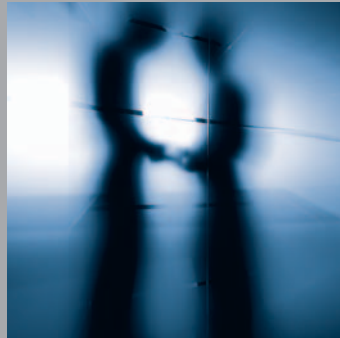


re^o Report

F&C Investments

1st Quarter 2006



In this issue...

- F&C blankets 4,000 companies with updated policy mailing
- Feeling the heat: Should funds disclose their votes?
- Canaries and coal mines, apes and jungles: Supermarkets in the hot seat again
- Drugs and money: Spotlight on the pharma sector
- Shopping for the future: The challenge of the Big Boxes
- Human Rights and Business: The UN tries, tries again

F&C
Investments

Expect excellence

Our philosophy

reo® stands for Responsible Engagement Overlay

The objective of reo® is to use the influence that F&C has through the share ownership of its clients to encourage investee companies to enhance their business performance by adopting better corporate governance, social, and environmental practices. F&C believes that it can better serve its clients, and

protect the value of their shareholdings, through sustained and constructive dialogue with companies as well as the judicious and transparent use of its votes, thereby ensuring that companies respond prudently to the emerging expectations of shareholders and other stakeholders.

Why this Report?

Our Obligations to You

F&C represents you: we have been appointed either to manage your pensions and investments, or to represent your interests to the companies in which you are a shareholder, even if your portfolio is managed by other fund managers.

As your representative, we have important obligations to you. These are to be vigilant about how companies 1) plan their future growth with the capital you have entrusted to them; 2) manage and minimise business risks; and 3) protect financial returns over the long term.

What Does This Mean in Practice?

This means that as your representative, we take the time to communicate our concerns to the managers of the companies in your portfolios. It also means that we expect full transparency from companies, so that we know what is being done with the money you have invested with them.

In addition, where F&C is your fund manager, this means exercising our voting rights – **your** voting rights

– at the annual and extraordinary shareholders' meetings of over 3,000 companies around the world.

Transparency: It Cuts Both Ways

If we expect transparency from companies, you should expect no less from us: we believe that as investors, you are entitled to know what company managers are doing in your name with the money entrusted to them. At F&C, we take this responsibility very seriously. With this quarterly report, we outline how we have asked questions and spoken up in your name to ensure that companies are made aware of the concerns of their shareholders.

What Could We Do Better?

We hope we have accurately reflected your concerns about good governance, environmental responsibility and the protection of basic employment and human rights.

Still, we want to be sure we get it right.

An electronic copy of this report can be found at: www.fandc.com/governance

Feedback: your money listens

Your input is valuable to us. Thank you for telling us how your money should talk. Please mark your comments 'reo report feedback', and email them to eve.crush@fandc.com

Or send to: Eve Crush, Governance & Socially Responsible Investment, F&C Asset Management plc, Exchange House, Primrose Street, London EC2A 2NY

reo® is operated on behalf of:



Introduction

A mighty conversation

For F&C, 2006 opened with a bang: over 4,000 in 50 countries worldwide received our updated Corporate Governance Voting Guidelines, which include 11 customised regional versions detailing our expectations in light of evolving national practices. We also sent our 2005 Annual Voting & Governance Report, which gives a comprehensive analysis of how F&C voted, engaged with companies and regulators, and expects future practice to evolve around the globe.

As we head into the peak of the annual voting season, we invite our investee companies to reflect not just on the items on the ballot, but on the broad questions that shareholders are increasingly concerned with: governance, ethical standards, and the social and environmental practices that can spell success, stagnation or crisis.

In this issue, we turn the spotlight on the Pharmaceutical Sector, with a wide-ranging look at the plethora of factors that face the industry, from clinical trials, to lobbying, to sales practices and more. Also on the menu is Biodiversity, which is starting to work its way up the risk register of brand-conscious food retailers and producers. And finally Human Rights, which, after a spluttering start at the UN, is back on the table as a matter for business to tackle head-on.

The true price of disposable chopsticks

“The Chinese use 45 billion pairs of disposable chopsticks every year, which adds up to 1.7 million cubic meters of timber or 25 million full-grown trees, which means badly depleted forests...Environmentalists warn that if China continues to use timber at current levels, China’s remaining forests will be gone in about a decade...In a surprising move, the government in Beijing has introduced a tax on “one-time” chopsticks from April 1...The chopstick tax, part of a package of environmental taxes, is part of the Communist Party’s latest Five-Year Plan, which is charged with moving the nation to a more sustainable growth model with less environmental degradation.”

The Independent, 27 March 2006



Karina Litvack – Director, Head of Governance & Socially Responsible Investment, F&C Asset Management plc

Engagement programmes

Governance



Corporate Governance & Voting **6-7**
The Governance Outlook for 2006 **8-9**

Sector focus



Focus on Pharmaceutical Sector **12-13**

Environment



Focus on Biodiversity **10-11**

Social



Update on Human Rights and Business **14-15**

Companies featured in this report

Corporate Governance & Voting

pages 6-7

Company	Countries	Company	Countries	Company	Countries	Company	Countries
ExxonMobil	US	Illinois Tool Works	US	William Morrison	UK		

