The water footprint of the Internet and e-commerce is hence huge and growing fast: few companies will remain unaffected by the need to manage water resources more efficiently.

On the other hand, virtualisation and cloud computing are becoming increasingly popular, with many businesses already outsourcing their data processing and storage to a centrally managed facility. Such economies of scale mean that data is handled much more efficiently, usually saving both money and the environment. Not tied to the location of businesses served, the managed data centres could be built where water supply is abundant and the external air temperatures lower (to minimise need for cooling), hence helping companies to get around local limitations, while the latest technology often utilised further tends to address water consumption.

As water awareness grows in the UK, companies positioning themselves as helping users to monitor, manage and reduce their water consumption will look attractive from societal and commercial perspective alike. Improved water efficiency in industrial processes is among key benefits of the products by engineering companies such as Rotork and Spirax Sarco, while Eaga offers domestic water efficiency programmes and installs devices. The expertise of consultancies such as WS Atkins and RPS will be in demand as projects and processes need to be designed with water-related limitations in mind, with WS

Atkins, in particular, benefiting from its global presence much of the infrastructure development worldwide is taking place in already water-stressed emerging markets.

Turning from demand-side efficiency to distribution, water infrastructure is highly wasteful and/or inadequate in numerous places the world over, desperately needing investment. Maximisation of existing resources will also become even more crucial in years to come, and desalination and rainwater harvesting will have to be utilised in places where there is no fresh water readily available. There are many companies in FTSE 350 which already provide products and services whose demand will increase significantly as desalination, in particular, becomes more affordable, or simply vital, and hence more widely utilised. First mover advantage cannot be underestimated.

## **The Co-operative Asset Management Takes Action on Water**

For investors, water is very much a material issue and one of the key challenges for the future. Yet while some companies have acknowledged water management as a crucial issue, most are yet to proactively integrate the related risks, let alone the burgeoning opportunities, in their business plans. This is something we as responsible investors will aim to push for. The Co-operative Asset Management has been integrating the assessment of water strategies of relevant companies in our investment analysis, and sought to identify 'water winners', particularly in the context of our Sustainable funds. We have also discussed the challenges with companies in which we hold shares.

In 2009, we took part in the collaborative Principles for Responsible Investment (PRI) engagement encouraging participation of the CEO Water Mandate, and this February endorsed the Carbon Disclosure Project (CDP) Water Disclosure survey. An extension of the CDP, the Water Disclosure survey was undertaken for the first time this year and the results to be revealed in November will provide critical water-related data from the world's largest companies to inform the global market on investment risk and commercial opportunity.

We feel it is perfectly reasonable to expect companies – especially, but not exclusively, those with water-intensive operations, presence in water-stressed areas and/or long supply chains – to discuss various issues as part of their strategy. These include: consumption and targets to reduce it, waste water, pollution/emissions to water, usage efficiency, risk assessment (e.g. facilities location and project planning), water quality issues, and capitalising on the opportunities in the field. We are about to embark on a series of engagements focusing on the key issues discussed in this piece, and look forward to reporting on our progress in future reviews.

<sup>5</sup> [www.bbc.co.uk/news/world-us-canada-10797988](http://www.bbc.co.uk/news/world-us-canada-10797988)

<sup>6</sup> [http://www.samgroup.com/html/publications/studies/documents/2010\\_Water\\_study\\_e\\_FINAL.PDF](http://www.samgroup.com/html/publications/studies/documents/2010_Water_study_e_FINAL.PDF)

<sup>7</sup> [www.businessweek.com/magazine/content/07\\_24/b4038064.htm](http://www.businessweek.com/magazine/content/07_24/b4038064.htm)

<sup>8</sup> [http://responsibleresearch.com/WATER\\_IN\\_CHINA\\_Issues\\_for\\_Responsible\\_Investors\\_FEB2010.pdf](http://responsibleresearch.com/WATER_IN_CHINA_Issues_for_Responsible_Investors_FEB2010.pdf)

<sup>9</sup> [google.brand.edgar-online.com/EFX\\_dll/EDGARpro.dll?FetchFilingHTML1?ID=6458726&SessionID=Cx2VHv6UTIKsQP7](http://google.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHTML1?ID=6458726&SessionID=Cx2VHv6UTIKsQP7)

<sup>10</sup> <http://www.foe.org.au/anti-nuclear/issues/info/Water-nuclear-power.pdf>

# Section 4 Recent Developments

## Good Companies Guide 2010

Since 2007, The Co-operative Asset Management has produced an annual in-depth study of the UK's largest 350 quoted companies (FTSE 350) around environmental, social and corporate governance (ESG) issues. In 2009, we focussed on what efforts companies were making to ensure they had access to the most diverse pool of talent, with a particular emphasis on gender.

