

Managing risk in controversial regimes

Advance

ROBECO
The Investment Engineers

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sustainability investing

SUSTAINABILITY INVESTING IN FOCUS | OCTOBER 2012

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for eco-efficiency

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Palm-oil producer
takes a sustainability
u-turn

Burberry

packs in bag making at Chinese factory

Burberry, the UK luxury goods producer, has halted production of its handbags at a factory in China's Guangdong province on concerns about conditions and working hours.

This isn't the first time that the factory, which is run by Korean outfit Simone

Accessories Collection, has been in the news. In June last year, workers went on strike for four days in protest against low pay and abusive management behavior.

Burberry joined the Ethical Trading Initiative (ETI) in June 2010. The ETI's

code is now part of the company's own ethical trading code of conduct. That means its workers should not work more than 48 hours per week and must have at least one day off a week. Burberry acted when it became clear that staff in Guangdong were working for more than 60 hours a week.



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INSTITUTIONAL INVESTORS CAN SHAPE THE FUTURE OF CAPITALISM

Corporations increasingly recognize that sustainability is a strategic and reputational success factor for their business. It is no surprise, then, that responsibility is no longer the preserve of investor relations. It has jumped up the corporate hierarchy onto the agenda of top management. This elevation is highlighted by the Winter 2012 edition of the MIT Sloan Management Review. It reports that sustainability is on top management's agenda at 70% of companies, compared with just 20% a decade ago. This upswing is based on the conviction that corporate sustainability—if done right—is financially material: it helps improve efficiencies and reduce costs. And there is mounting evidence that companies' financial performance correlates positively with their sustainability performance. Take our 2011 study "[Alpha from Sustainability](#)". It indicates that a portfolio of sustainability leaders outperforms a portfolio of sustainability laggards. These findings were confirmed by 2011 research from Harvard Business School. In short, companies have an interest in implementing sustainability policies. They create a competitive advantage and long-term stakeholder value. By comparison, institutional investors generally lag behind. But this can change. Institutions are well-positioned to build a more sustainable capitalism without compromising the financial returns required by their fiduciary duty. Indeed, in the longer term, fiduciary duty must include investing across generations without depleting socio-economic and environmental resources. Moreover, a sustainable capitalism will have greater legitimacy with a skeptical public. Regaining public trust requires greater efforts toward ESG integration, increasing transparency and focusing on long-term value creation. We are convinced that expertise and innovation in sustainability will define the leading financial institutions of tomorrow. But to get there, sustainability experts need to demonstrate the financial materiality of sustainability factors. And they must begin to speak the language of financial markets.

DANIEL WILD, SAM'S HEAD OF RESEARCH

Introducing Advance

Welcome to the first issue of Advance, the quarterly sustainability-investing magazine from Robeco and SAM. This is the latest incarnation of a publication that started out in 2007, initially as the Responsible Investing Quarterly. Why Advance? Because our ambition is to drive the sustainability agenda into the core of mainstream finance. Join us in moving forward.

One of our partner organizations in this undertaking is the International Corporate Governance Network. As vice chair of the board of ICGN, I'm delighted to invite you to our first Oxford-style dinner debate, which will take place in Rotterdam on 3 December 2012. The four keynote debaters will cross swords on "Companies that do not report on material ESG factors are less attractive to institutional investors." Please sign up for the event [here](#).

ERIK BREEN, HEAD OF RESPONSIBLE INVESTING AT ROBECO

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Trends in sustainability reporting

Corporates and investors are discovering the benefits of sustainability reporting. For companies, it plays a key role in making their operations sustainable. "Investors are increasingly integrating analysis of such non-financial information in their investment strategies," says Carola van Lamoen, senior engagement specialist at Robeco.

Van Lamoen identifies four major trends in the sustainability reporting space. First, sustainability reporting is increasingly being integrated into companies' financial reporting. Second, there is growing external verification of reports. Third, a strong increase in reporting by emerging market companies is occurring. Finally, the Global Reporting Initiative is rolling out its next generation of guidelines.

> Click here to find out what changes are coming—and what enhancements are still needed—as well as to discover more about sustainability reporting in general.

Audit shows proxy-voting flaws

"In April, we received a call from a Dutch financial institution, asking why we voted against their incentive program," notes Robeco Engagement Assistant Michiel van Esch. "But we hadn't voted against it. Our vote had been processed incorrectly."

