

2010

Engagement Review

Overview July 2009 – June 2010

Summary

The 2009/2010 year was another eventful period for ESG as investors continued to ride the long tail of the global financial crisis, and stakeholders – the market, regulators, consumers and special interests – across the globe struggled to determine appropriate strategies for the post-GFC world.

As at the end of the year (30 June) Regnan owners held around \$54 billion of S&P/ASX200 stock (5.25%). With this investment supporting us, we have been able to extend and deepen our engagement with company directors across this index. We have had productive dialogue and observed improvements in many cases while we continue our contact with others into 2010/2011.

Key themes we discuss in this review include:

1. Board quality
2. Climate change
3. Long-term ownership
4. Executive remuneration
5. ESG disclosure

Our engagement activity for the period is discussed in more detail at page eight. We also include an update on Regnan's people and throughout this report we highlight our priorities for 2011.

There remains a great deal to do.

Australia's superior performance relative to global peers has been a mixed blessing, masking the continuing need for corporate governance improvements in Australia. We may yet – to borrow from Hillary Clinton – waste a good crisis.

Our protection from the GFC's effects owes much to demand for our natural resources; to taxpayer funded stimulus measures and bank guarantees; and to APRA and the RBA; not – by and large – to the unassailable strength of our governance.

The Australian market and its listed companies have benefited enormously from the savings of the Australian workers who, through compulsory super and voluntary savings, have underwritten market growth. Regnan analysis of independent public data since 2001 suggests that in today's dollars, average working Australians invest around \$33 every week across a basket of Australian companies – through the technology wreck of 2001, during the aftermath of 9/11, before and after the China-driven commodities boom and during the oil and food price spikes in 2008 and of course, into the GFC and its continuing consequences. We estimate that superannuation contributions have run as high as 19% of growth in market capitalisation prior to the GFC.

The superannuation industry, as stewards of their members' capital, consequently have a legitimate and a crucial role in requiring companies to be accountable to them for long-term performance factors, and in advocating reforms that enable and ensure such accountability.

Supporting advocacy

In some cases it is clear that there is no advantage to companies that initiate the move to more sustainable practices while their peers continue operating unchanged. Achieving improvement in the threshold for ESG practices through regulatory change or uniform guidelines constitutes a critical part of efforts to lift the ESG performance of the whole market. In addition to our private meetings with stakeholders,

Regnan provides submissions to, and works with, government and regulatory bodies to effect improvements to ESG practices, including the foundational rules upon which these practices operate. Regnan also selectively works with the media to promulgate ESG messages. Detail on our submissions and media mentions for FY2010 may be found at our website: www.regnan.com

A note on our people

Regnan is a service enterprise and is as only as good as its people. We were very pleased to announce that the team formerly known as Monash Sustainability Enterprises joined Regnan as employees effective 1st July 2010. These seven experienced ESG professionals secure important ESG risk expertise, while Regnan will continue to enjoy its relationship with Monash University – a relationship that has grown since 1999 and resulted in multiple ESG innovations.

A loss for the ESG community

It is with great sorrow that we report one of our long-serving ESG analysts, Angelina Lee, passed away in September. Angelina had been battling cancer for some years, and although her health had declined in the last 12 months, her death at age 38 came very suddenly and unexpectedly. Angelina – formerly an engineer with BHP – worked for more than eight years with MSE and Regnan on ESG issues. She was talented, focused and passionate about her work. Her passing was a great loss for the team and the wider ESG community.

Key Engagement Themes July 2009 – June 2010

1. Board Quality

Board performance

Board performance is fundamental to company performance – and to this end Regnan welcomes research from the Australian Council of Superannuation Investors (ACSI) with UTS into board effectiveness and board performance launched in October this year. Most board reports continue to allude to their own performance reviews and training initiatives in general terms without providing the colour that would inform shareowners or build trust with stakeholders. Regnan recalls few companies who augment their “we conducted training” with detail or examples that would enable shareholders to assess the currency of board skills and knowledge.

