HERMES | Equity Ownership Services

Q4 Public Engagement Report 2013

Unlocking human potential to add value for shareholders.

www.hermesfundmanagers.com

This report contains a summary of the responsible ownership activities undertaken by EOS on behalf of its clients. It covers significant themes that have informed some of our intensive engagements with companies in Q4 2013.

The report also provides information on our voting decisions and the steps we have taken to promote global best practice, improvements in public policy and collaborative work with other shareholders.

What is EOS?

Hermes Equity Ownership Services (EOS) helps institutional share-owners around the world to meet their fiduciary responsibilities and become active owners of public and private companies. EOS' team of engagement and voting specialists monitors its clients' investments in companies and intervenes where necessary with the aim of improving performance. EOS' activities are based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

Through pooling resource with other like-minded funds to create a stronger and more representative shareholder voice, our joint company engagements can be more effective. We currently act on behalf of 32 investors with roughly $163bn* in assets under stewardship.

Hermes has the largest stewardship resource of any fund manager in the world. Our 30 person team includes former CEOs and other board members of public companies, as well as senior strategists, corporate governance experts, investment bankers, fund managers, lawyers and accountants.

The depth and breadth of this resource reflects our philosophy that ownership activities require an integrated and skilled approach. Intervention at senior management and board director level should be carried out by individuals with the right skills and with credibility. Making realistic and realisable demands of companies, informed by significant hands-on experience of business management and strategy setting is critical to the success of our engagements.

Hermes has extensive experience of implementing the Principles for Responsible Investment (PRI) and other Stewardship Codes. EOS' Chief Executive Colin Melvin chaired the committee that drew up the original principles and we are actively engaged in a variety of work-streams through the clearinghouse. This insight enables EOS to help signatories to meet the challenges of effective PRI implementation.

How does EOS work?

EOS uses a proprietary screening process to determine which companies are likely to benefit from intensive engagement. The first element of this screen looks at the companies' ability to create shareholder value by comparing the weighted average cost of capital with cash returns to investors. We then apply further screens across a range of other metrics including environmental and social issues. Finally, we assess the prospects for engagement success.

The Hermes Responsible Ownership Principles set out our basic expectations of companies in which our clients invest. These cover business strategy, communications, financial structure, governance and management of social, ethical and environmental risks. The Principles and their regional iterations guide our intervention with companies throughout the world. Our approach is pragmatic and company and market specific, taking into account individual company circumstances.

We escalate the intensity of our involvement with companies over time depending on the nature of the challenges they face and the attitude of the board towards our intervention. Some engagements involve one or two meetings over a period of months, others are more complex and entail multiple meetings with different board members over several years.

At any one time there are many companies included within our core engagement programmes, meaning that significant additional resources are dedicated to these situations. All of our engagements are undertaken subject to a rigorous initial assessment and ongoing review process to ensure that we are focusing our efforts where they can add most value for our clients.

While we are robust in our dealings with companies, the aim is to deliver value to clients, not to seek headlines through campaigns. These can often undermine the trust which would otherwise exist between a company and its owners. We aim to be honest and open with companies about the nature of our discussions and will seek to keep such discussions private. Not only has this proved the most effective way to bring about change, it also acts as a protection to our clients, so that their position will not be misrepresented in the press.

For these reasons, this public report does not contain specific details of our interactions with companies but aims to bring clarity on some of the most important issues relevant to responsible owners today and EOS' related activities in these areas.

We would be delighted to discuss EOS with you in greater detail.
For further information please contact:
Colin Melvin on +44(0)207 680 2251.

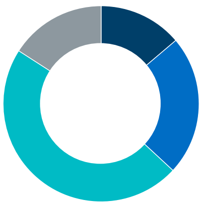
* as at 31 Dec 2013

Engagement by region

Over the last quarter we engaged with 172 companies on a range of 377 social, environmental, business strategy and governance issues. EOS' holistic approach to engagement means that we will typically engage with companies on more than one issue simultaneously. The engagements included in these figures are in addition to our discussions with companies around voting matters.

Global

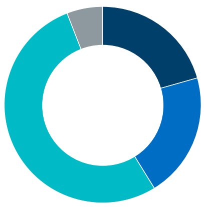
We engaged with 172 companies over the last quarter.



- Environmental **13.8%**
- Social and ethical **23.1%**
- Governance **47.2%**
- Strategy and risk **15.9%**

Australia and New Zealand

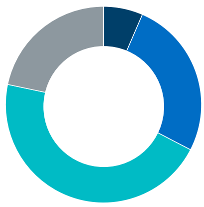
We engaged with 11 companies over the last quarter.



- Environmental **20.6%**
- Social and ethical **20.6%**
- Governance **52.9%**
- Strategy and risk **5.9%**

Developed Asia

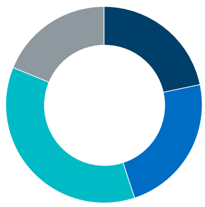
We engaged with 17 companies over the last quarter.



- Environmental **6.5%**
- Social and ethical **26.1%**
- Governance **45.7%**
- Strategy and risk **21.7%**

Emerging and Frontier Markets

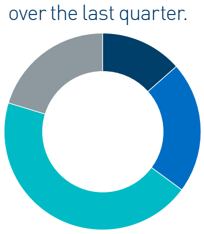
We engaged with 32 companies over the last quarter.



- Environmental **21.7%**
- Social and ethical **23.2%**
- Governance **36.2%**
- Strategy and risk **18.8%**

Europe

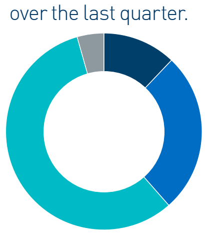
We engaged with 34 companies over the last quarter.



- Environmental **13.5%**
- Social and ethical **21.6%**
- Governance **44.6%**
- Strategy and risk **20.3%**

North America

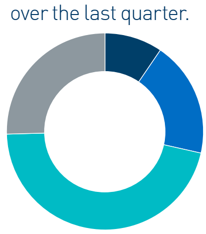
We engaged with 49 companies over the last quarter.



- Environmental **12.1%**
- Social and ethical **26.4%**
- Governance **57.1%**
- Strategy and risk **4.4%**

UK

We engaged with 29 companies over the last quarter.



