The **co-operative**
asset management

Responsible Investments Quarterly Review

Winter 2010

Part of The **co-operative** financial services

Section 1 **Engagement Update**

Diving into Water Dialogue

Following on from our commitment to a series of engagements on water-related issues, we recently responded to the Department for Environment Food and Rural Affairs (Defra) survey seeking views ahead of the publication of the Water White Paper in mid-2011. We called for better appreciation of the water-energy nexus (i.e. water companies are energy-hungry and have big carbon footprints while certain energy sources are extremely water-intensive and/or require specific quality of water) and for it to be taken into account in government policy and its blueprint for future. We also highlighted flooding caused by changing weather patterns and the supply of products being disrupted by lack of awareness and preparation as needing attention. We further voiced our concern about the chlorination, fluoridation and other pollution of water habitats and its consequential impact on biodiversity and human health (e.g. bioaccumulation of oestrogen causing negative reproductive effects in fish and people).

Rather like energy efficiency, we strongly encouraged the focus on making the most of what gets pumped through the system (particularly through accelerated investment in leakage reduction) to mitigate the need for heavier, ecologically disruptive civil engineering projects to build more reservoirs/long-distance pipelines. We are concerned that such projects may struggle to secure adequate private sector capital, thereby storing up problems for the future if leakage is not heavily reduced. Before this problem is tackled it is unrealistic to expect the consumers to fully get on board. Nevertheless, we consider it important that this coincides with raising awareness to empower households and companies to also do their part in water conservation. Especially those living/operating in areas experiencing acute water stress should be educated about the issue and the effect it has on the nature, economy and availability of everyday products.

We pointed out that people and companies need to first be made aware how much water they are consuming and then incentivised to reduce usage. Cost savings tend to be an effective way to encourage behavioural change and so installing more water meters to ensure users get charged for what they consume is a crucial first step. The price itself should adequately reflect the cost of transport, treatment and infrastructure (including the investment needed to upgrade the latter), but also the scarcity of the resource in particularly water-stressed areas. That said, we cannot allow second class citizens to emerge who cannot afford what is regarded as a basic human right. Support for those unable to afford the necessary price rises needs to be a central part of the pricing strategy.

Finally, we noted that guidance on water reporting should be offered to companies, while cheaper or subsidised water-saving devices (along with practical support) would enable households and communities to take positive action themselves. We intend to provide further input to the development of the Water White Paper as Defra makes available opportunities for doing so in early 2011.

As mentioned in our Autumn 2010 review, the Carbon Disclosure Project's (CDP) first Water Disclosure Report was launched in November, with The Co-operative Asset Management attending the event. As a signatory to the original request for information from 302 companies around the world, we were pleased to find that the responses appeared to prove that water security is rising up the corporate agenda, with many companies having developed water-related policies (89% of respondents) and performance targets (60%), and a high number (62%) also identifying business opportunities in areas such as water management and reduction. On the other hand, there is a need for better addressing related issues in supply chains with only 53% of respondents readily aware of water risks in this part of operations, while the overall questionnaire response rate of 50% also has room for improvement.

Acknowledging the last point, The Co-operative Asset Management in December wrote to ten non-respondents in which we hold bonds and/or shares to quiz them about their perceived water risks and opportunities, as well as to encourage participation in next year's CDP Water Disclosure questionnaire. We are pleased to have received a number of responses already and will report on the outcomes of this engagement more fully in our Spring 2011 review once all companies have had the chance to address our questions.

Courting Controversy: G4S Operations in the West Bank

The global security solutions group G4S was recently criticised for the services it provides for the Israeli authorities in the West Bank, thereby allegedly contributing to the abuse of the human rights of the people in Occupied Palestine. The company supplies equipment to Israeli-run checkpoints and is also condemned for its role in running prisons that are said to hold Palestinian political prisoners. We had previously entered into dialogue with G4S on other corporate social responsibility (CSR) matters. On the back of this discourse it first asked us to provide feedback on its CSR reporting and management generally, and, as the allegations regarding the illegally occupied territories resurfaced, also approached us to gauge any concerns we may have over this particular aspect of the business.

We explained that The Co-operative Group has identified Israel's illegal settlements as presenting a compelling case for action (similarly to Burma), reflecting the fact that the economic injustices and human rights issues in the area are of significant concern to our Co-operative members. At The Co-operative Asset Management specifically, the analysis of a potential investee either in our screened or whole market funds includes a consideration of whether the company is associated with or proximate to exploitative human rights practices - especially in places such as the Occupied Palestinian Territories where human rights are disregarded. The proximity criterion means that the company does not need to be directly involved in human rights abuses for it to be highlighted as an investment risk and/or excluded from our screened funds. We look at companies on a case-by-case basis whereby our

decision depends on the exact products/services provided as well as the human rights policies the company has in place to mitigate risks and protect the vulnerable within its sphere of influence.

