## Voting and engagement summary 2018

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Foreword

It has been a turbulent year for politics, and for the societies in which we operate as an investment firm. It has also been a volatile year for global investment returns in many different asset classes. The coming year looks set to continue in the same fashion. However, this provides context for our stewardship and environmental, social and governance (ESG) research activities.

Our Research Institute published its ESG Index in Q4. This measures the social aspects of many countries’ capitalist activities. The research behind the index helps us to focus on some of the longer-term measures of a country’s success. It also helps our investment teams to identify ESG risks and opportunities emerging within their investment universes.

The index highlights where countries need to act to improve the sustainability of their development efforts. Addressing climate risks is often high on the list. During Q4, the Intergovernmental Panel on Climate Change updated its thoughts on global progress in tackling climate change. The results are alarming, and are summarised in this report. This update will inspire us to keep climate discussions at the top of our agenda when meeting with companies, regulators and policymakers.

When we introduce the topic of integrating ESG factors into our investment research, we often have to justify this. Why we go to so much effort to analyse longer-term considerations that often prove difficult to calibrate? This quarter’s report turns that question on its head, as our real estate colleagues ask ‘Why not?’, rather than ‘Why?’.

We also highlight some of our more significant recent corporate engagements – along with one surprising development. In November, Persimmon announced the dismissal of CEO Jeff Fairburn following an outcry over his remuneration. I attended the company’s AGM earlier in the year to emphasise our related concerns. The new chair has acted swiftly and decisively to redress the balance of influence on the board. We hope and expect Persimmon can look forward to a successful future.

Finally, I would like to extend my gratitude to Colin Walklin, our group chief operating officer and outgoing chair of Standard Life Investments Ethical Funds Advisory Group. Colin’s contribution has been outstanding and his observations from his time as chair can be found within the report.

“In 2019, climate discussions will be at the top of our agenda when meeting with companies, regulators and policymakers.”
ESG Fund Forum

We presented at the Fund Forum Global ESG and Impact event in the Netherlands. Numerous European asset owners and asset managers attended the event.

Attendees considered:

- how management integrates ESG into boardroom strategy;
- what regulation is currently influencing ESG;
- how ESG informs portfolio construction; and
- new investment products, including green finance, green bonds and impact investing.

Andrew Mason, ESG investment analyst, took part in a panel discussion on asset managers’ corporate commitment to ESG and how this is integrated across asset classes. He also presented on a separate platform detailing his work on the opioid epidemic in the US and what steps investors can take. We believe the event is an important gathering of industry leaders. We are thankful for the opportunity to highlight the need for investors to engage with companies regarding the US opioid epidemic. This is an area that is largely overlooked in Europe. We therefore welcomed the ability to raise awareness and the positive responses we received.

Italian Corporate Governance Conference

We attended the fourth Italian Corporate Governance Conference. This event was well-attended by Italian non-executive directors, regulators and investors.

Alison Kennedy, ESG investment director, took part in a panel discussion considering: ‘Controlling shareholders, growth and access to capital markets: the role of loyalty and multiple voting shares’. We expressed strong support for the principle of one share, one vote. We also noted that the issue of unequal voting structures is a global phenomenon. Italy has a large number of family-controlled listed-companies, where the family controls the voting rights. This is reflected in board structures and in the large number of related party transactions. We think this has the potential to undermine perception of the strength of corporate governance in Italy. ‘Sunset clauses’, which set a limit on unequal voting structures, might be one way to address this issue.
“We expressed strong support for the principle of one share, one vote. We also noted that the issue of unequal voting structures is a global phenomenon.”
With the UN’s 2015 Sustainable Development Goals (SDGs), governments across developed and emerging markets have a tangible set of goals to address sustainability and fairness in their societies.

As investors, we already have the opportunity to support these efforts at the firm level. However, measuring success at the macro level has consistently posed a challenge. This is due to poor data quality and issues of transparency. To recognise this, we have built a new indicator of national progress for 135 countries. It measures the extent to which nations are persistently economically dynamic. It also captures those that are making progress towards meeting the ESG aims that the UN has aligned to its SDGs. The results of this exercise are a testament to the benefits of more open economies and societies – a message that risks being lost amid the wave of political populism sweeping through the developed and developing world.

We took the economic growth data for the past five years and ESG scores from our new global ESG index. From this, we have identified 46 countries that are exceeding both their development-adjusted growth and ESG benchmarks. The vast majority of ‘Social Capitalist’ countries are developing economies and can be viewed as hunting grounds for the places that will generate both global economic and sustainable development leadership over the next 20 years.

Although two of the most prominent developing economies – India and China – do not make the ‘Social Capitalist’ grade, both have been persistently economically dynamic. Moreover, recent developments suggest that their governments are placing more weight on broader measures of progress. If China is to become a ‘Social Capitalist’ it will need to improve the transparency and representativeness of its political and governance institutions in particular. In India, the focus should be on environmental indicators and social equality.

Conversely, the majority of developed economies – particularly in the Eurozone – have outperformed their ESG benchmarks, but failed to generate robust economic growth over the past five years. The danger is that this persistently weak economic growth will amplify existing populist pressures and eventually undermine support for broader sustainability goals.

If developed countries’ commitment to open economies and societies were to weaken further, it will inevitably weigh on their own growth prospects. It would also damage the prospects for further catch-up growth in developing countries. At a time of enormous productivity, demographic, social and environmental challenges, this would prove especially counterproductive. The task then is to identify country-specific political and policy solutions that can reconcile each of these objectives.

Exceptions to the pattern of weak economic performance and strong ESG performance among the developed economies include countries like Portugal, Ireland and Sweden, which have performed well across both dimensions. Meanwhile, Japan stands out – contrary to general wisdom – as an economy that has been more economically dynamic than most, with the country’s shrinking population masking relatively healthy productivity performance. The economic policy adopted by Japan has not been the failure it is sometimes made out to be.

Although most countries’ ESG scores have been rising over time, there is a lot of room for improvement. Most nations are not doing enough to reduce greenhouse gas emissions and limit the damage from climate change, nor improve air quality. And while income and other inequalities between developed and developing countries have been shrinking, disparities within countries are high and have risen over recent decades. Addressing these issues is important for gaining broad-based buy-in for growth-enhancing reforms.

