Schroders Responsible Investment Report

Q1 2016

Introduction

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 a robust environmental, social and governance (ESG) performance benefit from a lower cost of capital and are more likely to deliver superior returns over time*. That's why ESG is 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 it adds value by enhancing communication and understanding between companies and investors.

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

* 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.

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"Our 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, Schroders

Special topic:
Turning sustainable intentions into fiduciary practice

As ESG considerations converge with fiduciary duties, the industry's challenge will be how to turn good intentions into practice.

A clear trajectory has built up since the end of the last century establishing good governance and oversight as an important part of the fiduciary duty of both companies and investors. This trend shows no sign of slowing: stewardship codes for asset managers and owners are being rolled out around the world. As they become established, expectations are rising. The growing demand is for those in the investment chain to be transparent about their activities, objectives and outcomes in the governance arena. Best practice is no longer signing up to a code, voting and never discussing the issue again. The direction of travel is clear – a better dialogue between owners, investors and companies on the thorny long-term issues that companies face: strategy, board succession, and stakeholder management. Sophisticated asset owners are already questioning their managers, not just on their buy and sell processes, but on their approach to ownership. They expect detailed reports and a quantification of impact.

Governance leads the way

This move away from tick-box governance will lead to more changes over time, which we welcome:

- Asset managers and owners are being called upon to demonstrate an active approach to ESG.
- Investment reporting across the industry will focus not only on performance statistics but also on engagement activity.
- Asset owners should understand their manager's governance style as closely as they do their investment style.
- We expect to see an evolution of the fiduciary's agenda with governance appearing more frequently in discussions.
- Companies should expect to face closer scrutiny and more demanding questions coming from investors as a result of this. This will not take the form of a "shareholder spring" as many have argued but will come about as a result of an ongoing evolution and upward push towards higher standards.

Environmental and social considerations are following fast

More contentious perhaps are the environmental and social aspects of corporate activities. What is the evidence that these are real risks that should influence investment decisions? Certainly the World Economic Forum (WEF), which brings together leading business, political and academic figures from around the world, put three climate-related threats among its top-10 global risks for 2015*. This is clearly a wake up call for any fiduciary worried about long-term risks.

A climate of change

On the particular question of climate change, fiduciaries are being directed to assess the specific impact of warming temperatures on their portfolios already, given the potential financial risks. We are seeing clients looking at fossil-fuel and carbon risks in their portfolios so that they can start to quantify the impact. We have been pushing companies to demonstrate that they have robust planning processes that take account of a tougher regulatory environment for emissions. While momentum has been gathering behind "carbon footprinting" – the quantification of an individual or company's contribution to carbon emissions – the methodology and data have not necessarily kept pace with demand. We consider that more work needs to be done in this area and results need to be put in context. A consequence of this will be yet more demands on companies to provide asset managers with information that allows them to assess the risk and how well it is being managed.

* Global Risks 2015: 10th Edition, World Economic Forum, Geneva. Uniting fiduciary duty with sustainability

> "Stewardship codes for asset managers and owners are being rolled out around the world. As they become established,expectations are rising."

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Uniting fiduciary duty with sustainability

Some commentators are calling for more explicit guidance and clarification aimed at embedding ESG considerations into investment processes as part of the fiduciary duty of asset owners. An important first step has been taken with the focus on governance. If a company has an effective board, robust internal controls and good risk management, then it should have the oversight and policies to manage the environmental and social risks across the business.

Recent comments from policymakers and regulators around the world have recognised the compatibility of ESG issues with fiduciary duty:

- The United Nations Environment Programme, which sponsors the UN's Principles for Responsible Investment, believes that implementing ESG policies is central to investors' fiduciary duties.
- In the UK, the government has declined to impose a mandatory requirement on pension trustees to take account of ESG and stewardship considerations in making investment decisions. However, in announcing its decision**, the government implied clearly that any such long-term factors which are germane to the long-term sustainability of investments are properly part of trustees' duties.
- The US Department of Labor clarified previous guidance on so-called "economically targeted investments". The interpretive bulletin*** states environmental, social and governance issues "are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices".
- The EU Commission published a report it commissioned from accounting firm Ernst & Young to provide clarification and policy advice on the integration of environmental and resource efficiency issues into the fiduciary duties of institutional investors. The report confirmed that integration of these factors is compatible with fiduciary duty, so long as they are relevant to risk management and financial returns.