This is not an isolated incident. But how serious is this problem? Robeco carried out a vote audit to find out. It involved a painstaking investigation of Robeco's AGM votes at 16 companies. The results were eye-opening. Consider two examples. At Reckitt Benckiser, faulty processing meant that Robeco voted for and against one motion. Chevron refused to disclose what happened to Robeco's votes because it wants to protect shareholder privacy...

Van Esch describes the results as "shocking". **> Click here** to discover how many companies could confirm that Robeco's votes had been registered correctly.

2012 DJSI launched

The annual revision of the composition of the Dow Jones Sustainability Indexes (DJSI), which was unveiled in September, showed that the sustainability space continues to develop rapidly. The DJSI World index, which has 340 components, saw 41 additions and 41 deletions. The DJSI is based on SAM's Corporate Sustainability Assessment (CSA), in which the 2,500 largest companies are invited to report annually on their sustainability performance. The top 10% of companies in each of 58 sectors are included in the DJSI World sustainability benchmark. SAM also identifies the top company in each of 19 "supersectors". Among the leaders in 2012 is Roche (healthcare). On page 12, you can read the Swiss company's reaction to this nomination.

> Click here to read more about DJSI



50% of global pork production

is consumed in China, making it a major importer of corn and soybeans to support its livestock

Innovation is key in F&A investing

Investing in agriculture is about funding the innovation required to meet soaring demand for food, says Jürgen Siemer.

Headlines that UK bank Barclays made more than GBP 500 million on positions in food staples in 2010 and 2011 have put the focus back on speculative investment in food & agriculture (F&A). Speculative investors are felt to be contributing to global hunger because their activities make food more expensive in poor countries. It comes as no surprise, then, that mistrust of financial products linked to the agricultural sector is widespread.

But while misgivings about speculative practices are justified, it is regrettable that investor skepticism extends into other parts of the F&A space. That's because the agricultural sector is facing enormous challenges and long-term solutions are needed to address them. "This is creating new investment opportunities

for investors—opportunities that have nothing to do with speculation," says Jürgen Siemer, Senior Analyst at SAM.

Challenges include demographics & biofuels

What are these challenges? For one thing, global population growth and increased protein consumption are fueling strong growth in demand for food and feed. Moreover, increased biofuel use is putting pressure on the available arable land resources. At the same time, high-quality arable land reserves are limited. And there aren't any "easy" productivity increases as occurred in the 50s and 60s. The result is growing food scarcity, as reflected in high prices. This sounds like a depressing scenario. But don't forget that resource scarcity in areas such

as energy and basic materials can spark human ingenuity: the more pressing the challenge, the more people will invest in new, improved and more efficient products and processes.

Investing in long-term solution providers

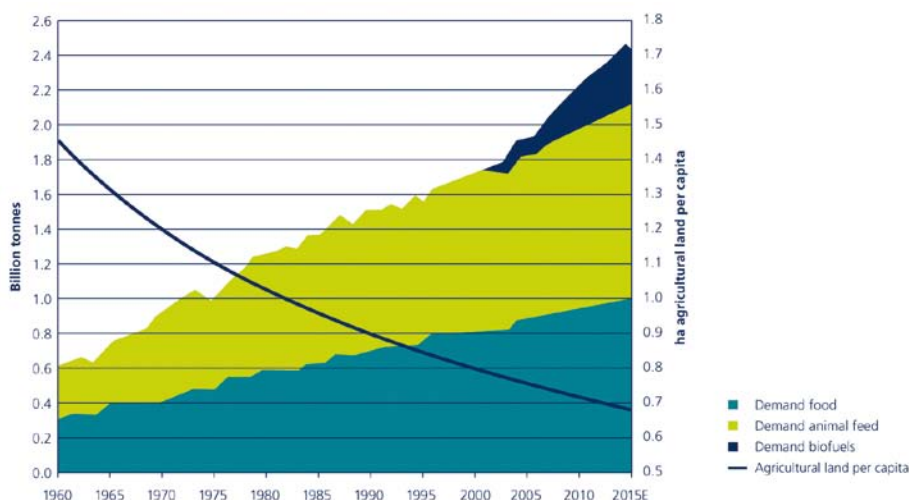
That's where investors enter the equation. "Investing in agriculture is about providing capital to companies whose technologies and services contribute to solving, or at least mitigating, these problems," explains Siemer.

