SUSTAINABLE TRENDS

Sustainable Insight CAPITAL MANAGEMENT

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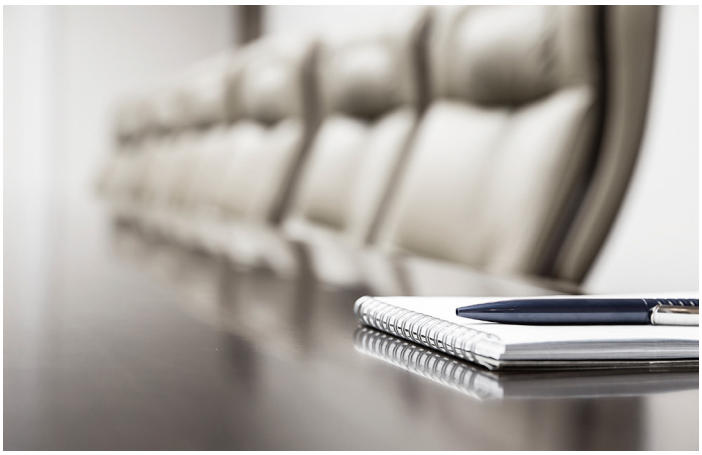
GOVERNANCE ISSUES TAKE FRONT AND CENTER

Tax planning, successing planning and gender all move up corporate agenda; Japan expands governance requirements for GPIF

In the final quarter of 2014 we saw more institutional investors ask if tax payments belong in the conversation about corporate social responsibility. Similarly, UK regulators made a move to tighten governance rules over growing concerns of having unique expertise at the board and executive level. And while the gender wealth gap widened in Australia, we saw more women in the boardroom this year. Meanwhile, Japan's GPIF may be catalyst for change in corporate Japan.

G20 countries of the OECD Base Erosion and Profit Shifting (BEPS) Action Plan approved a plan to require the exchange of tax information by the end of 2015 in order to deter cross-border tax evasion. The International Trade Union Confederation (ITUC), the world's largest trade union federation, led an effort by unions to urge asset owners to step up pressure. ITUC says that pension funds have a moral and fiduciary duty to respond to the tax issue: "Fair and appropriate tax payments and management of tax risks must be incorporated as part of responsible investment policies. Tax is not an external cost to be avoided but a legitimate payment that helps create sustainable long-term value."



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This comes on the heels of a new report by the Tax Justice Network and the union United Voice, which shows that nearly a third of companies are paying less than 10 per cent tax. A 2012 report by IBIS and Global CSR says it is becoming increasingly difficult to argue that tax should not be part of the corporate responsibility agenda, and that including responsible tax behavior would "help create a global level playing field of value to corporations as well as societies". (Sustainable Insights: Edition 62)

SUCCESSION PLANNING

UK regulators hope to tighten company succession planning guidelines. In the fourth quarter investors criticized retailer Tesco for leaving vacant the spot of financial director for several months. The director of corporate governance at the Financial Reporting Council (FRC), David Styles, said: "Board succession planning and the quality of management are very important, and it is not just at chief executive level, but throughout companies too."

The need for a clear succession plan also came to the forefront after Christophe de Margerie, the CEO of French oil group Total died in a plane crash in late October. The FRC will publish a recommendation on succession planning, hoping to strengthen guidelines and policies. (Sustainable Insights: Edition 66)

