



November 2009

Newton's *more government* theme is central to responsible investing

Newton's investment approach is grounded in the use of themes which outline our ideas about the likely forces of change in the world. Newton's global, thematic philosophy and process allow us to gain long-term perspective on global financial markets and economies, to understand how the world is changing and to identify the beneficiaries of such change. Newton's *more government* theme explores how governments are seeking to increase regulation in many areas. This theme is central to responsible investing and highlights the importance of the consideration of environmental, social and governance matters in Newton's investment approach.

State intervention and forms of managed capitalism are becoming more prevalent around the world. The current economic crisis has seen the hard commercial capitalists seeking financial support from many governments. These actions, however, come at a price; a likely increase in state intervention, regulation and measures that may hinder globalisation. As a responsible investor, Newton believes this intervention will spread beyond a business's day-to-day operations, to the wider longer term impact companies have on the environment and society.

In a world where governments face increasing levels of debt, investors are likely to witness a greater degree of social responsibility being placed on business by the state, as governments attempt to achieve positive social change without resorting to increased taxes or other unpopular measures. With the

nationalisation of the banking sector, for instance, it is possible to see a shift to more socially conscious banking activities, such as access to credit for those at the lower socio-economic scale, financial education, free advice and attractive mortgage services. This shift, be it subtly encouraged by government or a consequence of the banks' desire to avoid further government intervention, is already evident through the changing banking services now on offer.

Newton's assessment of environmental, social and governance risks of the companies in which it invests, is conducted in the belief that the reputation and performance of companies could be at stake if these risks are poorly managed. Much of this work explores the potential regulation imposed on business relating to wider societal impacts.

Environmental legislation

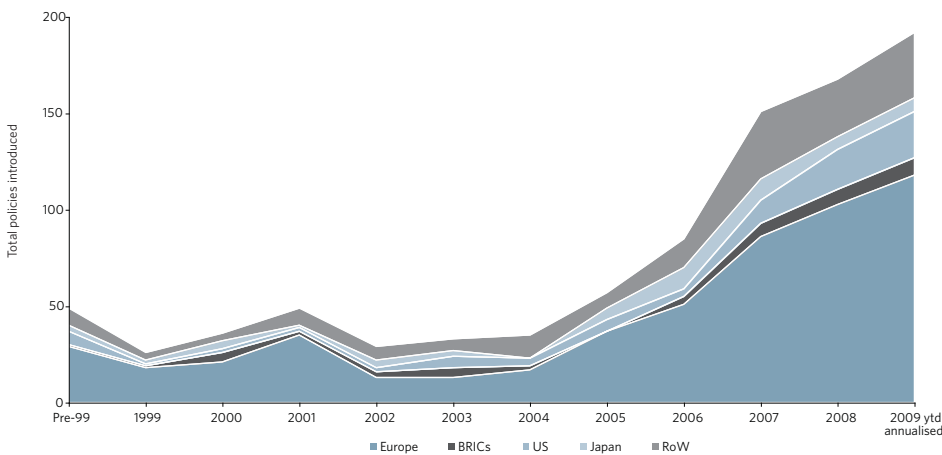
The *more government* theme is evident in the increase in the amount of climate change related legislation being introduced. As the world reaches a consensus that global warming is linked to increased levels of CO₂ in the atmosphere, governments around the world have moved to reduce greenhouse gas emissions. Free market measures, such as carbon trading, have been established. However, it is government legislation on carbon allowances that is likely to have a bearing on the carbon price in the future and, in-turn, drive changes in corporate behaviour as companies attempt to reduce the risk of additional costs.

As most carbon emissions come from industry, with the transport sector accounting for 20% and power generation 38%¹ of greenhouse gas emissions, investors will need to be cognisant of future legislation that is likely to drive a higher carbon price. Governments are acutely aware that, without carbon becoming an expense for companies, industry will lack the incentive to reduce greenhouse gas emissions, or invest in infrastructure that will help drive cleaner transport or emissions efficient sources of energy.