Environment Biodiversity

pages 10-11

Company	Countries	Company	Country	Company	Countries	Company	Countries
Anglo American	UK	Carrefour	FR	Metro	DE	Richmond Foods	UK
Asda (Wal-Mart)	UK (US)	CVRD	BR	Monterrico Metals	UK	Rio Tinto	UK
Associated British Foods	UK	Danone	FR	Morrison	UK	Sainsbury's	UK
Barratt Developments	UK	ExxonMobil	US	Nestlé	CH	Shell	UK
Berkeley Group	UK	Genting Berhad	MY	Northern Foods	UK	Sinopec	CN
BG Group	UK	GUS	UK	Office Depot	US	Tesco	UK
BHP Billiton	UK	HeidelbergCement	DE	P&O	UK	Thorntons	UK
Body Shop	UK	IOI Corp	MY	Petrobras	BR	Total	FR
Boots	UK	Lindt & Spruengli	CH	PPB Oil Palms	MY	Travis Perkins	UK
BP	UK	Lonmin	UK	Premier Foods	UK	Wal-Mart (Asda Stores Ltd.)	US
Cadbury Schweppes	UK	Lukoil	RU	Premier Oil	UK	Wolseley	UK
Cairn Energy	UK	Marks & Spencer	UK	Repsol-YPF	ES	Woodside Petroleum	UK

Sector focus Pharmaceutical Sector

pages 12-13

Company	Countries	Company	Countries	Company	Countries	Company	Countries
AstraZeneca	UK	GlaxoSmithKline	UK	Novo Nordisk	DK	Wyeth	US
Bristol-Myers Squibb	US	Johnson & Johnson	US	Pfizer	US		
Eli Lilly	US	Novartis	CH	Roche	CH		

Social Human Rights and Business

page 14

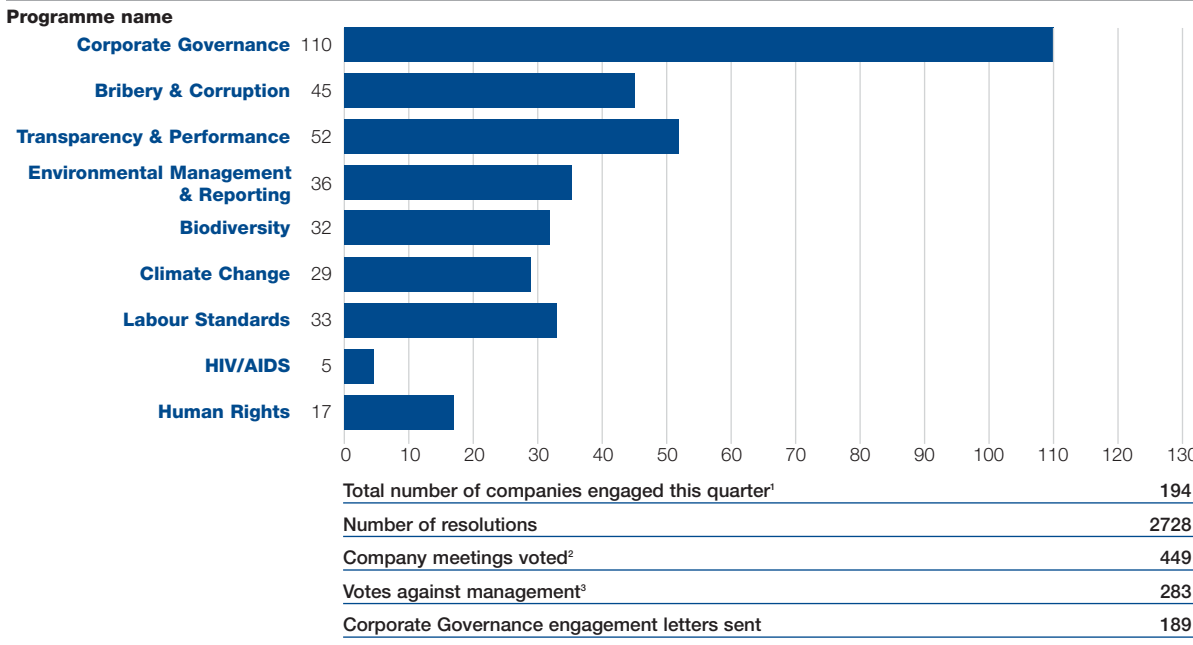
Company	Countries	Company	Countries	Company	Countries	Company	Countries
Bed Bath & Beyond	US	Costco	US	Lonmin	UK	Target	US
BHP-Billiton	UK	CVS	US	Staples	US		

Quarter 1 2006 Activity Report

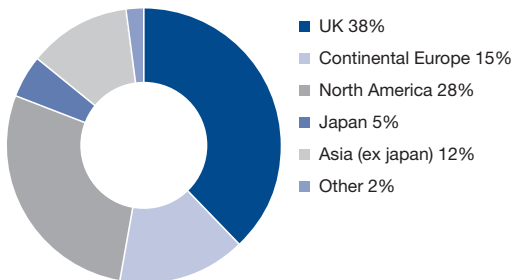
F&C's responsible engagement overlay is unique in the depth and breadth of its engagement, as the quarterly statistics below demonstrate. Key features are:

- A 15-person team of Governance & SRI specialists, allowing full monitoring of the portfolios for environmental, social and governance (ESG) risks and the capacity for in-depth and prolonged engagement with individual companies where necessary
- Global engagement – in all markets
- Comprehensive voting – F&C votes all of its clients' shares worldwide, as well as publishing the voting record each month

Number of companies engaged this quarter

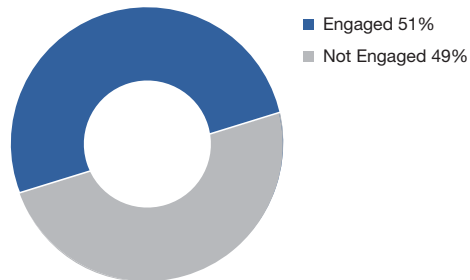


Geographical spread



This table shows the domicile of companies that have been engaged by F&C in the last quarter.

