SOCIALLY RESPONSIBLE INVESTING PAYS DIVIDENDS

BY DOMINIC MCMULLAN AND
OLIVER PHILLIPS, BRUNSWICK, NEW YORK

From climate change to human rights, big business is embracing a socially responsible agenda. We have come a long way from the days when a soft-spoken nun was shouted down when she raised these issues at annual meetings. Today, she is more likely to be taken to lunch by the Chairman

When Sister Patricia Daly rose to prominence as a shareholder activist in the 1990s, the mild-mannered Dominican nun was booed during annual meetings. Her attempts to change corporate behavior on issues such as pollution, climate change and human rights were ignored.

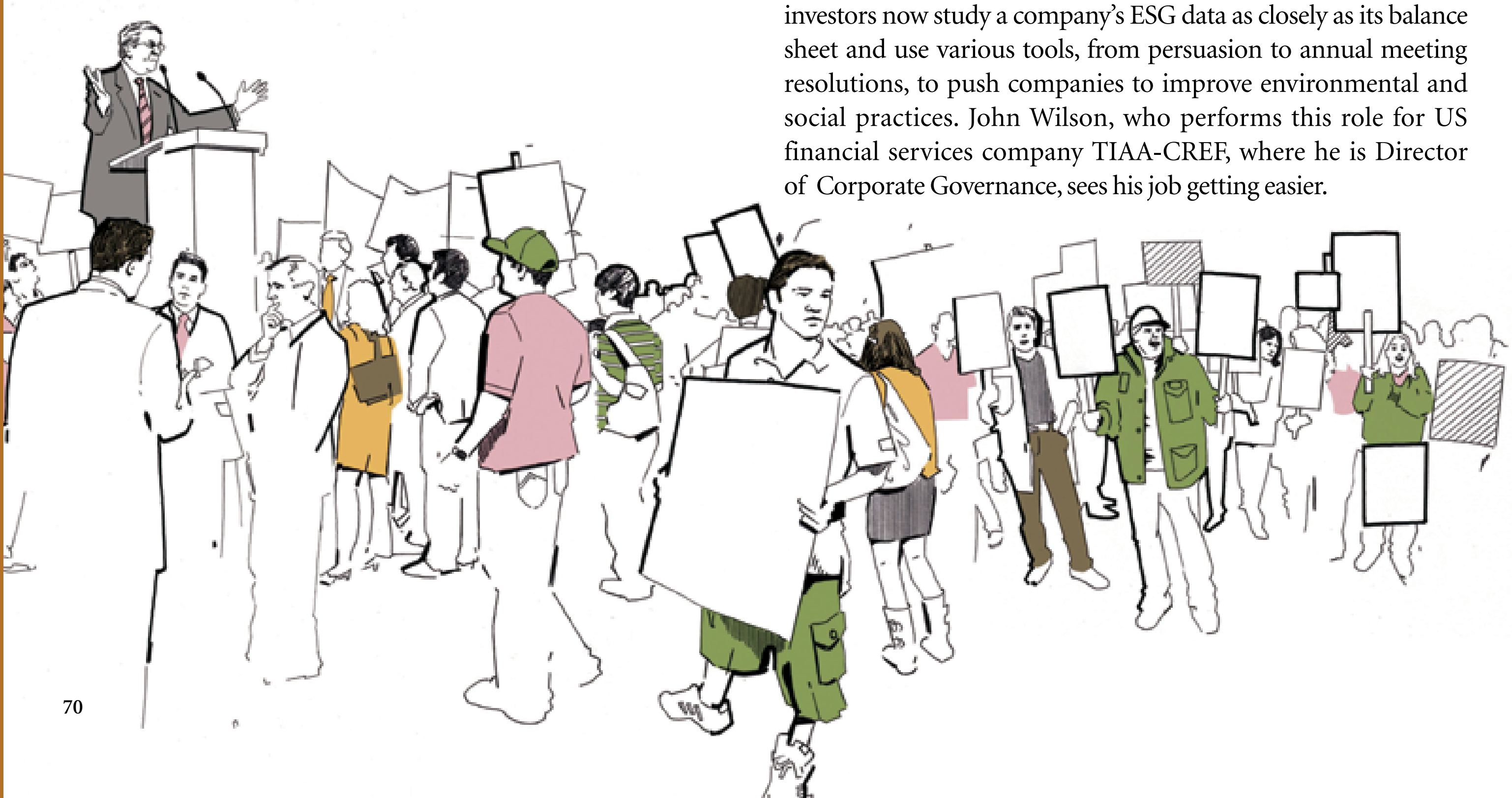
In the years since Sister Daly – who heads the New Jersey-based Tri-State Coalition for Responsible Investment – began cajoling companies to do the right thing, the landscape around her has changed considerably. For one, she finds she does a lot less cajoling. No longer an interloper at annual meetings, she is often invited to boardrooms for a one-on-one session with executives keen to convince her that their companies are on the right side of the issues she cares about.

