The **co-operative**
asset management

Responsible Investments Quarterly Review

Autumn 2009

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

Section 1 **Engagement Update**

Welcome to the engagement update of The Co-operative Asset Management, where we talk about companies or projects where we've been using our influence as owners to push for best practice on environmental, social and governance (ESG) issues. This quarter sees an investor coalition led by us and backed by US$3 trillion of assets asking companies and regulators involved in the oil sands of Canada to explain their investment rationale and how it takes into account the requirement to reduce carbon emissions and protect the local environment. We also pressed several UK companies with US operations to take a progressive approach to imminent legislation that will affect the way companies and employees deal with unions.

In focus – oil sands

In July, 44 institutional investors, representing US$3 trillion of assets under management, backed a letter from us to the leading companies involved in extracting oil from the oil sands of Alberta, Canada. The oil sands are controversial because their extraction is on average several times more carbon intensive than for conventional oil; involves land to which indigenous communities have rights; and has the potential to cause long-term damage to the local ecosystem. The letter was also sent to the Federal State regulators.

Background

The largest source of unconventional oil is the tar sands of Alberta, Canada – other sources include shale oil in the US and the heavy oil belt in Venezuela. The Alberta tar sands have seen rapid, massive development, against a backdrop of high oil prices last year and concerns over security of supply of conventional oil. The exploitation of the Alberta resources involves strip-mining and underground extraction of the sands for bitumen and energy intensive processing to remove and refine the oil.

Most of the oil majors now operate in the area, which claims potential reserves on a par with Saudi Arabia. In 2006, BP reversed its decision to stay out of Alberta. Shell still plans to source 15% of its supply from the area despite the costly extraction process being compounded by the volatile price of oil. The key concern with unconventional oil is that the energy intensive production process produces carbon emissions between 2.5 and 8 times higher than for conventional oil extraction. Large-scale exploitation of the tar sands would cause massive carbon emissions and have disastrous effects on global climate, though most of these emissions would come from burning the fuel. In addition, production requires extensive use of local water and scars the area where the extraction takes place.

It's not just nature that's suffering. Indigenous communities who live and fish downstream from the oil sands are raising concerns around the possible health risks posed by toxicity levels in local water and fish. Together, these issues call into question the future exploitation of the tar sands. Perhaps most importantly, the massive contribution to climate change posed by the tar sands suggests a strong possibility of a political backlash against their continued development. The Co-operative Group supported the EU's recent fuel quality standard that will penalise in the market fuel sources where their production process involves high carbon emissions. While host governments and oil companies point to the development of Carbon Capture and Storage (CCS) technologies as a solution, there is little evidence CCS can be developed fast enough or effectively enough to solve the problem of carbon emissions from the tar sands production.

What we're doing

We've joined together with other investors to engage with the oil companies, to press our concerns and to ask for greater disclosure on risk management in unconventional oil. We will press for caution on unconventional oil and set out minimum standards of operation around environmental and social issues.

Among our actions so far

In July 2008, The Co-operative Financial Services (CFS) published a joint report with WWF: 'Unconventional Oil: Scraping the bottom of the barrel?'

- On 16th September 2008 we organised an investor seminar with presentations from CFS, WWF, the Tyndall Centre for Climate Change and others. The seminar debated investor risk and explored options for collaborative engagement with companies. The seminar was covered extensively in the Financial Times, the Guardian and other media.

- On a number of occasions we have directly engaged with Royal Dutch Shell, BP and Chevron on the issue.

What is next?

- Now we have organised an investor coalition which is embarking on thorough engagement with these companies to press them on the specific 'asks' in the aforementioned investor letter, which we hope will yield some positive commitments. We will also be producing a report at the end of the engagement setting out the issues and how the industry is faring against the challenges it faces.

The US Employee Free Choice Act

We have been engaging with several companies who will be affected by the Employee Free Choice Act (EFCA): the proposed legislation on how companies deal with unions in the US. Labour relations in the US have a difficult history: unions often complain that employees are intimidated to not join a union or are punished, even with dismissal, for doing so. The legislation would create a more even playing field by trying to eliminate some of the obstacles to freedom of association at workplace but unsurprisingly, it is unpopular with some companies. The opponents to the Act claim that its proposed provisions would expose employees to union pressure, while also discouraging negotiations being conducted in good faith.