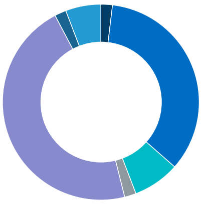
- Environmental **9.5%**
- Social and ethical **19.0%**
- Governance **46.0%**
- Strategy and risk **25.4%**

Engagement by issue

A summary of the 377 issues on which we engaged with companies over the last quarter is shown below.

Environmental

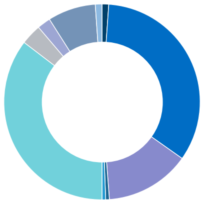
Environmental issues featured in 13.8% of our engagements over the last quarter.



- Biodiversity **1.9%**
- Climate change/carbon intensity **34.6%**
- Forestry **7.7%**
- Oil sands **1.9%**
- Other environmental **46.2%**
- Waste **1.9%**
- Water stress **5.8%**

Governance

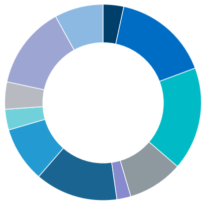
Governance issues featured in 47.2% of our engagements over the last quarter.



- Accounting or auditing issues **1.1%**
- Board structure **33.7%**
- Other governance **14.0%**
- Poison pill **0.6%**
- Related-party transactions **0.6%**
- Remuneration **35.4%**
- Separation of chair/CEO **3.4%**
- Shareholder communications **2.2%**
- Succession planning **7.9%**
- Voting rights – not 1 share 1 vote **1.1%**

Social and ethical

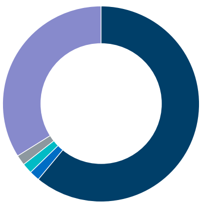
Social issues featured in 23.1% of our engagements over the last quarter.



- Access to medicine **3.4%**
- Bribery and corruption **15.9%**
- Community relations **17.0%**
- Corporate culture **9.1%**
- Customer relations **2.3%**
- Employee relations **13.6%**
- Health and safety **9.1%**
- Licence to operate **3.4%**
- Operations in troubled regions **4.5%**
- Other social and ethical **13.6%**
- Supply chain (inc child/other labour issues) **8.0%**

Strategy and risk

Strategy and risk issues featured in 15.9% of our engagements over the last quarter.



- Business strategy **61.0%**
- Capital structure **1.7%**
- Reputational risk **1.7%**
- Returns to shareholders **1.7%**
- Risk management **33.9%**

Environment

Carbon intensity of investment portfolios

UNEP FI presents the case for funds measuring, disclosing and managing their GHG footprint

As the concentration of CO_2 in the Earth's atmosphere increases, the transition to a low-carbon economy is becoming increasingly urgent. It is in the interest of the financial sector to take action now.

Overview

The growing mainstream perception among policymakers, political and economic leaders and civil society is that green house gas (GHG) emissions are among the most important global risk-drivers. Climate change-related risks are accepted to have a high likelihood of materialising in the near future with a significant economic impact; see, for example, the World Economic Forum's Global Risks 2013 report (World Economic Forum 2013). This conveys the level of priority and political focus that is likely to be put on reducing GHG emissions in the future.

Reducing such emissions will require the participation of the global financial sector and will also have tremendous implications for the sector itself. It is in the self-interest of financial intermediaries to take action now, rather than later, to prepare for this transition.

Despite the lack of a global agreement to price carbon, a global landscape of policies and regulation to cap and/or reduce greenhouse gas (GHG) emissions continues to emerge at the national and sub-national levels. These GHG-relevant regulations will increasingly impact the profitability of businesses across various sectors, even when policy development at the global level stagnates. Furthermore, the current lack of policy ambition on climate change will likely lead to more sudden and radical policy interventions in the future. We expect the public and political prioritisation of GHG emissions to sharpen as the physical impacts of climate change intensify with increasingly disruptive economic consequences.

Mandatory reporting frameworks are emerging for both companies and investors. These include Grenelle II in France and mandatory carbon reporting for companies listed on the Main Market of the London Stock Exchange. Furthermore, these requirements might expand to the European Union as the European Commission considers requiring retail investment funds to report on their approach to environmental, social and corporate governance (ESG) issues. Civil society organisations are exerting more pressure on institutional investors to be more transparent about the ways in which they are addressing climate change challenges. For instance, following the success of the Carbon Disclosure Project (CDP), the Asset Owners Disclosure Project (AODP) is mobilising pension fund beneficiaries to request further transparency on how their investment agents are addressing climate change. Increasing pressure is also arising from companies that are becoming frustrated because they perceive their own carbon disclosure under investor-backed initiatives, such as the CDP, as not having the impact it should have. This perception stems from the fact that the extent to which investors are systematically integrating the data disclosed under such initiatives (to the degree justified by financial materiality) into their investment decisions remains unknown to disclosing companies.

Over the past few years, institutional investors have developed a sophisticated understanding of the implications of climate change and climate change policy for their investments. GHG emissions are relevant to investors particularly because they can be a source of two types of financial risk: i) regulatory risk, and ii) reputational risk. When analysed together, these can be jointly referred to as 'carbon risk'. To account for carbon risk, institutional investors need to understand their overall risk exposure through ownership of investee companies and be able to assess changing conditions (for instance: regulatory, physical, demand patterns, etc.) in order to identify sources of risk for companies, sectors and geographies.

Meaningful assessment of carbon risk requires using qualitative and quantitative tools. Qualitative tools can help identify how regulatory and policy factors may increase liabilities for companies. Quantitative tools are necessary to assess company internal factors, such as carbon intensity relative to peers and competitors. They also track changes in carbon intensity over time and assess the contribution of internal factors to carbon risk exposure. Carbon footprint analysis is one of the quantitative tools that can be used to better understand how the internal factors of the company can contribute to carbon risk exposure. In GHG accounting terminology, the carbon footprint of a company is referred to as its 'emissions inventory' over any given period of time. The Greenhouse Gas Protocol, the most widely used international accounting tool for government and business leaders to assess GHG emissions, classifies a company's direct and indirect GHG emissions into three 'scopes':

- Scope 1 (or 'direct') GHG emissions occur from sources that are owned or controlled by the company;
- Scope 2 GHG emissions occur from the generation of purchased electricity, steam, or heat, consumed by the company;
- Scope 3 GHG emissions are a consequence of the activities of the company, but occur from sources not owned or controlled by the company.

For investors and their agents, the greatest proportion of GHG emissions by far will be those associated with their investments; therefore, an important proportion of investors' GHG emissions will likely be Scope 3 emissions.