The best known piece of climate change legislation is the 1997 Kyoto Protocol. The Protocol set binding targets for the reduction of greenhouse gas emissions and was ratified by 184 parties of the United National Climate Convention. One missing party at the time of ratification was the United States of

¹Low-carbon energy: May the wind blow for carbon capture and storage" June 2, 2009, Goldman Sachs Investment Research

NUMBER OF CLIMATE CHANGE RELATED POLICIES INTRODUCED ANNUALLY



Source: European Union; Goldman Sachs Research

America. However, the US government is now considering intervention with both the House of Representatives and the Senate recently considering energy bills that cover carbon emissions and renewable energy. For the first time, the USA will be part of the global discussions at the next United Nations Climate Change Conference in Copenhagen, where it is hoped future global targets for the reduction in greenhouse gas emissions will be agreed.

In June 2007, China released its National Climate Change Program outlining a plan for both the mitigation of greenhouse gas emissions as well as the consideration of adaptation strategies. Goals include a doubling in renewable energy use by 2020, closure of inefficient industrial

facilities and a tightening of efficiency standards for buildings and appliances. This will have material consequences for industrial and manufacturing businesses operating in China. Some international observers believe that China has been more proactive than some developed countries on its consideration of climate change. With the leading greenhouse gas emitters, USA and China, now taking an active position on carbon emissions, investors are likely to witness a continued introduction of climate-related legislation around the world.

Newton believes those companies (particularly large emitters of CO₂ such as cement makers, coal powered power stations and other industrials) measuring and setting targets to reduce greenhouse

gas emissions from their business operations will be well placed to gain competitive advantage over those that have yet to address carbon emissions within their business operations.

Social legislation

Increasingly, society is holding both business and government to account. There appears to be a growing consensus that it is no longer acceptable for business or government to ignore the wider responsibilities linked to their activities.

Governments around the world, particularly those with limited financial resources, are recognising that companies can play a valuable role in offering social benefits alongside commercial ones. Host governments in resource rich countries increasingly demand social benefits in addition to tax revenues from any company seeking access to their resources. As part of gaining access to minerals around the world, extractive companies now offer a range of social benefits, such as the building of infrastructure, schools and health services in countries where these social services have historically been lacking. Understanding the community issues of the areas in which a company operates is becoming increasingly important and is now considered by some enlightened international companies as an obligatory part of a license to operate.

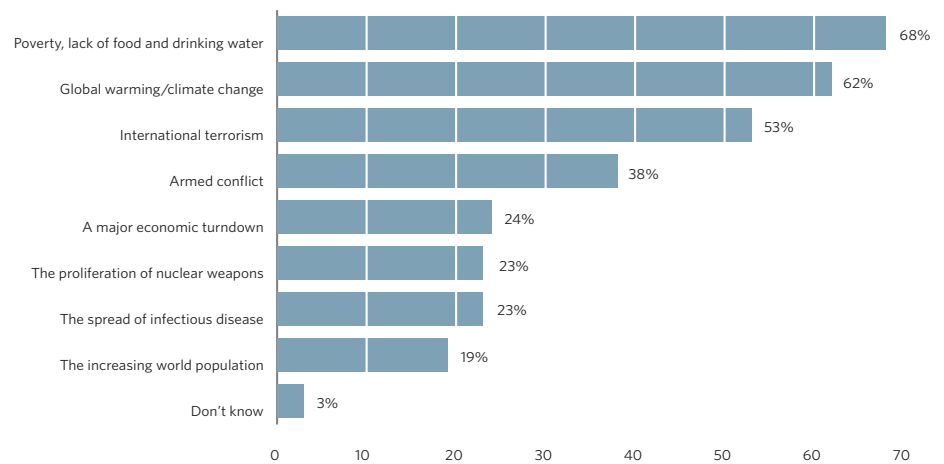
In South Africa, for example, the government has long expected companies to deliver social benefits. Following the end of apartheid, the government

commenced a national strategy of redistributing wealth through its Black Economic Empowerment (BEE) programmes. Companies that have demonstrated their social commitment through imaginative BEE programmes have helped minimise the risk of further government intervention in their businesses.

Social issues are not limited to the extractive industries or those operating in developing regions of the world. In the USA, for example, the largest budgetary spend (even larger than defence) is healthcare. The government, having spent billions bailing out indebted companies, is now looking for ways to restructure its budget. Newton believes that healthcare companies that have adopted responsible business practices which offer additional social benefits, such as access to medicines and services for those at the poorer end of society, will be better placed in dealing with the USA healthcare reforms.

