The **co-operative**
asset management

Responsible Investments Quarterly Review

Summer 2011

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

Section 1 **Engagement Update**

Gender High on the Agenda

Following dialogue last year we were delighted to see the latest Annual Report and Accounts of United Business Media (UBM) includes the gender information we asked of them. UBM now commendably provides both a standard breakdown of males and females in the office as well as an analysis of the managerial positions held by each sex along with a comparison with the previous year's data, showing gender mobility.

Our attention now turns to the Financial Reporting Council's (FRC) consultation on whether the UK Corporate Governance Code should be revised to require listed companies to publish their policy on gender diversity in the boardroom and report against it annually. This was a recommendation in Lord Davies' report 'Women on Boards' which was published in February. Prior to completing our consultation we contacted several of our investee companies such as Reckitt Benckiser, with the multifaceted aim of piquing their interest in responding to the consultation as well as to hear what works in practice and what barriers and limitations affect our investee companies.

We will report back on our responses to both the FRC's consultation and the Green Paper on the EU corporate governance framework which asks, amongst other matters, three questions on gender balance in the boardroom. This, in itself, is indicative of the intense focus on gender we are presently witnessing, buoyed by the growing number of FTSE chairmen who have voluntarily committed to bringing more women onto corporate boards under the auspices of the 30% Club, whose inaugural debate we attended.

Fishing for Commitments

Overfishing occurs when fish and other marine species are caught at a rate faster than they can reproduce. Despite widespread awareness of the increasingly perilous state of the world's oceans, we have witnessed the escalating and rapid decline in aquatic biodiversity, wild fish stocks and the marine habitat. Most of the world's most valuable fish stocks are either fully exploited or overexploited.

The state of the world's oceans straddles all four corners of the risks that The Co-operative Asset Management analyses:

Environmental – The strongest demand drivers focus on the insatiable appetite of consumers and seafood merchants for large predatory fish such as shark, tuna and cod. The tripartite accumulation of low reproductive rate, slow growth, and indiscriminate catching methods which remove these fish in the prime of their fertility combined with the high catch rates has resulted in population collapse by as much as 90 per cent of these apex predators at the top of the food chain. There has been a significant decline in shark numbers around the world with the population languishing at a mere 10 per cent of the levels 50 years ago. Sharks now rank amongst the most endangered species on the planet.

When an apex predator is removed species further down the food chain become overpopulated. This has far-reaching consequences such as that seen along the east coast of the United States. In the past 15 years cownose rays have increased ten-fold as there were no sharks to prey on them. As the cownose ray numbers multiplied, the scallops, clams and oysters which form the majority of their diet decreased dramatically. This population boom wiped out the North Carolina scallop fishery several years ago.

Similarly, in a reef-dominated ecosystem, when sharks and other apex predators are removed, herbivorous (plant-eating) fish become overpopulated. Because there are no predators to eat them, these fish over-graze the coral, and the coral can die. With so many species in a coral reef depending on the corals for survival, the whole reef system can consequently go into decline.

Social – Globally, hundreds of millions of people historically dependent on fishing for their livelihoods and food are facing resource depletion as well as competition from mass-scale, global fishing fleets. In many African and South Asian coastal nations fish may supply up to 50 per cent of dietary protein. Livelihoods based on marine ecology can be extinguished as we have seen in numerous instances. Take Chesapeake Bay where oysters were fished into non-existence, or the desecration of the cod stocks off the Newfoundland coast in the 1990s which forced the Canadian government to take drastic measures and close the fishery with over 40,000 people losing their jobs and their way of life for generations. The Newfoundland and Chesapeake Bay marine ecosystems are still in a state of collapse.

Governance – Given the rapid and continual decline of stocks, current fishery practices and management systems are simply not fit for purpose.

Financial – The World Bank has estimated that fish stocks depletion has resulted in real, cumulative global loss of $2.2 trillion of net benefits from inefficient fisheries over the 1974 to 2007 period.

With our long-term orientation we are concerned about the possibility that the aforementioned risks and impacts coupled with the march towards an irreversible decline in fish biomass may have far-reaching consequences, not least on supply chains.

Metro

We met with Metro, Europe's largest retailer of fish and the parent company of the only multiple retailer selling shark meat in the UK, Makro Self Service Wholesalers. We had several concerns about the fish they traded both from an environmental point of view as well as a consumer safety perspective.

The US Federal Drugs Agency and the UK Food Standards Agency, on the advice of the independent Committee on Toxicity of Chemicals in Food, Consumer Products and the Environment and the World Health Organization, have strongly cautioned against the consumption of shark, swordfish and marlin due to the high amounts of methyl mercury. Mercury is highly toxic and distributed throughout the body in the bloodstream over time, affecting the brain, liver and other organs. Due to the effects of bioaccumulation, shark, marlin and swordfish are among the most contaminated fish available.

We discussed the reputational risk posed by the perception that Metro's products are linked to shark extinction which may cause significant damage to the company's intangible assets, and the stance of their peer group who have withdrawn the aforementioned fish from their stores (Asda in 2005 and Tesco in 2009, for instance). In addition, we explored the financial and other implications of withdrawing from the market in shark, marlin and swordfish. In our view, this could protect or enhance Metro's reputation and reduce the prospects of potentially costly future litigation stemming from the high levels of methyl mercury.

We were delighted that Metro's UK subsidiary, Makro, has now de-listed fresh marlin with immediate effect and will cease selling shark products throughout its 30 UK stores. We remain in dialogue with Metro about its purchasing policy and the entire range of exposure to fish.

Mitsubishi Corporation

Mitsubishi Corporation is the world's largest tuna trader and recently published a position paper on Atlantic Bluefin Tuna (BFT), one of the world's most endangered species, inviting stakeholder dialogue. We picked up the baton and spoke with Mitsubishi on a wide range of concerns from capture methods through to the quantities killed and the politics sitting behind the quota decisions.

The effects of BFT trade impact widely across different species. For example, the purse seine nets commonly used capture entire schools of BFT along with anything swimming with them. This often results in a by-catch including other tuna species, swordfish and sharks which are all under significant commercial pressure. Pole and line fishing is considered significantly more sustainable than either purse seine or long line fishing and dramatically decreases the problem of by-catch, yet their usage has not been explored by Mitsubishi.

We echo, with urgency, Mitsubishi's stated belief in its position paper that "*measures need to be taken above and beyond the International Commission for Conservation of Atlantic Tunas (ICCAT)*" to prevent imminent extinction.

However, we were disappointed that Mitsubishi is not leading in this arena and appears to be waiting for the whole industry to move forward together.

The monitoring of BFT stocks and therefore enforcement of fishing quotas has been made more complicated by tuna ranching; BFT are netted at sea, fattened offshore, killed offshore, and flash-frozen onboard ships. Furthermore, the spread of tuna ranching has caused all stages of their life cycle to be targeted. One of the primary areas where quota violations occur is the number of juveniles landed per catch, which end up in the ranches. We were encouraged by Mitsubishi's preparedness to explore the introduction of an anonymous whistle-blowing procedure for reporting exceptions to minimum catch sizes and required practice.

The Co-operative Asset Management will continue to engage with Mitsubishi Corporation on this matter.

