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Schroders

Responsible Investment Report

Q4 2014



Inside...

Banks' new approach to risk...or have we heard it all before?

Corporate tax avoidance in the spotlight: we assess the investment risk

The value of carbon action: our progress with **Newcrest Mining**, **Santos** and **Sime Darby**

ESG engagement highlights: **BHP Billiton** and **Debenhams**



Schroders



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

Jessica Ground,
Global Head of Stewardship,
Schrodgers

Responsible Investment at Schroders

Q4 2014

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

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

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

Special topic

Banks: a new approach to risk?

Governance, culture and risk management in a revamped banking industry

The impact of the financial crisis on the banking sector has been tremendous. Yet, despite the increased regulatory burden they are facing, banks still have a long way to go in addressing two of the key risk management areas: governance and culture.

We researched and engaged with a sample of European (and a few US) banks with the aim of identifying best practice in these areas in order to identify those most likely to preserve shareholder value over the long term. The analysis focused on a limited number of indicators reflecting what we consider good risk governance and cultural change. These indicators include transparency around the board's oversight function, the use of dedicated risk committees, the appointment of Chief Risk Officers (CROs) and the role of the Chief Financial Officer (CFO) and Chief Compliance Officer (CCO). We assessed how risk management was integrated into remuneration structures. We also considered the independence, capacity and effectiveness of the compliance and risk functions.

We concluded that **risk management regulations are not prescriptive enough in Europe to impose a good governance model**. We believe that bank managements need to go beyond standard box-ticking exercises to ensure robust risk management.

The key issues we discovered include:

- **A lack of risk management expertise.** Historically, risk management has been under-resourced in the banking sector. This restricts boards' ability to deal with unforeseen risks. It also limits CROs' ability to implement the framework necessary to properly manage risk in large and systemically important organisations.
- **The limited authority of CROs.** We think the sector has yet to recognise the key role played by risk specialists.
- **The high importance of non-compliance issues.** Certain matters are beyond the reach of compliance departments yet are still critical to the functioning of the sector. These should be managed as risks, but many banks have yet to change their approach.
- **The independence of control functions should be clarified and strengthened.** Oversight needs to be as free as possible from management interference. As part of this process, banks should also be more transparent about how these functions are resourced.

Engaging with companies remains the best way of making banks aware that we as investors are increasingly paying attention to these crucial questions. Engagement also allows us to encourage best practice across the banking sector. Changing banking culture will take years, but we think that establishing good governance is the first step towards achieving this.

The full report is available at www.schroders.com/talkingpoint.

Special topic

Taxing times

Corporate tax avoidance under the spotlight

The stakes are rising...

Pressure is mounting from all angles on companies undertaking aggressive tax avoidance. Such tax 'optimisation' measures have typically been seen as useful tools for managements to maximise returns to shareholders. But against a backdrop of austerity, governments need corporation taxes more than ever to help close national deficits. At the same time, individual taxpayers – and voters – are increasingly frustrated at headlines claiming prominent multinational companies are not making a fair tax contribution in countries where they have a large presence. Regulators and politicians have reacted to this conundrum more quickly than expected. We have researched the issue from an investment perspective and identified three key investment risks:

1. Regulatory:

Scrutiny from regulators is accelerating with pace. The OECD's involvement means a multilateral agreement is on the cards. This is a real game-changer – up until now tax rules have been regional or bilateral. Several governments have committed themselves to incorporating the OECD's recommendations into national law. At the same time, they have been tightening existing tax laws. In the light of this, we argue that complicated tax optimisation structures are unsustainable in the longer term. Aggressive tax planning should therefore be factored into the tax assumptions in a company's valuation to provide realistic forecasts. Companies that are unprepared for regulatory changes could face immediate costs, as well as impacts to their cash flow and earnings.

2. Reputational:

In certain industries, gaining a reputation for not stumping up a 'fair' share of local or national taxes could have an impact on brands. While measuring these effects is difficult, it is probable that for consumer-facing companies or those facing a shortage of skills and therefore wanting to attract talent, responsible corporate tax practices could help maintain a company's 'licence to operate'.

3. Societal:

Over the longer term, there is a need for companies to support the infrastructure in which they operate to ensure the smooth running of their operations. Avoidance of taxes can disrupt national development – clearly more of a problem in developing countries – and can widen the inequality gap.

...and several industries look particularly exposed

The regulatory risk has the most wide-reaching and short term effects. Our brief report looks at existing and approaching regulations, which sectors they might affect and where the gaps still lie. We find that, across all sectors, companies adopting the most aggressive tax policies in comparison to their peers will be the most exposed. Those without a 'plan B' are the likely losers. We throw a particular spotlight on the **financials, pharmaceuticals, and technology** sectors, which are those most likely to be affected by impending regulation. We also look at reputational and societal impacts, finding that **consumer-facing** companies are most at risk.