Engagement of FTSE-350 companies⁴



This table shows the proportion of the FTSE-350 Index, by market capitalisation, engaged by F&C in the last quarter.

1 Companies may have been engaged on more than one issue
 2 i.e. company meetings for which F&C has issued voting instructions
 3 Votes against management or abstentions
 4 By market capitalisation



Corporate Governance & Voting

Our objectives

- Ensure high standards of corporate governance in line with F&C Corporate Governance Guidelines with a focus on:
 - Board Structure and Composition
 - Remuneration
 - Appropriate internal controls and risk management systems
- Issue voting instruction on 100% of shares held

Voting Activity Report

This table sets out the scale of voting for the past quarter. It is important to note that several votes in favour of management mask detailed dialogue, where, following compromise or mutual persuasion, we elected to support management.

Voting to date...

	Number	%
Total number of meetings	449	
Number of countries in which we voted	43	
Number of resolutions	2728	100.0
Total votes for management	2319	85
Votes against management	195	7.1
Abstentions	88	3.2
Split vote	0	0
No vote required	126	4.7

Analysis of votes

Issue	% for	% against	% abstain	% split	% no vote
Routine business	90	2	3	0	5
Directors	70	26	2	0	2
Capital	90	5	1	0	4
Mergers/reorg	91	0	0	0	9
Share options etc	72	16	10	0	2
Anti take-over	43	57	0	0	0
Others	87	4	3	0	6
			For	Against	Abstain
Shareholder resolutions	number of votes for or against management		22	18	3

Engagement by F&C

Introducing the new F&C policy and voting guidelines

As corporate governance practices, regulatory standards and shareholder expectations continue to evolve around the globe, F&C revised and updated its "Responsible Ownership Policy" and "Corporate Governance Operational Guidelines". These were sent to over 4,000 investee companies in 50 countries, alongside F&C's Annual Voting and Governance Report, so as to give them a clear sense of how F&C is likely to vote. Rooted in one common philosophy, these policies strike a pragmatic balance

between global principles and local best practice, and weave together the principles of independence, sound risk management, appropriate incentives and transparency.⁵

... with global reach and higher standards

F&C's reach as a responsible shareowner extends to all its global holdings. As the 2006 voting season begins, F&C has clarified its stance on a number of global governance issues, tightening and setting new standards in some key areas including:

5 F&C's General Corporate Governance Operational Guidelines and UK guidelines are available within "Publications" at www.fandc.com/governance. F&C's other guidelines for specific markets are shared with investee companies but are proprietary to F&C. They include guidelines for China, Eastern Europe and Russia, Hong Kong and Singapore, India, Japan, Latin America, The Netherlands and the US.

- **Director commitments and tenure** – voting against directors sitting on more than five large company boards, unless specifically justified, and raising the limit on director service from 10 years 15 years, albeit with a policy to abstain on directors after 12 years.
- **Board size** – withholding support from one or more directors in the case of overly large boards (i.e. boards with over 15 directors) and in the absence of a commitment to reduce board size.
- **Pensions** – calling on companies to manage pension liabilities prudently, and to disclose them clearly in line with International Accounting Standards, along with key assumptions such as longevity and discount rates.
- **Political donations and influence** – asking companies to put their political donations budget to a shareholder vote and to enhance transparency on key lobbying positions.

“We said... It is legitimate for companies to play a part in the policy development process, but this is an area where they need to take care not to expose themselves to allegations of buying influence. We want to make money by investing in companies whose profitability is based on a successful business model rather than cosy relations with the political powers-that-be.”

Karina Litvack, F&C, quoted in “Influence Peddlars face new curbs”, *The Mail on Sunday*, 15 January 2006

Update – Other engagements

No justification for voting secrecy

F&C gave public support to the UK Government’s proposals to introduce mandatory voting disclosure, in the event that voluntary disclosure by institutions fails to deliver. While some business groups fear that this could lead to a “politicising” of voting decisions, with lobbying from single issue pressure groups, F&C believes that this is no justification for secrecy. Institutions need to “practice what they preach” and learn to live with the pressures that may come with being accountable. F&C prefers a voluntary approach, yet believes the threat of government action is a necessary incentive for institutions to act.

“We said... Compulsion is not something F&C inherently feels comfortable with. It is preferable for institutions to disclose votes voluntarily, as some already have. There are, however, no guarantees that all will do so. This leaves some investors and pension fund beneficiaries in the dark about how their stocks have been voted”

Karina Litvack, F&C, quoted in “Calling time on the secret ballot”, *European Pensions & Investments News*, 13 March 2006

Turning up the heat at Illinois Tool Works and ExxonMobil

Good governance includes prudent management of

employment and environmental issues, and F&C recently took its case for change to the shareholders, filing resolutions at **Illinois Tool Works** and **ExxonMobil**. As an industrial manufacturing company, Illinois Tool Works’ health, safety and environmental impacts need to be managed carefully, yet the company stood out for its poor transparency on these questions. After two years of blocked dialogue, F&C filed a first-time shareholder proposal asking the company to publish an annual sustainability report. This prompted the company to resume dialogue and commit to improvements, in turn leading F&C to withdraw its resolution.

Progress is not so quite rapid at **ExxonMobil**, where F&C and others have spent six years fruitlessly trying to persuade the company to revise its anti-discrimination policy to include sexual orientation. Despite the company’s intransigence, F&C is hopeful that its new Chairman and CEO, Rex Tillerson, will take a more pragmatic view, particularly as **ExxonMobil** is now the last remaining company in the Fortune 100 that has not closed this gap. F&C co-filed this proposal in 2005, where it received the support of a record 30% of shareholders.