The sustainability of returns

As fundamental investors we know that assessing how companies are dealing with all of their stakeholders impacts corporate performance and plays a role in investment decisions. Understanding the sustainability of returns and potential risks on the horizon, from cyber security to tax clampdowns, is as important as understanding the valuation. ESG risks are real risks.

In our experience, a rigorous understanding of all the risks that a company faces – financial, environmental, social and governance – leads to better investment decision making. Ensuring that companies are being run in a long-term, sustainable manner through engagement during ownership further improves returns.

Those with fiduciary responsibility should be encouraging those managing their money to take such a long-term holistic approach to investment. Current policy changes underline the importance of a process that many asset owners have already embarked on.

In the light of these clear trends, we envisage that there will be a number of people charged with fiduciary responsibilities who are wondering how to put these fine intentions into practice. To satisfy this demand, we have put together a few precepts to follow and questions to put to professional asset managers.

You can find the full report and further reading at www.schroderstalkingpoint.com.

** Better Workplace Pensions: Reducing regulatory burdens, minor regulation changes, and response to consultation on the investment regulations, Department for Work & Pensions, November 2015. *** "Interpretive Bulletin Relating to the Fiduciary Standard under ERISA in Considering Economically Targeted Investments", US Department of Labor, Employee Benefits Security Administration, 29 CFR Part 2509, RIN 1210-AB73, 26 October 2015.

"Understanding the sustainability of returns and potential risks on the horizon, from cyber security to tax clampdowns, is as important as understanding the valuation."

Jessica Ground
Global Head of Stewardship, Schroders

Special topic: Oil & Gas: Weighing the carbon costs

As part of a project to assess mounting carbon risks in the energy sector, we reviewed the direct impact of potential carbon costs on oil and gas upstream activities.

Global pricing mechanism?

The most obvious and efficient climate change regulation should be the introduction of carbon pricing. Ecofys estimates that 12% of global emissions are covered by carbon pricing mechanisms – this represents a threefold increase over the past decade. We think the trend will continue, and we should therefore factor this risk into valuations for companies with long-life-cycle business models.

Our analysis

Our latest analysis focuses on the direct impact of a potential carbon cost on oil and gas upstream (exploration and production, or E&P) activities. While the energy used during extraction is minor compared to the scale of carbon embedded in fossil products (see our previous work*) E&P remains an energy-intensive process.

We see greenhouse-gas-emission intensity in E&P activities as both a proxy for operational efficiency (as it reflects the energy cost of operations) and a risk of additional costs to operations (as carbon becomes regulated). Analysing emissions per barrel produced gives an indication of the carbon efficiency of extracting fossil fuels.

Is producing oil more carbon intensive than producing gas?

We compared our investee companies' carbon operating efficiencies (E&P activities only) and attempted to differentiate between the types of fossil fuels they extract. We found that beyond the required upgrading process, it is not clear that production mix impacts emissions. Some companies are particularly carbon efficient despite being oil-focused and vice versa. Therefore, the carbon efficiency ratio is more likely to reflect operational efficiency.

Sensitivity to a carbon tax?

We analysed the carbon intensity of production (GHG emissions per barrel of oil produced) of our investee companies, looking at the cost of a carbon tax on their upstream businesses (based on 2014 emissions). We ran the analysis against a range of carbon tax levels. The higher the carbon intensity (per barrel of oil or per operating income) the more vulnerable to carbon taxes a company will be.

Before drawing radical conclusions about individual companies, we would point out that:

- The carbon cost impact is a function of profitability (the stronger the financial performance, the better the resilience to more costs);
- Efficiency gains should be factored into longer-term analysis so that the ramping up of a carbon tax is offset – to some extent – by a reduction in energy use and carbon emissions in operations over time;
- Downstream activities may compensate for lower upstream profits (although one should bear in mind that a carbon tax would impact refining activities as well);
- Oil sands companies are impacted by some level of carbon price already (Alberta carbon tax on efficiency) hence we should see faster energy and carbon efficiency improvements in this local industry over the coming years.

