As we have mentioned in previous letters, when incorporating ESG factors into our investment process we have had considerable focus on the 'G' of the term ESG over the past few years. This is understandable, and logical even. Governance is about people, relationships, values, and incentives, and these factors guide corporate attitudes and activities, including social and environmental performance. All of these governance factors will influence the long-term returns of the companies we invest in for our clients.

The difficulty with environmental and social indicators is that they are less clear cut, and are often more relevant to sectors and countries than to individual companies. So, what is interesting and helpful for us, as bottom-up stock-pickers, is to understand how each company is responding to the broader risks and opportunities from a reputational and business operation perspective.

Two significant 'E' and 'S' projects we are currently working on are climate change and garment supply chains. This is not an easy task because these are complex issues; the more time that is spent understanding the issues, the bigger the challenge seems to be.

Environment – climate change

Climate change is a topic we have thought about frequently over the past ten years, and it is an area where we are seeing an increasing amount of interest from our clients. It has been difficult to analyse a company's exposure to climate change risk with any degree of conviction beyond saying 'oil is more carbon intensive than gas; energy efficiency is a positive idea; and adaptation, remediation and mitigation technologies should be long-term winners'. We have carried out portfolio reviews and looked at renewable energy companies, but there remains a hurdle to answering the 'so what?' question. Many factors interlink to create this uncertainty; lack of regulation, the very low carbon price where one exists; timeframes (climate is a very long-term issue); the inconsistency of subsidies, and the many difficulties in accurately estimating an individual company's carbon footprint. But a shoulder shrugging 'it's difficult' is obviously not a satisfactory answer.

To introduce a different perspective, we are participating in the Mercer Climate Change project. This is a global project involving a number of asset owners together with some investment managers. The report, which examines the potential implications for investors under various climate change scenarios, is expected in the first half of 2015. We hope it will increase knowledge levels, challenge accepted assumptions, and raise the baseline for continued thinking on this topic and for debate with investors and our clients. This is clearly going to be a really long-term issue. Climate change happens over hundreds of years. Even though we think we are adopting a long-term view in looking for companies we can hold for ten or even 20 or 30 years, climate change models are looking at 300 years. So, long-term investing and climate aren't easy companions. What is clear though is that the volatility in weather patterns is increasing, and so companies should be looking to be energy efficient and able to adapt to increases in weather volatility.

Social – supply chain management for the garment industry

A number of our strategies have holdings in companies which are involved in the garment industry. Sitting behind a desk in Edinburgh is a very comfortable place to be when analysing garment companies and assessing their approaches to working conditions, pay scales, what the correct minimum age for employees is and whether subcontracting to an unaudited supplier factory is acceptable or not. Companies' sustainability reports tend to describe the issues in black and white terms with a list of actions that are unacceptable and others that require improvement and monitoring. In reality, it is not that simple. And the challenge does not lie simply with the retail companies' policies or the factory owners; order volumes are instantly reduced if there is a contraction of the European or US economies, for example. A member of the Corporate Governance team visited Bangladesh and Myanmar to learn about the realities of the challenges, what responsibilities lie with the brands themselves, the factories and with us. The 2014/15 Governance Review (published in the second quarter of this year) will include a more detailed review of the trip and summarise the insights that we will be applying to our research of existing and potential holdings in the garment industry.

Governance – China 'A' shares

We realise that the evolving opportunities for investment in China are of interest to clients, regardless of whether their portfolio has direct exposure to the region. Historically, there has been limited access for non-domestic investors to companies listed on mainland Chinese stock exchanges. This is beginning to change with the opening up of the A-share market via the Hong Kong-Shanghai Stock Connect project, which will significantly increase the number of investible companies for foreign investors. In conjunction with greater research efforts from our equity teams, we are increasing our focus on what arguably is one of the more inefficient markets that we will be able to invest in for our clients. Indeed, given the inefficiencies, China could be very rewarding for investors, such as Baillie Gifford, who have rigorous bottom-up research processes, and lead to significant opportunities for clients. However, opportunity comes with its own challenges. Information is limited in inefficient markets, bribery and corruption is a visible risk in the country, and the prospect of inaccurate, exaggerated disclosures from companies exists. The regulators have good laws but enforcement is often half-hearted, albeit this is improving. Assessments of governance structures, management quality and motivations are therefore a key component of the investment research for this market. This is something the investment and Corporate Governance teams look forward to cooperating on as opportunities for investment become available.