Institutional investors, as owners and creditors of large segments of the global economy, have a key role to play in decarbonising it by systematically measuring, disclosing and over time reducing the GHG emissions embedded in their portfolios. Ultimately, a decarbonised financial economy will make the decarbonisation of the real economy much more likely and easier to achieve.

Leon Kamhi
Head of Global Engagement
Hermes Equity Ownership Services
Chair – UNEP FI Investment Commission

This article is based on and heavily excerpted from United Nations Environment Programme Finance Initiative's (UNEP FI) Investor Briefing entitled "*Portfolio Carbon: Measuring, disclosing and managing the carbon intensity of investments and investment portfolios*".

http://www.unepfi.org/fileadmin/documents/UNEP_FI_Investor_Briefing_Portfolio_Carbon.pdf

This Investor Briefing initiates a two year process (2014-2015) for UNEP FI to collaborate with the Greenhouse Gas Protocol (WRI and WBCSD) and develop a financial sector standard for Scope 3 emissions reporting and accounting. Hermes is directly involved in this process and chairs the UNEP FI Investment Commission.

For more information about this process, please refer to http://www.ghgprotocol.org/feature/financial-sector-guidance-corporate-value-chain-scope-3-accounting-and-reporting

Social

Unlocking human potential

Why optimising human capital benefits shareholders

The concept of human capital has existed for some decades. Increasingly, companies realise that a strong source of competitive advantage is the people who work for them and how they create value. We look at how this is an increasingly important area for engagement.

Overview

Human beings are not mere automatons. Their complexity and ability to adapt make human capital harder to define than financial capital or physical assets like factories, machinery or even services for sale. We perceive that human capital encompasses the skills, experience and qualifications of employees and contractors as well as the more indefinable culture, *esprit de corps* and collective will of the organisation. While the board is responsible for developing the company's vision and mission, it cannot develop strategy without a deep understanding of the company's people, what they produce and how both people and products can evolve. Moreover, realising a company's mission depends on its human capital, more than physical assets or financial capital. People are the most important factor in a company's success or failure.

More enlightened boards and businesses have realised that skilful investment in human capital can strengthen their competitive advantage and reap sustained value. This idea has become so widely accepted that many businesses that view employees as a cost to be minimised, rather than capital to be invested in, cynically use similar rhetoric to describe their human resources practices.

EOS' engagement work in this area seeks to understand the true nature of human-capital management at companies. We implement our findings by engaging with companies that we believe could improve employee relations, develop and maintain their desired culture, and invest appropriately in staff to deliver sustained improvements in company performance.

Employee health, safety and wellbeing

In our Public Report for Q2 2013, we wrote about the work that we have done in response to the crisis in the Bangladeshi garment industry. Our fundamental belief that workers should have the right to return home safely at the end of each day's work extends to all industries and countries. We engaged extensively with the oil and gas industry after the Macondo disaster and are pleased by the greater focus on health and safety risk management that we have since observed among leading oil and gas companies and the larger oil services companies. In the mining industry, there has not been a similar trigger event and progress is slower. However, we continue to challenge apparent complacency and look for and encourage cross-fertilisation of the latest thinking from the oil and gas industry and elsewhere. The best companies are increasingly looking at how they can minimise the risk of compromising the long-term health of their employees and the communities in which they operate. For example, as a representative of universal owners, we encourage companies to mitigate the unhealthy, sedentary lifestyles of many office workers as well as the lung diseases and other industrial injuries prevalent in mining.

Employees' human rights

We have engaged with a number of companies with ostensibly inappropriate labour relations practices. For example, we have engaged with the board of a mining company about serious labour unrest in South Africa that resulted in a number of deaths at the hands of the police. While the reasons for the dispute and the resulting deaths continue to be contested, we urged the company to do everything in its power to reduce tensions within its workforce, in the local community and more widely. More positively, at an important investor conference in the US, we co-hosted, with Microsoft, a meeting for companies and investors on the importance of effective human-rights management to ensure that companies enjoyed ongoing social licences to operate as well as to maximise employee loyalty and engagement.

Remuneration

People seeking better corporate governance have historically focused on the pay of executive directors. Instead, we have increasingly engaged on pay as it relates to the whole organisation. EOS was the guiding hand behind the remuneration principles that we jointly published with the UK's National Association of Pension Funds[1], which has been endorsed by three of the largest and most active pension funds in the UK. Significantly, one of the five principles states that: "Pay should be aligned to long-term success and the desired corporate culture throughout the organisation". We are sharing these principles with remuneration committees internationally as we increasingly engage on how remuneration is designed to drive the right behaviour – not just in the boardroom but also on the shop floor, with a common approach for everyone in an organisation. The banking industry is where we have engaged most on non-board pay, focusing on pay to investment bankers, encouraging reduction in overall pay, greater pay in equity and longer-term targets. The aim here is to manage the risks that bankers take more effectively and leave more of the rewards to shareowners. Increasingly, we are challenging remuneration committees and company chairs in non-banking industries to demonstrate that pay philosophy is congruous at every level of all parts of the organisations they oversee.

Organisational restructuring

We engaged with a large former German state-owned business about how it was managing a significant reduction in the size of, and change in the nature within, its workforce. In particular, we encouraged sensitive handling of its older workers and maximising the number it could re-deploy in different areas.

Effective human resources management

We have challenged an international outsourcing firm that has failed to deliver on two very high-profile contracts, and which faces a litany of other serious allegations about its staff failing to fulfil contracts properly, including serious allegations of fraud and human rights abuses around the world, and whose reputation has been severely damaged, to demonstrate to us that it is capable of managing such a large workforce carrying out a wide variety of activities, many of which are high risk. If it cannot manage its divergent businesses then it should consider whether it should divest parts.

Collaborative human capital management

We have participated in an informal group of mainly US funds which has written to a number of US retailers about their human capital policies and practices. The group's intention is to encourage these companies to demonstrate that they have coherent policies and practices towards human capital. Its first follow-up meeting with a large retailer, which has a progressive approach to these issues, has been arranged. The group is looking forward both to learning from the company and also encouraging other companies to take a similarly enlightened approach. In a notoriously low-paying industry with high staff turnover, this company pays its staff significantly more than average and its results appear to demonstrate that the increased staff loyalty and motivation leads to longer term success.