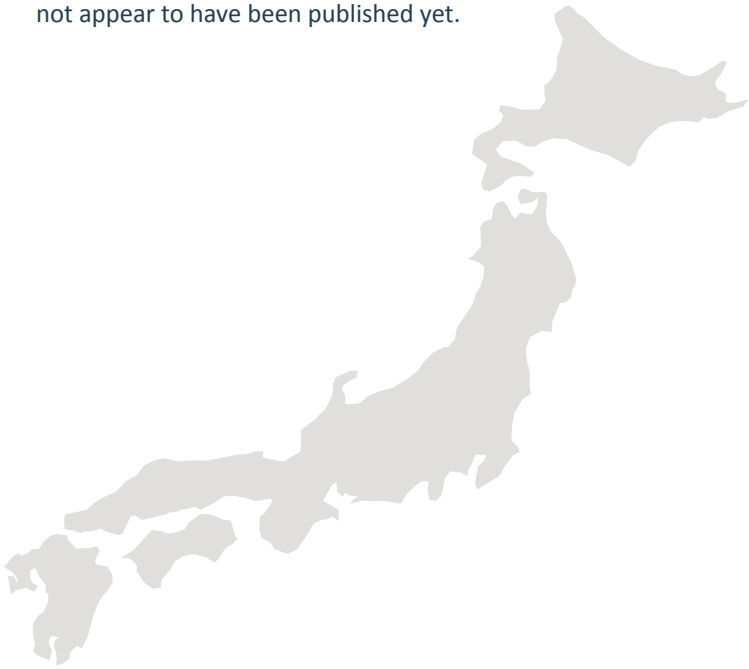
GENDER EQUALITY AT THE BOARD LEVEL

Women are taking a seat in the boardroom. A new analysis by the Wall Street Journal and MSCI Inc. found that approximately 54% of the 67 companies in the Standard & Poor's 1500 Index with a female CEO now have at least three women on the board. Roughly 15% of firms led by a man have at least three women on the board. The study also found that women comprise 15.8% of S&P 1500 boards, up from 12.5% in 2009.

However, another study by economists at Curtin University in Australia found that Australia's gender wealth gap has widened sharply over the past decade leaving single young women with "a little over half the average assets of their male counterparts". The research found that the difference in average wealth between single men and single women across all age groups grew from $18,300 to $47,000 between 2002 and 2010. (Sustainable Insights: Edition 68)

JAPAN MOVE TO IMPROVE CORPORATE GOVERNANCE

Under the leadership of Prime Minister Shinzo Abe, the Government Pension Investment Fund of Japan (GPIF) is making a push to improve corporate governance and raise the return on equity for shareholders for the USD 1.1 tn fund. A third-party report on the governance of the fund–which will emphasize making the fund more independent, more transparent, and more activist–was expected to be made public this quarter but does not appear to have been published yet.



> "After 20 years of a deflationary mindset, Japan Inc is too conservative and is hoarding too much cash, rather than investing and contributing to Japanese growth."
>
> -Yusuhisa Shiozaki, Minister of Health, Labor and Welfare

Critics fear that this push may mean the government is even more involved in the financial markets. But others, including the Minister of Health, Labor and Welfare, Yasuhisa Shiozaki, believe that "after 20 years of a deflationary mindset, Japan Inc is too conservative and is hoarding too much cash, rather than investing and contributing to Japanese growth." (Sustainable Insights: Edition 67)

WATER: POLITICAL AND CORPORATE HOT BUTTON

The National Oceanic and Atmospheric Administration reported in October that California's severe drought would "likely persist or even intensify in large parts of the state". The drought, which has lasted nearly four years, is expected to continue, despite higher than average predicted rainfall this winter. "Complete drought recovery in California this winter is highly unlikely," said Mike Halpert, acting director of NOAA's Climate Prediction Center. Agriculture is feeling the burden. It is expected that due to drought, up to 25 percent of the rice crop could have been lost in 2014.

A recent NASA analysis found that it will take about 11 trillion gallons of water (42 cubic kilometers)–around 1.5 times the maximum volume of the largest U.S. reservoir–to recover from California's continuing drought.

Meanwhile, residents in Sao Paulo have also been experiencing shortages in their water supplies. Sixty percent of residents have experienced some restrictions on water supply in September. This comes at the heels of a highly contested election. President Dilma Rousseff–days before the Oct. 26 runoff election against Aecio Neves–increased attacks on the state's handling of this water crisis.