Noting that because the gap between increasing demand for food and current agricultural production will have to be narrowed primarily through increases in productivity and improved efficiencies in processing, storage and distribution, Siemer says innovation—and investment—will be required along the entire F&A value chain.

Innovation could thus be in improved farming inputs such as seeds, in new agricultural machinery or in irrigation technologies. But it could also be in measures that prevent harvest, process and distribution losses. There is nothing objectionable about this sort of investment generating positive returns. "By providing incentives for optimal capital allocation, they contribute to more efficient production processes and, ultimately, to improved distribution and access to food, including in poorer regions of the world," says Siemer.

To find out more about sustainable agribusiness investing, [Click here](#) to read SAM's recent research paper, *Harvesting Opportunities for a Sustainable Food Supply*.

Increasing food demand & declining agricultural land per capita, 1960-2015



Source: WRI, Aquila, Robeco

A portrait of Sylvia Van Waveren, a woman with short, curly blonde hair and blue eyes, smiling slightly. She is wearing a grey and white patterned blazer over a dark top with a colorful necklace. The background is a solid, vibrant red.

'Greed can be

SYLVIA VAN WAVEREN ON ECO-EFFICIENCY IN THE CEMENT INDUSTRY

Sylvia van Waveren is spearheading Robeco's year-old engagement theme on eco-efficiency in the metals and cement industries. The Senior Engagement Specialist is trying to persuade companies to make more while using fewer resources and creating less waste and pollution. Here, she explains how Germany's HeidelbergCement is leading the way in its industry.

Why should investors be concerned about eco-efficiency?

Eco-efficiency will be vital for everyone as we move towards a low-carbon economy. But from an investor's perspective, quite simply, eco-efficiency can have a major impact on a company's bottom line, and therefore on its investment returns.

How does eco-efficiency affect the cement industry?

Eco-efficiency is a major concern for companies that make cement, the production of which is very energy-intensive and results in significant CO₂ emissions. However, different companies have embraced the concept to varying degrees. One of the best-in-class companies in this respect is, in our view, HeidelbergCement. The company has been particularly adept at finding ways to recycle waste from other processes to make cement and other products.

its use of traditional energy sources such as gas and coal, saved it a great deal of money—even though prices are rising, this kind of biomass energy is still cheaper than fossil fuels—and is a very efficient way to deal with waste from other industries. This is exactly the kind of win-win situation we like to see when looking at eco-efficiency.

'Eco-efficiency can have a major impact on a company's bottom line, and therefore on its investment returns.'

Similarly, HeidelbergCement is a leader in finding innovative ways to incorporate waste from other industries into its cement. For example, it adds blast-furnace slag and fly ash (which is produced when coal is burned) into its cement mixture, so that the limestone content of its cement is only 51%. This is the lowest percentage in the world, and well below the 79% industry average. But this has absolutely no negative effect on the quality of Heidelberg's product. Again, by doing this the company reduces its use of raw materials (limestone), minimizes its energy consumption and has

found an environmentally-friendly way of using waste from elsewhere.

Is this a case of HeidelbergCement just acting in its own interest?

We actually like to see companies acting in an eco-efficient manner because it is in their own financial interest—sometimes, in a sense, greed can be good. However, HeidelbergCement also acts with an eye on wider society in some instances. For example, one of its limestone mines near Maastricht in the Netherlands is set to be decommissioned in 2018, and the company has worked closely with the regional government, the Natuurmonumenten (a Dutch environmental-protection NGO), the province of Limburg and local residents to come up with the best way to return it to the environment, setting aside a considerable amount of money to do so. This is a great example of a company taking its long-term responsibilities to the people and communities it works alongside seriously.

So is HeidelbergCement a perfect example of corporate responsibility?

No company is perfect—in the case of HeidelbergCement, it could do much better in terms of information disclosure. Robeco's Responsible Investing team is therefore actively encouraging the company to release information more freely, as well as making other suggestions about how it could improve its eco-efficiency even further. By engaging with the companies in which we invest, we believe we can promote greater corporate responsibility, which in turn can help to improve the risk/return profile of our funds. This is another win-win situation.

Can you give some examples?

