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SRI Focus

Please be advised that the companies named throughout this document are not indicative of current investments made by Newton on behalf of its clients.

Supply Chain Management: the evolving debate

Introduction

A company's standing can be tainted not only by its own activities but also by those of its suppliers. The ability of a company to manage its supply chain can, therefore, be highly important in terms of reputation, sales and, ultimately, share price.

2007 saw a number of high profile cases of supply chain difficulties. The abuse of workers rights figured at Bangladeshi factories producing garments for Tesco, Asda and Primark, while Gap faced allegations of child labour in a contracting supplier's factory in India. Also in 2007, Mattel was required to undertake several high profile product recalls. In one case, this was due to high levels of lead being discovered in the paint of certain products. In another case, a product was recalled because it contained a small part that posed a choking danger to children. Alongside these incidents, the US Food & Drug Agency (FDA) warned consumers to avoid pet food and toothpaste that had been made in China after several brands were found to contain harmful substances.

In Q1 2006, Newton's SRI Focus Report, Supply Chain Management, discussed the buying practices of large western retailers and the benefits of responsible sourcing. Companies have typically responded to supply chain problems by adopting voluntary Codes of Conduct. In general, these Codes outline minimum production standards to be adopted by suppliers. Many companies have invested resources in auditing and monitoring compliance with their Codes. Additionally, leading brands have worked with suppliers to improve working conditions.

These efforts have brought about real benefits in the working conditions of supply chain factories, particularly in those located in countries with poorly developed regulatory frameworks. The Ethical Trading Initiative (ETI)¹ Impact Assessment² findings highlighted that auditing has contributed to widespread improvements in health and safety, correct payment of overtime premiums to more workers and a reduction in working hours.

However, concerns around the effectiveness of audits, including questions over whether audits capture the real problems, have been raised by companies, NGOs and governments. Additionally, multiple audits on the same factory, diverse audit approaches and inconsistent corrective action plans, have created confusion for suppliers.

This report explores the efforts that companies are making to improve management of supply chain issues. It begins with an overview of why efficient and responsible supply chain management is important for businesses. It discusses the increasing importance to consumers of good workplace standards and responsible care for the environment and how this attitude can be reflected in purchasing decisions. Potential areas for improvement in responsible sourcing practices are then highlighted. Finally, Newton, contacted some of the companies held by its clients to find out how they are managing supply chain issues in the current environment of rising input costs and downward pricing pressures.

1. Ethical Trading Initiative: See notes in Appendix 1 for details

2. The Ethical Trading Initiative Impact Assessment Study was undertaken by the Institute of Development Studies, University of Sussex, 2003-2006.

Background

Supply chain management

A company's supply chain is the network of organisations involved in the production, manufacture and delivery of a finished product or service. Supply chain management is the coordination of these operations by a company. Efficient management of a supply chain can help to reduce costs and enhance margins for a business. For example, quality can be enhanced and price reduced while speed and reliability of delivery of the product or service can be increased.

Sourcing from the developing world

The drive to gain competitive advantage has caused companies to look beyond their home country for sourcing opportunities. Sourcing products from developing countries can provide access to cheap labour and resources that may not be abundant in home markets. It can also offer opportunities to access new markets. As companies have moved to take advantage of these opportunities, supply chains have grown increasingly complex.

Wal-Mart, for example, has more than 3000 supplier factories in China alone and accounts for approximately 10% of China's total exports to the United States³.

Accountability for business practices in the supply chain

Efficiently managing supply chains, while upholding commitments to sustainable business practices, can be a substantial challenge for businesses. Many large US and European retailers source products or services from developing countries that may not have well-developed regulatory frameworks, particularly in the areas of human rights and environmental standards. Increasingly, shareholders, consumers, Non Governmental Organisations (NGOs) and Governments are holding retailers accountable for the practices of their supply chain business partners.

In the late 1990s, there were several allegations of violations of labour standards in the supply chains of Western companies. A significant number of consumers reacted to these allegations by protesting and participating in boycotts. As a result, a number of major brands have invested considerable resources in improving supply chain management. Nike is a notable example. After the company paid US\$1.5 million to settle allegations that it made false claims about how well its workers were treated, it went on to produce a detailed report that described the working conditions in its 705 factories worldwide. The report admitted to widespread problems, particularly in some Asian factories. The company now employs approximately one hundred people to manage corporate responsibility issues.

Responsible sourcing practices

Companies have typically responded to supply chain problems by adopting voluntary Codes of Conduct. In general, these codes outline minimum labour standards to be complied with by suppliers. Like Nike, many companies have invested resources in monitoring compliance with these codes. Leading brands have also worked with suppliers to improve working conditions over time. For more information on responsible sourcing practices, please see Newton's April 2006 SRI Focus Report titled Supply Chain Management. The report is available on www.newton.co.uk.

Problems continue

However, despite the efforts of companies to improve management of supply chains, problems continue. The ETI in its 2005-2008 Strategy document states that issues such as excessive working hours, low wages and lack of respect for trade union rights recur with alarming frequency. Further, in 2006/7, several large retailers faced allegations relating to abuses of the rights of workers in their supply chains.

3. Wal-Mart: A College Curriculum – The World's Largest Company and its Impact. Written by Elizabeth Cohn and published by Wal-Mart Watch, December 2005.

- **The Gap Inc**

In October 2007, a reporter from a British newspaper undertook an investigation into the working conditions of a factory in India. The investigation found children as young as ten years old sewing garments destined for sale in Gap stores.

- **Tesco, Asda, Primark**

The NGO, War on Want, has an ongoing campaign to improve the pay and conditions for garment workers globally. In December 2006, War on Want published a report titled “Fashion Victims”. The report alleges that Tesco, Asda and Primark are able to sell clothing cheaply due to garment factory workers in the developing world being paid low wages and working long hours.

Also in 2007, a number of high profile product recalls brought the matter of supply chain integrity to the forefront of media attention.

- **Mattel**

Mattel faced several product recalls during 2007. In one case, a recall was due to high levels of lead being discovered in the paint of certain products. In another case, a product was recalled because it contained a small part that posed a choking danger to children. The company admitted that design flaws and problems in quality control were the main reasons for the recalls.

- **“Made in China” brand**

The “Made in China” brand came under scrutiny after melamine and cyanuric acid⁴ were found in pet food that originated from China. On 1 May 2007, the US Food and Drug Agency (FDA) stated it had received over 17,000 complaints about the tainted pet food. More than 60 million packages of pet food, affecting nearly 100 brands, were recalled. Not long after this incident, the FDA warned consumers to avoid using toothpaste that originated from China after several brands were found to contain diethylene glycol⁵.