Carbon: Time for Action

Carbon Action is a new Carbon Disclosure Project (CDP) initiative which works with investors and corporations to encourage companies to take rational action to reduce their greenhouse gas (GHG) emissions by making investments in emissions reduction activities (e.g. in energy/process efficiency) that have a satisfactory financial return. The Co-operative Asset Management joined the CDP Carbon Action engagement with Global Equity Index Series (Global 500) companies. This engagement brings the focus beyond disclosure to improving performance, with the letter urging the Global 500 to make emissions reductions and identify appropriate investments to support further cuts in the future. The responses provided by the companies targeted will be analysed and results reported to investors for use in engagements and investment decisions.

Due to the lack of GHG emissions disclosure we abstained on the Annual Report resolution at John Wood Group's 2011 Annual General Meeting and wrote to inform them as such. We were delighted to receive a response from the company assuring us that it has committed to participate in the 2011 CDP.

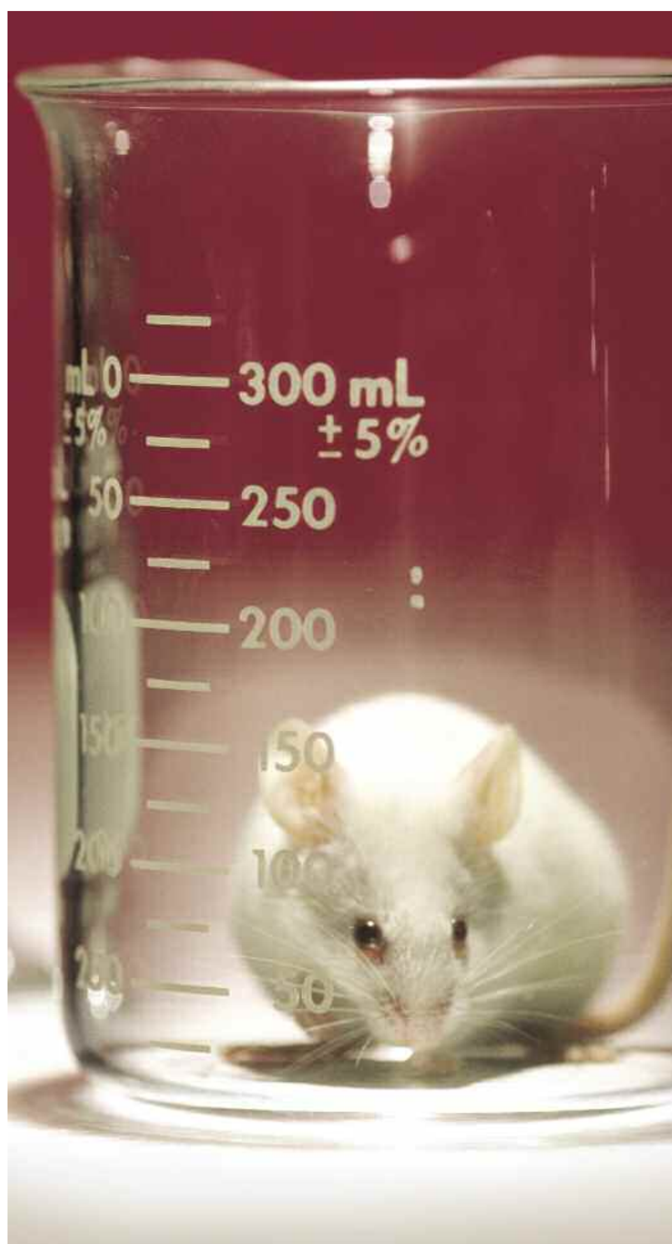
Animal Testing – out of Sight but Not out of Mind

In line with our ongoing efforts to bring an end to non-pharmaceutical animal testing we recently held a conference call with Unilever to ensure it remains suitable for investment in our Sustainable Funds and to press the company to effect change beyond its immediate operations.

Unilever informed us that a vast majority (well over 90 per cent) of its products reach the consumer without any animal testing on materials having been carried out, and that it applies the highest due diligence to animal testing that is required by regulation. We queried whether Unilever will be ready for the EU directive banning the sale of cosmetic products tested on animals, and emphasised the fact that although similar regulation as regards household goods doesn't yet exist, it is equally important to take steps to reduce the use of animals on related processes. The company assured us that there is very little difference in how it deals with cosmetics and household products in this respect and that it will be ready for any EU-wide or national laws in the pipeline.

We discussed the non-harmonised state of product safety testing at the global level and the difficulties Unilever is experiencing especially in countries like Russia and China which are strongly in favour of utilising animals. Different requirements in different markets and the consequent need for duplicate testing is a real cost to the company and it would happily apply EU standards in its operations across the world.

The Co-operative Asset Management urged Unilever to use its power and connections as a global giant to educate and convince authorities in non-EU markets that alternative methods of testing should be accepted and supported. We also encouraged Unilever to integrate considerations relating to animal welfare and development of alternatives in its Supplier Code, and to generally become more transparent when it comes to animal testing issues. We further suggested the company considers public engagement and/or cooperation with BUAV (the British Union for the Abolition of Vivisection) to proactively tackle reputational risks and assist in its quest for uniform global standards.



Banking on Sustainable Emerging Market Finance

Most banks and financial service providers are open to all-comers in the economy and in doing so are also exposed to the whole spectrum of sustainability challenges. Banks need to understand the environmental and social risks attached to the infrastructure they lend to while the re-insurance industry has become the foremost expert on climate change outside the Intergovernmental Panel on Climate Change – because not understanding future weather patterns is not an option for them. Furthermore, biodiversity provides economically valuable 'ecosystem services' such as natural protection against floods.

Expectations are high in the banking and financial services industry for transparent remuneration structures and adequate capital buffers. Will we in future demand to know how the banks' and insurers' financing decisions take account of preserving the natural capital base? Whilst these issues are relevant to financial services providers the world over, sustainability disclosure is far less developed as a board level issue in Asia-Pacific. Yet the economic growth in emerging markets and the prevalence of environmental and human rights problems there arguably make the region a greater priority.

We corresponded with several of our emerging market banks during the quarter, including one of the major Philippine banks Banco de Oro Universal Bank (BDO) and CIMB Group, Malaysia's second largest financial services provider. We asked BDO for indications that their recently approved Social & Environmental Management Systems Policy operated in a robust manner as well as probing into their sustainable energy finance capacity.

CIMB's corporate reporting is less developed than BDO's so our questions to the former focused on understanding the steps that it is taking to capture and report on environmental and social factors across its portfolio and how it may move to a culture of integrating such risks in its lending policies. We also met face to face with Itaú Unibanco to gain further insight into the opportunities and challenges to responsible investment in Brazil.

Investees Upping Their Game on Corporate Responsibility

We are pleased to note that the trend of companies proactively seeking feedback and suggestions for improvement on corporate responsibility (CR) continues. In the past quarter, we spoke with the photography equipment manufacturer Vitec and Croda, a speciality chemicals company, who are both committed to putting greater emphasis on the management and reporting of social, ethical and environmental (SEE) issues.

