

For professional clients only and not suitable for retail clients

**Schroders**

# Responsible Investment Report

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Q1 2015



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**Schroders**



“At Schroders, we see ourselves as long-term investors and stewards of our clients’ capital. We look beyond the numbers, embedding environmental, social and governance principles into our investment process. Our approach involves engaging with companies on ESG issues and their activities, helping them manage their risks and, in turn, driving better performance.”

**Jessica Ground,**  
Global Head of Stewardship,  
Schroders



# Responsible Investment at Schroders

## Q1 2015

Our responsible investment approach isn't merely an attempt to follow recent market trends. Neither is it distinct and separate from our mainstream investments and services. We know that companies with robust environmental, social and governance (ESG) performance benefit from a lower cost of capital and are more likely to deliver superior returns over time<sup>1</sup>. We look to integrate understanding of ESG issues into our investment decisions, across asset classes.

Engaging with companies and their management is a fundamental part of our investment process as an active investor. As well as improving performance, we believe that it adds value by enhancing communication and understanding between companies and investors.

This report brings you the details of our ESG engagement this quarter, as well as some of the broad issues and themes our eight-strong team has been considering. It demonstrates Schroders' responsible approach to managing clients' assets, and how we are integrating our ESG thinking into our investment processes.

<sup>1</sup> 'Sustainable investing: Establishing Long-Term Value and Performance', Fulton, June 2012

## Special topic

# “We’re going to need a greener boat”

## The costly future of green shipping

- The environmental impact of shipping operations has been known for decades. It is only recently, however, that the damages to human health and biodiversity have been demonstrated.
- Regulatory measures from the International Maritime Organization and the European Union (EU) on air pollution, greenhouse gas emissions as well as ecosystem disruptions will impose significant compliance costs on shipping companies.
- The most immediate operational challenge for shipping companies is abiding by international standards on emissions of sulphur oxides (SO<sub>x</sub>).
- Restrictions around nitrous oxide (NO<sub>x</sub>) emissions and carbon dioxide (CO<sub>2</sub>) emissions will kick in over the next three years. Under a yet-to-be ratified international convention, ballast water management systems will also have to be installed by the end of the decade.
- Depending on the type of environmental pollutant, the financial impact on companies will be felt on operating and/or capital expenditures.

What?	When?	Where?	Impact on opex	Impact on capex
SO <sub>x</sub>	2015, 2025	Regional, Global	High	High
NO <sub>x</sub>	2016	Regional	Limited	High
CO <sub>2</sub>	2018	Regional	High	High
Ballast Water	Uncertain	Global	Limited	High

Source: Schroders

- It is expected that companies’ balance sheets will reflect these costs from 2016 onwards. Once the monitoring and enforcement systems have matured, we could also see an effect on provisions for environmental liabilities.
- Companies that have delayed investment in cleaner technology or cleaner vessel fleets could be more vulnerable to these environmental regulations. As a result, they may need to incur costs and essential investments for which they are ill-prepared. In contrast, those companies that have tackled these issues proactively and anticipated these regulatory requirements will be better placed to retain a competitive advantage over their peers.
- We engaged with four investee companies and evaluated their level of preparedness in relation to these environmental requirements, concluding that **AP Møller Mærsk** and **Mitsui OSK** lead the pack.

The full report is available at [www.schroders.com/talkingpoint](http://www.schroders.com/talkingpoint).

## Special topic

# Living wage

### A UK perspective

The idea of a living wage is gaining momentum in the UK. The number of companies that have committed themselves to paying what is increasingly accepted as the minimum hourly rate of pay to meet an individual's basic needs has doubled to 400 during 2014. The living wage has relevance across the globe, but here we focus on two UK sectors that have the most exposure to this issue.

There is increasing pressure from a broad range of stakeholders on companies to pay a living wage. There is clearly a cost: it is estimated that earnings per share will be cut by between 1%-7%, depending on both the sector and the individual company. However, while difficult to quantify, and while the underlying assumptions may vary, it appears that the benefits are also significant. The effects, both good and bad, are greater than average for the **retail** and **leisure** sectors. Our proprietary research suggests that across the UK retail sector, up to a third of the increased costs can be offset through the potential benefits listed below. Potential benefits include:

- increased employee productivity;
- higher retention rates;
- lower employee turnover;
- the ability to attract higher quality candidates; and
- improved customer service.