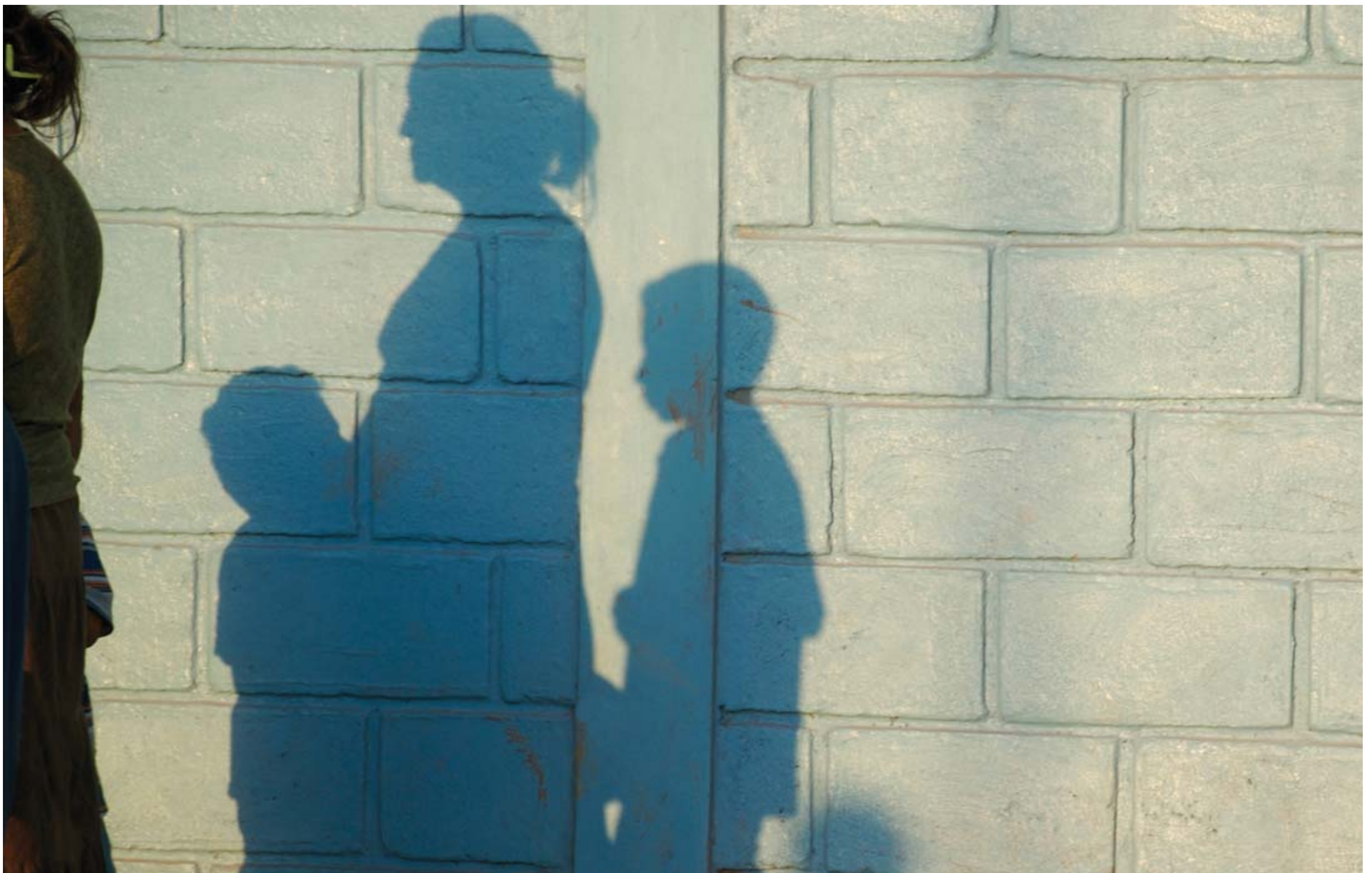
In this instance, G4S falls foul of the proximity to human rights abuses criterion of our screened funds and the matter is also flagged up as a reputational issue for the non-screened funds, albeit not necessarily making G4S uninvestible for these. In line with our Ethical Engagement Policy, we took the opportunity to further discuss the situation with the company in order to effect positive change. We emphasised that G4S needs to set out measures and monitor them to ensure that it does not contribute to the conflict (where applicable) or otherwise to human rights violations on the ground (directly or indirectly, possibly through its business partners), or generally harm the public even in stable locations. This would be crucial information for many investors concerned about the reputational as well as ethical implications.

Similarly, we recommended G4S improves the systems and disclosure relating to employee stress management and pre-deployment screening so as to minimise the risk of unprepared employees slipping through the net in a stressful, sometimes volatile job with tragic human consequences and reputational damage to the company. G4S suffered negative publicity in 2010 when a refugee Jimmy Mubenga died in its custody on a flight from London to Angola.

