RESPONSIBLE INVESTMENT REPORT

GOOD CAPITALISM

“I find there’s a lot of pressure to be good.”

CCLA

60 YEARS OF GOOD INVESTMENT
RESPONSIBLE INVESTMENT REPORT

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CCLA AND THE CHURCH OF ENGLAND
Welcome to our 2017-2018 Responsible Investment Report. Increasing populism, ever-growing inequality, and rising trade barriers are partially resulting from questions about the impact of free-market capitalism. It is also building a requirement for economic activity that is more sensitive about the broader needs of society.

It is important that investors understand and respect this changing environment. Experience suggests that if corporate activity isn’t on sustainable terms for society, it will eventually cease to be financially viable. For this reason, when investing for clients we always consider the sustainability of corporate activity.

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Short term traders may feel able to ignore these issues. However, in order to maximise long-term investment returns it is important that we understand and incorporate sustainability risks into our decision making. This involves identifying how companies are addressing risks and avoiding those that are likely to destroy shareholder value as a result of unsustainable business models.

We have a strong record of engaging with companies to change behaviour and improve outcomes. We support the Taskforce on Climate Related Financial Disclosure and are involved with Climate Action 100+, at the forefront of the pressure on companies to take climate risk seriously. Through engagement we believe that we can make companies better global citizens and, in so doing, increase shareholder value.

In order to deliver strong long-term returns, companies and investors need to recognise and respect their impact on society. This report demonstrates our commitment to good capitalism, and I hope that you enjoy reading more about our work.

Michael Quicke, OBE
Chief Executive, CCLA

The United Nations backed Principles of Responsible Investment (PRI) is the ‘world’s leading proponent of responsible investment’. It is supported by investors with over $80 trillion in assets.*

As a PRI signatory our responsible investment approach is assessed annually. We make the full results of this assessment available on our website. In 2018, we were awarded an ‘A+’ (the highest possible grade) for our responsible investment ‘strategy and governance’, ESG integration in listed equity and our approach to active ownership. We received a median grade (B) for our approach to ESG integration in property.

Achieving at least an ‘A’ Grade in all areas is a core Key Performance Indicator for CCLA.

* Source: PRI
WHY WE PROMOTE GOOD CAPITALISM

Investing ethically, or investing with environmental, social and governance (ESG) issues in mind has for many years been a specialist activity. Excluding stocks or sectors has been the primary way investors have managed ethical and sustainable portfolios.

Although this is reasonable, and in a sense meets the requirement not to participate in doing harm, we believe that investment managers can be more of a force for good. They can use an ESG or an ethical lens to create a more productive economy with less or better managed risk.

It is now becoming increasingly recognised that taking ESG issues into account is simply good investment management. However, proper implementation of this analysis is challenging. It requires significant expertise and commitment. An investment manager that wishes to integrate ESG issues into their analysis has to demonstrate that it is an integral part of their investment culture and impacts portfolio construction. The reason ESG issues are starting to gain traction across the investment world is that they offer a new perspective on risk. ESG risks are fundamental risks to shareholder value that are often missed by traditional investment analysis.

There are very clear examples of stocks CCLA has avoided on sustainability grounds that subsequently fell from grace. One example is Volkswagen, where a weak governance structure allowed cheating on the diesel emissions tests to go unchecked. Paying attention to governance issues helped preserve value for our investors.

We will not invest in any energy company that does not have a credible plan for transition to a low-carbon economy. We also avoid the inappropriate promotion of high calorie products to children. Not only could this be seen as unethical, but it also carries the significant risk of running into adverse regulation with financial consequences.

Responsible investment is not, however, just about stock selection, or staying ahead of regulation. Our investors’ obligations are over the very long term. This means that, through engagement and dedicating capital to ‘positive’ activities, we help build a world that can support healthy companies and markets. This is not a nice to have, it will be essential if we are to give future trustees and councillors the same opportunities to fund their purpose as those offered to investors today.

For this reason, over 15% of the capital value of each of our three flagship multi-asset funds (the COIF Charities Investment Fund, COIF Charities Ethical Investment Fund and CBF Church of England Investment Fund) is dedicated to activity that promotes at least one of the 17 United Nations Sustainable Development Goals*. Investors used to think that they had a choice between doing good and making money. Now, we find it hard to see a future that will support healthy economies without investors and companies helping to solve the environmental and social challenges that the world faces.

*Source: MSCI
RESPONSIBLE INVESTMENT

OUR APPROACH TO RESPONSIBLE INVESTMENT IN LISTED EQUITY

Responsible investment seeks to identify and control financial risks, that are not often visible through the lens of conventional financial analysis. This predominantly relates to understanding the short, medium and long-term impacts of ESG factors. It is also the way in which investors can contribute towards promoting good capitalism.

