Responsible Investment

Quarterly Report
Q2 2014

Standard Life Investments

Contents

Introduction

Standard Life Investments is committed to being a responsible investor. This quarterly report details engagements our Responsible Investment Team has undertaken throughout the period with various companies specifically related to environmental, social and governance (ESG) issues*.

While not an exhaustive list, this report is a comprehensive representation of the various steps taken by Standard Life Investments to ensure it remains an active and responsible steward of our clients' assets.

In addition to details of specific corporate engagement, we have included recent reports written by members of our Responsible Investment Team. These research papers provide insight on the pressing issues of stranded assets, the electronics industry and labour challenges in China and human rights as a business risk.

Standard Life Investments is one of the world's leading investment companies. Responsible for investing assets on behalf of over five million customers, we offer global coverage of a broad range of investment instruments and markets. With global assets under management of £184.1 billion (as of 31 December 2013), our capabilities span equities, fixed income, real estate, private equity, multi-asset and absolute return solutions.

Headquartered in Edinburgh, Standard Life Investments employs more than 1,100 talented professionals. As a global investment manager, we maintain a presence throughout the world including Boston, Hong Kong, Paris, London, Beijing, Montreal, Sydney, Dublin and Seoul.

* Given the nature of their work, the Governance & Stewardship Team report on ESG activites in their end of year review.
See: http://www.standardlifeinvestments.com/governance_and_stewardship/index.html

Foreword

Amanda Young
Head of Responsible Investment

At Standard Life Investments, we continue to see a high level of interest from both clients and external stakeholders on responsible investment issues. As a result, we continue to develop our regular reporting, providing more comprehensive information to our wider stakeholders.

There are three pillars which form the basis of the work of our Responsible Investment Team.

- **Integration** – embedding business ethics, human rights, environmental and employment issues into our mainstream investment process.
- **SRI** – using principles of Sustainable and Responsible Investing (SRI) to screen and engage with companies based on their commitment to the UN Global Compact.
- **Ethical** – screening companies based on their business activities. Our ethical funds have a positive bias towards those companies with activities that benefit both the environment and society.

In order to ensure our ethical criteria remain relevant, we conduct an annual ethical investment survey. This survey was completed during the second quarter, with an encouraging 25% response rate. This indicates our clients remain fully engaged with this area of investment. While our clients also retain strong views on segments of the market they wish to avoid, they appreciate our active approach and being informed on a wide array of environmental and social issues.

Our policy of corporate engagement, in order to promote better corporate behaviour, is of the highest importance to our clients.

This quarter our research focus included analysis on human rights. Managing human rights risks within a business is challenging, as the definition of human rights continues to evolve. Again, robust engagement at the corporate level is the most effective route to understanding the risks companies face. We seek to understand corporate processes in order to ensure the highest standards are adopted.

A further topic we have recently examined is the issue of stranded assets. With the use of a proprietary analytical tool, we are currently assessing the risk for fossil fuel companies, should their carbon intensive assets become stranded. During the quarter, we outlined our approach to the issue of stranded assets and the extractive industry. This includes articulating our engagement approach with relevant companies with further work being undertaken.

We hope that you find this report engaging, informative and, above all, insightful with regards to the extensive work undertaken during the quarter by our Responsible Investment Team. As this is the only second quarterly report we have published, we would very much welcome your thoughts, comments and feedback as we develop and evolve our reporting style. Please send your comments to: **responsible_investment@standardlife.com**

The Responsible Investment Team

Who are we?

The Responsible Investment Team is dedicated to research and analysis of environmental and social issues that have a bearing on Standard Life Investments' client portfolios. We place specific focus on four key areas:

- employment issues
- human rights & community issues
- environmental matters
- anti-corruption.

The Team works closely with our separate Governance & Stewardship Team and seeks to ensure that environmental, social and governance (ESG) considerations are embedded throughout our investment process. The team has over 30 years' combined experience in responsible finance.