The tools we have developed can be used in a number of ways. For policymakers, they can be used as a benchmark for assessing absolute and relative national performance. And investors can use them as a screen to support asset allocation decisions and product development.

Our work reinforces a strong history of ESG-related development and research at Aberdeen Standard Investments. Our ESG index builds on a screen created for the developing economies by our Emerging Market Debt team that already underpins funds we are offering to clients. And we have collaborated closely with our ESG research team, who continue to advance the firm’s thought leadership in this area. We have also worked with companies and other internal investment teams to ensure ESG factors are properly taken into account. Our work reinforces a strong history of ESG-related work and research at Aberdeen Standard Investments.

The full report can be found on our website.
“The vast majority of ‘Social Capitalist’ countries are developing economies”

46 countries that are exceeding both their development-adjusted growth and ESG benchmarks
What difference will half a degree make?

The IPCC (Intergovernmental Panel on Climate Change) recently published a special report on the implications of 1.5 °C global warming.

It concludes that “climate-related risks to health, livelihoods, food security, water supply, human security and economic growth are projected to increase with global warming of 1.5°C and increase further with 2°C. We are already at 1°C warming today and have experienced record-breaking heatwaves, storms and floods around the world in recent years. This will continue as warming continues. The distribution of impacts is extremely unequal. It will hit the poor and most vulnerable in least developed countries, dryland regions and small islands the hardest.

We believe that, for businesses, three impacts highlighted by the IPCC report are particularly relevant.

<table>
<thead>
<tr>
<th>Impact - 1.5°C vs 2°C scenario</th>
<th>Associated Consequences</th>
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</thead>
<tbody>
<tr>
<td>Extreme heat - At 1.5C warming, 14% of the population is exposed to severe heat at least 1 in 5 years compared to 37% at 2°C.</td>
<td>Human health and fatalities, migration, droughts, damaged plants &amp; crops, increased need for air conditioning.</td>
</tr>
<tr>
<td>Water stress - At 1.5C warming, the population exposed to increased water stress (quantity &amp; quality) caused by droughts and floods is 50% less than at 2°C warming.</td>
<td>Droughts, heavy precipitation and flooding impacting crop yields, commodity prices, infrastructure and business operations reliant on water.</td>
</tr>
<tr>
<td>Sea level rises - At 1.5C warming, the amount of sea level rise is 0.4m by 2100 compared to 0.5m at 2°C.</td>
<td>Loss of coastal land and islands, 10mn more people exposed to climate risks at 2°C, coastal adaptation costs, damage to assets.</td>
</tr>
</tbody>
</table>

Is 1.5°C still achievable?

Yes, it is scientifically feasible – but requires radical global action and international cooperation. Global emissions would need to decline by 45% in 2030 and reach net zero by 2050. This would be expensive, as the marginal abatement costs for reaching 1.5°C are 3-4 times higher than for the 2°C scenario. Current efforts to reduce carbon emissions are far from sufficient. With current policies, we are on track for over 3°C warming by 2100 as shown in Figure 1.

What policy response is to be expected?

In simple terms, we need to be prepared for two main options: governments around the globe will step up action to achieve the 1.5°C target urgently, or they won’t.

1. Radical mitigation action – governments implement stronger policies and regulations. These include higher carbon prices and subsidies for negative emission technologies which are critical for achieving 1.5°C. For investors, this means analysing the impact of transition risks and also opportunities on companies and assets.

2. Limited mitigation action – emissions continue to rise and physical impacts are more frequent. This will require increased investment in adaptation to help minimise the impacts. For investors, this means understanding the financial impact of physical risks on companies and assets across different regions. It also means identifying opportunities relating to higher demand for adaptation measures, such as flood defences and cooling equipment.

We believe that the first option is ultimately inevitable. Pressure on governments will increase due to more severe and frequent physical impacts relating to rising temperatures. This will see businesses and society demand more certainty and action. The question is: how frequent and severe do physical impacts have to become before serious action is taken?

Who is going to be most affected?

1. Businesses heavily reliant on water – certain industries will be particularly impacted by water scarcity such as food & drink, agriculture, energy, cement and water utilities. Droughts also impact crop yields and push up commodity prices which intensifies the supply chain impact.

2. Infrastructure and real estate – Extreme weather events, such as floods and fires can affect any business with operations and real estate in vulnerable locations such as coastal regions.

3. Insurance – damage to assets will result in higher payouts for insurance companies. The increase in frequency and severity of physical risks should be priced in.

Business must prepare for the impacts of a warming planet on their operations and reflect this in their risk management and business planning. We believe that climate change has and will continue to have a material impact across many businesses and is therefore an important consideration in our investment strategy.
“The question is: how frequent and severe do physical impacts have to become before serious action is taken?”

Sea level rises

At 1.5°C warming, the amount of sea level rise is 0.4m by 2100 compared to 0.5m at 2°C
It is interesting to see when new and emerging trends become established norms. When it comes to how not-for-profit investors link their investments to something global, we see an established norm with a number of our charity clients. For example, many like to refer to international standards when setting aspects of their investment policy statement.

The UN Principles for Responsible Investment, now over 10 years old, has become a benchmark for investors when placing importance on ESG factors in their investment policy. Some charities are also incorporating the UN Sustainable Development Goals (SDGs) into their investment policy.

We believe the Edinburgh Finance Declaration (EFD) could become a similar reference point for faith groups who wish to align themselves to a shared values framework.

The Edinburgh Finance Declaration (EFD)

The EFD was launched in October 2018. It is the product of a two-year inter-faith dialogue between the Church of Scotland and the Islamic Finance Council UK. Its shared values framework reflects six values, detailed below.

- Stewardship
- Love of the Neighbour
- Human Flourishing
- Sustainability & Purposefulness
- Justice & Equity
- Common Good

There are a number of ways the EFD values could be translated into ethical screens for an investment portfolio. Justice and Equity could involve screens relating to high interest-rate lending and gambling. The EFD associates the Common Good with the UN SDGs. This could introduce screening factors linked to clean energy and climate action (SDG goals 7 and 13 respectively). Stewardship points to being an active and informed shareholder. Here, investors should be mindful of how they cast votes on resolutions. They should also seek to influence more positive corporate behaviour.

