

reco[®] Report

F&C Investments

3rd Quarter 2008



In this issue...

- Spicing up governance in Asia: F&C takes the show on the road
- ¡Ándale! Serving up sustainable fast food, Mexican style
- Nature's value-added: Turning ecosystems into shareholder value
- If it's broke... Fix it: F&C presses Brazilian, German and EU regulators on minority shareholder rights
- All aboard! Special Spotlight on Sustainable Transport:
 - Trains, Planes and Automobiles: What's clean, what's not
 - Alternative lifestyle: hybrids vs. fuel cells
 - Driving the rule makers: How are companies lobbying government?
 - Aviation carbon permits: Ready for take off



Expect excellence

Our philosophy

reo® stands for responsible engagement overlay

- Leveraging our clients' share ownership position to encourage companies to improve long-term business performance through better management of environmental, social and governance (ESG) risks
- Exercising our influence through voting and engagement, drawing on the skills of one of the largest specialist teams worldwide
- Implementing in full the UN Principles for Responsible Investment (PRI)

Why this report?

Our obligations to you

F&C represents you when speaking with companies about their environmental, social, and governance (ESG) practices. Your provider of pensions and investments has entrusted us with your portfolio, and tasked us with ensuring that the companies you hold adopt responsible practices and run their business with an eye to success over the long-term.

As your representative, we have an important obligation to you – 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, including those related to ESG factors; and
- 3 protect financial returns over the long-term.

What does this mean in practice?

This means that as your representative, we engage in direct face-to-face dialogue with senior management of the companies in your portfolios, listen to what they have to say, communicate your concerns – and, when necessary, challenge them to do better.

This generally also means exercising our voting rights – your voting rights – at the annual and extraordinary shareholders' meetings of over 3,000 companies around the world¹.

Transparency: It cuts both ways

Just as we expect transparency from companies as part of their obligations as responsible corporate citizens, you should expect no less from us. As the ultimate owners of the companies in your savings and pensions portfolios, you are entitled to know what companies are doing in your name with the money you have entrusted to them – and you should likewise know how we have represented your interests in exploring these questions.

At F&C, we take our obligations to you very seriously. With this quarterly report, we tell you how we have asked questions and spoken up in your name to ensure that companies know and act on the concerns of their shareholders. An electronic copy of this report can be found at:

www.fandc.com/gsi

reo® is operated on behalf of:



¹ This applies for all funds managed directly by F&C, as well as several other funds that have appointed F&C to undertake share voting on their behalf. Some funds carry voting separately.

Introduction

As F&C went to press, the financial markets were in the grip of the greatest crisis since the crash of 1929, iconic names were being wiped off the corporate map, seemingly in a matter of days, and politicians and central bankers grappled with how to respond.

With shock waves still rippling across the globe, and possibly still more to come, it is too soon to gauge how deep or lasting the damage will be – but what is clear is that at the heart of the crisis lies a fundamental failure of governance. Banks and other financial institutions got caught in the frenzy of the race for talent and growth, and designed incentive structures that rewarded staff and executives for irrational risk-taking. The implosion provoked by the sudden reckoning has triggered a complete loss of confidence and has left markets paralysed

and dysfunctional, threatening to spread the crisis “from Wall Street to Main Street”. With the meltdown overlaid by the final weeks of the US elections, the rhetoric has been focused on the ills of deregulation.

In fact, there will be many lessons to be learned, in terms of both smarter regulation but also more accountable behaviour of management towards boards and boards towards shareholders. Rules alone cannot prevent crises – or, in the inimitable prose of Robert Jenkins, “We will not outlaw greed and cannot legislate against stupidity”². A healthy economic system depends on checks and balances, including the debate, scrutiny, challenge and give-and-take that comes with active shareholder dialogue, transparent companies and strong boards.



Karina Litvack
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and Sustainable Investment,
F&C Management Ltd

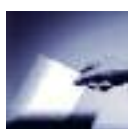
In this report...



Quarter In Review

- Global Round-up
- F&C battles for shareholder rights in Brazil, Germany and Europe
- LatAm success: Mexican fast-food giant Alsea tackles sustainability

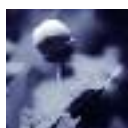
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- Going for gold in China – in the governance marathon
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Focus on Sustainable Transport

- Costs up, Rules tighter and Customers changing their minds
- Transport technologies: What’s clean, what’s not, what’s coming next?
- The hybrid vs fuel cell debate
- Driving the rule makers: How are companies lobbying government?

12-15

² ‘Searching for the calm after the storm’, Robert Jenkins, Chairman, F&C Management Ltd, quoted in *Investment Week*, 22 September 2008

Companies featured in this report

Quarter In Review

pages 6-7

Company	Countries	Company	Countries	Company	Countries	Company	Countries
Alea	MX	Deutsche Telekom	DE	Levi Strauss	US	Shaeffler Group	DE
Aracruz	BR	Gap Inc	US	Marks & Spencer	UK	Sime Darby	MY
BAE Systems	UK	Hennes & Mauritz	SE	Hellenic Telecommunication Organisation (OTE)	GR	Tesco	UK
Continental AG	DE	Kulim	MY			Votorantim Celulose e Papel (VCP)	BR

Governance Asia

pages 8-9

Company	Countries	Company	Countries	Company	Countries	Company	Countries
China Mobile	CN	Hyundai Heavy Industry	KR	Mitsubishi Holdings	JP	SK Holdings	KR
China Shenhua	CN	Hyundai Motor	KR	Mitsui Corp	JP	Sumitomo Metals	JP
CNOOC	CN	Hyundai Steel	KR	Nippon Oil	JP	Takeda Pharmaceuticals	JP
Doosan Heavy Industries	KR	Idemitsu Kosan	JP	PetroChina	CN		