Health issues account for a large amount of government spending. As such, governments explore ways to reduce the financial burden of healthcare through the introduction of legislation. Any company associated with the cause of health problems face government scrutiny and potential product regulation. The tobacco industry is a good example of where governments have already taken action in order to reduce the cost of treating tobacco related disease. Cancer Research estimates that the cost to the NHS of tobacco related illness in the UK now stands at some £2.7bn. Governments

**EU PUBLIC SURVEY OF THE MOST IMPORTANT CHALLENGES FACING SOCIETY
(% FIRST AND THEN ANY OTHERS)**



Source: Eurobarometer

continue to legislate against the industry in order to curb smoking, through increased taxes, banning smoking in public places and marketing restrictions. Surprisingly, the more recent health problem of obesity and its range of significant health impacts are estimated to cost the NHS significantly more than tobacco related diseases. The Department of Health reports that current estimates suggest costs of approximately £4.2bn. It is forecast that this will double by 2050. Further costs to the economy, such as a reduction in productivity owing to sickness absence, have been suggested to be as high as £16bn. Under Newton's *more government* theme, investors may need to factor in the costs of potential legislation that companies may face in order to tackle the obesity problem.

The risk of increased legislation could affect a range of industries from food producers and food retailers through to the leisure and restaurant industries. Some companies have already recognised this and have adopted clear labelling on food products, as well as providing education on healthy eating.

Consumer or public opinion is vital in determining the risk of future government legislation, given politicians are keen to be seen in a positive light. An EU public survey conducted in 2008 showed that the public thought that poverty, lack of food and drinking water were the largest challenges facing society. In Newton's theme of *more government*, these issues of public concern will be high on the agenda of politicians.

Governance legislation

Responsible investors have long expected companies to demonstrate commendable business practices through clear and transparent disclosure of how their businesses are governed. Past business failures and the events leading to the current economic environment, including perceived rewards for failure, have caused governments to demand reviews of financial markets' legislation, corporate governance codes and guidelines.

With regard to good corporate governance, the UK is more advanced than most economies, particularly in relation to protecting shareholders rights and making constructive advancements in corporate governance codes and guidelines. Many developed and emerging economies, such as the US, Japan, China and India, have only recently begun to address some of the fundamental areas of corporate governance. It is clear that the underlying aim of many governments is to enhance their corporate governance in order to attract and secure investment by providing markets where economic growth is sustainable and business are trusted. New regulations, codes and guidelines are likely to tackle the key areas surrounding companies' corporate governance related disclosures, remuneration arrangements, board structures and capital allocation decisions.

Enhanced corporate governance practices will recognise and strengthen the shareholder position as the owners of

companies and the main providers of capital. While this will come at a price to the individual companies, the long-term benefits of investor support and reduced cost of capital for companies should outweigh these costs.

Regulations concerning capital raisings and capital re-organisations are of immediate focus for governments and investors, alike. During the recent challenging economic environment, many companies have needed to alter or refinance their debt structures and raise additional funds. Over the years, pressure has been mounting on governments and regulatory bodies to better protect shareholder value and voting power in the event of companies reorganising their capital. The main focus has been on a company's authority to issue shares whilst dis-applying existing shareholders pre-emption rights and the issuance of convertible debt instruments. More recently, contingent capital instruments are being heralded by some governments as a promising form of capital for companies. Contingent capital instruments start life as a corporate bond but convert to common equity when a pre-determined trigger is reached that suggests the company is in difficulty. While there are arguments both for and against such a capital arrangement, it remains to be seen if it is a truly viable or popular form of capital. Suffice to say, companies' capital decisions need to be thoroughly scrutinised by a company's board, which is charged with protecting

the long-term interests of shareholders. It is, therefore, essential that a board's balance of power be skewed towards independent non-executive directors that have the skill and knowledge to ensure existing shareholders' interests are kept at the fore of all board decisions.

For governments to make truly substantive and effective changes, there needs to be global alliance on some of the key aspects of corporate governance. Given cultural differences, there is unlikely to be harmony across all markets in the near-term. This leaves investors with opportunities to benefit from investing in markets that are active in improving their corporate governance.

In summary

Responsible investment provides an additional method of assessing the broader legislative changes around the world and their impact on business. In particular, wider societal changes, expectations and global public trends will have a bearing on the way governments think and therefore legislate. Given the financial difficulties of the past couple of years, and the increased reliance of companies on public finance, governments around the world will be seeking ways of preventing the current crisis from happening again, as well as seeking some form of compensation for its assistance to the corporate world. After all, it has often been said that "there's no such thing as a free lunch".