All of these factors could have a positive impact on sales and reduce costs in the long run, bringing lower training, recruitment and employee absence costs.

We have spoken to several companies across the consumer sector on the topic of the living wage. While very few have become accredited living wage employers, there is some evidence of higher wages and attempts to improve workforce skills. Some employers monitor the proportion of their workforce that is paid a living wage, but do not disclose this publicly. Others are struggling with the definition of the living wage. In the UK there is a widely-accepted figure for both the London and the national living wage, but this is not the case in all countries.

We conclude that both the costs and potential benefits are most material across the retail and leisure sectors. Our engagements with companies across these sectors reveal that there are challenges to introducing a living wage. We believe that the feasibility of increasing pay should be understood on a case by case basis, looking beyond just the tangible costs of salary increases, but also the potential benefits. We acknowledge that the business case for some companies is stronger than others. There are a number of variables that need to be considered when assessing the overall costs and benefits. At company level, investors need to consider profit margins, the size of the workforce, proportion of costs allocated to staff costs and human capital as a source for competitive advantage. At the macro level, the labour market and regulation risk should be considered. We will continue to engage with companies and encourage them to better understand the value of good human capital management and to quantify potential benefits that can be gained from increasing pay.

The full report is available at [www.schroders.com/talkingpoint](http://www.schroders.com/talkingpoint).



## Special topic

# Carbon in Portfolios

## Responding to Climate Change Risk in Portfolio Management

The majority of assets owned by listed fossil fuel companies cannot be used if the world is to keep global warming to within scientifically recommended limits. This poses a dilemma for investors: should they sell or should they engage?

Our latest paper on the subject explores the various strategies that investors can employ in understanding and mitigating their exposure to these “stranded assets” and other climate change risks. The paper considers:

### Assessing the carbon risks in a portfolio

- How investors can undertake economic analysis of the long term impacts of climate change on portfolio investment strategy
- How we can analyse portfolio carbon risk exposure, for example through:
  - Carbon footprint and carbon asset exposure analysis of portfolio constituents
  - Climate change risk management analysis of portfolio constituents

### Managing carbon risk exposure in a portfolio

- Company stewardship
  - Engagement with fossil fuel companies
  - Engagement with all companies on climate change
- Integrating carbon risk into stock selection and valuation
- Hedging
- Divestment

### Background

- Unless global warming is limited to no more than 2°C above pre-industrial temperatures, scientists warn there will be catastrophic climate change
- Keeping atmospheric concentrations of CO<sub>2</sub> to 450 parts per million (ppm) will give us a 50% chance of achieving this target
- Current atmospheric concentrations of CO<sub>2</sub> are 395ppm. This means we can only emit around 570GT (gigatonnes) of CO<sub>2</sub> between now and 2050 to stay within the limit
- The carbon embedded in the world’s fossil fuel reserves is around 2,800GT, implying only a fifth of it can be burnt, with the remaining reserves being “stranded”

The full report can be found at [www.schroders.com/talkingpoint](http://www.schroders.com/talkingpoint)

## Engagement highlights

### Minority shareholder rights

#### Protecting shareholder rights in France and Italy

This quarter, the issue of protecting minority shareholder rights has been high on the agenda of Schroders and several other institutional investors. Recent legislation in France and Italy giving preferential treatment to long-term and majority shareholders prompted us to engage with companies and governments to ensure that minority shareholders' interests were not being ignored.

##### Background

In January, the Italian Parliament sought to extend temporary provisions allowing companies to pass special resolutions with lower shareholder approval levels. The measure had originally been introduced as part of the Italian Growth Decree in 2014 to help restart the economy. It enabled companies to give loyalty shares to shareholders that have owned their shares for at least two years. The attempt to extend what had been temporary provisions raised concerns for two reasons. Firstly, it could give rise to majority shareholders taking greater control and influence without a corresponding increase in their economic stake and associated risk. And, secondly, it could entrench management.