The Team

Amanda Young
Head of Responsible Investment

Alix Chosson
Analyst, Responsible Investment

Rebecca Maclean
Analyst, Responsible Investment

Andrew Mason
Analyst, Responsible Investment

Working with our Governance & Stewardship Team

The trend within the investment industry is towards establishment of a singular environmental, social and governance (ESG) function. However, we believe there is merit in developing distinct skills and expertise within both responsible investment and governance and stewardship. Consequently, Standard Life Investments has both a Responsible Investment Team (environment and social issues) and a Governance & Stewardship Team (governance matters).

Two dedicated resources

These two teams each require a different set of skills to understand the approach to two very different, although complementary, parts of a company's structure and business.

The focus of the Governance & Stewardship Team (established in 1992) is on board oversight and the governance framework within which companies operate. This includes how a company is governed, the development and delivery of strategy, board composition, remuneration, audit issues and voting at shareholder meetings.

Its process normally includes discussions with the company chairman and board, particularly non-executive directors. The Governance & Stewardship Team's policies and principles document can be found on our website: **http://www.standardlifeinvestments.com/CG_Corporate_Governance_Booklet/getLatest.pdf**

The website also includes details of voting activity, which was included in last quarter's Responsible Investment Quarterly Report. **www.standardlifeinvestments.com/governance_and_stewardship.**

In contrast, the focus for the Responsible Investment Team is on environmental and social operational issues affecting our investee companies. The Team examines board policies, such as those relating to health and safety, anti-corruption and the environment. It explores how these policies are implemented in practice, normally involving discussion with the CEO and senior management. This allows a fuller understanding of whether the tone set at the top of a company is being embedded throughout the business.

Having two different access points to a company offers Standard Life Investments better insight into the quality of management. The key objective is to ensure these conversations are shared and, where both teams have concerns, there is an ability to work together to encourage better corporate behaviour from the company. In addition, having these conversations at different levels of the business provides a superior understanding of a company's risks. This is the value which these two teams add to the investment process.

Two distinct teams with dedicated expertise and one aim: to add value to the investment process

Regular dialogue

These two teams regularly share information. Once a week, members of the Responsible Investment Team attend the Governance & Stewardship Team's morning meeting. This provides a forum to share information on engagement and current ESG trends, and identify areas of mutual interest. In addition, the heads of both teams meet bi-monthly to discuss wider strategic issues. There are regular communications on forthcoming meetings and participation in a number of joint engagements.

Reporting

Given the nature and type of conversations held with our investee companies, the Responsible Investment Team reports quarterly on activities and our approach to current issues.

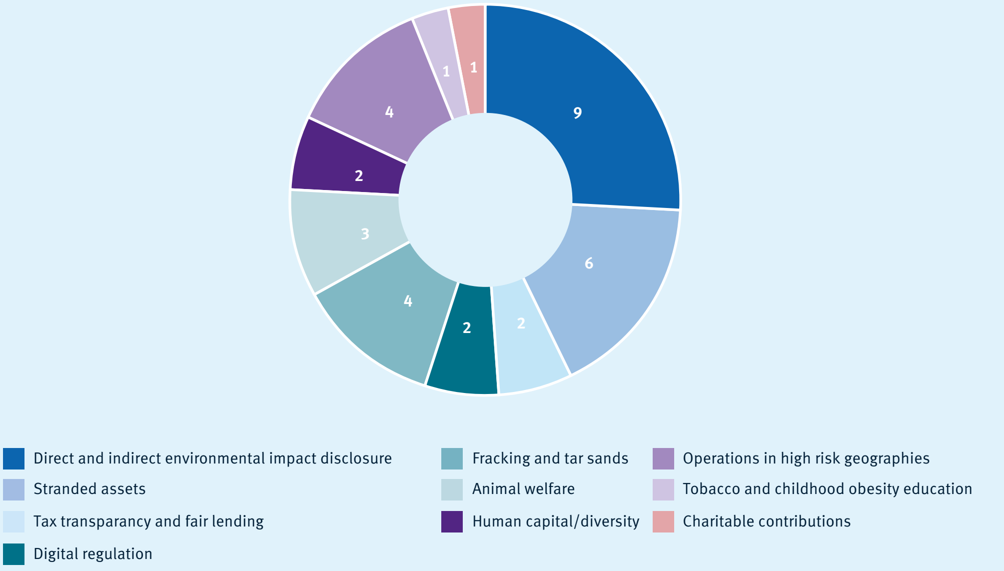
The Governance & Stewardship Team produces an annual review of how it has met its responsibilities. This report outlines significant engagement achievements and Standard Life Investments' views on a number of evolving public policy and regulatory issues that have particular relevance to the interests of long-term investors. The 2013 report can be found within the Governance section of the Standard Life Investments website along with quarterly updates of our voting and engagement activity.