Regnan believes that a board nomination committee report on the workings and activity of the board could offer investors greater insight and build trust while addressing some of the opacity that underlies calls for annual director elections. If offered as a non-binding vote, it is conceivable that it would develop along the lines of the annual remuneration report, which has proven to be a useful stimulus

for shareowner engagement – despite initial opposition when it was introduced. Regnan will approach company directors on the concept of a board process report, including performance assessment, diversity, renewal and range of skills during the coming year, based on the evidence that board quality is directly correlated with performance (see Charts 1 below and 2 overleaf) and therefore of high priority for shareholders.

Board diversity

A highlight of the year was the long awaited translation of talk about women on boards into action. Regnan congratulates both the AICD and the ASX for their leadership on this issue.

Our three caveats are:

1. that the important work to promote opportunities for greater representation of women on boards should occur under the umbrella goal of improving diversity generally, not gender alone;
2. that companies should not be lulled by initiatives that seek, through targeted mentoring or prescriptive career pathing, to “mold women” into facsimiles of the current director prototype. There is a genuine opportunity to enrich the corporate landscape and improve corporate performance by adapting its frameworks and cultures to authentic diversity; and

3. that the tangible benefits to business from increasing diversity needs greater emphasis. Our own research, based on nine years worth of data, shows a clear positive correlation between Regnan’s proprietary governance ratings, board diversity and business performance.

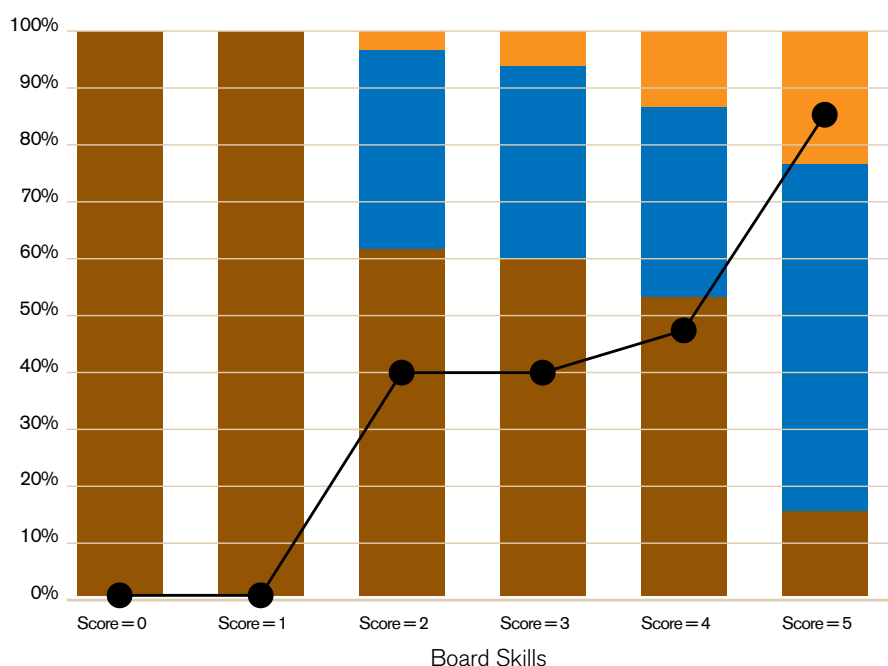
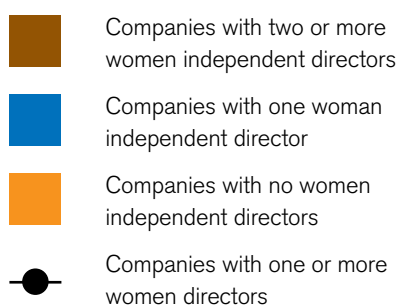
Mix of skills

Regnan notes, notwithstanding the difficulty of accurately capturing the entire skillset of experienced directors, the continuing dominance of lawyers and accountants on boards. We understand that boards require core industry skills and benefit from legal and accounting skills, however in a service economy such as Australia’s, we would expect to see marketing and human resources (for example) more widely represented.

Chart 2 overleaf illustrates the correlation between board skills and superior investment performance as analysed by Goldman Sachs JBWere using Regnan data from 2001 – 2010. It illustrates the performance achieved through a strategy of a long position on stocks with the top half of Regnan’s governance ratings and a short position on stocks with the bottom half of governance ratings.

Chart 1:
Board skills and governance ratings

The chart on the right illustrates that the presence of women on boards tends to be associated with stronger Regnan scores for board skills, a factor shown by Goldman Sachs JBWere to be correlated with stock performance (see Chart 2).