Nevertheless, we commend the huge strides G4S has taken in the past couple of years particularly in the field of employee relations. Its poor workplace practices and deteriorating stakeholder relations had led to systematic cases of labour standards violations and subsequent contract losses, however the pioneering agreement between G4S and UNI Global Union in 2009 has gone a long way to handling – and solving – difficult issues constructively and collaboratively. It appears to have succeeded in improving employment standards, transparency, and respect for trade union rights across the company's global operations, thereby reducing the operational and reputational risks. G4S also now actively seeks a leadership position on many other corporate responsibility issues such as health and safety management and stakeholder engagement.

Driving up standards in the oft-maligned private security industry is no mean feat but, as G4S has undoubtedly realised, differentiation and ultimately higher standards and a more level playing field across the sector will also work for its own benefit. Along with a number of issue-specific suggestions for improvement – including wider range of quantitative H&S data, measurable targets for more CSR objectives and seeking external assurance for future CSR reports – we therefore encouraged G4S to keep driving global best practice and share its experiences with those aspiring to follow in its footsteps.

We intend to continue our dialogue on human rights issues with the company; in our view it is incumbent on G4S to give an account of how its operations in the Occupied Palestinian Territories can be justified both against its own human rights policies and the norms endorsed by the UN.



BIS Consultation on Women on Boards

As part of our ongoing efforts to increase the representation of women on company boards we fed our views into the UK Department for Business, Innovation and Skills (BIS) consultation on women on boards headed by Lord Davies.

We welcomed the consultation, attending a round-table on the topic in the presence of the Home Secretary, as well as meeting civil servants in person. We made specific recommendations including:

- A call for improved disclosure of gender balance in company management hierarchies and specifically at the two levels below the board;
- A request for clarification of the legality of women-only executive searches;
- Enhanced guidance should be prepared for chairmen on differences in communication styles between women and men;
- That there be better dissemination of the business case for improved gender balance;
- Requirements for boards to consider gender balance within the UK Corporate Governance Code should be strengthened, with increased focus on implementation;
- Steps should be taken to improve dialogue and transparency over board nominations processes, particularly with an increase in prior consultation with investors;
- Legislation requiring companies to implement flexible working should be introduced;
- That as regards quotas, all the options should be left on the table.

We look forward to the results of the consultation due in February.

BP: the Long Hard Road to Recovery

We've reported in previous reviews on our engagement with and position on BP, both on its plans to develop oil sands and the Deepwater Horizon tragedy. We recently attended an investor meeting with the company designed to give an update on BP's involvement in the Gulf Coast Restoration Organisation and the changes it is making to its safety procedures, governance and remuneration systems to ensure in as far as possible that such an accident never occurs again.

Early Indications Are That Impacts Are Less Than Thought

BP made its case for why the actual environmental impact, though clearly very serious, is not nearly as catastrophic as some first predicted. It explained this was because the conditions of the Gulf were disposed towards breaking down the oil and because of the rapid and large-scale response (from multiple partners) including the use of dispersants. The first level of clean-up should be complete by the end of the first quarter of 2011, after which management should be responsive to sporadic, localised issues. BP also claimed that 99% of Gulf fisheries were up and running again.

Known Unknowns

The US Government has not yet disclosed its figure for how many barrels were spilt (this is key to determining punitive costs under either a negligence and gross negligence charge). In the meantime, BP is holding off the negotiation of compensation costs for the environment and loss of amenity until all the scientific data is in. On the economic impact, it will take many years to get past the bulk of claims but BP said it remained committed to honouring valid claims while vigorously defending the many bogus ones anticipated in what is, after all, a highly litigious country. What is not known are any long-term ecological impacts, for example the bioaccumulation of contaminants in fish and seafood larvae. BP will, in April, start donating $500m to universities for pure research over the next ten years and believes even the worst case scenario is covered in its $39bn provisions.

How Much Blame Will BP Be Forced to Accept?

The big question for BP is whether the courts will rule its role to be one of negligence or gross negligence, with the company rejecting the latter. The Bly Report identified eight major errors, some of which were clearly BP's, however the company maintains that what started the chain of events was a bad cement job. It seems clear that BP will be seeking to recoup costs from parties that it believes to be partly accountable: the other owners of the license and the contractors who helped construct, install and inspect the parts which are alleged to have failed.

Changes to the Governance of Health Safety and the Environment (HSE)

Mark Bly, who wrote the initial US Government Commission report, has been co-opted onto the BP executive and is the ultimate go/no-go authority in the newly created Safety and Operational Risk Function; a team of specialists to whom line management refer risks. He reports to a board committee of non-executives one of whom will presumably be the recent appointee Skip Bowman, former head of the US nuclear navy. HSE will be more heavily weighted in balanced scorecards for all operational staff in future.

