Schroders

Responsible Investment Report

Q2 2016

Inside...

- Feature: The road that led us to Brexit (and where it's heading)
- Aviation: The wings of (climate) change
- Why investors should be caring about sharing
- AGM season: The year of shareholder revolt?
- Beverages: Sweet advantage for early movers
- Costly cures: Pressure on US drug prices

Schroders

At Schroders, we believe well-run companies that act responsibly are not only good for society; they can be good for shareholders' pockets too. Research has demonstrated 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[1]. That's why ESG forms an integral part of our investment process across asset classes.

We see engaging with companies and their management as a fundamental part of our duty as an active investor. As well as improving performance, we believe that engagement adds value by enhancing communication and understanding between companies and investors.

Investors are increasingly becoming aware of the impact ESG factors can have on companies and their investment performance. Not only are they asking whether asset managers are considering ESG factors and actively engaging with companies, they are asking how these factors are being incorporated within valuation and stock selection and are looking for ways to measure the sustainability of their investments. In an effort to address this growing demand, we have seen two key players launch fund sustainability ratings within a week of each other towards the end of Q1. While the emergence of such ratings serves to increase the dialogue around sustainability, it is vital investors understand what they represent. Different rating firms regularly reach very different conclusions for the same company; there are myriad interpretations, definitions and approaches to ESG analysis and fund ratings reflect a particular interpretation rather than a definitive answer. Investment banks produce research recommendations designed to highlight the investments they think most likely to outperform but funds are rarely judged on the proportion of holdings rated "Buy" by one team of analysts. We explored the challenges of defining sustainability and the merits of fund sustainability ratings in our 'Painting by numbers'[2] piece published in May.

This report brings you details of our ESG engagement this quarter, as well as some of the broad issues and themes our nine-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.

1 Sustainable investing: Establishing Long-Term Value and Performance, Fulton, June 2012 and "Can investors do well while also doing good?", Schroders Investment Horizons, issue 3, 2015
2 http://www.schroders.com/en/uk/tp/markets2/markets/painting-by-numbers---the-difficulties-of-measuring-sustainability/

Responsible investment at Schroders

"Schroders' credentials as one of the largest ESG managers in the world are vividly demonstrated by our engagement activities. Portfolio companies increasingly take notice of what we say. As long-term stewards of our clients' capital, we aim to engage constructively with companies on ESG issues, helping them manage their risks and, in turn, drive better performance for our clients."

Jessica Ground
Global Head of Stewardship

The road that led us to Brexit
(and where it's heading)

"Effective corporate strategy is becoming less about forecasting the future and plotting a course towards it, and more about building the organisational resilience to adapt to unexpected change"

Andrew Howard
Head of Sustainable Research

Schroders' ESG team examined the social pressures that led the UK to vote Leave and the challenges and opportunities they imply for global industries and markets.

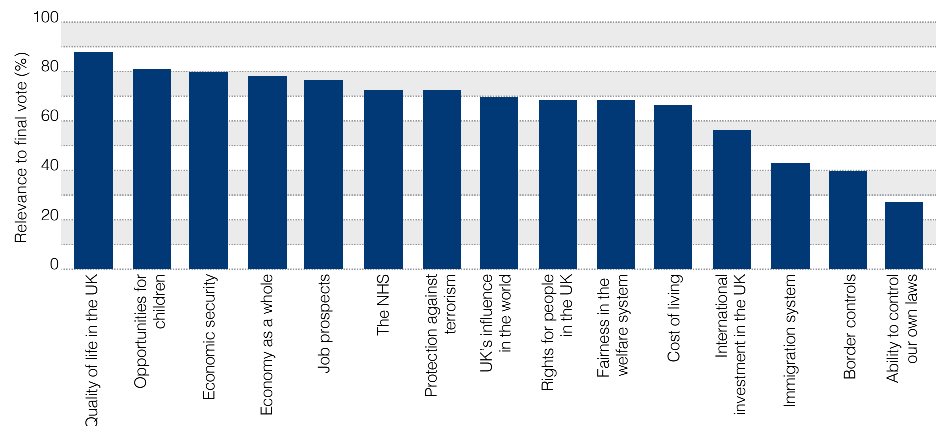
The UK has voted to leave the European Union (EU), sending ripples through financial markets that had anticipated a vote to maintain the status quo.

The media has been awash with opinions on the near-term implications for financial markets. We do not intend to add yet another view; the red on our terminals provided a succinct summary, even if some of the initial market moves were subsequently reversed. At Schroders we prepared for the possibility of an Exit vote and believe others in our industry did so as well.

Rather than speculate on future political decisions, we focus here on the underlying issues that led us to this point and their implications for the future. Those trends stretch far wider than the UK's continued membership of the EU and we believe remain under-appreciated by financial markets.

Although characterised by the media as a vote on immigration or bureaucracy, a closer examination of the reasons voters gave shows a broader, more conventional list of concerns. It appears less a vote about borders and red tape and more a judgement on our economic and political system.

Issues voters highlighted as motives behind EU referendum voting



Source: Lord Ashcroft Polls

The Brexit vote reflects growing social tensions that have resulted from rising inequality, moribund income growth and falling job security, and discomfort with the political systems that have caused them. This is a global trend that is as evident in the US presidential elections as it is in demonstrations in Hong Kong or impeachments in Brazil.

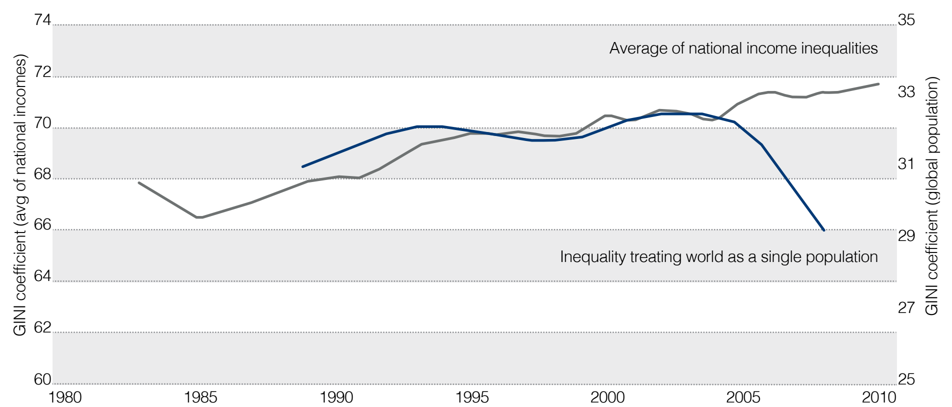
It is a trend that is reflected in the continued declines in trust in political institutions across major economies. Eurobarometer finds that trust in national EU governments has fallen by one-third since the mid-2000s. EKOS finds an even larger drop in the US, where the percentage of respondents saying they trust their government to do what is right most or all of the time has fallen from over 70% in the 1960s to under 20% most recently.

Tensions are building and will lead to more political "surprises" in the future. We focus here on three drivers we believe underpin the tensions that have led us to this point, and examine their implications for businesses and investors.

More protectionist, domestically-focused policies

For decades, globalisation has been a dominant political theme across developed and emerging economies, and has generally been very successful. Growth in global trade has outstripped GDP more than two-fold over the last 30 years, international migration is up 40% since the start of the century and the stock of foreign direct investment is a three times larger share of global GDP than it was 20 years ago.

Rising income inequality in most countries; convergence in the global population



Source: Branko Milanovic, World Bank. The GINI coefficient is a measure of inequality where larger values indicate more disparity

> "Economies are becoming more global but societies are still national"

While those policies have generally achieved what they set out to deliver, they have exacerbated social tensions within countries. Economies are becoming more global but societies are still national. Globalisation may raise overall economic growth but its speed has left many unable to adjust. Consequently, whereas global incomes have risen and inequality fallen, the opposite is true within most countries.