Voting on environmental and social issues

The Responsible Investment Team has worked closely with the Governance & Stewardship Team to develop a policy on voting on all environmental and social resolutions lodged at company AGMs and EGMs. While the Governance & Stewardship Team conduct all voting on our funds, the Responsible Investment Team has the in-depth knowledge and expertise on environmental and social matters. This information is fed into the process to ensure we have given due oversight with regard to a company's policies and activities, and can make informed judgements on the validity of these resolutions. Hence, there is a formal process of identifying, assessing and voting on these resolutions.

We voted on 20 different company, environmental or social resolutions during the second quarter. In the chart below, we have outlined both the number and nature of the various issues we voted on. In addition, further details can be found at the end of this report. Many of the issues we are considering will form part of our ongoing corporate engagement activities.

Summary of voting resolutions



Source: Standard Life Investments, June 2014

Thematic commentary

Standard Life Investments is committed to inform and lead debate on core issues involving responsible investment, governance and stewardship.

As part of this commitment, the Team published several research papers during the quarter, providing insight into particular areas of concern to clients. We further participated in several important initiatives within responsible investment and corporate governance. In this section, we provide an overview of these responsible investment articles and engagement.

Human rights as a business risk

Standard Life Investments' approach to evaluating corporate responsibility is based on the four pillars of the UN Global Compact. The first of these pillars is human rights, along with environment, labour relations and bribery and corruption. However, human rights, as a concept, is more than a pillar to be considered independently. It constitutes the foundation from which all environmental and social issues thrive and, as such, it should be given particular attention.

From a vague concept based on moral considerations two decades ago, human rights and the risk of violating these rights have transformed into a major operational and reputational risk for companies. It is a key issue for investors to analyse in order to assess the ability of companies to sustain growth, maintain their license-to-operate and protect their reputation

Evolving generations of human rights
The UN Declaration of Human Rights, the International Covenant on Civil and Political Rights, with its two Optional Protocols (1966) and the International Covenant on Economic, Social and Cultural Rights (1966) form what is called the International Bill of Human Rights. This set of core individual rights that all human beings are entitled to encompasses civil and political freedoms (first generation of human rights), as well as economic, social and cultural rights (second generation of human rights). In the second half of the 20th century, a third generation of human rights, described as collective and developmental rights and including the right to sustainable development, has taken shape through conventions and soft law. The UN Global Compact encompasses these three generations of human rights.

Corporate responsibility to respect human rights
Companies have a responsibility to ensure that their actions do not violate or infringe on the human rights of their stakeholders, including employees, business partners and civil society. While companies cannot be expected to take the roll of public authorities when it comes to protecting those rights, they have the duty to "respect" human rights. This is to act with due diligence to ensure that they avoid infringing the human rights of those stakeholders affected by their business operations, as stated by the UN Guiding Principles for Business and Human Rights adopted in 2011 and in particular the "Protect, Respect, Remedy" framework set out by John Ruggie.