The EFD writes its shared values framework in general terms and can therefore be open to interpretation. This helps link those faith groups wishing to frame their own, more detailed, investment policy statement with the work of the EFD.

US developments

At Aberdeen Standard Capital, we act for a number of churches and faith-based organisations. We understand the importance placed on ethical screens so that investments reflect the mission and purpose of an organisation. We benefit from access to research sources, which give us insight into a range of global ESG themes. This includes, for example, commentary on the investment guidelines of the United States Conference of Catholic Bishops. It focuses on doing no harm, protecting human life and promoting human dignity.

At a practical level, a client investing according to these particular guidelines would exclude the healthcare sector due to links to abortifacients, contraception or the manner in which companies conduct research. This can pose a challenge in the management of an investment portfolio because pharmaceutical companies are defensive stocks. That is, they are companies that tend to perform better during periods of market weakness and pay stable dividends. These are valuable features for charities. The solution to this challenge lies in research, data and software.

Modern screening provides in-depth ESG research and allows the alignment of any client’s ethical criteria without ruling out an entire industrial sector. So in the above example, companies such as medical technology (manufacturers of pacemakers, stents, etc.) and veterinarian pharmaceutical businesses would provide similar sector exposure while complying with the ethical screening criteria of the faith group in question.

Investing with purpose

It is estimated that faith organisations command assets of around $7 trillion. This jumps to $13 trillion when charities, endowments and philanthropic entities are included. The investment frameworks of many of these not-for-profit groups use ethical screening of one kind or another. The Edinburgh Finance Declaration adds a new inter-faith dimension to this world. We welcome its launch and will support our faith-based clients who want to align their investments with this new shared values framework.

Aberdeen Standard Capital is the UK discretionary investment management arm of Aberdeen Standard Investments.
“We believe the declaration could become a similar reference point to the UNPRI.”

Faith organisations command assets of around $7 trillion
Potential changes to voting rights in the USA

Nick Duncan
Governance & Stewardship Manager

When President Trump appointed former Wall Street lawyer Jay Clayton as the new SEC Chair, there was concern from shareholders that he would follow up on his pledge to ease the regulation and burdens of listed companies by weakening corporate governance requirements.

The SEC held a roundtable on 15 November 2018 to solicit comments on the proxy process. This was to include topics such as proxy advisor regulation, shareholder proposals and the reliability of the proxy voting system. The roundtable followed on from increased lobbying efforts by the US Chamber of Commerce and the National Association of Manufacturers. They are looking to change the resubmission thresholds for shareholder proposals that have been in place since 1954. Shareholder proposals permit investors to collectively express their voice on issues of concern without the cost and disruption of waging proxy battles. The proponents of changing the shareholder proposal rules complain that the voting rules have allowed special interest groups and proxy advisor firms to hijack the proxy process. This has often resulted in costly demands that are unrelated to a company’s core business. However, this argument misses the many improvements to US corporate governance practices that would not have happened without the current robust shareholder proposal process.

Shareholder proposals helped establish the practice that independent directors make up at least a majority of the board. They also ensured that all members of the Audit, Compensation and Nominations Committees are independent. These practices are now largely incorporated into the listing standards of the major US stock exchanges. The practice of electing directors by a majority rather than a plurality vote was revolutionary 15 years ago when first advocated by shareholder proposals. Today, more than 90% of large-cap US companies use majority voting to elect their directors. This is thanks to the robust shareholder support for majority voting proposals. The cost to companies from the existing shareholder proposal process is low – especially as most companies do not receive many, if any, shareholder proposals. According to Ceres, the average Russell 3000 company will receive a shareholder proposal every 7.7 years. The filing of shareholder proposals is mainly with larger companies who have the time and resources to deal with them without undue burden. Some of the changes mentioned above were ‘slow burn’. As such, they required a period of time to gain critical mass from shareholders. In our view, this would not have happened had the resubmission thresholds been higher. It is also worth considering that increasing the resubmission thresholds would be problematic where companies have dual class share structures. Such scenarios would make it more difficult for shareholders to gain traction through the proxy voting process.

The SEC has previously looked at the issue of universal proxies, which could be used in proxy contests when director elections are contested. The current voting system restricts shareholders who are voting by proxy (post or electronically) to selecting only the entire slate of directors proposed by either management or the dissident. However, shareholders cannot ‘split their ticket’ by choosing to vote for a mix of directors from both slates. The ability to do so is currently only available to shareholders who attend the AGM in person. This is unhelpful given most shareholders cast their votes by proxy. In 2016, the SEC issued a proposal on universal proxies, but has yet to finalise the rule. With a new SEC Chair, there is concern this issue could be permanently kicked into the long grass. Shareholders are rightly worried that their hard-fought rights in a number of areas could be eroded for political reasons. As such, they will have to be vigilant to any regulatory changes that favour business interests over shareholders rights. The SEC will shortly issue its findings on the proxy voting process. This will be keenly watched by shareholders and corporates alike.

Aberdeen Standard Investments is strongly supportive of the current system for shareholder proposals. We would view any change to the resubmission thresholds as a negative development and believe it would impact shareholders’ ability to hold companies to account. We would also encourage the SEC to finalise the universal proxy rules to enable shareholders who are unable to attend an AGM in person to be able to ‘split their ticket’. This would allow them to vote for a mix of director candidates from each proposed slate of directors in contested elections.
“US corporate governance practices would not have happened without the current robust shareholder proposal process.”

More than 90% of large-cap US companies use majority voting to elect their directors.

Average Russell 3000 company will receive a shareholder proposal every 7.7 years.
The US truck driver shortage

The truck driver shortage has dominated America’s headlines in the logistics space this year. This has been a result of high demand (over 68% of all freight is moved on US highways) at a time when millennials are shunning the profession.

Implications for companies and investors

Last year’s implementation of the Electronic Logging Devices (ELD) mandate has further reduced capacity in the industry. Drivers are at risk of penalties or could be shut down if they do not comply with ELD. With a current shortage of around 51,000 drivers in the US, the American Trucking Association (ATA) predicts that the situation will likely get even worse. It forecasts a 175,000 truck driver shortage by 2026.