Wanted: Quality directors for high performing board

Quality directors are key to effective boards, and F&C values the opportunity to meet with them so as to reach a judgement based on the merits of each individual. We recently met with all four newly-appointed non-executive directors at troubled UK supermarket group **William Morrison**. Three of the four were little known to institutional investors, coming from major private companies, and the meeting reassured us of the valuable perspectives and skills they bring to the board.

Italy and Spain power ahead

F&C welcomed Italy’s new code, issued by the Borsa Italiana, which emphasises the need for independent directors and provides guidance on improving internal controls. F&C has been encouraging the Borsa Italiana to set stronger governance standards since 2002. Meanwhile, F&C responded positively to Spain’s consultation on its “Unified Code on Good Corporate Governance”, welcoming the elimination of voting right ceilings, but opposing the proposal for board composition to be determined by director shareholdings. We also recommended that audit and remuneration committees consist exclusively of independent directors and called for separation of the roles of chairman and chief executive.

Shareblocking – could Germany be the first domino?

F&C has long been engaging companies and custodians to discontinue the practice of shareblocking – a major impediment to the exercise of shareholder rights. This issue is also featured in the EU Shareholder Rights Directive, which calls for the elimination of shareblocking over time. We are pleased that Germany has finally made the leap, introducing a “record date” effective from early 2006, and are actively pursuing German custodians to ensure that they adhere to this.



Focus on The Governance Outlook for 2006⁶

Overview

We sent our 2005 Annual Voting & Governance Report to over 4,000 companies; this report gives a comprehensive analysis of how F&C voted, engaged with companies and regulators, and expects future practice to evolve around the globe. Below are some of the issues we will be focussing on in the year ahead.

Paying for a marathon, not a sprint

Companies around the world were penalised at the ballot in 2005 for weak performance conditions and an excessive focus on the short term in their pay policies. This theme is here to stay as investors dig in their heels and call for remuneration that rewards excellence, not mediocrity, and incentivises a long-term view. The trend for litigation against board directors whose bonus payments are made on the basis of misstated accounts is also set to continue.

- F&C will continue to encourage effective performance conditions and a focus on the long term, and to reflect this in its voting decisions.
- F&C's 2006 guidelines ask for the remuneration committee to use its discretion to claw back bonus payments where these have been based on misstated accounts and/or misleading representations as to the effectiveness of internal controls.

Auditors off the hook?

The debate about auditor liability is set to run, as a bill to the UK parliament proposed a shift towards **limiting their liability** and an EU Directive triggered discussions across Europe on the subject. The UK reforms represent the biggest shake-up of the legal regime for auditing in years, intended to avoid further concentration of the industry in a handful of firms and to give auditors the confidence to make more **meaningful audit statements**.

- F&C will engage with regulators on audit liability and quality, encouraging a shift towards limited liability provided this is matched by a requirement to provide more detailed and meaningful audit statements.

Whose vote is it anyway?

Companies can no longer afford to ignore shareholder concerns and fail to act on votes that represent the views of the **majority** of voting shareholders. Nor can they persist in maintaining **unequal voting rights**, which distort the outcome of votes by arbitrarily capping some votes and multiplying others. In 2005, F&C co-filed resolutions at four French companies, calling for an end to voting caps, and raised the issue of unequal voting rights with over 150 companies worldwide.

- F&C will continue to withhold support from directors who have not acted on past majority votes. It will also

withhold support from directors who have been on a board committee that has made questionable decisions with regard to recruitment or remuneration.

- F&C will continue to press for the adoption of a one share/one vote policy, and support or file resolutions calling on companies to eliminate voting caps and multiple voting rights.

Pills and poison...

Takeover defences continue to rear their ugly heads, with a sharp increase in **Japan** and protectionist moves to defend particular industries across Europe, including in **France, Spain and Italy**.

- F&C will continue to oppose poison pills, since it believes that good management is the best take-over defence. It will also encourage regulators to introduce takeover codes as a more effective means of protecting minority shareholder interests.

...and pensions

As debate over pensions provisions raged in government, corporate, investor and union circles alike, investors began to wise up to a new kind of valuation risk: **under-funded pensions**. In addition to straining the creditworthiness and liquidity of many companies, and thereby threatening dividends, these also act to depress their attractiveness as a takeover target. In this respect, they act like an **inadvertent poison pill**.

- F&C considers that pension deficits act as a significant drain on value, as well as a deterrent for takeover bids. Hence it expects companies to manage pension liabilities prudently, and to disclose them clearly in line with international accounting standards, along with key assumptions such as longevity and discount rate used.

The investor's KYC: Know Your Company

Investors demand increasingly high levels of transparency on the full range of factors that affect business performance, including **remuneration policies, pension liabilities, political donations and influence**, and other significant **social and environmental** issues. While a good number of companies now accept the need for greater disclosure, progress is slow overall and shareholders remain in the dark about potentially material risks.

“We said... F&C supports moves to enhance narrative reporting as a mechanism for improving the quality of understanding and depth of dialogue between companies and their owners. Equally, however, we recognise the very legitimate concerns expressed by many about the lack of clarity on director liability. Both aspects must be addressed simultaneously... In relation to narrative reporting, we particularly support moves to ensure that it cover adequate forward-looking information and the full range of factors underpinning long-term business profitability.”

Extract of letter from F&C to UK Government, 23rd March 2006

- F&C will continue to engage with companies worldwide to encourage better disclosure, with a particular focus on remuneration policies and pensions and other “hidden” liabilities as well broader social and environmental issues.

Climate control

With the Kyoto Protocol in effect since early 2005, a chorus has risen from political, scientific, media and corporate circles urging decisive **political action** to confront climate change. This is set to continue throughout 2006, as the EU’s cap-and-trade **Emissions Trading Scheme** enters its second year amid concern that, unless the scheme is internationalised, business will flee Europe to escape emission curbs.