The result has been rising tensions in many societies, which see (in many ways correctly) globalisation as the cause of their problems, and are looking for solutions that will shield them from those forces.

While it is doubtful protectionism can work given the extent to which globalisation has permeated economies and societies – disentangling the "good" and "bad" bits is virtually impossible – there is likely to be support for politicians that promise to try.

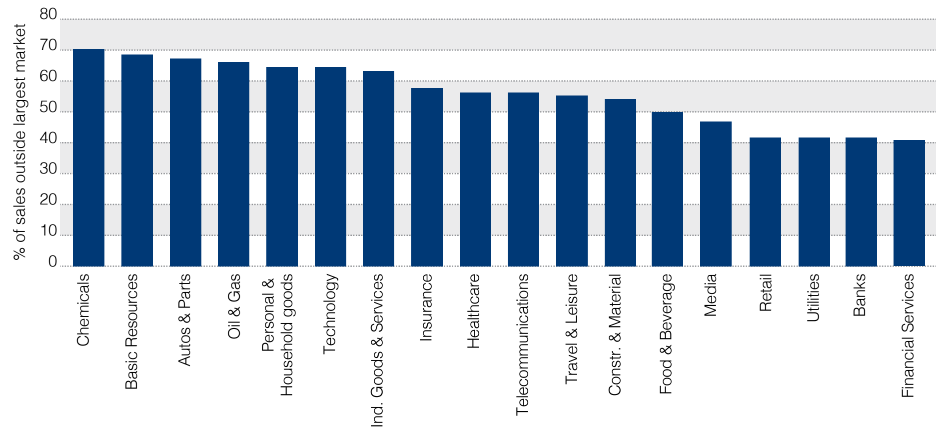
Global businesses need to operate locally

Societies are still defined at a local level and while large companies have become more international, the most successful are doing so through locally defined tactics. Companies that focus on understanding the environments they operate in and tailoring their strategies to them will be better able to meet the diverse needs of customers, employees, regulators and other stakeholders in the markets in which they compete.

Companies in more global sectors will typically face both greater challenges and opportunities adapting to an environment in which local expectations and regulations are unique and require distinct strategies. The chart below plots the share of revenues European companies in each sector generate outside their largest market, based on reported geographic sales. Those towards the left of the chart will typically face a wider range of markets.

The road that led us to Brexit
(and where it's heading)

Share of revenues generated outside their home (largest) market

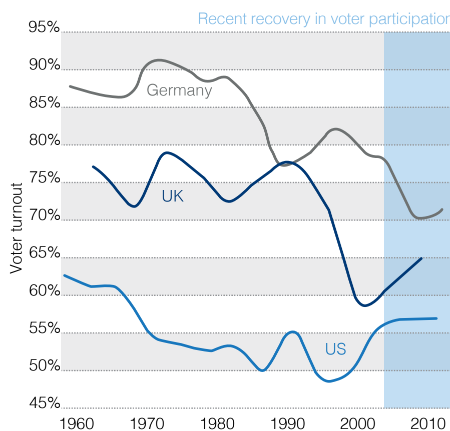


Source: Thomson Reuters DataStream, Schroders estimates. Uses ICB sectors, based on c2,200 European companies. Uses reported geographic segments (which may be countries or groups of countries) to calculate the share generated outside companies' largest market.

More political and social instability

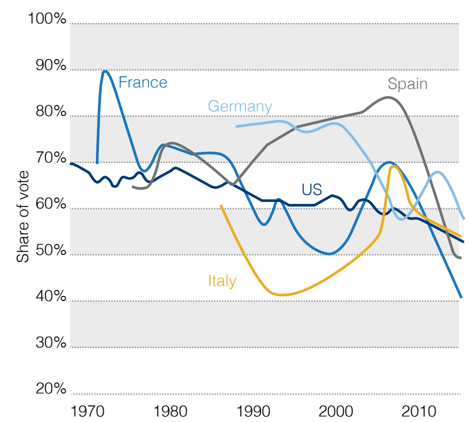
Disillusion has spawned a search for alternatives. Change has become a more attractive choice than maintaining the status quo. This is not restricted to the left or right of the political spectrum; both ends have benefited from disappointment with the middle ground. Movements like Occupy gather the headlines but the rise in voter turnout over the last decade is a far more powerful force.

Voter participation has picked up in major economies over the last decade



Source: Institute for Democracy & Electoral Accountability.

Centrist parties' share of national vote has been in decline as fringe parties have expanded



Source: National Election records via Barclays.

So far as we are doubtful any single solution exists to the challenges voters face, it's likely that hopes for a panacea will be passed from one party to another, leading to potentially significant swings in political tendencies over short periods.

"The failure of most people to benefit from the globalisation and global economic expansion of recent decades lies at the heart of much of the disquiet"

Flexibility and adaptability are key

Effective corporate strategy is becoming less about forecasting the future and plotting a course towards it, and more about building the organisational resilience to adapt to unexpected change. Culture, oversight, incentives and structure are more important and durable strengths than forecasting abilities or deal making skills. Effective corporate governance is an important element of that flexibility, as is the ability of managers and employees to engage stakeholders to identify pressures at a local level.

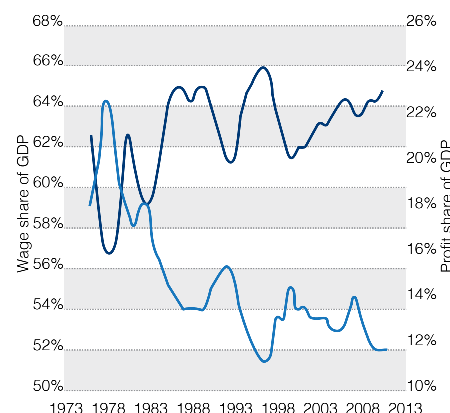
Companies that operate in industries in which change is common and where governance is typically stronger should be better prepared to meet the challenge of more fluid regulation, political pressures and social expectations. In contrast, those which are typically less attuned to change may be less prepared, particularly where governance is weaker.

More pressure to ensure workers and societies benefit

The failure of most people to benefit from the globalisation and global economic expansion of recent decades lies at the heart of much of the disquiet. Median incomes in the US have not risen since the mid-1990s, allowing for inflation. Since the financial crisis, the average worker in OECD countries has seen his/her standard of living fall 5–10%. Meanwhile those who own financial assets have seen their value rise, buoyed by quantitative easing, and media headlines are filled with stories of CEO pay packages and corporate riches.

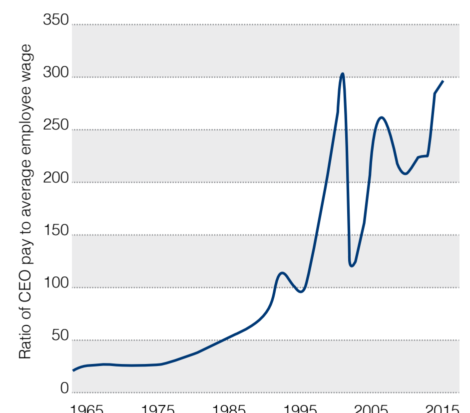
That perception is supported by evidence. Corporate profits have been a rising share of GDP for decades, mirroring the declining payout to workers. CEO remuneration has continued to escalate far faster than employee wages. We believe the pendulum of power is likely to swing back towards workers going forward. Accelerated by the events of 2008, trust in big business has been in long-term decline and governments have been given a clear mandate to regulate for social benefits.