What does this mean for investors

The ongoing labor shortages in the trucking industry is creating risks with material financial impacts for investors. Wages represent trucking companies number one cost and so any inflation in that line item can be a huge headwind for shippers. Our equity and credit teams at Aberdeen Standard Investments have see some of these impacts across several sectors in recent earnings calls. Amazon for example, cited increased shipping costs as a result of driver shortages as the reason for it boosting the price of its Prime membership. We have also seen a number of building products companies, such as residential and commercial flooring distributor Mohawk Industries, and building materials producer Owens Corner impacted by higher freight costs due to labor shortages. Household product businesses such as Clorox, and Procter & Gamble have also been explicit about the impact of labor induced rising freight costs in recent earnings calls.

What are the solutions?

Many companies are increasing driver wages as a means to attract and compete for more drivers; some by as much as 15%, with many drivers now earning around $80,000-a-year. However, this still does not appear to be enough to entice drivers and many are moving around to get the ‘best deals’. Longer term, several companies are looking to driverless vehicles to help solve the driver-shortage issue. However, most analysts and freight companies do not expect such technology to be on the roads for decades.

One of the more positive outcomes of the driver shortage seems to be the pressure put on companies to revisit the efficiency of drivers’ time. Trucking can be a hugely wasteful industry. Nearly 20% of miles are driven with empty trailers, which equates to around 65 billion miles a year. Over the last 12 months, we have been talking to the companies in which we invest to understand the steps they are taking to make their journeys more efficient and therefore reduce demand for drivers. Earlier this year, logistics services company XPO Logistics launched government-approved mega-trucks in Spain. Increased capacity will ultimately result in fewer miles on the road. It will also reduce CO2 emissions. Companies are having to rethinking their employee package options, as wages alone are no longer enough to compete for talent.

In the near term, driver shortage will likely continue to lead to wage inflation, which could further pressure truck margins. Longer term, elevated trucking costs could lead to a rotation to lower-cost rail-freight firms. Here, union contract means wage inflation is locked at 2% per annum. It is unclear how long it will take to solve the US truck-driver shortage. However, it is clear that there are both risks and opportunities faced by companies in addressing the problem. We therefore expect to see winners and losers emerge over the coming years.

Source: FTR Transportation Intelligence; data compiled by Bloomberg

Drivers Wanted

The shortage of truck drivers is at historic levels as a strong economy boosts freight demand

Why the shortage?

In the tight labor market, the rebound in construction and manufacturing jobs has driven employment demand over the last two years, post an industrial recession that ended at the beginning of 2016. Such jobs have proved preferable over trucking, in part a reflection of the poor wages and working conditions often associated with driving trucks.
“Wages represent trucking companies’ number-one cost and so any inflation in that line item can be a huge headwind for shippers.”

Over 68% of all freight is moved on US highways

175,000 truck driver shortage by 2026.
We believe that understanding the interrelationship between ESG factors and underlying investment performance is pivotal to embedding ESG factors even further into our investment process. With this aim, we have developed a database containing the scores for multiple ESG metrics for a large number of the buildings we manage. This is so we can examine the relationship between an asset’s investment performance and its core ESG factors.

Many cynics say that considering ESG factors impacts returns; our research shows that the converse is true. Perhaps the most notable and compelling finding of our research is that we could find no detrimental effects from integrating ESG factors into real estate investment management. And, in many instances, a positive contribution can be clearly evidenced. As they are inextricably linked, we believe good ESG risk and performance management should be viewed as a proxy for good investment management.

Understanding complexity
When considering this research, we were mindful that real estate and ESG are heterogeneous by nature. In essence, very few properties can be fairly compared. This meant that we are typically missing a clear ‘control’ asset for comparison of performance. Measuring real estate investment performance itself is not straightforward. However, it is further complicated when trying to unpick the contribution of ESG factors. The perception that ESG is a single factor is misguided. ESG is shorthand for a multi-faceted and holistic assessment of material risks and opportunities affecting an asset. This can include issues and opportunities arising from climate and environmental change; urban living and population dynamics; governance and engagement; and the effects of rising technology and connectivity. It isn’t easy to distil this into a small number of ESG factors.

Expanding the dataset
Given the clarity of ESG factors and relationships with investment returns remain complex, we initially sought to investigate the income components to simplify the analysis. In theory, ESG factors should encourage tenants to pay higher rents. This is either through simple preference for better buildings or clear economic benefit in lower utility costs. However, the link to higher rental growth is not always apparent. We conclude that to fully measure these relationships, we need much more data on very similar assets within the same cities and micro locations; the buildings would also ideally be of a similar size and of a similar age and quality. However, even as the UK’s largest landlord, we still do not have a large enough sample size to accurately conduct this factor analysis.

Testing the data over time
The difficulties associated with measuring how ESG factors affect performance are also exacerbated by the relatively short timeframe over which data has been collated. Identifying the positive effects of ESG in isolation from other initiatives or, indeed, from market movements is also problematic. The benefits of ESG integration are only likely to be realised over long periods once trends, such as climate change, have started to play out. This could either be through regulation or through physical effects. These time horizons, though, are much longer than those used to measure investment performance.

Given our findings to-date, we have committed to expand our database and research to all of our direct real estate assets under management. We are therefore confident we can identify clearer results in the future. Indeed, we have already ensured that all prospective acquisitions and all annual strategic planning of assets reflect ESG factors. On the basis of our findings, we will also use this scoring system within our strategic cashflow forecasting.

Collaborating for change
Given the volume of work we have undertaken against one of the largest real estate investment data sets in the UK, we believe that there is a need for industry collaboration to take the work further. Like-minded real estate owners could work together to share data on ESG factors and investment performance, so that we can all reap the benefits.

In the meantime, we remain committed to embedding ESG within our investment behaviours. We anticipate that this important area of work will ultimately demonstrate that appropriate adoption of best-in-class ESG behaviours will not only enhance investment performance, but will also limit longer-term risks. It is simply a matter of modern, good, investment management practice, which has a benefit to society, tenants and clients. We urge an open debate in this regard. However, the first question should be: if you can achieve at-least market returns and generate a positive environmental or social benefit – why wouldn’t you?
“We believe good ESG risk and performance management should be viewed as a proxy for good investment management.”
Colin Walklin’s Ethical Investment Observations

Over the past six years I have had the pleasure of chairing the Ethical Funds Advisory Group. The time has come, though, to hand over the reins. I am pleased to announce that Barry O’Dwyer, who leads our UK business, will be taking over the role.