Conclusion

Through our engagement at director and senior management levels, we assess the cultures of both boards and companies. Increasingly, company culture and how boards assess, motivate and interact with their staff to ensure maximum long-term value and mitigate risks from poor human-resources practices is a focus of our engagements. We will continue to expect companies to demonstrate how they ensure that they are managing their human capital as effectively as their financial capital.

Tim Goodman

Head of North American Engagement
Hermes Equity Ownership Services

[1] Available at http://www.hermes.co.uk/Portals/8/Hermes_EOS_remuneration_Principles.pdf

Executive remuneration

Remuneration – Hermes EOS' principles for building and reinforcing long-term business success

Executive remuneration remains a hot topic, and for good reason. Traditional reward schemes neither effectively link pay to performance over the long term nor cause CEOs to think like owners of the businesses they manage. Hermes EOS launched its remuneration principles, in conjunction with other major investors, to begin a conversation about potential improvements and to help guide our conversations with companies globally on this topic. We have had many conversations on the principles with companies, investors and other market participants and plan to publish a final version before the end of the year. We are also extending our work internationally, building on our experience in the UK.

Overview

In February 2013 Hermes EOS, together with the UK's National Association of Pension Funds (NAPF), the Railway Pension Investments Limited (RPMI Railpen) and the Universities Superannuation Fund (USS) published *"Remuneration principles for building and reinforcing long-term business success"*. This document was based on the outcomes of the meeting held in February 2012 with representatives from FTSE100 companies and occupational pension funds. That meeting considered solutions to the problems associated with executive pay and sought to encourage a more productive debate on the way forward. We were pleased to note considerable appetite for substantial change among different market participants.

The principles

1. **Remuneration committees should expect executive management to make a material long-term investment in shares of the businesses they manage**

2. **Pay should be aligned to long-term success and the desired corporate culture throughout the organisation**

3. **Pay schemes should be clear, understandable for both investors and executives, and ensure that executive rewards reflect long-term returns to shareholders**

4. **Remuneration committees should use the discretion afforded them by shareholders to ensure that awards properly reflect business performance**

5. **Companies and investors should have appropriately regular discussions on strategy and long-term performance**

Feedback from the roundtables

Since the principles were published, EOS has held further discussions with the chairs and remuneration committee chairs of almost half of FTSE 100 companies, along with executives responsible for reward, remuneration consultants and other institutional investors to seek feedback. Participants in the events found it extremely useful to be able to debate issues around remuneration outside of the context of their individual companies. The inclusion of asset owners, rather than investment managers, also helped lead to a debate more focused on long-term outcomes.

At these roundtables there was broad support for the principles and, in particular, the fact that we are not seeking to be prescriptive. This is extremely important: each company is unique and as such faces different challenges and opportunities. While we hope that our principles will provide a useful guide, it is for boards to determine which pay structures will work best for their company's executives and to intelligently communicate their reasoning to investors.

The concept of long-term ownership of shares by senior executives also found much resonance, although there was considerable discussion about what 'long-term' really means and how to ensure that some tail risk remains once executives leave a company. It is now broadly accepted that three years is not genuinely long term in the life cycles of many companies. A time horizon of five or seven years, or even longer, may be appropriate in some cases. Likewise the concept of clarity and the importance of tying pay to performance garnered widespread agreement with very many of the company representatives who likened long-term incentive plans to a lottery. Unless executives understand what they need to do in order for their rewards to vest, and they are empowered to pursue these targets, it is extremely difficult to understand how they can be motivated by a scheme.

Another subject that attracted a great deal of attention was the relationship between shareholders and companies. Many participants felt that this had become overly focused on pay, with some investors spending excessive amounts of time analysing performance measures and other detailed information. Far better to focus on strategy and then lead on to a discussion of how to incentivise the right behaviours to achieve objectives – as well as how success might be measured. It was felt that the excessive concentration on detail was at least partly a result of a deterioration of trust that shareowners hold in remuneration committees. Rather than being able to feel confident that remuneration committee members would do a good job, investors instinctively distrust them. Further, this means that any use of discretion or judgment by a remuneration committee is subject to a huge amount of scrutiny. As a result, many company representatives said that they were unwilling to put into place a scheme which might require them to exercise such judgment and instead felt safer relying on a more formulaic approach to determining pay outs.

This is a significant problem and one which participants in the roundtables felt would take many years to resolve. For this reason, Hermes EOS strives always to have holistic conversations with companies rather than talking solely about pay. The comments also reinforce our approach of meeting with the company chairs and remuneration committee chairs where we have concerns in order to asses the extent to which they are aware of their responsibilities and the views of long-term owners.

Next steps

EOS published the revised principles, together with the groups of investors who collaborated on the first draft, in November. The NAPF has incorporated the principles into its corporate governance polices for UK companies. This work will therefore have a significant impact on the future shape of remuneration schemes at UK companies. EOS continues to engage with a large number of companies each quarter on issues related to remuneration. These conversations always take place within a broader strategic context.

We are also beginning work to roll out the principles to markets outside the UK. In particular, we plan to publish them in the US, where there is considerable scope for engagement on pay. While the issues are slightly different – for example there is usually significant share ownership among US executives but little disclosure around performance conditions – we believe that they would be a useful tool. The principles have also been shared with a number of European companies and have enabled us to have some useful debates, which we will continue in the coming months.

It is important to stress that we seek neither to prescribe a particular structure, nor to micro-manage pay, but rather to start a healthier and more constructive on-going conversation than is often the case today. We firmly believe that there is a significant appetite for change and urge companies to consider how they might align pay more closely with the interests of their long-term owners in order to position themselves best for future success.

Jennifer Walmsley
Director
Hermes Equity Ownership Services

Strategy

The wise man builds his house on rock

Opportunities for integrating ESG in infrastructure investment

Institutional investors have the opportunity to support and benefit from infrastructure investments. Given the nature of the projects, appropriate management of environmental, social and governance issues are crucial to ensure that the projects have sustainable foundations and returns.

Overview

The world's infrastructure assets are woefully under-prepared for future population growth and the pressures that will come with increased travel, resource use and communication demands. Governments and commercial banks – the traditional sources of funding for development – are unable to contribute the finances needed to plug the $50 trillion investment gap in infrastructure, with private investors needing to step into the breach. Encouragingly, the asset class by its nature aligns itself well with long-term investor needs. However, there are many long-term risks associated with investment in infrastructure which if managed badly can have negative ramifications; if managed properly, institutional investors will be able to secure stable returns, whilst facilitating sustainable growth in the wider economy.