UK workers' share of global growth has dwindled, as profits have risen



Source: Office for National Statistics.

CEO-to-worker compensation ratio in the US (including value of options granted)



Source: Economic Policy Institute.

Compounding the social pressure, governments cannot afford to continue supporting employed workers unable to get by on the wages they receive; their responses are already evident in the social and political focus on living wages, tax avoidance, pension and healthcare reform and other "subsidies" from the public to private sector.

The road that led us to Brexit
(and where it's heading)

Investing to strengthen stakeholder relationships

Long-term success ultimately stems from companies' abilities to attract talent, engage customers, manage supply chains and establish strong relationships with the spectrum of stakeholder they rely on. Companies that ensure stakeholders – in particular employees – benefit from those relationships, through adequate wages and reasonable working conditions, will be better able to withstand mounting pressures without suffering margin squeezes than those which continue to see stakeholder investment as a trade-off to profitability.

Companies operating in industries where wages are typically lower will face the greatest pressures, while those which also contend with low operating margins will have less room for manoeuvre. Higher wages across a sector are ultimately likely to push prices up, leaving the industry's overall profitability broadly unchanged, but with potentially significant shifts in value from those businesses that rely on low wages and those that do not.

The strongest companies will address the causes rather than the symptoms.

While every company faces immediate challenges in the aftermath of Brexit, those that recognise and adapt to the underlying trends the vote reflects will be in the stronger positions for the long-term. We have focused on three trends here, although the challenges and opportunities are likely to be more complex and diverse:

- More protectionist, domestically focused policies: global businesses need to operate locally
- More political and social instability: flexibility and adaptability are key
- More pressure to share rewards with workers and societies: investing to strengthen stakeholder relationships

Whereas these considerations are typically far better understood in the corporate world than in financial markets, differences remain between companies and present investment opportunities for those investors able to understand them.

> "We are convinced new tools are needed. We are focusing on building analytical models and tools that reflect companies' abilities to adapt to the changing social and environmental trends they face"

We need a better tool kit

For investors, the Brexit vote highlights the growing need for new models and tools. The fundamentals of markets are constant. In the long run, earnings drive equity returns and, in the shorter term, fluctuations in sentiment and valuation multiples force variations around those longer term trends.

However, the lenses markets have conventionally used to examine these issues tend to assume maintenance of the status quo and are becoming increasingly exposed as inadequate. Our industry has built short-term earnings models based on analysis of current operations, recent financial trends and near-term economic forecasts. We have compared the earnings that emerge from that modelling to share prices and based decisions on companies' relative attractions. The effects of changing social pressures – while often recognised and accepted to be important – do not fit that model.

As a result, we are convinced new tools are needed. At Schroders, we are focusing on building analytical models and tools that reflect companies' abilities to adapt to the changing social and environmental trends they face. This means analysing industries and the ways social trends impact business models, competitiveness and profitability. It means focusing on how companies are run, rather than just on how much money they make. And it means thinking about investments as companies not symbols.

Special topic
Aviation: the wings of (climate) change

"Delivering change on the scale implied by global climate commitments will mean a more fundamental rethink of business models"

Belinda Gan
Associate Product Manager, Global Sustainability

According to the International Energy Agency (IEA), aviation greenhouse gas (GHG) emissions growth will be among the fastest of any sector over the next few decades. The sector is currently responsible for 2–3% of total global greenhouse gas emissions. Under a business-as-usual scenario and without any adaptation or regulatory intervention, the aviation sector could be responsible for approximately 22% of world emissions by 2050 assuming every other sector reduced emissions in line with a two degree scenario.

Despite these current and anticipated impacts, the aviation sector managed to sidestep the COP21 climate negotiations held in Paris in December 2015. There was no direct reference to aviation in the final agreement drawn up by the Convention, leaving it to industry associations, such as the International Civil Aviation Organization (ICAO), to come up with its own voluntary emissions reduction framework.

The primary goal of the Paris agreement is to hold the increase in global average temperature to well below two degrees Celsius above pre-industrial levels. Based on the IEA's scenario analysis, achieving that goal will mean reducing the absolute volume of global greenhouse gas emissions by around 60% over the next 35 years. While there is little clarity on the policy measures that will underpin that goal, momentum towards more stringent regulatory intervention is growing and we use that goal as our baseline in assessing industries' readiness to adapt.

Over the past few years, ICAO and IATA (International Air Transport Association) have been active on the climate change front, and drafted a series of measures in response. Crucially, ICAO is expected to reach a final agreement in October 2016. IATA has outlined a long-term goal to achieve "a reduction in net aviation CO2 emissions of 50% by 2050, relative to 2005 levels." Details of how this will be achieved are less clear.

We apply an objective lens to gauge the scale of the challenge of halving GHG emissions against a backdrop of 3–5% annual demand growth. Achieving both implies an approximate 80–90% reduction in emissions intensity through 2050. Extending the goals the ICAO targets for 2009–2020 (delivery of which are now relatively well assured) through 2050 implies fleet renewals, operational improvements, infrastructure investments, technology advances and biofuel use could collectively contribute around half of the required emissions reduction. Extending near-term goals is optimistic; many industry and technical analyses indicate that the rules of manufacturing, physics and gravity could limit potential for efficiency gains before that assumption is met.

The challenge facing the industry is therefore daunting. Halving emissions will mean heavy reliance on offset mechanisms. Although these can optically allow any industry to bridge a gap between reduction targets and tangible steps, they clearly cannot be used in every part of the economy and regulatory pressure is likely to push harder on practical change instead.

Most players in the sector, from aircraft manufacturers to airliners and airport operators, have made pledges to contribute to a steep reduction in emissions. They generally favour a global voluntary approach over regional regulatory schemes, such as the European Union's Emissions Trading Scheme. Delivering change on the scale implied by global climate commitments will mean a more fundamental rethink of business models than the incremental benefits efficiency gains and operational optimisation have delivered. Regulatory pressures are likely to intensify if voluntary progress is too slow. While more radical changes are likely to be needed in the longer term, companies that have started earlier – for instance by investing in more efficient fleet, maintaining higher load factors or optimising routes – will be better able to maintain financial flexibility as pressures intensify.

Special topic
Why investors should be caring about sharing

"Sharing businesses are typically based on a kernel of innovation that allows them to undermine the economics of traditional peers"

Solange Le Jeune
ESG Analyst

Sharing businesses have emerged as the hot topic in the current wave of technology excitement. Start-ups are competing to be "the next Airbnb" of every industry imaginable, and are vying for the capital that label can attract.

Airbnb itself advertises three times more beds than the world's largest hotel chain. Meanwhile, Uber has rapidly become the largest passenger transport network. Identifying sectors vulnerable to similar disruptions and understanding existing companies' exposure and strategic responses is increasingly vital given the scale and speed with which change can unfold.

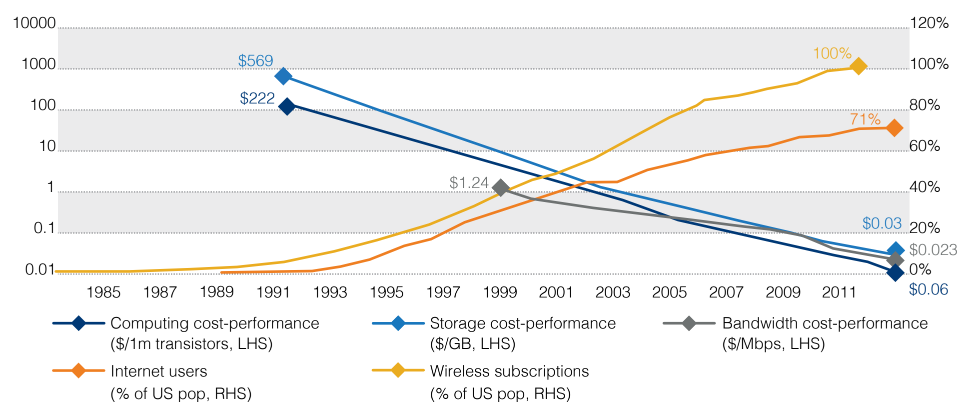
The signs of disruption are clear and fast

- Sharing businesses receive more venture capital funding than any other category, having overtaken social media platforms. The total value of sharing start-up businesses had reached $219 billion by mid-2015[3] , with $20 billion of new capital invested in the sector in just the last two years[4]
- Sharing revenues are set to grow at 25% annually over the next decade, and are expected to reach $335 billion by 2025, according to PWC[5].