Issue Ecosystem Services

pages 10-11

Company	Countries	Company	Countries	Company	Countries	Company	Countries
Ahold	NL	ENI	IT	Lonmin	UK	Royal Dutch Shell	NL
Anglo American	UK	Evraz	RU	LUKOIL	RU	Samling	MY
BHP-Billiton	AU	ExxonMobil	US	Marathon Oil Corporation	US	Sime Darby	MY
BP	UK	Freeport McMoran Copper & Gold Inc	US	Norilsk Nickel	RU	StatoilHydro	NO
Cairn Energy	UK	Golden Agri-Resources	SG	Novatek	RU	Total	FR
Carrefour	FR	Holcim	CH	Pepsico	US	Vedanta Resources	UK
CEMEX	MX	Idemitsu Kosan Co Ltd	JP	Petrobras	BR	Unilever	NL
Chevron Corporation	US	Impex Holdings	JP	PetroChina	CN	Xstrata	UK
China Shenhua	CN	IOI Corporation Berhad	MY	Rio Tinto	UK		
CNOOC	CN	Lafarge	FR	Rosneft	RU		

Sector Sustainable Transport

pages 12-15

Company	Countries	Company	Countries	Company	Countries	Company	Countries
Aisin Seiki	JP	Continental	DE	Hyundai Motor	KR	Samsung Heavy Industry	KR
Autoliv	SE	Energy Conversion Devices	US	Johnson Matthey	UK	Siemens	DE
BAA	UK	Ford Motor Company	US	Landi Renzo	IT	Shimano	JP
BAE Systems	UK	General Motors	US	Network Rail	UK	Tata Motor	IN
Boeing	US	Giant Manufacturing	TW	Nissan	JP	Toyota	JP
Canadian Pacific	CA	Honda	JP	Renault	FR	Umicore	BE
Chrysler	US	Hyundai Heavy Industry	KR	Rolls Royce	UK	Zap Cards	US

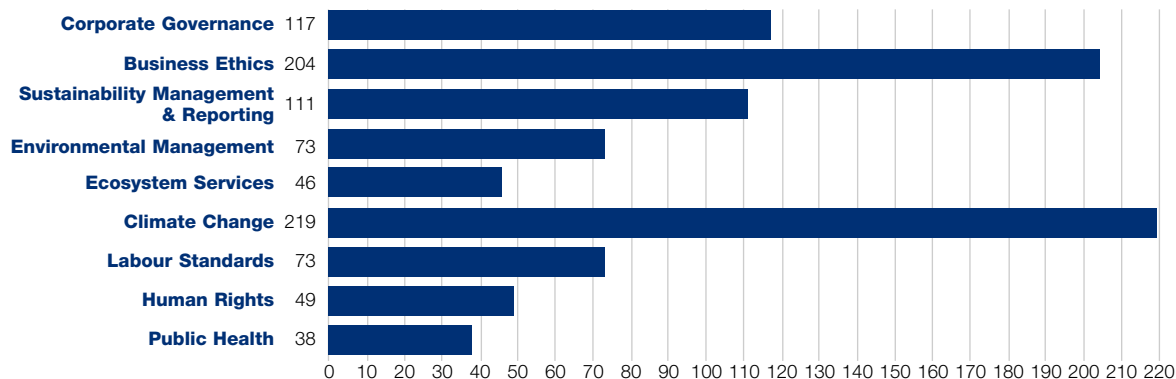
Activity report: How reo® helps implement PRI

F&C's responsible engagement overlay is unique in the depth and breadth of its engagement, and in its ability to help clients implement the UN Principles for Responsible Investment (PRI). Key features are:

- A 16-person team of Governance & Sustainable Investment 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.

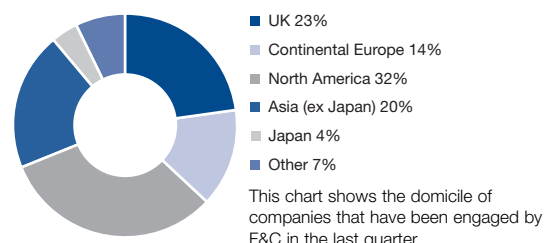
Number of companies engaged this quarter

Programme name

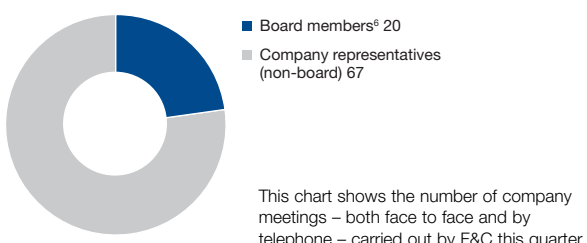


Total number of companies engaged this quarter ³	501
Number of countries	45
Company meetings voted ⁴	832
Corporate Governance engagement letters sent ⁵	435

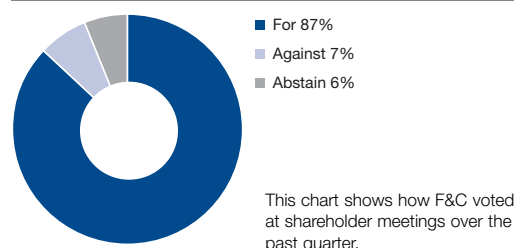
Geographical spread



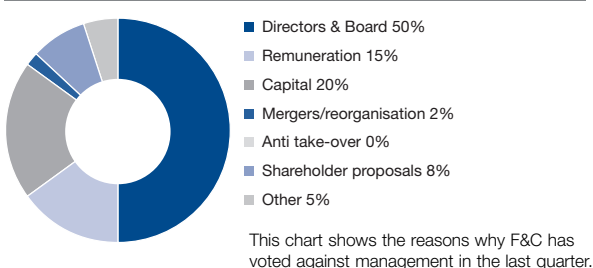
Number of company meetings



Resolutions at shareholder meetings



Reasons for VAMs



³ Companies may have been engaged on more than one issue.
⁴ i.e. company meetings for which F&C has issued voting instructions. Data refers to the period from 01/06/08 to 31/08/08.
⁵ Data for this quarter refers to the period from 16/06/08 to 31/08/08.
⁶ Includes Named Executive Directors in the US.