Growing pains

The world's population is growing at a pace never before experienced and it is projected to reach 8.1 billion in 2025, further expanding to 10.9 billion by 2100. People will increasingly live in urban areas; they will live for longer, travel more, and will use more technology. As a result, infrastructure, the backbone of any economic and societal development, has never been of greater importance. Most countries however are poorly prepared for the realities that face their ageing assets. It has been estimated by the OECD that to keep up with projected global GDP growth, global infrastructure investment requirements will be $50 trillion through to 2030, which is more than the estimated value of today's infrastructure. Unfortunately government spending on fixed assets has continuously decreased over the past 20 years and, together with widespread fiscal constraints, overstretched public finances and commercial banks (the traditional sources of infrastructure project funding) coming under pressure to restrain their credit growth, institutional investors are being seen as important, if not critical in bridging the funding gap.

Filling the gap

Institutional investor assets under management have grown to $71 trillion in OECD countries, but in parallel, global pension liabilities have grown very substantially too. The IMF has estimated that if individuals live three years longer than expected, the incremental costs could approach 50% of 2010 GDP in advanced economies and 25% in emerging economies. To put this into perspective, American baby boomers are already facing unfunded liabilities exceeding $4 trillion. Encouragingly for many funds however, especially defined benefit pension funds, infrastructure is an attractive asset class that provides long-term portfolio diversification, produces a predictable stream of inflation-linked income, and reduces reliance on equities and bonds. Two countries that have been leading the charge over the past decade are Australia and Canada, and more recently other nations have also been realising the potential of infrastructure investments. For example, the China Investment Corporation, a sovereign wealth fund responsible for part of China's foreign exchange reserves, has invested £2 billion in a gas liquification plant in Trinidad and Tobago. Governments are therefore keen to attract investors, and international trading barriers are beginning to lift to enable much needed funding.

… but avoiding the potholes

Infrastructure often goes unnoticed as part of daily life, despite its long-term nature. However when managed badly, the negative knock-on effects can be hugely detrimental to investment. One need only look to the Belo Monte Dam in Brazil, initiated in 1975, to see the negative financial and reputational ramifications of poor planning and social engagement. Spiralling costs, accusations of corruption and bribery and poor stakeholder consultation, have meant the project is still incomplete and the project is being challenged internationally on its economic viability and the detrimental social and environmental effects. EOS has been engaging with Brazilian Belo Monte consortium members for several years on ESG issues and, due to the relationships we have built up with these companies, we were the first ever investors to visit the dam and meet with all top level executives working on the project. In the UK, we have also sat for several years on construction company Balfour Beatty's Stakeholder Advisory Panel and recently gave policy advice to a UK utility company regulator, to help it develop its own voluntary corporate governance market guidelines.

The wise man builds his house on rock

With the returns that are required to cope with future liabilities, given its predictable inflation-linked income and long life cycle, infrastructure provides an opportunity for investors. Infrastructure investment, whilst requiring a change in skills and approach, will also provide the investor with significant influence in determining the governance, policies and environment that the project will follow through its life. Direct investors can have the ability to appoint management, ensure low carbon technologies are employed, and assets can be aligned not only to investment needs, but also wider stakeholder requirements. Even if invested indirectly, many infrastructure funds now own material stakes in projects and can appoint non-executive directors and guide strategy. What is more, investors can actively select fund managers with the strongest approach to ESG, thus heavily influencing the approach to asset governance.

There are many examples of world class ESG practices in the sector: AustralianSuper measures electricity, water usage and carbon emissions in their assets and RARE Infrastructure Limited, incorporates ESG into portfolio constructions, ensuring that cash flows and discount rates are adjusted for ESG costs and risks. Consequently, aside from considering traditional regulatory and financing risks, wider issues such as environmental impacts, bribery and corruption and community relations will have to be managed responsibly through all phases of an asset's life cycle, to not only result in more efficient operations but also to maximise sustainable returns.

Conclusion

Proper infrastructure underpins an effective economy, and institutional financing is increasingly necessary to provide the relevant funding. Equally, institutional investors benefit from holding infrastructure assets in their portfolios, to help service their liabilities which span many decades. In their capacity as owners and operators of huge, strategic assets, delivering vital services, it is therefore vital that they use their positions of influence to assess and direct projects to be as sound as possible. This will mean assessing the traditional financial, political and regulatory issues, but also taking environmental, social and governance issues into serious consideration. If this is done appropriately and sustainably, the risks can be substantially diminished and the benefits of long-term, stable infrastructure returns can be ensured for millions of fund beneficiaries.

Victoria Barron
UK Engagement Team
Hermes Equity Ownership Services

Strategy

Engagement on strategy

Many of the most successful engagements undertaken by EOS combine discussions of business strategy and structural governance issues.

Overview

EOS adopts an holistic approach to engagement combining discussions on business strategy and risk management, including social and ethical risks, with structural governance issues. Our engagements fill the gap left by the investment industry's tendency to focus on the short-term. The result of this tendency is that management too often goes unchallenged in its approach to the long-term future of its business and there is minimal pressure for change. EOS assesses and engages with underperforming companies from a long-term perspective, asking questions which encourage management and boards to think afresh to overturn long-running periods of underperformance. This proven approach is often successful in adding value or ending destruction of value.

Business strategy is also a key feature of other engagements such as those highlighted elsewhere in this report. We are generally most successful in achieving change on environmental, social and other matters where we lead the conversation from a business perspective and focus on these issues as risks to the company's strategic positioning. Companies can become locked into historic patterns where they are overdue for refreshment and new perspectives on the board. Injecting new thinking at the head of the company – an independent chair or change of CEO – is frequently the key to unlocking change and driving renewed operational performance, creating long-term value for shareholders.

Engagements on governance and business strategy may require a series of meetings over months and years. It takes time for board changes to generate the business and strategic changes which improve long-term performance.

Examples of recent engagements

We met executives at the headquarters of a prominent car manufacturer with a global presence, and visited its largest domestic factory. Our discussions focused on labour relations and social issues. We sought management's views on how best to manage its relationship with the main labour union and were pleased that the company seems to have tackled long-standing problems in this respect. It now demonstrates a more constructive attitude to discussions, with a clear focus on enhancing productivity and product quality. The company has also put various positive measures into place, such as an internal committee which meets regularly to discuss labour-related issues including health and safety, and plans to convert some contract workers to permanent workers over the next three years. We also welcomed more open communication with shareholders on these matters. It was encouraging to hear that the ethics committee, which is chaired by an independent director, is now a sub-committee of the board. We discussed its role in detail and encouraged the company to be more transparent about its responsibilities in relation to policy implementation, overseeing conflicts of interest such as related party transactions and dealing with whistle-blowers. As a result of our visit to the company's largest domestic factory, we were able to gain significant reassurance about the significant progress that has been made in managing labour relations and social issues since we first initiated our intensive engagement.