Consumer concerns

Evidence to suggest that consumers do care about supply chain issues

As highlighted in the Nike example, supply chain issues can influence purchasing decisions. If a supplier is found to treat its employees unfairly, it is often deemed that the global purchasing company is treating its employees unfairly⁶. Historically, consumers have taken action in response to corporate behaviour that they consider to be against the best interests of society. The following surveys provide some evidence to suggest that acceptable workplace standards, decent health and safety requirements, fair pay, and concern for the environment have become important issues for consumers.

- **The Edelman Trust Barometer 2007**

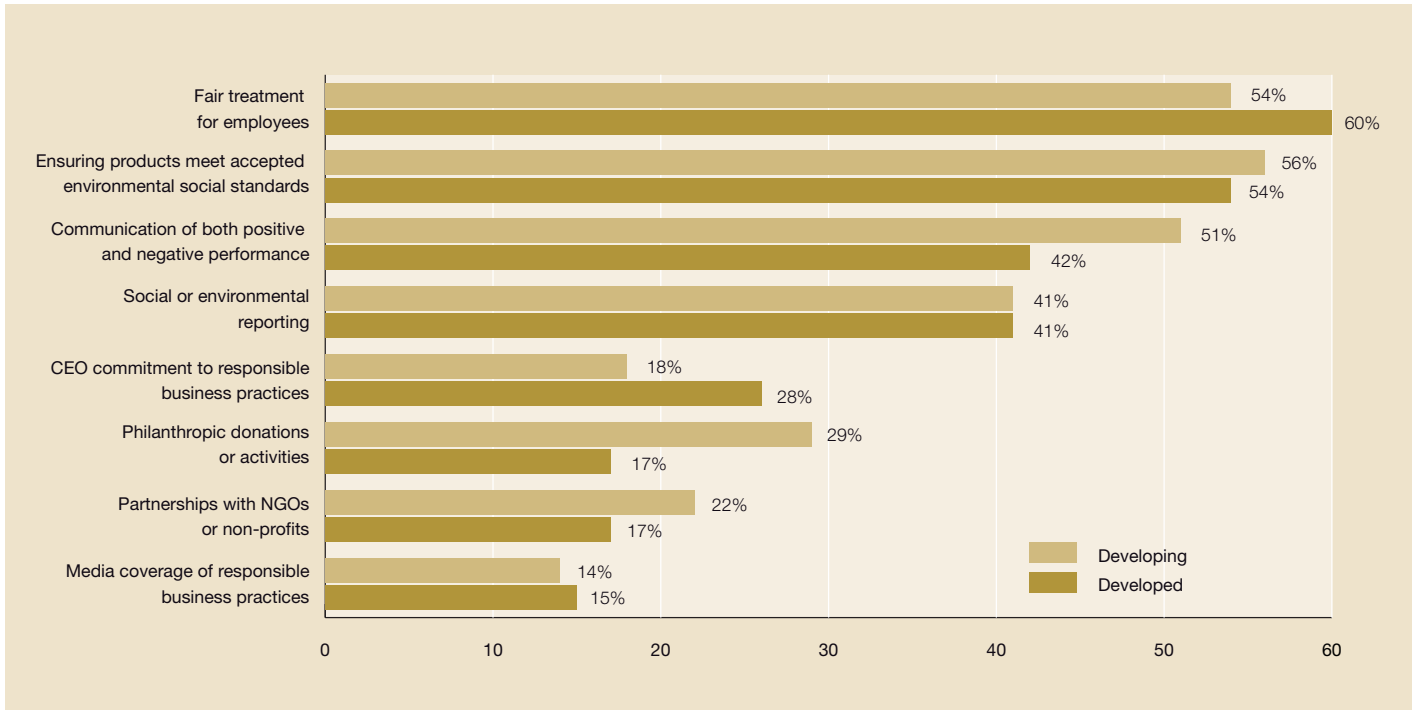
Edelman is a global public relations company. It undertakes an annual survey which looks at consumer attitudes towards business credibility and trust. In 2007, 31,000 people from eighteen countries participated in the survey. Figure 1 (page 4) highlights the response to one of the questions in the survey. Survey participants were asked: “When you think of the major global companies that you trust, which are the three most important activities for a socially responsible company to engage in?” In nearly every country surveyed, “fair treatment of employees” was viewed as the most or second-most important activity associated with a socially responsible company. This was followed by “ensuring that products meet accepted environmental and social standards”.

4. Melamine and cyanuric acid: Neither drug is toxic on its own. However, scientists found that when combined together and summed by cats, a chemical reaction occurs forming crystals which can block the function of the kidney.

5. Diethylene glycol: Diethylene glycol, if consumed by some human and animal populations, can lead to renal failure.

6. Edelman Trust Barometer 2007 Findings Report: Interview with Chris Deri, leader of Edelman's global corporate social responsibility practice.

Figure 1: The most important activities in which a socially responsible company can engage