"They now agree to meet at least every year, if not twice a year, going through updates of a broad agenda," says Daly. "And, in many cases, the CEO is part of that dialogue."

One Fortune 50 CEO who once yelled at Daly during an annual meeting invited her back to lunch to talk about how he could address climate change. His company is now an exemplar of environmental responsibility.

FROM ACTIVISM TO ENGAGEMENT

Sister Daly's Tri-State Coalition is among a growing group of shareholders assessing companies' environmental, social and corporate governance (ESG) performance on a par with their financial standing. Socially responsible investors, including the likes of Walden Asset Management and Calvert Investments, have built a reputation for excluding companies from their funds that do not meet ESG standards. Once viewed as being on the fringe, they now exert an increasing influence. Some institutional investors now study a company's ESG data as closely as its balance sheet and use various tools, from persuasion to annual meeting resolutions, to push companies to improve environmental and social practices. John Wilson, who performs this role for US financial services company TIAA-CREF, where he is Director of Corporate Governance, sees his job getting easier.



"I've been doing this a long time, and it used to be a real effort to get into a room with a company," he says. "Now they're calling us and saying: 'We want your input.' It's encouraging."

What's changed is a realization by companies that ESG performance can affect the bottom line as much as a series of bad quarters. "For large-cap companies, I think we're at a tipping point," says Tim Smith, Senior Vice-President of Walden. "We see more companies that understand that this can add value for them, rather than being forced into it reluctantly or with skepticism."

Sister Daly agrees that moral arguments do not move companies as effectively as a sound business case. She has seen a shift in corporate attitudes in this regard. They are willing to reassess opposition to change if they see that opposition posing a material risk to long-term financial success.

CLIMATE CHANGE

This focus on material risk has sharpened partly due to changes in government regulation. Last year's guidance from the US Securities and Exchange Commission made it harder for companies to exclude resolutions related to climate change from annual meetings and has had a dramatic impact. This year investors filed 101 resolutions with US and Canadian companies pressing them to assess the business risk of climate change, an increase of nearly 50 per cent on 2009.

Of those resolutions that went to a vote, the number gaining more than 30 per cent approval tripled over the same period. But the most telling statistic is the number of resolutions withdrawn before a vote, indicating agreement was reached before the annual meeting. That number quadrupled between 2005 and 2010.

DON'T TELL ME, SHOW ME

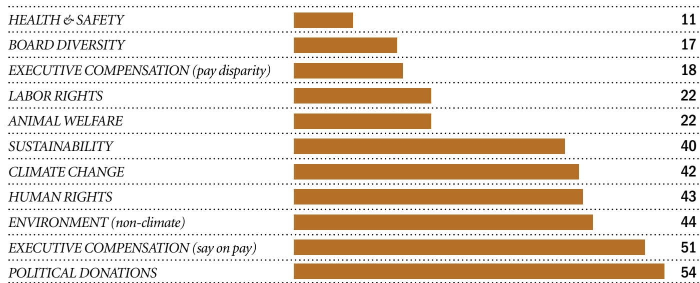
Even in a tough economy, there is consensus in boardrooms that a well-developed corporate responsibility platform is a strategic imperative. Many in the investment community have not only assimilated this view but argue that we are entering a second phase of corporate responsibility (CR) that is based on data, not rhetoric.

