The **co-operative**
asset management

# Responsible Investments Quarterly Review

Winter 2009

Part of The **co-operative** financial services

# Section 1 **Engagement Update**

## In focus – Improving Gender Balance

By now, we are all familiar with the question, 'If Lehman Brothers had been Lehman Sisters, would the credit crunch have happened?' But is gender imbalance really an issue for UK boards? The Co-operative Asset Management, which sees the issue of gender balance as both a matter of good business management and a question of social justice, has sought to answer this question and, as discussed in our last Quarterly Review, we have been active in engaging companies on this topic.

Worryingly, our research, which appeared in the *Observer* in August 2009, found that the majority of companies have proportionately fewer women in management compared to the general workforce and the proportion decreases dramatically at the higher levels. A critical step in challenging this prevailing culture is to analyse the gender breakdown of the workforce and management hierarchy to see where subtle blocks to advancement in careers might lie. Further key indications of a company's cultural acceptance of gender balanced leadership are the number of women in the top layer of operational management and the question of whether these women actually hold key positions of decision-making authority. In our view, when recruiting and replacing at the top, gender balance should be a consideration.

Women currently make up 60% of graduate numbers in Europe. Companies with disproportionately few women in management positions are probably missing out on the best talent. Firms that do not regulate their culture effectively because of inadvertent discrimination or unattractive opportunities for women are likely to lose out as women leave employment.

Given the increasing proportion of wealth held by women and their high share of consumption decisions, another critical issue for companies is ensuring that they capture women's perspectives in product and service design. Ensuring that key decision-making roles are open to women in practice – and not just in theory – is the simplest way of doing this.

Our engagement with companies on this subject has focussed on disclosure, as poor disclosure frequently indicates lack of sensitivity to the issue. The Co-operative Asset Management generally analyses disclosure when considering whether to adopt the Annual Report and Accounts of the companies under review. In many cases where we write to companies regarding their performance on environmental, social or governance policies or practices we also include comment on their disclosure of gender balance. We have also raised the issue on a number of occasions in our meetings and conference calls with companies. Over the second half of 2009 we have raised questions of gender balance in writing or in meetings with the following companies, as part of the Annual General Meetings (AGM) voting process.

### Companies Engaged on Gender

| | |
|---|---|
| **Hays** | **Headlam Group** |
| **Misys** | **Spectris** |
| **Findel** | **Inchcape** |
| **Consort Medical** | **Compass Group** |
| **NCC Group** | **Unilever** |
| **Ashtead Group** | **Johnson Matthey** |
| **DSG International** | **Mears** |
| **ICAP** | **Mitie** |
| **London Stock Exchange Group plc** | **Premier Oil** |
| **Paypoint** | **Smiths Group** |

## Aggreko plc

As a significant shareholder in the temporary power supplier Aggreko, its limited attention to human rights issues was a concern to us, particularly in light of the various politically unstable locations and post-conflict situations it operates in. Notwithstanding the company's positive undertakings with regard to large-scale power shortages, natural disasters and post-conflict reconstruction, we still felt it appropriate to encourage the company to improve its assessment of political and human rights risks within its sphere of influence.

Aggreko welcomed our subsequent recommendations as constructive and helpful and confirmed that it would look to integrate some of them into its operations. The company has since undertaken a thorough assessment of those aspects of human rights which it believes are most relevant to its business, graded their potential impact and identified existing control measures in place. Although Aggreko did not consider the outcomes of this assessment to require it to change the way it does business, the company nevertheless agreed that it should improve the way it manages and monitors its support for human rights within its existing systems and procedures. To this end, Aggreko decided to review its human resources policies, with Aggreko International business and the Middle Eastern operations taking the lead in this exercise.

The company recently confirmed that this process is now underway. It is reviewing current practice, gathering the right data on various policy-related issues, and issuing guidance for staff (and, where appropriate, third party contractors) in each country on management expectations of adherence to good practice on human rights.

