Schroders

Marketing material

Sustainable Investment Report
Q4 2017

Contents

We are proud of our engagement track record, and the way that scale has been building over recent years. In 2017 engagements will reach quadruple figures for the first time and touch more countries than ever.

Jessica Ground
Global Head of Stewardship, Schroders

Since 2000 we have been tracking our effectiveness, and reporting to you on the progress and impact of our engagement to effect change, the details of which you will find at the back of this report. However, 50% of our ESG engagement is fact finding. This also plays a vital role in our investment process, but receives less attention. While transparency around how companies are managing sustainability issues has improved, it still lags the disclosure that we receive in other areas. Often we identify challenges that are difficult to quantify or are not yet recognised by the market. Engagements that enable us to better understand how companies are navigating these issues feed into investment decisions and position sizing.

This quarter we share details of our fact finding activities. One project involved examining retailers' working practices at fulfilment centres. E-commerce continues to grow at a rapid rate and companies need to ensure that they are managing their operations and workforces in a resilient way. The site visits that we conducted were helpful in identifying what best practice is and will feed into ongoing engagement work.

Another sector facing significant structural upheaval is banking. We have been engaged in a multi-year dialogue with a number of pan-European banks about the right long-term metrics of success and how they can ensure that their businesses are truly serving customers and broader society.

Our work shows that investors are clear that they are looking for sustainable business models rather than quarterly earnings reports.

Moving to emerging markets, corporate governance is a major area of focus for us as investors and we were delighted to host a discussion focused on identifying practical improvements that involved securities regulators, companies and investors during the quarter. Everyone agreed that strong corporate governance is key for attracting capital. This sentiment was echoed in another debate that took place at Schroders involving the "Focusing Capital on the Long Term" initiative. Again, we involved a number of stakeholders to come up with practical steps that everyone in the investment chain can take to create better long-term value.

Looking at research, an increasingly important but poorly quantified area of company investment is human capital. Previously, we have examined this through the lens of modern slavery and living wages. Our latest research shows the impact that integrating human capital considerations into profitability and asset measures can have on the measurement of profitability. Lastly, in August of this year, President Trump declared an opioid emergency in the US. We take a closer look at the investment implications likely to result from a problem of this scale.

As the breadth of topics analysed in this report demonstrates, companies continue to face a myriad of issues in today's world. As stewards of investor capital, we need to challenge companies to understand how they are dealing with big topics ranging from the structural shifts around the internet to the management of workforces in a knowledge-based economy and meeting the growing expectations of a wide range of stakeholders. Fact finding engagement is a key part of a meaningful dialogue with companies on how they will continue to enjoy success in years to come so we hope this quarter's report sheds some light on our fact finding approach at Schroders.

INsight

Opioid addiction crisis: the cost of killing pain

A national opioid crisis has hit the US, with addiction numbers increasing fivefold over the past seven years. In 2015, more than one in three Americans was prescribed opioids to treat pain. Now, major opioid drug manufacturers have been sued by over 30 states, cities or counties in the US. The drug companies are alleged to have underplayed the addictive qualities of the drugs and overstated their benefits.

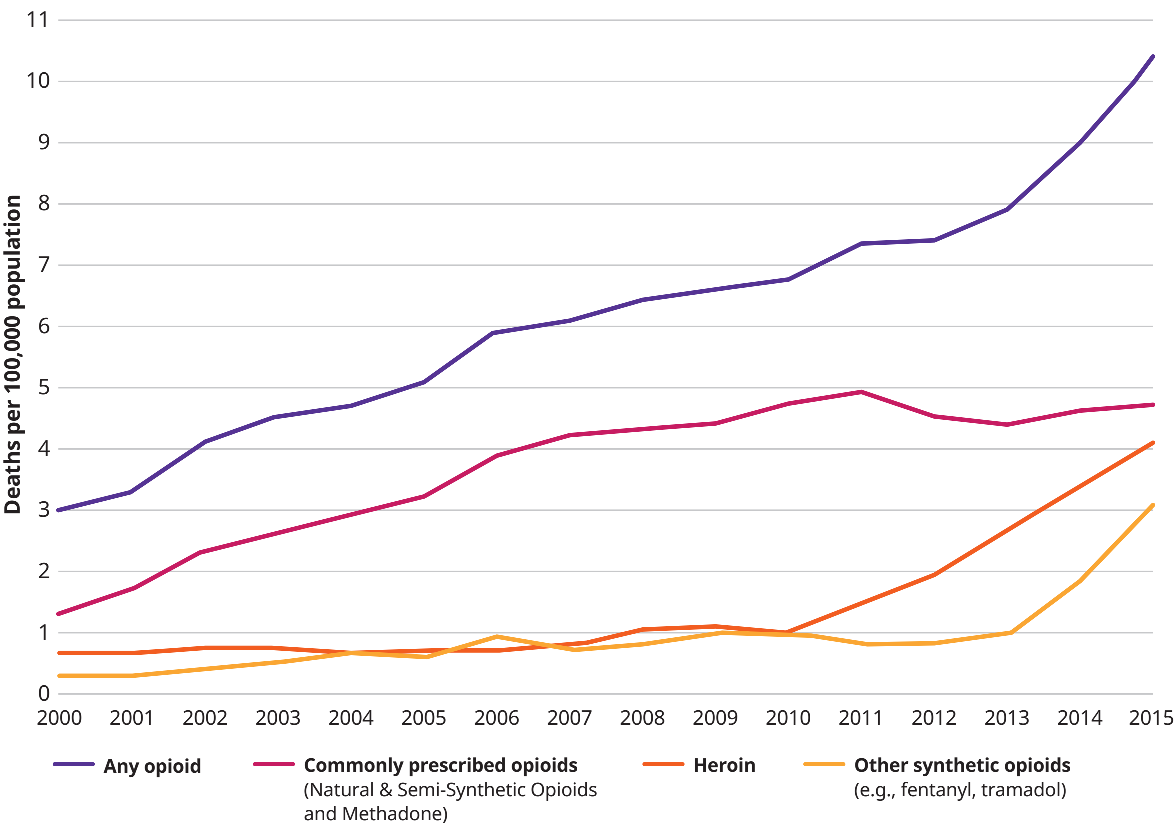
The cost of addiction paints a bleak picture. The total economic burden of prescription opioid and heroin abuse in the US has been estimated at $78.5 billion annually, nearly 25% of which is shouldered by public sources (via drug rehabilitation, foster care, Medicaid costs, etc). Federal Reserve Chair Janet Yellen recently said the crisis has weighed on labour force participation, particularly among working-age men, and Donald Trump has declared it a "public health emergency". These factors have built a heavy case for heightened scrutiny and legislative action.