We rate all companies’ exposure to, and methods of managing, ESG risk prior to purchase of either their equity or debt. This assessment is subsequently used to prevent companies with the highest levels of ESG risk entering our portfolios and set our priorities for engagement.

Our ESG assessment is based upon two factors. First, we rate companies’ corporate governance standards and their wider behaviour. This includes indicators such as the quality of accounting structures, board composition or whether they have violated internationally agreed behavioural norms, such as the International Labour Organization (ILO) Core Labour Standards. We believe that, over the short term, this is likely to be a key indicator as to which companies could destroy value for shareholders through, for example, poor management or an increased risk of litigation.

Second, we look at companies’ approach to sustainability. By concentrating on issues such as climate change, public health or water use, for example, we are able to identify business models and industries whose value is placed at risk over the medium-long term by changing consumer preferences or regulation. We believe that assets will be stranded by companies who do not stay on top of a changing world.

Our approach also seeks to identify ‘systemic issues’, such as climate change or inequality, that can affect the value of all companies. To address these, we work with policy makers, to encourage appropriate legislation.

We believe that this approach helps us to control risk and deliver more sustainable investment returns. For this reason, it also applies to our management of fixed interest assets.
ADDRESSING POOR CORPORATE GOVERNANCE

Understanding companies’ corporate governance and assessing their behaviour is the starting point of our approach to responsible investment.

Our approach begins with rigorous due diligence. This uses data from MSCI, supplemented by in-house analysis, to rate companies as having high, medium or low governance risk. This assessment is based upon 96 different corporate governance factors, including companies’ board composition, ownership and accounting quality. If a company’s corporate governance or accounting standards are in the bottom 20% of global or home market rankings they are not allowed to be purchased without detailed further work. This often includes fact-finding calls and meetings. The very worst rated companies, the bottom 5%, are not investible without the permission of both CCLA’s Chief Investment Officer and Head of Ethical and Responsible Investment.

High or medium governance risk companies, held within CCLA portfolios, are prioritised for engagement. This seeks to help companies address specific weaknesses within their structures and, as a result, lower the levels of investment risk for our clients. For example, we are currently working with, French luxury goods company, Louis Vuitton Moet Hennessey, to increase the number of independent representatives on their audit committee. This engagement is not open-ended and a lack of progress can lead to us deciding to remove a company from our portfolios.

We seek to vote, every year, at the Annual General Meetings of all investee companies. Our approach to voting aims to promote the very best standards of corporate governance and address client concerns, such as high levels of executive pay.

In order to better understand business behaviour, we supplement our approach to corporate governance with data assessing companies’ compliance with internationally agreed norms such as the ILO Core Labour Standards, UN Guiding Principles on Business and Human Rights and approach to climate change disclosure and protecting biodiversity.

Our processes on corporate governance and behaviour actively alter the shape of our portfolios. For instance, each of our three, main, multi-asset Investment Funds, display better, aggregate, corporate governance standards than the MSCI World Index.* We believe that this means that our holdings should be at less risk from unexpected incidents, and deliver more sustainable value to shareholders.

*Source: MSCI

HOW MUCH IS TOO MUCH?
OUR APPROACH TO VOTING ON PAY

In recent months, a number of high-profile UK companies have suffered negative news stories about their approach to remuneration. From shareholder rebellions over high pay for their executives, to media exposures of companies such as Sports Direct for poor working conditions, it is clear that the question of how investee companies remunerate and treat staff is increasingly important for investors.

But is following the headlines the best way to approach concerns about pay within companies and – most importantly - incentivise the delivery of long-term value to shareholders? We think it is possible to take a different approach and have more impact.

At CCLA, as shareholders, we care about the long-term financial sustainability of the companies we hold. This means that we have one test when addressing corporate governance and executive remuneration policies, will it lead to better long-term returns for our clients? That does not mean that we do not care about high, or low, pay. It is just that we look beyond the story to understand what is actually driving, or prohibiting, value growth.

We believe that many of the pay packages awarded to chief executives are rewarding potentially damaging short term behaviours. Research conducted by the McKinsey Global Institute showed that 55% of executives and directors at companies would cancel or delay a project, that would be in the company’s interest, if it would negatively impact their quarterly returns.

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panies with a long-term mindset delivered 80% higher average economic profit. For this reason, we look closely at what executive pay plans are incentivising and vote against those that are not promoting proper long-term thinking.