Vitec is at the beginning of its sustainability journey and The Co-operative Asset Management this year abstained on accepting the company's Report and Accounts due to insufficient disclosure on SEE matters. Our main concerns centred on the lack of reporting on CO_2 emissions and on the shortage of new information, coupled with the removal of sections relating to actual activities above and beyond policy, since last year. On meeting the company, we further recommended that Vitec pays more attention to risks (such as conflict minerals) in the supply chain, introduces targets to accompany its existing disclosure of non-CO_2 impacts, and considers utilising the guidance by the Global Reporting Initiative (GRI) on enhancing the overall SEE disclosure. In light of Vitec's decentralised approach to sustainability management we also pointed out that strengthening the company-wide oversight would likely make it more robust.

A relatively small company, Vitec acknowledges it is a little light on CR disclosure at the moment, however the interest and will to improve came through strongly in our conversation and we are hopeful about seeing some positive developments before long.

For Croda, sustainability is readily embedded in the business due to utilisation of natural raw materials for its products and the company has a good track record of managing and reporting its impacts. However, it is now keen to raise its game, illustrated by the fact that for the first time Croda now has a dedicated in-house CR professional tasked with managing and implementing the strategy globally. Croda contacted The Co-operative Asset Management due to our well-known focus on responsible investing and was interested in exploring how we assess the sustainability of investees and what we expect from companies like it.

We emphasised that integrating sustainability in strategy and operations throughout the company from shop floor to board room is crucial for it to truly work and how it should not be a separate function just taken care of by the CR team. Furthermore, we highlighted that sustainability is not merely about avoiding risks but also about maximising opportunities. Croda found our comments very interesting and admitted it still had some way to go on integration; however the internal buy-in seems to be there and encouragingly the board is getting more involved. With regards reporting, we again stressed the importance of integration as well as measurable targets, and further suggested that Croda considers seeking external verification for its GRI-compliant disclosure.

In our meeting, we also took the opportunity to present some asks and recommendations regarding areas such as responsible raw materials (e.g. palm oil and fish oils) procurement, animal testing, water management and opportunities, sustainability in R&D, biodiversity, the impact of climate change on the sourcing of the plant materials crucial to Croda's operations, and the positive role the company could play in food security. We will continue to follow the company with interest to see what impact Croda's conviction and good intentions will have in practice.

Section 2 **Corporate Governance**

'Get Your Defence in First': Pre-emptive Approaches from Companies Welcomed

As we review the first Annual General Meeting (AGM) season since the launch of the Stewardship Code we were pleased to note a 58% rise in companies approaching us proactively for one-to-one meetings ahead of AGMs and EGMs (Extraordinary General Meetings), and to discuss changes to remuneration schemes and sustainability data disclosure.

The Stewardship Code is part of a wider corporate governance shake-up following the financial crisis, when institutional shareholders were branded "absentee landlords" for failing to engage adequately with the banks heading for collapse. The rules provide shareholders with clear benchmarks for their engagement with companies.

However, we retain our concerns that too many companies have a track record of failing to engage with investors. We always make time to meet with companies to discuss concerns ahead of AGMs. In the same vein, we write to investees after AGMs to explain why we have abstained or voted against and provide a point of contact for future discussions.

In May, we published a list of companies with a track record of not responding to our letters explaining why we withheld support at their AGM due to environmental, social and governance concerns:

Company Name	Concern Raised
Burberry	The Co-operative Asset Management has not supported the remuneration report since the introduction of the vote on remuneration reports in 2003 due to their scant level of disclosure.
Carnival	We have not supported the Annual Report and Accounts (ARA) since 2006 due to material governance concerns such as a combined chairman/CEO with insufficient independent non-executive presence on the board to act as a counterbalance. We are also surprised that there was no disclosure of human rights and labour rights policies for a company of Carnival's size.
Enterprise Inns	We have not supported the ARA since 2008 due to insufficient disclosure on environmental impacts and greenhouse gas emissions. Given the lack of progress and non-responsiveness we have moved from abstention to a vote against the ARA in the last two years.
GlaxoSmithKline	Whilst improvements have been made, we have not supported the remuneration report since 2003. We find the potential pay at circa 800% and 1180% of salary for the CEO and Chairman of Research & Development respectively to be excessive.
Topps Tiles	We wrote to the company in 2009 highlighting concerns on the lack of greenhouse gas emissions data published. Having received no response we voted against in 2010 and 2011.
Xstrata	Thanks to retention awards having no link to performance and the excessiveness of bonuses in periods of downturn, we have not supported the remuneration report since 2003.

One might question why The Co-operative Asset Management continues to inform companies where we do not receive a response. It might just be that they disagree with our objections but don't care to pursue the matter.

Long before the Stewardship Code we believed that it was important to show the same consistency and transparency in our actions that we demanded from the companies we invest in – the fact that some are unresponsive doesn't remove our responsibility.

Building Markets for the Future

Over the last quarter our well-informed readers will no doubt have been monitoring with interest the emergence of public debate surrounding the assertion of 'short-termism' in the economic system. The issue was present before the financial crisis but now has taken a new urgency. The Co-operative Asset Management has participated in the deliberation via our submissions to Vince Cable's Department of Business discussion papers[1,2] and the European Commission's Green Paper on corporate governance[3].

As trustees over our customers' investments we feel duty-bound to contribute. An efficient capital market transfers today's savings into tomorrow's investment and growth thereafter. Short-term approaches jeopardise this enlightened chain of interests. To paraphrase Andrew Haldane of the Bank of England, if promised returns the day after tomorrow fail to induce savings today, there will be no investment tomorrow risking long-term growth and welfare.

We see this as more than just about the functioning of the economic system but something that speaks directly to the sustainability challenge society faces as a whole. There is much at stake: investment in the technologies of the future that will help society mitigate resource depletion, social unrest and damaging climate change require much longer-term investment horizons. This necessitates a market infrastructure that appreciates 'natural capital' such as the world's aquifers, biodiversity and other resources in the same way that it does traditional 'capital efficiency'.

But what do we mean by short-term?

In the pejorative sense it is a pattern of behaviour, exclusively focussed on short-term gain with no regard to how individual, cumulative and collective short-term decisions end up causing net harm to beneficiaries' long-term interests. Conversely, we define a long-term approach as one which is providential and seeks to be judged by delivering a net benefit over many years or decades as appropriate with acceptably smooth returns, rather than being judged to have succeeded or failed based on one quarter's results alone.

It is at this point that die-hard defenders of the Anglo-American, principle-agent model of governance will point to one of the founding reasons for the creation of stock markets: to enable the time horizons of investors to be divorced from that of the firm in which they invest. Diverse investment horizons, whether investing for next year's summer holiday or a mortgage deposit 10 years down the line, contribute to the liquidity of markets and therefore lower transaction costs and enhanced competition for corporate control. So, no problem then?

To avoid needlessly explaining the complexities of capital valuation techniques we'll use the analogy of the 'required rate of return' (RROR) in light of the understood risks to our investment. All the nuts and bolts of valuation and, more specifically, the RROR, alters quite significantly depending on your investment time horizon. With perfect information, and perfect markets, such would be the diversity and quantum of investors that the sum of those calculations and RRORs would converge on a fair net present value. But what if, as an extreme example, 90% of a company's investor base valued the company on a need to realise a return within only one year?