Source: The Edelman Trust Barometer 2007

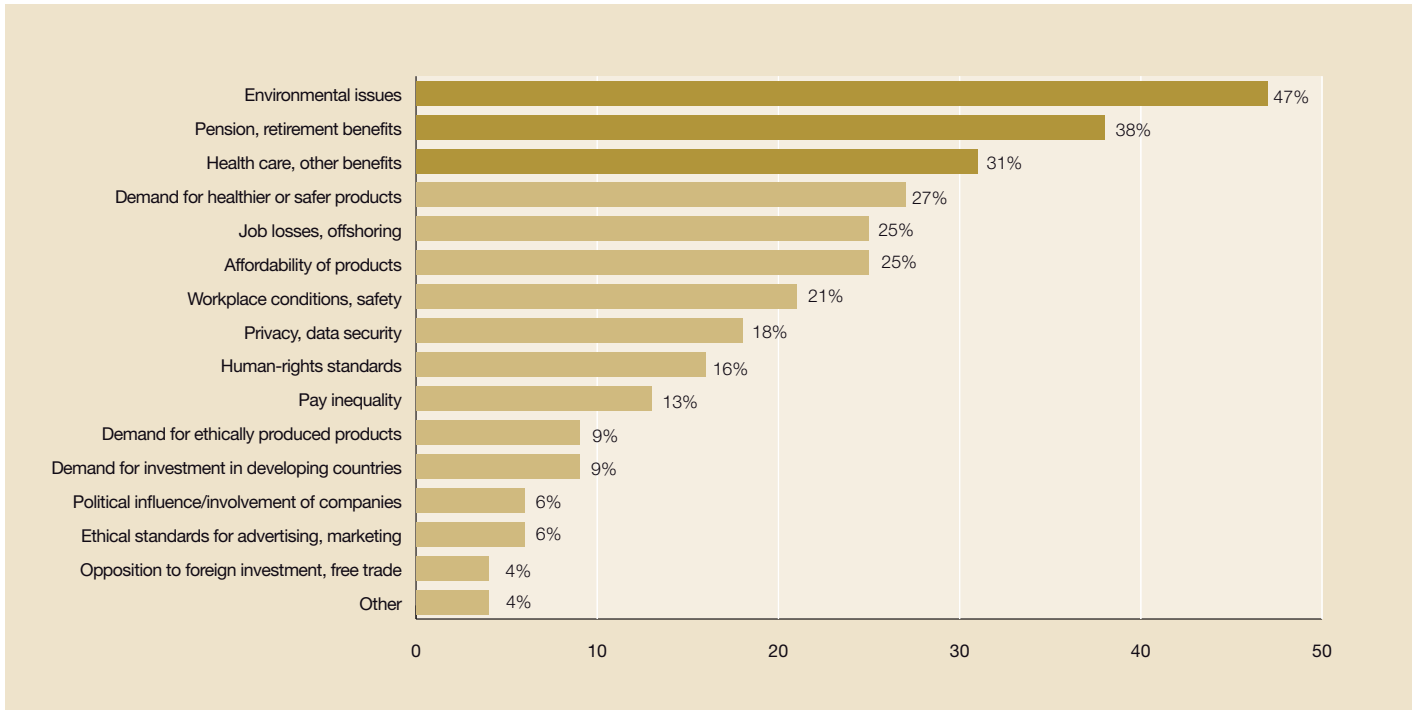
Other findings of the survey included:

- In all countries surveyed, the majority of respondents agreed that “global business plays a role that no other institution can in addressing major social and environmental challenges.” This sentiment is held most strongly in Japan (86%), the United States (72%), India (72%), and China (70%), and less strongly in most European countries surveyed.
- Survey respondents indicated that the three most important issues they want the global companies they trust to address include human rights, poverty alleviation and global warming.

• **McKinsey Survey on Customer Attitudes, July 2006**

In 2006, McKinsey carried out a survey which looked at the perceptions of consumers regarding the role of business in society. Over 4,000 consumers in seven countries were surveyed. One of the questions asked survey participants to select the three main issues that would be most important to them over the next five years. The survey found that participants selected environmental issues most often, followed by pension and retirement benefits, then healthcare and other benefits (see Figure 2: Which issues will be the most important in the next five years?).

Figure 2: Which issues will be the most important in the next 5 years?



Source: July 2006 McKinsey survey of 4,063 consumers in China, France, Germany, India, Japan, United Kingdom and United States.

Additionally, the McKinsey survey found that over half of US consumers said they had refused to buy products or services due to corporate behaviour which they considered to be against the best interests of society. This was also true for consumers surveyed in the other six countries.

• **The 2007 Ethical Consumer Report**

The findings of the McKinsey survey were reaffirmed by the 2007 Ethical Consumer Report⁷ which stated:

“2006 did see the emergence of a significant number of ‘low-cost’ clothing boycotts. For a number of consumers it would appear that low cost is now a potential indicator of poor labour conditions. Subsequently, overall clothing boycotts grew by 20% in 2006 to reach £338 million.”

Additionally, the report highlighted that consumers will also respond if they perceive that corporate behaviour is in the best interests of society. For example, the Report stated that UK household expenditure on ethical goods and services almost doubled from 2002 to 2007. However, it should be noted that the overall ethical market in the UK is still only a small proportion of total annual consumer spend.

7. The Ethical Consumer Report is written and produced, annually, by the Cooperative Bank.

Potential areas for development

Evolving developments

With supply chains problems continuing, some improvement in how companies manage supply chain issues is required. There is no doubt that efforts made over the recent years have brought about real benefits in the working conditions of supply chain factories, particularly in those located in countries with poorly developed regulatory frameworks. The ETI Impact Assessment findings highlighted that auditing has contributed to widespread improvements in health and safety, correct payment of overtime premiums to more workers and a reduction in working hours.

However, concerns around the effectiveness of audits, including questions over whether audits capture the real problems, have been raised. Additionally, multiple audits on the same factory, diverse audit approaches and inconsistent corrective action plans, have created confusion for suppliers. It is Newton’s view that the debate around supply chain management is currently evolving as companies, NGOs and governments recognise the inefficiencies in current efforts to improve working conditions. Potential areas for development include:

- **Improving efficiency in the audit process**

- 1) **Working collaboratively to improve the quality of audits**

The current individual efforts of companies have created an environment of unnecessary duplication of audits. This wastes time and resources for both suppliers and buying companies. Additionally, many companies conduct their own audits as they feel they cannot rely on audits undertaken by third party auditors, further exacerbating the problem. There is a growing need for companies to work towards harmonising the requirements of their Codes of Conduct and their audit processes. Additionally, sharing audit reports and corrective action plans could help reduce duplication.

SEDEX – Supplier Ethical Data Exchange

A number of industry-wide collaborative initiatives have emerged, most notably the Supplier Ethical Data Exchange (SEDEX). SEDEX is a web-based system for suppliers to input data on labour standards at their production sites. The system has been designed to allow the sharing of information to prevent companies being audited repeatedly and thus the duplication of information. Additionally, it enables instant access to the compliance status of suppliers allowing companies to see where areas of improvement are needed. The development of SEDEX has been supported by a group of UK retailers and suppliers, including Geest, Marks & Spencer, Northern Foods, RHM, Sainsburys, Tesco, Uniq and Waitrose.

- 2) **Reporting on the outcome of audits**

Many retailers report on the number of social audits that are undertaken. However, there is little reporting on the problems found and the actions taken to remedy them. Providing greater transparency in this area could increase stakeholder confidence in the work a company is doing to improve and monitor working conditions in its supply chain.

Improving supply chain performance reporting

In November 2007, along with eight other investors, Newton became part of a working group which aims to address the issue of performance reporting on supply chain labour standards. Newton is committed to being an active member of this group and will report on the progress made.

- **Ensuring workers are appropriately paid**

NGOs have often lobbied both governments and businesses to encourage workers to be paid a “living wage”. A living wage can be defined as one that enables workers and their dependents to meet their needs for nutritious food and clean water, shelter, clothes, education, healthcare and transport, as well as allowing for a discretionary income⁸.

