Responsible Investment: Outlook for 2010

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F&C Investments

Expect excellence

Outlook for 2010

The big surprise of 2009 was the speed of the global recovery. Dire predictions of the 'end of capitalism' were swept aside as unprecedented reflationary government policies succeeded in their aim of getting economic activity moving again.

But the recovery may be a fragile one. Fiscal stimulus has papered over some serious cracks. Governance failings were at the heart of the financial crisis; reforms are inching forward, but the furore over planned bonus payments by banks suggests that a genuine cultural shift has yet to occur. And the limited progress in the Copenhagen climate negotiations means that the credit crunch risks being eclipsed by a far more serious climate crunch.

Looking forward, 2010 needs to be a year of implementation. Governance reforms need to be embedded into corporate culture, with investors using their vote and their voice to press companies that are reluctant to implement change. Sound management of environmental, social and governance (ESG) issues has to become the norm not just in developed economies, but also in the fast-growing emerging markets. And progress must be made in agreeing a global climate change treaty, and in finding better ways to manage the earth's threatened resources.

Not back to business as usual

The immediate aftermath of the credit crunch saw hysterical headlines about the breakdown of the capitalist system and the need for global super-regulators to prevent such systemic risks from developing again. As confidence in the recovery has grown, the reforming zeal has waned somewhat, and fierce debate has broken out once more about whether the reappearance of generous bonuses for staff at certain financial institutions is a genuine reflection of outperformance – or merely a result of profits made on the back of extraordinary fiscal and monetary support for the banking system.

Regulatory reform is still a 'work in progress' in many countries, but the debates and consultations are likely to start translating into hard policy in 2010. In the UK, F&C has contributed to consultations on wide-ranging proposals to improve governance both at financial institutions and more widely across the corporate landscape; 2010 should see final decisions on what shape the changes will take. In the US, we expect a decision in the early part of the year on whether 'say on pay' will become a mandatory requirement for listed companies, alongside moves to enhance disclosure on climate change, and promote shareholder rights through improving the ability of shareholders to nominate directors.

In F&C's view, such reforms are a necessary, but not sufficient, condition for avoiding the recurrence of the systemic weaknesses that lay at the heart of the financial crisis. Changes to the letter of the law need to be accompanied by a change of heart about the importance of good governance. Companies need to do more to demonstrate that governance and remuneration systems are genuinely driven by the desire for long-term performance. And investors need to be more diligent about spotting early warning signs of trouble, and call for change.

The crisis also altered the investor landscape, as the rush to "de-risk" led investors to cut back their equity exposure in favour of the relative safety of bonds. This has been accompanied by the emergence of a more pro-active stance by some debt-holders, whose focus has broadened beyond the immediate concern of securing repayment covenants to addressing longer-term issues of corporate governance and sustainability, in much the same way that equity investors have done over the last decade. As such, F&C's clients increasingly include corporate credit investors eager to ensure that the companies they fund respect global standards of good governance, on the basis that this too can influence credit quality over time.

F&C will continue to engage:

- With regulators to ensure that reforms are effective in promoting better risk management and performance, yet calibrated realistically to avoid being swept aside as economic conditions improve
- With companies to improve awareness of governance reforms, both in our capacity as shareholders and bondholders.

Emerging markets on the rise

Most of the major emerging economies have proven their growth model to be relatively resilient to the global turbulence of the past two years, and have been an engine of growth as the world exits recession. They remain attractive markets for investors. But stung by the events of the past two years, investors are more sensitive to risk management issues, and are demanding better disclosure, improved governance, and more sustainable operating practices. The encouraging news for 2010 is that leading emerging markets have recognised these calls and begun to take action, with leading stock exchanges and securities regulators tightening listing standards and rewarding companies with good ESG credentials. For instance, while Brazil's Bovespa and the Johannesburg Stock Exchange were the first to establish specialist governance and sustainability indices, in 2010 Shanghai, Korea, the Philippines and Turkey will follow suit, creating greater impetus for emerging market companies to meet high standards of corporate governance and disclosure.