Is it time for new water standards? The ISO Water Footprint Standard hopes to simplify and streamline water reporting though the organization is still working on solidifying a definition of a water footprint. (Sustainable Insights: Edition 65)

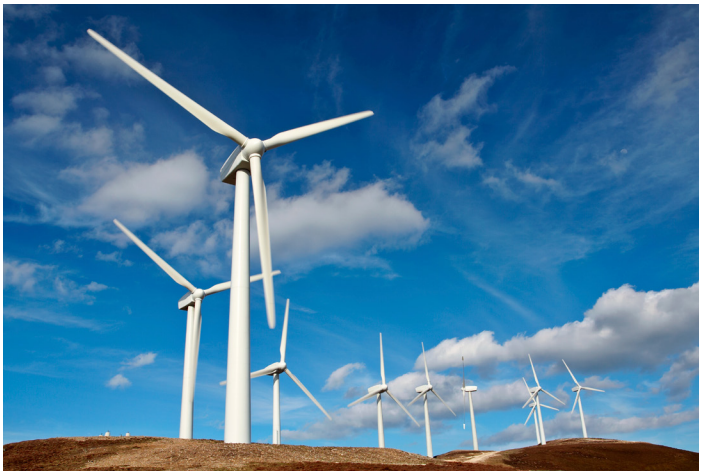
> ***In every sector, the demand for water is expected to increase and analysis suggests that the world will face a 40% global shortfall between forecast demand and available supply by 2030.***
>
> -World Economic Forum Global Risks Report 2014

Meanwhile, water is moving up the corporate agenda as many industries face water scarcity, quality and availability threats. Water quality, quantity and regulations affect companies across many industries. Shortages are not only affecting brewers and soft-drink producers, whose products are made of water, but also those that use millions of gallons in their industrial processes. Shortages impact almost all firms that do business in water-stressed countries, which include China and India.

CDP warns they may not be reporting the risks. According to a CDP survey that was published in Q4 2014, "two-thirds of respondents think water risk could produce a substantial change in their business, mostly within three years." According to CDP's survey, two of the industries that are most exposed to substantial water risks are oil and gas, and power utilities. (Sustainable Insights: Edition 67)

ENERGY ROUND UP: RENEWABLES MAY REACH PRICE PARITY BY 2020, OIL PRICES DOWN AND WHO IS DITCHING COAL ASSETS

In the fourth quarter we reported on how wind and solar may be cost competitive sooner than expected. Meanwhile, coal mining is causing high concentrations of methane in the US; Some pensions and universities continue to ditch coal assets, but the fossil fuel divestment campaign suffered a setback as Norway keeps oil investments.



Energy consultant Poyry Oyj reported in October that the cost of onshore wind power and solar may fall to the same levels as coal power generation by 2020. "Solar plants in Spain may produce electricity competitive with coal and gas as early as 2021, in Portugal by 2022 and in parts of Italy by 2025", Poyry said. In order for renewables to be competitive with coal increased efficiency in the storage of energy and lower capital costs associated with building clean-power plants is required.

"The revenues of any investment now undertaken with, say, a 30-year economic life will be affected by the build of unsubsidized renewables as typical subsidy regimes are 10 years to 20 years in duration," says a senior consultant at Poyry. (Sustainable Insights: Edition 63)

We may be heading towards energy "price parity" according to a study by Lazard. The cost of utility-scale solar energy is as low as 5.6 cents per kWh, and wind at 1.4 cents. In comparison, natural gas comes at 6.1 cents per kWh on the low end and coal at 6.6 cents. (Sustainable Insights: Edition 70)

SOME INVESTORS DROPPING DIRTY COAL

A new study published in October by the journal Geophysical Research Letters found that a small patch–or "hot spot"– of methane in the US near the intersection of Arizona, Colorado, New Mexico and Utah is the highest concentration of the gas in the US and accounts for 10 percent of all methane in the country. It appears that coal is the culprit. The methane gas is found to be coming from leaks in coal processing equipment, not fracking, as previously thought.

Meanwhile, the Australian pension fund LGS will drop coal assets (subscription required). It has decided to sell its positions in coal companies, saying "climate change is an unarguable scientific reality and a very real investment risk". In addition, Glasgow University announced this week its plans to drop £18M worth of fossil fuel investments. (Sustainable Insights: Edition 63)

In response to recent negative news, the coal industry is waging a war against skeptics, with some emphasizing coal's importance to global economies. "Mining is the largest earner of export income

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generating more than USD 200B in much-needed revenue for our country, a country in record debt" said Gina Rinehart, who's company is behind a new USD 8.5B mine in Western Australia. (Sustainable Insights: Edition 70)