It was a similar story with France's adoption of the "Loi Florange" in March 2014, which granted automatic double voting rights to registered shares held for over two years. Prior to this act, double voting rights were only granted to long term registered shareholders via special bylaws. Additionally, other provisions of the Loi Florange removed requirements for a company's board to remain neutral in the event of a takeover, which previously would have required prior approval from shareholders. This would enable a company targeted for acquisition to take defensive steps, such as providing an opinion on the merits of the offer or issuing shares, to thwart the bid.

In both countries, our concern was to protect minority shareholder rights. The changes to voting rights enable shareholders to reduce their holdings whilst maintaining the same level of corporate "voice" and strength. In contrast, shareholders who have owned their shares for less than two years or do not hold them in registered form, typically institutional managers, are penalised for doing so. This disparity between capital invested and voting power goes against the fundamental principle of "one share - one vote" that Schroders supports.

##### Our action

This quarter, we wrote to French companies that are members of the two main indices, the CAC40 and the SBF80, urging them to review their current voting rights practices. Specifically, we requested that they seek to bypass legislation by opting out of the automatic rights provision of the Loi Florange. We also asked companies to include proposals at their next AGM that would maintain board neutrality during a takeover bid. We have received several messages of support from companies, including Technicolor and Credit Agricole, which support our views, and expect further dialogue with many others. We will continue to monitor developments during the forthcoming AGM season.

In Italy, we signed an open letter calling on the Italian Government to end the time period for loyalty shares to be approved by lower shareholder approval levels. The letter was sent jointly by a group of over 100 institutional investors, board members and academics. Following this intervention, the government took the decision not to extend the provision. While the progress made in Italy is good news for institutional investors, we expect to continue to see companies requesting loyalty shares at forthcoming shareholder meetings.

## Engagement highlights

### Yum! Brands

#### Improving supply chain traceability

##### **Food safety challenges and falling sales in China**

Yum! Brands is a US-listed fast-food retailer that operates through three well-known brands; KFC, Pizza Hut and Taco Bell. Over the past few years, the company has come under scrutiny for its management of food safety concerns in both Europe and China. Across the industry, poor quality standards within the chicken supply chain in China have resulted in reputational damage and lower sales. As part of our ongoing dialogue with the company, Schroders contacted Yum! Brands to get an update on how it was improving its supply chain practices and managing its food safety standards.

##### **Improving traceability and catching up with peers**

A conference call with senior management provided reassurance that the company had made significant improvements in its supply chain practices. Schroders believes that supply chain traceability and robust supplier selection and auditing practices help to mitigate risk. We were encouraged to learn that new procedures had been introduced to improve these practices. The company had categorised all high-risk products in its supply chain by potential risk and traceability. Yum! Brands has also taken a more aggressive approach towards suppliers that do not meet the required standards, improved employee training on food safety, and strengthened its governance structure and oversight of food safety. While all of these steps allow the company to better mitigate risk, we believe that this is an area where best practice continues to evolve and that the company needs to continue with its current rate of change to ensure that it keeps pace with industry best practice. We incorporated this view into our investment analysis.

##### **Request for change: further transparency**

The transparency of supply chain practices and food safety across the sector remains weak. It is a challenge for stakeholders to effectively assess a company's standards and performance. Schroders has asked Yum! Brands to further strengthen its policies and disclosure in three areas: supply chain audits, governance structure and supplier selection process. We will continue to monitor progress.

For further details about the issues discussed and company responses, please contact your Client Director.



## Q1 2015 Company Engagement

We had 93 engagement instances this quarter with the 82 companies listed below. We engaged on a broad range of topics categorised under 'environmental', 'social' and 'governance'. Our engagement includes one-to-one meetings, joint investor meetings, conferences, teleconferences and written correspondence.

For further details about the issues discussed and company responses, please contact your Client Director.