Quarter: In review

Global Round-up



F&C addressed an audience of 270 pension fund trustees and investment consultants at the annual conference of JANA, **Australia's** leading investment consultant. This was the first time the JANA conference had profiled responsible investment, reflecting growing interest in this topic Down Under as the country struggles with record drought and climate change rises up the public agenda. F&C's delivery focused on its experience in integrating environmental, social and governance (ESG) themes into investment strategies, as well as the investment opportunities presented by climate-friendly technologies and adaptation.



F&C travelled to **Korea** to speak at the Annual General Meeting of signatories of the UN Principles for Responsible Investment (PRI). We led panel discussions on bribery & corruption, the Extractive Industries Transparency Initiative, and ESG in the insurance and mining sectors. While in Seoul,

F&C held detailed private engagement meetings with six major Korean companies, where discussions focused on supply chain management systems and climate change. Detail of these meetings can be found on pages 8-9 and pages 12-15.



F&C headed to **Singapore** and **Malaysia** to take part in the first International Corporate Social Responsibility Conference in Kuala Lumpur. Besides sharing tips with Asia-based investors, we engaged with seven companies, as well as regulators and local stakeholders such as the UN Global Compact representatives in Singapore and Malaysia. Among the companies engaged, we met with **Sime Darby** and **Kulim**, two of Malaysia's leading oil palm plantation owners, to explore how they can produce palm oil, a key feedstock in biofuels, while protecting the environment and benefiting local communities.

In other news:



F&C trains its guns... on corruption

Following recurrent allegations of bribery and corruption, the British defence giant **BAE Systems** announced in June that it would adopt the recommendations of the Woolf Committee, an independent committee led by the former Lord Chief Justice Lord Woolf, formed to review the company's ethical principles and practices. Earlier this year, F&C had made a submission to the Woolf Committee, calling for a range of new safeguards – many of which were reflected in the Woolf Committee's final recommendations. **BAE** plans to implement all 23 of the Woolf Committee recommendations over a three-year period.



Putting a stop to forced child labour

F&C joined over 60 investors and civil society groups in writing to President Islam A. Karimov of Uzbekistan and US Secretary of State Condoleezza Rice to urge an end to forced child labour in the Central Asian country's annual cotton harvest. This was echoed by similar calls from the four largest US retail and apparel trade groups, amidst growing concern that forced child labour is prevalent in the cotton fields of Uzbekistan. A dozen leading retailers, including **Tesco**, **H&M**, **Marks & Spencer**, **Levi Strauss**

and **Gap Inc** have taken the extraordinary step of freezing purchases of Uzbek cotton. F&C believes that active engagement over time to limit child labour is preferable to a boycott, in order to avoid plunging the country's main export industry and families into crisis – but retailers have in this case turned up the pressure due to the central role played by the Uzbek government in drafting the children.



'Wising up' to climate change

F&C has released its first annual ClimateWise Statement⁷, which details how it is managing risks and capitalising on investment opportunities presented by climate change. The Statement coincides with the first anniversary of the ClimateWise Principles, a set of commitments endorsed by 40 insurance companies and related organisations, including F&C, who have pledged to take action on climate change and to report publicly on their own performance. F&C Chief Executive Alain Grisay also addressed a group of senior executives from P8, a group of leading international pension funds committed to taking action on climate change, at a reception hosted by HRH The Prince of Wales.



Quarter In Review: Engagement Highlights

F&C defends Shareholder Rights in Europe and Brazil

As summer takeover bids in Brazil, Germany and Greece suddenly put minority shareholder rights under threat, F&C took up its pencil and urged the Brazilian and German regulators, Comissão de Valores Mobiliários (CVM) and the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), as well as the European Commission to tighten up on protections for minority shareholders.

Germany's **Deutsche Telekom** swallowed up its smaller Greek counterpart, **Hellenic Telecommunication Organisation (OTE)**, while Brazil's **Votorantim Celulose e Papel (VCP)**, a pulp and paper producer, tied the knot with Brazilian rival **Aracruz**.

In the first case, **Deutsche Telekom** acted in concert with the Greek state to ensure effective control of **OTE** with just a 25% stake in the company. In the second case **VCP** secured its control of **Aracruz** by using a loophole in Brazilian legislation to avoid paying a premium to minority shareholders. Meanwhile, Germany's **Schaeffler Group**, a family-owned ball bearings maker, stunned the market by building up a stake of 36% in **Continental AG**, the German tyre and auto parts maker, through secret derivatives purchases.

While these transactions respect the letter of the law, they clearly flout the spirit of good governance, by evading the need to offer minority shareholders an appropriate takeover premium. The **Schaeffler** case, in particular, has revealed the weaknesses in Germany's disclosure regime.

In all three cases, F&C urged regulators to improve the regulatory framework in order to prevent such practices, which ultimately undermine market efficiency. In particular, we have asked⁸:

- The German regulator, BaFin, to improve transparency and disclosure of direct or indirect ownership positions, so as prevent further "creeping takeovers".
- The European Commission to investigate whether the **Deutsche Telekom** bid for **OTE** breaches the European Takeover Directive by using Greek government support to avoid having to make a mandatory bid for the company.
- The Brazilian regulator, CVM, to consider the framework for protecting minority shareholder rights during takeover. The current Brazilian regime allows for a "two-tiered" takeover that means companies can act both as an acquirer and a controlling shareholder, thereby shutting out minority shareholders.

Ignoring minority shareholder rights not only harms shareholders in the short term but also undermines investor confidence in those capital markets with weak regulation. In an era of global finance, markets that fail to ensure credible governance regimes will find it increasingly difficult to attract flows of capital and are likely to see an increase in the cost of that capital. F&C considers the disregard of minority shareholder rights as a fundamental investment risk and will continue to engage with markets where it sees these rights being flouted.