* Q4 2015 Responsible Investment Report, http://www.schroders.com/en/SysGlobalAssets/staticfiles/schroders/sites/global/press-releases/q4-2015-ri-report.pdf

> "The most obvious and efficient climate change regulation should be the introduction of carbon pricing. We should factor this risk into valuations for companies with long-life-cycle business models."

Solange Le Jeune, ESG Analyst, Schroders

Special topic:
Water stress in the beverages sector

In the wake of rising company awareness and the increasing costs of water risk, we explored potential financial impacts of water stress on companies in the beverages sector.

Water stress: increasing pressure on supply and demand

While 71% of the earth's surface is covered in water**, only 0.6%*** of this is water available for consumption by people and business. The supply of clean, fresh water is also decreasing. At the same time, there is increasing demand for water from agriculture, the growing global population and economic development. Supply side and demand side pressure means that water is increasingly becoming a material risk for companies that are struggling to source scarce, clean water. In our view, understanding and managing water risk may be fundamental to a company's ability to continue as a going concern.

Licence to operate: rising costs

As awareness of water risk from all stakeholders improves, the regulatory burden on companies and their suppliers will increase. This, in turn, will push up the cost of operating licences for various businesses. However, complying with the regulations should be the minimum standard. Companies also need to attain a social licence to operate. Water management is no longer about just the environmental risks – avoiding water pollution and maintaining water quality – it is also about broader social risk. Water availability is important in terms of human rights (access to clean drinking water) and agriculture (the reliance on water for livelihood), and is a vital resource for companies supporting economic development. Failing to secure a social licence to operate in water-stressed regions can result in a material cost to businesses.

Sector focus: water risk for beverages companies

The beverages sector is highly dependent on water for both direct operations and along the supply chain through sourcing agricultural commodities. Of the 36 global beverage companies responding to the CDP water survey in 2015, over 90% evaluated water quality over the next 10 years as a driver to the success of their long-term strategy[†]. The brewing sub sector is particularly vulnerable to changes in regulations and increasing water-related costs. Along with soft drink producers, brewers have the highest absolute volumes of water consumption. Our analysis shows this exposure is already driving up costs, with brewers reporting the biggest increase in water-related capital spending (as defined by CDP).

We conducted analysis of the brewing companies held by Schroders. We found that most brewing companies have adequate water management practices to help them identify water risk at the local level. However, evidence that firms are mitigating the impact of identified local water stress is less conclusive. The analysis also revealed that compared to other beverages sub-sectors, brewers are failing to engage adequately with local communities; other sectors provide access to water, support local agriculture and collaborate with local partners and non-governmental organisations (NGOs) to a much greater extent.

Overall, these two factors may expose companies to greater pressure on margins in the medium term. Greater exposure to water-stressed regions will likely be reflected in greater operating spend in order to maintain operating licences while the need to invest in community-related projects will add to social operating costs.

The full report is available at www.schroderstalkingpoint.com.

** National Oceanic and Atmospheric Administration, http://www.noaa.gov/ocean.html, November 2015. *** Schroders, ESG research: Water – Cheap and abundant, but not for long, R. Stathers, December 2007. † Schroders / CDP Analytics data 2015.

> "Supply and demand side pressure means that water is increasingly becoming a material risk for companies that are struggling to source scarce, clean water."

Elly irving, ESG Analyst, Schroders

Banking Futures: Addressing mistrust across the banking system

Case study

The global financial crisis changed banking in a huge way. Management teams were fired, capital levels raised and a multitude of regulations put in place. However, in the aftermath of the immediate crisis a number of issues such as LIBOR and FX rigging indicated that while some of the immediate fixes had got the banks out of the Emergency Room, major surgery was still required before banks got a clean bill of health.

We first looked at the issue in our January 2015 report Banks: a new approach to risk? Governance, culture and risk in a revamped banking industry. The report outlined a number of actions that banks could put in place to create a more sustainable business model. These included independent risk committees, senior risk and compliance officers, whistleblowing mechanisms and links between compliance, risk management and remuneration. We also assessed how well various companies were progressing on driving change in these areas.