- 2005 saw the UK Prime Minister invite a group of 12 business leaders, including F&C’s CEO, to advise him on climate change policy, thus forming the Corporate Leaders Group on Climate Change (CLGCC). F&C will continue to press for decisive action at a political level and engage with companies to encourage them to prepare effectively for a lower- carbon future.

Welcome to London: Step this way please?

As the Sarbanes-Oxley Act (SOX) has taken hold of US stock markets, overseas-domiciled companies have headed for the welcoming arms of the rather more lenient London Stock Exchange (LSE). The FSA does not require foreign companies to “comply or explain” with the UK’s Combined Code, resulting in the potential emergence of a **two-tier system**. The FSA has introduced a requirement for foreign companies to set out how they comply with their own national codes and how these differ from UK standards. But this stops short of the standard F&C would prefer, which would assume that companies that seek capital in the British markets will strive to meet the stringent standards that apply in that market unless there are sound reasons – including conflicting home country regulations – not to.

- F&C will engage foreign-domiciled companies listing in the UK to encourage adoption of best practice, and work with fellow investors and the UK regulator to advance this agenda.
- F&C will continue to engage with regulators worldwide to encourage high listings standards.

“We said... There seems to be a general belief that listing in London provides a certain standard level of good governance. People are not aware there is a two-tier system. People take for granted that in Rome you do as the Romans do.”

Karina Litvack, F&C, quoted in “Firms list in UK to avoid tough US standards” Reuters News, 3rd February 2006

The business of politics

The role of business in shaping government policy and funding elections drew increasing scrutiny at the ballot box of US companies, with resolutions calling for greater disclosure on **political donations** and **lobbying**.

Although business involvement in campaign financing has reached nothing like the proportions seen in the US, the debate has stretched across the Atlantic. F&C believes that corporate involvement in the political process is desirable and necessary, provided it is undertaken in a transparent manner and is accountable to shareholders.

- F&C will continue to engage with companies to encourage a more transparent and disciplined approach.

“We said... Good governance is synonymous with trust, and with trust come more transparent markets. If that trust is dented – due to weak company practices or national standards – everybody loses: share price may stagnate, capital costs tend to go up, and investors may miss out on potential investment opportunities”

Fernando de Figueiredo Ribeiro – Head of Investments, F&C Asset Management, quoted in F&C’s Annual Voting and Governance Report 2005



Focus on Biodiversity

Our objectives

- Encourage all companies where biodiversity is a material risk to adopt a biodiversity policy and define and implement a process for managing biodiversity impacts
- Sustainable Forestry: Encourage the adoption of a policy on legal and sustainable sourcing of timber by companies in high-exposure sectors with an explicit commitment for setting targets for sourcing independently certified timber
- Palm Oil: Encourage relevant companies to adopt F&C recommendations on sustainable palm oil sourcing

Engagement by F&C

Biodiversity: an emerging risk for business

F&C has published three research reports on biodiversity:

- *'New risks in old supply chains: Where does your palm oil come from?'*
- *'Are Extractive companies compatible with biodiversity?'*
- *'Is biodiversity a material risk for companies?'*

These reports highlight which sectors are materially affected by biodiversity, and identify seven key risk areas for 'high-risk' companies. They form the basis for engagement by F&C on biodiversity.

Focus on...

Food Producers and Retailers

A jungle-sized 'canary in the coal mine'

F&C's first report on biodiversity, issued in 2003 and entitled *"New Risks in old supply chains: Where does your palm oil come from?"* focussed on a little-known but increasingly controversial ingredient in companies' supply chains. A survey showed surprisingly low awareness by companies about how much palm oil they use, and where it originated. While 67% of companies felt they were managing the risk adequately, 83% did not appear to know where their palm oil originated. The study had concluded that the commercial risk to food producers and retailers was still modest, but warned that it would increase if and when palm oil sourcing became the subject of widespread consumer or public concern.

Since then, palm oil, which is ubiquitous in cosmetics and food, has become a rallying point for environmental pressure groups because soaring consumption has fuelled deforestation in Indonesia and Papua New Guinea. This has led to wider biodiversity loss, including photogenic species such as the Orang-Utan. A new study entitled *"The oil for ape scandal: How palm oil is threatening the orang-utan"*, points the finger at UK supermarkets for increasing demand without having adequate controls in place.

What's at stake?

At this stage, retailers and manufacturers of branded food and cosmetics are in the front line. Because palm oil is hidden in so many products and rarely labelled as such, consumers are not likely to boycott products directly, but could increasingly demand that retailers enforce tough supply chain tracking standards so that their market power leads to more sustainable plantation practices.

In the light of increased focus by regulators on the market dominance of supermarkets, and in particular the great leverage they wield over suppliers, high-profile campaigns that attack their reputations and environmental credentials could undermine their credibility as responsible corporate citizens, and thereby interfere with their ability to win a licence for expansion.

What can be done?

Tackling the problem is not simple because no single company, however large, can single-handedly change agricultural or trading practices. F&C has therefore been in contact with producers, processors and retailers of food products containing palm oil, including **Carrefour, Danone, Nestlé, Sainsbury** and **Tesco**, and recommended that they:

- Assess how much palm oil they use, directly or indirectly, and where it is sourced from;
- If the risk exposure is material, join the Roundtable on Sustainable Palm Oil.