[1] The Department for Business, Innovation and Skills. The Future of Narrative Reporting.
[2] Ibid. A Long-Term Focus for Corporate Britain: A Call for Evidence.
[3] The European Commission. Green Paper: Corporate governance in financial institutions and remuneration policies.

Markets understandably attach much greater credibility to the delivery of near-term cash flows as they carry a higher degree of certainty. So the announcement of a major capital investment programme would need to be very well communicated to drive short-term share price performance.

Now, to be clear, this is an over-simplification. However, what we can point to is increasing evidence from the Bank of England[4] that average holding periods are decreasing and investors are discounting expected cash returns excessively when forecasting over prolonged durations. In other words, the average investment horizon is shortening, thereby altering the RROR valuations.

But the question is whether this translates into changes in management decision-making and if so, does it veer our society away from tackling important longer-term considerations? We certainly know that a tremendous amount of the accrued CEO wealth is held in shares. We also know that a large amount of executives' performance pay is determined by reference to the share price over rolling 1-3 year periods. This perhaps reinforces findings in the US that senior management are fearful that long-term capital investment decisions regarding, for example, research and development (R&D) will scare investors due to the high up-front costs.

A survey[5] of 400 executives found that a staggering 80% would decrease spending on items as diverse as R&D, advertising, and maintenance in order to meet short-term earnings targets. Approximately half also indicated that they would mothball projects even if it meant sacrificing genuine value creation over the long-term. The tendency of markets to overreact to short-term bad news only reinforces timidity and decisions based on avoiding criticism rather than creating long-term value. This is not dissimilar to the dilemmas faced by democratically elected governments seeking to ensure re-election.

This is an incredibly important issue for The Co-operative Asset Management as it undermines those taking long-term investment approaches as well as influencing management decisions that ought to eventually support that long-term conviction approach, ultimately risking the future health of the economy and society.

The decision of whether to buy or sell can therefore be judging the balance between fair value, which can take longer to achieve, and simple market momentum. Because of this, not only do we seek to invest in sustainable companies but also believe that as stewards we ought to engage with investees so as to buttress governance systems and engineer them toward a long-term focus. These are systemic and company level issues. Accordingly, in our submissions to various consultations we have highlighted the design of pension fund mandates and the important role of investment consultants in advising asset owners as well as focusing on important company level governance reforms. In our engagements with companies we have pushed for management to be rewarded for both financial and sustainability performance, and for executives to have longer performance appraisal periods and to be required to hold realised shares for longer. In the same vein, we have called for bonuses at banks to only be awarded where the credit quality of the business remains healthy. In the coming quarterly reviews we will continue this discussion by expanding on why these are important governance reforms for the companies, the capital system and, of course, our customers' investments.

The Mysterious Case of the Missing AGM

It would appear that one of our investee companies Talbex Group, listed on the PLUS market, failed to hold an AGM in 2010. As the AGM is one of the most important channels for shareholders to hold the board to account we were understandably alarmed.

We spoke with Talbex prior to the 2011 AGM and subsequently wrote to the company secretary to clarify the situation around the legal obligation to hold an AGM stemming from s 336(i) of the Companies Act (2006) which is binding on all companies.

Owing to the lack of a response and the unprecedented situation we raised the matter with other institutional shareholders as well as Companies' House, and also contacted the PLUS market regulator who are investigating.

Global Governance Update

We recently wrote to the Economic Advisory Council of the Prime Minister of India to highlight how we consider their removal of the ability to vote remotely – via a proxy – to be a material impediment to and erosion of shareholder rights. We own equities in companies across the globe and without having the ability to cast our votes by proxy we would simply not be able to vote which is clearly highly undesirable. We emphasised how we strongly disagreed with the recommendations of the Standing Committee on Finance to remove the rights of shareholders to appoint proxies.

As mentioned in previous reviews we are involved in the 5th Analyst initiative that encourages US companies to co-chair a conference call with investors to discuss corporate governance matters as reflected in their proxy circular. The first company to rise to the challenge was Occidental Petroleum who held its inaugural 5th Analyst call in April with the lead independent director and the chair of the remuneration committee in attendance to answer shareholder questions. We look forward to more of the companies we have approached about the initiative making themselves available to discuss governance matters.

The Singapore Stock Exchange (SGX) consulted shareholders over changes to its rules for General Meetings with a view to increasing shareholder engagement and enhancing corporate governance practice. We fed back that we were delighted to see the announcement on June 2, 2011 that SGX was proposing a requirement for all listed companies in Singapore to vote by poll at their shareholder meetings. We are strongly in favour of this and commend the companies who have already taken steps in this direction. We further took the opportunity to reiterate our support for and the benefits of the Sustainable Stock Exchange initiative that we are involved in.

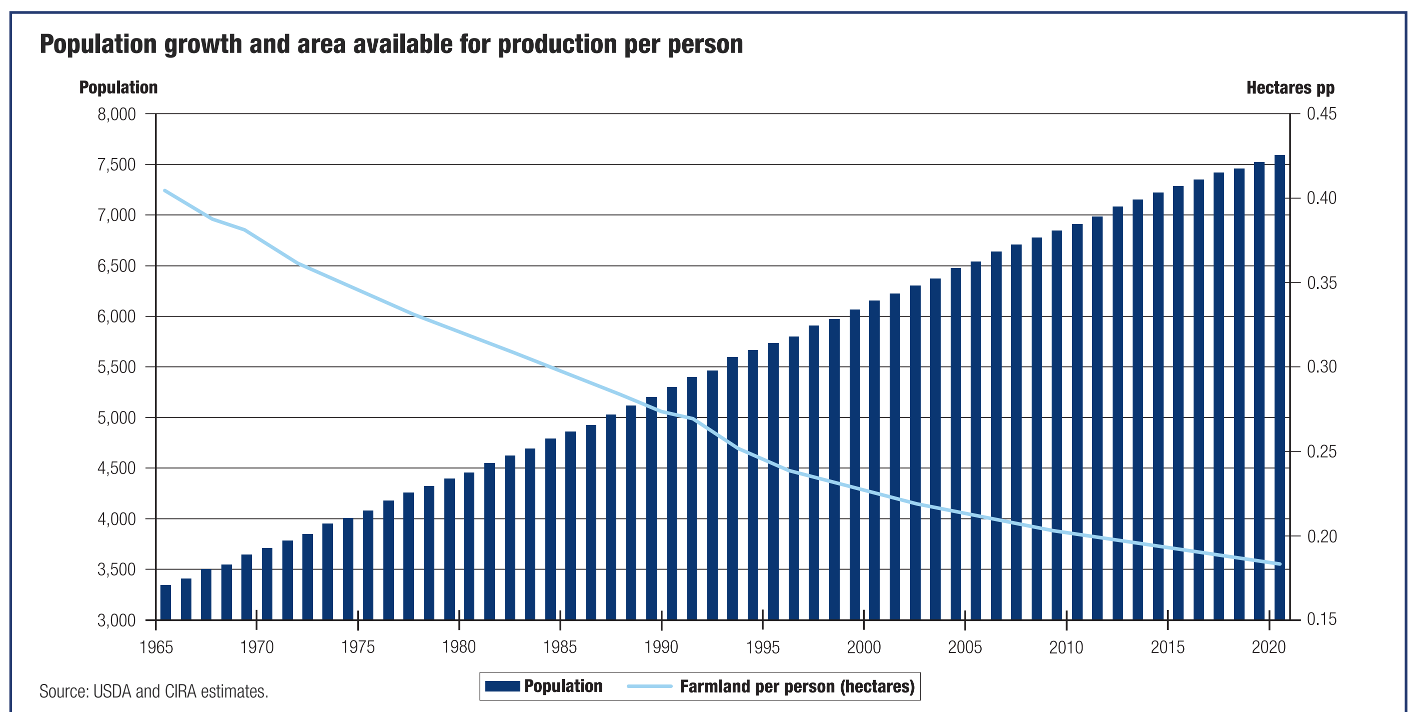
[4] Bank of England. Speech: The Short Long. Andrew Haldane, Executive Director, Financial Stability, and Richard Davies.