While media and market attention focuses on the drug companies caught up in the legal proceedings, we believe the implications spread further. We have mapped risks and opportunities across sectors, tracked corporate responses, and spoken with companies. Given the burden of opioid addiction on the US economy and the political attention it receives, we believe there will be opportunities for companies offering solutions as well as risks to those companies implicated in its causes.

Rapid escalation

Opioids are a class of drug that includes heroin, synthetic opioids such as fentanyl, and pain relievers available legally by prescription in the US, such as oxycodone, hydrocodone, and many others. Access to legal category medications has been reduced given the problems caused by their overuse, but the problem has now spilled over into abuse of stronger and illegal opioids such as heroin. While the number of deaths from the overdose of prescribed opioids has flattened over the past few years, the number of heroin-related deaths has soared, with over 70% of heroin addiction originating from prescribed painkiller abuse.

Figure 1: Overdose deaths involving opioids, United States, 2000-2015



Source: US Center for Disease Control and Prevention, 2016

Several actions are being taken to address the challenge, including a series of civil lawsuits (30 and rising) against five major opioid manufacturers, and a Senate Committee investigation into 10 manufacturers, three distributors and three Pharmacy Benefit Managers. The US Drug Enforcement Administration (DEA) has also lowered its manufacturing quotas for opioids in an attempt to restrict unnecessary consumption.

Beyond drug makers

Opioid manufacturers are already in cross hairs, and those companies reliant on opioids for their revenues are seeing the effects. But the issue extends more broadly, as indicated in the table below.

Table 1: Sectors impacts

Sectors at risk	Reason	Sector response
Opioid manufacturers	Accused of understating the addictive qualities of drugs and overstating their benefits. Some financial penalties already incurred.	Varied: amending practices, shifting blame to physicians for overprescribing, amending formulations to "abuse-deterrent". Some also have the opportunity to market less addictive painkillers.
Opioid distributors	Under Senate investigation. Whistleblower alleged the industry was a key player in opioid proliferation. One key distributor already fined for failing to report suspicious orders.	Arguing that they have no access to patient information; they adhere to instructions from physicians and the DEA. The company fined is implementing several additional compliance checks that will need to be independently audited.
Pharmacies	The "front line" of addiction – need to establish additional security, controls and customer checks to limit usage.	Some large pharmacy chains have responded with increased options for patients to dispose of unwanted opioid drugs, enhanced patient education and awareness-raising.
Pharmacy Benefit Managers (PBMs)	Set the price of drugs for pharmacies, and control which are available. Been asked by New York Attorney General's office how they are dealing with the crisis.	Implementing stricter controls, e.g. restricting availability to seven days for first-time opioid users.
Health insurers	Criticised for not including less addictive painkillers in insurance plans due to their higher price, or for not providing drugs that help curb addiction.	State that they carefully monitor patients and have witnessed more cautious opioid prescription patterns from doctors. They will be compelled to offer other painkillers, possibly at a cost.
Construction	Labour shortages as a result of addiction in workforce. Face increased insurance premiums.	No public responses found.
Non-opioid painkiller manufacturers	Other painkillers such as buprenorphine are deemed not to be as addictive (although are often not covered on insurance plans or formularies due to their higher price).	Manufacturers of opioids are also trying to innovate in this area.
Pharmaceutical innovators	Products that can help tackle addiction or lessen the effects. Naxolone, for example, is a medication that can be taken to reverse the effects of an overdose.	The price of naxolone has been steadily rising; any significant rises may need to be limited, given political scrutiny of both drug prices and opioids.

Source: Schroders

The new tobacco?

Parallels have been drawn between the opioid epidemic and the Big Tobacco settlements of the 1990s. In reality, there are some stark differences, not least the system by which these drugs have been prescribed, sold, distributed and insured. For example, insurance plans may have covered prescription opioids, but not other painkillers which are more expensive but less addictive. Physicians have been criticised for prescribing painkillers rather than tackling the root cause of pain.

This partly explains the varied corporate response to the crisis, with some companies tackling the issue head on and amending corporate practices, others rushing to innovate the next generation of painkiller, and still others denying their involvement or attempting to defer the blame to those that prescribe the drug. Our work to determine the strength of corporate responses is helping us navigate the investment implications of this health crisis.

INsight

A difficult job: Accounting for human capital

Human capital has become a critical asset to most businesses, overtaking physical assets in size and competitive importance in many sectors. The refrain "people are our greatest asset" has become a core element of corporate lexicon over the last decade, bolstered by hundreds of management books and consulting assignments.

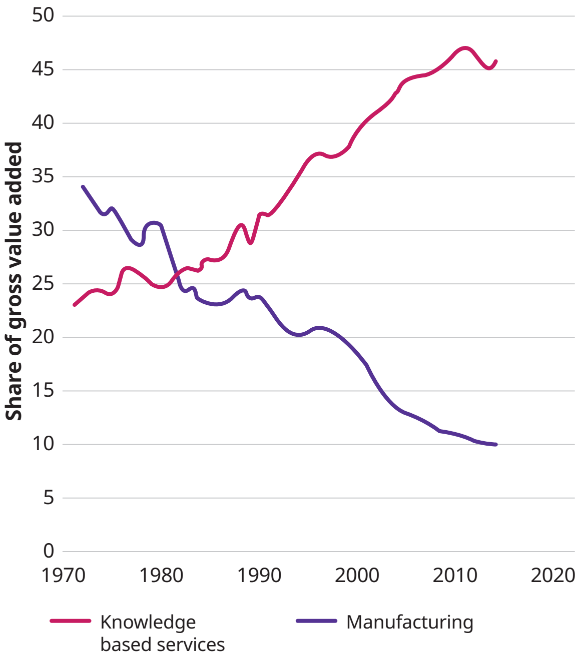
We have developed a new approach to measuring profitability which incorporates human capital alongside more traditional categories of assets. This measure provides a more complete view of profitability, which correlates more closely with valuations than conventional measures. This approach should be part of long-term investors' toolkits.