We are pleased to see Aggreko taking concrete steps to improve its approach in this area and welcome its responsiveness to our concerns. We look forward to the outcomes of policy and practice revisions, and their eventual roll-out to employees and other stakeholders.

## Arriva plc

For several years the Sustainable Leaders Trust has invested in Arriva plc, the European bus and train operator, based in large part on our conviction that public transport will be an increasing beneficiary of the transition to a low-carbon European economy. However, Arriva was somewhat late among competitors in publishing a carbon target and its fleet had not been the most carbon-efficient. As an investor in the company, we want Arriva to be in a good position to bid for business – both to governments and to consumers – on the basis of being an environmental leader.

The Co-operative Asset Management, along with various other signatories to the UN Principles for Responsible Investment (PRI), attended a meeting with the company, which proved instructive. Arriva's Head of Investor Relations believed that most public transport rolling stock and infrastructure is highly carbon-inefficient and that it could become the next target for environmentalists and policy-makers, after cars. The company had found that it could achieve significant cuts in emissions just from training drivers to drive better and had limited success with various forms of biofuels. The transport sector as a whole needed to catch up on cutting-edge hybrid fuel technology and a modernisation of rail and roadways, but vehicle manufacturers were currently too focussed on cars. Meanwhile, local governments particularly were preoccupied with lowest-cost provision and therefore carbon was not yet an issue for them, despite official government policy.

We believed that we could best exercise our influence by taking these issues and turning them into recommendations to be put to the Chief Executive and the Chairman to help raise awareness and debate at the highest level. We await their response.

## International Power plc

The Co-operative Asset Management has invested in International Power plc, an owner of power plants, via several of its funds, including The Sustainable Leaders Trust, for several years. The company has a varied mix of assets, most coming from gas, some from renewables, but also some from coal. We engaged with International Power during 2008 to ask them to come into line with industry best practice by publishing a carbon intensity target, to focus managements' minds on moving onto a lower-carbon trajectory.

In our first meeting in January 2008, the company was resisting this call because it saw itself as an acquisitive company that valued every deal on its financial merits first and couldn't commit to carbon being an influential factor. We felt this was unsatisfactory as carbon regulation was having an increasing impact on the value and life of power generation assets. This came home to roost when the Australian Carbon Pollution Reduction Scheme put International Power's coal-fired stations there in the spotlight, meaning they will have to be either cleaned up massively or retired early.

We met with the company again in November 2009. This time the company conceded that the investment committee routinely and vigorously discussed the climate profile of existing assets and potential acquisitions. Although there were no hard and fast rules about what kind of asset they would invest in, it said it was difficult to conceive how the company could risk moving in a more carbon intensive direction. In this context, the company said it was prepared to consider adopting a range of carbon intensity targets, based on type of fuel. It also accepted our point that in future, clients would not necessarily be prepared to absorb any carbon costs International Power would try to pass on.

We see this as a subtle but significant shift in the debate at International Power that recognises that greenhouse gases are going to be a standard and sometimes critical decision in the company's strategy. We have asked the company to confirm its targets so we can check they are challenging and to provide regular updates on progress.

## Oil Sands Update

In our last Quarterly Review we reported on our leading a coalition of PRI signatories, backed by US$3 trillion of assets, that wrote to 19 companies operating in the oil sands of Canada. The coalition asked the companies to justify the prudence of their investments in view of significant regulation and legal risk, and setting out what the investors saw as key mitigation actions.

In December, The Co-operative Asset Management agreed to respond positively to an invitation from the NGO Fair Pensions to co-file a shareholder resolution at Royal Dutch Shell plc and BP plc regarding their operations in the oil sands. The resolution asks for a report from the audit or risk committee on how the companies' oil sands investments would cope under more 'unfriendly' macro-economic and local scenarios. The resolutions will be voted on and discussed at the companies' 2010 Annual General Meetings (AGMs).

We will report more fully on progress on these resolutions in our next Quarterly Review.

