# Sustainable Investment Report

## First quarter 2019

Marketing material

Schroders

# Contents

## One of the most profound social changes that we have seen over the past decade relates to health and wellbeing. Never before has so much focus, from regulators, from the media and from ourselves gone on what we consume.

**Jessica Ground**
Global Head of Stewardship, Schroders

We are in the midst of a structural shift that we see as having profound implications for companies. Consumer tastes, whether nudged by governments or by peers, are shifting. Companies in turn need to innovate and invest, or face the risk of seeing historic areas of profitability go into run off. In this quarterly report, we examine three facets of this issue: sugar, the legalisation of cannabis, and climate change and sustainable food production.

We first wrote on sugar in 2015, identifying an emerging trend that we show has gathered pace with increasing regulation globally in the form of sugar taxes and an ongoing switch from processed foods towards healthier alternatives. It doesn't feel as if the world is quite going to be ready for meat taxes in 2019, but given the benefits for health and the environment we wouldn't rule it out over the medium term especially against a backdrop of more scrutiny on food production. Elsewhere, the legalisation of cannabis will provide a revenue boost for governments that embark on the change, and we have already seen beverage and tobacco companies respond.

In terms of the broader investment impacts of climate change, we provide an update on our Climate Progress Dashboard. Launched in 2017 and updated every quarter since, it is Schroders' most downloaded piece of thought leadership. It continues to point to temperature rises of 4 degrees (twice the level considered "safe" by global leaders). In light of this we review the outcomes of COP 24.

Given the rising environmental and social challenges discussed so far, it will be of little surprise that we have turned our attention on how investors should consider sustainability in a multi-asset portfolio. Despite growing pressure from regulators to embed environmental, social and governance (ESG) integration into investment portfolios, much of the work done to date focuses on individual asset classes rather than a total portfolio approach. For those keen to progress in this area, we introduce the idea of a "sustainability budget" to work alongside other existing tools to ensure a thoughtful approach. We will be writing more on this topic over 2019. We also look at sustainability issues from an infrastructure debt perspective. While investors are allocating more to alternative assets in their hunt for returns, we must be thoughtful about how we build the right tools and approaches on integration; best practice is still emerging in many of these areas.

Finally we provide an update on our stewardship activities and set out the issues that we feel will dominate engagement and voting in 2019. Many of these are ongoing discussions on fairness in executive pay, action on de-carbonising, and building diversity in the workforce and management. Some of these are more emerging issues like ensuring businesses have robust balance sheets as we head into a more difficult economic macro environment and engaging with auditors to improve best practice. All of which we hope will contribute towards creating sustainable long-term value for our clients.

INsight

# Initiating on cannabis: How sustainable is this "high"?

**The legal cannabis market is well placed to expand but is at risk from the high environmental costs of sourcing and manufacturing, and uncertainties related to long-term health impacts of use. We believe these challenges will have significant implications for companies across the value chain. It will be critical for investors to differentiate between companies well placed to adapt and their less prepared peers. We propose an appropriate framework to identify the likely winners[1].**

### Cannabis: a potential $130 billion market within a decade

Over the last few years, cannabis has moved from cult distraction onto investors' radar screens. Canada became the first G7 country to legalise recreational use in October 2018, following in the footsteps of several US states and opening the door to a viable investment theme. The market's prospects matter for the pure-play companies operating in the space but also for the major companies that have placed bets on its growth as expanding legality is proving to be disruptive for many traditional industries, impacting everything from medicine, agriculture, banking, beverage production, home construction, and others.

- Alcohol producer Constellation Brands has invested $4 billion in cannabis Canopy Growth
- Tobacco producer Altria has taken a $1.9 billion (45%) stake in cannabinoid company Cronos
- Beverages firm Anheuser-InBev has established a partnership with medical cannabis producer Tilray
- Tobacco firm Imperial Brands has invested in Oxford Cannabinoid
- Brewer Molson Coors is collaborating with medical cannabis company Hydropothecary to create a line of non-alcoholic cannabis-infused beer

Those investments reflect defensive moves to counter the threat cannabis poses to companies' core markets, as much as the growth opportunities they create. Some industries at risk of disruption – pharma, alcohol, beauty and wellness, tobacco, and food – represent global retail sales of $6,000 billion[2].

## Growth prospects hinge on regulation

Legalisation rather than increased use is the key driver of the industry's growth. Penetration is already relatively mature in most markets; the UN estimates that 3.9% of the world's population are regular users, around one fifth the penetration of tobacco smokers[3].

Although political doubt looms, the potential growth in the market is significant and we think relatively attractive on balance. The global legal market was worth $10.8 billion in 2018. Conservative base-case industry assumptions see this opportunity reaching $50 billion by 2029[2], assuming full legalisation across the US, Europe and Latin America, and cannabis disruption of other industries. Furthermore, social attitudes have changed and governments also increasingly recognise both the revenue-raising attractions of legalisation and the benefits of bringing the industry under its regulatory oversight. As a result, a wide range of countries including the UK, South Africa, Mexico, Malaysia, India and China have taken initial steps toward decriminalisation, at least of the medicinal market. Going forward, a much larger legal market looks likely.

1 Weak disclosure and action suggests the most prominent pure plays in the industry are poorly prepared.
2 Source: Owen Bennett and Ryan Tomkins, 25 February 2019, "Initiating on Cannabis: Long-term highs expected but not all at the party", Jefferies Equity Research.
3 Source: (Quoted in) Gaurav Jain, Mandeep Sangha and Lauren R. Lieberman, 3 September 2019, "Cannabis Inc.- A growing industry", Barclays Equity Research.

### To be blunt: Overlooked health and environmental impacts may pose a negative catalyst

While the market seems well placed to expand, producers face challenges. Two key areas stand out for this fledgling industry:

- **The high environmental costs of sourcing and manufacturing:** Cannabis production relies on intensive farming practises with a high energy and emissions footprint, involves significant discharges to water, air and land, and the use of toxic pesticides and associated chemicals.
- **Continued public health and safety concerns:** There is a large and growing body of academic research outlining adverse acute and chronic health impacts – particularly related to mental health disorders like psychosis and substance dependence[4].

### Framework to assess preparation

We have developed a framework to assess pure-play companies' along six dimensions of preparation:

1) **Scale and routes-to-market:** How much flower can it grow? Has capacity been brought on line as expected so far? Is it operating across geographies and well placed to capture the opportunities as more markets decriminalise?

2) **Differentiation:** Does the company have a strong brand, intellectual property or clinical trials and differentiated products to address both recreational and medical markets? How does it ensure the source, quality and integrity of products with enhanced traceability?

3) **Diversification:** Is it diversifying away from 'higher risk' categories?

4) **Experience, expertise and resources:** Does it have the financial capital, qualified personnel and skilled labour to expand its product pipeline and oversee the maturing of its business?

5) **Responsible governance:** Are there robust controls in place to ensure 'high-risk' populations are appropriately safeguarded? Is it proactively self-regulating marketing and consumer messaging?

6) **Sustainable cultivation:** Does the company use environmental resources efficiently?