Studies or indices of this nature often satisfy themselves with a conventional appraisal of the companies' corporate social responsibility (CSR) programmes, which may tell one little about how the company is affected by material ESG issues, and its strategy for coping or capitalising on them. In 2010 we decided to turn this around and look at 'sustainability' in a more strict sense.

Our study posed the question of which companies would enjoy financial tailwinds and which face headwinds from critical long-term social and environmental challenges including resource depletion, pollution, demographic change and pressure on the distribution of wealth.

The double page coverage in the main section of *The Observer*, over the August bank holiday weekend, showcased the way The Co-operative Asset Management adds value to its own investment process by building in these often underappreciated themes. Worryingly, our analysis shows that 56%, or more than half, of the FTSE 350, will have to overcome negative financial effects from depleting resources, climate change and pollution, while only 10% stand to gain by providing solutions.



### The results

#### Top 10 for Ecology

Company	score out of 5
<b>Eaga</b>	5
<b>Hansen Transmissions</b>	5
<b>Invensys</b>	5
<b>Atkins (WS)</b>	4.5
<b>Johnson Matthey</b>	4.5
<b>FirstGroup</b>	4
<b>Spirax Sarco</b>	4
<b>Engineering National Express Group</b>	4
<b>Severn Trent</b>	4
<b>Unilever</b>	4

#### Top 10 for Society

Company	score out of 5
<b>Smith &amp; Nephew</b>	5
<b>Synergy Health</b>	5
<b>Carnival</b>	4
<b>Eaga</b>	4
<b>National Express Group</b>	4
<b>Pearson</b>	4
<b>Standard Chartered</b>	4
<b>Old Mutual</b>	3.5
<b>Promethean</b>	3.5
<b>World SSL International</b>	3.5

### Ecology Driving Profit

Eaga scored highly as its product lines in heating and renewables, as well as carbon reduction services, are in the sweet spot of solving climate change and energy challenges. Invensys, an engineering company, is seeing strong demand from clients looking to increase efficiency in logistics and cut energy use, while National Express, offering flexible low-cost public transport, will benefit from a modal shift towards mass transit in the fight against climate change. Turning to Severn Trent, the water company, we believe it will be allowed to increase revenues on the back of investment into improving the resilience of our fresh water infrastructure, while its water testing business will see demand increase as more marginal water supplies need cleaning up. Unilever, though not providing pureplay 'solutions' like the wind turbine gear boxes of Hansen Transmissions, will nevertheless benefit from food price inflation as a consequence of pressure on land and resources, while insulating itself relative to competitors to supply disruption through more sustainable supply chain management.

### Moving with Society

Smith & Nephew's hip replacement therapies will be in demand from an ageing population. Controversially, we also see Carnival, which normally performs poorly in ESG ratings, benefiting from this theme, with opportunities to grow in emerging markets, as well as an increase in demand for cruises from an ageing population. These prospects may be tempered by the fact that Carnival's business is highly oil dependent, which may eat into margins, and shipping's high greenhouse gas emissions will



likewise soon come under scrutiny. The increased need for essential financial products such as bank accounts, microfinance and insurance in emerging markets will be a strong boon to Standard Chartered and Old Mutual, while Pearson and Promethean World, both in different parts of the education market, will benefit from increased spend on literacy and learning in emerging markets, as their middle classes expand.

## Conclusion

Sustainable business practice is becoming an increasingly influential factor on company bottom line performance. Indeed, we believe such considerations are already a primary strategic driver in a number of industries, while there are few companies that cannot benefit from cost reduction and productivity improvements, through a more methodical assessment of their relationships with environmental and social stakeholders. Our study is a warning of testing times ahead for both business and society. It also presents a major challenge for institutional investors such as The Co-operative Asset Management, who will need to ensure that their investments will provide long-term returns for their clients.