Mexican Fast-Food Giant: From Philanthropy to Sustainable Business Strategy

Alsea is Mexico's leading operator of fast-food restaurants. By 2006, the company, which runs iconic American franchises like Starbucks Coffee and Burger King, boasted 12 brands, almost 20,000 employees, and a planned expansion throughout South America. Success was fuelled by both a perception of quality and hygiene, as well as attraction to American brands. However, growth outpaced the company's risk management systems – particularly in the areas of sustainability and reputation. Alsea lagged well behind operations bearing the same logo in the US, risking damage to these global brands and soured relations with US partners. Moreover, these systems were ill-suited to the demands of the Mexican market, where weaker enforcement of labour and other regulations, lingering anti-Americanism and a startling obesity trend challenged Alsea's business model.

Like many firms in Latin America, Alsea's corporate responsibility strategy focused on philanthropic activity in neighbouring communities. This was evident in the company's annual social reporting, which stressed charity work over corporate strategy and practices. In 2006, F&C asked Alsea to revisit its approach and demonstrate how it

systematically manages environmental and social risks. We urged Alsea to meet global best practice standards by:

- Adopting a labour standards policy referencing international conventions;
- Establishing targets for waste and energy efficiency; and
- Using customer materials to communicate nutrition facts and healthy food options.

We also encouraged Alsea to draw on ties with American franchisers, cooperating to manage risks on the ground and preserve brand integrity.

Within two years, Alsea responded with an enhanced corporate responsibility report for 2007, featuring waste management systems developed to support its environmental commitment. The company also enhanced disclosure of employee practices with an explicit labour rights policy, as well as data on workforce diversity and retention, a major cost factor in the fast-food sector where turnover is high. Finally, Alsea has moved to tackle reputation risk with a new customer nutrition programme and featured healthy food offerings. We will continue to monitor Alsea, with a particular focus on the introduction of clear performance targets, which are still missing. However, its progress is a positive example of how to integrate sustainability management in emerging markets.



Focus on Corporate Governance: Asia

Our objectives

Enhance corporate governance standards in Asia. Key areas of focus include:

- Strengthening minority shareholder rights, specifically for companies with controlling shareholders
- Improving levels of transparency and disclosure
- Improving board independence and accountability to minority shareholders
- Reducing bribery and corruption

The context

No scope for complacency

Despite some hiccoughs, corporate governance in Asia is looking up, as standards of law, regulation and transparency generally have improved in recent years. But investors cannot be complacent; corporate governance remains one of the most important risk factors in Asia – regardless of whether the economies are developed, as in Japan, or still developing, as in China and India. Key concerns include weak shareholder rights, which in many jurisdictions are exacerbated by ineffectual, non-independent boards, and deep-rooted corruption.

Voting and Engagement: F&C active in the region

F&C's engagement in 2008 has involved extensive outreach to both Asian companies and regulators, through voting, letters and visits to the region – including to Japan, Korea, China, India, Malaysia and Singapore.

Turning up the pressure in Japan

F&C's engagement in Japan has been underpinned by its co-authorship of the Asian Corporate Governance Association (ACGA)'s White Paper on Corporate Governance in Japan⁹ which recommended several specific actions to protect shareholder rights, boost transparency and strengthen independent board oversight. The Tokyo Stock Exchange responded by sending a questionnaire to foreign investors to sound out their views on the corporate governance practices of Japanese companies. While this may not result in overnight changes, this is a clear indication of how far corporate governance has risen up the agenda in Japan.

F&C's input into the White Paper drew heavily on the last four years of comprehensive engagement with over 40 companies, as well as a further six face-to-face company meetings this year in Japan prior to the peak 2008 voting season – **Mitsubishi Holdings, Mitsui Corp, Idemitsu Kosan, Takeda Pharmaceuticals, Nippon Oil** and **Sumitomo Metals**. Top of the list were concerns about lack of independence on the board and protection of shareholder rights. In addition, we encouraged companies to introduce environmental, social governance (ESG) performance measures in determining executive remuneration.

We said...

“While a number of leading companies in Japan have made strides in corporate governance in recent years, we submit that the system of governance in most listed companies is not meeting the needs of stakeholders or the nation at large.”

White Paper on Corporate Governance in Japan, co-written by F&C and published by Asian Corporate Governance Association, May 2008.

They said...

“... those opposed to bringing Japanese corporate governance in line with the west's would eventually 'dampen the future of Japan'.”

Atsushi Saito, Head of Tokyo Stock Exchange, quoted in 'TSE Chief fears financial sell-off', Financial Times, 12 June 2008

Going for Gold in China – In the Governance Marathon

As China geared up for its great coming-out Olympics party, F&C took its message of global best practice directly to China's business, political and civil society leaders:

- Anti-corruption: We met with oil and gas giants **PetroChina** and **CNOOC** and coal miner **China Shenhua** to recommend that they and the Chinese government itself support the Extractives Industries Transparency Initiative (EITI), which aims to combatting corruption in resource-rich countries by promoting fiscal transparency; we await their responses.
- Adoption of international governance standards: In our outreach to 27 Chinese companies, we recommended that they implement F&C's business ethics guidelines and move towards international good practice in board independence and transparency.

We also met with the Shanghai Stock Exchange and suggested that listing rules be tightened on pre-emption rights and whistleblower protection. We welcomed China's introduction of international accounting standards (IFRS), and highlighted that these must be properly enforced to improve investor confidence. We also asked that the Exchange provide guidelines for voluntary disclosure on corporate social responsibility to help the transition to international practice.

China Mobile's Great Leap Forward:

In 2007 F&C began a wide-ranging dialogue with Chinese state-owned telecoms giant **China Mobile** and offered recommendations on both its sustainable development strategy and its reporting. In June of this year, **China Mobile** unveiled a three-year sustainability strategy, a new oversight committee and its first-ever sustainability report. It has pledged to address public health risks associated with electronic waste and electromagnetic fields, and has set an ambitious energy efficiency target of 40% by 2010. F&C welcomes these efforts by the world's largest mobile telephone operator, and will be monitoring how its impressive public commitments are backed up by evidence of results. With ambitions to expand in Europe and the Middle East, **China Mobile's** success will reflect on the sincerity of its effort and how effectively it manages key relationships, including with customers, local regulators and communities.