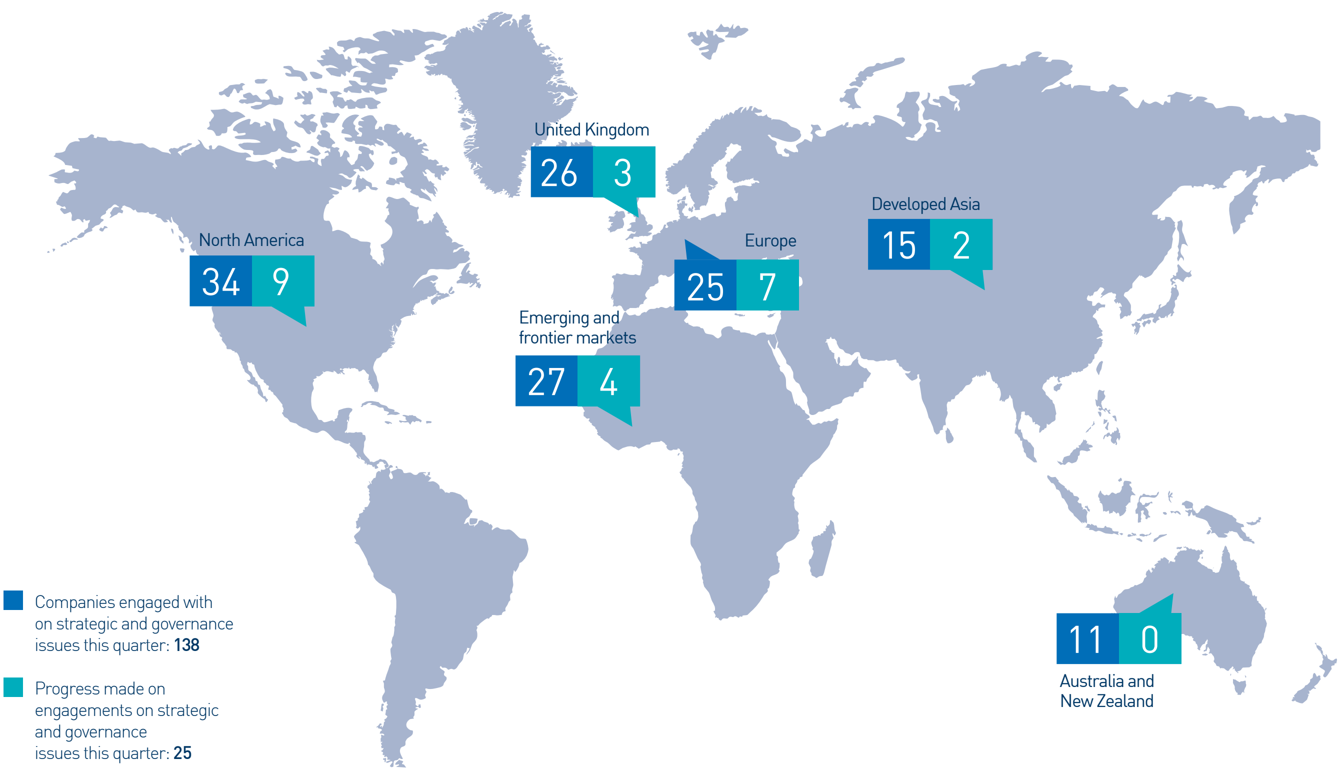
We met with a senior executive of this Emerging Markets' natural gas company to discuss governance and sustainability issues. We welcomed the meeting, as the company has so far been unresponsive to meeting requests. The principal objective of our meeting was to renew our dialogue with the company and seek a follow up meeting with a board-level director. We took the opportunity to follow up on our letter and reiterated our key sustainability and governance concerns. We encouraged the company to do more to address the negative image it has among foreign investors, particularly with regards to the State's influence on the company's decision-making and its management sustainability risks. We commented on the company's environmental and social performance and agreed to provide it with detailed recommendations on the areas in need of improvement. We reiterated our keen interest to meet the company's independent director to discuss how it manages the risks associated with the various environmental, social and governance challenges it faces. We stressed that such dialogue should assist the board in learning more about its shareholders, as many of its domestic investors do not take an active interest in ESG matters, and that a meeting with this non-executive director will allow us a to learn how the company's directors fulfill their duties to shareholders. The executive welcomed our comments and committed to arrange a meeting with the non-executive independent director. This is a very positive development as minority shareholders rarely obtain access to board members in the region, particularly in predominantly state-owned companies.

We spoke with the recently appointed CEO of a European based multinational engineering and electronics company to probe his approach to the company's long-standing problems as well as seeking to understand his priorities for the near-term and relationship with the supervisory board. He was CFO during the tenure of the previous CEO and thus bears some responsibility for management decisions during that period. While the formal strategy update was scheduled shortly after our meeting, with key strategic announcements following in the second quarter of 2014 we were told to expect a focus on operational discipline rather than a major restructuring. Client priorities will be the key driver for the review of the portfolio with client contact becoming less centralised and other functions more centrally managed. The CEO hopes that this structure will allow for a better flow of information to the management board and earlier detection of potential cost overruns in large-scale projects. He is conscious of the role targets have played in increasing unprofitable growth and disrupting appropriate asset allocation. He conceded that, in hindsight, he could have raised his concerns about some aspects of the former CEO's strategy earlier and more vocally during discussions on the management board.

We discussed the relationship between the management and the supervisory boards following the apparently disorderly succession process for the CEO position in the summer. While the CEO sought to reassure us that he feels appropriately supported by the chair, he also underlined that he would like the supervisory board to provide more challenge. Our analysis of the supervisory board suggests that some of the necessary skills to do this may be lacking.