In 2014, we were offered the chance to join BankingFutures – a group of senior bankers, ESG experts and investors brought together by a non-profit group to discuss what a healthy banking sector could look like (in the UK). Participants included HSBC, Lloyds, Barclays, Virgin Money, Deutsche Bank, and UBS. Over an 18-month period, the group met 200 individuals representing regulators, employees, customers and civil society to define what a health banking sector should look like for the UK. For many of these groups this was the first time they had engaged with banks or investors. The importance of a culture based on serving clients and rebuilding trust came through overwhelmingly.

Our findings were then published and presented to a wider audience. The report highlights the fact that the size and profile of the UK banking sector, and its importance to the economy, give rise to tensions that require ongoing and careful management. To do this well means addressing the mistrust that is endemic across the banking system. The banking sector in particular has a tremendous amount to do before it regains societal, investor, consumer and regulatory trust. However, the fact that this dialogue has begun and received an endorsement from Andrew Bailey – soon to be head of the Prudential Regulation Authority – is, in our view, an important step in the right direction.

Recommendations for further progress include measures for banks to better serve the real economy's current and future needs, to engage with customers, and to have clearer reporting standards. Other countries have also expressed interest in this type of model.

Changing the industry's culture is a long process, but the banks that have been involved in the process have already demonstrated a clear commitment to improve. The presence of shareholders in the room sends a clear message to companies as to how important investors feel these issues are. We have committed to supporting these ongoing discussions with BankingFutures.

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

The banking sector in particular has a tremendous amount to do before it regains societal, investor, consumer and regulatory trust.

Animal Welfare: Raising standards for reduced risk

Case study

Following several food safety issues in recent years – including the discovery of mislabelled horsemeat across European retailers, E.coli in US fast food chains and unsafe meat in the Chinese supply chain of multinationals, food safety is now high on the agenda. Robust supply chain standards and good visibility across the supplier base is required to mitigate these risks.

However, reporting on supply chain standards is limited and the complexity of supply chains from farm to fork heightens the risk of further scandals. In addition, consumers are increasingly questioning the provenance of their food and the use of antibiotics in meat production. Both the operational risk in the supply chain and increased consumer awareness put companies under pressure to address this issue.

We have been monitoring the results of the Business Benchmark on Farm Animal Welfare (BBFAW) to assess the performance of our investee companies. This benchmark was developed in 2012 and measures the progress of 90 global food producers and retailers. It focuses on four core areas*:

- Management commitment and policy, including overarching farm animal welfare policies as well as specific policies on issues such as close confinement and long-distance transport;
- Governance and management, including management oversight, farm animal welfare-related objectives and targets, supply chain management and performance reporting;
- Leadership and innovation, including research and development and customer and client engagement;
- Performance reporting

In 2015, along with a group of other investors, we co-signed engagement letters contacting both leaders and laggards on the 2014 BBFAW index. The latest benchmark results for 2015 demonstrated significant improvement. For example, 69% of companies have now published farm animal welfare policies, compared to just 46% in 2012. Of the companies in which we invest, we were encouraged to see significant improvements at several companies that had previously ranked in the bottom two tiers of the index. These include Compass Group, Greggs, Metro, Mitchell & Butlers and Whitbread. We believe that animal welfare can be a proxy for good supply chain standards as robust risk management, visibility along the supply chain and a good understanding of risks across the supplier base must be achieved in order to achieve a higher score relative to the benchmark. We commend the improvements made by these companies and will continue to engage with companies that have so far demonstrated only limited efforts to address this risk.

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Monsanto:
Engaging for meaningful votes

Case study

As part of our discussions in the run up to Monsanto's Annual General Meeting, we had a conversation with the company's governance and sustainability team. There were four areas on the meeting agenda we wished to discuss before submitting our vote:

- **Board composition:** The company combines the roles of CEO and Chairman. We welcomed the good proportion of independent directors on its board, in particular, the creation of a 'lead independent director' role which in our experience serves to improve boardroom dynamics and a sounding board for the CEO/Chairman. However, we continue to encourage the company to separate the roles in the future.
- **Metrics used to determine executives' long-term performance:** Monsanto's current short-term and long-term cash incentive plan relies heavily on 'earnings per share' (EPS) and 'free cash flow' (FCF) to measure performance. We suggested to Monsanto that the use of an additional metric in equal proportion, such as total shareholder return (TSR) for its long-term incentive plan (LT IP), would be better aligned with shareholder interests and be more easily comparable across companies of varying size and industry.