Corruption in Korea: How Long 'til the Party's Over?

Korea has long laboured under the twin ills of rampant corruption reaching the highest echelons of business and politics, and profound apathy on the part of the judiciary and general public. Egregious cases have been quietly dropped or ended in suspended sentences, for fear of landing the leaders of Korea's *chaebols* in jail, and thereby imperilling GDP. However, as the economy opens up and the media expose wrongdoing, questions are being raised about the damage corruption might do to the reputation of Korea Inc. F&C has systematically raised anti-corruption as

a key corporate governance issue, including in meetings with **Hyundai Heavy Industry**, **Hyundai Motor** and **Hyundai Steel** after they were fined by the Korean Fair Trade Commission. We have probed how boards review internal controls and ensure effective risk management systems, and have asked these companies to strengthen the audit committee's role, and to report on internal controls in their 2009 annual reports.

We also pressed these points through our votes: we opposed the entire board at **SK Holdings**, **Hyundai Motor** and **Doosan Heavy Industries** to protest against executives continuing to serve on the board following their conviction on criminal counts of accounting fraud, embezzlement and tax evasion. We also wrote to these companies to ask the board to remove these executives from management positions.

Finally, F&C led investor efforts to promote stronger anti-corruption practices by producing a new set of policies and guidelines for the International Corporate Governance Network (ICGN), which were unveiled at its annual conference in Seoul. We also led conference discussions on anti-corruption practices and the EITI at the annual meeting of the Principles for Responsible Investment (PRI).

Asia's Governance Leaders: Dilution Risk Looms

In Singapore and Hong Kong, F&C's voting hammered away at dilution risk, as new share issuance proposals typically included requests to allow an increase in authorised share capital of up to 20% without pre-emption rights, or up to 50% with pre-emption rights. We therefore voted against these requests at nearly every company.

They said...

“There is a word in Korean society that says when you have money then you are not guilty and if you have no money then you are guilty.”

Kang Sung-goo, Secretary of Korea's Transparency International, following the President of South Korea's announcement that some of the biggest corporate criminals in the country were to be pardoned. Australian Broadcasting Corporation, 14 August 2008.





Focus on Ecosystem Services

Our objectives

Encourage all companies faced with significant risks or opportunities related to ecosystem services to understand and manage them, through:

- **Biodiversity management:** adopting a policy and management process for direct and indirect biodiversity impacts.
- **Access to land:** developing appropriate strategy and management systems for regulatory and community approval.
- **Water:** integrating water-use planning into project planning and setting reduction targets.
- **Other ecosystem services:** implementing policies and management systems for ensuring security of supply of biological resources.

Nature's value-added: Why do ecosystem services matter to investors?

Business depends on products and services provided by the natural environment, known as “ecosystem services”. Ecosystem services enable vital processes, such as pollination for food crops; provide essential products like freshwater; and “regulate” the natural environment, such as trees that store carbon or marshes that absorb and filter floodwaters. Over the past fifty years, human activity has altered ecosystems significantly, mainly through soaring use of natural resources, such as food, water, timber, fibre and fuel.¹⁰ Unless action is taken swiftly to reverse this damage, business performance will suffer. Degraded ecosystem services will bring sudden, unpredictable changes, such as flooding, deteriorating water quality, disease and shifts in climate. Already by 2010, coastal provinces representing 25% of China's GDP will face a gap of 16.6-25.5 billion m³ of water per year.¹¹ Protection of ecosystem services is therefore a significant long-term challenge for the global economy, and one that companies individually will increasingly need to confront. In the next ten years, they will come under political scrutiny for their impact on ecosystem services – and also foot the bill for degraded services not necessarily of their own making.

Engagement by F&C

F&C has engaged the sectors facing the greatest risks and opportunities related to ecosystem services: extractives, food & beverages, tobacco and construction.

Extractives

The sector has improved practices substantially in the last decade, but its impacts on ecosystem services remain significant and new players are only getting to grips with global good practice. F&C has engaged with over

30 companies¹², including with “wisened” majors like **Anglo American** on emerging issues of biodiversity offsets and water, and with relative newcomers like **China Shenhua** and Russia's **LUKOIL** on basic biodiversity risk management. Our focus areas have included:

- **Biodiversity management:** F&C has encouraged mining giants **Anglo American, BHP-Billiton, Freeport-McMoRan Copper & Gold Inc, Rio Tinto, Xstrata** and **China Shenhua** to adopt comprehensive, risk-based biodiversity management relating to their core activities, and move away from isolated conservation projects. F&C has also recommended factoring in biodiversity at the earliest stage of new projects, in downstream impact assessment and where project management is outsourced. Improvements are evident at **Anglo American, Rio Tinto** and **Xstrata**, who face tighter environmental regulation in markets like South Africa, making preventive action much more economic than retrospective remedies.
- **Biofuels:** we have urged oil majors¹³ to establish industry-wide sustainability standards, so that first-generation biofuels deliver both emissions reductions and sourcing practices that protect ecosystem services. **Shell, BP** and **Petrobras** have taken the lead and formed a new industry initiative to do this: the Roundtable for Sustainable Biofuels. F&C is contributing to this initiative to ensure agreed sustainability standards are sufficiently robust.

Food, beverages and tobacco

These sectors are particularly vulnerable to degraded ecosystem services, and have started to make headway in managing them. Momentum is evident in palm oil and freshwater – serving as good examples of business action to protect ecosystems.

¹⁰ The Millennium Ecosystem Assessment, 2006. This is a state-of-the-art scientific appraisal of trends in the world's ecosystems and presents options to restore, conserve and enhance them. A key finding is that approximately 60% of ecosystems assessed are being degraded or used unsustainably, including fisheries and freshwater supply.