[5] Breaking the short-term cycle, CFA Centre for Financial Market Integrity/Business Roundtable Institute for Corporate Ethics, 2006.

Section 3 **Food Prices: Anything New under the Sun?**

Reading the newspaper headlines about fears over food and water shortages those old enough to remember will be forgiven for thinking it's the 1970s all over again, when The Club of Rome's 'Limits to Growth', oil price shocks, and Paul and Anne Ehrlich's 'The Population Bomb' made dire predictions of impending societal collapse as demand for natural resources driven by population growth was about to outstrip supply. They drew upon a gloomy English geographer of the late 18th century, the Reverend Thomas Malthus, who postulated that population growth naturally increases exponentially in relation to food supply, implying famine would always haunt our finite planet, keeping population in check. However, the wonders of the industrial revolution and the productivity brought by fertilizers and mass agriculture cast Malthus as an unimaginative prophet of doom. Likewise, new exploration techniques allowing us to reach obscure sources of oil and other minerals meant Ehrlich et al. lost the bet that the world would be on its knees by the 1990s. Now, as food insecurity is widely predicted to become a fact of life, Malthusian ideas are back in vogue.

Population growth and area available for production per person



Source: USDA and CIRA estimates.

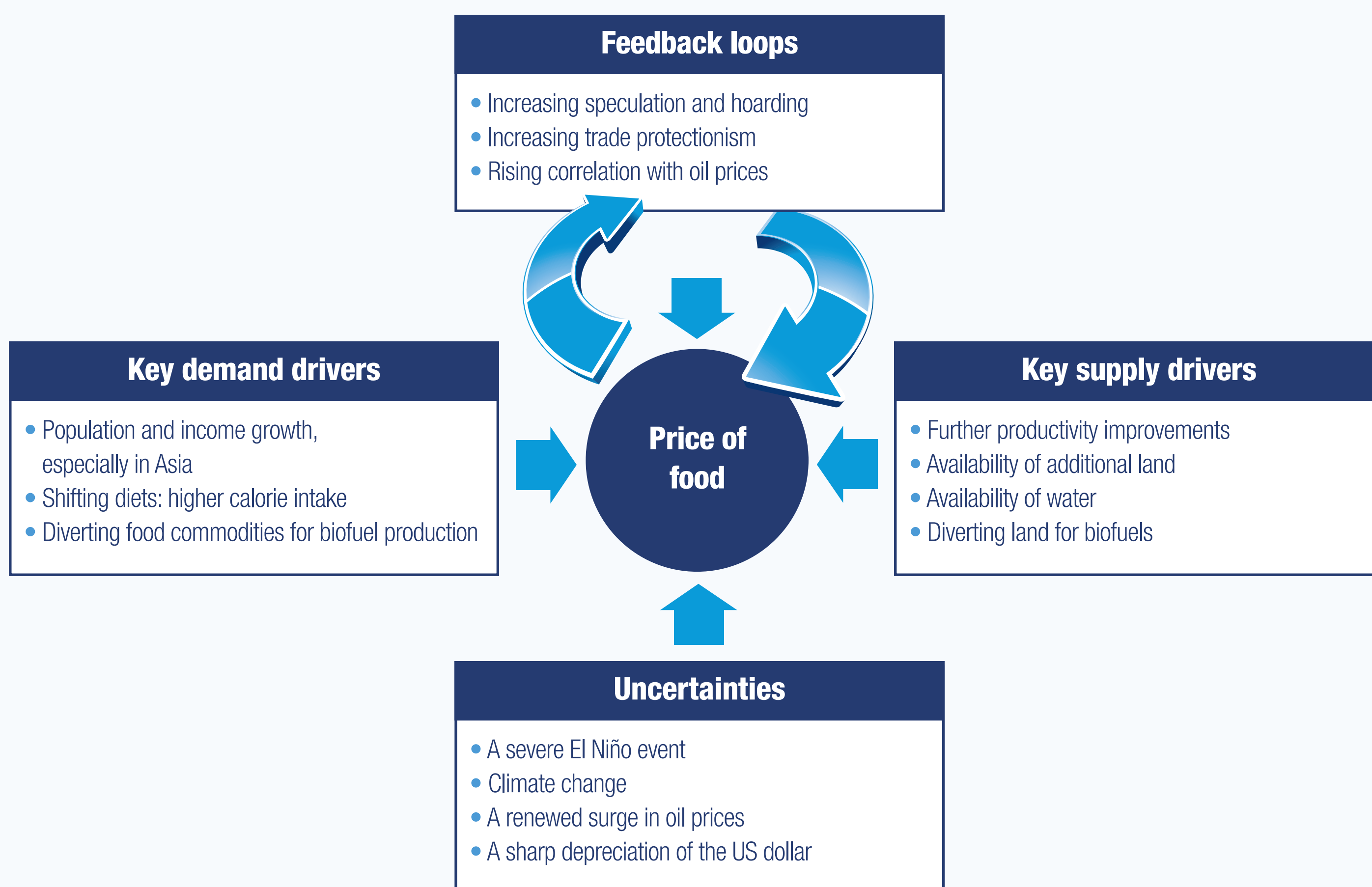
The bald facts are that three billion extra mouths are expected to be added to the world's population by 2050. Cultivable land and water are in short supply while agriculture is a major contributor to the climate change that undermines it. Should we take comfort in history as a guide or worry that this time it will be different?

In December 2010 The Co-operative Asset Management took a sober look at the fundamentals of the food system. The basics - supply and demand - are predictable and simple but straightforward answers proved elusive, as ever. We looked at supply and demand in the context of ecological constraints, inputs (e.g. fertilizers, diesel, pesticides) and outputs (e.g. food production and greenhouse gases). We examined the interrelations between them and the 'levers' society has left to pull in order to try and keep demand and supply more or less in balance, all within the confines of tolerable environmental and social limits. These levers included technology, among them genetic modification (GM), resource efficiency and expansion of land cultivation. Set against them were competing needs such as demand for biofuels and the need to preserve biodiversity for economic as well as moral reasons.

The history of the relationship between supply and demand in commodities is a fairly normal cycle of boom-bust leading to correction. Since the agricultural revolution of the 1950s and 1960s the general trend has actually been deflation in real prices for food as supply has outstripped demand. This was reversed with the severe shock in the 1970s (the oil crisis) and inflation since the beginning of the 21st century, spiking in 2008, due to weather and oil price surges.