# Section 2 **Corporate Governance**

## Remuneration

The last quarter of 2009 saw another remuneration report voted down by shareholders. Punch Taverns plc lost the vote with 55% of shareholders voting against the company's remuneration report. This brought the year's total to five and set a new record. Previously, the highest number of remuneration reports defeated in a single year was four during 2005.

The four other remuneration reports defeated during the year were Bellway, Royal Dutch Shell, Provident Financial and the Royal Bank of Scotland. The Co-operative Asset Management voted against all of these remuneration reports and in the case of Bellway and Royal Dutch Shell also attended the Annual General Meetings (AGMs) to ask remuneration-based questions.

The focus on remuneration during the fourth quarter in 2009 continued with the publication of the final recommendations of the Walker Review of Corporate Governance of UK Banking Industry in November. There were no real shocks in the final report and Sir David Walker did not move very far from his initial recommendations.

The Co-operative Asset Management fed into this consultation, not only calling for the Chairmen of board committees to stand for annual re-election but also for the annual re-election of all board members in an effort to increase accountability to shareholders.

In our view, the Walker Review did not go far enough. Its failure to call for mandatory voting disclosure on behalf of institutional investors – something we have been disclosing since 2002 – is now well behind the curve in best practice.

Whilst some of our recommendations didn't make the final cut we will continue to engage with companies to effect changes in these areas outside of the Walker framework.

## Collaborations

One recommendation of the Walker review and a favourite theme of City Minister Paul Myners is that there should be more co-operation among long-term investors in exercising their fiduciary responsibilities. The Co-operative Asset Management has a long history of collaborating with other investors which predates the recent calls for shareholders to increase their activism to effect positive change by pooling resources.

These collaborations include US and European investors. We co-signed a letter with the Ethos Foundation urging Swiss companies to put their remuneration report to the vote. Zurich Financial Services and Swiss Re have recently voluntarily done so in response to this letter.

## Intel

Intel's attempt to do away with its physical AGM in lieu of a web based event prompted a letter from The Co-operative Asset Management to its Company Secretary. We urged Intel to consider accompanying this web-based event with a physical meeting so as not to weaken shareholders' ability to address management, which would be a backwards step in governance practice.

As responsible investors we frequently attend the AGMs of the UK companies in which we invest and we are aware that shareholder attendance, in most cases, is on the wane. We asked Intel to consider ways of rejuvenating the format of the AGM to encourage greater participation from shareholders, rather than scrapping it altogether.

In January 2010, Intel bowed to shareholder concerns and scrapped plans to hold an online only shareholder meeting. It is planning a conference in the Autumn of 2010 to establish safeguards for the conduct of any future virtual meeting that may accompany the physical meeting.

## Eni

We recently held a conference call with Eni International Resources to discuss the governance measures in place to negate any concerns arising from the Italian Government's stake in the company.