A greater focus on human capital...

The size of knowledge-intensive industries in developed economies has roughly doubled over the last 40 years, while manufacturing has more than halved. Differentiation in physical assets has been falling as manufacturing capacity becomes commoditised and supply chains become more integrated in many industries.

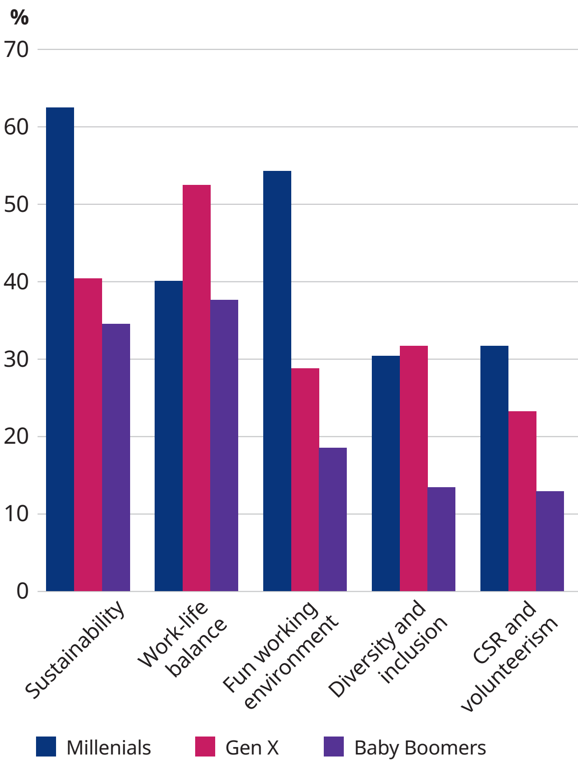
On the other hand, effective human capital management is becoming more challenging as new generations of workers become more demanding, with higher expectations of their employers. Those trends are evident across developed economies, bringing the issue of building and retaining strong workforces into management focus.

Figure 2: Knowledge and human capital are becoming increasingly important business assets



Source: EU KLEMS database, 2014

Figure 3: Workforce management gets harder as priorities change (% respondents identifying each issue)



Source: Deloitte Talent Edge survey, 2011

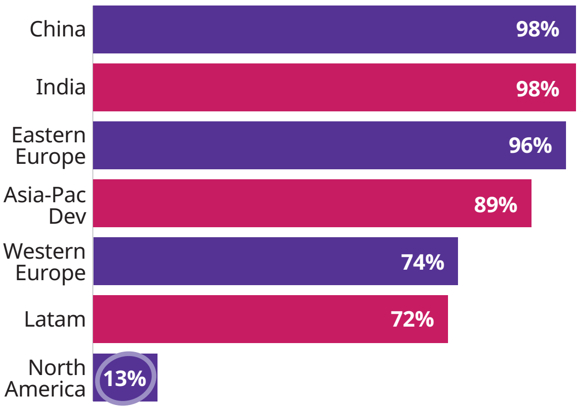
...yet uncaptured by current accounting practices

While investors have become used to hearing about the importance of human capital, there has been limited effort to incorporate it into financial analysis. Accounting principles were designed for different purposes to those of equity investors, and have become less useful in capturing intangible business drivers.

Current accounting principles treat spending on workers as an expense without future economic benefits but capital expenditure (capex) as an investment. While we understand the book-keeping rationale, the distinction is becoming increasingly unhelpful to assessing business performance as human capital becomes more important.

In part, the small steps taken to develop new measures reflect the disclosure limitations that continue to hinder detailed examination. The challenge is greatest in the US where few companies provide basic disclosures like wage expenses.

Figure 4: Percentage of $500 million+ market capitalisation companies disclosing wages



Source: Datastream, Q2 2017

Adjusting for human capital

We believe there is merit in treating spending on employees in the same way as physical asset investment. Whereas current accounting practices require expensing wages and benefits through the income statement, we argue human capital is a long-term asset which should instead appear on the balance sheet. We recognise that the human capital asset can walk out the door in the evening while plant and equipment cannot, and that selling on that asset has been illegal since the abolition of slavery. However, while employees could leave en masse, in reality the pace of their departure is more predictable.

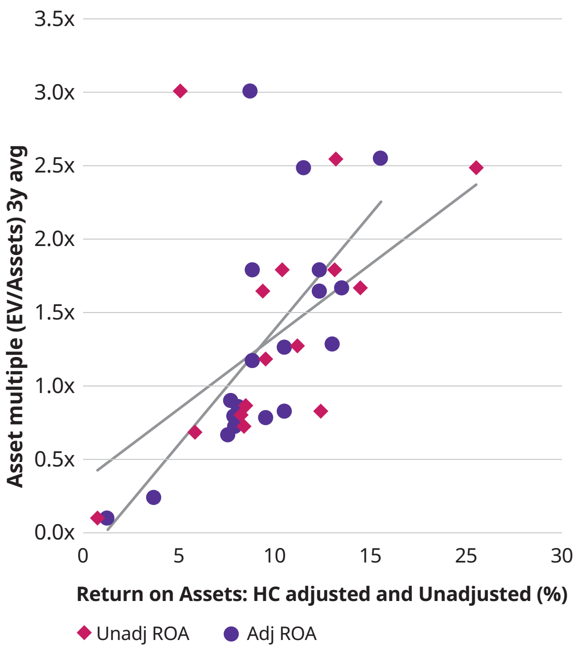
We have developed a framework to adjust conventional return on capital measures so that human capital is treated similarly to physical assets:

- Capitalise wage expenses to create a new asset.
  - We use the inverse of the average employee turnover rate as a proxy for the human capital asset life and add that to current reported assets to create an **Adjusted Assets** value.
- Add back wage expenses to reported operating income, and subtract the yearly depreciation of the newly capitalised human capital asset.
  - This leads to an **Adjusted Operating Income** value.
- Dividing the latter by the former yields an **Adjusted Return on Assets** value which can be compared to the unadjusted equivalent with which most analysts are familiar.