This framework provides a structure to help our investors navigate the challenges that look likely to accompany the growth opportunities the industry offers and we believe these key factors will define the winners in the space.

### Industry poorly prepared

We have assessed the propositions of 12 major pure play cannabis companies using this framework. In general, although meaningful differences persist across the peer group, weak disclosure and action suggests most are poorly prepared for the challenges that we believe are inevitable as the industry expands. We will continue to engage with incumbents that have moved into the space to better understand their strategies and to encourage them to take steps to ensure their efforts are both responsible and sustainable.

4 A study by the University of Montreal concludes that cannabis is more harmful for teenagers' developing brains than alcohol.

# ESG and infrastructure investing: Two sides of the same coin

**With the world facing intensifying challenges as environmental tensions grow and populations age and urbanise, the relationship between ESG and infrastructure investment will only strengthen. Addressing these challenges will require a rebuilding of the physical fabric of the global economy. But many governments face challenging fiscal positions and traditional sources of financing, such as bank lending, have become increasingly constrained. This is where specialised and ESG-aware asset managers can step up to the plate.**

### Core to growth and prosperity

Infrastructure projects and companies are core to the growth and prosperity of economies, creating jobs and delivering essential services to the communities that they serve.

A study by the Economic Policy Institute estimates that each $100 spent on infrastructure boosts private sector output by, on average, $17 in the long run.

Certain segments of the infrastructure sector can also play a key role in building a greener future and help combat climate change by supporting more energy efficient or environmentally friendly ways of producing energy.

These may include the investment into, and the development of, renewable energy projects, carbon-friendly transportation such as electric vehicle charging stations, devices to measure and more efficiently use energy and public transportation facilities that reduce carbon footprints.

### Infra challenges

The world today invests some $2.5 trillion a year in infrastructure, according to McKinsey. However, the world needs to invest an average of $3.3 trillion annually just to support currently expected rates of growth[5].

Unfortunately, infrastructure is not always fully and adequately served by the traditional avenue of bank finance. Recent developments in the Basel regulations, for example, place more onerous capital requirements on long-dated infrastructure loans, as well as for financing that is not investment grade quality. Banks are more hesitant to lend than before, resulting in lower volumes and less attractive financing.

Asset managers can look to fill this gap and offer their clients access to the stable, long-dated cashflows that these infrastructure projects can provide.

Moreover, the long economic lives and relatively extensive debt horizons of these investments, coupled with their ‘buy and hold’ approach only serve to emphasise the importance of these projects being run sustainably, and with good governance, for the long-term.

Furthermore, in an ideal scenario, these projects would also contribute to improving the sustainability profile of a region.

### ESG philosophy

ESG is also a critical element for investors to consider when it comes to exercising their fiduciary duties. Any infrastructure business, whatever its size, needs to have healthy relationships with its stakeholders in order to thrive in the future. This includes employees, suppliers, customers, the environment, regulators and the communities in which they operate.

These stakeholders assume different degrees of importance according to the company’s specific business activities and strong oversight of these stakeholder relationships are in the best interests of the company, its investors and funders. By integrating this ESG analysis into the investment process, stronger long-term risk adjusted returns should materialise.

### Different ESG approaches

Facilitating this, sustainability analysis can be built into an investment process from both a bottom-up and top-down perspective. This can include a range of exclusions, identifying which infrastructure projects address the greatest unmet need, as well as quantitative and qualitative assessments.

5 McKinsey Global Institute, “Bridging Global Infrastructure Gaps”, June 2016.

In terms of exclusions, investments should be screened based on their business model or sector. For example, investments into coal-fired power plants or biomass power plants where biomass was supplied from non-sustainable sources and shale gas projects should raise red flags.

In terms of quantitative assessment, we at Schroders analyse just under 50 micro criteria for each and every investment we make and, of those, 13 directly relate to ESG factors.

Examples of these criteria are the company's health and safety policy, environmental risk and impact factors, quality of shareholders, governance practices and investment horizon.

Having these factors embedded into our ESG investment scorecard means they form an integral part of the credit assessment and ultimately determine whether we will invest in a given asset.

Before making an investment decision, infrastructure investors should also discuss any qualitative ESG considerations that they face today, as well as potential issues that they may encounter throughout the life-cycle of the investment.

These may include topics such as the implications of aging work forces, job automation and increasing pressures on the use of fossil fuels.

We believe that both quantitative and qualitative ESG analysis should be monitored throughout the lifecycle of the investment and any developments reported to investors in a proactive manner.

### ESG commitments

For infrastructure, the long-term and illiquid nature of investing means ESG analysis is critical. This is why we believe ESG integration is a crucial component of the investment process, ensuring that the assets selected are of the highest possibly quality, helping to ensure they meet infrastructure clients' long-term investment needs.

INsight

# Multi-Asset investments: Managing sustainability from a total portfolio perspective

**Whatever the reasons for integrating environmental, social and governance (ESG) criteria in a portfolio, managing this exposure across multiple asset classes is significantly more complicated than managing it within a single asset class.**

### The sustainability spectrum

The sustainability spectrum covers three levels of implementation:

- Screened – Negative screening beyond statutory requirements
- Integrated – ESG analysis is a building block of the investment process
- Sustainable – ESG analysis is a cornerstone of the investment process

There are advantages and disadvantages to each approach and the asset owner's decision as to where to position their portfolio depends on factors such as

1. Which approach closest meets their beliefs regarding the importance of sustainable investing
2. The availability of investment assets managed using an ESG approach
3. The impact on the overall portfolio of different ESG approaches
4. The skill of the active managers in combining ESG into their processes
5. The timeframe over which a strategy will be evaluated
6. The cost of implementing an ESG strategy.

Regardless of which level of ESG engagement an investor pursues, we believe active (in preference to passive) management is more effective in its application for a variety of reasons. Importantly, active fund management can lessen unintended consequences, for example from excluding certain sectors, while ensuring that risk and return parameters are maintained, and more accurately assess companies' ability to adapt to ESG challenges.

### Introducing a sustainability budget

We believe that asset owners for whom ESG is an important theme should consider introducing a sustainability budget. This would be similar to the concept of the risk and governance budgets whereby sustainability features would be identified and implemented with a view to delivering better longer-term risk adjusted returns.

Having decided on the size of the sustainability budget, asset owners need to address two further, interlinked, points:

1) The extent to which the sustainability budget impacts the risk and governance budgets

- Increasing the sustainability budget will increase the governance budget because more time and resources will be required to manage those assets in a sustainable way.
- Constraining the investment opportunity set – for whatever reason, sustainability grounds included - is likely to compromise the degree of diversification in the portfolio. As such, exposure to acute shorter-term risks resulting from unexpected shocks, may be higher for portfolios that take a sustainable approach to investing. If the asset owner's time horizon is long enough, however, then such risks are of lesser importance. Indeed, the advantages of sustainable investing are expected to be realised mostly over the longer term.