Finally, we outline our actions in this area, suggesting tools for investors to identify poor, opaque or aggressive tax practices. We also outline best practice indicators and engagement questions to improve tax transparency. Companies should be able to demonstrate 1) a clear policy on tax, 2) a visible tax governance structure, and 3) meaningful and transparent data on tax rates, use of tax havens, and the location of profits.

The full report will be available shortly at www.schroders.com/talkingpoint.

Engagement highlights

BHP Billiton

BHP Billiton – three-way engagement

This quarter Schroders held several engagement discussions with BHP Billiton to gauge its response to the challenges facing the global mining sector, including volatile commodity prices and cost cutting measures.

1. Cyclical industry, cyclical pay?

One key strand in our discussions was how the cyclical downturn in the mining industry was affecting the remuneration of BHP's management team. We feel it is important that incentives provide the right signals for management to allocate capital to maximise returns. Discussions are ongoing and we expect them to be concluded by the time of the company's AGM next year.

2. Protecting the London listing

A second area of concern was the London-listed company's plan to spin off some assets in a new company (now named 'South32'), to be listed only in South Africa and Australia. This would prevent certain European funds – including Schroders – from investing in South32, thereby reducing our exposure to BHP's aluminium, nickel, coal and silver assets which we felt could benefit from enhanced management attention leading to better value creation. We therefore held several meetings directly with BHP to encourage it to consider an additional London listing, resulting in an announcement from the company's CEO in October that this would be done – allowing us to maintain our exposure to these assets.

3. Increasing climate change transparency

In the third major area of engagement for the quarter, we were heartened by news that BHP had gone some way to delivering on an earlier promise to Schroders to increase the amount of information it provided about its carbon exposure. This followed a meeting earlier in the year when we had met BHP's climate experts to find out how it factored carbon regulation changes into its capital expenditure planning, especially for high-risk coal mining projects. At the time, we were encouraged to learn that BHP applied several different 'carbon scenarios', using a shadow carbon price to attribute a cost to those assumptions. We then wrote to the chairman of the company's sustainability committee to encourage more transparency on these scenarios and disclosure of the carbon price assumptions used. This would allow investors to evaluate BHP's climate strategy against policy developments and thereby determine the potential costs. BHP has now provided more information about the scenarios, but has fallen short of disclosing its carbon price assumptions. This has diluted the good news and we continue to encourage further transparency from the company.

What next?

The spin-off next year alters the balance of ESG risks in the remaining business (giving it, for example, higher exposure to petroleum and shale), while concentrating others in South32 (which will have more exposure to thermal coal and to regions with labour unrest and corruption). We will continue to seek reassurance that the sustainability risks will be managed with rigour in both companies.

Engagement highlights

Debenhams

Underpinning the future of Debenhams' remuneration

2014 has been a difficult year for **Debenhams**. The UK retailer ended 2013 with a profit warning and opened 2014 with major board changes. These problems prompted us, as a sizable shareholder, to have a number of engagements with the company.

Balance sheet concerns have been an area of particular focus. We have been pushing for discipline in how the company allocates its capital. For example, Debenhams has signed leases with lengths of up to 20 years – longer than those signed by its peers. In the face of structural changes in shopping habits and the rise of online shopping, we have therefore been pushing to ensure that any lease commitments make sense and create value over the full length of the lease.

During the year, the company contacted us with proposed changes it was making to the performance share plan element of its executive remuneration structure in 2015. We were concerned about a move away from a return on capital employed (ROCE) target towards measures based on the share price. Given our focus on capital allocation, we felt strongly that ROCE should be retained as a component in determining remuneration and also that store leases should be included in the calculation of the capital base. We communicated this view to the company during face to face meetings.

Following our comments, the company introduced a ROCE underpin in the performance share plan. The vesting of the plan will now be subject to an underpin based on an improvement in ROCE over three years. This calculation will also include a capitalised value of future store rental payments, while profitability will be calculated before both tax and rentals. We saw this as vindication of our engagement efforts, which should lead to much better alignment between board pay and the long-term development of the company.

Engagement highlights

Carbon Action Initiative

Carbon Action proves its value

Carbon Action is an investor-led initiative driven by the Carbon Disclosure Project (CDP), an industry-led climate data resource, and backed by 254 investor signatories. Its aim is to accelerate company action on carbon reduction and energy efficiency activities. Since 2010, a group of 14 investors has been engaging with selected emissions-intensive companies that have yet to establish an emissions reduction target.