The drivers of this growth are swelling

Growing trends particularly among the younger generation – who represent the most active users of sharing businesses – serve to complement the "sharing" culture. Such trends include: access to communication technologies; increased trust and social acceptance of online exchanges and sharing; recognition of existing inefficiencies; significant savings; and flexible working patterns.

The falling cost of digital technology capabilities and the growing number of internet users



Source: Deloitte University press, 2013. http://dupress.com/articles/from-exponential-technologies-to-exponential-innovation/

Few opportunities to invest in the theme through public equity markets

With an ability to scale with limited capital, most sharing businesses operate outside public equity markets and provide little visibility into their finances or operations. Our main focus is therefore on the abilities of existing companies to adapt and defend their competitive positions, and potentially ride the growth opportunities this presents if they are able to adapt quickly enough.

3 CS research, The sharing Economy.

4 http://fairviewcapital.com/downloads/Fairview_Capital_Sharing_Economy_Newsletter.pdf

5 PWC, Consumer Intelligence Series, the Sharing Economy.

The stocks mentioned are for illustrative purposes only and are not a recommendation to buy or sell.

Sharing businesses pose a threat to listed companies in exposed sectors

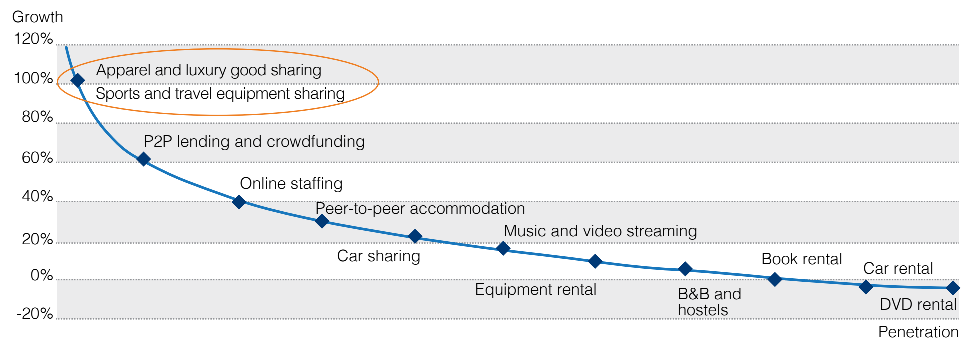
In markets for which sharing businesses started earlier and have achieved greater scale, the impacts on established companies are already becoming clear:

- Barclays has estimated that car sharing, when combined with autonomous driving technologies, could in time lead to a 40% drop in the demand for cars and a 60% fall in the number of cars on roads globally
- Airbnb – which currently represents 1% of global lodging supply – could grow to 5% of the global market by 2020, according to Credit Suisse
- Peer-to-peer lending and small-and-medium-enterprise crowdfunding remain tiny as a market share (1%–2% of bank lending[6]). However, global crowdfunding more than doubled last year to $34 billion[7], and The World Bank estimates it will reach $90 billion by 2020[8].

But more sectors may be at risk

By examining large categories of spending on consumer durable goods with low utilisation rates and for which physical sharing is straightforward, we have identified markets we think are likely to face new disruption, circled here in orange:

Maturity growth expectations of sharing industries



Source: Schroders, PWC, 2016

Sharing businesses are typically based on a kernel of innovation that allows them to undermine the economics of traditional peers. Airbnb uses the scale of an online marketplace to allow home owners to generate a positive return on property and eliminates redundant administrative and service overheads its users don't require. Uber similarly leverages an online market place to bring together self-employed drivers and passengers. Had existing companies recognised those business model opportunities, they might have more easily stemmed their growth by adapting their own strategies.

Every industry will face different challenges

Companies are starting to find novel ways to adapt. Peer-to-peer insurer Lemonade is apparently looking at ways to leverage behavioural analytics and distributed ledgers (holding records with customers rather than centrally). Others – like Heyguevara, Bought by Many and Friendssurance – are building policy pools that create small "captive insurers" for groups of people or friends, who are likely to try to keep their claims and premiums down. Many established insurers are looking at ways of exploiting ubiquitous smartphone ownership to monitor driving behaviour and even patterns of home occupancy. Another strategy is to buy emerging competitors once their business is scalable, although this is typically costly and difficult to execute.

We are monitoring trends to identify winners and losers

Our approach is to (i) observe markets where the conditions are ripe for disruptors; and (ii) conduct discussions with companies on the changes they expect and the responses they are preparing. This two-pronged approach is providing insight into the winners and losers of the sharing economy.

6 CS, The Sharing Economy

7 Massolution, http://www.crowdsourcing.org/editorial/global-crowdfunding-market-to-reach-344b-in-2015-predicts-massolutions-2015cf-industry-report/45376

8 http://www.forbes.com/sites/chancebarnett/2015/06/09/trends-show-crowdfunding-to-surpass-vc-in-2016/2/#7519669c76da

AGM season:
The year of shareholder revolt?

Case study

The 2016 UK AGM season has made more headlines than ever, some viewing it as "the year of shareholder revolt." In our opinion quantum of pay has been the biggest point of contention. The grant of exceptional one-off payments, salary increases and continued high pension percentages has pushed absolute levels of pay to unprecedented levels, at a time when returns to shareholders have been low. According to Deloitte, average FTSE 100 Executive Pay has grown at 8% annually since 2000, compared to an increase in average earnings for all employees of less than 3% per annum. It is important that companies look at the wider picture when setting pay, assessing returns to all stakeholders; shareholders, employees as well as executives.

How a company remunerates board members can also be an indicator of wider company culture. In our experience some companies continue to struggle with the challenge of setting meaningful, stretching targets to incentivise and retain management and make a clear link between pay and performance. We believe the time has come for remuneration committees to exercise their power and use their discretion in bringing pay in line with shareholder returns, or radically change their approach to executive incentives. Clawback should be implemented; in our view, clawback policies are widely underutilised.

Our policy is to engage with companies ahead of our votes; in many cases, our dialogue results in changes before we submit our vote, often paving a smoother path towards a company's AGM. Where companies are not open to changes, we may decide to vote against certain resolutions on the agenda. Debate in these areas looks set to continue, and we continuously consider new approaches to create long-term incentives for management that are fully aligned with long-term shareholder value

Below we highlight some of the more contentious votes:

"Companies continue to struggle with the challenge of setting meaningful, stretching targets to incentivise and retain management and make a clear link between pay and performance"

GlaxoSmithKline

Having been concerned with the lack of succession planning for some time and having engaged extensively on the issue, we believe GSK is on a road of refreshment. Sir Philip Hampton became chairman and there was a high turnover of non-executive board members. Long-term CEO Andrew Witty also announced he would be stepping down in 2017. Despite some progress, we believed it was important to exercise our vote against five directors of long tenures due to a lack of results in this area. One of the directors we voted against has now announced his intention to retire from the company in 2017.