  We believe a remuneration policy that incentivises directors in the short-term and long-term for hitting the same financial targets, i.e. EPS and FCF, can create the wrong incentives. Including an element of TSR as a long-term performance metric would further align shareholder and management interests – particularly as TSR is a good measure of long-term corporate performance. As a result, we voted against the company's remuneration proposal.

Total shareholder return (TSR) as a long-term performance metric would further align shareholder and management interests – particularly as a good measure of long-term corporate performance.

- **Glyphosate:** A shareholder proposal requested that Monsanto disclose more risk-based reporting of glyphosate use. Glyphosate, a weed killer accounting for around one third of Monsanto's earnings, has recently been classified by the International Agency for Research on Cancer (IARC) as 'probably carcinogenic'. Monsanto strongly refutes this classification, and has provided detailed disclosure on its website tackling the issue. In our view, the company has been transparent about its own position, in particular with the provision of direct links to the academic research. We therefore did not support this resolution.

  However, we believe that the glyphosate issue is ongoing and could have material impacts. We encouraged the company to include commentary on this within its SEC filings – ideally reflecting the wide arguments from both sides, particularly given that public perception alone of a product's safety can sometimes lead to usage restrictions being imposed. We still have some concerns over the various research methods used to determine glyphosate's safety, and the potential influence of Monsanto's position in the research space, and will continue to monitor this issue.
- **Lobbying:** Another shareholder proposal requested that the company expand its disclosure and report on its lobbying payments below $50,000. The company felt this level of reporting was unnecessary and would detract from the larger payments. We learnt that the company already collects this information, and we believe there would be little additional burden to disclose it. Given Monsanto's position of influence on federal lobbying and its potential influence on the sustainability of global agriculture, we believe it should be as transparent as possible about its lobbying activities, and so we supported this resolution.

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

Company engagement:
Q1 2016

Our ESG team had 101 engagements this quarter with the 88 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 Portfolio Manager.

Consumer Discretionary

Company	Environmental	Social	Governance
Aisin Seiki			✓
Apollo Group			✓
Bovis Homes			✓
Daily Mail and General Trust			✓
Debenhams			✓
General Motors			✓
ITV			✓
McDonalds		✓	
Patisserie Holdings		✓	
Pearson			✓
Thomas Cook			✓
Walt Disney			✓
Whitbread		✓	
YUM! Brands		✓	✓

Consumer Staples

Company	Environmental	Social	Governance
Britvic	✓	✓	
Imperial Tobacco		✓	✓
Greggs		✓	
Tesco	✓	✓	✓
Danone			✓
Avon Products			✓
AG Barr		✓	
Suntory Beverage & Food	✓	✓	
British American Tobacco			✓
Walgreens Boots Alliance		✓	✓
Fevertree Drinks			✓
Conviviality			✓
Hindustan Unilever		✓	✓
Tate & Lyle		✓	✓

Energy

Company	Environmental	Social	Governance
Hunting			✓
Occidental Petroleum	✓	✓	
Sasol	✓	✓	
Sinopec		✓	
Statoil	✓		
Total	✓		

Source: Schroders as at 31 March 2016. The stocks mentioned above are for illustrative purposes only and not a recommendation to buy or sell.