We also engage with companies on their approach to managing employees at the bottom end of the scale. By treating employees well, companies can reduce turnover and improve loyalty, as well as avoiding significant reputational risk. We also recognise the role that inequality continues to play in driving the growth of political populism—a key barrier to the development of ‘good capitalism’. For this reason, we support the UK Government’s recent package of corporate governance reforms. The highest profile of these was the new requirement to report the ratio of chief executive pay to the median employee’s pay, (the median employee is the one in the middle, with the same number of employees earning less than her as those earning more than her). This follows similar legislation in the United States of America and is a welcome contribution to the efforts to ensure appropriate pay levels. Nevertheless, whilst we vote against the remuneration report of any UK company that has not disclosed their own pay-ratio, we caution that a single data point should not be used to compare companies directly without taking into account sector or company structure.

Companies with a large contingent of relatively low-paid employees, like retailers, will have a much larger pay ratio than a company in, for example, financial services, where there will be relatively few low-paid employees. The ratio could also be massaged by contracting out cleaning or other low-status or part-time work – since this would likely be most damaging for the lowest-paid, this is something we will be keeping an eye on. Other corporate governance legislation could follow, if Theresa May is to honour her commitments on the subject from last year.

Like all areas of our voting we write to the company if we have any concerns. By writing 10-12 days ahead of a vote, we give the companies time to respond, even to start to make changes before the vote. We are not trying to ambush anyone, just encourage best practice. In addition, where there are long-running concerns, we engage throughout the year.

With further regulation, aimed at curbing excessive pay deals for top staff, and the likelihood of global labour forces requiring a larger piece of the pie it is clear that if companies are to deliver shareholders sustainable returns they will need to get a better grip on pay.

**CORPORATE GOVERNANCE**

**ADDRESSING CONTROVERSIES**

In addition to our work on corporate governance we use data from MSCI to analyse corporate behaviour. This identifies whether any of our holdings have faced, substantiated, allegations of non-conformance with internationally agreed norms. Our main focus is on the ILO Core Labour Standards, the Guiding Principles on Business and Human Rights (UN Guiding Principles), major incidents that threaten biodiversity and non-disclosure of key metrics relating to climate change at some of the most exposed companies.

During the year, two companies have faced allegations. AT&T, a US-listed telecommunications company, faced allegations of non-compliance with the ILO Core Labour Standards, regarding their response to 37,000 workers striking over poor pay conditions. The company has now signed new contracts with the workers and the allegation has been addressed.

Novartis, a Swiss pharmaceutical company, face litigation in Greece following allegations of bribing 10 top politicians to gain access to the country’s market and fix prices. This runs contrary to the UN Guiding Principles. We are working with the company to understand more about, and encourage better implementation of, their systems and controls designed to prevent such incidents. This engagement is time limited and if no progress has been achieved by 2021 we will divest.
Studies have found that increasing the participation of women in leadership roles and removing artificial barriers to their full participation can have positive impacts on the performance of individual companies and by extension the economy as a whole.*

While gender diversity at board level has increased, women now hold 25.2% of board seats among the largest listed companies in the UK**, they are still under-represented in key board positions and in the ranks of senior executives. Recognising that better diversity leads to better decision making, we vote against the re-election of the Chair of the Nomination Committee at FTSE350 constituent companies when their Boards do not feature at least 33% gender diversity. Accordingly, we did not support 34 nomination committee members’ re-elections during the year.

Recognising the need for companies to better develop female leaders we are also encouraging our investee companies to disclose their levels of gender diversity at other senior levels.

PROMOTING GENDER DIVERSITY

CORPORATE GOVERNANCE AND OUR PORTFOLIO

We currently hold three companies rated by our data provider as having high levels of corporate governance risk; these are Nomura Research, SGS SA and Sonic Healthcare.

Whilst poorly rated by our data provider, due to a lack of disclosure, Nomura Research’s corporate governance is not unusual for companies in the Japanese market. Whilst both the Chief Executive and Chairman are executive directors, 30% of its board is comprised of genuinely independent non-executives. This is more than the norm for the market. We have prioritised the company for engagement in 2018/19 to better understand the work of their Audit Board (equivalent of the Audit Committee) and to push for higher levels of disclosure.

SGS SA, a Swiss-listed certification and testing company, is poorly rated due to lower than normal levels of independent directors and a high number of directors who could be considered to have insufficient time to dedicate to the company. However, the company has a strong family-based ownership structure that has provided stability and a structure for good performance. To manage the risks associated with a lack of independent oversight, we have prioritised engagement to seek to encourage disclosure about succession planning and board refreshment.

Over half of the directors of Sonic Healthcare, an Australian pathology, radiology and laboratory company, have served on the company’s board for over 12 years. This calls into question their ability to provide independent oversight. As a consequence, we are engaging with the company to promote board refreshment.

CORPORATE GOVERNANCE

*Source: Credit Suisse
**Source: UK Government
CORPORATE GOVERNANCE STEWARDSHIP PROGRESS REPORT

Ambev
Engagement Performance: ■
The company provided clarification on discrepancies between their 20F filing and Annual Report. These related to issues regarding internal control procedures, which have now been resolved.