A clearer valuation signal

We have applied our approach across over 2,000 listed European companies. We find the relationship between valuation multiples and profitability is stronger when human capital adjustments are included than when they are not. While few investors, to our knowledge, make adjustments like these in their assessment of businesses, the statistics indicate that the market typically rewards leaders in human capital management over time as their strengths become clear.

Figure 5: Profitability adjusted for human capital provides a clearer valuation signal



Source: Schroders, Datastream, 3 year averages (2014-16)

Human capital analysis in investors' toolkits

Across markets and economies human capital is becoming increasingly important to business success. We expect this trend to continue and believe human capital analysis should be part of long-term investors' toolkits. Our framework allows investors to value human capital and integrate it into traditional financial analysis. As a result, investors are equipped with a more meaningful measure of profitability that is more closely linked to valuation, bringing new insights to their investments.

INsight

UK fulfilment centres: the labour standards' blind spot

Labour standards are an important topic for sustainable investors. A high level of scrutiny has been placed on labour standards along global supply chains from apparel manufacturers in Bangladesh to shrimp fisheries in Thailand. At Schroders, we have a long history of engaging with companies on human capital management within both direct workforces and further along the supply chain. One area that has not received much attention is the labour standards of the workers that are neither direct employees or workers captured by the traditional definition of "suppliers": the recruitment agencies supplying staff to our investee companies.

Rising awareness

Recruitment agencies are used across many retail and distribution businesses to provide thousands of contract staff to UK-based fulfilment centres during peak times. Until recently, the standards in place to protect these workers had been a blind spot - not discussed in company reports or questioned by investors. That changed earlier this year, when the media, trade unions and the UK government raised concerns about alleged poor treatment of contract workers at a major UK retailer's fulfilment centre. These allegations then spread across the UK retail sector and so we sought to gain a better understanding of the labour practices employed within fulfilment centres in general.

More direct workers

In collaboration with other investors, we conducted four site visits in the UK, speaking with senior management and board members about labour standards at these centres. All the management teams we met took the exposé seriously. Historic practices had lagged standards elsewhere in the sector like the shop floor or along supply chains, but the efforts to improve these issues were evident in our meetings.

The practices observed on these site visits led us to conclude that emerging best practice within this "blind spot" is moving towards a higher ratio of direct workers over agency staff, allowing retailers greater control over, and incentive to invest in, employee wellbeing.

Based on our research, we found that the retailers who had already implemented these changes found it easier to attract new staff and strengthen employee engagement than those who haven't done so yet. This has benefited their businesses through higher productivity and order accuracy as well as lower absenteeism.

Improving standards

We believe that having an engaged workforce is essential for retailers if they are to remain competitive within the current environment where consumer expectations are changing and competition is intensifying. Our site visits provided some comfort that labour standards are improving but we will continue to monitor and engage with the retail sector on an ongoing basis.

INfluence

Focusing capital on the long term: highlights from the debate

Are markets and company boards too focused on the short-term? Are activists a source of long-term value creation or are they short-term asset strippers? How should the weaknesses of corporate governance along the investment chain be addressed? Are public or private markets better at creating value? These issues were at the heart of a debate we held on 28 June 2017 to celebrate Schroders' membership of Focusing Capital on the Long Term (FCLT), a think tank set up to promote long-term decision-making across businesses and the investment industry.

On our panel were:

- **Sir Win Bischoff**, Chairman of the UK's Financial Reporting Council (**WB**)
- **Jessica Ground**, Global head of Stewardship at Schroders (**JG**)
- **Mark Machin**, President and Chief Executive Officer of the Canada Pension Plan Investment Board (CPPIB) (**MM**)
- **Sarah Keohane Williamson**, Chief Executive Officer of FCLT Global (**SKW**)
- **Huw van Steenis**, Global Head of Strategy at Schroders, who chaired the discussion (**HvS**)

We include below a summary of our discussion:

How big a problem is short termism? And is it located more amongst corporates and investors, or is it all along the chain?

SKW There are people and entities with long-term needs on each end of capital markets, whether it be companies investing in new products and markets at one end, or investors saving for a pension at the other. The problem really is us, the asset managers, the asset owners and the corporations, whose capital allocation decisions have become short term. A study by McKinsey commissioned by FCLT[1] has shown that if more companies took a long-term outlook, the benefits over the last 15 years would have been tangible in the form of five million more jobs, 1% higher US GDP and $1 trillion of increased asset values. We think the problem is soluble, which is why FCLT is putting together owners and managers to discuss how things can change.

MM At CPPIB, we invest for multiple generations and have a very long-term horizon. We are seeing "intense" pressure on the 2,560 companies we invest in to respond to short-term influences. Breaking this pattern of behaviour will require all involved, from the asset management industry to analysts and the financial press, to better communicate with each other to overcome the current "dissonance".

WB I do not agree entirely with the previous speakers. It is up to the board and management to determine the long-term strategy of a company. It is not up to shareholders to decide how companies are run. Culture has a large part to play in this: for instance, there is often much more of an "endowment" approach in family-controlled companies. All boards need to think about how they explain their long-term strategy to shareholders and then get them to agree to it.

JG We certainly don't want to run companies and haven't lost sight of the fiduciary role of the board. However, we think there are things shareholders can do. For instance, we believe quarterly reporting is a distraction, we think there is a need for better key performance indicators against strategic objectives, and succession planning is a vital part of our engagement with companies.

Are there particular sectors that are prone to short-term behaviour?

MM Short termism is not universal. Although certain sectors may seem to have an inherent need for a longer-term focus by management teams – due to R&D, product development cycles and so on – from an investor perspective, there are also underlying drivers that cut across industries and sectors which can help identify opportunities over a longer investment horizon. Moreover, geography makes a difference: about 20% of US companies still offer quarterly earnings guidance, whereas the figure is only 3% for Europe.

WB My view is that there is a greater short-term emphasis in the US, where quarterly guidance remains closely watched. However, my experience of US boards is that it is possible to plan for the long-term without compromising quarterly guidance. In Europe, there is perhaps more understanding of the need to look towards a more distant goal.