Company engagement:
Q1 2016

Financials

Company	Environmental	Social	Governance
Aviva			✓
Bank Of Kyoto	✓		
Close Brothers Group	✓		
Grainger			✓
Habib Bank			✓
HSBC			✓
Intesa Sanpaolo			✓
Iyo Bank	✓		
JP Morgan Chase	✓		
Legal & General			✓
Lloyds Banking Group			✓
Rathbone Brothers		✓	✓
Regions Financial	✓		
Standard Chartered			✓
Storebrand			✓
Swedbank			✓
Turkiye Garanti Bankasi			✓
United Overseas Bank			✓
Workspace Group	✓	✓	✓

Healthcare

Company	Environmental	Social	Governance
Astellas Pharmaceutical		✓	✓
AstraZeneca			✓
GlaxoSmithKline			✓
Molina Healthcare		✓	✓
Pfizer		✓	✓
Roche Holding		✓	✓
Zimmer Biomet		✓	

Industrials

Company	Environmental	Social	Governance
Avon Rubber			✓
Bodycote			✓
Carillion		✓	
Chemring Group			✓
Diploma			✓
Dun & Bradstreet		✓	
G4S			✓
General Electric	✓	✓	✓
Interserve		✓	
Irish Continental Group	✓		
Leoni			✓
Rolls Royce			✓
Spirax-Sarco Engineering	✓	✓	✓
Weir Group			✓
WS Atkins			✓

Source: Schroders as at 31 March 2016. The stocks mentioned above are for illustrative purposes only and not a recommendation to buy or sell.

Company engagement:
Q1 2016

Information Technology

Company	Environmental	Social	Governance
Fidessa		✓	✓
Laird			✓
SDL			✓
Total System Services		✓	
Western Digital		✓	✓

Materials

Company	Environmental	Social	Governance
Anglo American	✓	✓	✓
BHP Billiton	✓	✓	✓
Monsanto		✓	✓
Stora Enso	✓	✓	
Tyman		✓	
Ultratech Cement	✓		✓
Vale		✓	

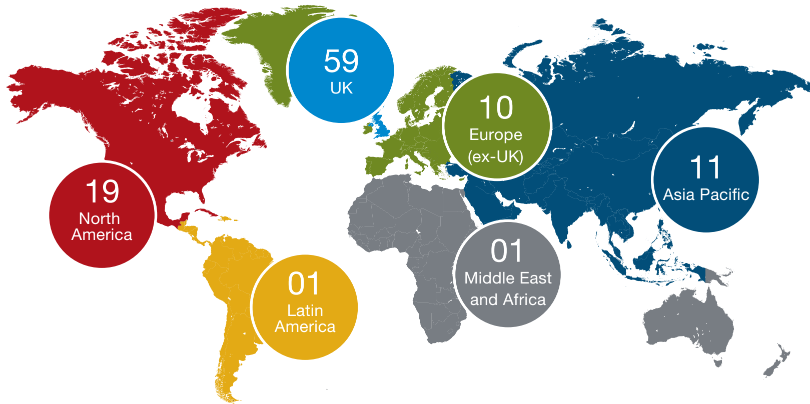
Utilities

Company	Environmental	Social	Governance
Centrica			✓

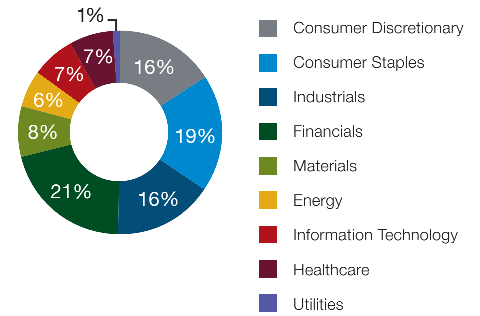
Source: Schroders as at 31 March 2016. The stocks mentioned above are for illustrative purposes only and not a recommendation to buy or sell.

Engagement:
In numbers

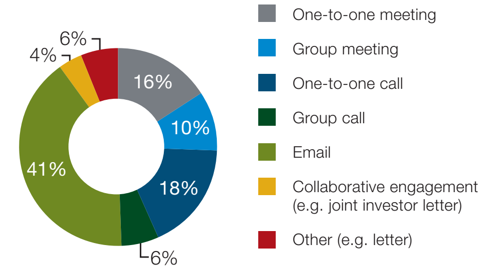
Companies engaged by region



Engagement by sector



Engagement by type



Source: Schroders as at 31 March 2016.

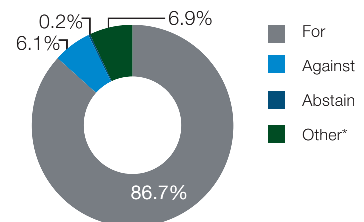
Engagement:
Shareholder voting

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).