## Investment Themes

The third quarter is traditionally a quieter time for markets. In keeping with the summer holiday season, there were fewer corporate results or significant news from companies that indicated it to be appropriate to change views. The trading patterns of our funds have reflected the lower volumes on the market and have, in the main, been in line with the longer standing investment themes, particularly exposure to emerging markets, where economic growth remains robust in comparison to the lack-lustre performance of developed economies.

Names featuring on our buy list include Unilever, Burberry and Rolls Royce; all of which benefit from consumer spend in developing markets. Investments for the sustainable funds have included Roche and GlaxoSmithKline in healthcare; as well as Hewlett Packard, Google and Microsoft, all driving the spread of information technology. Across our funds there have been reductions of holdings in the support services sector, where public sector cuts in the UK are likely to hold back prospects. Companies where we have been scaling down our position include MITIE, Serco, and RPS.

## The Co-operative Asset Management at the Liberal Democrats Party Conference 2010

The Co-operative Group has a presence each year at all three party conferences to ensure our message of a fairer, more sustainable economy and society is heard. The Liberal Democrats had reason to be excited about their Annual Conference in Liverpool this year. It was the first in sixty years where they could discuss their policies in the knowledge that they enjoyed some executive power to try to implement them through the Coalition Government.

We were invited by the NGO Fair Pensions, to speak at a fringe event alongside Pensions Minister Steve Webb and Ed Davey, Consumer Affairs Minister (with responsibility for corporate governance). The topic of the roundtable was how to encourage responsible investment. The conversation took place under 'Chatham House Plus' rules, which prevents us from reporting anything other than what The Co-operative Asset Management said.

Niall O'Shea, Head of Responsible Investing at The Co-operative Asset Management, focused on the problems in the custodial chain: ultimate beneficiaries (people who own pensions) not knowing how their pension money is used; most trustees not sufficiently informed to understand ESG implications and scrutinise implementation; and pension funds having multi-decade obligations, while outsourcing to fund managers who are incentivised to respond to extremely short-term signals.

Niall also pointed out the fallacy of 'more disclosure equals ESG being taken more seriously': there was too much focus from supporters of responsible investment on improved disclosure in the Annual Report, when most investment analysts make limited use of what is a mostly backward-looking document. The real issue, he said, is persuading the decision makers of the current relevance of longer-term sustainability issues to performance and aligning their pay accordingly. Then, Niall argued, the mainstream would have more reason to read all that disclosure. Finally, he suggested that remedies would logically involve a balanced blend of regulation, taxation and incentives; and training of beneficiaries, trustees and investment analysts.

The Co-operative Asset Management will shortly be submitting its response to the Coalition Government's consultation on its manifesto commitment to re-instate the Operating and Financial Review (OFR)<sup>11</sup>; a more thorough, forward-looking alternative to the present Business Review required in the Annual Reports and Accounts of UK public limited companies (PLCs). Our position remains as it was in 2006: that the OFR is welcome and should be mandatory, but should focus on achieving the right outcomes, not on micro-managing company disclosure.

## Responsible Investment Annual Review 2009/10

The Co-operative Asset Management has just published its second Annual Review<sup>\*\*</sup>, in which we explain in detail who we are, and how our commitment to responsible investment is applied in our stock-selection process and across asset classes, showcasing our funds as prime examples of how integrating ESG factors in company analysis can increase returns for our clients. Reflecting our dedication to leading by example, we provide a thorough account of our implementation of the six principles of the United Nations-backed Principles for Responsible Investment (PRI) throughout last year, and also look back at the Good Companies Guide 2009, which highlighted some very thought-provoking trends in the areas of gender balance and executive pay. The Annual Review further describes how we have put our Ethical Engagement Policy (EEP) into practice, offering readers case studies on how our interaction with companies has led to progress in the areas deemed most important by our clients.

We would be delighted for any feedback on both our annual and quarterly reviews, and invite you to get in touch via [tcam@cfs.coop](mailto:tcam@cfs.coop). Should you wish to obtain a printed copy of the Annual Review 2009/10, please do not hesitate to contact us at the above address and we will be happy to post one to you.

<sup>11</sup> The OFR was dropped controversially by Gordon Brown despite acceptance and much preparation by the investor and corporate worlds.

<sup>\*\*</sup> Available online at <http://co-operativeassetmanagement.co.uk/advisers/responsible-investment.php>

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