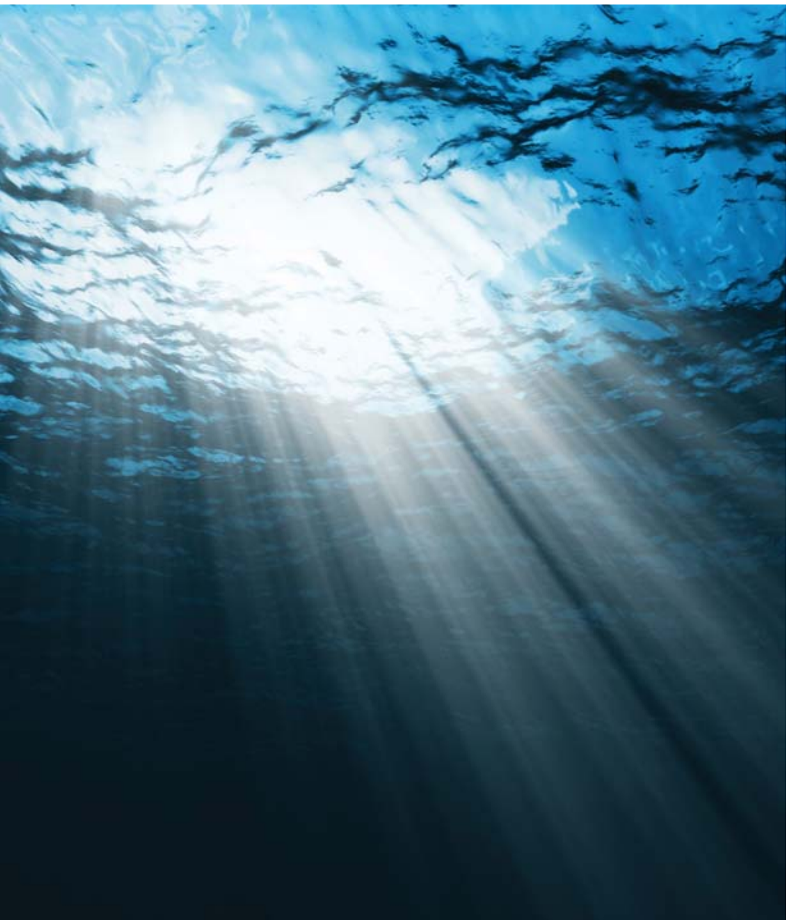
# Section 3 **Tobacco: A Case Study**

Our customers sometimes ask how we decide what companies to invest in and why some of our funds invest in different sectors of the market. For example, our Income with Growth Trust holds British American Tobacco whilst our Sustainable Leaders and Sustainable Diversified Trusts don't.

The Co-operative Asset Management has never said that we avoid all businesses which are controversial, albeit legal, such as tobacco. Nevertheless, we are highly sensitive to the concerns of our customers as regards such sectors. Consequently, whilst our primary fiduciary or financial duty is to ensure customers receive an acceptable return within an acceptable level of risk, we do our best to accommodate our customers' concerns into our investment process using two complimentary approaches.

## Our Sustainable Funds

For customers who wish to avoid certain industries we have three screened trusts, Sustainable Leaders, Sustainable Diversified and Sustainable World. These trusts exclude tobacco companies, defence companies and nuclear generators, to name a few. Instead, they focus on companies making a positive contribution to society across the themes of sustainability, human welfare and the environment. The funds also benefit from our Ethical Engagement Policy which is outlined below.



## Our Engagement Funds

For customers who do not wish the investment universe to be restricted, but who want a strong social responsibility element, we invest across the market and then, via our Ethical Engagement Policy, use our position as a major investor to engage with companies to encourage them to improve their environmental and social performance towards best practice. Investment products like UK Growth Fund and UK Income with Growth require us to be 'universal investors', spreading risk across a range of sectors. To exclude sectors such as tobacco and others which some customers would find unpalatable would expose customers to an unacceptable level of financial risk. Furthermore, these funds simply do not have a mandate to exclude – that is, customers never signed up to such a 'screen' and it would be improper to impose one retrospectively. Instead, we use our influence to engage with companies on a commercial level to discuss issues of customer concern and challenge companies to improve.

For example, we have previously engaged with Imperial Tobacco because we felt that its public position on tobacco and health was untenable and potentially damaging. The company has since reformed how it communicates on these issues. We have also had extensive conversations with British American Tobacco on the issue of marketing and advertising in emerging markets. We monitor companies' performance in this as well as other areas, such as the development of Potentially Reduced Exposure Products.

The lower level of awareness of the risks of smoking in developing countries is a real concern. We are supportive of the principles of the WHO Framework Convention on Tobacco Control, which does not seek to ban tobacco but to educate consumers and encourage ratifying countries to introduce effective public tobacco control measures including bans on advertising, promotions and so on. We believe this process is having some success. Bulgaria, the second heaviest smoker in Europe, recently voted to ban smoking in public places. Many developing countries have adopted comparable measures, though there is a long way to go. These countries are undoubtedly 'growth markets' for tobacco companies as Western markets slowly decline. Therefore, the standards companies apply in developing countries are closely scrutinised. Should companies act outside the law or contrary to best practice we would be quick to challenge them.