"There's an increasing lack of tolerance for companies that argue their case but can't demonstrate change," says Meg Brown, the Climate Change Analyst for Citi Investment Research and Analytics. "It's not the policies we need to know about. What we do need to know is what your emissions are, and how you plan to reduce them."

Over the following pages we hear from some leading experts on how corporate responsibility strategies are evolving as data eclipses policy in importance among socially responsible investors.

CARING ABOUT MORE THAN THE BOTTOM LINE

NON-FINANCIAL RESOLUTIONS SUBMITTED BY US SHAREHOLDERS, BY CATEGORY, 2010



Source: Proxy Preview 2010, As You Sow Foundation April 2010

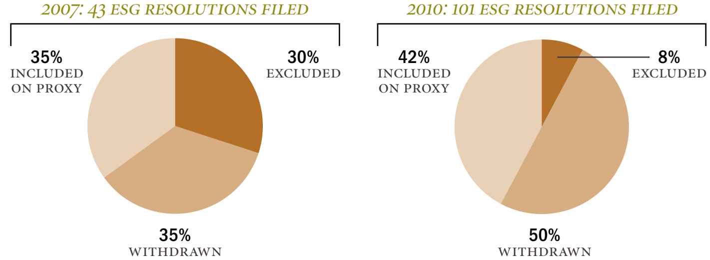
MORE TALK EQUALS MORE ACTION

PROGRESS OF US SHAREHOLDER ENVIRONMENTAL, SOCIAL, GOVERNANCE (ESG) RESOLUTIONS – 2007 AND 2010

Proposals are often withdrawn when management addresses shareholders' concerns ahead of the annual meeting. Recently, there has been a steep decline in the percentage of resolutions that have made it on to the agenda, signaling increased dialogue between shareholders and management. In addition, more proposals have made their way to C-suite desks, demonstrated by the smaller number of resolutions excluded. This can be attributed to an easing by regulators of the requirements for inclusion of resolutions on proxy ballots.

"The only real win is withdrawn resolutions"

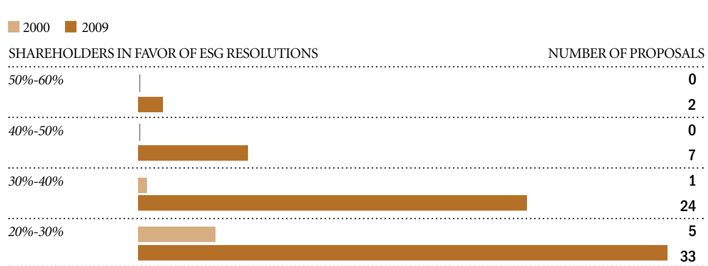
Laura Barry, Interfaith Center on Corporate Responsibility
interview with SocialFunds.net



Source: Investor Network on Climate Risk

ONE IN FIVE SHAREHOLDERS SAY AYE

MANAGEMENT CANNOT AFFORD TO IGNORE RESOLUTIONS THAT GARNER 20% OR MORE OF THE SHAREHOLDER VOTE



Source: Proxy Preview 2010, As You Sow Foundation, April 2010

Dominic McMullan is an Associate in Brunswick's New York office, having started with Brunswick in London. He advises on corporate positioning and issues management for clients in the energy sector, among others.

Oliver Phillips is a Partner in Brunswick's New York office, where he leads the firm's US corporate responsibility and sustainability practice.

Greg Faje and **Beau Allen** also contributed to this article.