Additionally, one of the requirements of the Ethical Trading Initiative Base Code (See Appendix 1 for further information) is that “wages should always be enough to meet basic needs and to provide some discretionary income.”

There is evidence to suggest that companies are coming under increasing pressure to ensure employees in the supply chain are paid a living wage. Alongside pressure from NGOs, some shareholders are also highlighting their concerns. For example, in 2007, Tesco faced a shareholder resolution at its Annual General Meeting relating to employment conditions in the company’s supply chain. The resolution acknowledged the report written by War on Want, entitled “Fashion Victims”. The resolution sought for the company to take appropriate measures to be independently audited and to ensure that workers in its supplier factories are provided with appropriate working conditions. The resolution suggested that appropriate working conditions include payment of a living wage, reasonable hours of work, job security, freedom of association and of collective bargaining and, where available, the right to join a trade union of their choice.

Though the resolution was not passed, c.20% of shareholders either voted in favour of the resolution or withheld their votes. For more information, please see the SRI Activity Log in the Q207 Corporate Governance & SRI Report, available at www.newton.co.uk.

There are many difficulties surrounding the issue of employees receiving a living wage. There is a range of views as to what constitutes a living wage. Additionally, a living wage would be different in each country. There may also be variations as to what constitutes a living wage between regions and industries within a country. Therefore, collaboration between companies, governments, NGOs and trade unions is required to establish a benchmark for agreement on a living wage.

8. As defined by NGO, Labour Behind the Label, in its 2007 update report titled: Let’s Clean Up Fashion.

Further, agreement is needed between buying companies to ensure a similar approach is adopted by companies working with the same supplier. The knock-on effects to a sourcing country's economy must also be fully assessed and considered. Finally, wages paid to employees can be commercially sensitive information making open collaboration between competing companies difficult.

Though Newton recognises these difficulties, it does believe that companies should ensure that workers are being paid appropriately. Next has begun a process to assess the financial impact of paying workers a living wage. Marks & Spencer is developing six model "ethical factories", in key sourcing countries, in order to establish working methods of best practice relating to ethical sourcing. The ethical model factories will be developing sustainable methods to increase wages. Tesco is conducting research into the calculations of living wages by international organisations, academics, trade unions

and NGOs. Tesco is also researching the capacity for collective bargaining by local workers to enable negotiations for a living wage. Other companies are looking into sustainable methods to increase wages over time. Additionally, the ETI is undertaking a project to look at living wages around the world.

- ***Collaborating with other stakeholders to develop a sustainable working environment***

It is the role of government to make and enforce laws that protect the rights of workers. However, in many countries law enforcement is weak. Therefore, workers may not be protected by law or through any enforcement of international labour conventions. Codes of Conduct are not a substitute for effective law enforcement. At best, they can be a stepping stone towards achieving the desired conditions. Therefore, it is important that companies, suppliers, trade unions, governments and NGOs all work together to develop a sustainable working environment.

The Global Social Compliance Programme (GSCP)

The GSCP was formed in early 2007. Initial members include Carrefour, Metro, Migros, Tesco and Wal-Mart. It is a business-driven programme for companies that want to harmonise their respective efforts in delivering a "shared, global and sustainable approach for the improvement of working conditions in the global supply chain". The programme aims to define a clear and consistent message to both suppliers and authorities by building consensus on existing best practices. In this way, it is hoped that industry will progressively move towards a convergence of ideas and actions. Additionally, the programme aims to coordinate industry efforts to allow for mutual recognition of audit results, thereby creating a reduction in audit duplication.

The GSCP has designed a 6-step working plan in order to achieve its objectives. The Group had its first meeting in October 2007. The main focus of the meeting was remediation issues, such as supervisor training in China and methods to meet production without requiring staff to work overtime. The second meeting was scheduled for January 29th where it was hoped that a common reference Code of Conduct would be agreed.

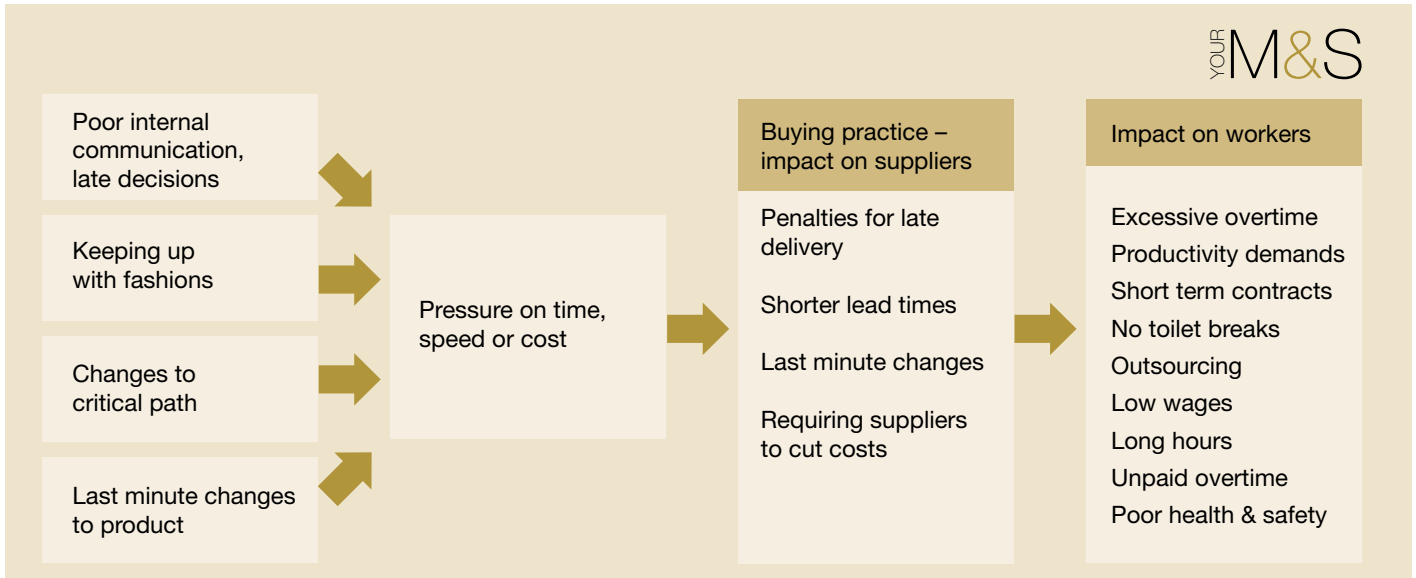
Newton will continue to monitor the development of this important programme.