In addition, Australia's Queensland state will support plans for the nation's largest coal project. The state will help fund a 388-kilometer (241-mile) rail line to link a coal project to the port of Abbot Point near the Great Barrier Reef. Secondly, India's Prime Minister Narendra Modi made a speech in Australia, asking the country to supply India with energy—coal and natural gas—as the country continues to develop. He also supported the growth of renewables. (Sustainable Insights: Edition 69)

DIVESTMENT SETBACK

Although the source of the Norwegian Government Pension Fund's wealth is built on the back of oil revenues, an expert panel (subscription required) reviewed whether it should divest from fossil fuel companies (see Sustainable Insights: Edition 55). The panel recommended that it remain a shareholder in fossil fuel companies, encouraging the world's largest sovereign wealth fund to become more active on environmental issues, particularly on issues relating to climate change. This is a setback for the fossil fuel divestment camp, which has chalked up a number successes recently. It's difficult to ignore an investor which owns the equivalent of nearly 1.5% of every listed company in the world. (Sustainable Insights: Edition 70)

However, KLP, the Norwegian insurer and asset manager has announced that it will divest NOK500m (USD 73M) from companies (subscription required) which have a high exposure to coal. It plans to put the assets into renewable energy following a review prompted by a client. It defines coal companies as coal mining companies and coal-fired power companies which derive a proportion of their revenues from coal. (Sustainable Insights: Edition 69)

WHAT'S NEXT?

Are we entering an era of energy abundance? Increased domestic production of oil and gas is reducing the U.S.'s reliance on energy imports. In fact, imports are expected to provide just 21 percent of US liquid fuel consumption in 2015, down from 60 percent ten years earlier. In addition, supply from Opec regions is up, despite supply lagging due to a sluggish economy.

In a recent meeting, OPEC decided to maintain its production target for the first half of 2015. However, some longer-term trends–including an increase in demand for energy–suggest that resource constraints will re-emerge in the foreseeable future. (Sustainable Insights: Edition 70)

SPOTLIGHT ON SECTORS: AUTOS, INSURANCE, FINANCE

AUTOS

Are auto makers the new big oil? Several automakers were slapped with investigations in the fourth quarter. In China, a car maker was ordered to pay for a violation of the Anti-Monopoly law (subscription required). China has simultaneously been battling worsening air pollution, which is further restricting new car registrations in major cities. Meanwhile, in the U.S. the Environmental Protection Agency and Justice Department recently reached a settlement with two auto makers that emitted 4.75 million metric tons of GHG emissions over what they had said they would release. Both companies will need to pay a civil fine. (Sustainable Insights: Edition 67).

INSURANCE

It appears the insurance industry has "quietly engaged in what looks like a retreat." Given the increase in weather disasters and the bleak outlook for coastal properties, insurers are backing out of markets they are deeming not profitable. In a new report, sustainability advocate Ceres writes: "Over the past 30 years annual losses from natural catastrophes have continued to increase while the insured portion has declined." According to reinsurer Swiss Re, less than one third of $116M suffered in damages from weather, less than one-third was covered by insurance. What does this mean for public institutions and local communities? (Sustainable Insights: Edition 65)

Meanwhile, regulators are warning the U.S. insurance industry to start paying attention to the climate change risks that face their clients' policies and investments under management. Myron Kreidler, the insurance commissioner for the State of Washington urged insurers not to rely on "what they've done historically". The National Association of Insurance Commissioners have been monitoring climate change for almost a decade and has been instrumental in the movement to push all insurers to consider climate change risks including the close monitoring of building codes.