Tim Smith
— Walden Asset Management

The genie is out of the bottle. Corporate responsibility issues will not go away, so companies should look to lead in this area

We like companies that are responsive; that is really important. We write a lot of letters to companies and sometimes never hear from them. After the third letter, we get a little frustrated, so we ask ourselves: how else can we get their attention? Finally, we file a shareholder resolution, and the company asks: 'Why did they do that?' And we say, well, we wrote to you three times!

One response I did appreciate, because of its authenticity, said: 'We've been working on this hard, we didn't have anything polished to show you, we felt we weren't ready to write back, we apologize, we should have done it, but let's talk because we don't disagree with you on the issue.' I thought: 'Forgiveness is in order there.'

Ideally, we appreciate an opportunity to speak with decision makers in the company. For example, if we are talking about environmental issues or the supply chain, then we want to talk to the people that work on those operations. However, it's not a game of how high up the ladder can we go; we want to talk to the people who really get the work done.

Now, if we write to a board member on an issue that their committee is responsible for, and they send the letter back through Investor Relations, then I think they are missing an opportunity to engage. If we write to the board, it is because we want to know about a board issue, not a management issue.

Ultimately, our goal is to try to change behavior, thinking and policies by dialogue, letters and exchanges of information. If we feel a company is asleep at the switch, or is recalcitrant, we will file shareholder resolutions and vigorously and publicly campaign for them to change, whether the issue is governance, executive compensation, the environment or a social issue. There are a lot of issues that companies need to be paying attention to. Some have not made the front pages yet but could quickly get there, such as chemicals in food or cosmetics.

Governance issues, from executive compensation to annual majority votes for directors, are getting big investor support. Companies need to pay attention to the trends here, too. These issues are getting huge visibility right now. Few companies want investors to have a say on executive compensation, but it is going to be the new reality soon.

My advice for companies is threefold. First, these are important abiding issues that are not going to go away. They deserve your thoughtful attention and responsiveness. Some companies really think the genie will go back in the bottle, but that is not going to happen.

Second, I would say that companies should strive to lead in this area. Leadership in sustainability and corporate responsibility issues protects and adds shareholder value. You just have to look at Goldman Sachs' *GS Sustain* project to see that in effect.

And third, I guess for all companies, it is really important to treat your shareholders with respect and seriously engage them on these issues. Remember, you and your shareholders – even those with CR priorities – still have the same ultimate objective, to be a profitable company. We would not have any money to invest, and would not have any clients, if we walked in the door and said 'we are a leader in responsible investing, but investing in this way will cost you this many basis points.'

We can only be credible if we are offering competitive, above-benchmark returns. Some investors have different priorities, but all have a fiduciary duty to protect shareholder value and beneficiaries' interest.

Tim Smith – Senior Vice-President, Walden Asset Management
Smith is a veteran campaigner and a leading authority on corporate responsibility and ESG investing. He chairs Walden's Research & Engagement Committee and previously served as Executive Director of the Interfaith Center on Corporate Responsibility for 24 years.

Paul Boykas
— PepsiCo

Sustainability reports will always have their limits – the key is to open a dialogue with socially responsible investors

In general, I think things are much less adversarial now. We clearly understand that many issues raised by socially responsible groups are important to the company's long-term success. At the same time there seems to be greater understanding on the part of socially responsible investors that companies face significant issues outside of sustainability and they are willing to set their requests in context.

For example, the United Nations' 'Human Right to Water' resolution was brought to us by a shareholder, NorthStar Asset Management. PepsiCo did not believe it made sense for a company to unilaterally guarantee a specific right. However, PepsiCo worked closely with the shareholder to reach an appropriate solution, by endorsing the UN resolution. We continue the dialogue with external parties. It is groundbreaking for PepsiCo and the food and beverage industry to support such efforts, and we continue working on the issue through other organizations such as the UN CEO Water Mandate.

Investors often ask questions in slightly different ways, so we put as much information in our sustainability report online as possible. Over the years we have been able to be more and more transparent. In this year's annual report, we set more than 40 goals under the 'Performance with Purpose' banner, which we will be reporting on. Investors often use other methods, beyond our own reporting, to obtain data. We often find that, in discussing specific data points, it becomes more of a dialogue so that investors understand how we have put together a certain metric and see a specific goal as strategic.