2) How the sustainability budget can be implemented

- This depends on the asset owners beliefs as to whether sustainability manifests itself through individual securities (in which case the budget should be implemented on a bottom-up basis) or whether it is more appropriate to do so at an asset allocation level

### Consider ESG in light of whole portfolio

We believe that asset owners should consider ESG in the context of the entirety of their assets, rather than having a piecemeal approach to implementation through individual components. This requires decisions about where on the sustainability spectrum they should position their portfolios, as well as the introduction of a sustainability budget, to be managed alongside more traditional budgets such as governance and risk budgets. Evaluating the likely impact and trade-offs between the budgets will take time and discussion, but we believe that it is worthwhile to agree a position with regard to ESG for a whole asset portfolio.

INsight

# Climate progress despite COP24's shortcomings

**December 2018's meeting of global climate leaders may not have delivered entirely, but our Climate Progress Dashboard shows some progress in mitigating climate change is being made in certain areas.**

### Certain areas disappointing

In December 2018, global climate leaders gathered in Katowice, Poland as part of the UN conference of the parties 24 ("COP24"). The goal was to bring to life the climate agreement reached in Paris in 2015, by creating a rulebook that details tangible rules and actions for each country involved.

While progress has been made, the rulebook falls short in several significant areas. For instance, Article 6 of the Paris Agreement - concerning voluntary carbon markets - is now slated for discussion at the next conference given a lack of consensus on the market mechanism[6]. Such a mechanism would allow countries to trade the overachievement of their climate pledges, or nationally determined contributions (NDCs[7]). This would provide an incentive to not only achieve, but overshoot emission ambitions.

Article 4 on climate pledge guidance also remains vague, allowing countries to use "nationally appropriate methodologies" when reporting emissions and tracking their progress on ambitions, rather than using a common set of scientifically robust methods.

With no market incentives for overachieving emissions reduction commitments and no common reporting methodology – two of the most technically demanding sections of the agreement – pressure on COP25 in Chile in November this year is mounting.

### More radical action needed

The event should give climate change leaders a chance to assess the shortcomings of COP24's rulebook, particularly in light of last year's Special Report on Global Warming by the Intergovernmental Panel on Climate Change (IPCC). The report repeatedly emphasizes the insufficiency of current climate efforts and the significant difference between a 1.5°C and 2.0° temperature increase. On current projections, net emissions must reach zero[8] by around 2050, leaving policymakers until 2030 to implement climate policies that are much more radical and far-reaching than agreed so far[9]. At the same time, estimated global greenhouse gas (GHG) emissions in 2018 have been on the rise in many of the largest global economies, with only the EU showing a potential decrease compared to 2017 levels (Figure 1).

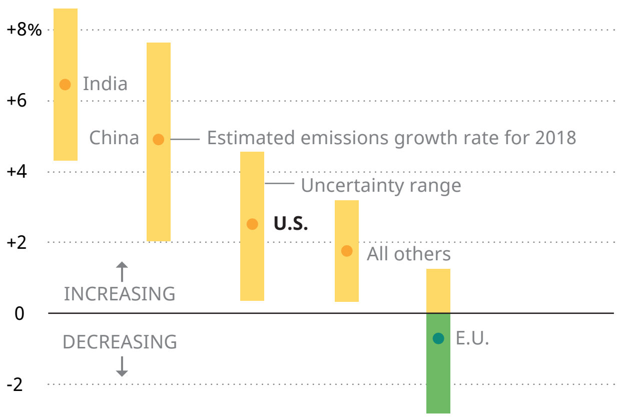
### Climate Progress Dashboard update: Reasons for optimism

We are becoming increasingly doubtful that a binding global consensus will be reached quickly enough to deliver the change needed to meet the commitments made in Paris three years ago. However, it is not all doom and gloom if we look past simplistic headlines at the more complete picture painted in the Schroders' Climate Progress Dashboard. While our analysis implies that the global economy is on track to record a long-run temperature rise of 3.9°C (nearly double the targeted 2.0°C rise), there are some signs of hope.

Specifically, there has been much progress made independently of the annual COP summits. Countries representing more than half the world's car sales have now committed to banning combustion engine cars. In November, The Climate Group, Carbon Disclosure project (CDP), and PricewaterhouseCoopers (PwC) reported that 120 leading states and cities, representing over one-fifth of the global economy, had committed to decarbonising twice as quickly as the G20 group of leading countries.

Furthermore, the costs of clean energy and electric transport have also plummeted in recent years. Onshore wind and solar power generation costs are now close to the cheapest fossil fuel power stations. Electric vehicle costs have similarly fallen close to the levels of gasoline or diesel engine prices, with China now adding 4,000 electric buses to its roads every two weeks – equivalent to the total number of buses serving the Paris region.

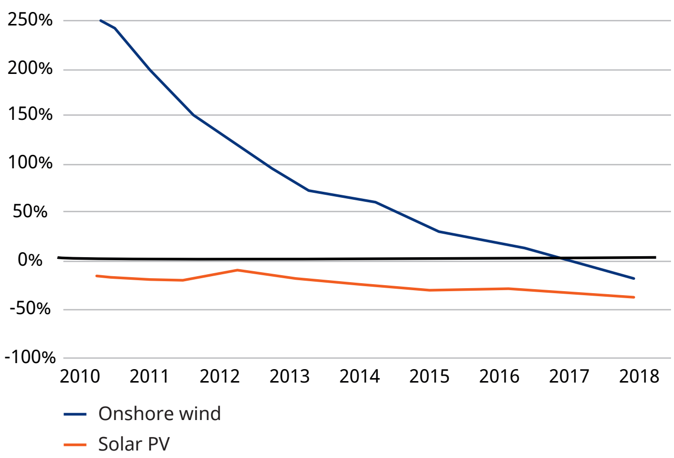
**Figure 1: Global greenhouse gas emissions on the rise again**




Source: IRENA, Schroders calculations.

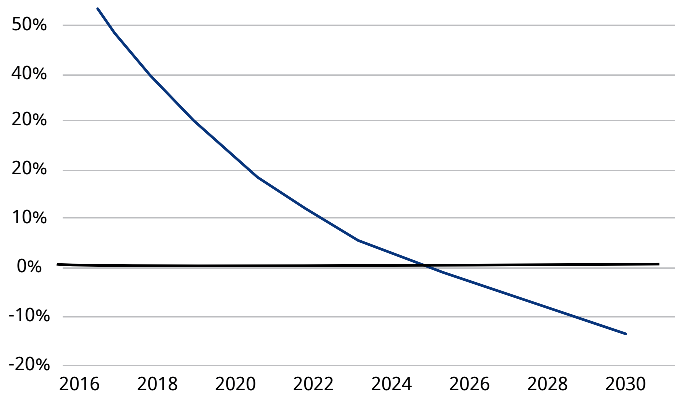
6 [Carbon Brief report on outcomes of COP24](#).
7 [World Resources Initiative definition of INDC](#).
8 Net zero emissions require any additional emissions to be offset by removing an equivalent amount of $CO_2$ from the atmosphere.
9 [IPCC summary of Special Report on Global Warming](#).

**Figure 2: Average costs of clean power relative to fossil fuels**




Source: IRENA, Schroders calculations.

**Figure 3: Average costs of electric car ownership relative to combustion engine**




Source: IRENA, Schroders calculations.