The questions, as predicted by diverse quarters, are i) whether the recent trend to food price inflation is here to stay because of new drivers to demand and supply and the inelasticity of demand (people have to eat and don't like to cut back); ii) how might a correction occur; iii) what actions can be taken to induce re-balancing of supply and demand; iv) what are the push-pull effects in the triangulation between increased food production, fossil fuel based inputs and climate change; and v) whether technology, agricultural and economic reform can break this triangle?

Drivers of global food prices



Source: Nomura Global Economics.

Demand

Forecasted global population growth is 33% by 2050 (though the growth rate is slowing), most coming from emerging markets where nascent middle classes will add more in number and calorific intensity to global food demand. This multiplier effect is estimated by one account to lead to global demand growth of 50% in calorific equivalent. The demand for biofuels may exacerbate demand for food where competition for land is at stake, though it's likely to be a localised problem. Finally, increased demand for protein, primarily through meat as diets scale up, has a disproportionate impact on the need for land and agricultural feedstock to feed some animals (mainly cows).

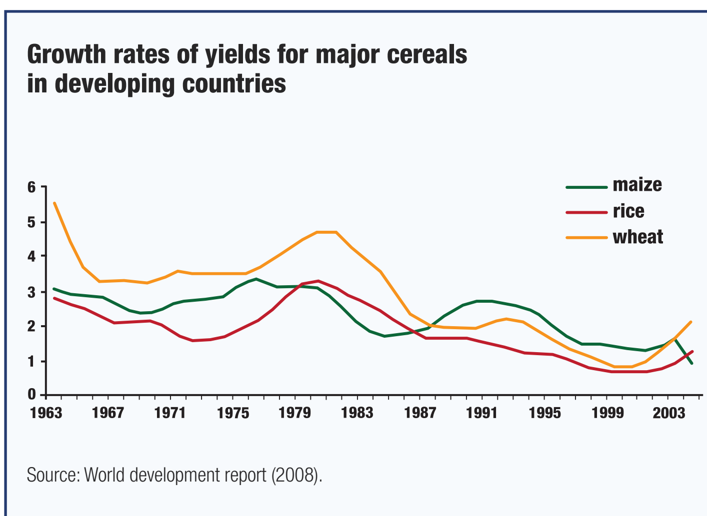
Supply

The key components which could increase supply are land conversion, improved labour productivity, increased use of inputs (water, fertilizer, pesticides), climate effects and feedbacks (also a factor of demand), and technology application. There is both potential and problems for each of these:

Land conversion & labour productivity

Productivity growth has, on average, been gradually declining since the 1960s (though this trend has begun to be reversed in the last decade).

Growth rates of yields for major cereals in developing countries



Source: World development report (2008).

Half of suitable land cover for crops not already under cultivation is mostly forest whose clearance removes a carbon sink. The picture for land quality is mixed; 20% of degraded land is cropland while 16% is improving due to human influence. The agricultural revolution that fuelled the baby boomer generation saw large increases in yield from relatively small areas whereas productivity has been weakest in Africa, for example, suggesting some headroom left, but not without social and climatic problems. The overall picture is that theoretically there's room for additional conversion in the order of 10% to 20% to 2050; most of which will obviously come from 'under-cultivated' regions. However, a simple arithmetic read-through from the first agricultural revolution is not a good idea: newly available land will tend to be either marginal, involve deforestation or come with political and social tensions attached – as seen in the controversy caused by foreign purchases of land in Africa and Australasia. It will also have knock-on effects for 'input intensity' and climate.

Resource inputs

The cost of agricultural production is strongly correlated to the price of oil, both as a direct input (diesel) and indirectly as most fertilizers and pesticides depend on oil and gas. The International Energy Agency forecast for the oil price out to 2035 is north of $100 per barrel (where it has hovered in recent months) assuming increased demand, production failing to keep pace, and the absence of alternative inputs. GM as a substitute for some pesticides has kept prices in check. In fact, it may be more profitable for farmers in some regions to convert for biofuels rather than food (estimated to displace c.3-4% of land for food). This will add to food cost volatility though it may provide some relief on the oil price.

Effects of increased climate change on food

The effects are still quite uncertain, though an 'average' impact would be meaningless as climate change will have sharply different repercussions in different regions. Estimates of increases in time spent in drought versus the last 30 years vary from 11% to 20% depending on a 0.5 degree centigrade variation in either direction in mean annual temperature. Climate change may actually open up new regions such as Siberia and Northern Canada to increased production, and indeed the presence of extra CO_2 in the atmosphere will cause additional growth spurt under clement conditions, possibly even creating net growth. Semi-arid regions on the other hand are likely to be subject to desertification while humid regions are expected to see intensification of precipitation. What we didn't appreciate before the study was that the yields of important staple crops like maize, wheat and rice, and other important commodities like cotton and soy are highly susceptible to small bouts of above average temperatures. Even climate scientists can't make a confident call on what the climactic impacts will be but the theme that dominates the scientific projections is volatility. The ability of farmers to cope and respond to localised effects varies enormously. They will either invest to adapt or leave for the cities, leading to food price inflation and starvation in some parts.

Impacts of increased food production on climate

Agriculture is estimated to account for some 20% of global CO_2 emissions; fossil fuel and fossil fuel-derived inputs are carbon intensive and tilling reduces the soil's capacity to retain CO_2 (not to mention transport, packaging etc). A growth spurt similar to that witnessed under the agricultural revolution based on business-as-usual inputs would set back efforts to reduce absolute emissions and induce both positive and negative feedback loops, increasing volatility.

Technology

GM is hailed in some quarters as the answer to hunger. It holds out the promise of de-linking from expensive, natural resource-bound inputs and the potential to build in hardiness to extreme weather, poor soil and pests in a fraction of the time this takes with conventional cross-breeding techniques. There is hypothetical merit in this argument, however to date GM has not been used for these purposes. There is powerful commercial logic for agri-pharmaceutical companies to concentrate on large-scale, single-crop (monoculture) farming tying seed to a particular spray. While this may indeed prove positive for yields, it works against smallholding subsistence farming and in favour of urbanisation, displacing a number of food producers to simply being food consumers.

This places even more dependence on efficient, uninterrupted and equitable food distribution to alleviate hunger without taking account of the distorting impacts of trade subsidies and speculation. While rich markets will bear quite a lot of food price inflation, poor markets cannot. Existing alternative technologies (or non-technologies) such as planting varied crops among each other (polyculture) and organic show some promise of reducing expensive inputs but the lack of investment in this area means there's little evidence to judge whether these can be scaled up enough to make a big difference.

Implications for food prices

Against a backdrop of increasing demand the supply constraints presented by resource depletion, restrictions on land conversion to agriculture, increased competition with biofuels and the forced adaptation response to climate change will place great pressure on productivity improvements over the coming decades, leaving aside the requirement for agriculture to play its part in mitigating climate change. With stretched government balance sheets in most jurisdictions, enhanced productivity is only likely to be possible with prices high enough to attract continued investment.