Our View

The Co-operative Asset Management's opinion is that one would expect a company in BP's position to downplay the impact but the figures quoted - if accepted by their partners at state, federal and academic levels - certainly suggest that a mix of luck, rapid deployment and the use of dispersants prevented it from being the kind of short-term catastrophe predicted. However, the truth is no one really knows what the long-term impact will be. We are encouraged by BP's commitment to setting aside such a large amount for a range of independent scientists to study the impacts. We have urged the company to make sure it strikes the right balance in ensuring it deals with genuine claims honourably while defending spurious ones and to also go back to first principles on what really motivates safe behaviour. After all, top executives at BP already had a chunk of their bonus based on HSE performance before Deepwater Horizon. We also asked whether there was acceptance in the industry that expensive provision for low probability, high impact events was going to become a necessity not just in the US, even if on a purely cost/benefit basis it didn't make sense. BP said they expected this to become the norm, consistent with what we have heard when we put the same questions to the chief executives of Royal Dutch Shell and Total.

We also fed back that the new governance and remuneration process is still opaque and complicated. BP will have to do a better job of explaining how it will ensure something like this never happens again and we continue to engage on the matter.

Section 2 **Corporate Governance**

Remuneration and the Governance of Sustainability

Just as the financial crisis pushed forward the development of higher standards of corporate governance for directors, it is now also recognised that sustainability issues are strategically material to financial performance. According to a recent CEO survey by Accenture, sustainability issues will be important or very important to the future risk and return profile of 93% of corporations around the world.

Recent regulatory changes reflect this realisation: the King Governance Code has brought the management of sustainability directly under the aegis of corporate governance in South Africa while the Norwegian corporate governance code similarly now incorporates corporate responsibility standards. Companies are increasingly expected to have enduring governance practices that demonstrate an appreciation of sustainability risks and opportunities.

For this reason companies' corporate governance and sustainability standards are more and more seen as interdependent and we at The Co-operative Asset Management are therefore beginning to assess the systems and processes in place for the effective 'governance of corporate sustainability'. But what does the integration of corporate governance and sustainability look like?

Firstly, and most importantly, as the tone from the top drives company performance and culture, a board member or a board level committee should be designated to oversee sustainability. Secondly, a company's sustainability policies should be built into the general corporate strategy and objectives. Thirdly, the importance of these objectives should be communicated effectively throughout the organisation. Finally, this integrated approach needs to be aligned effectively with employee pay incentives to motivate the achievement of key strategic targets. We believe this means integration at the executive pay level and as well permeating it throughout the organisation to the 'shop-floor' so as to reinforce its importance and aid a shift in company-wide culture.

Having already seen the benefits of future-proofing their businesses through the frame of sustainability, some companies have looked to executive remuneration as the next logical step in the integration process. A review of 174 pan-European companies identified 61 with a reference to a variety of non-financial metrics in short and long-term bonus payments. However, just as companies can be incredibly opaque in relation to financial targets, similar problems riddle the application of extra-financials. We believe the principles of remuneration are universal and therefore should be consistently applied whether in the context of financial or non-financial metrics.

Any metric should be:

- relevant to the strategy of the business and its sector;
- relative against market competitors;
- measurable for all stakeholders;
- challenging to meet; and, above all,
- transparently disclosed.

Ticking all these boxes is inevitably easier when employing financial metrics, given that they are normally accounting-based and as such subject to statutory audit. Environmental, social and governance (ESG) metrics are almost always non-accounting and indeed frequently not subject to external verification; they are also typically regarded as being too vague or intangible. One direction companies have taken is to use sustainability or 'ethical' indices as a proxy for ESG performance; however we believe this fails the test of relevance given the lack of genuine alignment to companies' strategic objectives. It is also important that sustainability aspirations are financially material to the business. For example, specific sustainability targets should tie in with overall corporate goals, with things like green product sales or eco-efficiency projects linked into group profit targets.

In addition, financial and non-financial targets should not be operated in a mutually exclusive manner but concurrently. If a company flounders during the year hence failing to meet threshold performance levels across the financial targets, the sustainability element of the bonus should not be inflated to make up for the financials. Likewise, if a mining company loses its license to operate due to poor community relations then awards driven from financial metrics should also be re-assessed to reflect the broader reality. To illustrate, in the case of Vedanta Resources it would be hard to justify large bonus awards for financial metrics in the context of the company losing 10% of its market cap due to poor ESG performance in the state of Orissa, India.

Companies need to consider very carefully the possibility of integrating sustainability metrics into pay structures and The Co-operative Asset Management will assess all targets, whether financial or non-financial, on their merits to the business and its performance. While there has clearly been some movement in this regard, it is still the case that most companies operating in sectors with high ESG risk profiles continue to take no account of important sustainability objectives within executive director remuneration. So far we have undertaken a soft start of company engagement on this topic, but will in 2011 be formally launching a more structured framework for action, setting out our objectives for the project. We are already well placed to move forward on this agenda with a seat on the UN-backed Principles for Responsible Investment (PRI) Sustainability & Pay Steering Committee positioning us as a thought-leader on the topic.