<b>Consumer Discretionary</b>	<b>Environment</b>	<b>Social</b>	<b>Governance</b>	<b>Consumer Staples</b>	<b>Environment</b>	<b>Social</b>	<b>Governance</b>
Carnival	✓	✓	✓	British American Tobacco		✓	
Halfords			✓	Grupo Bimbo		✓	
Home Retail Group	✓	✓		Imperial Tobacco		✓	✓
Hyundai Department Store		✓		Kerry Group			✓
InterContinental Hotels Group	✓	✓		Naturex			✓
Ladbrokes			✓	Procter & Gamble			✓
Merlin Entertainments		✓		Tesco		✓	
Millennium & Copthorne Hotels			✓	Unilever		✓	
Pearson				Wm. Morrison			✓
Pierre & Vacances			✓	Walgreens Boots Alliance		✓	✓
Suzuki Motor			✓				
Tata Motors			✓	<b>Energy</b>	<b>Environment</b>	<b>Social</b>	<b>Governance</b>
Taylor Wimpey			✓	BG			✓
Tesla Motors	✓	✓		BP	✓	✓	
WH Smith		✓	✓	Premier Oil	✓	✓	
William Hill			✓	Repsol	✓	✓	
YUM! Brands	✓	✓	✓	Statoil			✓

## Q1 2015 Company Engagement

<b>Financials</b>	<b>Environment</b>	<b>Social</b>	<b>Governance</b>
Arrow Global			✓
Barclays			✓
Crédit Agricole			✓
Gecina			✓
HSBC	✓	✓	✓
Intesa Sanpaolo		✓	✓
Lloyds Banking Group			✓
Novae			✓
Prudential			✓
Royal Bank of Scotland	✓	✓	✓

<b>Health Care</b>	<b>Environment</b>	<b>Social</b>	<b>Governance</b>
Boiron			✓
Cambian			✓
Consort Medical			✓
Novartis		✓	✓
Novo Nordisk	✓	✓	✓
Sanofi		✓	✓

<b>Industrials</b>	<b>Environment</b>	<b>Social</b>	<b>Governance</b>
Abengoa	✓		
BAE			✓
Faiveley Transport			✓
G4S			✓
ID Logistics			✓
James Fisher and Sons			✓
Kuehne & Nagel	✓	✓	✓
Mitsui	✓		
Saint-Gobain	✓		✓
Sensata Technologies			✓
Xaar			✓

<b>Information Technology</b>	<b>Environment</b>	<b>Social</b>	<b>Governance</b>
ARM Holdings	✓	✓	✓
Catcher		✓	
Ericsson		✓	✓
Eutelsat			✓
Gresham Computing			✓
Halma			✓
Inside Secure			✓
Kulicke and Soffa Industries			✓
Lectra			✓
Microsoft	✓	✓	
Premier Farnell			✓
SAP	✓	✓	✓

<b>Materials</b>	<b>Environment</b>	<b>Social</b>	<b>Governance</b>
Anglo American	✓	✓	
BASF		✓	✓
Sealed Air Corp	✓	✓	
Taiwan Cement	✓	✓	
Yara International	✓		✓

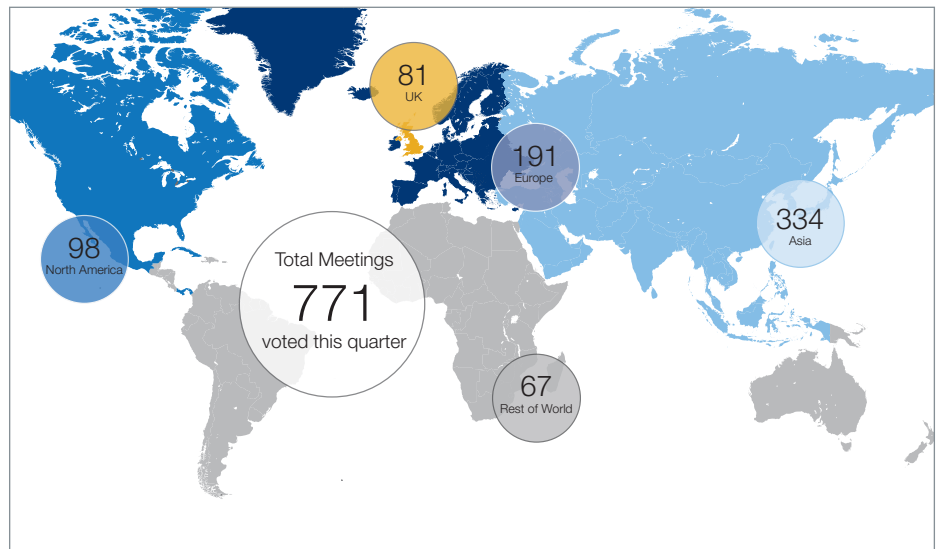
<b>Telecommunication Services</b>	<b>Environment</b>	<b>Social</b>	<b>Governance</b>
SK Telecom			✓