2. Climate Change

While technically occurring as a “post reporting-period development,” Regnan notes that debate on climate change is showing signs of maturing. Nonetheless, the poor quality of debate from non-scientists on the matter has been notable. As a risk-focused business, Regnan continues to support the precautionary principle and notes that climate change preparedness brings a renewed focus on sustainable growth, resource efficiency and technical innovation, all of which have value to long-term owners.

Australian companies include those exposed both to the emissions intensity of our coal-fired energy sector, and those among the most vulnerable to physical impacts of climate change. Our investment portfolios are highly diversified and have long-term horizons. From this perspective, climate change imposes inescapable costs. Research has shown that failure to reduce carbon pollution will be more costly in the long term; to our portfolios, to our beneficiaries and to the economy. Research also shows that significant carbon abatement is achievable and economic. We urge the government to set assertive medium-term carbon reduction targets that reflect these considerations.

A carbon pollution reduction scheme needs to give business and investors policy certainty in the long term and therefore must be robust in meeting current and future climate priorities. Businesses, quite appropriately, will seek to shelter individual operations from the impact of a scheme. Shielding some businesses from scheme impacts will continue to limit their engagement with strategies for competitiveness in a carbon-constrained future. Australian superannuation fund members own entities that would benefit from concessions in the short term alongside others that would bear disproportionate abatement burden as a consequence; and still others that face serious harm if climate change consequences are not averted.

We look forward to clarification on the carbon regulatory framework to help business in setting strategies and committing investment. We note that many directors assure us that carbon pricing is occurring internally within their companies for all major projects, belying the difficulty of carbon pricing implementation within businesses.

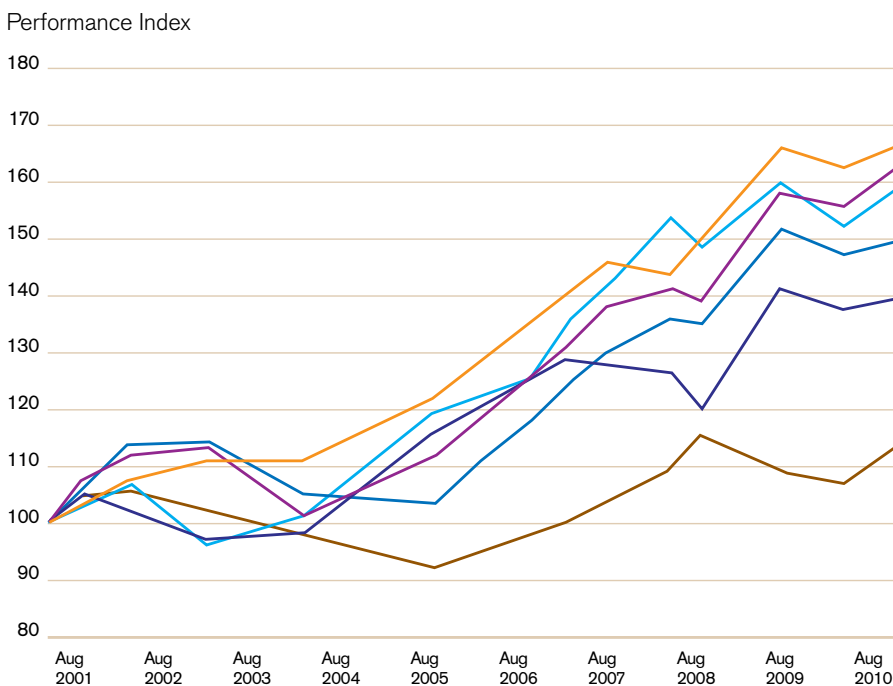


Chart 2: Governance ratings and investment performance

Governance Investment Strategies – Long/Short Median

Strategy:

Long Top Half Governance Ratings / Short Bottom Half Governance Rating
 Median Return Achieved
 Re balanced when new ratings issued

- Overall
- Board Overall
- Accounting
- Audit
- Remuneration
- Board Skills

SOURCE: IRESS, Regnan, GS&PA Research estimates



3. The Role of Long-term Ownership – Are We There Yet?

On paper, Australia has one of the greatest commitments to long-term ownership of any developed market. At the time of writing, signatories to the UNPRI number over 800 globally, with more than 30 Australian asset owners and 60 Australian fund managers as signatories.