For the second year running we voted against the remuneration report. We were concerned the committee has not communicated detailed target information for incentivised pay, which is well behind market practice. The CEO received maximum bonus payments but, as the company failed to disclose details of an individual performance multiplier element used in respect of the 2015 bonuses, we found it impossible to determine the stretch of these payments.

HSBC

In 2015, HSBC received a substantial vote against its remuneration report. Our concerns, which we relayed to the company at the time, were that the plan was mainly focused on a fixed pay element and lacked specific disclosure on incentivised targets resulting in what we felt was a "pay-for-performance" misalignment.

Due to these previous objections of high fixed pay, such as 50% pension and a large percentage of bonus targets being attributed to a non-financial driver of promoting HSBC values, we once again voted against the remuneration report.

We remained in continuous dialogue with the company throughout the year to encourage changes to address the issues from the 2015 vote and align with the company strategy.

The stocks mentioned above are for illustrative purposes only.

This year, HSBC has implemented significant changes to its board with five new non-executive directors and has proposed a new remuneration policy to reflect updates in the regulatory environment.

As a result of the CRD IV requirement, maximum variable pay will now be expressed as a percentage of base salary rather than fixed pay. Pension contributions have also been reduced to 30% of base salary. We are encouraged by HSBC's progress and believe these changes will result in a lower quantum of pay. We are supportive of the new remuneration policy framework.

Standard Chartered

In late 2015, Schroders met with Standard Chartered to discuss past senior management. In light of recent capital raising and writedowns we were keen to discuss the issue of malus and clawback provisions. We felt that past management had been rewarded substantially while leaving a legacy of heavy losses for shareholders.

Our dialogue with Standard Chartered's remuneration committee reassured us that the company does spend significant time analysing what executives receive based on past long-term incentive plans. We were disappointed that the company was not more publicly transparent about its consideration of malus and clawback for the departed senior management team. As such, we voted against the remuneration report.

This year, a new remuneration policy has been implemented which simplifies incentive arrangements with a clearer separation of Long-Term Incentive Plan (LTIP) awards and annual bonuses. More than 60% of variable remuneration is now based on forward-looking performance targets – which led to us voting in favour of the remuneration policy.

British American Tobacco

With significant increases in the maximum award levels under the annual bonus and LTIP, we actively reached out to the company for the reasoning behind these increases. The company confirmed that the increases were due to what they feel is a lack of competitiveness in the design of the executive directors' compensation and that the company needs to increase the amount of incentive opportunity to bring it more into line with the marketplace.

We are not usually supportive of increases due to benchmarking and, with these increases, we expect targets to become more challenging and stretching to warrant the upswing in opportunity. Through our internal analysis we concluded that the targets were not sufficiently stretching in light of the maximum increases, and voted against.

The stocks mentioned above are for illustrative purposes only.

Costly cures: Pressure on US drug prices

Case study

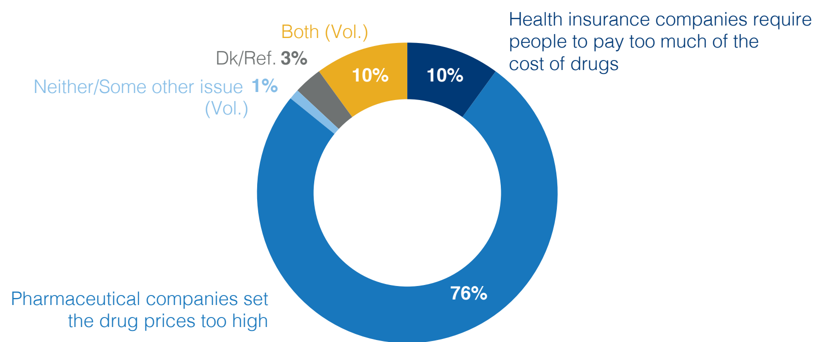
"There are concerns that key drugs are becoming unaffordable and inaccessible, even for the insured and relatively affluent"

Rising drug prices have triggered something of a political explosion during the US presidential nomination campaigns. Perceived by some as a vote-winning tactic, the discussions have nonetheless shone a spotlight on the prices set by drug companies and paid by health insurers, hospitals and government health schemes. There are concerns that key drugs are becoming unaffordable and inaccessible, even for the insured and relatively affluent.

Stepping aside from the radical price hikes imposed by companies such as Turing and Valeant, we sought to understand what the impact of a regulatory clampdown on drug prices might mean for the pharma industry and its stakeholders.

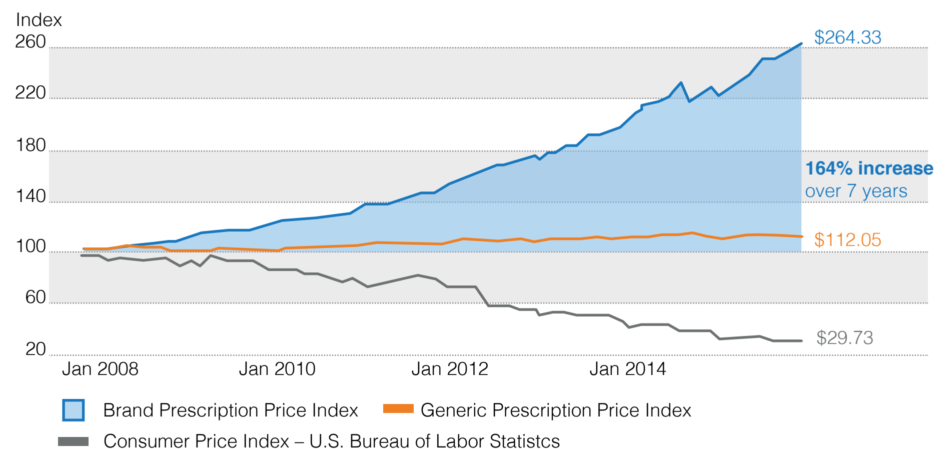
Financial impacts could vary – for example, Morgan Stanley predicted a 4% impact on 2017 earnings per share from pricing restrictions (regulatory or other). Hilary Clinton's tweet in 2015 following Turing's excessive price hike brought share prices in the biotech sector down by 4%. Employers and insurers are also affected, many of whom may start to transfer some of the increased costs to consumers, via higher monthly premiums or rising co-pays, or may simply exclude the expensive drugs from their lists.

Of the 73% who say the cost of prescription drugs is unreasonable, these are the reasons they give:



Source: Kaiser Family Foundation Health Tracking Poll (conducted June 2–9, 2015)

Branded prescription drug prices are rising:



Source: Express Scripts 2015 Drug Trend Report.

The stocks mentioned above are for illustrative purposes only.

We summarise our research below:

> "We believe the healthcare industry as a whole will have to address increased scrutiny and pressure on pricing"

1. A dual pressure for drug companies

Currently there is no regulatory "cap" on drug prices. In theory prices should be controlled by market mechanisms, for example through drug companies providing rebates (a type of discount) to insurance companies. There is a widening gap between the "net" price provided to insurers and pharmacies once rebates have been taken into account, and the headline "list price" which is the price if the drug has to be paid out of pocket. It is this list price that has been rising, due to several factors but partly to compensate for the increasing pressure to provide rebates. For drug companies, this signals pressure at both ends of the price spectrum. Furthermore, there is little evidence to show that patients are benefitting from the increased rebates.