The company's processes require a lot of energy, but it has been able to get round this by using alternative fuel sources. It uses biomass waste from elsewhere so that 40% of the fuel it used in 2011 was climate-neutral. This reduced

'We like to see companies acting in an eco-efficient manner because it is in their own financial interest.'

good'



Managing risk in controversial regimes

The risks of investing in mining companies operating in controversial regimes can be managed, say Jaap Smit and Willem Schramade. They focus on selecting larger companies, using risk-adjusted valuations and emphasizing safety.

Although Colombia's Marxist rebels, FARC, are in peace talks, the Latin American country remains one of the riskiest places to do business. Terrorism, human-rights violations by government security forces, abuses of labor law and corruption are just some of the issues faced by corporations active there.

For mining companies, it is hard to avoid such risky environments. After all, new commodity supplies tend to be found in countries not only characterized by political uncertainty but also often featuring harsh climates and a lack of infrastructure. Indeed, most large diversified mining companies will likely have some operations in regions where the government is classified as a controversial regime.

But what exactly is a controversial regime? According to a recent study commissioned by Robeco, the definition is largely (70%) driven by human rights issues, such as personal security, labor rights and food & water security. It also includes a political risk component (30%), comprising resource nationalism, conflict intensity and terrorism occurrences. Colombia is one example of the report's "extreme risk" category. Democratic Republic of Congo and Russia are two others.

Investable companies can operate under controversial regimes

"We can invest in companies operating in controversial regimes," says Smit. "But it is a question of how the company is managing that risk and how we are compensated for the additional risk." Robeco's fixed income team uses the sustainability scores provided by SAM as the basis for its credit analysis. They are supplemented with additional external data and insights based on the analyst's experience. "We aim to balance risk assessment and return potential," says Smit. As an equity analyst, Schramade says he is primarily focused on valuations, building models to calculate cash flows and assigning a discount rate that corrects for risk. "The higher the risk, the higher the discount rate and the lower the value," he summarizes. Both Smit and Schramade generally prefer larger companies. "Smaller mining

Jaap Smit is Portfolio Manager, Credits, and Willem Schramade, is a Global Equity Analyst at Robeco.



‘Smaller mining companies will often have higher country risk.’ Willem Schramade

companies will often have relatively higher country risk,” says Schramade. “The five largest mining companies tend to manage their country risk carefully,” adds Smit. Part of this is ensuring that the majority of their core activities are located in OECD countries. “Larger mining companies will also typically have better-developed strategies to gain a local license to operate and are better able to manage their country risks than smaller mining companies,” concludes Smit.

Some commodities are safer to mine than others

Some mining projects are also more risky than others, and this is also factored into the investment decision. For example, open-pit iron-ore mining using large machines operated by skilled workers is generally safer than the underground mining of diamonds, gold and platinum by large numbers of unskilled workers. In addition to being less safe, Schramade points out that labor-intensive mining is also more expensive, in terms of both costs and accidents. Safety records therefore become key to analyzing potential risks. “The safety record says a lot about a company’s mining sustainability,” notes Smit.

Both he and Schramade caution that the existence of safety policies cannot replace further analysis. Instead, safety policies may actually be red flags indicating where the company has encountered the most problems or where it is most at risk.

Working with companies operating in controversial regimes

Companies engaged in the oil & gas and mining industries have the highest exposure to controversial regimes, post-conflict regions and countries with high political risk, says Lara Jacob, Robeco Senior Engagement Specialist.

Other sectors, however, could also be exposed to controversial regimes. She has taken part in engagements with companies in the food & beverage and transportation sectors, for example, which have supply chains in regions labeled as controversial.

“The point of engagement with a company operating in a controversial regime is to look at how these companies analyze and manage their risks, so that they operate as responsibly as possible in these countries,” says Jacob.

PARTNERSHIPS WITH STATE-OWNED COMPANIES CAN RESULT IN DEPENDENCY

Operating in a country controlled by a controversial government can be difficult. Natural resources companies, for example, are often required to enter into partnerships with state-owned companies. They might also need to rely on the military for site security or other services. According to Jacob, these relationships “can put a company in an awkward position of dependency and partnership.”

It is not uncommon for companies operating in less-developed countries to provide seed capital for roads and basic infrastructure. While this may seem far from vital to the company’s bottom-line, Jacob sees a clear benefit. “These activities are often necessary to secure a license to operate. That’s a valuable contribution for shareholders.”