SKW In Silicon Valley there is now a strong feeling against going public because of the pressure it exerts on companies to think short term and innovate less. This is a dangerous idea for capitalistic societies if it means companies largely remain private. In the US, for instance, it would restrict investment to "qualified purchasers", often wealthy or large ones, which would lead to a narrower concentration of capital invested in growing, innovative companies.

1 Finally Evidence That Managing for the Long Term Pays Off", by Dominic Barton and James Manyika of McKinsey, and Sarah Keohane Williamson of FCLT, Harvard Business Review, February 2017, https://hbr.org/2017/02/finally-proof-that-managing-for-the-long-term-pays-off.

JG We have seen various cases where there have been "problematic junctures" for companies. One is when a chief executive has stayed on too long and has let their focus on their legacy get in the way of important decisions. Another is where companies give insufficient thought to the long term when planning mergers and acquisitions. And in cyclical industries there is often a misplaced belief that "this time it's different" when really the cycle is about to turn. We spend a lot of time making sure boards are giving enough weight to the long term in all these situations.

What are the benefits and disadvantages of activist investors?

SKW Some can be useful. The test is whether they are interested in long-term value creation or short-term value extraction. My suggestion for activists: if they are really in it for the long term, they should be willing to lock up their shares for five or even seven years.

WB At one company in which I was involved a well-known activist encouraged us to do something rather more quickly than we had planned, which helped lift the shares by about 30% before they sold out. Had they stayed around for another five years, however, they would have benefited from a further quadrupling in the share price.

JG We don't see the distinction between "activist" and "engaged" as very helpful. I recognise that sometimes our interventions can raise eyebrows, but we only go public after polite private engagement has failed. Sometimes it is difficult to get others involved to agree, which is why we helped establish the UK's Investor Forum[2] to develop a more collective approach to such issues. We have a long way to go in the UK, but we are ahead of areas like, say, Japan.

MM We believe in the role of "creative destruction" in capitalist markets. Active shareholders can be a catalyst for useful change, but we recognise that sometimes we get it wrong. That's why we have written a set of company engagement principles that set out guidelines for when we intervene. We are sufficiently confident in the benefits of long-term investing to have committed $1 billion to a fund tied to a new index, the S&P Long-Term Value Creation Global Index, which focuses on companies that take a long-term approach to sustainability and drivers of long-term investment returns[3].

Is there a tension between public and private markets? How do you persuade the "unicorns" that it's better to be in a public than in a private domain?

SKW Part of the issue is getting both the unicorns and the private equity world to see that the public markets are important to them. For private equity, it is important to have a way of realising an investment and often that can only be through public markets. They need the public markets to buy companies from and to sell companies to. It's not private versus public equity: there's a symbiotic relationship and they need both so that companies can move back and forth between the two.

WB The discipline of the public market can be very useful. It would be a retrograde step if certain companies, say in the technology sector, were put off going public. Speaking personally, rather than for the Financial Reporting Council, I am not against allowing differential voting rights if it meant that owners of these companies felt happier that they would not lose control on flotation.

JG One needs to be careful here: stewardship of companies will become more difficult if there is a race to the bottom in terms of governance standards. In terms of differential voting, investors need to do their due diligence and be careful who they are getting into bed with. There are, for instance, founding families that have treated minority shareholders well and there are ones who have behaved less well. It is important for there to be accountability when things go wrong. The problems of Uber, the online taxi company, illustrate the difficulties that can arise very quickly.

MM One of the benefits of going private is the ability it gives companies to restructure and plan for the long term without being distracted by the "noise" of the public market. In this, private equity can be useful. We agree that public markets are necessary for the public good and the discipline they instil, but half of CPPIB's portfolio is private. We can weather the higher risk, the increased leverage and the limited liquidity due to the long-term nature of our pensions business.

Through the chain there are a series of incentives that may not be aligned. Are there better ways of framing incentives?

MM In every step, people need to be measured over the long term, rather than quarter by quarter, starting with the fund manager. At CPPIB, we have started this process by moving the basis for employees' remuneration from

2 The Investor Forum was established to encourage better stewardship of companies by bringing together institutional investors and individual companies: https://www.investorforum.org.uk/.

3 The new index was launched by CPPIB, RobecoSAM and S&P Dow Jones Indices on 21 January 2016: http://www.cppib.com/en/public-media/headlines/2016/sp-ltvc-2016/.

three to five years. We push for a similar long-term framework for the management of the companies in which we invest. Research suggests the typical period just now is only one-and-a-half years.

SKW Last month, FCLT held a meeting in Amsterdam bringing together asset managers, including Schroders, and asset owners to look at mandates and see how the gap between the long-term aspirations of the industry and the short-term reality of the way it acts can be bridged. New ideas are emerging. One might be to put the ten-year performance at the beginning of regular reports to clients and work back to the quarterly numbers.

JG I would echo Sarah's point on reporting. We are now communicating with clients on engagement and voting in a more interesting way and being honest when engagements haven't worked. On remuneration, much of what we see is overly complex.

WB Complexity has become a real problem in many companies, with even recipients of remuneration not really understanding how it is worked out. At the Financial Reporting Council we believe that there should be more simplicity. One way would be to award shares that vest over a period. This would provide a built-in performance factor, so existing performance conditions would fall away, and the way the share price performs over time would provide the long-term incentive. The only additional element might be to include a necessity for management to comply with certain conduct standards.

Questions from the floor

What about the impact of indexation on long-term engagement?

SKW There are many ways to manage money, ranging from index funds, active public equity, activist public equity to private equity. Each type of manager needs to look at the tools they have at their disposal to influence managements to make markets think longer term.

JG I worry about the future of the creative destruction inherent in capitalist markets and of price-setting with the rise of passive investment. We engage as fundamental investors, thinking about the economics of the business and longer-term value, not as box tickers. Crucially, effective engagement needs to be based on analysis.

Are people avoiding capital markets because managers are no longer accountable to the pensioners and other investors who ultimately own the capital?