In 2010, we expect investors to become more active in holding companies accountable for meeting good governance standards and disclosing steps for managing key ESG-related risks. We believe that the governance discount between leaders and laggards will continue to widen as investors shun companies that they feel they cannot fully trust or understand. We also expect that pressure to proactively manage ESG issues will increase, as leading emerging market companies compete globally and are evaluated against global peers, and as responsible investors increase their exposure to emerging markets and begin requesting more information from companies.

- In 2010, F&C will continue to engage companies throughout the emerging markets, encouraging them to meet global governance and sustainability standards and to incorporate ESG issues into board planning and strategy discussions
- As well as continuing to focus on the major markets – primarily the 'BRICK' economies of Brazil, Russia, India, China and Korea – F&C also plans to expand its engagement programme to include companies in countries such as Egypt, Turkey, Israel, Colombia and Nigeria.

Climate change: the talk goes on

The UN climate talks in Copenhagen were the culmination of two years' hard work to set a framework for international climate action beyond 2012. With over 100 world leaders in attendance, hopes were high that a binding global deal could be forged – but the resulting 'Copenhagen Accord' fell short of these lofty ambitions. 2010 will bring efforts to turn the skeleton agreement into a fully-fledged treaty. With the credibility of the UN process undermined, continued pressure from investors and business will be needed to maintain the momentum for an eventual deal.

Even in the absence of a comprehensive global agreement, national governments will continue the work of meeting their unilateral targets for emissions cuts, many of which were newly announced in the run-up to Copenhagen. Key developments in 2010 will include attempts to get cap-and-trade legislation agreed in the US and Australia, as well as the implementation of new 2020 goals to improve emissions performance in China, India and the other major emerging markets.

The key question for companies is the compatibility of business strategies with the emissions reduction aspirations of the countries in which they operate. Although delays in negotiations may provide some breathing space, companies that are continuing along a high-carbon, 'business as usual' trajectory will eventually find their profitability and performance undermined by carbon constraints imposed by governments. And with further climate change already locked in for the next two decades or more, companies also need to think about the impact this will have on their business – such as vulnerability of infrastructure to extreme weather, and impacts on agricultural supply chains. In this regard, F&C will continue to:

- Use its influence in investor and corporate groups to call for an ambitious global treaty in the fastest possible timescale
- Actively seek out investments in companies whose business model will position them to benefit from efforts to cut greenhouse gas emissions
- Press laggard companies to reposition their business to respond effectively to the risks associated with climate change.

Natural capital: putting the economics into biodiversity

Climate change discussions have a tendency to turn environmental management into a numbers game, with intense debate over the appropriate percentage reduction in emissions, which is often incomprehensible to the wider public. Fundamentally, though, good environmental management is about something everybody can understand – the stewardship of the Earth's resources, whether it be, at the global level, the atmosphere, or at the more local level, management of water, forests or species diversity.

In 2009, investors encouraged companies to identify and safeguard the economic benefits of natural resources, for example through the Natural Value Initiative and Forest Footprint Disclosure Project. With high-profile pension funds throwing their weight behind efforts to encourage better water management by companies, and climate change throwing the spotlight on the need for forest protection as never before, 2010 is likely to see companies pressed to measure, manage and invest in protecting natural capital.

There is also a strong link between natural resource issues and human rights. Shortages of water and other essentials for life are often triggers for conflict and unrest, which present huge difficulties for the management of safety and security by companies. And resource management of a different type will continue to present problems in 2010: the challenge of extracting oil and gas in some of the most insecure parts of the world, as the 'easy' oil and gas runs low. F&C will continue to engage with companies on:

- Measuring and protecting natural capital, with a particular focus on water and forests
- The specific social and environmental challenges for extractives companies operating in difficult regimes.

Winning gold with F&C

Delivering highly effective investment strategies is just one part of the service we provide. As principled asset managers, we are determined to lead our industry in all aspects of our business.

In 2009 F&C were voted winners of the 'Gold Standard' in the Fund Management category for the fourth year in succession. Only a few companies have been privileged enough to win a Gold Standard award, and as such, this is an exceptional achievement. The Gold Standard Awards aim to identify financial services companies that excel not just in service but in five key areas important to consumers of financial products and services:

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