2. Whoever wins the election, regulation is far off the mark

The Clinton and Trump campaigns have both proposed some regulatory tweaks to pricing structures, such as allowing Medicare (the government health scheme for the elderly) to negotiate prices directly with drug companies, which has been met with criticism. In addition, a trial is already underway to shift doctors to a value-based payment model. But in reality, any major federal change will be difficult to achieve in the near- to mid-term, due to congressional barriers and more pressing campaign priorities. Consequently any near-term requirements on drug companies are likely to be state-wide rather than federal. Indeed, state initiatives that are already being discussed include improving transparency on pricing structures and applying partial caps.

3. Companies are struggling to tackle the debate

Drug companies are generally resistant to either increased transparency or regulatory change, arguing firstly that pricing structures already take into consideration many complex factors, such as R&D costs, availability of other treatments, impacts on patients and ability to reduce other healthcare costs. Secondly, they contend that regulatory action would change the whole healthcare and insurance industry, with drug pricing just one part of a broader challenge. Some companies appear more proactive than others. For example, a major pharmaceutical has trials underway for "pay for indication" (where a drug is priced according to its effect on different tumours), and "pay for performance". Again, these face various challenges such as who to reimburse, how physicians would respond, and incompatibility with the pricing structure adopted by Medicaid (the government scheme for those on low incomes).

4. Uniqueness will pay; transparency will help

Companies that have limited innovation in their portfolio and pipeline, or whose strategy has relied on price hikes without incremental R&D investment, are the obvious losers – this is already well-known by the market. Those with lower US exposure will also obviously be less sensitive to any limitations on US price hikes – again, this has been factored in by the market. The key differentiating factors for other companies will be uniqueness and transparency. Uniqueness encompasses factors such as better innovation, a higher proportion of sales from new products, and exposure to therapeutic areas that are hard to replicate. Transparency focuses on clearer patient outcomes and proactive communication on the pricing debate. Such companies have a better chance of shielding themselves from restrictions on price rises and negative public opinion.

Regardless of political outcomes, we believe the healthcare industry as a whole will have to address increased scrutiny and pressure on pricing. As long-term shareholders, we continue to engage with companies including GSK, Pfizer and Roche, to understand their position, exposure, and response.

The stocks mentioned above are for illustrative purposes only.

Beverage companies: Sweet advantage for early movers

Case study

We highlighted the prospect of a sugar tax in our recent analysis and report looking at its implications for the food and beverages sector. As global obesity and diabetes rates continue to rise, a sugar tax is one of several tools that governments can use to respond to rising healthcare costs.

A similar approach was taken with the tobacco sector in the 1990s. Taxing sugar, however, is a newer trend. The country with the highest consumption of sugary drinks per capita, Mexico, has already introduced a sugar tax. Whilst this tax has raised 18 billion pesos to help combat rising healthcare costs, it is thought to have had only a temporary impact on consumption. But in the UK, tax rates have not yet been set, so it is difficult to assess the direct impact on consumer demand for sugary drinks.

Regulation isn't the only pressure food and beverage companies face

Consumers are becoming increasingly aware of nutritional content and ingredients, driving the demand for clean labels and healthier products. Awareness of sugar content is likely to increase following the recent tax announcement. Other groups have also highlighted the negative health implications of excessive sugar consumption including public health bodies, NGOs and the scientific community. From a company perspective, adapting to these trends is likely to benefit those companies that have moved earlier to reformulate products and deliver healthier products but put pressure on companies that have been slower to change. Ingredients companies are also well-placed to benefit from reformulation trends. At a macro level, it has been suggested that the broader economy will benefit as workforces become healthier and productivity increases.

> "Ingredients companies are also well-placed to benefit from reformulation trends"

Adapting to changing demands

Whilst some sector leading beverage companies have already demonstrated significant progress in developing sugar-free alternatives and diversifying product portfolios with bottled water and healthier products, we believe the industry will face increased scrutiny from a range of stakeholders and the gap between industry leaders and laggards will continue to widen. Through our extensive discussions with companies and the industry, we have been able to improve our understanding of the challenges companies face, their responses and support those companies keen to adapt to the changing demands placed on them.

Understanding risks

We continue to engage with the sector on this potential risk. In addition to one-on-one company engagement meetings, we have also established a "Sugar Roundtable" that allows investors and companies to discuss the issues and challenges in adopting healthier product portfolios. As investors, this will allow us to build expectations about what future reporting around the broader health and wellness trends could look like. We held our first roundtable with investors including Aviva, Standard Life and Rathbones and UK beverages companies just two weeks before the UK sugar tax was announced. We will host another roundtable later in the year to engage with food producers and retailers.

Company engagement

Our ESG team had 116 engagements this quarter with the 103 companies listed below, on a broad range of topics categorised under "environmental", "social" and "governance". They included one-to-one meetings, joint investor meetings, conferences, teleconferences, written correspondence and collaborative engagements.

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

Company	E	S	G
Consumer Discretionary			
ABC Mart	✓	✓	
Amazon	✓	✓	✓
Autogrill		✓	
Burberry			✓
Compass Group		✓	
Daily Mail			✓
Darden Restaurants		✓	
Domino Pizza		✓	
Findel			✓
Halfords Group			✓
Inchcape			✓
Intercontinental		✓	✓
J D Wetherspoon		✓	
Marks and Spencer		✓	
McDonalds		✓	
Mitchells and Butlers		✓	
NH Hotels			✓
Pearson			✓
Starbucks		✓	
Target		✓	
Whitbread		✓	
YUM! Brands		✓	

Company	E	S	G
Consumer Staples			
British American Tobacco		✓	✓
Carrefour		✓	
Costco		✓	
Dairy Crest		✓	✓
Delhaize		✓	
Greggs		✓	
Heineken	✓		✓
J Sainsbury		✓	
Mondelez International		✓	
Nestle		✓	
Philip Morris	✓	✓	
Reckitt Benckiser		✓	
SSP		✓	
Tesco	✓	✓	
Unilever		✓	✓
Universal	✓	✓	
Wesfarmers		✓	

Key: E: Environment S: Social G: Governance

The stocks mentioned above are for illustrative purposes only and not a recommendation to buy or sell.

Source: Schroders as at 30 June 2016.

Company engagement

Continued...

Company	E	S	G
Energy			
BP	✓	✓	✓
Cabot Oil & Gas	✓		
Chevron Texaco		✓	
Cimarex Energy Co.	✓		
CNOOC		✓	✓
Exxon Mobil	✓	✓	
Hess	✓		
Northern Oil and Gas			✓
Occidental Petroleum	✓		
Royal Dutch Shell	✓	✓	✓
SINOPEC	✓	✓	
Total	✓	✓	✓
Woodside Petroleum	✓	✓	
Financials			
Assura	✓		
Bank Rakyat Indonesia	✓		
Emirates REIT			✓
BBVA Bancomer			✓
Hiscox			✓
HSBC	✓	✓	✓
Intesa Sanpaolo			✓
KBC Groep			✓
Legal & General Group			✓
Man Group			✓
Paragon Group			✓
Royal Bank of Scotland	✓	✓	✓
Standard Chartered			✓
Tullett Prebon			✓
Universal Insurance			✓

Company	E	S	G
Health Care			
Apollo Hospitals			✓
Fresenius Medical Care			✓
Genus	✓	✓	
GlaxoSmithKline		✓	✓
Lupin		✓	
Novartis			✓
Pfizer		✓	✓
Roche Holding		✓	
Shire			✓
Smith & Nephew			✓
Industrials			
Adecco			✓
Air Partner			✓
BAE Systems			✓
Brenntag			✓
Experian		✓	✓
Gategroup		✓	
Legrand			✓
National Express		✓	✓
NWS Holdings			✓
Renold			✓
Royal Mail			✓
RPS			✓
Sime Darby	✓		
Weir Group			✓

Key: E: Environment S: Social G: Governance

The stocks mentioned above are for illustrative purposes only and not a recommendation to buy or sell.