It is difficult to make a sustainability report the same as a financial report. If you look at our efforts within sustainability, although we try to tie them to financial impact and return on investment, the fact of the matter is that it is much more qualitative. Obviously, it is difficult for a set of numbers to show the full commitment of PepsiCo on sustainability. The dialogue is important because there is no doubt that, as a large consumer and products company, we should be informed by things going on in the external environment. We cannot and should not make decisions solely based on internal goals; we have to know the environment within which we operate.

Our Chairman makes a point of talking to the SRI community at our annual meeting and to shareholder proposers. There is no wall between management and shareholders. The idea that these concerned investors, who are owners of our company, want to contribute to make it better is something we appreciate, and we want to learn more from them.

The dialogue has been much more open than ever before on both sides and that has to be a good thing. Many times the SRI community and other external stakeholders understand the solution to issues is much more sustainable if it comes from a company's commitment rather than government regulation.

The dialogue with SRIs continues to be critically important for long-term success. Although quarterly financial reporting remains equally important, the fact is that long-term success requires the dialogue that helps you see around the corner to the next big issue, the next big hurdle or the next big opportunity.

Paul Boykas – Vice-President for Global Public Policy, PepsiCo
A 20-year veteran of PepsiCo, Boykas now works with sustainability leaders and global business units to assure strategic engagement with external stakeholders on public policy issues and sustainability commitments. In 2007, PepsiCo launched *Performance with Purpose*, the company's mission to deliver sustainable growth by investing in a healthier future for the planet.

Meg Brown
— Citigroup

SRIs need to know about performance not policies – and how do you compare different companies on these issues?

Following the credit crunch there's a growing pressure on my clients – institutional investors – to be accountable for the decisions they are making. In Europe this is not limited to specialist funds, it is a trend across all leading investment houses. This, in turn, is putting pressure on companies to explain what they are doing about reducing social and environmental risks in order to attract investment. More detailed analysis is starting to show up about which companies are really changing their behavior and which are just talking about it. I think there's an increasing lack of tolerance for companies that argue their case but cannot demonstrate change.

Ever since investors stopped investing in South African companies because of the apartheid regime, socially responsible investors (SRIs) have been campaigning to get broader information from companies than just financial results. To date, it has worked well. However, one problem faced by companies is that some investors have not quite narrowed down or been able to quantify their key SRI issues, meaning that they are bombarded with questions on policies on a huge range of topics. I think companies are generally getting a lot better at helping investors to see which are the most important issues, though there will always be pressure on those organizations that omit information that their competitors disclose.

Another issue for companies is how to condense CR information into a presentable, understandable and comparable format. Disclosure itself is important, but what we're really looking for is tangible proof of improved performance in the areas of interest to SRIs, in a way that allows one company to be compared with another.

At Citi we publish fact sheets that act as a quick guide to comparing companies across peer groups on key issues such as CO_2 emissions and safety performance. We publish the facts and compare them across companies, so that investors can start their discussions from the same basis of what is reported and what is out there.

For example, our benchmarking fact sheets look at data points such as fatalities and injuries. Now, if you are the CEO of a mining company and you walk into a meeting with an investor, regardless of whether they are an SRI investor or not, if they are armed with your company's fatality performance you should be able to explain why your death rate is going up or down. If you are a utility company with fossil power generation and your investors have quantitative data on how your emissions liability compares with your peers, you need to be able to provide a credible explanation as to how that cost is being reduced.

Ultimately, it is important for the SRI community to start looking more at a company's performance on social and environmental issues rather than judging them on their policies and their communications. There must be a balance between talking about the policy and delivering on it. You would never talk to a CFO for half an hour in a one-on-one meeting about how committed he was to financial reporting, how many people he had in his accounting team and who he reports to. It is just not relevant. What you need to know is how much money the company made. SRI needs to become more like that; we need to focus on the fundamental social and environmental performance indicators and reward improvements, not greenwash.