- ***Buying practices***

There is a potential link between buying pressures and unacceptable behaviour by suppliers. The need to produce goods quickly can lead to excessive working hours in an attempt to meet demand. Issues around flexibility and seasonality can affect a supplier's ability to provide secure and regular employment. The search for lower prices can mean manufacturers want to keep labour costs at a minimum. Cost pressures may also lead to a lack of investment in health and safety measures.

Retailing companies need to ensure that buying practices are inline with responsible sourcing policies. Buyers should be trained in a way that highlights the potential effects of their buying decisions. Marks & Spencer is a leader in the industry when it comes to responsible sourcing. Figure 3 provides an example of some of the training resources received by buyers for Marks & Spencer.

Figure 3: How you can affect labour standards, Marks & Spencers Buying Training Programme



Source: Marks & Spencer

• **Adjusting to the increasing costs of worker and environmental protection**

Until recently, China has been viewed as a country with the capacity to provide a seemingly endless supply of cheap labour. However, the Chinese government has begun to accept that economic growth cannot come at any cost. On 1 January, 2008, the new Chinese labour law came into force. It is the most significant overhaul of workplace regulation in a decade. Additionally, it has sparked debate on the trade off between economic growth and worker protection.

The law aims to improve worker protection by, for example, making it harder for employers to fire workers easily. Evidence of a just cause for a termination of employment must be provided. Additionally, the law requires that all employees need to have individual written contracts. Further, the law states that an employer will be banned from recruiting juveniles under the age of 16 years. The law also intends to move industry up the value chain, pushing China to become less dependent on low-value-added export processing.

Additionally, the Chinese government has been putting pressure on companies to comply with environmental regulations in order to reduce pollution. For example, in July 2007, the China Banking Regulatory Commission called on banks to withdraw lending to firms listed by the National Development and Reform Commission as heavy polluters or operating with inefficient, outdated facilities. This followed an order made by the central bank, a week

previously, for commercial banks to stop lending to polluting producers and to call in existing project loans deemed undesirable by the government. Further, in September 2007, the Sydney Morning Herald reported that China’s environmental watchdog had closed down 400 companies for failing to tackle water pollution. Another 762 companies and projects had been suspended or fined due to environmental violations.

Additional examples of actions the Chinese government is taking to enforce environmental regulation can be found in Newton’s October 2007 SRI Focus Report. The Report is titled Water – Increasing demand, diminishing supply. The report is available on www.newton.co.uk.

Management of downward pricing pressure

If undertaken, the developments discussed above are going to add to the cost base of a business. Additionally, the current environment of high oil prices, increasing raw materials and transport costs, and food inflation indicates that companies are facing considerable input cost pressures. This creates a concern as to how companies can manage downward pricing pressures while encouraging improving labour practices and ensuring integrity in their supply chains.

The following exert, taken from a conference call held by JP Morgan on December 10, 2007, clearly outlines the pressures that both suppliers and purchasers are facing.

The China Supply Chain – Is It Fixed or Is It Broken?

Jing Ulrich – Chairman of JP Morgan China Equities
10/12/07

“In the last several years we’ve continued to see costs escalate for Chinese consumer product manufacturers. Wages have been increasing at a rate of 10% to 15% per annum. Raw material costs have also increased – you might be surprised to learn that quite a number of toys and sneakers are produced from oil derivatives. In addition, transportation costs have been going up – again due to high oil prices. We’ve also seen an increase in environmental costs.

As energy costs rise, the Chinese government is imposing tighter environmental standards on manufacturers. For example, manufacturers are now required to treat their industrial water, rather than dumping it into local rivers. So all these costs are mounting, but Chinese suppliers are under intense pressure to keep their margins razor-thin.

On the foreign buyers’ side, as you know, companies like Wal-Mart are huge bulk buyers of Chinese goods. In 2006, Wal-Mart purchased \$18 billion of goods from China, effectively serving as China’s eighth-largest trading partner. Since these companies purchase such large quantities of goods from China, it’s virtually impossible to inspect every item that comes across American or European borders.

Ultimately, you have pressure from both sides – Chinese producers are pressured to cut costs, while buyers from Europe and the U.S. are pressured to negotiate the best prices. The confluence of these factors has created the problems that we’re seeing.”

Comment from Newton’s Retail analyst: Rosie Bichard

Companies which take a thoughtful and proactive approach to supply chain issues should benefit both in the short term and longer term. In particular, avoiding product safety issues should prevent negative consumer sentiment towards a company and protect a company’s reputation. Certainly, companies which have been affected by quality problems have seen weaker sales and higher costs in the short term, not to mention significant management distraction while the issues are being resolved.

Though many consumers are attracted by cheap prices and retailers are eager to source products at a lower cost from overseas, there is a growing awareness that this may be achieved at the expense of either quality standards or adequate wages for the employees of suppliers. Retailers will have to be increasingly aware of this debate and be able to demonstrate that short cuts on safety and social issues are not being taken, otherwise the market will attribute less value to their shares. Newton is actively engaging with companies on these issues as part of its investment process.

Company contact

It is Newton's view that the debate around supply chain management is currently evolving as companies, NGOs and governments recognise the inefficiencies in current efforts to improve working conditions. Additionally, there is concern surrounding how companies can manage downward pricing pressures while encouraging improving labour practices and ensuring integrity in their supply chains. Therefore, Newton contacted eight of its retail investee companies. Newton's objective was to find what its investee companies are doing to drive this debate forward. The companies contacted included:

Belle (China)

Gildan (Canada)

Marks & Spencer (UK)

Ports Design (China)

Praktiker (Germany)

Tesco (UK)

Woolworths (UK)

Yamada Denki (Japan)

At the time of going to print, Newton had received a written response from Ports Design and had undertaken in-depth discussions with Tesco, Marks & Spencer and Gildan. Praktiker, Woolworths and Yamada Denki had all committed to respond to the questions and Newton is awaiting their replies. Despite several attempts to engage with the company, Belle is the only company that has not responded to Newton's request for information.

A summary of the findings is provided below.

A) Gildan Activewear (Gildan)

Gildan is a vertically integrated marketer and manufacturer of premium quality activewear, underwear and socks. Its business is high volume, basic, frequently replenished, non-fashion apparel. Gildan manufactures all of its textiles in its company-owned facilities. Additionally, Gildan sews the majority of its products in its facilities. A small amount of activewear products are sewn by contractors located in Haiti. The majority of its sock manufacturing is in Honduras and the United States with some outsourcing in Latin America, the Caribbean Basin and the Far East.