Source: Schroders as at 30 June 2016.

Company engagement

Continued...

Company	E	S	G
Information Technology			
Fidessa			✓
Micro Focus			✓
Realtek Semiconductor			✓
RIB Software			✓
Materials			
Anglo American	✓		
Ball	✓		
BHP Billiton	✓	✓	✓
Glencore	✓	✓	✓
Johnson Matthey		✓	✓
Rio Tinto	✓		✓
Utilities			
Centrica			✓

Key: E: Environment S: Social G: Governance

The stocks mentioned above are for illustrative purposes only and not a recommendation to buy or sell.

Source: Schroders as at 30 June 2016.

Engagement in numbers

Companies engaged by region

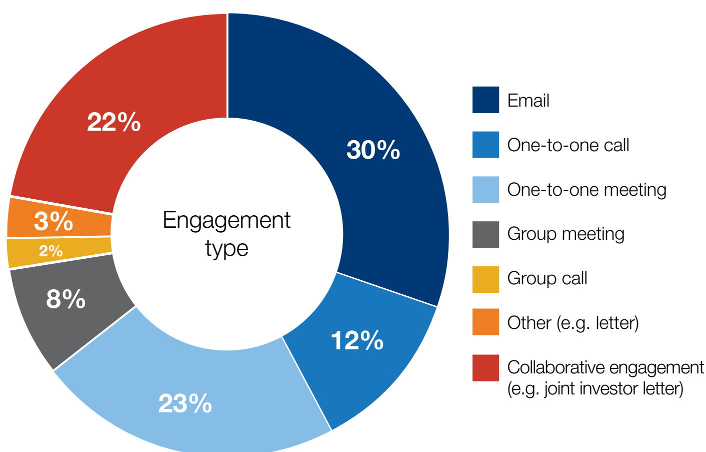
59 UK

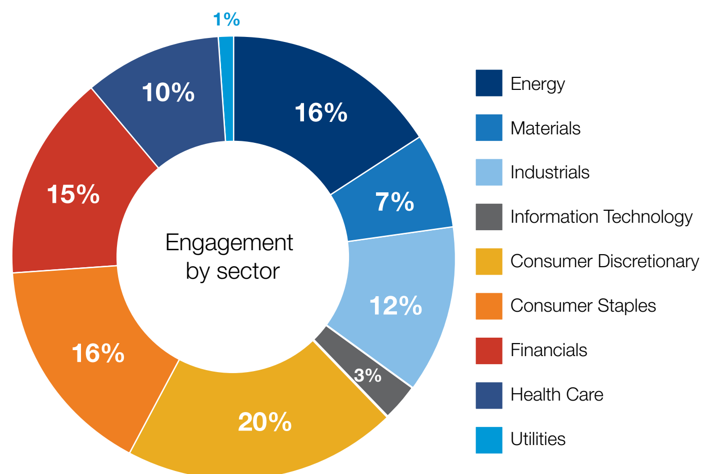
19 Europe (ex-UK)

25 North America

12 Asia Pacific

1 Latin America





Source: Schroders as at 30 June 2016.

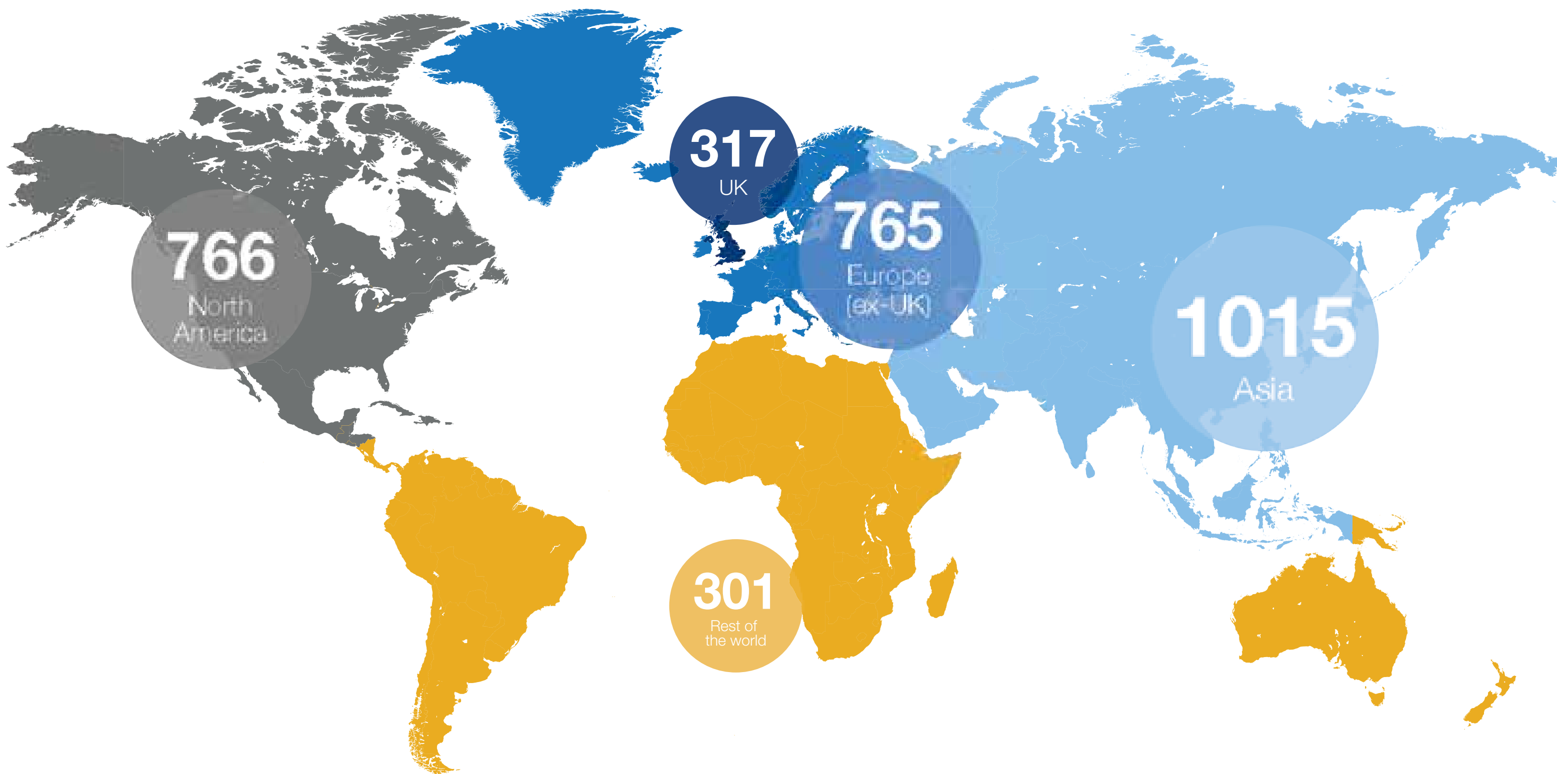
Shareholder voting

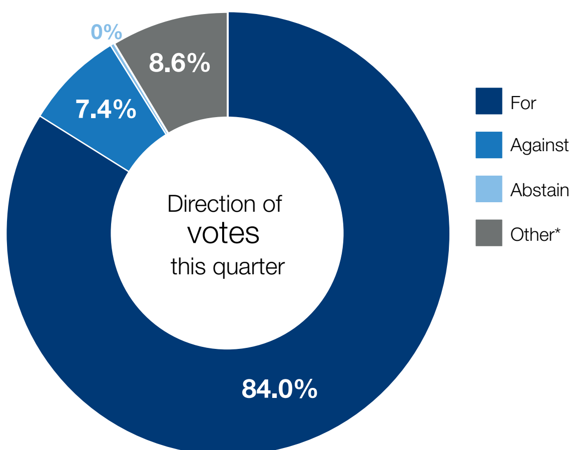
We believe we have a responsibility to exercise our voting rights. We therefore evaluate voting issues on our investments and vote on them in line with our fiduciary responsibilities to clients. We vote on all resolutions unless we are restricted from doing so (e.g. as a result of shareblocking).