We then met the chair of the company to discuss succession planning and board refreshment. We queried the process that had lead to the seemingly abrupt departure of the former CEO, who had enjoyed the chair's open support until shortly beforehand. The chair talked us through the rationale and explained that as 2011 had been a successful year, the board had taken the decision to renew the CEO's contract from 2012. We asked whether external candidates had been considered and the chair explained that, since the former CEO had done a good job of dealing with the consequences of the compliance scandal from 2007-2008, it was not seen as necessary for his successor to come from outside. He was also keen to emphasise that the supervisory board had unanimously approved the appointment of the new CEO and supported the strategy he has outlined. The company has recently added a new board member, whose appointment we welcome. However further board refreshment does not seem to be a priority. We are also concerned that the process of succession to the chair is insufficiently developed. We talked through planned measures to ensure clearer reporting lines and questioned the headcount reduction and resultant decrease in the diversity of the management board. Finally we touched on remuneration and the chair expressed his confidence that, following a recent review, shareholders will be comfortable with what the company is proposing. We will review the results of our engagement so far before deciding on next steps.

Engagements on strategy and governance issues



Public policy and best practice

Protecting and enhancing value by promoting better regulations

EOS contributes to the development of policy and best practice on corporate governance, corporate responsibility and shareholder rights to protect and enhance the value of its clients' shareholdings over the longer term.

Overview

We actively participate in debates on public policy matters to protect and enhance value for our clients by increasing shareholder rights and boosting protection for minority shareholders. This work extends across: company law, which in many markets sets a basic foundation for shareholder rights; securities laws, which frame the operation of the markets and ensure that value creation is reflected in value for shareholders; and in developing codes of best practice for governance, management of key risks and disclosure. In addition to this work on a country-specific basis, we address regulations with a global remit, which are currently in the areas of accounting and auditing standards.

Investment institutions are typically absent from public policy debates even though they can have a profound impact on shareholder value. EOS seeks to fill this gap.

By playing a full role in shaping these standards we can ensure that they work in the interests of shareholders rather than being moulded to the narrow interests of other market participants (particularly companies, lawyers and accounting firms, which tend to be more active than investors in these debates) whose interests may be markedly different.

Highlights

Asian Business Dialogue on Corporate Governance

We actively participated in discussions at the 2013 Asian Business Dialogue on Corporate Governance in Seoul, organised by the ACGA (Asian Corporate Governance Association) of which EOS is an active member. This conference was also officially supported by the Korea Exchange and the Korea Corporate Governance Service (KCGS). The discussions were largely on corporate governance and sustainability. We shared our views on the strengths, weaknesses and the areas of potential risk in the current governance system and encouraged Korean companies to consider corporate governance in a strategic way and to demonstrate a clear commitment from the top. We also initiated informal dialogues with Korean institutional investors on how domestic investors view the governance of listed companies in Korea and to what extent they integrate environmental, social and governance metrics into their investment decision-making. We plan to continue these direct and constructive discussions in Korea with the aim of enhancing ESG standards and practices.

Statement on acting in concert by the European Securities and Markets Authority

We were pleased to note that the European Securities and Markets Authority (ESMA) has published a statement on practices governed by the Takeover Bid Directive (TBD), focusing on shareholder cooperation relating to acting in concert and the appointment of board members. We have been calling for this clarification since 2009, when we initiated a PRI clearinghouse engagement, and have held a number of meetings with ESMA, including one with its chair last year. Investors across the European Economic Area now have the benefit of a consistent framework for collaborative engagement. The statement lists the activities on which shareholders can cooperate without the risk of being deemed to be acting in concert. This list covers most of the topics on which we would generally collaborate, with the exception of the nomination of board members which is left to local regulators to clarify. Notwithstanding this, the statement provides helpful clarification on what has until now been a grey area for active shareholders in Europe.

Stewardship code in Japan

We met with a senior executive of the Financial Services Agency of Japan in Tokyo to exchange views on the introduction of a Japanese Stewardship Code. We discussed challenges in implementing the Code effectively and pushed for a number of actions including the adoption of a Corporate Governance Code in Japan, measures to encourage active participation by Japanese asset owners and for engagement activities to be defined as being more than simply proxy voting. We also took this opportunity to have discussions with major domestic institutional investors, including Nissay Asset Management, Daiwa SBI and Sumitomo Trust and Banking. While the majority of Japanese investors remain sceptical about the effectiveness of stewardship, we were pleased to learn that many intend to sign up to the Stewardship Code, which we believe represents a significant step forward in Japan.

Other work in this quarter included

Promoting best practice

- We spoke at the Peruvian Mining and Investment Conference as part of a panel focusing on how mining companies in Latin America can maintain positive relations with local communities and reduce their environmental impact whilst continuing to grow. We were satisfied with the active debate that our speech generated amongst the predominantly mining company audience.
- We presented our views on German supervisory board practice to a large group of German non-executive directors, including the chairmen of Bertelsmann and Bosch, two of the largest companies in the country, and regulators in Berlin. Our messages on company specific approaches, and more regular and meaningful dialogue with shareholders were very well received by the audience and we had many private follow up conversations.
- We met with the VP Markets and Oil Sands at the offices of the Canadian Association of Petroleum Producers (CAPP) in Calgary to explore their commitment to advancing sustainability in the industry. We suggested that doing so would provide long-term benefits, and discussed key challenges including transportation of products and compliance with rules on tailings reductions. We also sought CAPP's views of the more promising new technologies emerging for oil sands extraction.
- We attended Deloitte's second stakeholder forum through which the audit firm seeks to provide reassurance to external interested parties of the robustness of its approach to issues of public interest. Topics on the agenda included the effectiveness and quality of the audit, extended auditor reporting and the value an auditor can add beyond this.
- As part of our series of FTSE 100 non-executive-director lunches, and following the recent publication of EOS' position on cyber risk, we hosted four non-executives from a range of sectors to discuss the issue. We discussed relevant challenges, including the changing nature of the risk over time, and identified potential elements of best practice such as reverse stress testing, inclusion of cyber risk consideration in project appraisals and prioritisation of cyber risk in audit committee agendas.
- For the fifth year we jointly hosted the ICSA Transparency in Governance Awards ceremony. EOS provides analysis for these awards which cover the FTSE 100 and the FTSE 250 and recognise and reward best practice and innovation in corporate reporting. We continue to use our learnings from the process when engaging with other companies and regulators on communications with shareholders.