The Consultation on the Future of Narrative Reporting

TCAM submitted a response to the Department for Business, Innovation and Skills' consultation on the Future of Narrative Reporting in October. The consultation had a wide scope and asked for input into ways that the quality of company reporting could be driven forward, thereby enabling stronger and more effective shareholder engagement.

We drew on our experience of global company reporting and presented examples of what we felt worked and what was lacking. For instance, in our view, corporate social responsibility (CSR) reporting can tend to focus disproportionately on non-material community investment or boilerplate environmental initiatives (whether material or not) as opposed to risks and opportunities presented by the sustainability of the company's operations.

We were careful to note the need for quality over quantity in environmental and social reporting and the perils of unintended consequences stemming from the demand for more disclosure around sustainability reporting.

We look forward to the results of the consultation due in February.

Post-AGM Season Reflections: Companies Respond to Shareholder Engagement

As snow settled on the busy proxy voting period, the fourth quarter of the year brought a much needed pause for reflection as companies consulted with their shareholders on proposed changes for 2011. While some were taking proactive steps by communicating clearly their plans for the new period, for others the process was more about regaining shareholders' confidence following a bruising Annual General Meeting (AGM) season that saw significant levels of proxy protest.

St Modwen certainly fell into the latter category as it set about reviewing its executive remuneration following 49% of shareholders voting against this at the 2010 AGM. While at an early stage in the process there are some encouraging signs as the remuneration committee looks to incorporate a formalised bonus deferral system, clear vesting scales for each performance metric and a clawback policy applying up to four years following any award. We will continue discussions with the company into the New Year ready for the AGM in March.

At BHP Billiton the Chairman took the proactive step of writing to significant shareholders in advance of the 2010 AGM in an effort to set out some of the major corporate governance developments during the period as well as planning for 2011. This open-door approach has proven beneficial in understanding the company's board renewal plans, current thinking on succession planning and the nature of amendments to the executive share plan. We are hoping to continue dialogue into the next quarter in an effort to address concerns over the composition of the remuneration committee.

A consultation process that began in the summer at housebuilder Galliford Try was finalised in the fourth quarter with some positive developments. We had supported the proposed changes by the remuneration committee but also pushed for greater consideration of sustainability factors among the management incentives. We were subsequently pleased to find that going forward the company will be amending the annual bonus to include an element relating to the company's health, safety and environment (HSE) performance. HSE in the construction industry is clearly crucial and we hope the alignment within management incentives will serve to reinforce the behavioural health and safety programme being rolled out across the business.

As reported in our Autumn 2010 review, Tesco had received a significant level of opposition to its remuneration report with some 40% of shareholders not supporting the resolution. This quarter saw the first steps from the company in responding to the vote by initiating a comprehensive review of executive remuneration and beginning the process of consulting with significant shareholders. In a positive departure from similar processes at other companies, Tesco took the step to brief shareholders on an ex ante basis providing the opportunity to influence at development phase the parameters of the review. We believe this will help shareholders sing from the same hymn sheet when it comes to reviewing more specific proposals in the New Year. We will be sure to keep you posted on how the review takes shape as it progresses, but the early signs are encouraging.

Section 3 **Sustainability in Fixed Income**

During the last quarter of 2010 we significantly deepened our consideration of sustainability regarding fixed income, undertaking a review of our holdings as well as stepping up bond engagement and investigating new product options. Our renewed emphasis stems from both the financing requirement for the transition to a lower carbon economy and the changing nature of demand for financial products in the investment industry due to the aging population in Europe and the US.

Demographic factors have been driving changes in asset allocations from equities to bonds. This is particularly clear in pensions where investor appetite for risk notably declines in the years up to retirement, while following retirement the need for income takes over from that of capital growth. These financial factors have contributed to an overall increase in the share of total assets represented by fixed income at most European pension funds and many US ones as the numbers of people moving into retirement as a proportion of the population rise. Bond allocations to sustainable and responsible investment (SRI) have grown even faster than mainstream funds, with innovation relating to the types of bonds issued to investors as well as funds available to invest in.

At The Co-operative Asset Management we have long held the view that integration of environmental, social and governance (ESG) factors can have considerable implications for company finances and our internal conclusions are increasingly supported by emerging academic evidence relating to bonds. In the quarter a recent empirical study showing ESG leaders as enjoying reduced default risk and linked to better credit ratings and lower debt costs won the acclaimed Moskowitz prize for financial research[1] confirming previous findings looking at corporate governance and bonds[2]. Various studies also find that SRI fixed income funds perform in line with the mainstream benchmark, with some in fact outperforming mainstream rivals[3].

Our review considered ESG risks and opportunities that might materialise for each of the companies to which we have bond exposure. This highlighted major issues within the banking and utilities sectors where such factors are particularly material, as well as a number of instances where bond and equity investors in the same company face differing prospects.