In addition, quarter four brought to light some of the toll that climate is bringing on property values in coastal cities in the U.S., especially considering the lifetime of a 30-year mortgage. The Risky Business report–a collaboration between Michael Bloomberg, Tom Steyer and Henry Paulson– noted that with potential increases in the number of and intensity of hurricanes, the total annual price tag for coastal storms will increase to about USD 35 billion. (Sustainable Insights: Edition 73)

FINANCIAL INDUSTRY

Green bonds–the fixed income investment product structured to raise capital for green, low-carbon, renewable energy investments–was expected to reach USD 40 bn in value in 2014. Although Zurich Insurance has doubled its investments in green bonds this year, it noted that the industry is at risk if it doesn't come to a consensus on the definition of a green bond. "In capital markets, trust is key. If there is going to be a lot of 'green washing', this market will die," Reyes said at the insurer's headquarters in Zurich. "It's in our best interests to safeguard the integrity of this market, otherwise it will be a one-time show," she said. (Sustainable Insights: Edition 71)

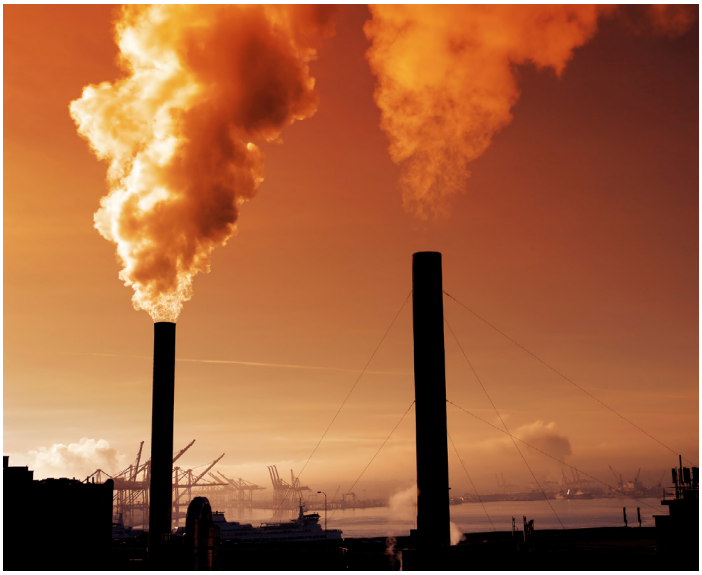
The Euro 23bn PensionDanmark has attacked the dramatic rise in green bonds, at an OECD Roundtable on Long-Term Investing (see Sustainable Insights Editions 64 & 60). It raised questions about the difference between green and mainstream corporate bonds. Meanwhile, Japan has been criticized for providing USD 1bn of loans to Indonesian coal-fired power plants under a UN climate finance plan. The Japanese Government responded that the financing was used for a more efficient power plant replacement. (Sustainable Insights: Edition 64)

CLIMATE CHANGE COMMITMENTS

Activity in Q4 will keep us on our toes for what's to come

This quarter the EU urged member states to move toward low-carbon economy, but businesses are at odds about carbon allowances. China and US announce a commitment to curb Greenhouse Gas emissions by 2030 or earlier. Hopes were high that the Lima conference would pave the way for Paris 2015. But were they realized?

The The European Union made progress in October towards a deal that will help its member states transition to a low-carbon economy by 2030. A summit brought together energy and environment ministers from 28 member states to discuss a deal on policies that will support a low-carbon economy and increase energy security. Ed Davey, the U.K. secretary of state for energy and climate change said in a statement: "There's a real sense that a deal can be done and a real determination to try to get a deal done. There's still quite a deal of diplomacy to be done, but we're narrowing down on the differences."



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Meanwhile, business groups in the region are divided about reforming the Emissions Trading System (ETS) at a time when the carbon trading market in Europe is coming under scrutiny. Eliciting mixed reactions, the European Commission has recommended putting aside hundreds of millions of surplus carbon allowances, in part to stabilize market shocks and to drive carbon prices up, making them competitive with lower carbon technologies. (Sustainable Insights: Edition 63)

CHINA & US

Just weeks later, China and the US announced a joint committment to reduce GHG emissions. When President Barack Obama and Chinese President Xi Jiping met in Beijing in early November, climate, the military, and visa agreements were on the agenda for their marathon two days of talks. The leaders reached a historic agreement on climate change–a first of its kind for the two nations. The US agreed to double its pace of carbon-dioxide reductions, committing to an overall cut of greenhouse gases between 26% and 28% by 2025 compared with 2005 levels. China, on the other hand, set its goals slightly lower, agreeing to stop its increases in carbon dioxide emission by around 2030. Given China's quick industrial growth, its commitment will still result in emissions "a lot lower than they would be," said an official.