These three topics are increasingly relevant to listed companies, regardless of where they are listed or the sector in which they operate. Climate change is a global issue, every company has a supply chain in some form and China is an increasingly important market for investors and investee companies.

Image: © iStockphoto.com/ArtBoyMB

Voting Activity

Votes Cast in Favour		Votes Cast Against		Votes Abstained/Withheld	
Companies	None	Companies	None	Companies	None
Resolutions	None	Resolutions	None	Resolutions	None

Climate change is a topic we have thought about frequently over the past ten years. It has been difficult to analyse a company's exposure to climate change risk with any degree of conviction. We are a partner in the Mercer Climate Change and Strategic Asset Allocation Study

Supply chain management for the garment industry is complicated, with many competing priorities

Historically, there has been limited access for non-domestic investors to companies listed on Chinese stock exchanges. This is beginning to change with the opening up of the A-share market via the Hong Kong-Shanghai Stock Connect project

Firmwide Company Engagement

Engagement Type	Company
Corporate Governance	Burberry Group
AGM or EGM Proposals	Splunk Inc, Tesla Motors
Executive Remuneration	Burberry Group, Splunk Inc, Tesla Motors

Notes on company engagements highlighted in blue can be found in this report. Notes on other company engagements are available on request.

Company	Engagement Report
Burberry Group	Burberry Group plc is a British fashion house, distributing unique luxury outerwear, accessories, fragrances and cosmetics. The company's remuneration report was voted down at the 2014 AGM with a 52% vote against. Shareholders' main concerns focused on large one-off equity awards granted to senior management, while there were frustrations with the development and structure of the new remuneration policy. We met the chairman of the remuneration committee in our offices. The company acknowledged that its communication with shareholders ahead of the AGM could have been better, and it is working to improve disclosure and engagement. The new long-term incentives are aligned with Burberry's long-term strategy and will be based on profit, revenue growth and efficient capital management. Furthermore, the new remuneration policy prohibits the use of one-off equity awards. With regards to succession, the company is pleased with the retention and transition of Christopher Bailey to CEO and believes that with John Smith as COO and Carole Fairweather as CFO, this means a strong senior management team is in place.
Splunk Inc	Splunk is a US-based corporation which produces software for searching, monitoring and analysing big data. We abstained on the executives' compensation at the 2014 AGM due to special equity awards to CEO Godfrey Sullivan. The resolution failed to receive majority support and therefore this engagement was the company's response to shareholders' concerns. Consistent with recommendations we made following the AGM, the Compensation Committee has introduced performance-based equity awards, new stock ownership guidelines for executives and improved disclosure levels. The company has also adopted a clawback policy for variable pay and a majority voting standard for director elections, which will improve board and management accountability. Furthermore, CEO Sullivan forfeited the unvested portion of his equity incentives following the failure of the Say-on-Pay vote. This is extremely rare and on face value shows a commitment and respect for shareholder concerns. This was a positive engagement example where we believe the company has responded appropriately to its shareholders and we believe that the proposed changes represent significant enhancements to the company's governance policies. We look forward to developing our relationship with the company.
Tesla Motors	Tesla Motors designs, manufactures, and sells high-performance electric vehicles and electric vehicle powertrain components. We abstained on the executives' compensation at the 2014 AGM due to the stock option plan allowing the company to reprice previous awards which had suffered because of a falling share price. Although this is not the case with outstanding awards, and the company has never used this provision, we do not believe it is aligned with shareholders' best interests and therefore we communicated our concerns to the company. We were pleased that the company contacted us to explain its decision to remove the repricing provision from the stock option plan, as well as outlining other improvements to its governance and compensation policies. Tesla's willingness to engage with its shareholders on these issues is encouraging.