¹¹ Dr. Richard Hardman, EU Commission, *Challenges in Water Resource Management in China*, April 2009

¹² **Anglo American, BHP Billiton, BP, Cairn Energy, CEMEX, Chevron Corporation, China Shenhua, CNOOC, Eni, Exxon Mobil, Evraz, Freeport-McMoRan Copper & Gold Inc, Idemitsu Kosan Co Limited, Holcim, Inpex Holdings, Lafarge, Lonmin, LUKOIL, Marathon Oil Corporation, Norilsk Nickel, Novatek, Petrobras, PetroChina, Rio Tinto, Rosneft, Royal Dutch Shell, StatoilHydro, Total, Vedanta Resources and Xstrata.**

¹³ F&C has engaged on biofuels with the following oil majors: **BP, Chevron, Eni, ExxonMobil, Petrobras, PetroChina, Shell, StatoilHydro** and **Total.**

Palm oil – green fats please

Demand for palm oil – used in goods ranging from food to cosmetics – has soared in recent years, driven mostly by rising demand for edible oil and food. Expansion of palm oil plantations has raised consumer concern in Europe though about rainforest destruction and loss of species like the orang-utan. F&C has asked producers and users of palm oil to take action to protect rainforests, which provide essential ecosystem services, including carbon stores.

Unilever has announced all palm oil used in Europe will be fully traceable by 2012, while **Ahold** and **Carrefour** have joined the Roundtable for Sustainable Palm Oil, aimed at promoting responsible cultivation of palm oil. F&C has pressed roundtable members to tighten sustainability standards required of palm oil producers, and specifically to protect peat swamps that store carbon, which are being drained and often burned to make the soil suitable for new palm oil plantations. F&C has also engaged with suppliers to global brands involved in cultivating, processing and trading palm oil, such as **Golden Agri-Resources**, and held face-to-face meetings in Malaysia and Singapore with **Samling**, **Sime Darby** and **IOI Corporation Berhad**. **Sime Darby** aims to have all of its palm oil certified independently by 2009, and has pledged to investigate allegations concerning deforestation in Indonesia by one of its third-party suppliers.

Water - Can we quench the world's thirst?

Today, 5-20% of freshwater use exceeds long-term sustainable supply, and 15-35% of irrigation withdrawal is unsustainable.¹⁴ Population growth, urbanisation, changing consumption patterns and climate change are putting increasing stress on water supplies. Following

conflicts with local communities in India over depletion of groundwater dating back to 2003, **Pepsico** faced a shareholder resolution at its 2008 Annual General Meeting, calling for a policy committing to “the human right to water.” F&C did not support the resolution, as **Pepsico** has pledged to reduce water consumption per unit of production and improve water supply to local communities near its production sites. But F&C has recommended **Pepsico** publish group-wide water efficiency targets and locate its production plants based on local water risk analysis. We will monitor whether the company adopts these recommendations for water-scarce regions.

“As long as PepsiCo is in the beverage business in places like India, it will remind potential customers of a resource that's increasingly in short supply.”

‘Pepsi: Repairing a Poisoned Reputation in India’, *Business Week*, 31 May 2007

They said...

“Business cannot assume that there will be ample warning of a change in the availability of key services or that company's past responses to changes will be successful in the future. Ecosystems often change in abrupt, unpredictable ways. Most ecosystems are being altered by human actions in unprecedented ways.”

‘Ecosystems and Human Wellbeing’, a report by *Millennium Ecosystem Assessment*, 2006





Focus on Trains, Planes and Automobiles: All aboard for sustainable transport

Our objectives

Encourage companies in the transport sector to:

- Research, develop, and invest in sustainable transport solutions
- Introduce environmentally-efficient production methods
- Maintain appropriate health, safety and labour standards
- Manage business ethics risks including corruption and undue political influence

Engagement by F&C

Introduction

As fuel prices spiral ever higher, the global economy sputters, pension deficits loom, and consumers rethink their purchasing priorities, we asked the question: “What will the transport sector look like in 2020?” To answer this, we identified the key challenges facing companies that want to deliver both competitive investment returns and truly sustainable transport solutions.

The issues: Higher costs, changing demands and tougher rules

As demand from China and other key emerging markets has soared, crude oil prices have surged, reaching a record \$147 a barrel in July before tapering off in the face of a weakening global economy. Such dramatic increases have had a domino effect across the transport sector, prompting consumers to shun “gas-guzzlers” in favour of more fuel-efficient cars; driving up production costs as raw materials and finished goods criss-cross the globe; and even triggering emergency fiscal measures as governments slash fuel subsidies they can no longer afford.

Other macroeconomic forces are also taking their toll. Margins in the transport sector have been squeezed by surging steel and aluminium prices, which have been driven by both galloping demand in emerging economies and higher energy costs. Meanwhile, demand has suffered from rising unemployment, the credit crunch, and food price inflation that are causing consumers to make tough choices about how they spend their cash and how they get to work each day.

The regulatory backdrop for the transport sector has also begun to shift in the last year. In 2006, the EU announced plans to include the aviation sector in phase II of the

European Emissions Trading Scheme (EU ETS). From 2012, all airlines flying into or out of Europe will be required to meet strict emissions targets or buy carbon credits to offset their emissions. Meanwhile, automakers face sharply higher vehicle standards. In late 2007, US regulators revised fuel economy standards for cars and light trucks for the first time in over 30 years. By 2020, all cars sold in the US must meet minimum fuel efficiency standards of 35 miles per gallon, reflecting an average increase in fuel efficiency of over 30%.¹⁵ At the same time, the EU announced stretching new regulations for the auto sector, including stricter limits on tailpipe emission beginning in 2014, and revisions to the rules governing the renewable transport fuels obligation under the Biofuels Directive.

Against these pressures, companies in the transport sector must position themselves to meet changing regulatory and customer demands, while satisfying often restive workers and keeping pace with fierce competition from emerging market players.