Bank of America
Engagement Performance: ■
We are encouraging the company to put in place succession plans for the current Lead Independent Director. Whilst engagement is ongoing, we are yet to identify progress.

Carsales.com
Engagement Performance: ■
Following engagement Carsales.com have increased the level of disclosure about the performance metrics and levels of awards made in their executive remuneration scheme.

CatCo Reinsurance
Engagement Performance: ■
The company has agreed to disclose the fees paid to their auditor for audit and non-audit work separately. This is important for ensuring that the auditor is properly independent of the day-to-day running of the business.

CHR Hansen Holdings
Engagement Performance: ■
The Remuneration Committee have agreed to consider increased disclosure of the ESG issues contained within the company’s executive remuneration scheme.

Dechra Pharmaceuticals
Engagement Performance: ■
We continue to engage with Dechra Pharmaceutical regarding issues identified in their annual audit. This questioned fair value assumptions for the acquisition of a small company. Whilst we are not concerned about the materiality of the issue in question we are keen to learn more about Dechra’s approach to conducting due diligence on acquisition targets.

Ediston Property
Engagement Performance: ■
We continue to engage with the company on the levels of independence on their board and setting a limit on the maximum possible awards payable to executives under their incentive scheme.

GlaxoSmithKline
Engagement Performance: ■
We continue to engage with the company on the composition of their executive remuneration scheme.

HSBC Holdings
Engagement Performance: ■
We continue to engage with the company on limiting the maximum share awards available to executives under their remuneration scheme.

JP Morgan Chase
Engagement Performance: ■
We are encouraging the company to establish succession plans for the Lead Independent Director as the current incumbent has served on the Board for 17 years and, as such, can no longer be considered independent from company management.

Royal Dutch Shell
Engagement Performance: ■
We continue to encourage the company to include a metric in their executive compensation that relates to the strategic implications of the transition to a low carbon economy.

Samsonite
Engagement Performance: ■
We engaged with the company following allegations from a short seller relating to accounting structures, misstatements in the Chief Executive’s biography and concerns about a joint venture in India. Engagement did not provide further comfort and we have divested from the stock.

Tencent Holdings
Engagement Performance: ■
The company acknowledged our concerns regarding low levels of corporate governance disclosure and have committed to review their approach and revert back to CCLA on their plans.

NB. As an active manager we are constantly working on and updating our portfolios to ensure that they meet the needs of our clients. This means that we may not currently hold all of the companies that we have engaged during the year.
The second part of our approach to responsible investment is understanding the risks to businesses posed by changing regulations, societal norms, and eco-systems. Our belief is that the least sustainable businesses are likely to face significant challenges to their business model over the medium-long term and, therefore, place shareholder value at risk.

Climate change is arguably the biggest risk currently facing humanity and, whether it be through regulation or changing consumer preferences, we expect the market to increasingly penalise companies that are falling behind the wider de-carbonisation of the economy.

As investors we have a duty to manage our exposure to climate related risks. As investors we have a duty to manage our exposure to climate related risks.

“...as investors we have a duty to manage our exposure to climate related risks.”

We have a long-established record of being active in leading investor partnerships to call on companies to manage their businesses while adapting to anticipated changes in regulation and consumer preference. CCLA was instrumental in creating and co-ordinating the Aiming for A coalition, that has now merged into the Institutional Investors’ Group on Climate Change (IIGCC).

These bodies used shareholder resolutions to demand companies examine the environmental context of their businesses and explain to shareholders how they planned to manage the transition to a low carbon economy.

In the past year, the big development has been the launch of the Climate Action 100+ (CA100+) initiative at President Emmanuel Macron’s One Planet Summit in December 2017. We are actively involved with this investor initiative that aims to partner with companies to enhance their corporate governance of climate change, curb emissions and strengthen climate-related financial disclosures at companies with great opportunities to tackle climate change.

As part of its involvement with CA100+, CCLA has been designated co-lead on engagement with two US companies, oil major Chevron and electrical power company Duke Energy. We will work with our partners to bring these two companies to understand the implications of a transition to a low-carbon world.

The model for this is Royal Dutch Shell which, following pressure from the Aiming for A coalition and the IIGCC, announced it will seek to reduce the Net Carbon Footprint of its energy products by around 20% by 2035, and to deliver cuts consistent with societal ambition (currently embodied in the Paris Agreement) by 2050.