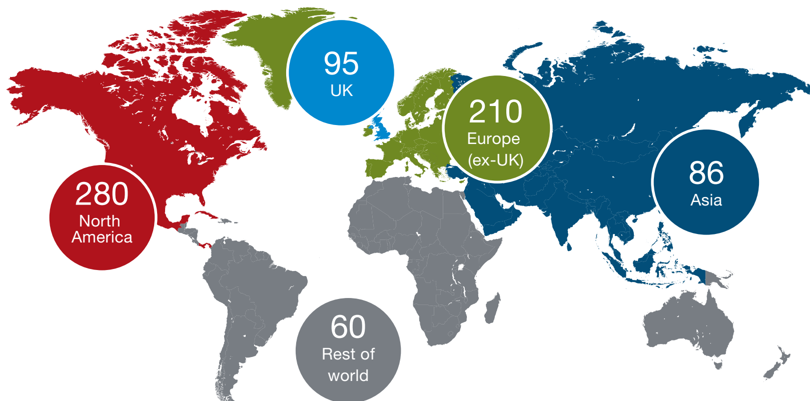
This quarter we voted on **731 companies and approximately 92% of all our holdings**. We voted on 24 ESG-related shareholder resolutions, abstaining on three and voting against nine.

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'.

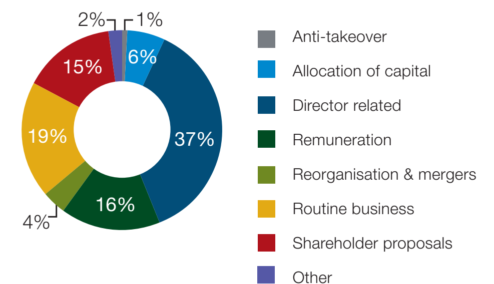
Direction of votes this quarter



Company meetings voted



Reasons for votes against this quarter

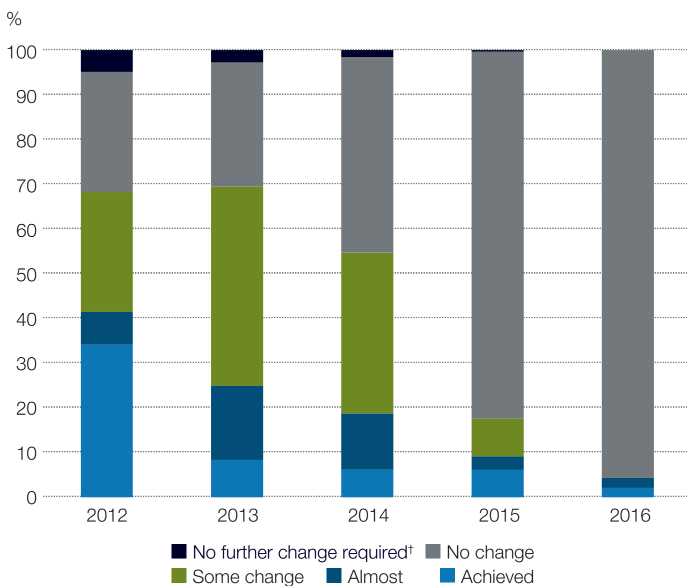


Source: Schroders as at 31 March 2016.
*Includes withheld or unvoteable resolutions, for example due to shareblocking.

Engagement progress:
Q1 2016

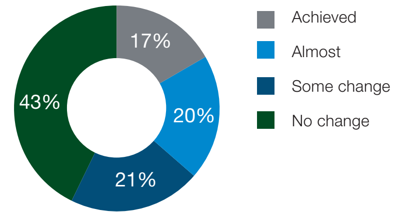
This section reviews any progress on suggestions for change we made a year ago, in this case the first quarter of 2015. There are four possible results: "Achieved", "Almost", "Some Change" and "No Change". Of a total number of 87 "change facilitation" requests made, we recorded 15 as Achieved, 17 as Almost, 18 as Some Change and 37 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



†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 31 March 2016.

Engagement progress from Q1 2015



* For background on our Loi Florange engagement please see our quarterly report for Q1 2015 at www.schroders.com/responsibleinvestment.

Important information

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