The Roundtable on Sustainable Palm Oil (RSPO) has emerged as a credible forum in which growers, end-users, government bodies and NGOs are forming an action plan for creating ecologically-sustainable supplies of palm oil. Following F&C's report, which included a recommendation to join the RSPO, companies engaged by F&C that have joined the RSPO include Asda Stores Ltd. (a division of **Wal-Mart**), **Body Shop, Boots, Cadbury Schweppes** and **Northern Foods**. F&C also invests in three palm oil growers that are all members of the RSPO, and with whom F&C has been in contact about sustainable sourcing: **IOI Corp, PPB Oil Palms** and **Genting Berhad**.

F&C assessment: Will it affect the bottom line?

While palm oil may be a lightning rod for public attention, it is really a proxy for a much wider set of biodiversity concerns that promise to be of growing significance to food producers and retailers. F&C research suggests that, in future, more biodiversity-related issues will be the subject of regulation, consumer concern and campaigning by NGOs. Fish stocks and the sustainable sourcing of fish, in the context of diminishing global supplies and soaring prices, is another case in point. It is a matter of time before such supply issues, which are in essence biodiversity-related, take their rightful place on companies' agendas. Companies that take effective action will protect their brands, their sources of supply, their license to operate and expand, and ultimately their share price.

Is it just about food?

By no means all companies are affected by biodiversity risks, but for those that are, the risks can be significant. Outside the food sectors, the issue of biodiversity, often expressed in other terms such as 'protected areas' and 'ecosystem management', is material to a limited number of sectors, and notably the extractive sectors.

For example, an issue that underpins valuations for extractive companies is access to oil reserves or mineral rights, which is clearly hampered when resources are located in protected or ecologically-sensitive areas. The World Resources Institute states that three quarters of active mines and exploratory sites overlap with areas of high conservation value and areas of high watershed stress.⁸

F&C considers that companies with a better track record in biodiversity management are likely to gain greater or faster access to reserves and suffer fewer delays in project development. For this reason, we regularly engage extractive companies on biodiversity issues, to ensure that they have an adequate strategy in place that is aligned with their environmental management systems. Among the companies recently engaged are: **Anglo American, BP, Cairn Energy, ExxonMobil, Lukoil, Shell, Total** and **Woodside Petroleum**.

Recent developments

F&C has participated in three recent business initiatives on biodiversity:

- During 2005, the United Nations published six volumes of its Millennium Ecosystem Assessment (MA), an analysis of the state of the world's biodiversity by over 1,300 leading scientists from 95 countries, including a contribution from F&C. The MA included a section on business and biodiversity, noting that many companies are dependent on biological resources yet are without a strategy for responding to diminishing supplies, while a small but growing number of companies that have a significant impact on biodiversity are beginning to integrate this within their environmental management systems.
- The Global Reporting Initiative, which sets guidelines for reporting by companies worldwide on corporate responsibility, is developing its guidelines on biodiversity.

- The Conference of Parties (COP) of the Convention on Biological Diversity (CBD), which meets in Brazil in April 2006, is for the first time running a session on business & biodiversity. F&C has written to the Secretary General of the CBD about the session on business, which will be hosted by Brazil's Environment Minister, noting which areas of business activity are relevant to biodiversity, and recommending that any regulation that is proposed about business should encompass state and non-listed companies so as not to disadvantage shareholders in publicly-listed companies.

“We said... We believe that the reputational risks for manufacturers and retailers have increased in the light of recent publicity about the use of palm oil from non-sustainable sources... In addition, we view palm oil as symptomatic of a wider set of issues relating to biodiversity, which are likely to be of increasingly material significance to companies in your sector.”

Extract of letter from F&C to Food Producers and Retailers, March 15th 2006

“They said... Companies exist to make a profit and thereby generate value for shareholders, so a company must have a business case for being involved in biodiversity conservation.”

Millennium Ecosystem Assessment, 2005

Companies engaged on biodiversity issues during 2005/6

F&C has undertaken a comprehensive review of all sectors to assess what biodiversity issues are material to the companies in its portfolios. The table below lists the companies engaged.

Extractive companies

Anglo American, BG Group, BHP Billiton, BP, Cairn Energy, CVRD, ExxonMobil, Lonmin, Monterrico Metals, Petrobras, Premier Oil, Repsol-YPF, Rio Tinto, Shell, Sinopec, Total, Woodside Petroleum.

Management systems for biodiversity risks

Berkeley Group, Heidelberg Cement, Keller Group, P&O.

Timber sourcing

ACS - Actividades de Construccion y Servicios, Barratt Developments, Fomento de Construcciones y Contrates, Grainger Trust, GUS, Inmobiliaria Colonial, Office Depot, Travis Perkins, Wolseley.

Food Producers & Retailers

Danone, M&S, Premier Foods, Richmond Foods, Lindt & Spruengli, Thorntons, Associated British Foods, Cadbury, Schweppes, Northern Foods, Asda (Wal-Mart), Boots, Carrefour, IOI Corp, PPB Oil Palms, Genting, Sainsbury, Nestle, Tesco, Morrison, Metro.



Focus on Pharmaceutical Sector

Our objectives

To encourage pharmaceutical companies to identify and address significant social, environmental and ethical issues consistent with protecting its license to operate and relationships with key stakeholders

Background – A sector in trouble?

Large cap pharmaceutical companies continued to face a tough environment throughout 2005, due to sustained pricing pressure, the pace of patent expiries and weak pipelines for new drugs. This was exacerbated by the increased regulatory risk and deteriorating public trust following the safety scandals of 2004. The industry as a whole faces allegations of putting profits before patient safety, exerting inappropriate influence on regulators and behaving unethically in the marketing and sales of drugs. There are also on-going concerns about the effectiveness of boards in overseeing company strategy and their accountability to shareholders, with boards approving huge pay packages for under-performing executives. Meanwhile, in the fourth quarter, the spotlight shone on the industry's ability to respond to the threat of avian flu as governments scrambled to stockpile anti-viral drugs.