Notwithstanding this, core commitments under UNPRI such as active ownership are applied in a limited fashion by the investment supply chain. Most fund managers continue to take the short-term positions that deliver visible short-term investment performance. Where ESG is taken into account to any meaningful degree, those that are informed use the information to trade rather than influence change – as these managers are paid to do. Companies consequently continue to struggle with longer-term decisions because of short-term pressure on their performance.

This situation is suboptimal for the millions of working Australians investing via superannuation, whose money is being invested for the long term via these processes. ABS data shows the average Australian is aged under 37. That means on average they have 28 years until they are able to access their superannuation investment. The assets required to serve

them into their retirement are poorly matched to the prevailing buy-and-sell trading mentality.

When it comes to asset-liability matching, the superannuation industry savings system can do more. The duration over which service providers – whether financial intermediaries or company executives – are rewarded, needs to reflect this longer term. The factors that need to be taken into account in selecting and rewarding service providers – just as for picking stocks – need to be widened. And broader performance characteristics – whether for companies reporting employee engagement or emissions reductions – or the investment industry reporting ESG activities – need to be promoted and reported. To quote Warren Buffet: “Time is the friend of the wonderful company, the enemy of the mediocre.”

4. Executive Remuneration

We have argued in public and in our private engagement meetings for remuneration structures that ensure the interests of executives are aligned with shareholders and disclosure that allows investors to assess what it is the executives are being paid to do. We remain concerned about:

- the phenomenon of board capture in pay negotiations;
- the attribution of performance to executive efforts when they are more likely explained by exogenous factors;

- the risk asymmetry inherent in executives receiving high fixed remuneration *and* cash incentives, with proportionately little in deferred equity or appropriate long-term incentives;
- the regulators' apparent lack of attention to quantum; and
- the “one-size-fits-all” approach to executive remuneration despite different business imperatives, environments, cycles and labour markets.

The Productivity Commission Report on Executive Remuneration was a significant milestone this year and Regnan was active in this process, contributing submissions and giving evidence at public hearings. Reform in favour of post-departure vesting of incentive payments remains unfinished business, particularly given support for this measure by the Productivity Commission and APRA, among others. At the time of writing, it would seem that pay outcomes do not reflect significant change. The termination benefits legislation and the regulators' lack of interest in quantum (as opposed to structure) may well, in the absence of boards with sufficient fortitude, contribute to inflating fixed remuneration.

More fundamental is the question of the extent to which the performance of our large established franchise companies is attributable to executive performance, versus to “pacemakers” provided by taxpayers, superannuants and the legacy



of those that preceded the current executive group. It remains a challenge for many boards to tailor rewards proportionate to this impact rather than to luck.

One issue of which we are certain is, that where the impact of executives is clearly quantifiable, any tailoring of rewards should attempt to take account of the “tail” of their decisions, even if this extends beyond their tenure. While not wishing to be overly prescriptive, we do challenge the prevailing practice of executive reward horizons being three to four years, regardless of sector or industry. While we acknowledge there are practical difficulties in extending the time horizon, we note that the much maligned Macquarie Group has an effective reward structure which delivers incentives over a seven year period. It is unhelpful that tax laws effectively penalise performance based executive reward plans by continuing the practice of taxing on termination.

We also question the conventional wisdom that executives need additional “incentives” to deliver value to shareholders, their employers. The average fixed remuneration for an ASX20 CEO in 2010 is \$2,652,631. When fixed remuneration continues to grow exponentially (and disproportionately to those of average workers) the idea that incentive schemes aid alignment is questionable. Executives are employees of

the shareholder. The long-term investor is the only one who bears the risk of losing capital over the long term (and beyond the executive’s tenure, or LTI payout periods).

In Regnan’s experience, some directors privately welcome executives having exposure to the long-term returns of the company over which they exercise great influence. But they point out the competitive disadvantages in being the only company to lock their executives into long-term performance. It is therefore vital that shareowners do more to encourage policy settings that support such moves by company directors, who in turn need to be supported to impose longer-term vesting for the sake of asset-liability matching.

