



# SRI Quarterly Report

## July-September 2011 Summary

We are pleased to announce that Threadneedle Investments has been named the Second Leading Fund Management Firm for Sustainable & Responsible Investing (SRI) in the annual Thomson Extel survey. This ranking places Threadneedle consistently among the top asset managers for SRI over the past four years. We are constantly refining our approach and are recognised for our focus on integrated ESG (Environmental, Social and Governance) research.

A smooth transition following team changes took place this quarter, with a junior analyst hired to help the team over the period. We have focused our work during the three months on the integrated ESG research process, and have been involved in several industry conferences and seminars.

In a sustained drive to improve our monitoring efforts, we initiated a desk review of all our preferred equity holdings. This deploys the external MSCI ESG ratings to screen company performance on ESG metrics. We use these ratings as part of the process to narrow our focus universe for further ESG research and engagement.

Increasingly, the investment community is recognising the need for renewed efforts in emerging markets. We are working particularly closely with the Far East desk to incorporate ESG issues into investment research. This has resulted in several stock reviews this quarter and a planned trip to the region towards the end of the year.

We also recognise the value of and hence fully support collaborative engagement. For the first time, we have co-led a collaborative engagement campaign to gather information on the sustainable sourcing of fisheries.

Industry and community participation is an essential component of our stewardship activities, and we have thus attended meetings such as the UNPRI annual conference and the FRC Stewardship Code "one-year-on" event.

## Company Monitoring and Engagement

We engaged with 35 companies this quarter, focusing on social, environmental and governance issues. 60% of our engagement efforts this quarter focused on ESG issues and 40% specifically to proxy voting or remuneration issues. Geographically we have a global reach but with a bias towards UK companies, given our significant presence in this region.

Company meetings and engagements	
Remuneration engagements	Berkeley Group, Ashtead, Rentokil, Dunelm, Bellway, Kier
ESG roadshow	BMW, Diageo, France Telecom, CFAO, Kingfisher, RBS, GSK, AstraZeneca, Chevron, Royal Dutch Shell
Mainstream meeting**	BP plc, Weir Group, Rio Tinto, Barclays, Intercontinental Hotels, Derwent London
Stock reviews	Derwent London, Merck KgAA, PPR SA, Brenntag, Illiad, Sembcorp Marine, Kingfisher, Invensys, De La Rue, Shinhan and Hana Financial, ENN Energy

\*\*This refers to integrated meetings with mainstream fund managers [holding?] stocks in businesses 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.

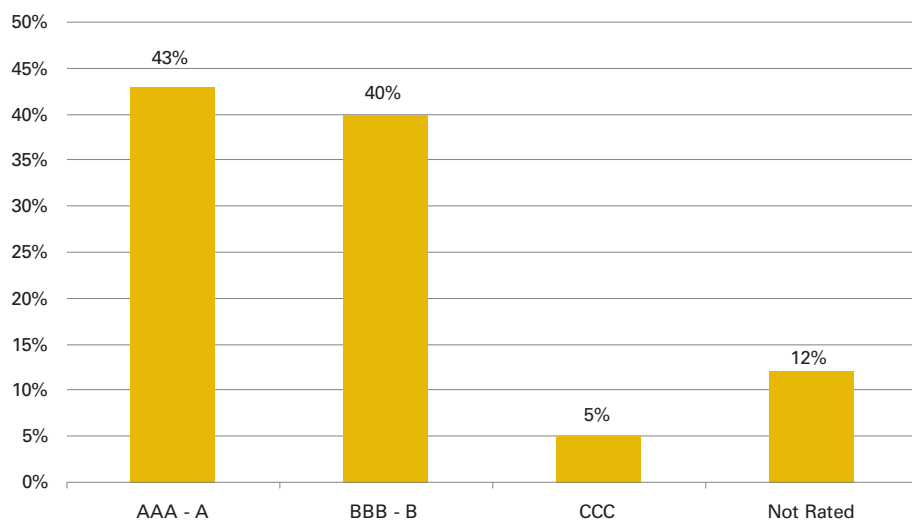
## Review of the Threadneedle Preferred Holdings

We commenced a review of our preferred holdings lists this quarter, and we will be engaging in Q4 with companies where we have identified significant ESG concerns. We strive to be a proactive investor and to engage dynamically with companies to understand the challenges that they face.