F&C Acts: Sorting the clean from the dirty in the transport sector

F&C has taken a critical look at this sea-change in the transport sector. First we asked, “Which sub-sectors will benefit or suffer most from the above changes?” Railroad and bicycle companies lead the pack of winners due to their more limited environmental impacts, and low or negative correlation with oil prices. Then we determined which companies within the remaining sectors were either well positioned to meet sustainable transport obligations, or were developing the solutions to help steer laggards in this direction. To date, F&C has identified over 20 companies offering sustainable transport solutions, including the following:

Company	Country	Sustainable Transport Product
Aisin Seiki	Japan	Hybrid drivetrains
Autoliv	Sweden	Car safety systems
Canadian Pacific	Canada	Railroads
Continental	Germany	Fuel-efficient tyres and auto controls
Energy Conversion Devices	US	Fuel cell technology
Giant Manufacturing	Taiwan	Bicycles
Johnson Matthey	UK	Autocatalysts, fuel cells
Landi Renzo	Italy	Advanced fuel systems for low-emission vehicles
Network Rail	UK	Railroads
Shimano	Japan	Bicycles
Umicore	Belgium	Autocatalysts to reduce emissionsdescription of approach to lobbying
Zap Cards	US	Electric cars

Automakers, shipbuilders and aerospace companies face the biggest hurdles in transforming their business models and will need both to overhaul their product portfolios and invest heavily to develop the sustainable transport solutions of the future. However, company responses to these pressures to date have been mixed.

To determine who will win out, and who may be left behind, F&C engaged companies in the shipbuilding and auto sectors and asked them how they are developing fuel-efficient, low-emission products that will position them to benefit from future regulatory demands. We met with representatives from Korean shipbuilding companies **Hyundai Heavy Industry** and **Samsung Heavy Industry** and asked how they were developing lighter, more fuel-efficient ships. We also met with leading Asian automakers, including **Hyundai Motor** and India's **Tata Motor**, both of whom aim to sell to the growing middle class in emerging Asian markets, and therefore will need to offer affordable, fuel-efficient vehicles. In 2009, Hyundai Motors plans to unveil the first Hybrid Electric Vehicle (HEV) fuelled by a combination of liquid petroleum gas and a lithium ion battery. If successful, it will also export its HEVs for sale across Asia. In contrast, Tata Motors management suggested that meeting affordable transportation needs was a higher priority than addressing climate change. F&C believes that sustainable transport involves developing cars that are safe, affordable, fuel efficient, and low emission. We therefore suggested that the company address public safety concerns as a primary impact, while still evaluating its greenhouse gas emissions in order to address these going forward in keeping with global good practice. In 2008, the company took the first step toward doing this when it participated in the Carbon Disclosure Project.

In developed markets, competition for the title of sustainable automaker also heated up, with European, US and Japanese automakers fighting to define the standard for the electric vehicle market of the future. European heavyweights such as **Nissan-Renault** argue that the

future of low-emissions vehicles lies in fuel cell technology that will enable the development of fully electric battery-powered vehicles by 2012. Japan's **Toyota** and **Honda** counter that the short-term future for automakers lies in ever-improving hybrid gas-electric vehicles that utilise the most advanced technologies. Meanwhile in the US, megaliths **Ford Motor Company** and **General Motors** continue to struggle to re-invent themselves, retooling SUV assembly plants to turn out smaller vehicles, fending off ongoing disquiet by workers over rising health insurance costs, and struggling to retain customers whose wandering eyes are looking at new fuel efficient vehicles. In 2008, F&C wrote to the boards at both US automakers to ask for specific targets regarding vehicle emissions and fuel economy standards across their fleets, and voted in support of shareholder proposals to this effect.

Beyond the 'What?' lies the 'How?'

In addition to questioning product development strategy, F&C also explored how transport companies were addressing environmental and social risks that could affect overall production costs, and therefore margins. We asked:

- Whether companies have an environmental management system for reducing hazardous emissions from their manufacturing facilities, and how their environmental performance stacks up on a year-on-year basis and compared to peers?
- How they maintain sound labour standards on the production line? What incentives are in place to reduce accident and injury rates? How they enforce labour standards for sub-contracted labourers?
- Whether they have taken any steps to improve the sustainability of their supply and logistics chain? Whether they have developed a Vendor Code of Conduct or a Responsible Purchasing Policy, that would reduce their indirect environmental and social impacts?



Focus on Trains, Planes and Automobiles: All aboard for sustainable transport (continued)

Experience suggests that companies that manage these challenges effectively are better positioned to avoid operational delays, withstand regulatory changes, and benefit from more efficient production methods that will yield better margins.

An aging workforce and rising pension obligations and insurance costs are also undermining the sustainability of US auto production, threatening further industrial disputes as companies seek to trim the cost burden.

Boeing, Toyota, General Motors and Ford Motor are all struggling to slash production costs despite pressure to lift wages, plug pension deficits and cover the rising costs of health care. F&C has worried about the impact of unfunded pension liabilities on share valuations and debt quality, and asked companies facing significant pension deficits to report on how they plan to manage these. In the US, rising healthcare costs and political pressure to offer universal healthcare will have a major impact on the financial statements of large employers. Therefore, F&C has asked companies to report on their strategy for responding to these pressures, and to disclose any public policy or lobbying activities they are undertaking.

Meanwhile, rising demand for private cars in India has led Tata Motors to expand its production facilities to include a new plant in West Bengal to build the world's cheapest car, the Nano. Despite state government backing, the company faces significant resistance from local communities and the main regional opposition political party over property rights, compensation and community resettlement programmes that will be necessary to build the facility. F&C met with company management and asked how the company engaged with local community members and regional political parties to agree community rehabilitation plans, safeguard its license to operate and avoid unnecessary costs or delays to the launch of the Nano. As F&C went to press, the company announced that violent protests by local communities had led it to suspend production at the facility altogether, and that the Board was considering moving the plant to another location, despite having invested \$338 million in the area to date.