We have been finding out about the handling of employee matters and preparations for EFCA in affected companies, with our activities having targeted both American and UK companies. We were amongst the signatories to a letter to the S&P 100 companies, coordinated by the United Nations' Principles of Responsible Investment (PRI), and also took part in a collaborative engagement by a group of UK investors, focusing on 12 affected FTSE 350 companies. While the results of the former are yet to be fully compiled and analysed, we found the latter to be very informative, with the company meetings and written responses shedding light on not only the impacts of EFCA and employee relations, but in many cases also on the company-wide ESG management more broadly. We succeeded in obtaining very valuable information on how well individual companies are equipped for potential risks and opportunities, and were pleased about the constructive dialogue that took place both with the companies and amongst the investors taking part in the engagement. We are looking to continue engagement on these matters in 2010 as the EFCA process takes shape in the US.

Forest Footprint Disclosure Project

The Forest Footprint Disclosure Project aims to reduce overall impacts on forests by better understanding the forest product supply chain and promoting best practice within it. We were one of the initial endorsers of the project, also attending the launch in June. We subsequently attended a round-table in September to discuss how to broaden participation in the project as well as how to maximise the upcoming report's relevance to investors. We have since approached a number of companies in which we are invested to encourage them to participate, with Cadbury, Next and Reckitt Benckiser responding particularly positively.

Total and Burma

The oil major Total has always maintained that a policy of business engagement and holding up high standards of corporate behaviour are more likely to result in reform of the controversial military junta than outright avoidance and sanctions – but some believe the regime has proved impervious to influence either way, pointing to the squashing of dissent in 2007, its resistance to aid during Cyclone Nargis in 2008, and the unjust trial of Aung San Suu Kyi in 2009 for breaking the terms of her house arrest. We joined US investors concerned with Total's Yadana pipeline in Burma. In a letter to the company, we reminded the company that according to its commitment to the UN Global Compact, it had a duty to uphold human rights where

it operated and asked what it was doing to exercise positive influence there, including advocacy around the treatment of Ms Kyi. Soon after, the NGO Earthrights International published two reports alleging ongoing human rights abuses in the area affected by the pipeline – something we took the chance to discuss with the company in a conference call about our letter.

Total maintained that most of the NGO's allegations were not credible because they happened outside what Total regarded as the pipeline footprint and pointed to evidence that militarisation was no worse around Yadana then elsewhere – counter to a key argument of the NGO. Total also argued that investor fact-finding missions that had visited the area and used independent translators began their trip sceptical and ended it satisfied Total was doing all it could. Whatever the case, Total did say that human rights abuses do sometimes occur; just much less often and the affected are compensated quickly once Total finds out about them.

We questioned them on how they were using their good offices to exercise influence and urge restraint at the higher echelons of the military. Unfortunately, the answer was that direct contact does not go above local Major level and that all complaints about abuses they report to MOGE, the national oil company, which then cascades them to the military. Total argues this is the best that's open to them and MOGE has a good record in rectifying wrongdoing quickly. Nevertheless, we regard that human rights are unlikely to improve while this arm's length arrangement is maintained.

The order to abide by Total's standards needs to be cascaded down the military chain of command so that local personnel know they stand to lose if they step out of line. The intercession of MOGE may stand in the way of this and weaken Total's message – something we intend to make clear to Total.

Section 2 **Corporate Governance**

Shareholder resolutions

In the UK, it is uncommon for shareholders to table independent resolutions, owing to the large number of shares required and a general aversion amongst large UK institutional investors to what can be interpreted as a public confrontation with management. To illustrate, in the third quarter of 2009 only two shareholder resolutions were proposed; one each at the AGMs of Tesco plc and Marks and Spencer Group plc.