Although Shell’s statement of intent is welcome, we are continuing to engage with them, asking for greater clarity on how it envisages achieving its aim over the short and medium term. While the 2020s will still see demand for fossil fuels, by the 2030s, these companies must either have diversified or be in managed decline. Failure to map out a realistic path to this outcome will result in shareholder value being put at risk.
CLIMATE CHANGE AND OUR PORTFOLIOS

We incorporate climate change considerations into our investment process in three ways. First, we seek to avoid the worst placed companies in the transition to the low carbon economy. During the year we tightened our approach by restricting any company that generates more than 5% of their revenue from the extraction of energy coal or tar sands and, recognising the medium-long term challenges to the industry, we remain significantly underweight traditional oil and gas companies.

Second, we seek to identify investments that meet our risk and return objectives and dedicate capital to accelerating the low carbon economy. Currently c4% of our multi-asset Investment Funds are dedicated to opportunities like renewable energy infrastructure, forestry and low carbon buildings.

Finally, we monitor our Funds’ Carbon Footprint. Each of our Multi-Asset Investment Funds have Scope One and Two carbon footprints below 39.2 tons of carbon dioxide per million dollars invested (tCO2e/$m). This compared favourably to the Funds’ comparator (121 tCO2e/$m).

IMPROVING STANDARDS ACROSS THE UK MARKET

Recognising that addressing climate change will take systemic activity across the market as a whole, we have once again engaged with UK listed companies that have not achieved a B Grade on CDP (formerly the Carbon Disclosure Project) Climate Change Ranks.

A B Grade requires companies to take steps such as establishing good governance practices related to the management of greenhouse gas emissions, link this to the company’s strategy and set (and, subsequently, meet) long term rigorous emissions reduction targets. During the year we engaged with 62 FTSE350 constituent companies, of which 19 improved their CDP after our dialogue.

This work is conducted on behalf of the Church Investors Group, to whom we act as Secretariat.

ABOUT CLIMATE ACTION 100+

Climate Action 100+ is a new investor initiative that works with the world’s highest corporate emitters of Greenhouse gases. It is supported by investors with over $30trillion in assets under management and aims to encourage companies to:

1. Implement a strong governance framework for managing climate risks and opportunities
2. Take action, to reduce greenhouse gas emissions across their value chain
3. Disclose their approach to climate change in line with the findings of the Taskforce on Climate Related Financial Disclosures.

As a key supporter of the initiative CCLA will be actively involved in engagement with all of our holdings in the ‘extractives’ and electrical utilities sectors as well as other ‘key emitters’ in our portfolios.
Duke Energy
Engagement Performance: ■
Duke Energy published a detailed analysis of the impact that limiting temperature rises to two degrees Celsius above pre-industrial levels would have on their business. On the back of this, they committed to a number of positive steps. These included increasing the percentage of electricity generated from renewables and natural gas.

Rio Tinto
Engagement Performance: ■
Rio Tinto continue to be receptive to investor engagement and announced that they would be divesting from all coal (the most carbon intensive fuel) assets.

Royal Dutch Shell
Engagement Performance: ■
During the year the company disclosed an aspiration to reduce the greenhouse gas emissions generated through the production and use of its products by 20% in 2035 and by half in 2050. Shell are now in a small group of oil and gas majors who have stated an aim to decarbonise their fuel mix.

SSE
Engagement Performance: ■
SSE remain a leader amongst the major electrical utilities companies. During the year they supported the Powering Past Coal Alliance; an initiative led by the Canadian and UK governments to remove coal from the fuel mix used to generate electricity.

Unilever
Engagement Performance: ■
Despite being one of the 150 largest corporate emitters of greenhouse gases Unilever continue to be a leader in the Consumer Discretionary sector. We are pleased with their response to engagement.

ENGAGING WITH PUBLIC POLICY MAKERS
Supportive legislation will be essential if we are to accelerate the transition to a low carbon economy. This took on increasing importance during the year following the USA’s commitment to leave the Paris Agreement and, as plans for Brexit progress, the threat of the UK’s supportive voice in the European Union being lost. As a member of the Institutional Investors Group on Climate Change CCLA were amongst a group of leading investors who wrote to the G7 supporting strong continued action on climate change. We also publicly supported the UK and Canadian government’s Powering Past Coal initiative, which calls on signatories to work together to remove coal from the fuel mix used to generate electricity.
MANAGING ENVIRONMENTAL SOCIAL AND GOVERNANCE RISKS

In order to encourage improvements, we also continually engage with a number of portfolio holdings on a wide range of ESG themes. This includes issues such as water use, tax transparency and labour standards. We measure developments over time and escalate engagement where companies are non-responsive. During the year we have engaged with six companies in this manner and our engagement progress is displayed in the table below. (NB. Engagement is ongoing unless otherwise noted).

Dechra Pharmaceuticals  
Engagement Performance:  ■  
Issue: Water Use, Labour Standards  
We have held positive discussions with the company and we expect increased disclosure on their approach to these important issues in 2019.