‘We aim to balance risk assessment and return potential.’ Jaap Smit

Sowing the seed of sustainability in palm oil

Golden Agri's transformation: a timeline

December 2009

Unilever cancels EUR 30 million contract

March 2010

Nestlé drops the group as palm oil supplier

February 2011

GAR says it is working with Indonesian gov't. & Forest Trust on developing sustainable plantations

September 2011

Nestlé resumes purchasing from Golden Agri Resources/ Sinar Mas

Engagement played a role in the transformation of Golden Agri-Resources from palm oil pariah to sustainability poster boy. *Sylvia van Waveren reports.*

It is cheap. It is versatile. And it is not always easily replaced by other oils. Palm oil is a key ingredient in shampoo, margarine and cookies. But several sustainability issues are connected to its production, including deforestation, pollution and degradation of soil and ground water, the rights of indigenous people and labor standards.

Against this backdrop, Robeco commissioned research on the industry and started a dialogue with companies in 2007. Perhaps the biggest change that this engagement has contributed to is the *volte face* at Golden Agri-Resources (GAR), the parent company of Sinar Mas and the world's second-largest palm oil producer.

A few years ago, GAR was one of the sector's worst performers in terms of sustainability. And

in December 2009, Greenpeace reported new evidence of illegal deforestation and peatland clearance by the group.

The environmental activist's report had an immediate impact. Unilever suspended all future purchases of palm oil from the group. Other multinationals, including Nestlé, Kraft, Mars and Burger King, followed suit.

Clearly, the hit from suspended contracts was an important prompt for the company to change its behavior. But investor engagement also played a role. On Robeco's part, the responsible investing team and portfolio managers pressed management in several meetings between 2009 and 2011. We reiterated the need for sustainable practices.

One way or another, GAR seems to have gotten the message. So much so that in September 2011, Nestlé resumed purchasing from the group, after a structural improvement in GAR's sustainability conduct.

What's changed? GAR now has a stated sustainability management policy. It has become a member of the Roundtable on Sustainable Palm Oil and the certification of its sustainable palm oil production is expected by December 2015. Greenpeace has suspended all active campaign work against the company. In short, GAR is now setting an example for other plantation players to follow.

A day in the life of an engagement specialist

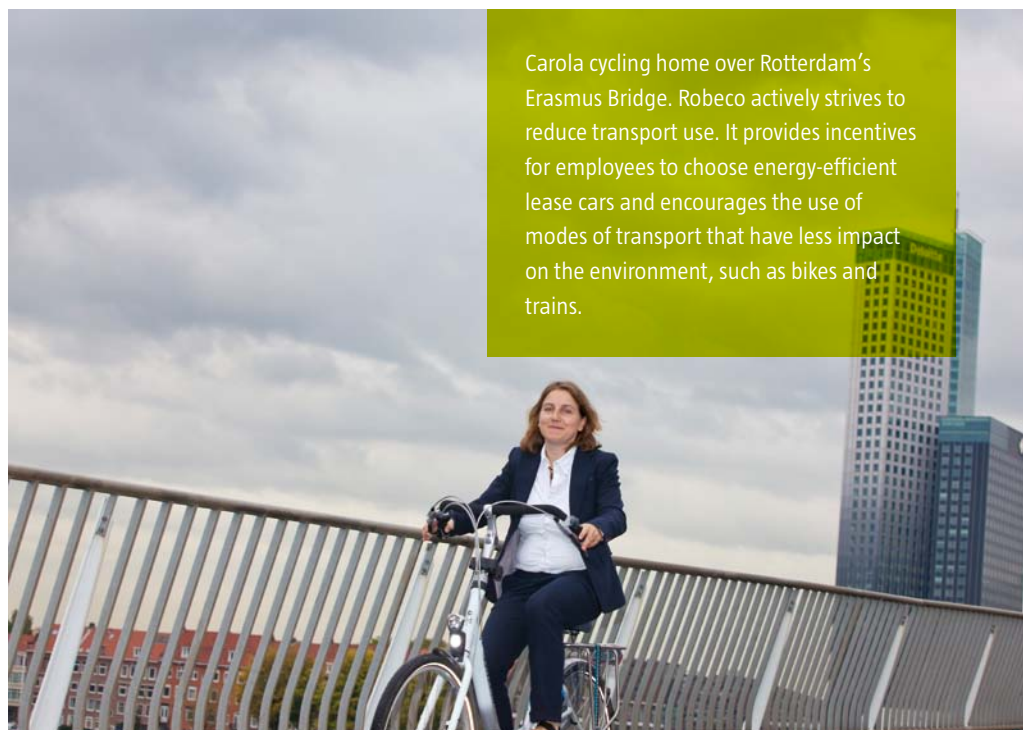
What does an engagement specialist do? Let's have a look at the agenda of governance specialist Carola van Lamoen to find out. It is Monday 17 September...