5. ESG Disclosure

We have been concerned to see instances of creep away from more robust ESG disclosure practices, with talk of significant withdrawal in other cases. Regnan does not encourage ESG disclosure for its own sake but sees most companies having some environmental and social exposures that warrant reporting to the market.

We continue to be surprised to hear responses that focus on the costs of disclosure. Recognition that ESG facilitates reporting to the market on many intangible assets, which make up the majority of company market capitalisation is lacking. In a service economy, where

innovation is a source of value and where service (including cross selling and upselling customers) is critical to future profitability, disclosures relating to human capital (people) management, employee engagement, customer satisfaction, workforce diversity and training and development practices are all relevant for current and future investment value.

This is one of the reasons Regnan is a strong supporter of the work of the Institute of Chartered Accountants and its Broad Based Business Reporting initiative. Closing the gap in the market’s understanding and valuation of ESG remains a key challenge (and opportunity) for investors and companies alike. As pointed out by Roger Urwin, Towers Watson’s international investment expert, at the 2010 ASFA conference “Sustainable development is THE number one investment theme in the decade ahead, and yet funds managers are very poorly positioned on it”. Prevailing corporate practices do not deliver adequate ESG disclosures to the market, and Regnan will continue to support greater efforts to change this.



Engagement Activity July 2009 – June 2010

By 30 June 2010, Regnan's engagement activity was supported by our representation of \$54 billion in FUM or 5.25% of the S&P/ASX200. While many issues run across reporting periods we are pleased to report success in our efforts to further improve the quality of our engagement results.

Focus of Engagement

Our engagement activity encompassed just about half the market as at 30 June, with the year-on-year comparisons reflecting the dominance of corporate governance engagement in 2008/2009 (owing to closure of our share trading mandate from clients). Environment engagement is up on the previous year in part due to attending a number of companies who appeared to represent to policy makers that the proposed ETS / CPRS would be a material risk to the relevant company, but did not appear to communicate the issue in a similar manner to shareowners.

- 31% (2008/2009 17%) of engagement was environment related
- 24% (2008/2009 28%) of engagement was human capital (social) related
- 45% (2008/2009 55%) of engagement was corporate governance related

Chart 3 overleaf provides more detail on our engagement focus.

Completion of Engagement

- In 43 of the 121 instances where we engaged on an issue, engagement was completed during the year, a completion rate lower than the previous year. As we flagged last year, this was to be expected owing to the lumpy nature of a large number of director share trading matters that were resolved in 2008/2009.
- The remaining engagement is ongoing for 2010/2011.

Engagement Plans for 2010 – 2011

Regnan's priorities for the coming year include board independence and diversity, executive remuneration and miscellaneous corporate governance matters (such as related party transactions (RPTs) and accounting practices).

Other matters include ESG disclosure and corporate controls for climate change related risks to financial performance. These include attention to our ongoing engagement mandates.

The Role of Positive Engagement

Regnan's approach has long emphasised communicating the interests of long-term owners, rather than adopting an adversarial stance towards boards and their management. Our experience of engaging with companies over the last nine years shows that engagement activity needs to support positive governance practices, not only focusing on governance gaps identified under our research processes.

Positive engagement represents significant value for investors, allowing the scope of discussion to widen from "what's wrong" to encompass "that's right!" and so supporting and encouraging positive deviance from existing market norms. In a world where some engagement warrants a determined approach and can involve bona fide disagreement, the balancing role of supportive engagement continues to rise.

During the year our "positive engagements" were down in number, in part because of the high volume of engagement activity mandated by our clients based on our gap-analysis research. While many of these mandated meetings included some elements of positive feedback, most of our efforts focused on addressing a gap; the "positive" engagements reported are those where we have purposefully sought to provide positive feedback on ESG performance.

Some of the positive engagement messages we provided during the year included:

- encouragement of a company to continue to embrace post departure vesting as part of their approach to executive remuneration;
- supportive feedback on ESG disclosures to identify the benefits of continued ESG reporting in the face of cost-focussed pressures to disinvest in ESG reporting; and
- in at least two instances where the company was making an initial foray into ESG reporting we provided feedback on the strengths of reporting, alongside suggestions for further development to ensure key ESG areas were more fully covered.