Duke Energy  
Engagement Performance:  ■  
Issue: Health and Safety  
The company has provided a comprehensive response to our concerns. We will continue to push for further disclosure and monitor the ESG Ratings given to the company.

Ecolab  
Engagement Performance:  ■  
Issue: Health and Safety  
The company has begun a project to standardise their approach to health and safety across all operations.

Freseinus Medical  
Engagement Performance:  ■  
Issue: Human Rights  
The company has committed to provide more detail about their approach to safeguarding human rights in 2019.

MoneySupermarket  
Engagement Performance:  ■  
Issue: Labour Standards  
The company has provided CCLA with full details of their processes and procedures. They will consider disclosing these to the public in 2019.

Reckitt Benckiser  
Engagement Performance:  ■  
Issue: Baby Milk Substitutes  
Reckitt Benckiser purchased Mead Johnson, a US based manufacturer of Baby Milk Substitutes (BMS). Mead Johnson were amongst the worst performers on BMS responsibility criteria created by FTSE and the Access to Nutrition Index. Reckitt Benckiser have identified an action plan to bring them up to best practice standards.

United Health  
Engagement Performance:  ■  
Issue: Labour Standards  
The company has responded well to engagement and has expressed a wish to develop new policies and processes in this area.

ADDRESSING CHILDHOOD OBESITY

As part of our approach to addressing environmental, social and governance risks we have continued our work with holdings, who are involved in the manufacture and/or retail of food and beverages, to help them take steps to mitigate rises in levels of childhood obesity. Whilst promoting high standards of public health is a priority for many of our clients we recognise that, with the introduction of further taxation and regulation aimed to control the consumption of sugar, this is increasingly a business risk for companies who fail to adapt.

The Coca-Cola Company  
Engagement Performance:  ■  
Coca-Cola continue to be a leader in product reformulation and offer ‘no’ or ‘reduced’ sugar alternatives to 80 of their most popular drinks. These make up a considerable percentage of their market share. The company are also looking at their marketing strategy.

Greggs  
Engagement Performance:  ■  
Greggs have continued to progress well through engagement. This includes continued progress towards meeting Public Health England’s target for a 20% reduction in sugar by 2020.

PepsiCo  
Engagement Performance:  ■  
Engagement with PepsiCo on nutrition has been limited during the year. That said, we were pleased to see the company increase it’s score on the new Access to Nutrition Index rankings.

Unilever  
Engagement Performance:  ■  
Unilever continues to be very receptive to investor engagement and is a leader in addressing childhood obesity. They are the second highest ranked company on the Access to Nutrition Index.
Regulators, investors and prospective tenants are placing greater emphasis upon the sustainability of property assets and we expect that this will have an ever-increasing impact upon their valuation. For this reason, responsible investment is a key part of our property investment process.

Prior to purchasing a property, our due diligence process includes consideration of issues such as energy efficiency, water usage, recycling systems in buildings, and environmental risks (historical, current and future) associated with site ownership. There are cases where this due diligence process has led to us walking away from investment opportunities because it has thrown up risks (and potential subsequent liabilities) that significantly changed our view of the property’s value. One recent example related to concerns about the risk of the building flooding. We are aware that our changing climate will cause evermore erratic weather patterns and increase the likelihood of heavy rainfall leading to flash floods. As the potential property was in a high flood risk area, we did not proceed.

Being at the forefront of environmentally-friendly buildings that also demonstrate high “wellness” characteristics for their occupiers can be very expensive, as new technology rarely comes cheap. As a consequence, it does not necessarily offer the financial return needed. For this reason, a key part of our property investment strategy is to acquire ‘non-trophy’ grade A assets, usually well-located buildings. These can be improved (both socially and environmentally) through refurbishment, delivering a substantial uplift in their value and increase their yield. Again, sustainability criteria is a key component of this approach. Converting a poorly performing ‘dirty’ building into something clean and green, for example, can often be done with relatively little investment, cuts the running costs, can be more appealing to prospective tenants, and improves the potential rental income.

We also seek to stay ahead of regulation. Following the introduction of the new Minimum Energy Efficiency Standards by the UK Government we are working to upgrade our properties with the worst Environmental Performance Certificates (EPC). Again, with an improved rating and an EPC that is valid for 10 years, this will protect their value for our investors.

Although it can have a positive impact on returns, running a sustainable property portfolio is not straightforward. There is also a degree of waste built in to commercial property management. As landlord, we seek to undertake our own refurbishment projects in line with good sustainability practices and ensure that our own supply chain is aware of sustainability requirements. In terms of occupiers, a trend for shorter tenancies leads to the need, or at least perceived need, for more frequent refurbishments, where relatively new carpets, fixtures, ceilings etc are required to meet a new occupier’s demand for perfection. For this reason, our agents create ‘fit out guides’ that encourage the use of sustainable materials, for instance.

