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Responsible investment in a credit constrained world

During the past six months, the world has witnessed an unprecedented change in the financial markets. The end of cheap credit in developed economies, for both consumer and company, will have far reaching consequences on future capital expenditure within the corporate world. As a result, fund managers across the world are realigning portfolios and reconsidering the future drivers of growth.

Given recent market conditions, there has been much debate from the corporate governance and socially responsible investment industry, as well as from companies and clients, as to the future role or emphasis of environmental, social and governance (ESG) considerations within the investment industry.

As a result of the inability to access credit, a wave of cost cutting measures and restructuring is occurring within many businesses. Companies look set to withdraw investment in areas considered less critical to growth or survival. What remains to be seen is whether corporate responsibility will be an area which can be sacrificed. Does this really matter? As a responsible investor, the answer has to be yes and now more than ever.

Companies that continue to identify and manage business risks holistically, such as the risk to reputation of poor ESG management, should ultimately survive and could be the beneficiaries from the economic downturn. We have explored briefly how this may work through a number of responsible investment themes.

Board balance: The right board members, consistently evaluated, are crucial to the long-term success of a company. Shareholders need comfort that their company is being managed in their interests. This can be hindered by the appointment of non-executive directors who are affiliated to the company in some way or non-executive directors that do not possess the necessary skills, knowledge and experience. In addition, the adoption of a well considered succession planning policy and process is essential to the sustainability of a company. It is necessary for any successful succession planning policy to cover all board positions and those senior positions below the board. The ideal board is one that allows its executive directors to act in an entrepreneurial manner within a closed circle of risk control.

Cost savings: A further reason for ensuring that environmental and social risks are well managed is the financial benefit that can be achieved through cost reduction over the longer term. There can be significant savings made by companies that reduce the amount of raw materials

or cut usage of water or energy in commercial operations. A few years ago, when Anglo American, the mining company, announced free anti-retroviral drugs for employees and family members in Sub-Saharan Africa, some investors suggested that it was a misuse of shareholder money. The company has subsequently gone on to demonstrate that the benefits of the scheme have outweighed the costs of replacing staff and having work lost as a result of illness.

Remuneration: A common criticism of companies and their contribution to the severity of the world-wide economic slowdown has been the structure of companies' variable remuneration arrangements. A well managed remuneration structure has many benefits; it will not reward or incentivise unnecessary risk taking, it will align the interests of the recipients with shareholders' long-term interests and it will only remunerate if the company has performed well for the long-term benefit of its shareholders.

Climate change: As a key theme for socially responsible investment, climate change remains a pressing issue for governments. The cost implications for heavy industry in a carbon constrained world are unlikely to abate and companies need to continue to adopt sound environmental policies in this area. Over time, even if economies across the world slow down or shrink, populations themselves will continue to grow.

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The UN has forecasted an additional 1.8 bn people across the world by 2030 (from 2005 levels), with 90% of this growth occurring outside the developed world. Demand for goods, services and particularly energy resources will ultimately grow, albeit at a slower pace in the near-term.

Licence to operate: A responsible global company has the ability to gain a competitive edge. For example, global mining companies often have to consider exploration in poor and developing parts of the world and compete with each other for a licence to operate in these areas. A cash strapped government may prefer to grant access to its natural resources to well managed companies that provide community development in addition to the normal tax revenues. At the same time, these areas are often rife with conflict. By ignoring the security and community issues around a company's operations, the risk of attack on facilities and staff increases. This could disrupt business operations, reducing profitability and add additional security costs.

Communication: Managing stakeholder expectations and clearly communicating business strategies and performance is a fundamental role of management in gaining stakeholders' confidence and ultimately their support. Not only is this important in good times, it is arguably more important in more difficult times. From a company's perspective, it also means that its share price will better reflect the company's true value and give a truer picture of its Total Shareholder Return (TSR). This is an incentive for many companies given that TSR is a common feature of performance conditions governing the vesting of share-

based incentive awards. Additionally, the company could be in a stronger position should it need to raise additional capital.

Cost of capital: Investors and companies do not, or at least should not, focus resources on corporate governance matters purely to appease their stakeholders and 'tick the box'. Much is lost if the letter of corporate governance is applied whilst the spirit is ignored. This is true for both the company and the shareholder. Through the adoption and disclosure of good corporate governance practices, companies should be able to benefit from a lower cost of capital. This could be very welcome in the current financial climate.

Increased legislation: Governments will be sensitive to the political considerations of providing finance to companies. They will not wish to be seen to be providing financial support to companies behaving in an irresponsible manner. Those companies considering the wider societal impacts of their operations will be better placed to meet increased government demand and regulation, which could offer a competitive advantage. In addition, those companies with functioning and accountable risk management operations will be best placed to stave off government intervention.

Supply chains: During these economically uncertain times, the survival of company suppliers has a fundamental impact on a company's own survival. Companies that constantly squeeze the margins of their supply chain could put a supplier's economic viability at risk. Ensuring the survival of supply chains, through fair dealings, prompt payments and fair worker conditions, makes sense in ensuring a sustainable source of raw

materials, products and services. In addition, the balance of power may shift in favour of suppliers. As the number of suppliers decline, those suppliers that remain may have the ability to be more selective with whom they deal and opt for those customers with considered supply chain policies.

Commitment to responsible investment

Despite the market turmoil, investors should continue to believe that ESG issues remain an important indicator of good company management. The United Nations Principles for Responsible Investment, to which Newton is a signatory, announced that in October 2008 alone, investors worth more than US\$1,500bn of assets had signed up to the six principles that were launched by the UN in 2007.

This demonstration of commitment supports the belief that asset owners and investors are recognising the benefits of responsible investment. Responsible investment has always focused on the risk to business, be it human rights, labour, corporate governance or carbon emissions.

Concluding thoughts

It will remain important for investors to hold companies to account. Responsible investment strategies will continue to focus on board structures, the cost benefits gained from companies managing ESG issues effectively and the alignment of executive remuneration with shareholders' interests. This will add substantially to long term shareholder return.

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