Licence to drive

Given the changes afoot governing transport sector regulation, we also urged companies across the sector to get involved in shaping the future of transport standards by engaging with regulators, in a transparent and responsible manner. Companies including **Johnson Matthey, BAA,**

Chrysler, Ford Motor, General Motor and Siemens have joined business peers in publicly lobbying UK, EU and US politicians to commit to binding targets to reduce greenhouse gas emissions, and to provide incentives to companies that take early action to do so. By doing so, we believe industry can help shape the environmental legislation of the future that will be both environmentally effective and cost efficient.

Despite these new emerging rules, companies in the transport sector still need to meet basic business ethics standards. Amid fierce competition and shrinking margins, the temptation to cut corners or engage in unlawful business practices can be intense. Following recent corruption scandals at **BAE Systems, Boeing, Siemens** and **Rolls Royce**, we asked companies what kinds of internal controls and business ethics systems they had to ensure compliance with existing laws and regulations. We encouraged them to publish a group-wide code of conduct, establish clear compliance monitoring systems, and to review internal controls on a regular basis to spot any weaknesses that could lead to regulatory fines or other losses.

Assessment & Next steps

F&C will continue to search out companies that are developing the sustainable transport solutions of the future for potential investment. We will also engage with those companies that continue to drag their feet and are likely to be left at the curb if they fail to respond to the rapid transformation that is shaping the sector.

At a macroeconomic level, F&C will also support legislative action that sets strong product standards for fuel efficiency, rewards environmentally responsible companies, and deters bad behaviour.

“ There is nothing like high oil prices, panic-selling of big cars and the prospect of swingeing new penalties on carbon-spewing vehicles to concentrate the minds of the world's carmakers. In less than two years something remarkable has happened. Technologies once regarded by horsepower-obsessed marketing departments as politically correct public-relations fluff, never likely to see the light of day, are entering the mainstream just as fast as the car firms can get them there.”

‘Cars: The Road Ahead’, *The Economist*, 6 September 2008

We said...

“We recommend that the company prioritise within its corporate responsibility programme strong implementation of international good practice in climate change, anti-corruption and political influence, employee relations – including non-discrimination and HIV/AIDS within the workforce – and effective community consultation, particularly during land acquisition.”

F&C letter to Tata Motors, 28 December 2007

They said...

“Tata Motors is distressed at the limited clarity on the outcome of the discussions,” the Mumbai-based company said in a release today. “In view of the same, Tata Motors is obliged to continue the suspension of construction and commissioning work at the Nano plant.”

Tata Motors press statement, quoted in ‘Tata Motors Says It Won’t Resume Work at Nano Plant (Update2)’, *Bloomberg*, 8 September 2008

Overall, **Toyota** has been responsive to our questions, clarifying that its operations in Burma are miniscule and do not involve any interaction with the military junta, and confirming its policies and systems for preventing whistleblower retaliation. However, the company’s hesitancy to respond to the specific allegations put forward by the whistleblower or its disputing workers, or to publish a statement on Burma, suggest that internal management systems may be fragile, or that it is uncomfortable discussing political or social issues. F&C’s engagement continues, with the objective of seeing the company proactively tackle product quality concerns, address its wage dispute to avoid production delays, and publish a public statement regarding its commitment to protecting human rights in Burma.

Shaping Public Policy – Aviation

In 2006, F&C, with support from both the Corporate Leaders’ Group on Climate Change and the Institutional Investors’ Group on Climate Change (IGCC), called on the European Union to expand the sectors covered by the EU ETS to include the aviation sector. In July 2008, the European Parliament took these recommendations on board and announced plans to include aviation in the EU Emissions Trading Scheme, effective January 2012. While this announcement was a long time in coming, airline operators in Brazil, Canada, China, India, and the US are now protesting the inclusion of flights originating outside the EU in the scheme. According to a recent study, airlines are pumping up to 20% more carbon dioxide into the atmosphere than previously estimated, making it one of the biggest, and fastest growing contributors to global warming if left unchecked. The question remains as to whether politicians will risk an international trade war to protect the future of the environment and society.

Other Engagement – Driving regime change in Burma?

There is little doubt that **Toyota Motor Corp.**, which took the hybrid motor from concept to reality for over a million customers, is the pioneer of sustainable transport. F&C has therefore concentrated its dialogue with the company on social issues. F&C’s concerns focus on **Toyota’s** increasing production troubles, which include wage disputes and product recalls, as the company strives to raise production levels. Signs of weaknesses in internal controls were also revealed earlier this year when an internal whistleblower alleged fraudulent activity, poor quality control systems, and retaliation. Meanwhile, as political and civil tensions mount in Burma, **Toyota’s** presence there has become increasingly controversial.

F&C has asked the company to review its internal control for product safety and protecting whistleblowers and report to shareholders on its findings. We’ve also encouraged **Toyota** to publish a public statement on its activities in Burma and how it is avoiding allegations of “complicity” in human rights abuses there.

They said...

“Growth of CO2 emissions on this scale will comfortably outstrip any gains made by improved technology and ensure aviation is an even larger contributor to global warming by 2025 than previously thought. Governments must take action to put a cap on air transport’s unrestrained growth.”

Jeff Gazzard, spokesman for the Aviation Environment Federation, quoted in ‘Airline emissions far higher than previous estimates’, *The Independent*, 6 May 2008

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 both 2006 and 2007, F&C were voted winners of the 'Gold Standard' in the Fund Management category. 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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WINNER



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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.

Please contact us for further details or visit our website at www.fandc.com

What could we do better?

We hope we have accurately reflected your concerns. Still, we want to be sure we get it right – your input is valuable to us.

Thank you for telling us how your money should talk.

Please mark your comments 'reio report feedback', and e-mail them to:

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Important information. All data is as at 30 September 2008, unless otherwise stated.

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