## Global transformation required

The global transformation required to address climate change requires a more comprehensive shift. Without it, temperatures and physical damage will continue to rise putting a drag on the global economy that will eventually become debilitating. Looking ahead, the rest of 2019 carries a weight of expectation for real change to be delivered. Numerous high profile climate change events are scheduled for this year, costs of renewables have fallen to finally compete with fossil fuels and society has grown ever more engaged to put further pressure on policymakers, corporates and investors alike. Ultimately, execution beats perfection in the fight against global warming. Even so, the longer we wait for the former, the greater the need will be for delivery of the latter.

INfluence

# Greed isn't good: The climate challenges posed by feeding the planet

**The world's demand for food – particularly protein – has major implications for climate change. We look at the opportunities arising from consumers changing how they eat.**

A monumental shift in how we produce and consume food - particularly protein - is needed if we are to avert dire climate consequences. This shift creates risks and opportunities for investors all the way from farm to finished product. Looking firstly at the challenges, it is clear that traditional livestock farming faces a looming sustainability crisis.

### The demand for protein is increasing

The global population is expected to reach almost 10 billion people by 2050, requiring an almost doubling of food production.

Rising incomes and population growth in developing countries are driving demand for meat in particular. Global consumption of beef, veal, poultry and pork is estimated to have risen by 30% in the last 15 years and the trend is expected to continue.

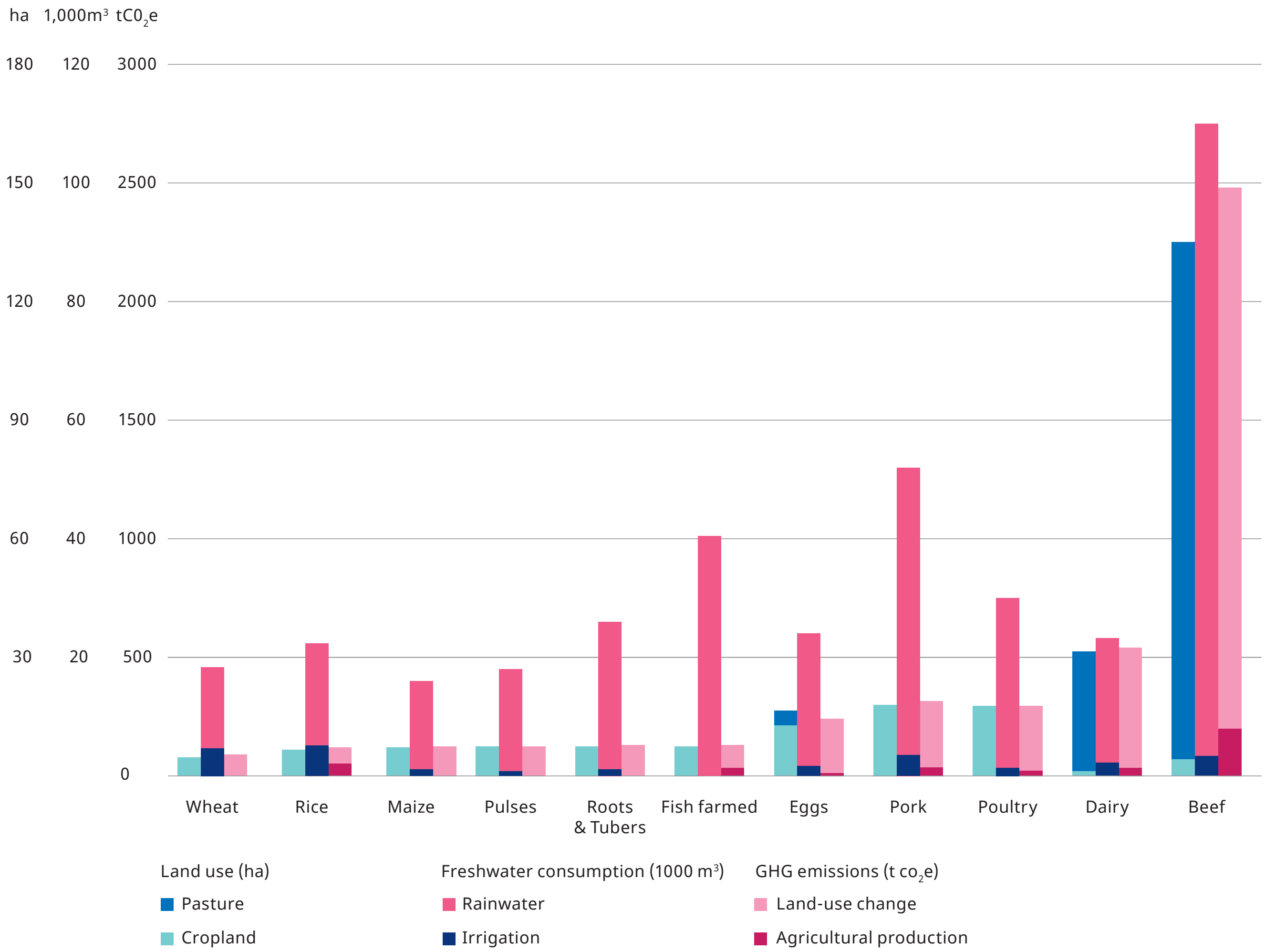
Unless this trend for increased livestock production and consumption is significantly decreased, agriculture will use up the whole world's carbon "budget" by 2050. Livestock farming currently accounts for 14.5% of global greenhouse gas (GHG) emissions and is an inherently inefficient process for creating protein. Even chicken – the most efficient source of meat – only converts about 20% of gross feed energy into animal protein. As it is unrealistic to expect every other sector to become carbon neutral, it is clear that dietary patterns must change.

### Farming also faces growing physical risks driven by climate change

Whilst we continue to try to extract ever greater yields from farming to feed the growing population, farmers will increasingly face physical risks to their output: more droughts, lower water availability and the negative impact of more extreme temperatures on animal health.

Whilst these challenges paint a bleak picture, some recent trends give us cause for hope, and suggest disruption is on the horizon for the way we currently produce and consume food.

**Figure 2: Per ton protein consumed**




Source: GlobalAgri model (land use and greenhouse gas emissions), author's calculations from Mekonnen and Hoekstra (2011, 2012) (fresh water consumption), and Waite et al. (2014) farmed fish freshwater consumption).

## Innovation advancing the availability of animal-free proteins

On the supply side, innovation in food is expanding and advancing the range of animal-free proteins available. Memphis Meats is using cell culture technology to grow "real meat" in its labs. Its protein products consume 1% of the land and 1% of the water compared to traditionally-produced meat. Companies like Beyond Meat and Impossible Foods are using advanced plant-based protein technology to isolate components from the plant world which can recreate the taste and texture of meat. Whilst some of these companies are yet to commercialise, the scale of their cost reductions and the speed of their technological development suggests widespread adoption may not be far away.

On the demand side, millennial dietary habits are making a break from previous generations. There is a growing trend of millennials adopting 'flexitarian' and meat-free diets.

According to a 2017 survey, 30% of US millennials eat meat alternatives every day, driven partly by environmental concerns, but largely to improve health, manage weight and "eat clean" (eat unprocessed foods), according to research from Nielsen.