Engagement by F&C

F&C's engagement focuses on areas of potential regulatory and reputational risk as well as encouraging good practice in corporate governance, in order to help ensure sustainable long-term performance. F&C is concerned that the widespread criticism of the sector could have a negative impact on its 'license to operate', particularly with regulators who hold the keys to the industry's profitability. It is therefore seeking assurances that companies are alive to these risks and taking appropriate steps to help rebuild public trust. F&C also looks for effective and accountable boards to challenge management and ensure they are incentivised for the long-term. This is particularly important when an industry is undergoing a period of transition and adjustment, requiring fresh insights and challenge.

Clinical trials – let the light shine in

- With safety scandals shaking confidence in the industry, F&C sees disclosure of clinical trials results as an important tool for enhancing public trust, limiting future liabilities and informing investor valuations.
- F&C has led investor calls for companies to enhance their disclosure since 2004, chiming with protests from the medical and scientific communities, and held detailed dialogue with specific companies including **GlaxoSmithkline (GSK), Johnson & Johnson,**

Novartis, Pfizer and Roche. Various trade association and company initiatives have followed, with particular leadership from **GSK** and **Roche**, both of which have gone further than industry guidelines in the breadth and scope of their disclosure.

Political influence – lifting the lid on lobbying⁹

- F&C believes companies need to be transparent in their political lobbying activities. This is particularly important in the pharmaceutical sector, where allegations of inappropriate and excessive influence on governments are undermining public trust in both regulators and companies.
- F&C has called on all companies to disclose key lobbying positions as well as membership and funding of organisations that lobby on their behalf (e.g. trade associations and patient groups). Some companies now publish position papers on key policy issues, including **GSK, Novartis, Novo Nordisk** and **Pfizer**. However, the sector as a whole has yet to publish formal submissions to governments and regulators, and the sensitive relationships with patient groups promise to yield further challenges to the sector's credibility. F&C has called on companies to establish policies for managing relationships with patient groups and to disclose funding of them.
- F&C discourages political donations yet recognises that they are deeply entrenched in some markets. In such cases, we call for full disclosure and the opportunity to vote on the overall donations budget. **Roche** and **Novo Nordisk** have taken a leadership stance, refraining from making donations in any market. Meanwhile, although progress has been made on disclosure, peer companies are resisting F&C requests to put global political donations budgets to a shareholder vote.¹⁰

9 F&C appreciates the participation of a number of companies in our recent study on this issue with the Institute of Business Ethics (see fandc.com/governance within "Publications") including **AstraZeneca, GSK, Novartis, Roche** and **Pfizer**.
¹⁰ **GSK** and **AstraZeneca** put donations to EU "political organisations", in excess of £5,000, to a shareholder vote as required under UK law.

“They said... A landmark ruling by the [UK] medicines watchdog has reprimanded Eli Lilly... for producing a leaflet for a patient organisation that failed to mention the potential side effects of its drugs... The move by the agency is the first ruling against drug company-patient organisation links. It highlights the sometimes opaque links between the two. Critics argue the connections can provide covert marketing and risk giving incomplete information to patients and prescribers.”

Andrew Jack, “Eli Lilly forced to withdraw advice leaflet”, *The Financial Times*, 15 February 2006

Marketing and sales – the high cost of hard sell

- Allegations of over-zealous selling of products to doctors have created serious reputational and litigation risks for the sector.
- F&C expects companies to establish strict guidelines and robust internal control mechanisms to spot and address any overly aggressive sales practices. It also encourages companies to ensure that incentive mechanisms encourage appropriate behaviour and to disclose any compliance breaches. We are pleased that **AstraZeneca**, **GSK** and **Novartis** now all disclose breaches, in line with F&C recommendations.

Avian flu – a risky business

- With the threat of an avian flu pandemic, governments around the world are scrambling to stockpile available treatments - principally **Roche**'s Tamiflu but also **GSK**'s Relenza. Both companies have been under pressure to step up their own manufacturing capacity and to grant licenses to other companies so as to meet escalating demand. This is a potentially explosive reputational issue, as well as a commercial opportunity, with a need for companies to demonstrate that they are working alongside governments to address the threat.
- Both companies have indicated, in public statements and in meetings with F&C, that they are alive to the risks and taking steps to manage them. In particular, **Roche** has expanded its own manufacturing capacity and granted licenses to 15 external contractors to help boost supply, as well as making donations to the World Health Organisation. **GSK** has developed plans to start work on a vaccine, should the virus mutate to allow human-to-human transmission.

CEO/Chairman – the great divide?

- F&C favours a separation of the chairman and CEO roles because it believes an independent chairman is best placed to leverage the capabilities of the board and to challenge the CEO.

- The sector is dominated by combined CEO/Chairmen, with notable exceptions including **AstraZeneca** and **GSK**. **Bristol-Myers Squibb** finally made the shift under pressure after an accounting scandal in 2002 exposed serious problems in its business-as-usual practices.
- While recognising that each company is a unique case, F&C has raised the issue with all its key holdings and has particularly called on **Pfizer**, **Novartis**, **Roche** and **Wyeth** to consider a shift. **Pfizer** has taken a welcome step forward with the appointment of a Lead Independent Director although F&C still thinks an independent chairman could be beneficial.

Paying for performance

- Alleged “rewards for failure” have kept the sector in the headlines over the last few years and F&C has called on companies to introduce more stretching performance targets.
- Some corporates are listening, with **GSK** introducing tougher conditions and discarding excessively long contracts for directors, and **AstraZeneca** introducing an incentive scheme that only gives high pay-outs for exceptional performance.
- More broadly, F&C has called on companies, particularly in the US, to step up their disclosure in this area. Meanwhile, **Novo Nordisk** is leading the way in linking rewards to performance on social and environmental issues, in line with F&C policy.