An initial review of companies based on ESG ratings shows that the majority of our preferred stocks are rated A-AAA. This reflects Threadneedle's focus on sustainable, high quality stocks. It also highlights the contribution to a company's appeal of the active management of ESG risks.

While our preferred holdings list contains significantly fewer CCC rated stocks, we believe that our duty to our clients as responsible stewards of their capital is to address these low ratings. We have commenced a closer analysis of the companies involved and we will be engaging with them vis-a-vis the issues identified. We will also focus on companies – primarily in emerging markets – that have not yet been rated.

### ESG Ratings of Preferred Holdings



## Threadneedle and Hermes launch collaborative UNPRI engagement on Sustainable Fishing



Growing evidence has emerged that over-fishing is affecting a significant number of global fish populations, with regulators and the public becoming increasingly aware of this issue. Common concerns related to declining fish populations include weak enforcement of the international law of the oceans, the perverse effects of quota systems, significant by-catch and unsustainable fishing methods. As long-term investors, we need to understand how companies exposed to the risks related to over-fishing are currently dealing with this issue, and how they intend to deal with it in the future. We have thus attempted to analyze our companies' exposure to fisheries and how that should be managed. What strikes us is the lack of information concerning the impact that companies believe fishing practices have on their business, in terms of security of supply and reputation management.

We thus approached other investors to gauge their interest in this topic, launching the initiative alongside Hermes to acquire greater clarity regarding the business risks involved in sourcing fish. By July 2011, 20 investors from all over the world (UK, US, Europe) had signed up to the initiative, according to the UNPRI website. The exercise had initially involved sending letters to a total of 40 global companies in the retail, food production and processing sectors, which had

been screened for exposure to fisheries. Given our focus on sourcing policies, fish farming companies and those involved directly in fishing operations were excluded from the initiative. However, such companies may be included in the future.

Thirty-one companies received a standard letter while nine that had disclosed information concerning significant policies or other important data related to fisheries received a modified version of the letter, acknowledging the steps that they had already taken.

**The letter asked companies to supply information relating to several areas:**

- Revenue exposure to raw materials and/or finished products derived from fish, the split between wild and farmed fish, and the company's view on the materiality of its exposure;
- Sourcing policies for fish and fish products, and the scope of these policies (e.g., group v business level);
- Percentage of wild catch sourced sustainably, the company's view regarding constraints to further sustainable sourcing and certifications used; and
- Guidelines or standards for farmed fish, and whether companies have evaluated sources against Aquaculture Stewardship or equivalent guidelines.

We had a good response rate and the information will be collated in a normalized format for easy comparison of practices, and for an overview of the material impacts. Practices currently differ widely and the initiative looks to achieve a deeper understanding of the range of approaches adopted. The group is likely to engage some or all of the companies in further discussions with individuals responsible for these policies. This was the first collaborative engagement initiative to be co-led by Threadneedle, and it has been a pleasure to work with such an engaged group of fellow investors. We strongly believe in the power of collaborative efforts to achieve better outcomes, and to facilitate bigger projects than those that we could achieve individually.

## Integrated Research

This quarter resulted in 12 stock reviews across the UK, European and Asian equity desks. The research is outlined below to facilitate a greater understanding of risks and opportunities.



**UK Pharma: AstraZeneca and GSK**

Threadneedle met with members of both AstraZeneca's and GlaxoSmithKline's (GSK) sustainability teams – a forum that allowed us to make interesting comparisons between the two major UK pharma companies. Issues that we tend to consider in this sector include access to medicines, marketing and sales policies, and product safety. For some time, GSK has featured ahead of AstraZeneca in the access to medicines index, and it is likely to continue doing so in the future. Emerging markets growth is indeed the focus of most multi-national pharma companies, and improving access is key to the sustainable and responsible (SRI) community; hence, such companies advocate “doing well by doing good”.