- **Protect**: it is "the duty of the State to protect against human rights abuses by third parties, including business enterprises, through appropriate policies, regulations and adjudication".
- **Respect**: it is "the corporate responsibility to respect human rights, which means that business enterprises should act with due diligence to avoid infringing on the rights of others and to address adverse impacts with which they are involved".
- **Remedy**: victims should have "greater access to effective remedy, both judicial and non-judicial".

Human rights risks are strongly correlated to a company's countries of operations and industry practices. As such, we pay greater attention to companies operating in countries with a higher risk of human right abuses occurring and sectors that have had a long track record of violations.

We view human rights as a reputational risk for companies as well as a key component of their license-to-operate. As such, we believe companies should go further than the traditional 'do-no-harm' approach and demonstrate how their activities have positive impacts on communities, including social progress and economic development.

Our approach: engagement and *Focus On Change*
As an active long-term shareholder, we believe we can create value by fostering change and encouraging better practices. This lies at the core of Standard Life Investments' *Focus On Change* investment philosophy, which applies to all our investments. We favour direct engagement with companies on human rights issues as we believe increasing companies' awareness and fostering better practices will result in longer-term growth. This approach is all the more relevant to an issue like human rights where companies' accountability has developed essentially through soft law.

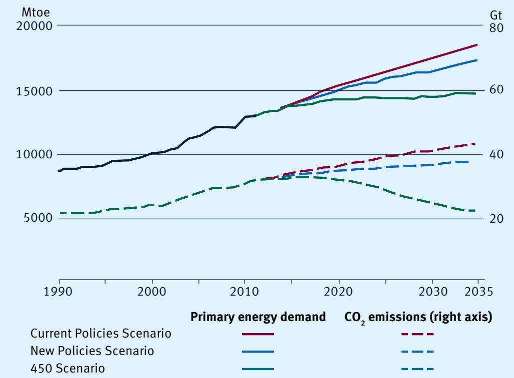
Stranded assets

Environmental, social and governance issues can strengthen or damage companies' intrinsic value. Traditionally, 'stranded assets' is a term used to describe the unexpected downward revaluation or write-down of an asset due to a variety of risks. The current debate looks to identify environmental risks, specifically the risk to fossil fuel reserves from increasing carbon regulation. In 2011, Carbon Tracker Initiative published the Unburnable Carbon report which focused on the embedded carbon of oil & gas and coal companies compared to the carbon budget.[1]

The IEA reports that roughly only one-third of proven fossil fuel reserves should be consumed by 2050 to limit the average increase in global temperature to no more than two degrees above pre-industrial levels.[2] This scenario is consistent with the policy goal to limit greenhouse gas emission concentrations to 450ppm of CO2. With company value driven by future cash flows from these reserves, the debate is whether fossil fuel companies are appropriately valued.

The IEA has modelled energy demand and associated CO2 emissions up to 2035 under different scenarios. In the business as usual case (new polices scenario), fossil fuel demand increases by 24%, while total world energy demand increases by 33%. Under a 450ppm scenario, global energy demand increases by 14% and fossil fuel demand decreases by 11%.

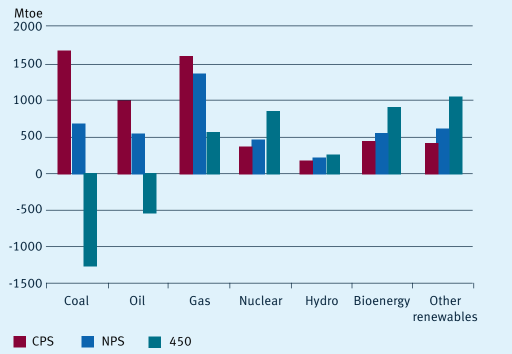
Chart 1: Global demand and emissions by scenario



Note: Mtoe = Million tonnes of oil equivalent; Gt = gigatones

Source: IEA, 2013 Word Energy Outlook (©OECD/IEA)