Access to medicines in emerging markets

- It is clearly the responsibility of governments, not drugs companies, to take the lead in addressing the health crisis in emerging markets. Yet, with regulators holding the keys to the industry's profitability, most companies agree it is in their enlightened self-interest to make a constructive contribution. The industry's reputation was seriously tarnished by allegations of blocking access to HIV/AIDS drugs in poor countries in the early 2000s, and F&C has long been engaging with the sector to ensure that this fall-out is not repeated.¹¹ In particular, F&C has called on companies to look beyond infectious diseases, to ensure that they are prepared to manage access questions across their broader portfolios.
- With early leadership from several companies, particularly **GSK**, F&C is pleased that **AstraZeneca** has now integrated access issues into its decision-making from early in the drug pipeline. This reaches beyond infectious diseases in recognition of the fact that so-called “first-world diseases” (e.g. cancer, heart disease) are increasingly prevalent in emerging markets. **Pfizer** has also established a framework for engaging stakeholders on access issues in advance of new product launches.

¹¹ F&C co-founded the Pharmaceutical Shareowners Group (PSG) in 2002 to address this issue, publishing “The Public Health Crisis in Emerging Markets – An Investor Report” with other PSG members in 2003 (see “Publications” within www.fandc.com/governance).



Update Human Rights and Business

Our objectives

Encourage companies operating in areas subject to weak rule of law, conflict or significant incidence of human rights abuses, to manage the risks to their business through the adoption of:

- Human rights policies across international operations, subsidiaries and joint venture partners
- Guidelines for managing the security of employees and plant
- Procedures for community consultation, including indigenous groups
- Contributing to stabilising local conditions as agents of economic growth and through direct engagement with political entities

Summary of F&C's Recent Engagement

Breaking New Ground: Mining sustainably

For mining companies today, many of the most attractive business opportunities are found in some of the most unstable parts of the world. Securing access to key mineral rights and land is therefore essential, and increasingly depends on maintaining good relations with local communities throughout the lifecycle of a project. F&C has engaged two major mining companies, **BHP-Billiton** and **Lonmin**, on this issue in relation to their operations in Peru and South Africa, respectively, encouraging them to introduce clear policies and procedures for community consultation. The past year saw the welcome introduction of new standards for community consultation at **BHP-Billiton** and the establishment of clear compensation procedures in cases where communities have been displaced. **Lonmin** has also formalised its consultation process to ensure that it hears the views of the widest possible group of stakeholders in the most culturally-appropriate manner.

Staff and plant safety and security can often present additional challenges, particularly where they involve reliance on local or government security forces in countries with weak governance. In the light of numerous allegations of misuse of force and human rights violations, and consequent accusations of complicity on the part of the companies that employ these forces, F&C has engaged mining companies to develop strict guidelines for managing security. Most recently, **BHP-Billiton** has introduced specific training requirements and enhanced its monitoring procedures for security forces. **Lonmin** has also restructured its safety, health, environment and community

management systems explicitly to incorporate key performance indicators relating to the use of security forces. Both companies have also endorsed the Voluntary Principles on Security and Human Rights (VPs) and **BHP-Billiton** has taken the additional step of participating in the VP working group consisting of 4 states, 16 companies and a number of civil society representatives.

'Big Box' Retailers: The Future of Shopping?

Retailers entering new communities bring benefits such as services, jobs, economic growth and tax revenues – but they can also bring unintended negative impacts that can ultimately affect a retailer's own ability to expand. In some cases, retailers have been accused of building on land seized unfairly by local governments in the interest of economic development. In other instances, companies have met with community resistance by demolishing historic buildings or contributing to congestion, pollution, or the perceived erosion of a community's character and cultural history.

F&C contacted US retailers **Bed Bath & Beyond**, **Costco**, **CVS**, **Staples** and **Target** in order to learn more about these companies' policies and management systems for sustainable store siting. Our initial review suggests that while some of these "big box" chains have addressed environmental impacts and others have considered community or cultural concerns, few have systems that comprehensively evaluate both sets of factors at the critical early stage of development. Through dialogue, F&C will encourage retailers to consider both environmental and social impacts as a standard feature of the property development process, and to publish their policies for siting new stores.

Recent Developments

The UN turns to Business and Human Rights

Companies have long struggled to define their human rights obligations in a context where international law is ill-defined and difficult to enforce, and the rule of law in high-risk countries is weak. In 2005, United Nations Secretary-General Kofi Annan appointed Harvard Professor John Ruggie as the UN's first Special Representative on Business and Human Rights. Professor Ruggie was tasked with defining standards of corporate accountability with regard to human rights, and in February he published an interim report on his findings. F&C welcomes these initial recommendations, as they lay out a clear and practical agenda for tackling some of the biggest challenges

companies face in this area. Further research will focus on: emerging legal standards for establishing corporate complicity in human rights abuses (e.g. when companies can be found guilty of assisting the perpetrator of a crime or of knowing that its acts would result in a possible crime); how companies can manage operations in countries affected by conflict and weak governance; practical tools for companies wanting to assess the human rights impacts of specific projects; and a compendium of the best company policies and practices. We believe that all companies exposed to these risks will benefit from clearer international guidelines, and will review the conclusions of the Special Representative as they emerge over the next year.

Products

F&C offers a wide range of investment opportunities for pension funds, charities, financial institutions, corporations and other organisations. We offer segregated and pooled portfolio management through a range of onshore and offshore vehicles. These cover developed and emerging markets in equity, bond, cash and property funds.

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Important information. All data is as at 31 March 2006 unless otherwise stated.

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