HOW HAS YOUR SALES FORCE RESPONDED?

The brokers like a good story! They don't necessarily trade on it, but our research thesis and our ability to tell, and ultimately sell, a story is the perfect excuse for them to pick up the phone to their clients and sell our research. If you are a company with a recurring safety issue, then investors listen to things like that. It is naïve to think that just because you can't put that risk into a discounted cash flow model, it does not influence their investment decision. For example, we have had a mining company that wanted to do a road show in London. Mainstream investors were saying no to face-to-face meetings because the company's fatality rate was too high. Until safety performance was improved and it was clear that the relevant changes had been made and understood, they would not touch them as an investment.

Meg Brown – Climate and Sustainability Analyst, Citi Investment Research
Brown leads the sustainability research team at Citi, which delivers investment advice on social and environmental themes to equity investors.

John Wilson — TIAA-CREF

In an ideal world, the concept of CR goes away, because such thinking simply becomes part of doing a good job

When I started, I would file a shareholder proposal, see what the vote was, and then I'd try again the following year. Companies started to talk to us as a way of avoiding the hassle.

But, slowly, some companies recognized that this was a valuable dialogue and that shareholders were not unreasonable. This gradual engagement went hand in hand with the recognition that there were real risks with environmental, social and corporate governance issues, and shareholders could often, because of their connections to the broader community (whether it be the NGO community or the broader investment community), highlight or help companies anticipate problems.

There are other trends: as companies become more interested and concerned with their branding and reputation, these issues have become more important. With the increase in information technology someone can take a picture on a phone in one part of the world and broadcast it globally a moment later. These things have combined to change the attitude about corporate social responsibility as a concept and about the value of engaging in dialogue with people critical of your practices.

Sometimes companies ask me: What is the most important issue? Is it recycling? Is it carbon emissions? Is it water? And my answer is: it is about a process within the company for making a determination. What I want to see is a governance process driven from the board level and from top management, and really ingrained into the culture of the firm.

At the same time, there must be goals and targets that are as quantifiable as possible, and transparency, so that you can say you've got plans – and these are the results. It is not enough just to have a policy. You have to show how it is implemented in real life.

The danger is that some of these issues are difficult to quantify. Carbon emissions are easy enough to count, but how do you measure a company's human rights record or how well it engages with community stakeholders? It will never be like accounting standards – it is never going to be a financial report.

Many of the laggards will assert that there couldn't possibly be anything wrong with what they are doing because they are people of higher integrity. There is this defensiveness, like they are being attacked personally. I ask them: 'How do you know that this is not happening if you're not measuring it, if you're not looking at it or counting it in any way?' They reply by saying: 'Because we have good people, and they would never do such a thing.'

Our goal is always not to be prescriptive, so I do not want to tell a company: 'This is how you must do it.' The ideal situation is that whatever strategy process is under way in the company, it should be led by the board, and corporate responsibility (CR), should be a part of it. In an ideal world, the concept of CR goes away, because it is not seen as being separate in any way from simply doing a good job managing a corporation.

My advice is: listen to your shareholders, particularly your large institutional shareholders, as well as other stakeholders. Obviously, they are here not to replace you or to usurp your natural prerogatives, but they should be perceived as an opportunity to inform your thinking and your understanding of where your corporation fits in the bigger picture.

John Wilson – Director of Corporate Governance, TIAA-CREF
Wilson is a long-time advocate of corporate governance and responsibility. Prior to joining TIAA-CREF he served as Director of Socially Responsible Investing for Christian Brothers Investment Services. He is Vice-President of the Board of the Leviticus 25:23 Alternative Loan Fund and a past Vice-Chair of the Interfaith Center on Corporate Responsibility. TIAA-CREF is a Fortune 100 financial services company that is the leading retirement system for people who work in the academic, research, medical and cultural fields.