Chart 2: Change in global demand by fuel and scenario



Note: CPS = Current Policies Scenario; NPS = New Policies Scenario; 450 = 450 Scenario

Source: IEA, 2013 Word Energy Outlook (© OECD/IEA)

[1]Carbon Tracker Initiative (2011). Unburnable Carbon – Are the world financial markets carrying a carbon bubble? Accessed at http://www.carbontracker.org/site/wp-content/uploads/downloads/2011/07/Unburnable-Carbon-Full-rev2.pdf

[2] IEA World Energy Outlook 2012

Under a 450ppm scenario, the IEA forecast that changes in coal demand will account for the majority of the fossil fuel demand decline with oil and gas being less impacted. Under this scenario, oil and coal prices could drop with the falling demand.

The stranding risk varies by region and by type of fossil fuel. In some cases, environmental drivers have already impacted the value of commodity producers and energy providers.

Energy efficiency gains have brought down the demand for energy in many products and processes. Technological advances have opened up cheaper and cleaner sources of energy; for example solar in Germany and shale gas in the US. Environmental regulation and competition from cheaper sources of energy has caused utilities to shut down 12% of Europe's power generation plants in 2013 as combined-cycle gas turbine power becomes uneconomical.[3]

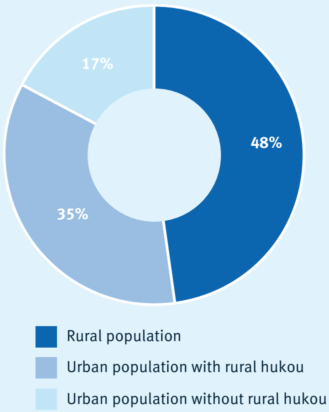
The discussion on stranded assets is building among asset owners, asset managers and companies. At Standard Life Investments, we are developing a framework to analyse the risk. We will continue to engage with companies to assess their management of the risk of future climate regulation and shifts in global energy demand. This is part of a broader assignment to question how different environmental, social and governance drivers can impact asset valuation.

Electronics industry and labour challenges in China

In recent years, China has struggled to sustain the double-digit growth of the previous decades driven by capital investment. Inequalities and other structural social issues are emerging as major challenges to China's transition to a more balanced economic model, which would be driven by internal demand.

Among those challenges is the status of the 260 million migrant workers, one third of the urban population, who are still considered as second-class citizens with limited access to welfare and social rights. Most migrant workers are Chinese people working in cities while holding a rural 'hukou', the certificate of residence used for population census. The hukou system, called huji, is also the basis for China's social welfare system as Chinese citizens are only entitled to social benefits in the area where they were registered at birth.

Chart 3: China's population structure



Source: CLSA, June 2014

The Chinese government announced its intention to reform the huji, although details and timelines are still unknown. This reform forms part of a broader reforming agenda aimed at fostering the emergence of a large consuming middle class. It includes easing the one-child policy, revamping pension schemes and reforming public services.

The status and social support of migrant workers in Chinese factories is a major challenge that companies have to address within their workforce and their supply chain in order to avoid significant operational and reputational consequences. Just this year in China, large companies such as IBM and Wal-Mart were confronted with major strikes and demonstrations, with workers demanding better wages and more social benefits. Yuen Yuen, the largest shoe manufacturer in the world providing products to major brands such as Nike and Adidas, faced weeks of work stoppages in April in what has become one of the biggest strikes in modern Chinese history. Workers, for the most part migrant, protested against the company's social practices. In particular, social benefits stipulated in their

[3] http://www.naturalgaseurope.com/utilities-moothball-gas-fed-stations-europe-2013

contracts, such as social insurance, free housing and meals, had not been provided by the company. We believe that growing social unrest may hasten the Chinese government to launch the necessary reforms to its socio-economic agenda, including reforming the status of migrant workers.