Both AstraZeneca's and GSK's strategies are focused on emerging markets; however, GSK's product range inclines towards vaccines, the development of emerging market medicines and a volumes based approach, with an entire department dedicated to formulating strategies aimed at reaching middle-tier consumers in such markets. AstraZeneca meanwhile is streamlining its approach towards developed market diseases. These fundamental differences give GSK a natural advantage in 'sustainability' terms. Both companies have a solid track record on product safety and GSK has worked hard to overcome the effects of past legal action against its marketing activities. AstraZeneca also seems to be on top of such issues, although the company has announced that it is reviewing its policies. This is particularly relevant given the introduction of the UK Bribery Code and their significant expansion in Russia.

The governance and responsible investment team highlighted the comparison between the two companies to the UK pharma analyst. This allows the analyst to take into account the ESG issues as part of the long-term structural considerations relating to the pharmaceutical industry.

## Kingfisher

Kingfisher is consistently seen as a top-performing company, based on sustainability criteria. It is currently aiming to incorporate sustainability issues fully across the group, in line with its group-wide strategy of more centralised management of the various business units. Kingfisher has thus formulated a 2020 group strategy aimed at combining its overarching businesses with common goals.



Tensions may exist between these sustainability targets and individual manager/business group goals. The company suggests that this is an on-going debate and that it is focused on initiatives that bring added financial value to the business in terms of reduced costs, improved sales and a better functioning business. Kingfisher's website states, for example: "Brico Dépôt France and Castorama France have achieved a combined annual cost saving of over €3.3 million as a result of waste reduction initiatives, and the group's 'eco-products' account for nearly 11% of total retail sales in 2010/11." Kingfisher focuses on organic growth but has made a small acquisition recently that will allow the company to improve its home energy servicing business. The company is very transparent and regularly meets with investors to provide sustainability performance updates.

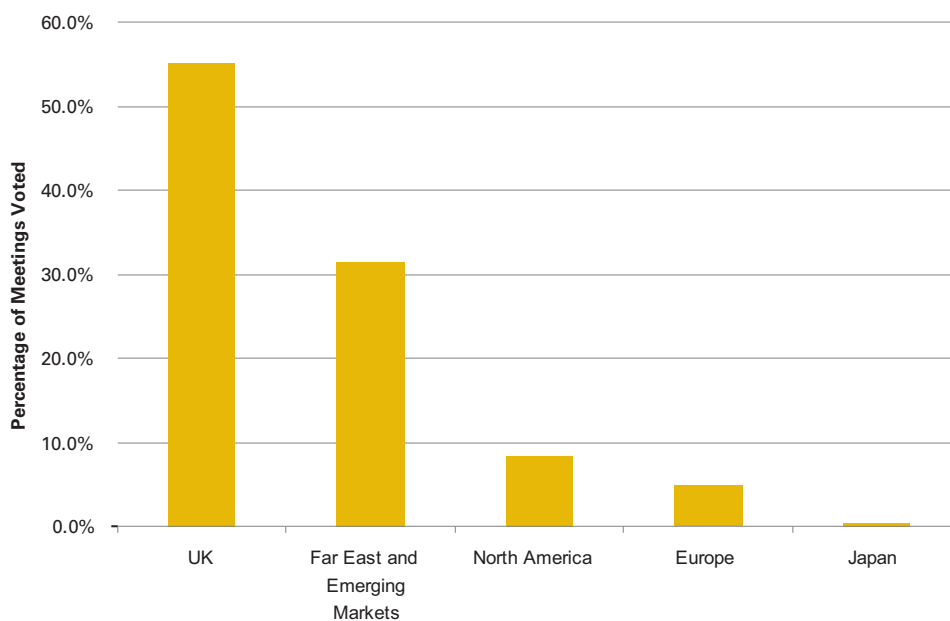
We incorporated the Kingfisher analysis and meeting into a stock review on the UK desk, a move positively received as contributing to a holistic investment view of the company.