Conclusions on food availability

The complexities and inter-linkages of the food system with other markets make forecasting difficult. The picture for demand seems clear, while there are likely new factors complicating the supply picture at a time when productivity growth has been declining. This sets the stage for price increases to destroy what is, in fact, surplus demand: when the price of oil got to $149 per barrel in 2008 Americans drove less and bought cars with smaller, more efficient engines. In some markets this may mean rationing, agricultural command-and-control practices, and alteration of subsidies and tariffs. For poor countries lacking basic self-sufficiency, however, starvation is a realistic prospect.

Though sheer availability may become an issue in the future we caution against the fallacy that there is presently not enough food to go around: there is more than enough food in the world to feed everyone, but obviously it is not distributed and consumed efficiently (or justly). Is the continued intensification and industrialisation of agriculture viable in the long-term? Clearly not. The difficulty is to find solutions that don't create longer term problems. Continued land conversion is not viable. A long term continuation of the rapid growth of biofuels is not viable.

Interventions

So we've seen the challenges. What can be done, or even not done about it?

Masterly inaction?

A laissez-faire approach to what is at its simplest a mismatch between growing demand and insufficient supply would suggest that, based on history, a natural correction will occur. This could involve over-stimulation of supply to meet demand, leading to a big fall in prices, going back to the boom and bust cycle, albeit leaving us at historically high prices. This would not be without tragic human consequences: demand for food is far less elastic and the physical constraints and positive feedback effects on boosting supply (i.e. climate change) limit room for manoeuvre. In this scenario, population growth and mortality from food shortages and policies around these remove unsustainable demand (however horrible to contemplate). Avoiding this callous situation is what has led David Attenborough to be a patron of the Optimal Population Trust, which seeks to promote humane methods of keeping the global population within planetary means.

Technology, technology, technology?

In such supply/demand situations in the past, not just in the realm of food but where other hurdles have had to be overcome, technology has been the means to break the deadlock. There are a number of tools available, including GM and alternative farming methods, but we've seen that it's unclear how much they can bring to the table. The first agricultural revolution was largely state-directed whereas most research in the developed world in this area is privately funded. Partnerships are needed between governments and the private sector to direct funding towards local food security in a way which is still profitable for companies.

Can't we just fix the flaws, and not go back to the Stone Age?

Often neglected is the issue of trade and economic reform: it's a common misconception that there is not enough food at present to feed the population (this is a problem of the future rather than the present). The problem historically is one of distribution, price distortion and, as a result, waste. Just like energy, there is much that can be done to ensure what food is made is what's required and that it is used efficiently, not to say distributed justly (food being a basic requirement of life). In the event of a food crunch, it's more straightforward for most sovereigns to introduce market reforms based on national borders to secure the bare necessities than re-revolutionise the food system, though that in time will likely become a necessity too. In this way, the analogy to energy security and climate policy change holds up: efficiency first, radical change later. Even so, such reform (or reactivity) would cause temporary volatility both in prices, populations and land-use.

We hope that we've set out the challenges facing us in a fact-based and holistic way. It is now for us as responsible investors to play our role in tackling the dilemma, starting with exploring the following questions:

- What should we invest in from a purely financial perspective for unscreened funds?
- What are the implications for screening and how do we invest in solutions?
- What should we be engaging and lobbying on?

We will report back on our tentative answers in the coming quarterly reviews.

Section 4 **Recent Developments**

Sustainable Palm Oil – Contradiction in Terms?

Palm oil is an in-demand commodity and accordingly a tempting investment opportunity but its potentially destructive impact on the environment presents responsible investors such as The Co-operative Asset Management a significant dilemma. When recently considering our stance on this burgeoning market the key questions were whether palm oil can ever be sustainable and what should we take into account when assessing its suitability in our portfolios.

A lot of precious rainforests are chopped down to make land available for oil palms which can only be grown on the narrow strip around the equator. Accordingly, the production of palm oil is generally considered a negative activity environmentally, not to mention its various social impacts: displacement of native farmers and theft of land; low pay and poor working conditions on plantations; and 'cash crops' replacing produce previously cultivated for local consumption. The end product's less than wholesome nutritional profile has also raised concerns. However, after consulting experts we concluded that managed responsibly palm oil can indeed be grown in alignment with our social and environmental standards – in a word, sustainably. Interestingly, while on health grounds more preferable alternatives for certain uses may be soy, rapeseed and sunflower oils, the cultivation of all of these has an inferior energy balance (i.e. input energy vs. output energy) to palm oil which also produces up to 10 times more oil per unit area than the others. That is, to produce a certain volume of vegetable oils fewer trees need to be felled and less land dedicated to production if the crop consists of oil palms.

We then turned our attention to stock-level analysis, namely looking at New Britain Palm Oil Limited (NBPOL) whose environmental and social credentials seemed to indicate that the company takes its responsibilities seriously. NBPOL is the world's leading producer of sustainable palm oil certified in accordance with the Roundtable on Sustainable Palm Oil (RSPO) Principles & Criteria and meticulously manages the traceability of its supply. It is committed to core International Labour Organization (ILO) standards, decent pay, and carrying out social impact assessments, as well as supporting the wider socio-economic development in Papua New Guinea and Solomon Islands where it is the biggest single employer.

Given the negative image of oil palm plantations, we set a gruellingly high bar for NBPOL to stand a chance of admission to our Sustainable Funds. We approached them with questions covering areas such as oil palms' impacts on soil productivity, erosion and biodiversity; the origins of the land converted to palm oil production by NBPOL; the company's efforts to help improve standards in the wider industry; and its progress on the target of 100% of NBPOL fruit being RSPO-certified. The company provided us with very informative and honest responses, leading us to conclude that NBPOL appears to have a thorough understanding of its role and responsibilities, both in terms of the natural environment and the affected communities, which is likely to help it manage and minimise its impacts in both short and long term.

Moving to business-critical environmental issues beyond NBPOL's control, we further queried whether the company had considered the risks relating to climate change to its plantations. Considering that oil palms can only be cultivated in specific conditions around the equator, we wondered if this makes them susceptible to changes in temperature, humidity or rain patterns which climate change may lead to, and if such changes could affect the yields. Furthermore, we asked if the plantations were based in locations prone to natural hazards, and whether any are in coastal areas, hence putting them at risk of rising sea levels and/or tsunamis. NBPOL found these questions very thought-provoking and went into great detail in producing maps of the locations of its operations – including how natural hazards may or may not manifest themselves there – and statistics comparing the (optimal) conditions that its oil palms are currently grown in with less-favourable climates. It agreed that these kind of factors are of material relevance to the viability of the business and thanks to our engagement intends to discuss them further in future sustainability reports.

Taking everything into account, we were satisfied with the robustness of NBPOL's environmental and social management and preparedness, and estimated that the resilience and location of its crops would likely withstand the plausible challenges posed by climate change and natural hazards that could otherwise jeopardise our investment. We also believe NBPOL is well placed to benefit from future sustainability-related legislation, incentives and consumer preferences expected to affect the palm oil industry.
As regards health implications, while we don't encourage people to eat fatty foods, we accept that to an extent there is a role that oils must play in today's (and tomorrow's) diets, especially when they are difficult to substitute. It then follows that we would, so far as possible, like to see people using supplies that are towards the healthier end of the scale and have the least negative impact on the environment. As such, a responsible operator like NBPOL producing the most energy-efficient vegetable oil is to us an acceptable way of meeting the world's dietary needs and our Sustainable Leaders Trust has now invested in the company.