Last year more people signed up for 'Veganuary' (abstaining from consuming animal products during January) than the previous four years combined. With sales of plant-based meat alternatives growing at twice the rate of processed meat, according to research and Markets (2017), there is a huge market opportunity for companies which can capitalise on this trend.

### Regulations and public advice are also changing

Governments are starting to take responsibility for persuading citizens to consume less meat. Motivated primarily by public health objectives (red meat consumption has been linked to increased risks of contracting non-communicable diseases like diabetes and cancer), several countries such as the UK and France have rewritten their dietary guidelines to recommend people reduce their meat and dairy intake. With a sharper focus on the climate impacts, Denmark is even considering putting a tax on red meat. Could other countries adopt a similar approach?

### Sustainably feeding the growing population over the coming decades is a massive global challenge

A fundamental shift in how we produce and consume food will have to occur if we are to keep global temperature rises below 2°C as pledged in the Paris Climate Change agreement.

### Engaging on building sustainable protein supply chains

As investors in the food sector, we believe that the scale of supply chain risks in intensive livestock systems make sustainable agriculture practices necessary, but not sufficient, to ensure the sector's long-term viability. Companies in the food sector must undertake a comprehensive, global, evidence-based approach to diversify their protein offerings, both to mitigate supply chain risks and to capitalise on changing consumer trends. We have engaged with a number of food companies on the issue of building sustainable protein supply chains. We have asked them to disclose information with regards to their company strategy, and tracking and reporting on protein diversification, with a focus on how the company will align with a 2 degree scenario, in line with TCFD recommendations.

INfluence

# Sugar in 2019:
# Current state of play

**Sugar is moving up social and political agendas, handing an advantage to those companies that are already adapting to a more sugar-constrained industry.**

Sugar has become an increasingly important driver of the food and beverage industry since we first explored the topic in 2015. Below we look at the original risks we identified in 2015, and provide an update on how the industry is responding and what we're doing at Schroders to incorporate this risk into our investment processes.

## Part 1: Sugar is a key strategic issue for the sector

The three catalysts we identified in 2015 have continued to build, pointing to tougher action and bigger impacts on the industry in the future.

### Catalyst 1: Increasing awareness amongst consumers and public health bodies

Increasing awareness of the health effects of sugar is leading to volume and price growth declines across the consumer staples sector, partly as a result of tougher regulations. While soft drinks have shouldered the bulk of this burden, food producers are next in the firing line.

### Catalyst 2: Rising healthcare costs

Sugar is adding to governments' increasingly burdensome healthcare bills, thanks to the part it plays in the global prevalence of obesity, diabetes and non-communicable diseases. Governments around the world have reacted by introducing sugar taxes, raising revenue and making products more expensive for consumers. Those companies that have already reformulated their ranges or have less exposed portfolios should benefit relative to slower peers.

### Catalyst 3: Increased possibility of large scale litigation

Litigation risk remains material. Despite challenges quantifying and attributing the damages caused by sugar consumption, we estimate the impact could be over 1% of the consumer staples sector's current earnings. Companies with portfolios which are structurally less exposed to sugar are in the strongest positions.

## Part 2: The industry is responding

### M&A, divestment and the threat from activist investors

Since 2015 we've seen the continued rise of smaller challenger brands creating a wide range of M&A opportunities for the food majors. We have also seen the food majors themselves become a target of activism regarding their commitment to R&D into healthier products.

### Reformulation, reducing portion sizes and product innovation

Food and beverage majors are also reformulating existing product portfolios to respond to consumer demand and the threat of sugar taxes. But the results of their efforts have been mixed; reformulation can be costly and can damage the brand if it doesn't meet consumer expectations.

### Increase in advertising spend

Another response we've seen is an increase in advertising to help offset the move to healthier alternatives.

## Part 3: We're taking steps to mitigate sugar risk

### Engaging for better disclosure

We have seen an improvement in corporate disclosure with greater coverage of the issues around sugar since the publication of our Investor Expectations: Sugar, Obesity and Non-communicable Diseases. Our research provides a framework for company disclosure and has been distributed to over 40 global food and beverage companies.

### Company research and stock recommendations

Our proprietary research platform at Schroders includes over 40 instances of analysts factoring sugar risk into their recommendations, research or company discussions. There are over 50 references to sugar taxes alone.

### Portfolio construction

That analysis is feeding into portfolio decisions across Schroders with teams adjusting their sector exposure to mitigate potential balance sheet risk faced by the food and beverages sector.

## Conclusion

The majority of the risks identified in our original research piece in 2015 have risen. We believe that trends such as the implementation of sugar taxes, regulations regarding advertising and selling practices, and ongoing changes in consumer tastes will continue to create headwinds for the food and beverages sector. Food companies now face greater pressure to reformulate and innovate to protect future earnings. Improved corporate disclosure has helped us to more effectively identify industry leaders and laggards but we will continue to engage and monitor emerging best practice.

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# Stewardship in 2019:

**An important, but under-acknowledged, aspect to stewardship is its ongoing nature. Often no sooner than we have achieved our stewardship goals, than we go back with an additional ask of the same company. There are many reasons for this. Companies are becoming increasingly complex: if we are dealing with a global bank, we will be engaging on a huge range of issues, from selling practices, to fossil fuel lending, to executive pay and diversity. At the same time, the issues themselves are evolving quickly, leading to a change in best practice. Our data shows that change can take two years to effect, so it is unsurprising that we have open requests on companies running in parallel. Over the past 20 years of engagement, we have built up an established process of asking for polices to be put in place as a first step and then requesting data as evidence of policy implementation. For this reason, many of our priorities in 2019 are continuation of the themes that we have been pursuing over the past few years.**

### Diversity

The academic evidence supporting the benefits of diverse teams is well established. We have been calling on companies to examine their own diversity at both board and executive level for some time. We acknowledge that change takes time, and we are keen to avoid tokenism in this area. However, we also note that laggards and leaders are already emerging. We are particularly focused on the laggards, as this lack of progress may indicate that succession planning overall is poor for the business in question.

In 2018 we started voting against all-male boards in developed markets, focusing our attention on the worst offenders. In total, we voted against the remuneration heads on 22 boards. Through the UK investment managers' trade body, the Investment Association (IA), we supported a mass engagement to all of those companies with only a single woman on their board - one is not done! In 2019, we will focus on the pipeline of executive talent, and how progress is being made at this level.

### Remuneration and fairness in pay

We have noted a tendency, in the UK in particular, for executives to be in receipt of particularly generous pension arrangements that are often at odds with the rest of the workforce. We have been active in pushing for greater alignment in this area. In 2018, the IA produced its Principles of Remuneration, which we fed into and which supports our work on fairness in pay. It called for new executive directors to have pensions in line with the majority of the workforce. We can already see this guidance having impact: in March 2019, HSBC announced that it would be reducing the pension cash contribution to all of its executive directors from 30% to 10% of their salary. We applaud the company for taking such a proactive approach on this issue. applaud the company for taking such a proactive approach on this issue.