Standard Life Investments Ethical Funds Advisory Group brings together the investment management specialists responsible for running Standard Life Investments ethical funds with our client-facing teams. Importantly, the Group also receives input and advice from three external advisors. Not only are they investors in the ethical funds, but they are also recognised experts in areas such as alternative energy, environmental pollution, ethical agriculture and dispute resolution.

I was persuaded to take on the role with a simple pitch: “this will make you look really cool to your children”. That’s as may be – but, I’m glad to say, that the role has been so much more. It has increased my understanding and appreciation of so many important subjects, from climate change and oil seed production, to standards of corporate governance in major companies. Over the years, I have also become fascinated by the juxtaposition of commercially driven investment decisions alongside huge ethical issues that affect the whole planet.

Every two years, the Group conducts a survey to gauge our investors’ opinions and priorities about ethical investing. It is interesting to see how ethical priorities have shifted over time. While areas like animal testing remain a high priority, other issues, such as the fair treatment of workers – in both the emerging and developed world – have gained ground. This is recognition that if a company cannot be trusted to treat its own employees well, then it can hardly be expected to respect the environment and the creatures that live within it.

There is a lot of talk in the industry about the ‘bifurcation of risk’. Investors are deserting traditional asset classes in favour of low-cost ‘tracker’-type products and/or high-yielding ‘alternatives’. The question is: where does this leave ethical investments?

In my view, there is another dynamic at work alongside the ‘bifurcation of risk’. This lies in the changing demographic profile of investors and how they invest. In the past, individuals would entrust their financial decisions to investment professionals. Today, thanks to the rise of defined contribution pensions, nomadic working styles and new technologies, people are increasingly making their own investment decisions. As issues like global warming and the unscrupulous exploitation of the world’s natural resources become ever more apparent, I believe these new, younger investors will seek to invest a proportion of their long-term savings into ethical funds.

I think the future of ethical investment is bright and it will only get brighter in the years to come. I for one have certainly moved on from trying to impress my children (generally a lost cause anyway) to become a strong supporter and advocate of this part of the investment industry. This will not change – and I will eagerly watch Barry as he makes the role his own.

Colin Walklin
Outgoing Chair of the Ethical Funds Advisory Group
“I think the future of ethical investment is bright – and it will only get brighter in the years to come.”
ESG voting and engagement summary

Voting summary Q4 2018

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<th>Total</th>
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<tr>
<td>Shareholder meetings at which our clients’ shares were voted</td>
<td>630</td>
</tr>
<tr>
<td>Percentage of meetings with at least one vote against or abstention</td>
<td>34.6%</td>
</tr>
<tr>
<td>Number of resolutions voted</td>
<td>4,697</td>
</tr>
<tr>
<td>Percentage of resolutions voted with management recommendations</td>
<td>89.3%</td>
</tr>
<tr>
<td>Percentage of resolutions voted against management recommendations</td>
<td>10.0%</td>
</tr>
<tr>
<td>Percentage of abstentions</td>
<td>0.8%</td>
</tr>
</tbody>
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During the quarter Aberdeen Standard Investments met with and discussed ESG issues with over one hundred companies. The chart below offers examples of companies that have been engaged with and the specific ESG topics discussed.

Engagement summary Q4 2018

- Human Rights: 35%
- Labour Issues: 16%
- Environment: 14%
- Bribery & Corruption: 10%
- The Board: 10%
- Values and Business Practices: 8%
- Remuneration: 3%
- Accountability and Audit: 4%

Source: Aberdeen Standard Investments
During the quarter, Aberdeen Standard Investments met with and discussed ESG issues with over 100 companies. The table below offers examples of companies that have been engaged with and the specific ESG topics discussed. © owned by each of the corporate entities named in the respective logos. Companies selected for illustrative purposes only to demonstrate the investment management style described herein and not as an investment recommendation or indication of future performance.

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Our voting is disclosed on our website each month

Bayer

Andrew Mason

Bayer AG produces and markets healthcare and agricultural products. The company manufactures products that include antibiotics, central nervous system drugs, over-the-counter medications, diagnostics, animal health products, and crop protection products.

We met with the company several times over the year. During previous meetings we have discussed the company’s approach to Neonicotinoids; its views on genetically modified organisms; and how the group believed regulation would affect the transfer of generic materials across borders. The key area of discussion was the company’s recent acquisition of Monsanto. Bayer announced the completion of the purchase in June 2018 for US$63 billion. Monsanto’s focus is agrochemical and biotechnology. We asked the company what synergies it would achieve, and whether merging the culture of both companies would create challenges. The company said that the chemistry and biological expertise of Bayer combined with Monsanto’s seed and trade offering created positive synergies. It also highlighted future opportunities in digital farming, which provided positive aspects in tackling climate change. This is an area we will continue to monitor.

We questioned the company on Monsanto’s product Roundup, an herbicide whose main ingredient is glyphosate. This is the subject of an ongoing legal dispute. A case was brought citing a number of scientific reports including the International Agency for Research on Cancer, part of the UN World Health Organisation. It classified glyphosate as a probable carcinogen. The case was brought by a terminally-ill user of Roundup who claimed that his illness was a result of the product. The court found that Monsanto acted with malice and that its product led to the plaintiff’s illness. This resulted in punitive damages of $US290 million awarded against the company. The company has questioned the scientific findings brought during the case and is contesting the court’s ruling. We continue to monitor the case closely. This includes studying the differing scientific findings/opinions about the carcinogenic properties of glyphosate.

We asked the company how it trains customers using its products, particularly products that could have negative impacts if misused. The company detailed an extensive set of training practices and instructions to users of its product. It stated that it is the misuse of the product - not the product itself - that is most likely to leads to negative outcomes. It has focused its agriculture education to areas that have lower education standards. Training extends beyond use of the product and also includes areas such as the correct crop rotation and types of irrigation.

The company faces a number of headwinds. However, we were encouraged by its transparency in relation to the court case linked to glyphosate, particularly as the case is subject to ongoing legal proceedings. We will continue to monitor its progress and reengage with the company in 2019.
BHP Billiton is an international resources company. Its principal business lines are mineral exploration and production, including coal, iron ore, gold, titanium, ferroalloys, nickel and copper concentrate. It also engages in petroleum exploration, production, and refining.