The Co-operative Asset Management recently also contributed to WWF's survey on investors' due diligence and decision-making process when it comes to palm oil-related opportunities, feeding back what we consider best practice, what kind of information we require from companies prior to investment, and how we relate to RSPO. We will continue to closely follow developments in the field, encouraging all investees directly or indirectly involved in the palm oil trade to take all possible steps to ensure that cultivation is managed with respect to the needs of the local population and the natural environment.

The Co-operative Sponsors Report into Sustainability Assurance

Vodafone was ranked top of the pile in a new Carbon Smart report 'Benchmarking Assurance of Sustainability Reports in the FTSE350 - Year 2'. The report ranked the FTSE 350 according to whether the level of assurance covered sustainability data and found that only 68 companies offered such a statement.

We are the only investor to sponsor this report and strongly believe that it is essential that companies improve their reporting of sustainability activity whilst ensuring that this is verifiable through robust assurance processes. We would not accept un-audited financial statements nor can we comfortably rely upon an unsubstantiated sustainability report.

Just as disclosure on sustainability matters is often taken as a proxy to the level of awareness on the issue, assurance of that data provides investors with the necessary confidence in respect of the quality of information. The push for improved reporting and disclosure goes hand in hand with assurance.

The Carbon Smart report also looked into which companies provided assurance for carbon data, identifying British Sky Broadcasting, British Land, Amlin and HSBC as the top four. Mandatory carbon reporting is a vital step to enable the UK to decarbonise its economy and meet its targets under the Climate Change Act, and also to deliver on its international obligations. Investors' appetite for emissions data is growing and requires improved reporting to better understand climate change risks and opportunities. We recently lent our input and support to the Co-operative Group's call on DEFRA to make greenhouse gas reporting mandatory for all large UK public and private companies in response to the government department's consultation.

As end users of sustainability reports we welcome the additional weight carried by the assured companies' validation statements. There is a considerable reputational risk in disclosing misleading data and sustainability assurance keeps in check the value and authenticity of the data published by companies.

Part of our governance of sustainability project is to press companies to integrate sustainability metrics into executive incentives and we welcome the growing number choosing to introduce such measures at the highest levels. Assurance has an underpinning role to play as we would not want companies to be basing bonuses on performance measures that are not covered by the appropriate verification.

The Carbon Smart report has acted as a good starting point for our work on assurance and dovetails with our efforts on improving reporting and ultimately sustainability performance.

Investment Themes

A sound investment theme is a sound investment theme. Here we take the opportunity to once again highlight how sustainability-themed investment ideas are not restricted to our Sustainable Funds but inform our thinking and investments across the piece and also in the opposite direction; from general funds to Sustainable Funds.

Among our top ten purchases for the quarter was Pearson, where we see opportunity in the company's leading position in digital education (its innovative content for iPads, for instance) with good exposure to emerging markets, where spend on education is set to increase over the medium term as more people join the ranks of the middle class and companies need access to educated workforces. Research by Bank of America Merrill Lynch notes that in India "the adult literacy rate will rise from 48% in 1990 to 80% by 2020: aided by both private and public sector initiatives." We identified Pearson as one of the beneficiaries of the sustainability agenda in our 2010 Good Companies Guide.

We also increased our holding in Tate and Lyle, a company synonymous with sugar but which has divested its raw commodities business to focus on value-add food additives. There is an increasing demand for derivative and alternative additives in foodstuffs that maintain their taste while increasing nutritional quality, or at least reducing less healthy aspects. A good example is Tate and Lyle's Sucralose product, driven by the need to respond to the obesity 'epidemic'. The company's concentration on these markets puts them at one remove from the inflation experienced lately in the soft commodities markets, offering some insulation from cost shocks; issues we have addressed in this review in our report on the food system (see Section 3).

Finally, we initiated a holding in Essar Energy. While investing in a power company in India based on burning coal sounds like an odd way of integrating sustainability, the difference here is that it was precisely our concerns around the likelihood of greater demand in India for cleaner air and lowering emissions intensity that led us to significantly lower our valuation for Essar, our engagement with them having revealed that their assets are not state-of-the-art in terms of clean coal. We also had concerns over family-dominated governance and political interference in India on environmental grounds, Vedanta being a recent case in point. But when the share price fell far enough to hit our heavily discounted target price we bought it, because we think it represents good value for money. But at least hopefully we've paid the right, lower price for it taking into account ESG risk. Now that we have a stake in Essar we will use our ability to engage more heavily with the management to get them to focus on how they can help us remove that discount – by being more forward-thinking about environmental standards and regulation. The nature of the company's activities mean that it is not permitted in our Sustainable Funds, however.

We reduced our holding in Reckitt Benckiser when the company triggered a governance red flag: its feted (and highly paid) chief executive Bart Becht unexpectedly announced he will leave the company later this year with little explanation, which followed the recent departure of the Finance Director not long after completing two significant acquisitions. Their departures may be co-incidental and the real reasons unremarkable but this situation has raised the risk profile for now.

Meaningful Water Disclosure

We attended the UN Global Compact Week in Copenhagen in May, speaking at a panel at the CEO Water Mandate working conference. CEO Water Mandate is a UN-affiliated initiative by business leaders in partnership with other stakeholders, with a focus on developing strategies and solutions to contribute positively to the emerging global water crisis. The aim of the meeting in May was to better equip companies to manage and disclose water risk and also to indicate what they can expect in terms of how investors and NGOs might evaluate this. The main objective was to understand issues around corporate water disclosure to guide the way forward, with the other priority workstreams – water as a human right and public policy engagement – playing second fiddle on this occasion.

The Co-operative Asset Management was the only UK-based investor in attendance and we took the opportunity to express an investor perspective by putting out a wish list for what kind of water disclosure would be useful and meaningful for us going forward. We strongly feel that the proliferation of standards is not in anyone's interest and don't want questionnaire fatigue or bureaucracy getting in the way of companies actually acting on water issues. More focused, standardised and consistent questioning would produce better informed answers from companies as they would have the chance to concentrate on what really matters, thereby enabling stakeholders to move from rating disclosure to assessing performance. Common language, definitions and metrics need to be agreed on to further support this goal and to enable benchmarking at least within sectors if not across them. Yet we noted that, unlike with CO_2, a unit of water doesn't have the same impact/importance everywhere in the world and this should be reflected in the form of disaggregated data and risk mapping, and by explaining data with reference to the local context.

We called for reporting that is more about strategic rather than philanthropic efforts, and recommended increased utilisation of assurance and verification of data, which would give disclosure crucial credibility. Moreover, we advocated a move away from concentrating only on risks to also identifying and describing opportunities that water stress may present companies - investors don't only want to avoid losers but put their money in those set to benefit as solutions providers. We will continue to engage with relevant companies to achieve progress towards the aims above, thereby not only improving the reporting we utilise in our analysis but also helping our investees mitigate water risks and capitalise on opportunities emerging in this space.

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.

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