SKW In the US, with defined contribution pensions having overtaken defined benefit pensions, there is no longer anyone fulfilling that intermediate fiduciary role looking after people's savings. But individual savers tend to make very poor investment decisions. A recent Dalbar study[4] has confirmed a huge annual shortfall of more than 6% over 30 years that individual investors are likely to have suffered against the index. The US has a huge problem with financial decision making, compounded by the loss of a sophisticated asset owner that stands between each end of the investment spectrum.

Are we able to properly assess and improve the impact of engagement on long-term value creation?

JG We have found that it takes at least two years to effect any change, so an investor has got to be long term. But it is sometimes hard to see an automatic performance benefit. We think this is because we are explicitly focusing on laggards and it is hard to know what would have happened had we not got involved.

Does better disclosure have a role to play and should it be mandatory?

MM Our Head of Sustainable Investing sits on the Financial Stability Board's taskforce on financial reporting on climate change. We are looking forward to the enhanced disclosure this will bring so that we can better understand the risks across the 2,560 securities in our portfolios. We hope it will be broadly accepted and adopted, because there is neither sufficient disclosure nor consistency at the moment.

SKW One of our projects is to look at risks in the context of a very long-term time horizon. At the moment, measures of risk – such as one-year volatility – make no sense if you have a 75-year timeframe or even a 5- or 10-year timeframe. It's pretty obvious that, if you are investing in a bridge, you need to know where the water level's going to be in 20 or 25 years to know whether that investment is going to be worth anything or not.

4 Dalbar's 22nd Annual Quantitative Analysis of Investor Behaviour reported that while the Standard & Poor's 500 Index has generated 10.4% annually over the 30 years to December 2015, the typical equity mutual fund had produced just 3.7%. See https://www.dalbar.com/QAIB/Index

INfluence

BankingFutures project: an update on progress

We have been involved with the BankingFutures project since 2015. A group of banks, investors and civil society facilitated by two non-governmental organisations (NGOs) came together to conduct an engagement with over 200 stakeholders on the future of banking in light of the Global Financial Crisis. The result was a report entitled "Banking on Trust: Engaging to Rebuild a Healthy Banking Sector", published in February 2016 and available here. It calls for banking leaders to take actions around serving the real economy and developing better internal cultures and processes for engagement with wider society.

Phase two was launched in May 2016 to explore two important areas in more depth: banks' contribution to the real economy, the small-and-medium enterprise (SME) sector in particular, and improving communication between banks, investors and other stakeholders in order to enhance banks' ability to deliver long-term value. Both projects were focused on finding practical and enduring solutions. It was funded by the participants including, HSBC, Barclays, Lloyds, Deutsche Bank and Schroders, demonstrating the strength of commitment to making changes. The full reports can be found **here**.

Improving the SME sector

Banks have been under increasing pressure from politicians, regulators and the public to effectively address the needs of SMEs, which account for 60% of private sector employment and 90% of UK business. Serving this fragmented sector is difficult. Data was identified as a key challenge and one that could be helped with the provision of both precise data and more narrative information to the British Business Bank, and work on standardised SME thresholds. Banks were encouraged to embrace simplified lending agreements in the form of a standardised lending contract, which allows SME customers to compare indicative offers between banks. A better articulation of strategy, on a regional basis, by individual banks is a targeted improvement. This is to include clear and easily accessible information to SMEs about where and how credit decisions are made within the bank and by whom, and clear communication on branch closures. Digital tools aimed at improving SME investor readiness and better feedback can help with this.

Focus on long-term value

The second work stream acknowledged that encouraging both banks and investors to focus more on long-term value creation rather than delivering short-term results will enable them to better serve the real economy and create sustainable business models. In practice, achieving this is more difficult. Constructive milestones were agreed upon to improve the current dialogue which is focused on quarterly earnings and financial statements rather than strategic advantages and organisation health. Investors will be working with the Investor Forum to signal the value that they place on long-term information, demonstrate the role that it plays in their investment process, and adopt a more holistic approach to engagement. It is hoped that a survey planned for 2018 will provide clarity to management teams on the importance of creating long-term value. Meanwhile, the banks have committed to working with UK Finance, a recently established trade body, to agree key elements of non-financial information disclosure. Ultimately, this should lead to an improvement in banks' strategic reporting as well as published metrics on culture, conduct, risk appetite, employee and customer satisfaction. More radically, boards and senior management are encouraged to provide annual public stakeholder feedback, again supported by UK Finance.

Important first steps

Change in a sector as complex as banking will not happen overnight, however as John Flint, CEO elect of HSBC, recently tweeted, "BankingFutures has revealed the value of talking and listening to the stakeholders that banks are here to serve." The successful implementation of the recommendations will require further work by banks, investors, industry bodies and policymakers. In funding and participating in the project the banks involved have demonstrated a willingness to embrace new practices and take some important first steps.

INfluence

Corporate Governance Dialogue with Investors: a focus on emerging markets

Schroders was delighted to host the International Organization of Securities Commissions' (IOSCO) "Corporate Governance Dialogue with Investors" at our offices on 30 June 2017. The event brought together investors and experts from every region.

IOSC has long been focused on improving regional corporate governance frameworks. In October 2016 it published its Report on Corporate Governance in Emerging Markets which identifies practice measures for local regulators to implement in order to improve the investment environment. Schroders was one of three asset managers who contributed to this report. The work concluded that the focus should be on improving board quality and accountability, risk management frameworks and internal controls, and ensuring remuneration creates long-term value. It also calls for greater diversity, sustainability reporting, social responsibility and an understanding of cyber risks.

Schroders moderated the panel in which the investor perspective was shared. Some clear messages came through.

- **Institutions:** All of the market and state institutions have to be willing to encourage strong corporate governance practices. Good governance relies on a complex chain of relationships from company management, to index providers, to the local courts.
- **Information:** Sadly, in some regions this is still poor, with public information not released in a timely fashion. Recent accounts and directors' biographies are considered essential and need to be available well before annual general meetings (AGMs). If the information is not there, many investors are forced to vote against management. Proxy research quality also lags in these markets in the eyes of many investors.
- **Investors:** All investors need to work together to improve the ecosystem. International investors often lack local presence, but they should seek to overcome this. Working with policymakers and regulators is increasingly important, and the OECD's work is instrumental. Messages need to be loud and clear. Collective engagement is developing slowly and could help build local and international investor relationships.
- **Influence:** Bundled resolutions create a particular problem, with some investors forced to vote against the entire resolution to express dissatisfaction with a single aspect. Some investors report not even knowing what comes under "other business." These issues, coupled with other information gaps, mean that investors find it difficult to support resolutions or give effective feedback on their concerns through AGMs. While some boards appear to be independent, the reality is that many members are long-serving or have other close links to the management. In these cases it can be difficult for investors to exert influence.
- **Impediments:** In some markets, physical voting is difficult and time consuming given power of attorneys or registration requirements. Shareblocking, less widespread than in the past, still exists in some markets.