Recent CDP research has shown that carbon reduction activities generate an annual return on investment (ROI) of 33%¹, equivalent to a payback period of three years. Tackling behavioural change and implementing energy efficiency initiatives have the biggest impact on emissions reductions. Additionally, high-emitting companies that set absolute reduction targets achieve reductions double the rate of those without targets, with firm-wide profitability 10% higher.

Companies in our sights

As part of our involvement in this initiative, Schrodgers is currently targeting four companies: **Newcrest Mining**, an Australian gold miner, **Santos**, an Australian oil and gas company, **Sime Darby**, a Malaysian conglomerate whose activities include palm oil production, and **Petrochina**, a Chinese state-controlled oil and gas group. Over the past two years, we have engaged with these companies to better understand their response to climate change and to encourage them to give greater strategic importance to the issue. Three out of the four have responded positively to our information requests.

– Newcrest Mining

We learned that management is focusing on energy efficiency improvements to gain cost savings, but has not yet crossed the natural bridge to setting targets for and managing carbon emissions.

– Santos

Although there has not been much progress in carbon emissions management, it was nonetheless encouraging to hear that the company would be ready to consider longer-term energy efficiency targets after 2015, as well as emissions savings targets

– Sime Darby

There has been good progress on carbon intensity targets, with the company publicly committing to a 40% reduction in upstream emissions intensity for its palm oil plantation division. It will be considering setting absolute emissions targets once its current carbon management plan has run its course.

– Petrochina

Disappointingly, Petrochina has not responded to our requests.

¹ www.cdp.net/Documents/Carbon-action-report-2013.pdf

What next?

Carbon emissions reporting and management is now relatively common for listed companies, yet the target companies have shown less recognition of climate change risk in their business strategy. In a difficult economic environment, the focus on growth and short operating processes make it difficult for companies to commit to both absolute reductions in greenhouse gas emissions (GHG) and longer term targets. Instead, companies have been focusing on reducing energy consumption and improving energy efficiency, mainly to reduce operational costs. A key driver for improving operational efficiency has been the cost of energy. One of the challenges ahead will therefore be to ensure that carbon action remains on companies' agendas at a time when lower energy prices are reducing the incentive to cut consumption.

The regulatory burden on high emitters is on the increase, and will rise further if a global climate change deal is struck in December 2015. Companies that are lagging their peers in reducing emissions in line with national targets will find themselves at a disadvantage. We will continue to maintain the pressure on all four of our target companies, particularly Petrochina, where action to date has been disappointing.

Q4 2014 Company Engagement

This section lists the 47 companies we have engaged with this quarter and the broad engagement topics. It includes one-to-one meetings, joint investor meetings, conferences, teleconferences and correspondence.

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

Consumer Discretionary	Environment	Social	Governance	Financials	Environment	Social	Governance
BMW	✓	✓		BNP Paribas			✓
Carnival			✓	ING Groep			✓
Debenhams			✓	Barclays			✓
Kingfisher			✓	Julius Baer Group			✓
Ladbrokes			✓	Banco Santander			✓
UBM			✓	UBS			✓
				Royal Bank of Scotland (RBS)		✓	✓
Consumer Staples				Unicredit			✓
Dairy Crest			✓	Deutsche Bank			✓
J. Sainsbury		✓		Standard Chartered			✓
Tesco		✓	✓	Natixis			✓
Unilever		✓		Lloyds Banking Group			✓
				HSBC Holdings			✓
Energy				Commerzbank			✓
Apache	✓						
BP	✓	✓		Health Care			
BG			✓	Bayer		✓	✓
Tullow Oil			✓	GlaxoSmithKline		✓	
				Medtronic			✓
				Stryker			✓

Q4 2014 Company Engagement

Industrials	Environment	Social	Governance
Canadian Pacific Railway		✓	
Melrose	✓		✓
AP Moller-Maersk	✓	✓	
Danaher	✓	✓	✓
Actividades de Construccion y Servicios (ACS)		✓	✓