### Climate change

We have co-filed on the BP climate change resolution, seeking additional corporate reporting in the context of the Paris climate goals, with a focus on material new capital investments. Management has indicated that it will support this.

As the chart opposite shows, co-filing resolutions is only a small part of how we effect change, but we recognise the visibility and importance to various stakeholders this approach represents.

We are constantly scanning the horizon for emerging stewardship issues. Experience shows us that prevention can be better than cure when it comes to corporate governance. Over the next 12 months we there expect increased focus on.

### Leverage

We were somewhat surprised when we looked at debt data to find that the share prices of companies with relatively high levels of debt hadn't been penalised over the past decade. The current credit and economic cycle has been running for quite some time. This means that few of the current cohort of managers and boards can remember what a bind high levels of borrowing can be when the interest rate or operating environment changes.

Currently few companies are struggling to service their debt because their operating income comfortably covers their interest expenses. However, the next three years will see 25-45% of this debt rolling over (i.e. the existing borrowing arrangements will mature and need to be renewed). Against a tougher global economic backdrop, this could prove a challenge. We are being proactive in raising this issue with management teams, and also encouraging them to limit distributions in the form of buybacks or dividends where our work shows that there is not enough leeway in the current balance sheet.

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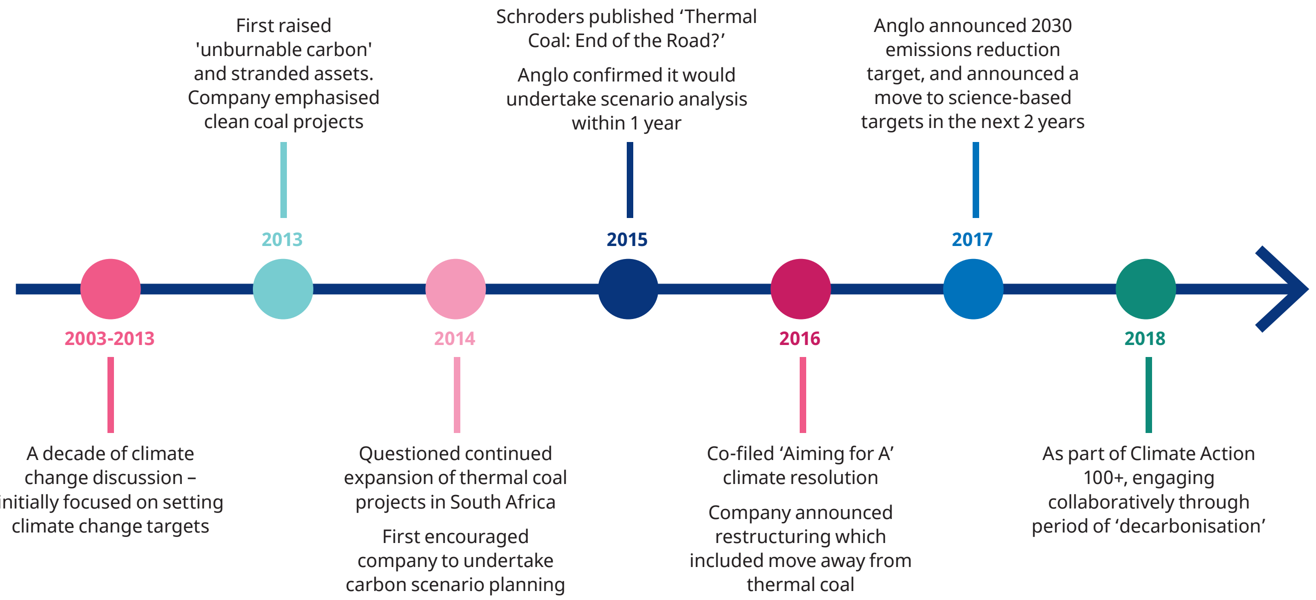
# Engagement in practice
## Anglo American




### Audit

Audit plays a vital role for investors. When done effectively, it ensures that agency costs are kept under control and supports confidence in individual companies and across markets. Our research has shown that companies that experience controversies related to accounting fraud have larger and longer drawdowns than other types of controversies. This is particularly the case in Asia where many governance failures can be traced back to audit and accounting issues.

As a result we are pushing for more insightful audit committee reporting and greater clarity on the steps they have taken to ensure that the process was challenging, focused on the key issues, and examined the issues requiring the most judgement. We are not afraid to vote against accounts where we have significant concerns, or against the individuals we deem responsible for them. There are a number of major companies where we have taken action in this way.

We have also engaged with the audit firms themselves, challenging them on how they drive quality and provide investors with more transparency. Ideally, we would like to see the governance of audit practices tightened up; we have pushed for this with individual firms and via our response to a recent Competition and Markets Authority review of the market in the UK.

### Conclusions

Covering a range of issues, long term in nature, and conducted both bilaterally and collectively it can be hard to distil engagement success when we are then moving on to set the bar higher. But in todays fast changing environment companies nor their owners can't afford to stand still.

## First quarter 2019

# Total company engagement

Our ESG team had 179 engagements this quarter with the 161 companies listed below, on a broad range of topics categorised under "environmental", "social" and "governance". They included one-to-one meetings, joint investor meetings, conferences, teleconferences, written correspondence and collaborative engagements.

For further details about the issues discussed and company responses, please contact your Client Director.

| Company | E | S | G |
|---|---|---|---|
| **Consumer Discretionary** | | | |
| Autozone | | ✔ | |
| Barratt Developments | | | ✔ |
| Beneteau | | | ✔ |
| Berkeley Group | | ✔ | |
| Brilliance China | | | ✔ |
| Buckle | | | ✔ |
| Burberry | | | ✔ |
| Ceconomy | | | ✔ |
| Continental | ✔ | | |
| Daily Mail and General Trust | | | ✔ |
| Debenhams | | | ✔ |
| Dillards | | | ✔ |
| Future Retail | | | ✔ |
| Garmin | ✔ | | |
| Gree Electric | | | ✔ |
| GVC Holdings | | ✔ | |
| H.I.S. | | ✔ | |
| Informa | | ✔ | |
| ITV | | ✔ | |
| Linamar | | | ✔ |
| Marks and Spencer | | | ✔ |
| Marriott International | | ✔ | |
| NEXT | | ✔ | |
| Nien Made Enterprise | | ✔ | |
| Ocado | ✔ | ✔ | |
| Omnicom Group | | | ✔ |
| Paddy Power Betfair | | ✔ | |
| Pearson | | ✔ | |
| Persimmon | | ✔ | |
| RELX | | ✔ | |
| RTL Group | | | ✔ |
| Schaeffler | | ✔ | |
| Taylor Wimpey | | ✔ | |
| Volkswagen | | | ✔ |
| WH Smith | | | ✔ |
| Whitbread | | ✔ | |
| WPP | | ✔ | |
| **Consumer Staples** | | | |
| Alicorp | | | ✔ |
| Associated British Foods | | ✔ | |
| Astral Foods | | | ✔ |
| British American Tobacco | | | ✔ |
| Coca Cola HBC | | ✔ | |
| Compass Group | | | ✔ |
| Costco | | | ✔ |
| Diageo | | | ✔ |
| Imperial Brands | | ✔ | ✔ |
| Sainsbury's | ✔ | ✔ | ✔ |
| Marie Brizard Wine & Spirits | | | ✔ |

Source: Schroders as at 31 March 2019.
The companies and sectors mentioned herein are for illustrative purposes only and are not to be considered a recommendation to buy or sell.