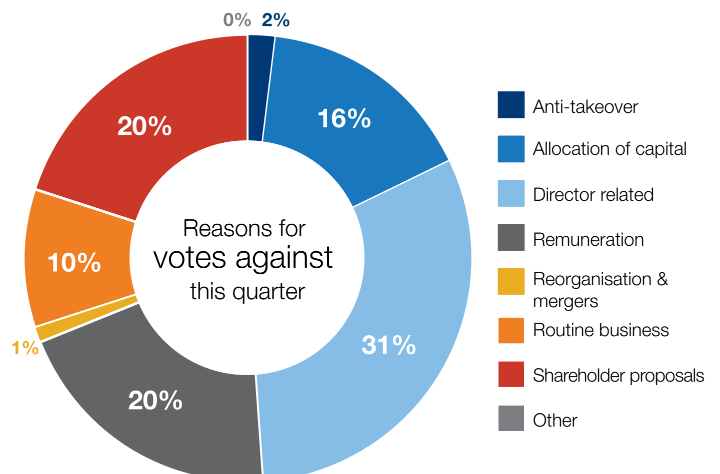
This quarter we voted on **3164 companies and approximately 89% of all our holdings**.
We voted on 137 ESG-related shareholder resolutions, abstaining on 10 and voting against 69.

The charts below provide a breakdown of our voting activity from this quarter. Our UK voting decisions are all available on our website at **www.schroders.com/responsibleinvestment** under "Voting".

Company meetings voted





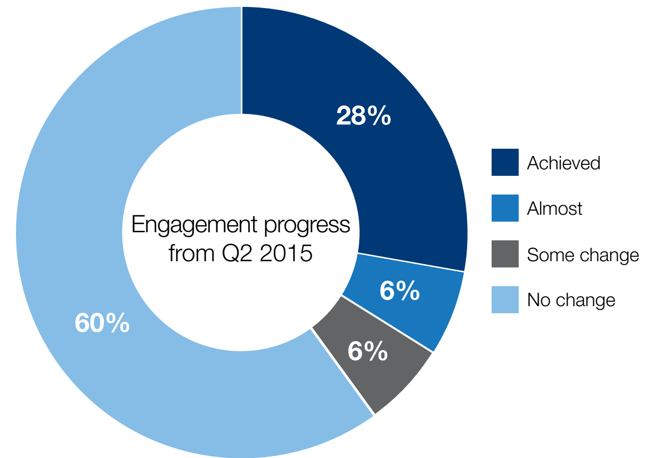


Source: Schroders as at 30 June 2016.
*Includes withheld or unvoteable resolutions, for example due to shareblocking.

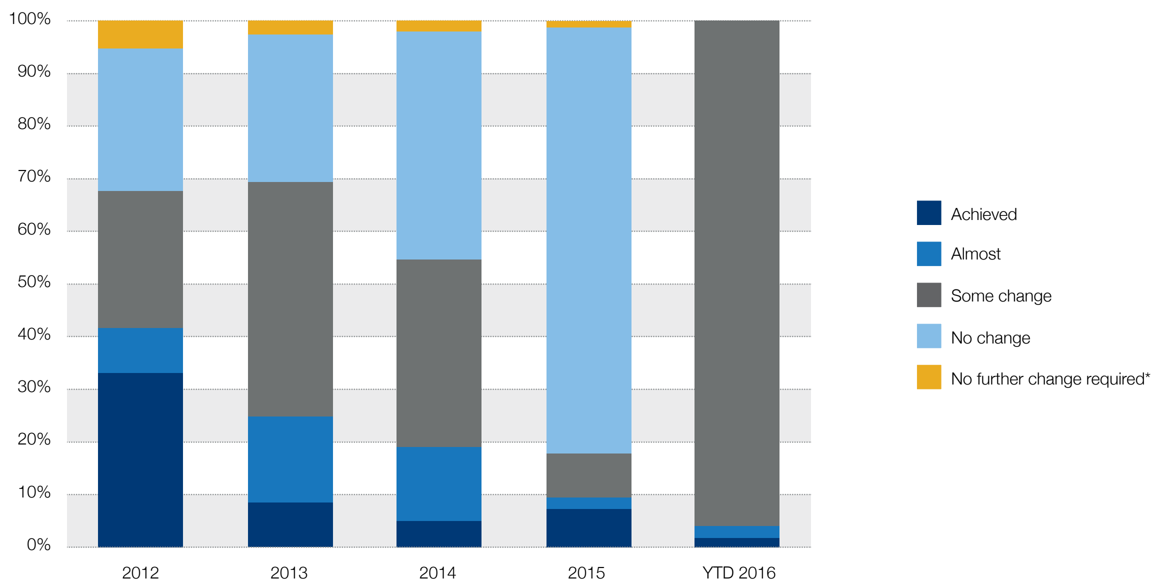
Engagement progress

This section reviews any progress on suggestions for change we made a year ago, in this case the second quarter of 2015. There are four possible results: "Achieved", "Almost", "Some Change" and "No Change". Of a total number of 67 "change facilitation" requests made, we recorded 19 as Achieved, 4 as Almost, 4 as Some Change and 40 as No Change.

Below we provide details on our successes.



Effectiveness of requests for change – 5 year period



* This refers to requests that are no longer valid, for example if a company has been acquired, or has changed its business activities.

Source: Schroders as at 30 June 2016.

The stocks mentioned above are for illustrative purposes only and not a recommendation to buy or sell.
Source: Schroders as at 30 June 2016.

Schroders

Important information: The views and opinions contained herein are those of the Environmental, Social and Governance (ESG) team, and may not necessarily represent views expressed or reflected in other Schroders communications, strategies or funds. This document is intended to be for information purposes only and it is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice, or investment recommendations. Information herein is believed to be reliable but Schroders does not warrant its completeness or accuracy. Reliance should not be placed on the views and information in the document when taking individual investment and/or strategic decisions. Past performance is not a reliable indicator of future results, prices of shares and the income from them may fall as well as rise and investors may not get back the amount originally invested. The opinions included in this document include some forecasted views. We believe that we are basing our expectations and believes on reasonable assumptions within the bounds of what we currently know. However, there is no guarantee that any forecasts or opinions will be realised. The stocks and sectors mentioned above are for illustrative purposes only and are not a recommendation to buy or sell. UK: No responsibility can be accepted for errors of fact or opinion obtained from third parties. This does not exclude any duty or liability that Schroders has to its customers under the UK Financial Services and Markets Act 2000 (as amended from time to time) or any other regulatory system. Issued by Schroder Investment Management Limited, 31 Gresham Street, London EC2V 7QA. Registration No. 1893220 England. Authorised and regulated by the Financial Conduct Authority. For your security, communications may be taped or monitored. Further information about Schroders can be found at www.schroders.com. USA: Schroder Investment Management North America Inc. is an indirect wholly owned subsidiary of Schroders plc and is a SEC registered investment adviser and registered in Canada in the capacity of Portfolio Manager with the Securities Commission in Alberta, British Columbia, Manitoba, Nova Scotia, Ontario, Quebec, and Saskatchewan providing asset management products and services to clients in Canada. 875 Third Avenue, New York, NY, 10022, (212) 641-3800. RC60076