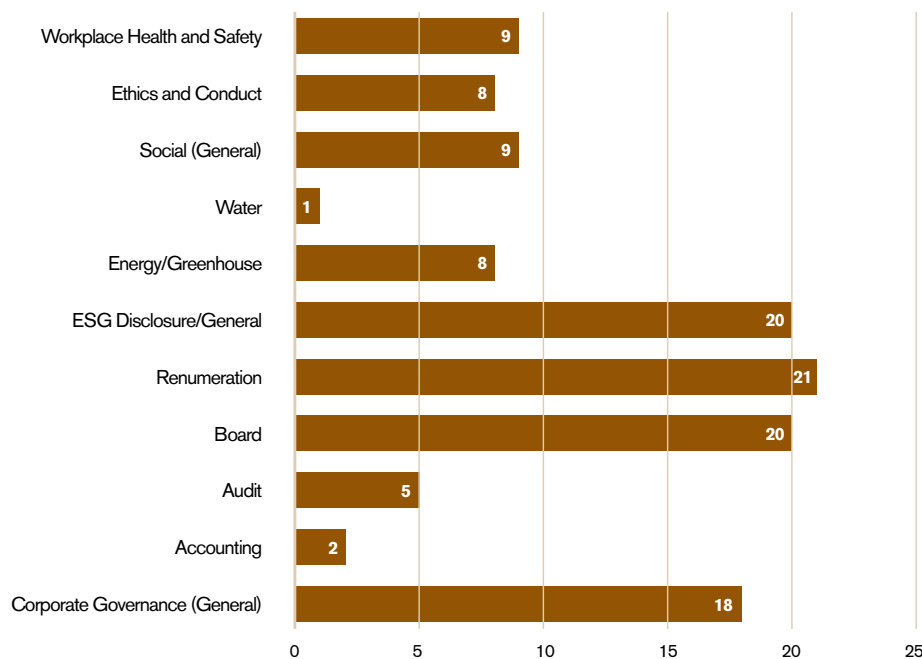


Chart 3:
Engagement activity by subject

This table shows the types of issues raised by Regnan during the year. Remuneration, board governance and ESG disclosure comprised the majority of issues raised with 45 companies throughout 2009/2010.

Submissions & Industry Activity July 2009 – June 2010

There are numerous areas where Regnan needs to go beyond engaging individual companies, to address structural or regulatory impediments to reform. Among the levers Regnan used in 2009-2010 are submissions and participation in industry events as outlined below:

Submissions

- Submission to ASX on proposed Listing Rule Amendments to strengthen listed company governance of director share trading.
- Submission to APRA offered support of draft prudential guidance which encouraged greater incorporation of risk in remuneration practices, longer vesting periods and post-employment vesting.

- Submissions to both Treasury and the Senate on termination payment legislation argued for the exclusion of statutory benefits from any termination payment calculation cap and consideration of a higher shareholder voting threshold if evidence of adverse unintended consequences was found after two years. The final legislation submitted to the Senate did in fact exclude statutory benefits from the termination payment calculation.
- Evidence to the Senate Legislation Committee on Economics further explained Regnan's earlier submissions on termination payment legislation, advocating reform in line with Regnan's Remuneration Reform Proposal.
- Submission to Treasury's Productivity Commission Report on Executive Remuneration argued against taxing at cessation of employment of share and option plan (ESOP) legislation, in order to facilitate post-employment vesting. This work is ongoing.

Industry Activity

- Presented at ASX/AICD director education roadshow on the investor perspective and governance expectations nationally.
- Presented investor perspectives at APRA seminar series in relation to APRA remuneration guidelines for financial services entities. This supported APRA's work and advocated the lengthening of remuneration vesting periods.
- Property Council of Australia – provided presentation of investor perspective of effective governance including aligned interests to key industry participants. Regnan has long been concerned about the conflicts associated with externally managed trusts, and we believe some of the current reforms are overdue.



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Regnan – Governance Research & Engagement Pty Ltd was formed in 2007 out of the proven engagement model and resources of BT Financial Group's Governance Advisory Service.

Regnan is owned by eight major institutional investors: ARIA; BT Investment Management; Hermes {UK}; HESTA Super; NSW Local Government Superannuation Scheme; Vanguard; Vicsuper; and the Victorian Funds Management Corporation.

Regnan provides company engagement services to institutional investors and research on companies' Environmental, Social and Corporate Governance performance for mainstream funds management.

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