Ultimately, where a company proves impervious to influence, and their social and environmental practices pose a threat to financial performance, we have the option to divest – and have exercised this option in other sectors, on occasion. We continue to keep a watching brief on the evolving views of our customers and the performance of investee companies and further information on our Ethical Engagement Policy can be found on our website **goodwithmoney.co.uk**

# Section 4 **Recent Developments**

## The Road Away from Copenhagen

As with many organisations, our review of the fourth quarter of 2009 would not be complete without a comment on Copenhagen.

The Co-operative Asset Management sits on the steering committee of the Institutional Investors Group on Climate Change and having contributed to the draft text of the combined statement made prior to Copenhagen, felt it important to have a presence at the conference itself. Our objective was to support the document and give voice to an investment community increasingly concerned at the prospect of changes in the climate. We discussed the barriers to investment with delegates and expressed our support for a strong deal that would help mobilise the private capital required.

As discussed widely in the press, the result of the conference – the Copenhagen Accord – was neither a deal nor contained the strong wording necessary.

This has several implications for companies and markets. Without a clear time frame and milestones, there is less of an incentive to invest in solutions. This increases the risk of tougher legislation and more stringent adjustment at an unspecified point in time. It also increases the longer-term risk that volatility in food, water and energy prices may cause ripples in the broader economy.

In the absence of an international framework for addressing the causes and effects of climate change, we will have to look more carefully at domestic regulation in different jurisdictions. The table below provides summaries of some of the unilateral pledges given by countries that offer potential for removing uncertainty and so lay the foundations for investment in solutions in each domestic context.

The due date for countries to sign the Accord with accompanying pledges in greenhouse gas reductions is 31 January 2010 and a better understanding of the status of the Accord will be gained at this time. The target of holding a rise in global temperature to less than 2°C above pre-industrial levels is not possible with the pledges given so far together with the measures described in the Accord. The next Conference of Parties (the sixteenth) is due to be held in Mexico in December 2010. There are other relevant meetings in Bonn earlier in the year.

Our agenda of engaging with companies to improve their responses to climate change – addressing their impact and dependence on the

| Country | Date of pledge | Pledge | Comment |
|---|---|---|---|
| US | Nov 2009 | 17% cut in $CO_2$ by 2020 from 2005 baseline | This includes significant offsets. The bills have not yet passed through the Senate and may not make it through in 2010 |
| EU | Dec 2008 | 20% cut by 2020 from 1990 baseline 30% if there is an ambitious agreement | Includes significant offsets. Given deterioration in economies, these are not that challenging and could be economically beneficial. Poland and Estonia trying to block European Commission mandating national targets |
| UK | Nov 2008 | 80% cut by 2050 from 1990 baseline including 26% by 2020 from 1990 | The Climate Change Bill was the first legally binding commitment to emissions reduction |
| China | Nov 2009 | Emissions per GDP reduced by 40% to 45% by 2020 from 2005 baseline. Will accept international verification | Much of this happens due to economic development. Given expectations for GDP growth, this would mean a rise in absolute terms |
| India | Dec 2009 | Emissions per GDP reduced by 20 to 25% by 2020 from 2005 baseline | Much of this happens due to economic development. Given expectations for GDP growth, this would mean a rise in absolute terms. The plans are not detailed and the data sets are incomplete |
| Brazil | Nov 2009 | 80% reduction in Amazon deforestation. 36% to 39% reduction by 2020 from reference remissions (or business as usual) | Brazil has created the Amazon Fund to help this and depends on international financing |
| Maldives | Sep 2009 | Become carbon neutral by 2019 | Aiming to be first such country. Detailed plan not yet published |

environment – continues, as does our work to understand those companies facing risks and opportunities with respect to climate change related factors and so ensure that our customers' assets are used to best advantage.