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We have had numerous engagements with the company. These have primarily focused on the impacts of the Samarco disaster and what steps the company is taking to address the issue. In 2015, the Fundão tailings dam, operated by Brazilian mining company Samarco in a joint venture (JV) with BHP, collapsed. This resulted in the loss of 19 lives, the pollution of waterways and damage to surrounding farmland. Since the incident, we have discussed the remediation steps BHP is taking and the measures it has in place to prevent future incidents, particularly in operations that are JVs.

We have been encouraged by the steps the company has taken, including the level of disclosure to investors on actions to address the subsequent social and environmental impacts of the dam breach. This has included the establishment of the Renova Foundation, which sought to support local communities and develop infrastructure. We expect further detail on the potential legal implications of the breach later in the year.

The focus of our meeting over the Q4 was the release of BHP’s inaugural water report for 2018. This details the company’s approach to water stewardship and the strategy it adopted in 2017 to use water in a sustainable way. The company is addressing challenges beyond water scarcity. It is also considering how to manage physical risk presented by extreme weather events, competition for water resources and types of water required by various stakeholders, including local communities. The company has adopted this approach across its assets and the differing water risks have been assessed in relation to these assets.

BHP has detailed five key pillars of its strategy. These are:

- establishing risk mechanisms;
- leveraging technological advances;
- effectively valuing the use of water in its operations;
- publicly disclosing its activity; and
- collaborating with stakeholders to improve practices.

We support the work BHP Billiton is undertaking in this area. However, both the company and sector will need to take further steps to fully meet sustainable water practices. We will continue to collaborate with the company and encourage best practice.

Over the years, ASI has engaged with numerous companies across different sectors in relation to water management. This has included collaborative engagement with the Principles for Responsible Investment. We believe that the mismanagement of water resources could present the ultimate ‘tragedy of the commons’ – an economic problem in which every individual seeks to reap the greatest benefit from a given resource, leading to an outcome that damages the overall social welfare. This year we are increasing our focus in the area and will offer an update on our progress late in the year.

“We believe the mismanagement of water resources could present the ultimate ‘tragedy of the commons.’”

Companies chosen for illustrative purposes only to demonstrate our ESG Investment process and are not intended to be an indication of performance.
Citigroup
Fionna Ross

Citigroup is a US-based diversified financial services holding company. It provides a broad range of financial services to globally-based consumer and corporate customers. These services include investment banking, retail brokerage, corporate banking, and cash management products and services.

We spoke with Citigroup about compliance issues, given the group's exposure to business-related fines over the past few years. We also asked about its cyber security and its exposure to climate-change risks.

In terms of compliance, Citigroup has had a number of fines for issues ranging from overcharging credit card customers to failing to implement sufficient anti-bribery and corruption procedures. Citigroup has taken steps to mitigate its risk in this area. Namely, over the past seven years it has tripled the number of employees in its regulatory and compliance divisions. Citigroup also states that the vast majority of the fines it had received were for events that took place around the banking crisis (2008) or resulted from regulations that emerged in the 2-3 years following that period. The anti-money laundering cases that were flagged at the start of 2018 largely relate to activities that took place sometime ago. The group's board has said that it has zero tolerance for wilful violations of the law. It expects all employees to adhere to its internal policies and procedures. Following the financial crisis in 2008, the group shifted its compliance function from being a legal one to more of a control function. Its chief compliance officer reports directly to the CEO, as does the group's chief risk officer. This means the CEO has greater visibility on any issues that may arise.

With regards cyber security, Citigroup has ample expertise on its board for oversight of these issues. The group implements wide-ranging training for its employees on data protection and security. Citigroup maintains three lines of defence for cyber security and invests heavily in counter measures for data theft and data loss.

In terms of climate change, Citigroup is a member of the United Nations Environment Programme Finance Initiative. As such, it has undertaken climate scenario analysis. It has looked at three different global warming scenarios in order to determine corresponding physical risks and transition risks. In the climate scenarios, the impact from transition or physical risks tends to be medium to long-term. This is less risky for financial institutions, as it gives them time to adapt and make changes to their business models. However, over time banks will need to make changes to their loan structures. Citigroup is currently working on its own dedicated Task Force on Climate-related Financial Disclosures reports, which it hopes to publish soon. Its board is fully engaged and continues to have oversight not only of climate change risks and environmental issues, but also of human rights concerns.

We will continue to engage Citigroup on its key material issues and escalate any areas that may affect its longer-term performance. We are encouraged by the group's work and look forward to seeing its publication under the TCFD guidelines.

"Its chief compliance officer reports directly to the CEO, as does the group’s chief risk officer. This means the CEO has greater visibility of any issues that may arise"
Finnish retailer Kesko operates in Finland, Sweden and a number of the Baltic States. It is primarily involved in the food and building sectors. In the food retail market, it operates through a ‘chain’ model. This is similar to a franchise arrangement, where independent retailers run the stores with support from Kesko. This includes buying power and marketing services.

Since early 2017, we have engaged with the company on board composition and the board nominations process. We initially spoke to the company secretary and followed this up with a letter to the chairman. The K Retailers’ Association (KRA), which represents the independent retailers, is a major shareholder and effectively controls the board nominations process. We were concerned that this was not a transparent or formalised process and appeared to give too much influence to the KRA. In terms of board composition, the KRA fills the role of chair and has two other representatives. This gives KRA three of the seven board seats.

During this quarter, we spoke with the board chairman. This was the first time he has engaged with independent shareholders. We had a broad discussion on ESG matters, including board oversight of strategy, the approach to risk management and its ESG disclosures. The main focus, however, was to get a more detailed understanding of the board nominations process. We discovered that a search firm is involved in finding candidates. The chairman then interviews these individuals and liaises with the KRA, which is responsible for proposing the directors at the AGM. This is a more formal process than we realised. However, the chairman is a representative of the KRA, while the wider board does not seem to be involved.

We were pleased to hear that the board had discussed our letter and that they are considering how to improve the nomination process. This could entail appointing a board nomination committee or shareholders’ nomination board. Either of these would allow wider input into the process. They will also improve transparency.