Banks make up a large part of the investment universe, so the new Basel III banking regulations also have significant implications for bond investors. While the details are highly technical, the clear thrust is to ensure that banks are better capitalised, following the failures that led to the credit crunch. The rules are a key component of the governance of the financial system and this tightening should bring about much needed longer term stability for banks and, over time, the broader economy. From a bond perspective the new rules reduce risk and should be a positive.

[1] "Corporate Environmental Management and Credit Risk", Bauer and Hann, 2010, European Centre for Corporate Engagement.
[2] "Can corporate governance take partial credit for fixed-income performance?", RI Inside Newsletter, November 2009.
[3] "Socially Responsible Fixed-Income Funds", Derwall and Koedijk, 2008.

Funding the Transition

A major new development going forward is the spending required to transition the UK economy onto a more sustainable footing. Areas requiring financing include power generation, electric vehicles, public transport, housing and commercial property, and industrial energy efficiency. The sums of money involved are very large – the Green Investment Bank (GIB) Commission estimated that £550bn of spending will be needed out to 2020, while the UK market for corporate and collateralised debt is £340bn.

For energy markets in particular capital expenditure will have to rise to ensure that the UK has a secure supply of energy that is also low carbon and affordable. With many of our power stations due for replacement over the next decade it is imperative that the government provides a clear policy framework, including such aspects as the requirements for carbon capture and storage and the development of nuclear.

Although utilities only represent around 10% of the bond universe, these issues present a number of concerns for bond holders. It is clear that increasing equity through rights issues will not be able to supply the necessary cash and that the funding demands on bond investors will consequently affect supply and demand conditions for credit, making debt more expensive for issuers. Aside from the credit market dynamics, regulatory uncertainty at the sector level and the risks for companies involved in large construction projects will further increase the returns that fixed income investors will require.

Within the sectors, our investment strategy favours water companies, where projected rises in capital expenditure are more predictable compared to electricity and gas companies. Further, regulated utilities may fare better in the suggested scenarios as regulators must allow companies to make returns on required capital outlays, while companies also have an implicit obligation to ensure their credit rating stays at investment grade which should offer extra protection to bond holders. Revenue and profit streams at unregulated businesses have no such defences and may be exposed to more challenging market conditions, rapid policy changes, or windfall taxation, any of which could result in credit downgrades and attendant bond price falls.

Within this analysis it has been important to consider that bond and equity holder perspectives can sometimes differ. Perhaps the clearest examples of this are when capital is returned to shareholders, often by way of share buyback or special dividend. From a bondholder perspective this capital is no longer available to redeem the bond, potentially increasing risk and reducing the price of the bond. A number of companies have built up cash on their balance sheets during the uncertain times since the credit crunch and there is an increasing prospect that such capital may be deployed in 2011.

Another example of diverging views between the providers of debt and equity holders can be the response to the announcement of new capital spending programmes. These often represent additional risk for bond holders, while equity investors focus instead on the potential rewards available through enhanced revenues and earnings. Such factors may be relevant for transport companies and some real estate investment vehicles in addition to the utilities companies mentioned above.

Further to the integration of ESG considerations into valuation, we are in the process of tailoring our engagement programme to our bond portfolio. This presents a particular challenge in that bond holders do not hold the right to vote at general meetings in the same way that shareholders do. This places greater onus on the process of engagement with company management for the purpose of safeguarding capital and income returns as well as protecting environmental and social stakeholders. Bond managers can enter into dialogue with companies at the development stage, leading up to and including the issuance period, whereas it is ongoing communications that are required. We will be looking to co-ordinate our engagement across asset classes to concentrate our efforts on expanding access to and influencing company management. Ultimately companies have an ongoing need to finance themselves through capital markets, so it is clearly in their interests to maintain a healthy dialogue with both equity and debt holders.

Options for Bond Investors

Finally, there is the question of what sorts of bonds are appropriate for different investors, in particular those that are looking to assist in financing the transition to a more sustainable economy, while securing a reasonable income at a more conservative level of risk than is generally available in equity markets. Such considerations apply both to the bond component of our Sustainable Diversified Fund as well as to some internal holdings.

The types of bonds available for investment by SRI funds fall into three broad categories, of which by far the largest relates to traditional corporate and sovereign notes where SRI funds will typically apply an ESG screen.

The second category comprises specific projects with environmental or social benefits and supranational organisations such as the World Bank or the European Investment Bank have been active in issuing related bonds. This category also includes corporate bonds, which are specifically issued to build green or social infrastructure, such as renewables or rail, and where the bond is backed by the asset being developed. These types of instruments naturally align the environmental objectives of both investors and issuers; however a word of caution is in order: investors will have to have confidence in the environmental credentials of the projects being undertaken.