Progress being made...

Incremental change is the most effective way of making genuine progress. There was agreement that progress was being made across all of these fronts, but that momentum needs to be maintained. Equally, governance requirements should not be so onerous that companies do not come to the market.

Stewardship codes were seen as a positive development. However, they cannot substitute for informed ownership and governance. There was a healthy debate about the role of active versus passive managers' engagement models. There were calls for investors to be policed more in their activities, for example in how they oversee conflicts of interest. The UK example in which the Financial Reporting Council (FRC) has just recognised leaders and laggards was proposed as a model.

...but higher standards still required in some areas

Equity finance is a key component of helping emerging market corporates prosper and the economies develop; permanent capital has substantial advantages over bank finance. However, corporate governance standards and experiences vary across, and even within, markets. Minority shareholder rights are of key importance. While many family businesses are run for the long term, there are others where the treatment of minority shareholders or related party transactions is a genuine area of concern. Similarly, state-owned enterprises are a substantial part of many local indices and investors would like to see them aspire to high governance standards.

Corporate governance is about an ecosystem, rather than a single code. It is encouraging to see securities regulators acting in a practical way to improve the environment with their reports but also by convening the dialogue. Leonardo Pereira, Executive Chairman of CVM Brazil said: "Securities regulators face, on a daily basis, problems that could be avoided or mitigated by the practical implementation of corporate governance principles and standards." We could not agree more and look forward to ongoing dialogue encouraging progress on this topic.

Fourth quarter 2017

Total company engagement

Our ESG team had 82 engagements this quarter with the 82 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
ABB Ltd.			✔
Amazon.com, Inc.		✔	✔
Kardex AG			✔
SGS Societe Generale de Surveillance SA			✔
Consumer Discretionary			
Alsea SAB de CV		✔	
American Eagle	✔		
Breadtalk Group Ltd		✔	
Brinker International		✔	
Cafe De Coral		✔	
Cheesecake Factory Inc		✔	
Darden Restaurants		✔	
Fairwood Holdings Limited		✔	
Famous Brands Ltd		✔	
GENUINE PARTS CO		✔	
Inchcape		✔	
Jack in the Box Inc.		✔	
JOLLIBEE FOODS		✔	
Lookers		✔	
Marks and Spencer plc		✔	
McDonalds Corpn		✔	
Michael Kors Holdings	✔		
NASPERS-Nasionale Pers BPK			✔
Pendragon		✔	
Starbucks		✔	
YUM! Brands		✔	

Company	E	S	G
Consumer Staples			
Alicorp		✔	
Arca Continental SAB de CV		✔	
Archer Daniels Midland Co		✔	
AVI Ltd		✔	
Barry Callebaut AG		✔	
BRITANNIA INDS		✔	
Campbell Soup Co		✔	
Chocoladefabriken Lindt & Spruengli AG		✔	
Coca Cola Amatil		✔	
Conagra Inc		✔	
Danone		✔	
Flowers Foods, Inc.		✔	
General Mills Inc		✔	
Grupo Bimbo SAB de CV		✔	
Hershey Foods Corpn		✔	
INDOFOOD CBP SUKSES MAKMUR		✔	
J Sainsbury		✔	
Kellogg Co			
KOF US		✔	
McCormick & Company Inc		✔	
Pepsico Inc		✔	
PRESIDENT CHAIN ST	✔	✔	
PT Indofood Sukses Makmur		✔	
RFM Corporation		✔	
SAPPORO BREWERIES		✔	

Source: Schroders as at 31 December 2017

The companies and sectors mentioned herein are for illustrative purposes only and are not to be considered a recommendation to buy or sell.

Fourth quarter 2017

Total company engagement

Company	E	S	G
Suntory Beverage & Food Ltd		✔	
Tesco PLC		✔	✔
The J.M. Smucker Company		✔	
Treatt PLC			✔
Energy			
Premier Oil	✔		
Financials			
BBVA			✔
Essent Group Ltd	✔		
Jupiter Fund Management PLC			✔
Man Group plc			✔
Prudential Corporation plc			✔
Wells Fargo		✔	
Health Care			
CSL Limited		✔	
GlaxoSmithKline			✔
Indivior			✔
Industrials			
Keller Group			✔
Rentokil Initial plc			✔
Information Technology			
carsales.com.au Ltd			✔
Catcher		✔	
Lam Research	✔		
Spectris		✔	
YY		✔	

Company	E	S	G
Materials			
Antofagasta plc	✔	✔	
Croda International PLC	✔	✔	✔
Elementis			✔
TOSOH CORP	✔	✔	
Telecommunication Services			
BT Group plc			✔
China Mobile			✔
KDDI Corp			✔
Utilities			
Centrica plc			
National Grid PLC		✔	
Perusahaan Gas			✔
Red Electrica Corp SA			✔

Key

E – Environment
S – Social
G – Governance

Source: Schroders as at 31 December 2017.

The companies and sectors mentioned herein are for illustrative purposes only and are not to be considered a recommendation to buy or sell.