We noted that board members serve three-year terms. The Finnish Governance Code suggests members should face annual elections. We did not sense that the company was minded to change this arrangement, although we will continue to raise this in future engagements.

We hope our input will result in improvements to the board nominations process. This would enable the board and non-KRA shareholders to become more involved in board development. We will monitor progress as the next AGM approaches.

“We were pleased the board had discussed our letter and that they are considering how to improve the nominations process”
Naspers
Fiona Manning

Naspers is a South African-headquartered internet and media group which also invests in technology companies around the world. The group has six business areas: Classifieds, Payments, B2C, Ventures, Video Entertainment, and Media. Group subsidiaries include MultiChoice and Media24. Naspers also makes investment in technology companies, such as Tencent, the Chinese multinational conglomerate.

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ASI's emerging markets team invested in Naspers in early 2018. It has engaged with the group several times on its governance issues. This has focused primarily on Nasper's governance structure, remuneration policy and transparency on governance practices. We aim to help Naspers improve in these areas to help its longer-term business continuity and valuation.

The board currently consists of a mix of long-serving executives and more recent appointees; 13 board members are non-executive directors.

As for remuneration, we highlighted that long-term incentives have not been based on group performance. Vesting for board members’ plans is also less than three years. Non-execs are also paid extremely well for their participation.

The group depends on the performance of its tech investments for board member’s remuneration packages. This is less than ideal. For example, the board was handsomely rewarded for Tencent’s strong performance last year. We are concerned this type of investment does not add value to the overall business. We would prefer the group to focus on the profitability of its business areas and believe board remuneration should reflect the success of these divisions. This should also be linked directly with group strategy. Naspers sees its future in e-commerce and is transforming into a fully online business – a strategy that shows clear profit potential.

Naspers said it faces challenges retaining board talent and has offered attractive remuneration packages to offset this risk. However, the group is making strides to improve remuneration disclosure. It is making improvements in its overall governance structure – efforts that we appreciate and acknowledge. The company has come a long way in terms of engaging shareholders on its governance issues. Progress may take time; however, we feel the engagement is taking place and is bearing fruit.

“Naspers is making improvements in its overall governance structure – efforts that we appreciate and acknowledge.”

Companies chosen for illustrative purposes only to demonstrate our ESG Investment process and are not intended to be an indication of performance.
In April 2018, we attended the AGM of UK housebuilder Persimmon. This was to voice our concern at the amounts likely to be paid out under a long-term incentive plan, which had the potential to set a new high watermark in UK public market pay. The controversy surrounding the plan had by then cost the jobs of the company chair, Nicholas Wrigley, and the chair of the remuneration committee, Jonathan Davie.

In June, Roger Devlin joined the company's board as chair and we took the opportunity to meet with him over a month later. Despite being new to the company and the role, Mr Devlin showed a strong grasp of the company's activities and the issues that the pay controversy was causing.

Our principal concern was the impact that such an excessive payment would have on the stability of the executive team. We also questioned how the board could mitigate the risk of one or more sudden departures, as well as considering a longer-term succession plan at the top of the company. At the same time, we had significant doubts about the suitability of CEO Jeff Fairburn to remain in such a prestigious and responsible role within Persimmon, a company that boasts a leadership role in UK housebuilding.

We had a long and fruitful conversation with Mr Devlin and some of his board colleagues. We undertook to maintain contact with a view to helping the company navigate some of the obstacles ahead.

In November, Persimmon surprised us by announcing that Jeff Fairburn had been asked to leave the company. In addition, the board had acted to restrict, where possible, the potential reward available to him on his departure.

This episode has highlighted the dangers to a company's reputation, operations and leadership stability from the adoption of controversial governance arrangements, often manifesting themselves as excessive executive remuneration. Persimmon had been in danger of becoming a byword for corporate excess. Instead, the swift and decisive actions of a new board chair have gone a long way to rebalance the influence on the board between the executive on and the non-executive directors. We hope this will enable Persimmon to put the pay issue behind it and for the company to enjoy a successful future.

“CEO, Jeff Fairburn, had been asked to leave the company. The swift and decisive actions of a new board chair have gone a long way to rebalance the influence on the board.”

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Royal Mail Plc
Deborah Gilshan

Royal Mail Plc is a FTSE 100 company. It provides postal and delivery services in the UK and parts of continental Europe.

During Q3 we had a constructive meeting with the previous Chair of Royal Mail, Peter Long, in the immediate aftermath of the 2018 annual general meeting. Here, the advisory vote on pay was heavily defeated because 70% of shareholders, including Aberdeen Standard Investments, voted against it. There was also a high level of dissent against the chair’s re-election, with only 60% of shareholders voting in support.

Mr Long stepped down shortly after our meeting to concentrate his efforts at Countrywide, where he is executive chair. We recently met with the new chair, Les Owen, and Orna Ni-Chionna, the chair of the remuneration committee and senior independent director. This was to help us understand how the board was addressing shareholder concerns over remuneration and wider governance issues. We also sought to understand the process that led to the abrupt departure of the previous chair. During the quarter, the company also issued a trading update, setting out the current challenges the company faced. In addition, the chair of the remuneration committee appeared before a House of Commons Select Committee to discuss remuneration decisions made by Royal Mail. We visited the headquarters of the company to view the new CEO’s service contract to understand the arrangements in place for him. In addition, we and our equity colleagues met the new CEO and the chief financial officer. Our goal was to understand the company’s strategy and current performance challenges.

Our discussions have focused on board governance issues, remuneration outcomes, corporate culture and the importance of rehabilitating Royal Mail to its shareholders and to wider society. This is particularly important given the high profile nature of the governance issues and the need to maintain Royal Mail’s reputation as a respected British institution. A key focus of these discussions has been the arrangements put in place to buy the new CEO out of his previous service contract with a subsidiary company of Royal Mail, and related disclosures. In addition, we sought to understand that actions the board was considering in response to the defeat of the advisory vote on pay. We again stressed the accountability of the board for the failure of the advisory vote. We discussed succession planning for the executive and non-executive members of the board, the challenges of changing corporate culture and the Board’s relationship with their wider stakeholders. This includes employees, customers and trade unions.

As one of their largest stakeholders, we will continue to engage with the board of Royal Mail.