Furthermore, just gathering the data on the sustainability of our buildings can be difficult. There is no commonly agreed standard for metrics and benchmarks, and many of our legacy leases do not require tenants to share data on the environmental performance of their buildings. Our agents work on our behalf to integrate sustainability into their day-to-day activities, for example including standing agenda items in occupier engagement activity. This integrated strategy has yielded direct sustainability benefits, with energy use across the property portfolio showing a downward trend (2% reduction in 2017 vs 2016) and recycling rates increasing to over 50% across the portfolio. Other initiatives include sustainable transport solutions (cycling facilities, electric charge points) and enhancing the natural aspects of the buildings and surrounding area.

As a further incentive, we have worked with our legal advisers to insert ‘Green Clauses’ into lease agreements when they come up for renewal. We are also increasing the resource available to us to work with tenants to improve the performance of our buildings. This will increase the visibility of ongoing works to enhance sustainability performance, create more engaged and satisfied occupiers and ultimately enhance financial performance. We believe that the increased sustainable performance of buildings will mean that we can continue to deliver the best possible returns to our clients.

“Please help us reduce our garbage and improve our energy efficiency and our water quality. Help us to be eco-wise–and above all–to empower others.”

RESPONSIBLE INVESTMENT IN PROPERTY

PROPERTY

FIRE SAFETY

Following the tragic Grenfell Tower Fire, we conducted a thorough review of the fire safety standards, and the types of cladding used, of all properties held within our property investment funds.

The review was initially conducted on a desk top basis with the objective to establish the scale of any potential risks in the portfolios and identify assets potentially posing the greatest risks. This was followed by detailed investigation, where necessary.

The analysis confirmed that no CCLA-owned properties were considered to be high risk and all but one were rated as ‘no’ or low risk.

Source: BNP Paribas Real Estate Services
ETHICAL INVESTMENT: ALIGNING OUR PORTFOLIOS WITH YOUR VALUES

As a specialist investment manager for charities and local authorities, we seek to invest our clients’ assets in a way that reflects their values and ethos. To aid us with this, we undertake an extensive programme of dialogue with our clients every three years. This helps us to identify their key concerns and guides the ethical investment policies implemented by our pooled funds.

During the year we have completed a survey on the ethical investment requirements of over 450 of our charity clients. Whilst all respondents recognised the potential for poorly aligned investments to damage their reputation, the survey results clearly show that there is no single approach as to how charities want to manage this risk. Instead, they tend to take, one of two, different approaches.

The first, and largest, group of charities require very limited, if any, ethical restrictions. In their place, they want their money to be managed in a manner that is responsible and based upon clearly articulated beliefs as to how ESG issues will affecting company performance. In contrast, the second, require extensive ‘ethical restrictions’, to avoid investment in controversial business areas, and, through ‘positive allocations’ and proactive engagement with companies, want their financial assets to actively further their charitable mission. For this reason, we offer our clients the choice between three different versions of our ‘flagship’ multi-asset Investment Fund.

Whilst our survey identified different ethical requirements all respondents agreed that they were not willing to sacrifice investment returns or income to align their portfolio with their values. Whilst the prevailing narrative suggests that ethical investment must cost performance or radically alter the characteristics of portfolios, our experience suggests that this is not, necessarily, the case.

To not affect returns, or introduce unwanted style biases, our approach to portfolio construction begins by removing any ethical restrictions from the investment universe. This allows us to, then, investigate the remaining companies and identify the right mix needed to build a portfolio that behaves as if it were unrestricted. This is different to the approach taken by many other investment managers who simply remove restricted stocks from a pre-existing model or, if using a passive investment approach, an index. If uncorrected this can leave portfolios unbalanced and impact upon performance.

Increasing numbers of charities are wanting to develop their own ethical investment policy and should be confident that, managed correctly, it should not stop them from achieving their investment objectives.

TOP TIPS FOR DEVELOPING AN ETHICAL INVESTMENT POLICY

As part of their SORP, charities with a turnover above £1 million are required to consider, and disclose, whether they require an ethical investment policy or not. For this reason, many charities are in the process of writing their first policy document. This can often be a difficult process for Trustee Boards, with divergent views across the table. In our experience there are a number of ‘top tips’ that, if implemented, can ease the process.

1. Recognise that being an ‘ethical investor’ is about aligning your investment approach with your charity’s mission: It is easy for trustees to think that ethical investment must mean extensive ethical restrictions. However, this does not necessarily have to be the case. Many charities may not require ethical restrictions and, if you do, it is possible to limit their extent to a level that should not compromise investment performance if you stick closely to issues most relevant to your mission.