Ed Davey, the UK climate change secretary said about the deal: "We don't have enough information from the Chinese or the Americans to really be clear about the implications of this." Experts and politicians asked for more detail, especially about how the emissions will fall in later years. These climate talks are expected to effectively replace the Kyoto protocol, currently the only binding treaty for reducing GHG emissions. (Sustainable Insights: Edition 68)

G20 COMMITMENTS

Australian Prime Minister Tony Abbott argued that climate talks should happen elsewhere, not at the November G20 meeting in Brisbane. Despite his wishes, several countries committed to raising money for the Green Climate Fund (GCF)–a UN-backed fund that supports developing countries dealing with climate change at the conference. Japan pledged to raise USD 1.5 billion, the U.S. agreed to raise USD 3 billion and the UK pledged approximately USD 1 billion. The fund reached USD 7.5 billion, about three-quarters of the way to its USD 10 billion goal. Italy and Australia have yet to pledge.

Germany and France have previously pledged approximately USD 1 billion each for a first round of funds for the GCF. The countries are now preparing for another summit in Paris next year—devoted entirely to the climate. (Sustainable Insights: Edition 69)

IPCC REPORT

The IPCC's 5th report, released November 2nd, noted that it is "extremely likely–probability of over 95%– that climate change is the product of human activity," which strikes a different tone than its first report, released in 1990, which said that it was just as likely as not that climate change was due to natural variability.

The report also noted that climate change has greatly impacted natural systems but has not had the same impact to human welfare. For example, the report cited "low confidence" that the increase of flooding is linked to climate change while impacts to human health are not well quantified. The impact to agriculture has been mixed, with production of some crops, such as maize, down, but rice yields are up. More analysis here (Nov. 5 episode)

Meanwhile, the UN released a report in November saying "governments can keep climate change in check at manageable costs but will have to cut greenhouse gas emissions to zero by 2100 to limit risks of irreversible damage". (Sustainable Insights: Edition 67)

WHAT'S NEXT FOR CLIMATE TALKS?

The Lima Conference in December 2014 aimed to provide detailed guidelines about emission commitments, so that they could be scrutinized before the December 2015 Paris Conference. On this issue there was some success. This is the first time all countries agreed to cut greenhouse gas emissions (but not until 2020).

Leading economies will publish detailed information about climate action plans by end-March 2015 – the so-called intended nationally determined contributions (INDCs). However, the post conference text mentions the "significant gap" between emission reductions pledged and the level required to adhere to a temperature increase of 2˚C or below. Further, there appears wiggle room in the requirements the countries are obliged to reveal.

The Lima text mentions that actions should reflect countries' circumstances; it is widely understood that this requires richer countries to make the steepest emission cuts. This replaces the simple split of developed and developing nations seen in previous climate change discussions. Developing countries did achieve recognition for the "loss and damage" vulnerable countries face from climate change. Some NGOs have expressed concern that the INDCs should only be "fair and ambitious", suggesting to some that eventual commitments will fall short of what is required.

What will 2015 bring? Will the two weeks of talks pave the way to a meaningful climate change treaty in 2015? Other questions remain. Have the climate talks between China and the US opened the doors for a meaningful agreement? Will India, the world's third largest emitter, which has been aligned with China on climate policy, also promise a meaningful reduction? (Sustainable Insights: Edition 65). The EU and US appear at odds with the former demanding mandatory emission targets while the latter wants more latitude. See Predictions 2015 for more on our expectations for the upcoming year!

FINAL NOTE: QUOTES OF THE QUARTER

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"For a heavily diversified universal asset owner such as a pension fund, which is focused on long-term wealth creation, destruction of such a valuable ecosystem with no comparable alternative makes no sense."

-Freddie Woolfe, associate director of corporate engagement at Hermes Investment Management on deforestation

QUOTES OF THE QUARTER

"And remember, as indexers, we are permanent shareholders. To borrow a phase from Warren Buffett: Our favorite holding period is forever."

-William McNabb, Vanguard's Chairman and CEO, explaining the rational behind the USD 3T mutual fund's decision this week to become a signatory to the UN Principles for Responsible Investment (PRI).