“Our discussions have focused on board governance issues, remuneration outcomes, corporate culture and the importance of rehabilitating Royal Mail to its shareholders and to wider society”
RWE
Rosie French

RWE AG generates, distributes and trades electricity to municipal, industrial, commercial, and residential customers. It does so via Conventional Generation and Renewables, the latter stemming from a 60% stake in Innogy, a business which RWE spun-off in 2018. Within Conventional Generation business, the group generates electricity through nuclear and coal assets. The Renewables business is the third largest renewables player in Europe by generation capacity. We engaged with RWE on three occasions during the second half of 2018.

The first engagement was to gain insight into a legal case in Germany around the expansion of a key lignite mine, Hambach. We discussed the group’s approach to managing the impact on local communities and the environment from such expansions, as well as the impact that a ruling against further expansion would have on RWE’s electricity generation capacity, strategy to reduce carbon emissions and financial performance. We were comfortable that the group’s approach to mining was in line with environmental legislation, that RWE took great pain to minimise any negative community impacts and paid particular attention to site rehabilitation. However, the meeting did imply that there was greater risk to the investment case than before.

We encouraged the RWE to wait until the Coal Commission ruled on the phase-out of carbon before proceeding. In the event, no final ruling was made as the case was sent to a higher court. The outcome is not anticipated until 2021.

During our second engagement, we met with the head of sustainability. We received an update on the Hambach mine expansion and concurrent legal situation before broaching the topic of the group’s sustainability strategy and governance relating to this issue. On the Hambach mine, the company reiterated that the financial risk from a negative outcome to the ongoing legal case would be more material than previously expected. It also said that the timeline for certainty on the case would be pushed out by several years. With regards to RWE’s ESG strategy, we were concerned by a lack of internal communication on the group’s sustainability strategy. This included how it applied to each business division or individual plant or asset. As a result, we expressly encouraged RWE to align its sustainability strategy with the overall group strategy, given the materiality of sustainability issues such as climate change, carbon emissions and deforestation to RWE’s business and to improve communication and training on these issues.

During our third meeting, we spoke to RWE’s CFO about the group’s preparation for the energy transition in relation to their Renewables asset deal, as well as its preparation for a potential 2030 coal phase-out mandate from the German government. We encouraged RWE to ensure a robust assessment and analysis of the business and financial impact should the German government mandate the phase-out. RWE suggested that it would be capable of responding to different dates for coal phase-out. We highlighted that many European countries were targeting the 2030 phase-out and that we would encourage the group to be as ambitious as possible in its attempt to reach this.

“We expressly encouraged RWE to align its sustainability strategy with the overall group business strategy”

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TUI
Peter Silver

TUI is the world’s largest tourism service provider, with operations in airlines, travel agencies, cruise ships, resorts and hotels across Europe.

The company is currently expanding its Destination Experiences business. A crucial part of this growth is through digitalisation. This will provide customers with a more end-to-end digital booking process through a global CRM customer relationship management (CRM) platform.

We asked the company how it had changed its risk mitigation, through cyber security, as it expands its digital platform. We also discussed the environmental impact of its airline and cruise businesses, and how it kept its 66,500 workforce engaged.

The company provided details of its information security statement and strategy for the business. It highlighted the level of staff oversight and a clear line of escalation to the executive team. The company also introduced new priority programmes to improve the level of awareness and measurement of secure behaviours for all staff. This included ensuring strong controls on the most critical systems.

TUI leads the pack ranking as one of the most carbon-efficient aircraft fleets in the world. It also continues to invest in more modern aircraft. This should improve carbon efficiency by a further 15%.

For 1 January 2020, TUI will need to ensure its ships meet the IMO2020 regulations. Thanks to scrubbing technology, a number of TUI’s fleet already meet this requirement. However, a number of other ships need work. The vessels being built for launch in 2024 and 2026 will be fuelled by liquefied natural gas. This shows that TUI is taking pre-emptive action before a shift in the types of fuel used in the industry.

Due to the scale and geographic reach of the workforce, employees are key to running the business. Internal engagement surveys show positive results and underlying staff turnover is relatively low across the company.

The engagement provided a better understanding on how the company was dealing with the emerging risks it faces. However, we have arranged a follow-up call in Q1 2019 to discuss cyber security and labour management. These are both fundamental to the company’s growth strategy. Once these additional factors have been considered, we will amend our internal ESG rating.
We engaged with XPO to enquire about employee allegations that had been made against New Breed regarding pregnancy discrimination. Specifically, the allegations focused on claims that women working at the group’s Memphis facility lost pregnancies after employers denied their requests for light duty. The allegations were made prior to XPO’s acquisition of the group in 2014.

Surprised by the allegations, XPO undertook an investigation going back over four years to find any evidence (including recorded compliance reports and employee files) of the allegations. It found that no record existed of any claims made against New Breed. There were also no reports made of issues to the management teams at XPO. There has been a reporting hotline available to employees for a number of years and we would have expected some record had the claims been made against New Breed.

In reviewing its past records, XPO also reviewed its current accommodation policies, its non-retaliatory and its non-discrimination policies. This was to ensure it has robust and up-to-date practices. A third party also reviewed the group’s policies for completeness. This third-party reported that XPO’s policies either met or exceeded legal requirements.

Given that XPO operates 813 facilities globally, it places emphasis on ensuring that its employees work in a safe environment – especially its female employees. The group also works hard to maintain a culture that values dignity and respect. XPO believes that its employees should feel safe in any environment. As such, it has a strict non-retaliation policy and provides ongoing training to employees on the different reporting channels they can go through. Training is also given to managers on how to properly work with pregnant employees to adjust work assignments and schedules. Once XPO becomes aware of any allegations against it from a labour perspective, the group retains outside counsel to conduct an internal investigation. If there are particular issues found at any one site, the group sends out its most senior executives to visit the location.

Ultimately, we found that XPO provided assurance that there is no neglect on its part regarding labour-related claims and no proof that the alleged occurrences had taken place. XPO also demonstrated that it had taken steps to ensure that its existing policies are sufficient for preventing this type of discrimination. Its employees are also aware of reporting channels and of XPO’s non-retaliation policy. Going forward, XPO plans to establish ESG-related metrics and report on these under a globally accepted framework next year.

“XPO Logistics works hard to maintain a culture that reflects dignity as well as respect.”
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