Public policy

- As part of our intensive work with the Business and Industry Advisory Committee to the OECD (BIAC) on the ongoing redraft of the OECD corporate governance principles, we met with the committee responsible for this work. We also had a follow up workshop with its bureau, which includes key representatives from member states. We will continue to actively contribute as the thinking of the OECD progresses.
- We held a lengthy meeting with a senior director and a group of his colleagues at the Ministry of Economy, Trade and Industry (METI) in Japan. The discussion focused on progress in METI's Corporate Reporting Lab project, as well as on a new initiative which aims to address similar issues to those covered by the UK's Kay Review. We responded to the public consultation on these issues by the METI in December.
- We spoke at a Brazilian capital markets seminar on the topic of corporate democracy focusing on the rights and duties of shareholders and companies. We were invited to speak by the President of the investors association which organised the conference (AMEC) who also sits on the board of Petrobras. The event was attended by senior representatives of companies, investors and regulators and as such was a good opportunity to establish a roadmap for the various agents in the proxy voting chain ahead of the 2014 voting season.
- We participated in the inaugural meeting of the OECD Middle East and North Africa (MENA) Investor Council, hosted by the Corporate Governance Association of Turkey and the Capital Market authority. We shared with the Council our recommendations to improve transparency and governance of MENA markets. We are confident the council will be influential in improving corporate governance practices in the region.
- We participated in an event organised by the Swiss Stock Exchange in Zurich, attended by more than 100 senior investor relations executives, to share our views on the practical implications of the so-called Minder initiative, which led to the introduction of new framework legislation dealing with shareholder rights in relation to remuneration policy and practice, board accountability and obligations of Swiss institutional investors. We will continue to participate in the debate about the implications of the new law and best practice implementation of the rules at the company level.
- We responded to a US Securities and Exchange Commission (SEC) rulemaking consultation regarding company disclosure of CEO pay ratios. In doing so we appended to our response our newly issued remuneration principles which we have formulated in collaboration with the National Association of Pension Funds (NAPF), BT Pension Scheme, RPMI Railpen Investments and Universities Superannuation Scheme (USS).
- We responded to the consultation by the Financial Reporting Council (FRC) on its proposed guidance on strategic reports, as part of the new reporting framework in the UK.

Working with other shareholders

- We held a number of meetings in Tokyo with various organisations and associations, including Japan Shareholder Services, Japan Corporate Governance Network, Investor Relations Japan and the Investors Network, to promote best practice governance in Japan.
- We were asked by the Council of Institutional Investors to present to its members on a conference call about the latest corporate governance developments in the UK. We were able to discuss and put forward our views on a number of issues including the changes to remuneration regulation and our public policy and company engagements. The participation and discussion suggested interest in the topic and the invitation and the response from the CII and its members indicate that we continue to be a highly regarded collaborator.
- We had a detailed conversation with the Chartered Financial Analyst (CFA) Institute, at its request, on governance issues in the US and the UK in order to inform its future publications. In doing so we agreed to continue to share views in the future.

Hermes votes at general meetings wherever practicable. We take a graduated approach and base our decisions on annual report disclosures, discussions with the company and independent analysis. At larger companies or those where clients have a significant stake, we seek to have dialogue ahead of voting against or abstaining on any resolution.

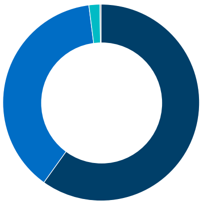
In most cases of a vote against at a company in which our clients have a significant holding we follow up with a letter explaining our concerns. We maintain a database of voting and contact with companies and if we believe further intervention is merited, we include the company in our main engagement programme.

Hermes votes at company meetings all over the world, wherever its clients own shares.

Overview

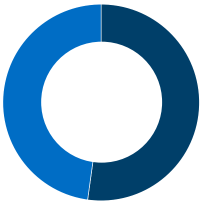
Over the last quarter we voted at 1,365 meetings (8,895 resolutions). At 520 of those meetings we opposed one or more resolutions. We voted with management by exception at three meetings and we abstained at 25 meetings. We supported management on all resolutions at the remaining 817 meetings.

Global
We voted at 1,365 meetings (8,895 resolutions) over the quarter.



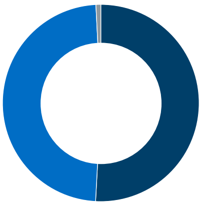
- Total meetings voted in favour **59.9%**
- Meetings where voted against (or voted against AND abstained) **38.1%**
- Meetings where abstained **1.8%**
- Meetings where voted with management by exception **0.2%**

Australia and New Zealand
We voted at 322 meetings (1,591 resolutions) over the quarter.



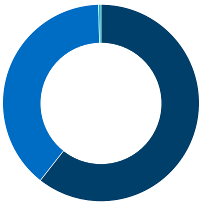
- Total meetings voted in favour **52.2%**
- Meetings where voted against (or voted against AND abstained) **47.8%**

Developed Asia
We voted at 242 meetings (1,432 resolutions) over the quarter.



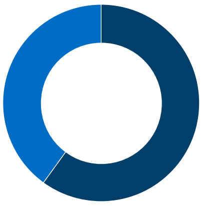
- Total meetings voted in favour **50.8%**
- Meetings where voted against (or voted against AND abstained) **48.3%**
- Meetings where voted with management by exception **0.8%**

Emerging and Frontier Markets
We voted at 231 meetings (1,560 resolutions) over the quarter.



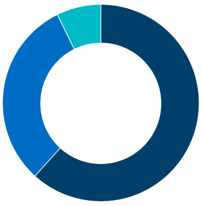
- Total meetings voted in favour **60.6%**
- Meetings where voted against (or voted against AND abstained) **39.0%**
- Meetings where abstained **0.4%**

Europe
We voted at 105 meetings (647 resolutions) over the quarter.



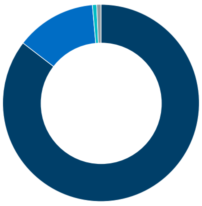
- Total meetings voted in favour **60.0%**
- Meetings where voted against (or voted against AND abstained) **40.0%**

North America
We voted at 313 meetings (2,248 resolutions) over the quarter.



- Total meetings voted in favour **61.7%**
- Meetings where voted against (or voted against AND abstained) **31.0%**
- Meetings where abstained **7.3%**

UK
We voted at 152 meetings (1,417 resolutions) over the quarter.



- Total meetings voted in favour **85.5%**
- Meetings where voted against (or voted against AND abstained) **13.2%**
- Meetings where abstained **0.7%**
- Meetings where voted with management by exception **0.7%**

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