## First quarter 2019

# Total company engagement

| Company | E | S | G |
|---|---|---|---|
| Mitchells & Butlers | | | ✔ |
| Reckitt Benckiser | | ✔ | |
| SSP Group | | | ✔ |
| Tesco | | | ✔ |
| Unilever | | | ✔ |
| Wm. Morrisons | | | ✔ |
| **Energy** | | | |
| Beijing Jingneng Clean Energy | | | ✔ |
| BP | ✔ | | |
| Cairn Energy | | | ✔ |
| Royal Dutch Shell | | ✔ | |
| Transportadora de Gas del Sur | | | ✔ |
| **Financials** | | | |
| Aldar Properties | | | ✔ |
| Arrowhead Properties | | | ✔ |
| Assura | | | ✔ |
| Bankinter | | | ✔ |
| BNP Paribas | | | ✔ |
| Cerved Information Solutions | | | ✔ |
| Coface | | | ✔ |
| CYBG | | | ✔ |
| Fortune REIT | | | ✔ |
| Franklin Resources | | | ✔ |
| Frasers Property | | | ✔ |
| HSBC | ✔ | | ✔ |

| Company | E | S | G |
|---|---|---|---|
| Intermediate Capital Group | | | ✔ |
| International Personal Finance | | | ✔ |
| Man Group | | | ✔ |
| Orange Life Insurance | | | ✔ |
| Paragon Group of Companies | | | ✔ |
| Plus500 | | | ✔ |
| Safestore Holdings | | | ✔ |
| Standard Chartered | | | ✔ |
| Swire Pacific | ✔ | ✔ | ✔ |
| TP ICAP | | | ✔ |
| Troy Income & Growth Trust | | | ✔ |
| United Bank | | | ✔ |
| **Health Care** | | | |
| Advanced Medical Solutions | | | ✔ |
| AstraZeneca | | ✔ | |
| Cerner | | ✔ | |
| GlaxoSmithKline | | ✔ | ✔ |
| Novartis | | ✔ | ✔ |
| Smith & Nephew | | | ✔ |
| Thermo-Fisher | | | ✔ |

| Company | E | S | G |
|---|---|---|---|
| **Industrials** | | | |
| Australian Pharmaceutical Industries | | | ✔ |
| Hualan Biological Engineering | | | ✔ |
| Recordati | | | ✔ |
| 3M Company | | ✔ | |
| Aramark | | | ✔ |
| Ashtead | | ✔ | |
| Bunzl | | ✔ | |
| CTT Correios de Portugal | | ✔ | |
| EasyJet | | ✔ | |
| Ferreycorp | | | ✔ |
| GEA Group | | | ✔ |
| Generac Holdings | ✔ | | |
| Georgia Capital | | | ✔ |
| HEG | | | ✔ |
| Hi-Lex | | | ✔ |
| Hillenbrand | | | ✔ |
| Homeserve | | | ✔ |
| International Consolidated Airlines Group | | ✔ | |
| Intertek | | ✔ | |
| Kanamoto | | | ✔ |
| Lockheed Martin | | | ✔ |
| Munters Group | | | ✔ |
| Northgate | | | ✔ |
| Recruit Holdings | | | ✔ |
| Renew Holdings | | | ✔ |
| Rentokil Initial | | ✔ | |
| Rolls-Royce | | ✔ | |
| Royal Mail | | ✔ | ✔ |
| Ryanair Holdings | | ✔ | |
| Teleperformance | | ✔ | ✔ |
| Trelleborg | | | ✔ |

| Company | E | S | G |
|---|---|---|---|
| **Information Technology** | | | |
| Fiserv | | ✔ | |
| Halma | | ✔ | |
| Hynix Semiconductor | | ✔ | |
| Inside Secure | | | ✔ |
| MasterCard | ✔ | | |
| NetApp | | | ✔ |
| S&T | | | ✔ |
| Sage Group | | ✔ | |
| Shenzhen Inovance Technology | | | ✔ |
| Total System Services | | ✔ | |
| Visa | ✔ | | |
| **Materials** | | | |
| Anglo American | | ✔ | |
| BillerudKorsnas | | | ✔ |
| CRH | | ✔ | |
| Directa Plus | | | ✔ |
| DS Smith | | ✔ | |
| Ferguson | | ✔ | |
| Fresnillo | | ✔ | |
| Glencore | | ✔ | |
| Kumiai Chemical Industry | | | ✔ |
| Lenzing | ✔ | | |
| Mondi | | ✔ | |
| Rio Tinto | ✔ | ✔ | ✔ |
| Smurfit Kappa Group | | ✔ | |
| Stora Enso Oyj | ✔ | | |
| Umicore | | ✔ | |
| Vale | ✔ | ✔ | ✔ |
| Yanzhou Coal Mining | | | ✔ |

Source: Schroders as at 31 March 2019.
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| Company | E | S | G |
|---|---|---|---|
| **Telecommunication Services** | | | |
| BT Group | | | ✔ |
| Global Telecom | | | ✔ |
| Mango Excellent Media | | | ✔ |
| Modern Times Group | | | ✔ |
| Telefonica | | | ✔ |
| Turk Telekomunikasyon | | | ✔ |
| Vodafone | ✔ | | ✔ |
| WPP | | | ✔ |
| **Utilities** | | | |
| Centrica | | ✔ | |
| Orste | ✔ | | |
| Severn Trent | | ✔ | |
| SSE | | ✔ | |

## Key

**E** – Environment
**S** – Social
**G** – Governance

## First quarter 2019

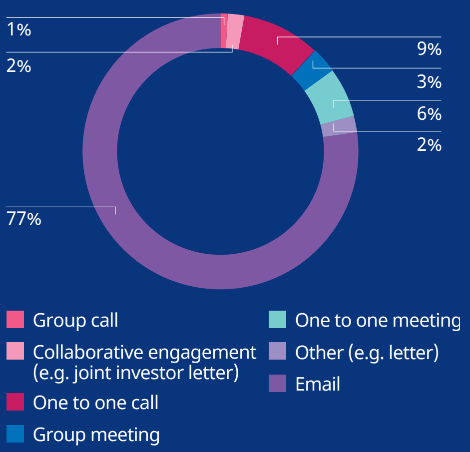
# Engagement in numbers

## Regional engagement


| | |
|---|---|
| UK | 81 |
| North America | 29 |
| Asia Pacific | 22 |
| Europe (ex-UK) | 35 |
| Middle East and Africa | 6 |
| Latin America | 6 |

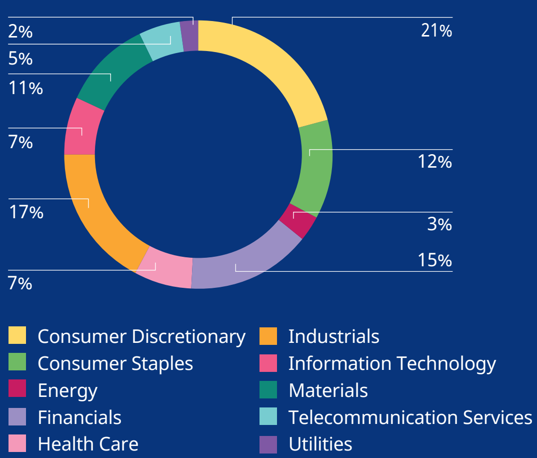
Source: Schroders as at 31 March 2019.