Given these growing social challenges, we contacted a number of companies in the electronics industry to discuss how they manage their workforce in China, the challenges they face and the way they address the issue of migrant workers. We started this sector engagement with Philips, Schneider Electric and Legrand with the aim of extending it to other companies and other sectors going forward.

The outcomes of these preliminary discussions were limited. Companies' human capital strategies in China are strongly focused on white-collar workers and the attraction of talent, giving little consideration to blue-collars workers, among which are many migrants. For instance, no company was able to provide data on the size of their migrant workforce or of the programmes in place to support this vulnerable group. We encouraged companies to provide evidence of how they will address this challenge, including developing relevant indicators. We will continue to discuss this issue with these and other companies at risk and report in future quarterly reports.

Collaborative engagement

UN PRI Steering Committee on Human Rights in Extractive Industry

In April 2014, Standard Life Investments joined the UN PRI Steering Committee on Human Rights in Extractive Industries. The Committee is composed of 12 asset managers and asset owners from across the world working together to engage in a collaborative way with extractive companies facing human rights risks. Companies in the oil & gas and mining industries face human rights challenges that go far beyond moral considerations and constitute clear reputational and operational risks that need to be addressed as such. This project is in its early phase of researching human rights issues, holding discussions with experts and determining the engagement universe. Collaborative engagement meetings with extractive companies should take place in 2015. We will report on progress in our next quarterly reports.

Steering Committee on Employee Relations

Over the past few years, there has been a great deal of focus by investors on labour standards within supply chains. However, little focus has been given to the management of companies' direct workforces. Recent studies have shown a correlation between strong human capital management practices and operational performance. The financial materiality of how companies manage their workforces demonstrates the need for companies to be transparent on this issue. Measurement and disclosure on specific key performance indicators and providing evidence of their approach to managing employee relations is clearly important.

The Head of Responsible Investment sits on the PRI co-ordinated Steering Committee on Employee Relations. Research and work carried out on behalf of this group of investors identified a number of labour key performance indicators linked to financial performance. The work of this Committee forms the basis of the PRI's collaborative engagement initiative on employee relations. A number of companies in the retail sector were identified for engagement, largely given the sizable workforce within this sector. Engagement has focused on the reporting against these indicators. Generally, reporting on human capital management remains fairly limited. Even those companies which appear to lead the sector do not disclose much performance data and provide limited information on how employees are managed.

During the quarter, Standard Life Investments was involved in a number of discussions with companies on this topic. This included Portuguese retailer Jeronimo Martin, Russian retailer Magnit, UK retailer J Sainsbury, and French retailer Carrefour. Joint engagement with retailers on this issue continues and will be reported in subsequent reports.

Responsible investment events

Climate Disclosure Standards Board reporting framework

Standard Life Investments participated in the public consultation on the Climate Disclosure Standards Board Edition 2.0. This is a voluntary reporting framework to help companies disclose climate change-related information to investors in mainstream financial reports. The framework focuses on greenhouse gas, water and forest risks to ensure alignment with the Carbon Disclosure Project.

Standard Life Investments voiced a concern that companies are operating in an environment with many overlapping but different disclosure guidelines relating to sustainability. These reporting guidelines and requirements could create confusion for companies who desire to report useful but not cumbersome disclosure. We would encourage consolidation of reporting requirements in the industry.

Environmental Bond Conference

We attended the Environmental Bond Conference hosted by Environmental Finance. According to S&P, the size of the 'green' corporate bond market is currently $10.4 billion. Although this is very small in comparison to mainstream corporate bond issuance ($18 trillion as at April 2013), the market is growing rapidly. S&P forecast that corporate issuance will be $20 billion in 2014.

Recent companies issuing green/environmental corporate bonds include EDF, GDF Suez, Toyota and Unilever. Each company presented on the drivers behind issuing green bonds, details of how the funds are ring-fenced and dispensed, and presented proposals on how they intend to report progress over time.