Efforts to improve efficiency in the audit process

- Gildan recognises the need for harmonisation of Codes of Conduct. Therefore the company has taken the approach of establishing its own Code of Conduct that adheres to the strict requirements of the Fair Labour Association (FLA – see Appendix 1). Gildan obtained accreditation from the FLA, for its labour compliance programme, in June 2007. Accreditation was awarded after a three-year period during which the FLA verified compliance with its own workplace Code of Conduct requirements. Since its creation in 1999, the FLA has accredited only ten companies worldwide. Gildan is regularly audited by the FLA. FLA audits are always unannounced and may be in any facility Gildan operates or works with. Findings of the audits are made public on the FLA website.
- Gildan has also established an in-house auditing team that is responsible for the monitoring of its Code compliance as well as rating factories based on how well they comply with the Code. Additionally, the in-house team works closely with key staff to identify the root cause of any problems and helps to design sustainable remediation solutions. Further, Gildan is regularly audited by its customers. Therefore, the in-house team has also integrated the most stringent requirements of its customers into its Code to comply with their requirements.
- Gildan also uses the services of other external auditors to ensure operations are in compliance with its Code of Conduct.

The FLA is shifting its approach to sustainable compliance of its Code from “auditing to assessing”. Instead of repeatedly sending in external monitors to identify non-compliant behaviours, the focus is on determining why these non-compliant behaviours take place. Once the root cause is established, the next step is to find sustainable solutions for remediation.

Ensuring workers are appropriately paid

- All Gildan’s production workers are paid above the minimum wage. The minimum wage serves as a base wage level. However, workers compensation includes incentivised arrangements, for example, a production bonus or an attendance bonus. Additionally, employees receive benefits such as access to free medical assistance – every plant has its own medical clinic – subsidised transportation to and from work, subsidised meals and access to education and training.
- In specific regard to the debate surrounding a living wage, the company takes efforts to participate in the debate and remain abreast of developments. Gildan recognises the need for industry collaboration as well as government leadership to gain consensus among industry stakeholders as to what constitutes a living wage.

Collaborating with other stakeholders to develop a sustainable working environment

A description of initiatives is located in Appendix 1.

- FLA
- WRAP
- MFA Forum
- Brand Collaboration Initiative – led by Levi Strauss & Co
- BSR working groups
- CCSR working groups

Gildan (continued)

Buying practices

- When engaging with Gildan on this topic, and due to the vertically integrated nature of the business, discussion focused mainly on how the company ensures optimal working conditions for its production employees. However, the company is currently undertaking efforts to ensure its suppliers comply with its own Code of Conduct.
- All contractors used by the company have received training on implementing Gildan's Code of Conduct. All contractors in Central America and the Caribbean Basin are audited every year. Potential new contractors are audited to identify their level of compliance with Gildan's Code prior to placing a production order. Gildan stated that if the rating is low, it will not place the production order.
- The company also mentioned it has a strict environmental Code of Conduct that suppliers must adhere to.

Managing downward pricing pressure while encouraging an environment of improving labour practices and ensuring integrity in supply chains

- Over the recent years, Gildan has undertaken a significant capital expenditure programme to modernise its factories and equip them with State of the Art technologies. This has led to economies of scale and less capital intensive operations. Therefore, the company feels that it is in a good position to handle the current, difficult economic environment. To highlight this point, Gildan has been able to improve margins over the last 12 months when many other companies in the general retailing sector have found margins squeezed. Additionally, the labour component of Gildan's cost structure is only c. 10%.
- Gildan also mentioned that it does not need to cut labour costs to continue to be successful and create value for shareholders. The attitude of management is that it is important to achieve profitability by generating quality products through the use of modern technology. The management of Gildan believe that the market rewards companies that are less risky. Gildan believes it is proactively managing the risks it faces through strong corporate governance and corporate responsibility practices. Gildan aims to continue to achieve growth in its share price by combining strong financial results with its good corporate reputation.

B) Marks & Spencer (M&S)

There are over 600 M&S stores located throughout the UK. In addition, the Company has 240 stores worldwide, including over 219 franchise businesses, operating in 34 countries. M&S has an ambitious 5-year plan, titled Plan A, to tackle some of the biggest challenges facing business and the world. Under Plan A, by 2012, M&S aims to be carbon neutral, send no waste to landfill, extend sustainable sourcing, set new standards in ethical trading and help customers and employees lead healthier lifestyles. M&S works with c. 2,000 suppliers of which 1,500 supply clothing, footwear, beauty and home products and 500 supply food products. Over half of food ingredients are produced in the UK and over 80% of finished food products come from UK companies. Over 90% of clothing and home products are made overseas. Because M&S stocks only own-branded products, the company has a good understanding of its supply chain. Additionally, it is in a strong position to influence suppliers to adopt appropriate standards.

Efforts to improve efficiency in the audit process

- M&S agreed that the auditing process needs to mature. Last year, M&S undertook an unannounced audit project in an effort to discover the real picture regarding the working conditions in its suppliers' factories. A negative outcome of the project was that the trust of some of its suppliers was broken. From the insights gained in undertaking the project, M&S concluded that the most effective way to undertake an audit was to indicate a three week period during which an audit might be undertaken.
- M&S undertook a 7-year project in Sri Lanka to assess the impact of different types of auditing procedures. The company looked at the efficiency of third party audits, multi-stakeholder audits and supplier self-audits. The study found that most of the audits picked up similar non-compliances, though each type had a slightly different viewpoint. M&S concluded that the best approach to auditing was to use all 3 types of auditing.
- M&S re-vamped their auditing procedures during 2007. The new framework is based around providing a clear definition of the company's standards and helping suppliers work towards meeting these standards. M&S is in the process of creating six model ethical factories, located in key sourcing countries, in order to establish methods of best practice relating to ethical sourcing.
- In 2008, M&S is adding capacity to its team of regional compliance managers. Currently there are 11 and, by the end of 2008, M&S plans to have 23. One of the key roles of a regional compliance manager is to help suppliers achieve their action plans for adherence to the company's standards.
- In 2007, M&S made it a requirement that all new supplying factories must be signed off by the Head of Ethical Compliance and the Head of Technology before being accepted as an M&S supplier.