## Engagement type




Source: Schroders as at 31 March 2019

## Engagement by sector




Source: Schroders as at 31 March 2019

## First quarter 2019

# Shareholder voting

We believe we have a responsibility to exercise our voting rights. We therefore evaluate voting issues on our investments and vote on them in line with our fiduciary responsibilities to clients. We vote on all resolutions unless we are restricted from doing so (e.g. as a result of shareblocking).

This quarter we voted on 810 meetings and approximately 99% of all our holdings. We voted on 15 ESG-related shareholder resolutions, voting with management on 11.

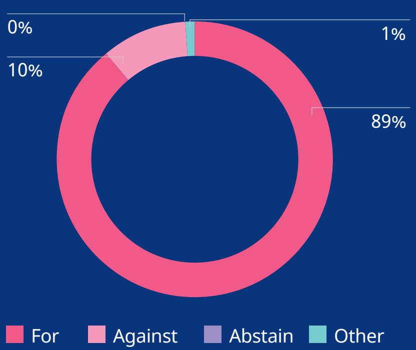
The charts below provide a breakdown of our voting activity from this quarter. Our UK voting decisions are all available on our website at [http://www.schroders.com/en/about-us/corporate-responsibility/sustainability/influence/](http://www.schroders.com/en/about-us/corporate-responsibility/sustainability/influence/)

## Company meetings voted


| | |
|---|---|
| UK | 14% |
| Europe (ex-UK) | 32% |
| North America | 9% |
| Asia Pacific | 36% |
| Middle East and Africa | 5% |
| Latin America | 4% |

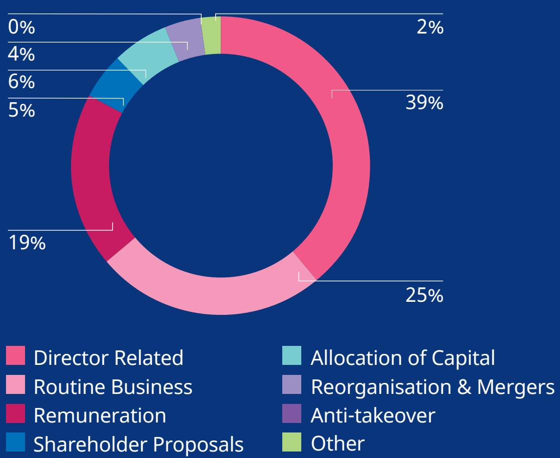
Source: Schroders as at 31 March 2019

## Direction of votes this quarter




Source: Schroders as at 31 March 2019

## Reasons for votes against this quarter

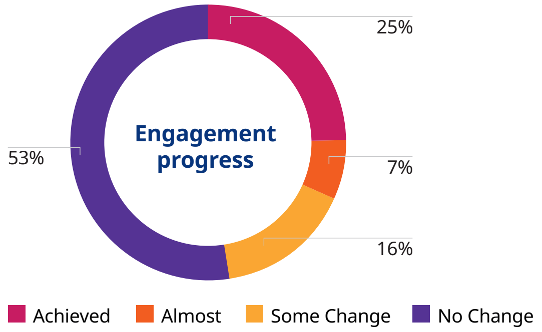



Source: Schroders as at 31 March 2019

# First quarter 2019

## Engagement progress

This section reviews any progress on suggestions for change we made a year ago, in this case the first quarter of 2018. There are four possible results: "Achieved", "Almost", "Some Change" and "No Change". Of a total number of 57 "change facilitation" requests made, we recorded 14 as Achieved, 4 as Almost, 9 as Some Change and 30 as No Change.

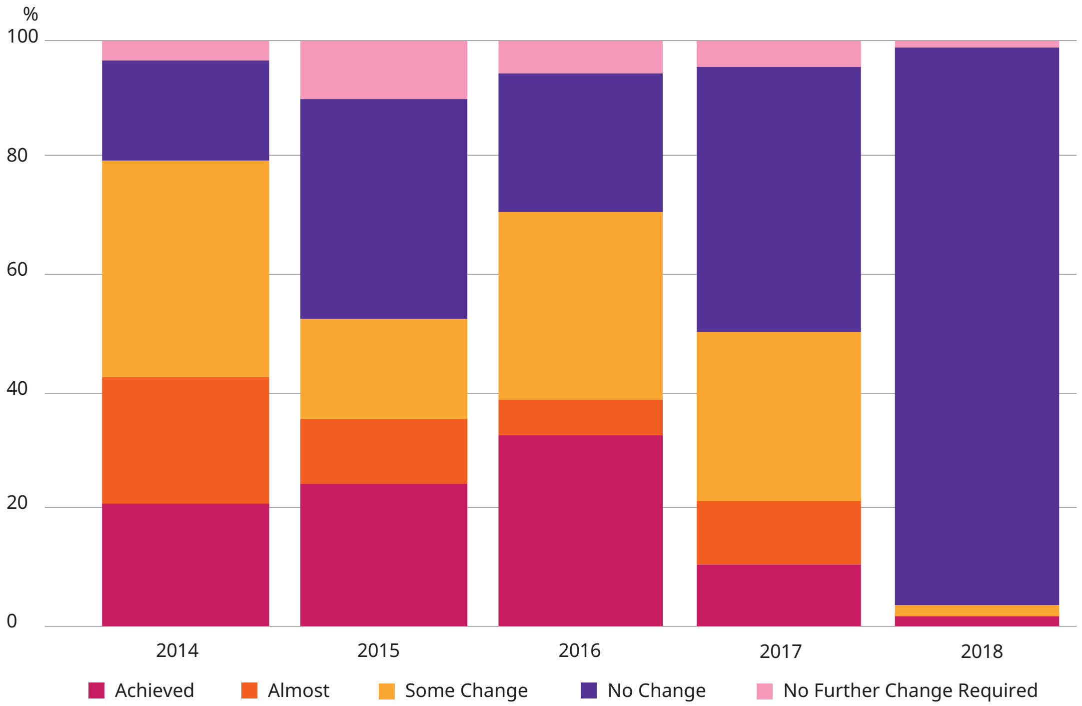



Source: Schroders as at 31 March 2019.

In our experience it takes an average of 2 years for companies to effect the change requested.

The chart below shows the effectiveness of our engagement over a five-year period. We recognise that any changes we have requested will take time to be implemented into a company's business process. We therefore usually review requests for change 12 months after they have been made, and also review progress at a later date. This explains why there is a higher proportion of engagement successes from previous years.

### Effectiveness of requests for change - 5 year period




Source: Schroders as at 31 March 2019.

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