The most novel and innovative approach includes green corporate bond issuance where repayment terms are linked to specific sustainability objectives. There have been a number of proposed developments including bond issuance with delivery of carbon permits, bonds with coupons linked to the carbon price, and bonds with coupons linked to company ESG performance. Danone is one company in the process of developing the latter type of instrument. It has a stated goal of linking economic and bond performance to a set of ESG key performance indicators so as to reflect the interests of their various stakeholders.

While the last two categories described appear to provide a more direct participation in progressing environmental goals, given that they are still relatively new products they may suffer from a lack of liquidity and higher risk profiles. Therefore the challenge for SRI fixed income investors is to construct a portfolio that retains a relatively conservative risk weighting while contributing as much as possible to important sustainability goals.

Section 4
Recent Developments

The UN Principles for Responsible Investment (PRI)

In November, The Co-operative Asset Management received the results from our third submission to the PRI annual participant survey, covering the calendar year 2009. UN-backed PRI is a voluntary investor initiative comprising of six Principles, aimed at raising awareness of environmental, social and governance (ESG) issues and providing a framework for investors fulfilling their fiduciary duty by integrating appropriate considerations into their investment process. The initiative currently has 861 signatories around the world. In order to remain compliant signatories must participate in the annual self-assessment process. The overall results this year showed expanding utilisation of ESG research within mainstream funds and a growing popularity of themed funds (e.g. forestry and clean tech), while applying the Principles into non-equity asset classes such as fixed income still has room for improvement.

Reflecting the fact that 2009 was the year we received the Financial Services Authority (FSA) licence to operate as a stand-alone asset management company, we changed our PRI signatory status from an asset owner to investment manager; a category where we expected the competition for the first quartile positions to be even tougher. Although it should be noted that the amendments in the scoring methodology and questions (as well as the limited verification of signatories' self-assessment) mean that scores are not necessarily directly comparable from year to year even when staying in the same category, we are proud to say The Co-operative Asset Management ranks in the first or second quartile on all Principles. However, our performance on Principles 1 (incorporating ESG into investment analysis and decision-making processes) and 2 (active ownership) deteriorated as we dropped from first to second quartile.

This was particularly disappointing as we take pride in assessing non-financial aspects throughout the investment process with ESG and financial analysts working closely together to ensure all relevant factors are accounted for. We vote on every resolution of every stock we hold and actively engage with companies to promote more responsible corporate behaviour with regards environmental and social issues. The deterioration of performance is partly because our application of ESG to non-equity asset classes was still underdeveloped in 2009, although we also failed in our submission to PRI to do justice to what we do in these areas. Looking forward, we had already begun to address the extension and deepening of ESG in other asset classes in 2010 by the time the PRI results were announced and we remain committed to ensuring that this remains a priority for 2011 and beyond, not merely because PRI asks it of us, but because it is a logical outcome of an investment philosophy that treats ESG as an indispensable part of our expertise.

On the other hand, following on from our pledge last year to improve our implementation of Principle 3 (seeking appropriate disclosure on ESG issues by the entities in which we invest), we are pleased to have now moved up from third to second quartile on it. This was in no small part supported by our participation in various consultations calling for mandatory ESG disclosure as well as our enhanced attention in engagement and when voting on the Annual Report and Accounts to climate change and diversity disclosure, as reported in several quarterly reviews. We also continued to take further steps forward in applying Principle 4 (promoting acceptance and implementation of the Principles within the investment industry) on which we now rank among the first quartile. We also maintained our position in the top quartile on Principles 5 (working together to enhance investors' effectiveness in implementing the Principles) and 6 (reporting on our ESG activities and progress).

ESG Integration in Private Equity

A good example of our continued efforts for further progress in integrating ESG factors in other asset classes is the newly-formed innovative partnership with the private equity giant KKR. KKR in recent years has become a convert to the school of thought that good performance on environmental and social issues is generally positive for the bottom line and makes for more efficient, risk managed businesses. We've agreed to contribute funding as a Limited Partner towards projects including joint ventures and buy-outs that have promising environmental, social and governance (ESG) potential. What this means is companies where there is an opportunity to derive business benefits by driving up ESG standards through KKR and The Co-operative Asset Management's involvement – or where we support businesses that are already showing leadership in this area. Private equity in general is a form of investment that will be crucial in providing funding to early-stage companies that will offer sustainable solutions such as clean energy and water to name a few. Hopefully, as General Partners like KKR realise there is increasing demand for sustainable investment from Limited Partners, more capital can be steered in this direction.

Investment Themes

This quarter saw a renewed emphasis on investments in telecommunications with purchases of operators and hardware suppliers. Vodafone has a broad spread of exposure to developing markets and will continue to benefit from the enhanced growth available there. Mobile communications are particularly beneficial in developing countries as they help social development at the local level while also allowing economies to leapfrog to the technology rather than installing expensive and resource intensive fixed-line infrastructure.

BT was another name on the list with risks reduced following favourable developments relating to its pension liabilities and permission to roll out super-fast broadband bolstering prospects. Satellite communications company Inmarsat also featured as did Spirent, which provides testing solutions and again has a strong presence in developing markets.