Fourth quarter 2017

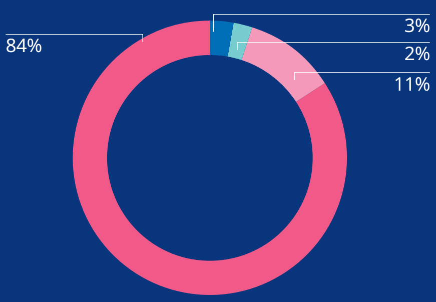
Engagement in numbers

Regional engagement

UK	22
North America	26
Asia Pacific	19
Europe (ex-UK)	8
Middle East and Africa	3
Latin America	4

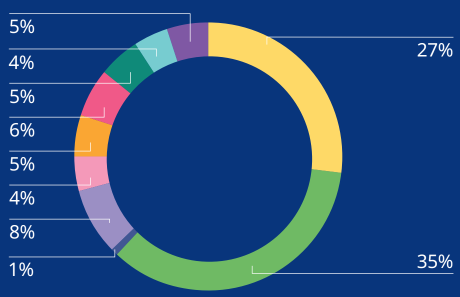
Source: Schroders as at 31 December 2017.

Engagement type



Source: Schroders as at 31 December 2017.

Engagement by sector



Source: Schroders as at 31 December 2017.

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 **634 companies and approximately 97% of all our holdings.** We voted on 17 ESG-related shareholder resolutions, voting with management on six.

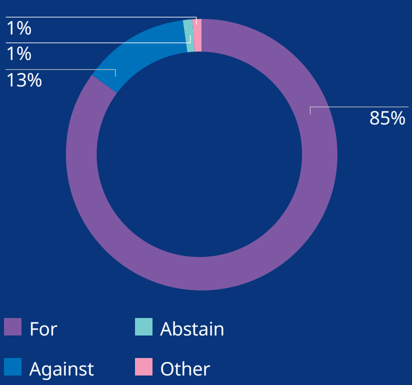
The charts below provide a breakdown of our voting activity from this quarter. Our UK voting decisions are all available on our website at www.schroders.com/sustainability under 'Influence'.

Company meetings voted

UK	24%
North America	14%
Asia Pacific	29%
Europe (ex-UK)	17%
Middle East and Africa	10%
Latin America	6%

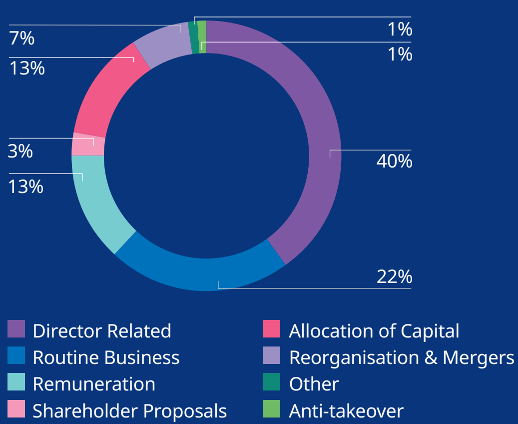
Source: Schroders as at 31 December 2017.

Direction of votes this quarter



Source: Schroders as at 31 December 2017.

Reasons for votes against this quarter

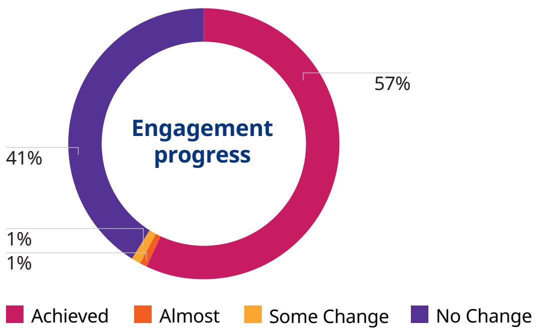


Source: Schroders as at 31 December 2017.

Fourth quarter 2017

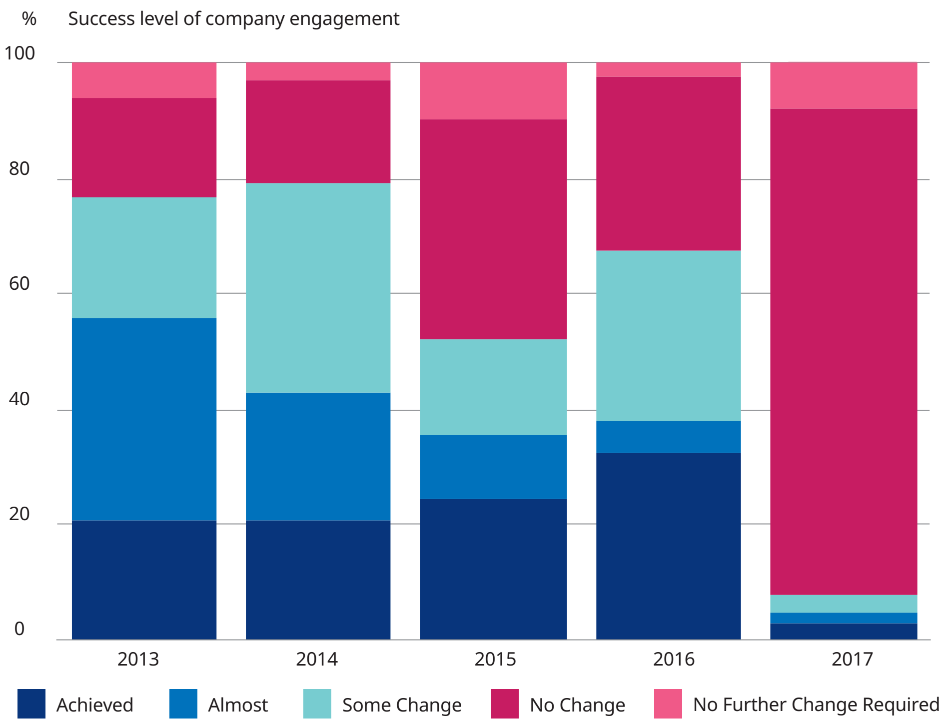
Engagement progress

This section reviews any progress on suggestions for change we made a year ago, in this case the fourth quarter of 2016. There are four possible results: 'Achieved', 'Almost', 'Some Change' and 'No Change'. Of a total number of 377 'change facilitation' requests made, we recorded 216 as Achieved, three as Almost, four as Some Change and 154 as No Change.



The chart below shows the effectiveness of our engagement over a five-year period. We recognise that any changes we have requested will take time to be implemented into a company's business process. We therefore usually review requests for change 12 months after they have been made, and also review progress at a later date. This explains why there is a higher number of engagement successes from previous years.

Effectiveness of requests for change – 5 year period



Source: Schroders as at 31 December 2017.

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