2. Work with your manager: Your investment manager should be able to guide you about the likely impact of your ethical investment policy. By working together, you should be able to develop a policy that is implementable.

3. Learn from others: Rather than ‘starting from scratch’ trustees often find it helpful to begin with the guidance of another body. Whether it be a charity working in the same area, or an investment manager’s fund that you respect, tailoring an existing policy to your own needs can act as an effective short cut.

4. Be pragmatic: Most charities invest through pooled investment funds. It is, therefore, unlikely that any fund will be a perfect match for your ethical policy. As a consequence, leading charities seek to identify the fund that gets as close as possible to meeting their ethical, as well as their financial, needs.

5. Don’t Accept Less: Good investment managers should be able to incorporate reasonable ethical restrictions without reducing performance or increasing risk.

Our ethical and responsible investment team are very experienced in helping charities come together and develop new policies in this area. Please contact your relationship manager or the CCLA client services team, if you would like to discuss your approach with us.
Many clients investing in the COIF Charities Ethical Investment Fund wish to use their assets to support their mission. For this reason, the Fund’s Advisory Committee prioritise one topic for a specialist, engagement programme that is designed solely to deliver the changes in corporate behaviour that our clients would like to see. This currently focuses on addressing modern slavery within company supply chains.

The International Labour Organisation estimate that 24.9 million people globally are trapped in forced labour and Grant Thornton estimate that modern slavery is worth approximately $150 billion to the world’s economy. Much of this value is realised through company supply chains.

Following the publication of the UK’s Modern Slavery Act, we are asking companies to develop rigorous processes for identifying and addressing slavery in their suppliers’ operations. This work takes two forms. First, we are using data from, the NGO, ‘Know the Chain’ to identify companies, in three key sectors, that have a poor approach to addressing modern slavery. We currently hold one company, Keyence (a Japanese industrial company), who are in the bottom half of a ‘Know the Chain’ rating. Our engagement with the company to date has been limited however – following dialogue – we are expecting an increase in the company’s score.

Second, we are encouraging our holdings to adopt the ‘Employee Pays Principle’, which prohibits suppliers from charging prospective employees recruitment fees. This has been prioritised as recruitment fees, particularly when charged to migrant labourers, can leave workers with unrepayable loans and stranded in bonded labour. As such, we were pleased that the principle that no employee should pay for a job was included in the recent International Tourism Partnership, a coalition of hoteliers and tourism related businesses, Principles on Forced Labour.
Our specialist funds for the Church of England are one of the Church’s three National Investing Bodies (NIBs). As such, we manage the Funds in line with, and participate in the work of, the Church’s Ethical Investment Advisory Group (EIAG).

During the year the EIAG published new advice on the ethics of investing in the ‘Extractives Industries’. The guidance was issued to complement the 2015 Climate Change policy and recognised the important role played by mining and oil and gas companies in providing the material needed for the products that we use every day and delivering employment in some of the world’s poorest countries.

However, it also noted that some elements of the industry have been plagued with issues such as poor human rights abuses, concerns over health and safety standards and corruption. As such, the NIBs have agreed to make the extractives industries one of their key engagement priorities and conduct additional due diligence when investing in the sector.

The EIAG’s work is consistent with CCLA’s existing approach to the sector. Recognising the high ESG risks inherent to bringing resources out of the ground, and conscious of the impact to investment returns when things go wrong, we implement a high minimum standard that we expect companies to meet before investing. We currently only invest in three companies in the extractives industries, all of whom we consider to be ‘best in class’ and believe that this will lead to more sustainable returns for our clients.

The Transition Pathway Initiative

Alongside the Environment Agency Pension Fund and the London School of Economics’ Grantham Institute, the Church of England NIBs created the Transition Pathway Initiative (TPI).

This ranks companies in the most carbon intensive sectors on their approach to managing the risks and opportunities posed to their business by climate change. Powered by data from FTSE Russell, and supplemented by analysis by the Grantham Institute, it ranks companies’ approach to the governance of climate change and plots where their pledges to decarbonisation fit (or do not fit) against the necessary reductions needed to implement the Paris Agreement.

The TPI is a key part of the NIBs approach to implementing their Climate Change Policy and will be used as an indicator to assess the success of engagement.
ABOUT CCLA

We manage investments for charities, religious organisations and the public sector. This is all we do.

Founded in 1958, we aim to deliver strong long-term returns and have unmatched experience in providing ethical and responsible investment to charities. We are independently owned by our clients with £8 billion of assets under management.

DISCLOSURE

This document is a financial promotion and is issued for information purposes only. It does not constitute the provision of financial, investment or other professional advice.

All data correct as of 30th June 2018