There were additions to holdings amongst extractives, with BHP Billiton and Xstrata purchased by our general funds and new holdings in the Sustainable range of funds of BG, where gas is considered a lower carbon transition fuel, and Lonmin, on account of platinum playing a pivotal role in a number of environmental technologies, as with Johnson Matthey's catalysts.

There was also a degree of rotation amongst industrials holdings, with reductions in holdings of Aggreko, Cobham and Smiths and purchases of GKN, Spirax-Sarco and Rolls-Royce.

Cancún's Can-do and Couldn't-dos

December saw the conclusion of the most recent round of international climate negotiations in Cancún, Mexico. Following last year's failures at Copenhagen, there was very little build-up to this set of meetings. Considering the extremely low expectations there was good progress overall, with some high (and low) lights outlined below. The next round is due to be completed in December 2011 in Durban, South Africa, which is the last meeting before the Kyoto Protocol runs out in 2012.

While the climate appears to have had less media attention this year, progress on capping CO_2 emissions remains of the utmost urgency: the International Energy Agency's (IEA) World Energy Outlook 2010, released shortly before Cancún, confirmed that emissions cuts so far volunteered would likely result in a temperature rise well above 3 degrees Celsius over pre-industrial levels – far higher than the EU definition of dangerous climate change of 2 degrees.

Areas of Progress

Fortunately on this occasion an agreement was reached and ratified by 191 countries and trust has been partially rebuilt after the failure at Copenhagen.

The agreed text, which is far more sophisticated than last year's outcome includes the following strongly worded points:

"[The group of ratifying nations] affirms that climate change is one of the greatest challenges of our time…[and] recognizes that warming of the climate system is unequivocal and that most of the observed increase in global average temperatures since the mid twentieth century is very likely [defined as >90%] due to the observed increase in anthropogenic greenhouse gas concentrations."

Agreement was reached on annual $100bn of financing for mitigation in developing countries to be run as a Green Climate Fund, initially administered by the World Bank and designed by a committee mainly comprising developing countries.

Procedures for verifying countries' greenhouse gas emissions were agreed – something that had previously been a sticking point between the USA and China.

Progress has also been made on the basis for technology transfer to help developing countries move more quickly onto low carbon development pathways.

Finally, the process for arranging credits under the Clean Development Mechanism (CDM, aka offsets) has been streamlined.

Areas Outstanding

It has not yet been decided whether the resulting agreement will be legally binding and whether the Kyoto Protocol will be continued. The latter is likely to be the most contentious area over the next year, with Japan and Canada particularly opposed to continuation as they missed targets and stand to face penalties should Kyoto proceed to a second phase. It is likely that some kind of a 'son of Kyoto' will emerge even if Russia, Canada and Japan take their ball home as the protocol has been the only legally binding international climate change agreement and to dump it would send the wrong signal.

Arrangements relating to Reducing Emissions from Deforestation and Forest Degradation (REDD) have not yet been finalised. The sticking point is that many of the developing countries do not wish REDD to become part of CDM schemes. Indigenous rights are considered particularly to be at risk.

What Are the Implications for Investment?

- Any legally binding global cap, which would get filtered down to caps for countries and sectors, is not a prospect until at least 2012.
- In the meantime, we are likely to see continued national and regional agreements and pressure for companies to make CO_2 cuts.
- We may see the introduction of carbon price reform (possibly a floor) in the UK or Europe in order to maintain momentum on emissions trading post-Kyoto, while entering into a zero free-permit phase for heavy emitters (which is already the case for utilities from 2012).
- Even in the absence of strong carbon trade or taxation measures, innovation is likely to continue in public/private funding mechanisms for low-carbon infrastructure with low risk exposure, for example via subsidies or credit rating. These include entities such as the UK Government's Green Investment Bank or the World Bank or European Investment Bank's green/low carbon bonds/funds.

The Co-operative Asset Management continues to support progress on emissions legislation and financing mechanisms as well as proactive action by companies to reduce footprints.

Contact client services

0845 603 9986

co-operativeassetmanagement.co.uk

tcam@cfs.coop

Please call 08457 46 46 46 if you would like to receive this information in an alternative format such as large print, audio or Braille.

The Co-operative Asset Management Limited is authorised and regulated by the Financial Services Authority. Registered office: Miller Street, Manchester M60 0AL. Registered in England and Wales, number 03858994.

The Co-operative Asset Management Limited provides asset management services to CIS Unit Managers Limited which is the authorised Manager of the CIS range of unit trusts.

Co-operative Financial Services Limited. Registered Office: New Century House, Manchester M60 4ES. Registered Number IP29379R.

Calls may be monitored or recorded for security and training purposes. Calls to 0845 numbers will cost no more than 4p per minute for BT customers. Call charges from other companies may vary and you may want to check this with your service provider.

MKT9956 01/2011