<b>Utilities</b>	<b>Environment</b>	<b>Social</b>	<b>Governance</b>
Drax			
E.ON			✓
GDF Suez	✓		
RWE	✓		

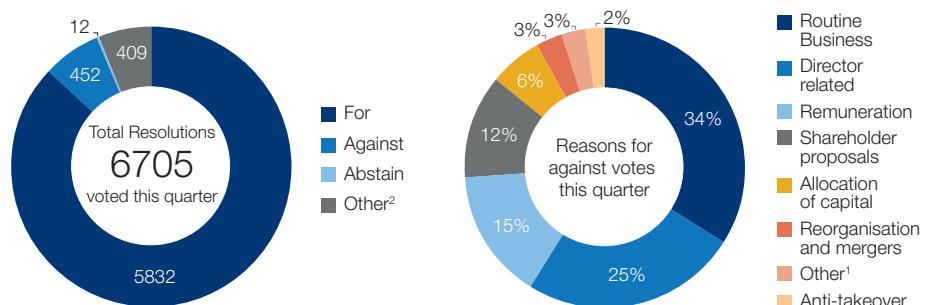
# Shareholder voting

We believe we have a responsibility to exercise our voting rights. We therefore evaluate voting issues on our investments and vote them in line with our fiduciary responsibilities to clients. We vote on all resolutions unless we are restricted from doing so (e.g. as a result of shareblocking). This quarter we voted approximately 95% of all our holdings. The charts below provide a breakdown of our voting activity from this quarter.

## Global Votes



## Direction of votes



## Shareholder Resolutions

We voted on 15 shareholder resolutions this quarter, which covered environmental, social and ethical issues, supporting 6, abstaining on 1 and voting against 8.

Source: Schroders as at 31 March 2015.  
<sup>1</sup>Includes withheld or unvoteable resolutions, for example due to shareblocking

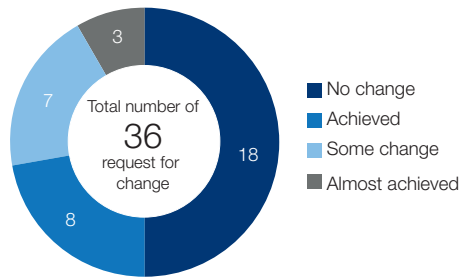
# Engagement process

## First quarter 2015

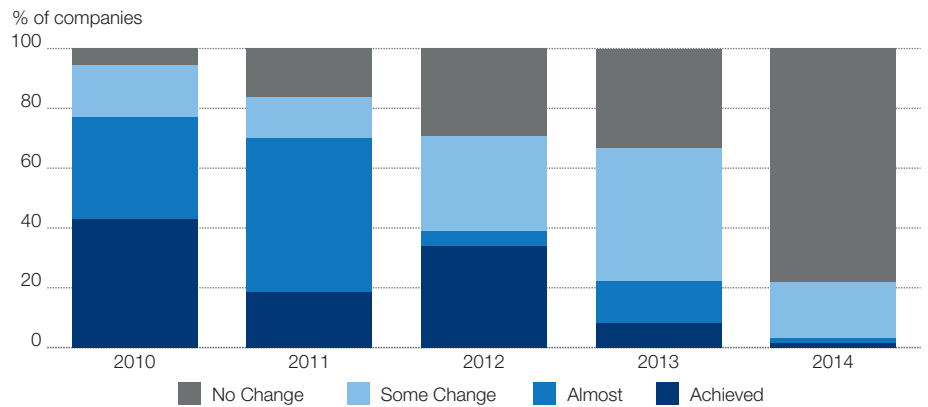
Each quarter we review progress on suggestions for change we made a year ago, in this case the first quarter of 2014. There are four possible results: “Achieved”, “Almost”, “Some Change” and “No Change”.

Of a total number of 36 “change facilitation” requests made, we recorded eight as Achieved, three as Almost, seven as Some Change and 18 as No Change.

We also track progress over a longer period. The table below represents the ongoing success of our engagement:



### Effectiveness of requests for change – 5 year period



Source: Schroders as at 31 March 2015.



# Schrodgers

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