Utilities	Environment	Social	Governance
SSE			✓
Beijing Enterprise Water Group	✓		

Information Technology

Inside Secure			✓
Google		✓	
AAC Technologies			✓
Apple		✓	
Gemalto			✓

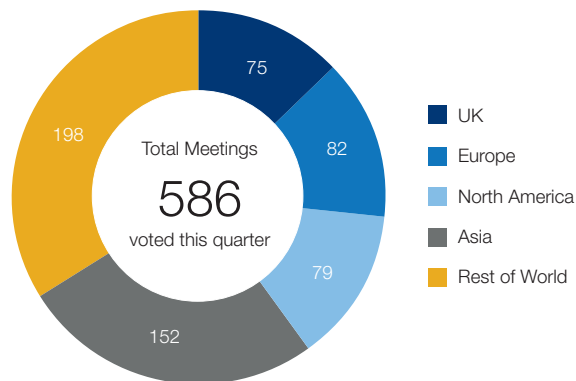
Materials

Antofagasta	✓	✓	
Kaz Minerals		✓	
Empresas CMPC	✓		

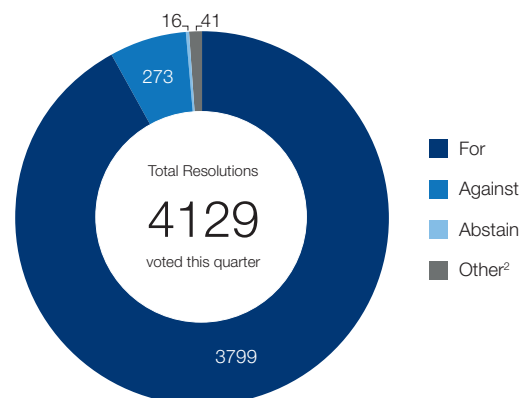
Shareholder voting

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 share blocking). The charts below show our voting activity for this quarter.

Global Votes



Direction of votes



Shareholder Resolutions

We voted on 4 environmental, social and ethical shareholder resolutions this quarter, supporting 1 and voting against 3.

Additional activities

Industry bodies promoting ESG practices

We provide below some examples of ESG activities in which we have been involved during the quarter.

Investment Management Association

We sponsored and judged the IMA Auditor Reporting Awards recognising the most insightful and most innovative audits reports across the UK market

Carbon Tracker Initiative

Schroders hosted the London launch of think-tank Carbon Tracker's new research on Carbon Supply Cost Curves. The report evaluates the financial risks of increasing capital expenditures on coal projects.

Cambridge Institute for Sustainability Leadership

We attended our first session as an adviser to a research project focusing on risks to pension assets from the physical impacts of climate change. The project is being conducted by the Cambridge Institute for Sustainability Leadership, an offshoot of Cambridge University. This is an under-researched area, but one which has very significant implications for our clients.

All Party Parliamentary Group (APPG) on Natural Capital

We attended an APPG session discussing how London could become the centre for natural capital accounting. It was a valuable opportunity to hear from Pavan Sukhdev (a specialist consultant in this field) as well as to think about how this might affect our own work.

Bank of England

We attended a lunch with the Deputy Governor for Financial Stability at the Bank of England, Sir John Cunliffe, to discuss ongoing regulatory issues in the banking sector. The lunch was hosted by Goldman Sachs.

All Party Parliamentary Group on Climate Change (APPGCC)

We attended an event on stranded assets organised by UKSIF and the APPGCC, and chaired by Tim Yeo MP. The session discussed how policy makers should react to the idea that with increasing regulation on climate change fossil fuel assets could become 'stranded' and the carbon 'unburnable'.

Access to Medicines Index

We attended the launch of the 2014 Access to Medicines Index, which ranks 20 global healthcare companies on their progress in making their products available to developing countries.

Collaborative initiatives

Board effectiveness

We participated in an investor forum organised by accountants EY (Ernst & Young) on the effectiveness of boards.

Stranded assets

We were invited to participate in a roundtable debate with peers, organised by Environmental Finance magazine on stranded assets.

Seminars and events

Biodiversity

We participated in a seminar exploring how biodiversity risk management at mining companies has developed over the last decade. This provided a valuable tool in understanding current best practice and how it has evolved.

China

The ESG team and China specialist at broker KeplerCheuvreux presented their latest report on the increasing environmental regulation in China and how it may affect investments in Chinese companies and foreign companies operating in China.

Climate change

We hosted a meeting with HSBC's Climate Change Centre for Excellence to discuss international policies including the US-China climate change agreement and the two countries' carbon emission reduction commitments.

Clinical trials transparency

We attended a seminar organised by campaign group Sense About Science. The group are engaging investors to support their 'AllTrials' campaign to encourage healthcare companies to disclose all results of clinical trials, past and present.

Fossil-free funds

Given the growing interest in fossil-free funds (broadly speaking, funds that avoid investments in companies involved in extracting fossil fuels), we met some providers during the quarter to better understand their methodologies in constructing fossil-free products.

Tax avoidance

We attended two workshops this quarter aimed at informing investors about tax avoidance as a potential investment risk. We had the opportunity to hear from and engage with a number of tax experts.

Weather variability

Evelyn Browning-Gariss, a specialist climatologist (aka 'the Weather Lady'), came in to give a presentation to Schroders' investment managers on the causes of weather variability and possible future patterns. Weather events are often blamed for earnings surprises at companies, as well as for general macro-economic effects, so greater understanding of potential long term shifts in weather patterns should improve our analysis.



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