## Investment Themes

Our funds position themselves proactively according to our view of both global and national events. Frequently investments/divestments are made in line with themes that are developing across society and so are reflected in many of the holdings in our funds. To illustrate, we made a number of purchases of companies with strong franchises in outsourcing during the fourth quarter. Underlying this is the fact that the UK is currently running an extremely high government deficit and irrespective of the outcome of the election, reducing spending will be a key priority over the next government. Outsourcing companies help with this by increasing the efficiency of local authority and central government spending. Purchases included shares in Mitie and Serco.

Within our sustainable range of funds there were a number of investments in technology-related companies. Here there are potential social benefits from increased information access and improvements in the efficient use of resources. One such company, where we added to our holding, is online auction company Ebay. The business model has the significant environmental benefit of helping citizens re-use their items.

We continued the theme of investing in companies with emerging markets exposure, as reported in our last Quarterly Review, with further purchases of SAB Miller and Aggreko. SAB Miller's story has interesting sustainability dynamics. While its business is alcohol related, it is also leading industry efforts to reduce dependence on water, including a significant research project with WWF. The project covers not just the footprint in the brewing operations, but also analyses the intensity of water use in the agricultural supply chain.

## TBLI

In November 2009, two of The Co-operative Asset Management's responsible investment representatives attended the Triple Bottom Line Investment Conference (TBLI) in Amsterdam. TBLI is the largest annual global networking and learning event on Environmental, Social and Governance (ESG) investing in Europe and the theme for 2009 was Retooling the Economy.

The wide range of issues covered included Integrating ESG; Water Scarcity; Responsible Corporate Restructuring; and Biodiversity. One over-riding message from the conference was that the recent financial crisis, compounded by snowballing sustainability issues such as climate change and product toxicity, made it clear that ESG integration is a work in progress and that more must be done to turn the patchwork of approaches into viable public policy and corporate governance solutions.

Another was the increasing shift of global institutional investors into emerging markets' equities, bonds, real estate and alternatives, which has been hastened by the financial crisis. Investors are now seeing emerging growth markets as a key source of higher returns compared to their developed market peers. Indeed, emerging markets are estimated to represent approximately 15% of world market capitalisation and in the region of 30% of world GNP. This suggests that institutions are relatively underweight in developing countries and will continue to diversify apace. However, the issues of investment risk/return and sustainability, governance and transparency issues in emerging markets go hand-in-hand. This leads to important questions about the quality/level of sustainability and risk research available today. Socially oriented investors discussed how allocations to emerging markets represent a key plank of development capital and can benefit increased economic activity on the ground. It was in recognition of these important themes that The Co-operative Asset Management launched its new global sustainability funds, Sustainable World and Sustainable Diversified,in 2009.

## The *Observer* Study: Executive Pay

Continuing our Good Companies Guide series, a study by The Co-operative Asset Management on executive pay was published in the *Observer* in December 2009.

Despite public outcry, boardroom pay continues to grow excessively. Our study analysed the remuneration policies of 30 companies in the banking and financial services sector of the FTSE 350 and compared them to the policies in place at a control group of 30 companies chosen randomly across other sectors of the FTSE 350.

The main findings were as follows:

- while some improvements have been made by some companies and widespread base salary freezes are common, there remains a trend of pay becoming more excessive at approximately half of the companies (29 out of 60) considered in the survey
- despite the media spotlight and heavy scrutiny falling on pay in the financial services sector, it is faring in line with the rest of the economy with rises seen in 15 of the 30 financial companies surveyed, compared to the 14 from 30 businesses in the control group of other sectors
- however, compared to the control group, discretionary payments and undesirable employment contract provisions, such as guaranteed bonuses and 'golden hellos', are more prevalent in the finance sector
- the introduction of new, ad hoc schemes or other bonus awards to compensate for loss of payouts under other schemes has continued and remains common across both groups.

We also analysed our votes cast on remuneration report resolutions at Annual General Meetings (AGMs) throughout 2009.

We found that:

- there was an 11% rise in votes cast against remuneration policies, while there was a rise in abstentions to 43% from 51% in 2008
- there was a 41% increase in proactive approaches from companies looking to engage on remuneration policies. Despite the rise, this failed to translate into a more constrained approach to remuneration.

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