Ensuring workers are appropriately paid

- M&S highlighted to Newton the difficulty of collaboration in relation to workers' wages due to the commercially sensitive nature of the information. However, the company is looking at ways to sustainably increase wages. The majority of this work is being done in the six model ethical factories that M&S has committed to developing.
- When it comes to ensuring that workers are appropriately paid, M&S believes that a key consideration is to ensure that wage increases must be sustainable over the long-term. The company also believes that wage increases should be incentivised.
- The company highlighted that over 70% of workers in Bangladesh factories that it sources from are paid over double the minimum wage.
- M&S, in 2008, plans to make it a condition of trade with M&S that all manufacturing sites implement Worker Rights training.

Collaborating with other stakeholders to develop a sustainable working environment

A description of initiatives is located in Appendix 1.

- SEDEX
- ETI
- MFA Forum

Buying practices

- M&S buyers must undertake an induction programme which includes a session on ethical trading and outlines the effects of buying decisions.
- Additionally, all buyers for M&S must participate in the company's "Buying Academy" which covers Forecasting & Planning, Critical Path Management and Cost & Negotiation. Assessment of participation is included in an employee's yearly appraisal.
- Over 50% of M&S buyers have already gained the Chartered Institute of Purchasing and Supply (CIPS) qualification. M&S is currently undertaking a review of the ethical trading module of its Buyer Training Programme. This includes working with CIPS to re-write its current ethical-trading module and developing a "Responsible Buying Guide". Additionally, M&S is in the process of updating the training modules included in the Buyer Academy training.

Managing downward pricing pressure while encouraging an environment of improving labour practices and ensuring integrity in supply chains

- M&S acknowledges that the consumer outlook is likely to remain tough for 2008. The company also recognises that its customers and stakeholders expect it to lead in setting the standard for management of social and environmental issues.
- M&S stated that working in an environment of high pricing pressure is nothing new. However, there is a right way of gaining best value. M&S has been sourcing from its largest 10 suppliers for between 50-100 years. These suppliers contribute to 65% of M&S turnover.
- M&S takes a partnership approach to working with suppliers, focusing on achieving efficiency and reducing waste. The company recognises that if it can buy in volume, suppliers are able to obtain better raw material prices helping to reduce the cost of goods. When sourcing from countries in the developing world, M&S participates in "preference deals" to take advantage of duty rates. Additionally, purchasing from countries where there is a currency benefit also helps add value.
- M&S believes it is key to plan ahead as far as possible. The company has been able to reduce the cost of men's underwear by 15-20% due to better planning. M&S now provides its men's underwear suppliers with 12 month rolling estimates of orders on a weekly basis. This enables suppliers to buy in bulk, reducing costs.
- M&S also commented that they have saved 66% of the weight of packaging for clothing and homeware since Plan A was implemented. This equates to a saving of one-third of the cost of packaging. Plan A is forcing the company to look at matters from a different perspective. Just one year into implementing Plan A, it has already become a significant driver for change.
- In regard to product safety, M&S designs products to be safe in the first place. The company's technical team is integrated into the buying team and any new contract must be signed off by a buyer, a merchandiser and a technologist. The company has a framework in place that clearly defines safety standards, ensures a product is designed correctly in the first place and requires that production is monitored. Independent product safety audits are also undertaken. The framework is based around the view that high quality standards support safe products. M&S believes that its emphasis on safety provides a point of difference for the company.

C) Ports Design

Ports is a vertically integrated, international fashion company engaged in the design, manufacture and retail of high-end fashion garments and accessories. The global operations of the company span North America, Europe and Asia.

Efforts to improve efficiency in the audit process

- Currently, the company does not disclose any information on how it manages material ESG risks in its Annual Report or on its website. Ports did state that it is working towards reporting on its Environmental, Social and Governance (ESG) efforts in a future issue of the Interim and Annual Reports.
- The vast majority of the company's products are manufactured in-house. The company states that factory and employment procedures are on a par with the best manufacturing plants in North America. For the small number of products that are outsourced, Ports requires suppliers to adhere to its Code of Ethics, which are in accordance with best practice standards in North America. The company employs monitors who perform regular visits to factories to ensure that they comply with its Code of Ethics.

Ensuring workers are appropriately paid

- Ports states that in its own production facilities, the pay scale is significantly higher than the industry average. The company's "mark-up" structure is such that fluctuations in salaries are relatively inconsequential. Therefore, Ports tends to pay wages which are better than the going rate, helping to improve staff retention. For employees directly employed by the company, accommodation, health care, pension, and unemployment insurance are provided.
- When asked about the company's views on paying a living wage, Ports responded by stating that it is customary for the company to provide accommodation for individuals or families who relocate to Xiamen for work. This is also customary at the group's suppliers' sites.

Collaborating with other stakeholders to develop a sustainable working environment

Not Stated

Buying practices

- All Ports' buyers are internal. Physical site visits to ensure quality standards and compliance with the company's Code of Ethics are undertaken before any new suppliers are used by Ports.

Managing downward pricing pressure while encouraging an environment of improving labour practices and ensuring integrity in supply chains.

- As the nature of the Ports business means a focus on high-end retail, the company only deals with high-end suppliers which generally tend to be best-in-class. Ports reiterated that due to its "markup" structure, fluctuations in salaries are relatively inconsequential. Therefore, Ports tends to pay wages which are better than the going rate to improve staff retention.

D) Tesco

Tesco has been listed on the UK stock exchange for 60 years. The company has grown considerably in that time, particularly over the last decade. There are now c. 1,780 Tesco stores in the UK and c. 1,000 stores outside the UK. 1,500 suppliers have supplied Tesco for 5 years or more. Tesco sources products from 96 countries.

Efforts to improve efficiency in the audit process

- Tesco acknowledged that auditing is necessary but not sufficient on its own. The company believes that a combination of auditing and working with suppliers to build partnerships is the best way to improve working conditions in the supply chain.
- Tesco believes that buying companies need to work together to improve the audit process. To improve inefficiencies and reduce duplication, information should be shared among the major buying companies. SEDEX provides a means of sharing audit information.
- To improve the quality of audits, Tesco has begun an “Auditor Recognition Programme”. Under the programme, Tesco provides a list of auditors to suppliers that it is prepared to work with/accept. Tesco knows that the auditors on this list have received appropriate training and have enough experience to provide high quality audits. Currently this is a Tesco only initiative.
- Tesco is actively involved with the Global Social Compliance Programme (GSCP – See notes on page 7). Tesco believes the GSCP could add significant efficiency to the current auditing process because members must agree to a common Code of Conduct, a common audit check list and a common auditor competence check list. Additionally, the GCSP enables members to discuss common methods for remediation.
- Tesco was a founding member of both SEDEX and the GSCP.