In contrast, the US has a more public culture of shareholder activism; independent groups frequently secure the required number of shares to enable a resolution to be tabled, although these are framed as advisory resolutions, where the outcome or request is not binding on the company. By way of example, in the past quarter, shareholder resolutions in the US included one on Board diversity at Liberty Global; one proposing Las Vegas Sands established a Sustainability Report; and one regarding the selection of a candidate with environmental expertise to be recommended for election to the Board of Directors at Freeport-McMoran Copper & Gold.

Marks and Spencer Group plc

A group of 102 shareholders requisitioned a resolution under the authority of the Local Authority Pension Fund Forum (LAPFF) to bring forward the appointment of an independent chairman from management's planned timetable of July 2011 by one year to July 2010. Whilst the Combined Code provides companies the opportunity to explain departures from the Code, we remained concerned at the current structure and the message it may send out to other companies.

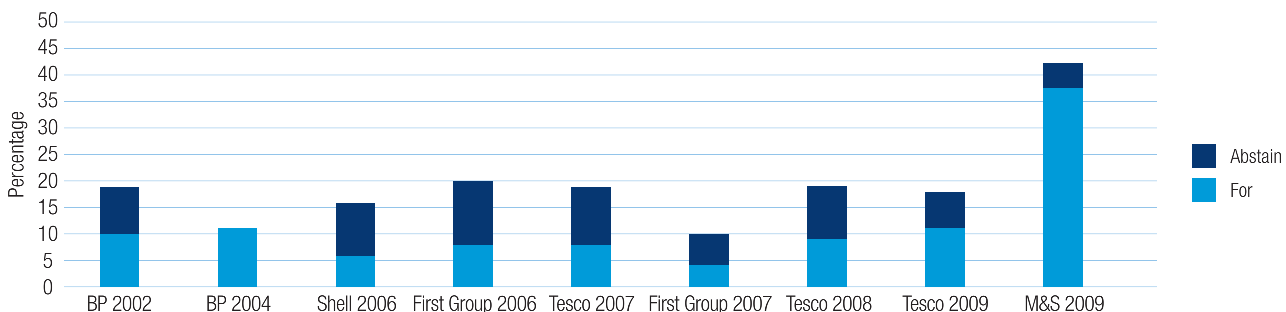
We voted in support of the shareholder resolution, as did 40% of shareholders' votes cast.

Tesco plc

Tesco's supply chain was again the subject of a shareholder resolution at this year's AGM as Unite (Britain's biggest trade union) alleged that the food giant is allowing the exploitation of agency workers among its UK meat and poultry suppliers. The resolution accused Tesco of knowingly allowing these companies to continually mistreat migrant workers and undercut their pay, whereas permanent staff are mostly indigenous and are disproportionately remunerated. The resolution called for the company to take a number of actions to rectify these alleged issues. The Board did not believe that the resolution represented the best way to progress what is an industry-wide debate and noted its 'well established and effective CR Committee' as well as 'comprehensive systems for reporting publicly on our performance against specific key performance indicators, both in the UK and internationally'.

Nearly 18% of shareholders supported this resolution, which is one of the highest levels of support a shareholder resolution has received in the UK, alongside the aforementioned M&S vote. We voted to abstain, highlighting our broad support of the resolution but citing drafting concerns.

Support for prominent shareholder resolutions in the UK



Annual General Meetings

Remuneration has been a high profile thread running throughout the 2009 AGM season. In the third quarter there were a number of instances where we felt unable to support the Remuneration Report resolution, with Findel and Homeserve being cases in point.

Findel plc

We abstained on receiving the Remuneration Report as we had concerns that the fundamental principles of the Performance Share Plan were changed without shareholders being given the opportunity to vote on the change.

Homeserve plc

We voted against the Remuneration Report due to concerns centering on the service contracts which base severance payments on total annual remuneration (including bonus), not just base salary. This sits out of line with best practice. Furthermore, a compensation payment of £46,000 representing 83% of his annual fee has been paid to the departing Senior Independent Director. We note that all non-executives' service contracts include this provision. Given the rarity of compensation payments to non-executives we raised this matter with the company.

Section 3 **The UN Principles for Responsible Investments (PRI)**

The UN Principles For Responsible Investment (PRI)

In August, The Co-operative Asset Management received the results from our second submission to the PRI annual participant survey, covering the calendar year 2008. PRI is a voluntary investor initiative comprising six Principles, aimed at raising awareness of environmental, social and governance (ESG) issues and providing a framework for investors fulfilling their fiduciary duty by integrating appropriate considerations into their investment process.