## Proxy Voting– a Tool to Promote Good Governance

In Q3 we voted 357 meetings across 35 different markets. The majority of meetings concerned UK, Far East and Emerging Markets. We opposed resolutions at 59 meetings (17%) and abstained at 25 meetings (7%). We engaged with a few holdings where we considered the issue sufficiently important or where we had a significant interest.

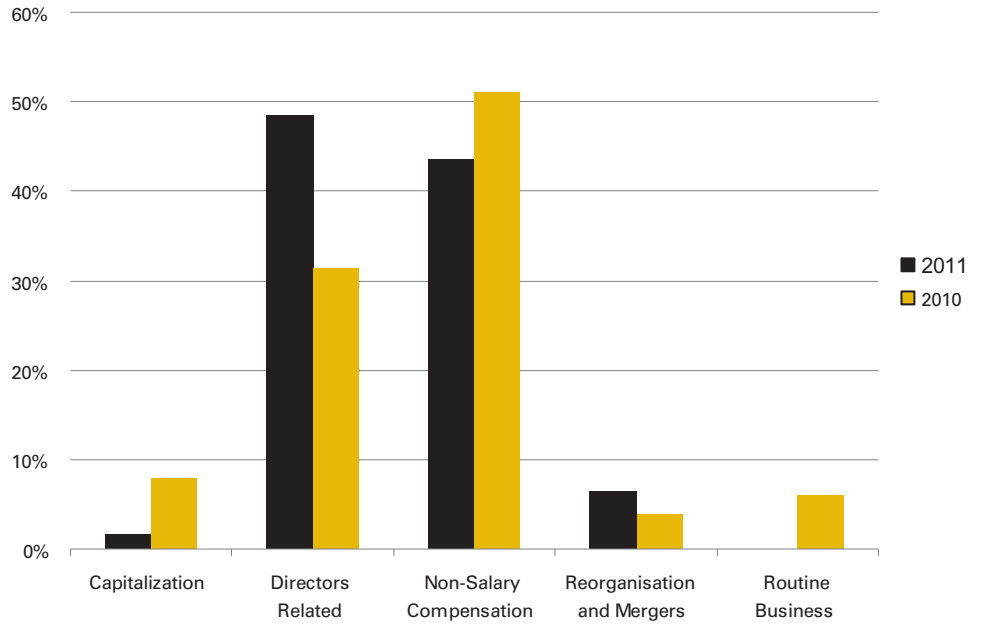
No meetings were missed during the quarter. As usual, we have engaged with a large number of holdings to protect our assets and to conform with our internal policies, as well as with external ones such as the Stewardship Code in the UK.

### Proxy Voting by Geography July to September 2011



The UK voting season was a primary focus this quarter, accounting for over 50% of meetings. We note an increase in director-related issues and a slight decrease in remuneration issues as a proportion of our votes against management. These remain our central themes for dialogue with UK companies. There were also cases of significant hikes in salary attributed to ‘benchmarking’. In these instances, we have encouraged companies to link increases to performance and to introduce them incrementally.

**UK Q3 Votes Against**



**Participation in the SRI Community**

**Governance Developments**

A year on from the implementation of the Stewardship Code, we are pleased to report that we are meeting the code requirements and that we are an active investor in 50 markets. In terms of the code, we have attended annual updates presented by the Financial Reporting Council (FRC) and the Association of British Insurers (ABI).

The FRC notes improvements in areas such as discussion of the broader risk agenda, succession processes, reputational concerns and board composition and capabilities. Moving forward, a shift in focus from shorter-term drivers of value to long-term success, as well as stress on the bigger picture as opposed to exclusive focus on governance detail, are areas considered in need of reform. Our experiences this quarter reveal that the industry as a whole is still attempting to master effective stewardship.