Ensuring workers are appropriately paid

- Tesco’s current policy is that suppliers must meet local minimum wages rates or industry benchmark – whichever is higher.
- Tesco recognises the need to clearly identify, in all 96 countries from which it sources, both the legal minimum wage provisions and the range of views on what constitutes a living wage. The company is currently conducting research to look at the calculations of international organisations, academics, trade unions and NGOs, and at local capacity for collective bargaining to achieve a negotiated living wage. This research started in 2007. Tesco hopes to build the information gained from this research into its efforts to implement the ETI Base Code requirements on a Living Wage. Additionally, Tesco hopes that the findings of the research will provide a useful contribution to the work being undertaken by ETI Wages Working Group.
- Tesco highlighted that a pragmatic approach towards assessing a living wage in all countries is needed. NGOs, Trade Unions and governments must agree on a benchmark figure to aid development. Companies also need to collaborate to ensure a similar approach is adopted by companies working with the same supplier.

Collaborating with other stakeholders to develop a sustainable working environment

A description of initiatives is located in Appendix 1.

- SEDEX • ETI • MFA Forum
- It is stated in a buyer’s job description that they are expected to understand and reflect ethical considerations in their purchasing practices. All buying staff, globally, must attend an ethical trading training course. The course provides information on how to recognise potential problems and employ purchasing practices that minimise ethical risk. Course content and length varies depending on the specific job but the training is mandatory.

Buying practices

Currently, Newton is waiting on an additional response to this question from Tesco.

Conclusion

The working practices of suppliers can give rise to operational and reputational risks. Many companies have made significant efforts to improve the social and environmental performance of their suppliers. However, problems continue. Newton believes that the debate around management of supply chains is evolving. Previously the focus has been on the development of Codes of Conduct and on auditing supplier compliance. Going forward, companies will need to work collaboratively to improve the quality of audits. Harmonising Codes of Conduct, the audit process and corrective action plans will help to prevent audit duplication. Open collaboration amongst companies,

suppliers, governments, trade unions and NGOs is required to develop a sustainable working environment. Additionally, companies need to ensure that their buying practices do not exacerbate supply chain problems and to ensure that employees of suppliers are fairly paid. The Global Social Compliance Programme is an interesting initiative that aims to coordinate industry efforts to improve management of supply chain issues.

Katie Swanston

Associate Director of Investment Management
SRI Officer

Appendix 1: Initiatives which aim to improve labour conditions

- **Brand Collaboration Initiative**

This initiative, led by Levi Strauss & Co, aims to engage major brands in a dialogue to harmonise their approach to codes of conduct, monitoring, training of vendor's, sharing of audit protocols and results.

- **Business for Social Responsibility (BSR)**

As a nonprofit business association, BSR promotes corporate social responsibility (CSR) by helping companies implement and improve CSR policies and practices to enhance the quality of life for current and future generations. BSR regularly convenes Working Groups to address critical and emerging issues as well as to promote collaborative solutions to pressing problems. The groups typically consist of 10 to 20 member companies with common needs.

- **Canadian Business for Social Responsibility (CBSR)**

Founded in 1995, CBSR is a business-led, non-profit CSR consultancy and peer-to-peer learning organization. CBSR provides its members with counsel and customised advisory services to help formulate business decisions that improve performance and contribute to a better world.

- **Ethical Trading Initiative (ETI)**

Founded in 1998, the Ethical Trading Initiative (ETI) is a UK based alliance of businesses, non-governmental organisations and trade unions whose objective is to improve labour standards in supply chains. By signing up, companies agree to ask suppliers to conform to a Base Code that requires high levels of labour standards, including the avoidance of child labour, forced labour, sweatshops, adverse health and safety conditions, and violations of labour rights.

- **Global Social Compliance Programme**

See page 7

- **Fair Labor Association (FLA)**

The mission of the Fair Labor Association (FLA) is to combine the efforts of industry, civil society organisations, and colleges and universities to protect workers' rights and improve working conditions worldwide by promoting adherence to international labor standards.

- **Multi-Fibre Arrangement (MFA) Forum**

The MFA Forum is an open network of c. 70 participants representing corporations, governments, trade unions, NGOs and other interested stakeholders. The MFA Forum has agreed to a set of overarching principles to guide the actions of those involved and to develop collaborative initiatives. These principles are implemented through engagement at a country level, ensuring that efforts are or lead to, "home owned" and "home grown" actions to sustain the national industry. This means that MFA Forum participants try to meet with all stakeholders of national industries, including governments, in order to bring these different groups together into discussions around the future of their industry.

- **SEDEX**

See page 6

- **Worldwide Responsible Apparel Production (WRAP)**

WRAP is an independent, non-profit organisation dedicated to the promotion and certification of lawful, humane and ethical manufacturing throughout the world. WRAP promotes a code of conduct, which ensures that core labour concepts are understood and practiced on the shop floor and by management. WRAP relies upon independent, third party monitors to certify that factories are in compliance with its code of conduct.

Appendix 2: Initiatives which aim to improve reporting on the management of environment, social and governance matters

- **Association Of British Insurers (ABI) –**

- **Guidelines On Responsible Investment Disclosure**

The ABI's Guidelines on Responsible Investment Disclosure aim to assess how well companies disclose information on the assessment of environmental, social and governance (ESG) risks in the context of the whole range of risks and opportunities that a company faces. The guidelines take the form of disclosures, which institutions would expect to see included in the annual report of listed companies. Specifically they refer to disclosures relating to Board responsibilities and to policies, procedures and verification.

- **Global Reporting Initiative (GRI)**

GRI is a worldwide, multi-stakeholder network. Business, civil society, labour, investors, accountants and others all collaborate through consensus-seeking approaches to create and continuously improve a "Reporting Framework". The Reporting Framework provides guidance for organisations to use as the basis for disclosure about their sustainability performance, and also provides stakeholders a universally-applicable, comparable framework in which to understand disclosed information.

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Newton Investment Management Limited
The Bank of New York Mellon Centre
160 Queen Victoria Street
London EC4V 4LA
Registered in England No. 1371973

Tel: 020 7163 9000
www.newton.co.uk

Registered office: As above
Authorised and regulated by the Financial Services Authority


Tel: 020 7163 9000
Fax: 020 7163 5063

newton.co.uk

Issued and approved by Newton Investment Management Limited,
The Bank of New York Mellon Centre, 160 Queen Victoria Street,
London EC4V 4LA.

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Tel: (516) 338 3521
www.newtoncapitalmanagement.com



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