Although the code is voluntary and aspirational, commitment is expected from the top-level leadership of the endorsing organisations and across their whole investment business, and in order to remain compliant signatories must participate in the annual self-assessment process. Overall, PRI found that this year's assessment shows encouraging signs of a growing culture of active ownership and collaboration among investors in response to the financial crisis.

Our results continue to be extremely positive and we succeeded in further improving our performance on five out of the six Principles, although it should be noted that the amendments in the scoring methodology and questions mean that scores are not necessarily directly comparable from year to year. Nevertheless, we have in particular taken significant steps forward in applying Principle 4 – 'promoting acceptance and implementation of the Principles within the investment industry'. We were already performing particularly well in Principles 1, 2, 5 and 6 and continue to do so despite improvement in signatories' performance across the board.

Disappointingly, we did not fare quite as well on Principle 3 – 'seeking appropriate disclosure on ESG issues by the entities in which we invest' – with our corresponding score declining this year. We acknowledge that we need to do more and are confident that changes already undertaken will in part help us get back to the level where we want to be. Including climate change disclosure in our voting criteria this year, for instance, is a prime example of how we already request standardised disclosure from investees, not to mention our call on the Department for Environment, Food and Rural Affairs (DEFRA) for mandatory climate change disclosure.

We have in the past year made further progress in integrating ESG factors in the equities analysis, and will next tackle the challenge of better and more formally applying a similar approach to other asset classes.

Section 4 **Thematics**

Gender study in Good Companies Guide

As part of the Good Companies Guide series, we prepared a paper entitled 'Diversity and Gender Balance in Britain plc', which was published in The Observer on 23rd August 2009. This involved us ranking companies on the gender balance of the Board as well as the presence and depth of policies and practices likely to improve gender balance and diversity. The feature had an extremely strong reception and gained significant exposure for the issue.

Our study primarily considered the issue of gender balance from the perspective of human capital management. It concluded that the poor representation of women in decision-making roles suggests significant opportunities to improve corporate performance while also addressing potential issues of social justice relating to discrimination.

Throughout the year we have been active in engaging companies on the issue of gender balance to a strongly positive reception.

Climate voting

As stated in our Annual Review, we believe that in light of the continuing rapid deterioration in the scientific picture it is imperative to maintain Board focus on the issue of climate change. As the responsibility for and potential impacts of climate change affect the broader environment, and through it all of society, we believe that all companies should have disclosure relating to the issue. This should include, at a minimum, a company's greenhouse gas emissions and the steps it is taking to reduce them. We also look for an indication of the strategic issues and physical impacts climate change may present to the company, along with the governance structures required to manage them.

We believe this is in line with the duty for directors of quoted companies to report on 'environmental matters (including the impact of the company's business on the environment)' as specified in section 317 of the Companies Act 2006. As a consequence, we have strengthened our stance relating to voting on companies' Annual Reports (ARs), where a company's disclosure appears to be lacking as regards to climate change. In the third quarter of 2009 we withheld support from 13 ARs and wrote to a further three companies on this issue.

Investment themes

Our funds position themselves proactively according to our view of global economics. 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. A theme that has been a particular focus this quarter has been the growth in developing economies, also known as emerging markets.

The outlook for consumption in these markets continues to improve with a growing middle class in a number of countries including China, India and Brazil. During the quarter there were several additions to our holdings with exposure to these consumers including Aggreko, HSBC, Standard Chartered and International Power.

Aggreko stands to benefit from increased demand for its temporary power supply systems as emerging economies grow faster than they can develop permanent power generation capacity, while both HSBC and Standard Chartered have significant Islamic banks and contribute to social inclusion through their microfinance subsidiaries. Both banks are also leaders in terms of their policies and practices relating to the environment, social and governance issues. International Power invests in a range of power generating assets around the world and implements strong environmental policies, frequently in excess of local regulation. It has a significant wind portfolio which helps offset some of its carbon-intensive assets.

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