The ABI’s recent paper on Board Effectiveness echoes many of Threadneedle’s views. The paper outlines examples of corporate governance best practice and clarifies investors’ preferences in the key contentious areas of remuneration, board independence and diversity. These are issues that we raise with companies repeatedly, encouraging the adoption of best practice while recognising local market custom.

Another increasingly prominent issue is that of external board evaluations, with the UK Corporate Governance Code recommending an external evaluation every three years. The FRC and the ABI further stress the need for improvements in the scope and effectiveness of these evaluations, perhaps in the form of greater disclosure. Yet a review of the 2011 proxy season has revealed a negligible response to the evaluation recommendation, with companies citing cost issues as a deterrent. Next season, we would expect to see companies applying the ‘comply or explain’ principle in this regard.

In its recent report, the ABI highlighted board diversity as contributing to board effectiveness. ISS notes that UK companies are pre-empting any potential legislation by introducing formal plans to increase female representation on the board, and it points to a marked increase in the election of women to company boards in 2011. We have not engaged specifically with the issue this quarter, but it is an element of diversity that we monitor when reviewing board structure. We are cautious not to focus solely on gender diversity, recognising that true diversity derives from a collection of skills and backgrounds that helps to build strong, competent boards.

Effective engagement involves complex processes and many factors, such as transparent oversight, strong dialogue, relationship management and the clear communication of outcomes. Threadneedle is seeking to increase its international engagement efforts, and we are thus continually reviewing our engagement processes. While developing our global presence, we maintain that our sole business is asset management. We recognise that asset managers are not social engineers and should not be deployed as executors of public policy.

## United Nations Principles for Responsible Investment annual conference

The UNPRI (United Nations Principles for Responsible Investment) is becoming big business, backed by \$30trillion of assets compared with just \$5trillion six years ago. Five hundred individuals representing asset owners, asset managers and research provider firms attended the conference in September. According to the UNPRI annual survey, approximately 33% of RFPs (Request for Proposal) consider ESG factors, while 74% of all respondents suggest the integration of ESG to some extent. According to Wolfgang Engshuber, the UNPRI chairman, and Princess Maxima of the Netherlands, the principles are about generating sustainability in capital markets. Many investors have indeed recognized that this is not just “nice to have” but rather an essential component of sustainable economic development, and increasingly a key attribute of a high-quality, asset-managing firm.

The conference discussed topics such as the link between ESG factors and financial returns, as well as long-term versus short-term drivers, the benefits of collective engagement and investment both for good financial yields and optimal social benefits.

### Key takeaways:

- The different approaches to the selection of companies for engagements were an interesting feature of the engagement workshop. We are currently aiming to formalise our selection process, which focuses on significant holdings, preferred companies and controversial issues;
- Emerging market representatives highlighted the need for on-the-ground expertise and the importance of local networks, in order better to understand the industry. China is a difficult market to penetrate due to government control, according to representatives of such networks;
- Leading academic research has shown that ESG inclusion over the 2005-2010 period lowered Beta and improved Alpha generation. The relationship is causal in that specific company risk has been reduced. It goes hand-in-hand with the philosophy that higher quality companies have weathered this volatile market period relatively better than those of lower quality peers;
- Impact investing is a big new theme. Large asset owners are beginning to match financial yield objectives with social impact ones by investing in farmland and renewable energy generation; and
- Investors are beginning to consider structural risks such as climate change in the asset allocation process, with a view to the reduction of systemic risk in their investment portfolios.

Representatives from the UK, Australia, Scandinavia, France, Holland and Asia met at the annual event to discuss the current trends. The conference reinforced the view that the UNPRI network is essential for collaborative engagement, and that it is a global positive trend that is likely to grow stronger.

## Investment implications of the Integrated SRI framework

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

We believe that ESG research is a feature of efficient risk control, fundamental enhanced information regarding risks and opportunities facing portfolio companies, and the overview of portfolio exposure to ESG risks.

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

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



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