8.21. On the way to a meeting at the Anglo-Dutch publishing group Reed Elsevier in Amsterdam. Catch the FYRA, the high-speed train, from Rotterdam Centraal to Schiphol airport. On the train, bump into a peer from fiduciary management group MN Services, who is also on her way to the meeting. The Dutch corporate governance scene is a small world.

9.30. Meeting with Mark Elliott, the chairman of Reed Elsevier's remuneration committee at the company's headquarters. This meeting is part of a long-running dialogue with the company. One of our objectives is to persuade Reed Elsevier to link its long-term variable executive remuneration to environmental, social and governance-related targets. The company seems to be open to this but it is not a done deal yet.

13.00. Back at the Robeco HQ in Rotterdam.

14.00. Meeting with several analysts and portfolio managers to discuss sustainability challenges in three sectors. Sustainability is integrated into the investment process of all



Carola cycling home over Rotterdam's Erasmus Bridge. Robeco actively strives to reduce transport use. It provides incentives for employees to choose energy-efficient lease cars and encourages the use of modes of transport that have less impact on the environment, such as bikes and trains.

Robeco's products and our analysts and PMs need to keep up to speed on developments in their areas. Today's discussion focuses on shale gas and the major risks in the mining sector.

15.00. Phone Hewlett Packard. As well as being a corporate governance specialist, I'm also responsible for the bribery & corruption theme at Robeco. The US IT group has made good progress in publicizing its anti-bribery policy and the quality of its systems. The call marks the end of a successful engagement with the company.

16.00. Take a call from Clara Sies, who runs De Voedselbank, the Rotterdam food bank. At Robeco, we believe it is important to play a role

in wider society. Around 40 colleagues have recently done voluntary work packing boxes at the organization's warehouse, which distributes 3,000 food packages per week. Clara wants to take our co-operation forward and we arrange to meet in October to discuss.

17.30. Leave the office. It is an invigorating end of the day to bike across the Erasmus Bridge on the way home. I've recently become co-chair of the International Corporate Governance Network's corporate risk oversight committee and as I'm cycling my thoughts turn to the working program that has to be put forward to the ICGN board later in the week. It is difficult to leave work in the office...



'If we don't think sustainably, we will not remain in business.'

STEPHAN FELDHAUS, ROCHE'S HEAD OF GROUP COMMUNICATIONS

Congratulations on being DJSI Supersector Leader in healthcare for the fourth consecutive year. How does Roche benefit from this?

It confirms the soundness of our corporate strategy. The nature of our business requires a mid- to long-term focus because we need, on average, 10-15 years to develop and bring to market new medications and diagnostic tests. We have no choice but to think of sustainable ways to achieve our objectives.

Which results of your sustainability strategy are you most proud of?

One of our goals is improving access to our medicines and diagnostic tests. Last year, we launched a pilot program with the Chinese government and the Cancer Foundation of China to improve access to one of our breast cancer medications, Herceptin. As a result, the number of women treated increased from 3,000 to 8,500. This is good for business, but more importantly, it is good for the patients.

How do you quantify the financial impact of sustainability?

That is hard, as sustainability is inherent to our business model. If we don't think sustainably, we will not remain in business. We can quantify revenues generated by our patient access programs, or cost savings from energy and waste reduction. However, the single driving force behind our sustainability strategy is delivering long-term value to our customers, employees, shareholders and society.

As part of the annual review of the Dow Jones Sustainability Indexes (DJSI), SAM identifies the year's top company in each of 19 Supersectors. Roche, the world's largest biopharmaceutical company, is the 2012 DJSI Supersector Leader in healthcare.

> Find out more about DJSI Supersector Leaders

Important Information

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