However, several issues remain outstanding and call into question the success of future growth. There is little agreement on how 'green' these bonds need to be, with large variance in the carbon or energy savings achieved, on account of the use of proceeds between various bonds. There are also concerns that this market is illiquid. Several corporate issues have been large enough to enter mainstream corporate bond indices and thus increase their liquidity. Finally, many investors are unwilling to pay a premium for this 'greenness'. Appropriate pricing is required to move green bonds from a niche investment into the mainstream. This is an area that we will continue to monitor and influence.

Responsible Investor Europe Conference 2014

On 4 and 5 June, we attended the Responsible Investor Europe Conference in London. This two-day event gathered asset owners, asset managers, brokers, companies and ESG specialists to exchange views on responsible investment and how to foster long-term and sustainable fiduciary capitalism. Plenary sessions and smaller group discussions reviewed some high profile responsible investment topics such as fossil fuel divestment, corporate tax avoidance and green bonds, as well as longer-term challenges including the development of responsible investment into alternative investment and emerging markets. We were very happy to take part in this now well-established annual event, which provides a great opportunity to exchange ideas and join forces to promote long-termism and stewardship within the financial industry.

UN Global Compact UK network

On 3 June, we took part in the conference "Assessing Human Rights Impacts: where the rubber hit the road" co-ordinated by the UK network of the UN Global Compact. Drawing from case studies presented by companies including BP, Nestlé, Rio Tinto, Kuoni and Marshalls, this event was an opportunity for corporate and non-business signatories of the UN Global Compact to discuss the challenges underlying the assessment of human rights impacts. In particular, participants exchanged views on the issues to address when conducting human rights impact assessments and how to implement relevant human rights due diligence. We believe the conclusions of this conference are fully embedded in Standard Life Investments' approach to human rights. For further details, please see: http://www.standardlifeinvestments.com/sustainable_and_responsible_investing/index.html

UKSIF's first Scottish event

We took part in the UK Sustainable Investment and Finance's (UKSIF) first event in Scotland, which was held in Edinburgh on 17 April. The event included discussion on Scottish independence and sustainable finance, tax responsibility and integrated reporting. Speakers included members of the Scottish Labour party, Carbon Disclosure Project and the Royal Bank of Scotland. We welcome the steps taken by UKSIF to host an event in Edinburgh, which is reflective of the number of UKSIF members and investment institutions in Scotland.

During the quarter, UKSIF announced the appointment of a new chair, Lesley Alexander, who will start on 1 July. Lesley is the CEO of HSBC Bank Pension Trust (UK) Limited and replaces Martin Clarke who is stepping down after his two-year term in the role. As a supporter of UKSIF and its work, we welcome this appointment and look forward to working closely with Lesley in her new appointment. We would also like to extend our thanks to Martin who has served UKSIF incredibly well over the past few years.

Sector and asset class reports

As a global investment manager with capabilities spanning the full breadth of asset classes, our active approach to responsible investment facilitates the provision of client insight across many sectors and areas of investment. We detail below two reports published during the first quarter of 2014. These cover ethical investment and sustainability within real estate.

Views of an ethical investor

Standard Life Investments manages a number of ethical funds. Each year, we conduct a survey of investors in our funds to ensure that the ethical criteria remain relevant and reflect the views of our investors. Lesley Duncan, one of our UK equity fund managers who has managed the UK Ethical Equity Fund for 10 years, comments on this year's survey.

Over the last 10 years, I have witnessed that the most important ethical criteria remain broadly the same in our survey. The survey highlights that we should avoid companies that manufacture weapons, produce tobacco, are involved in human rights abuses or fail to address environmental issues. Interestingly, in our recent survey, there was a shift in focus towards business ethics, which focuses on corporate governance practices, anti-corruption mechanisms, company remuneration policies and ensuring that board level committees should exist to oversee environmental, social and health and safety matters.

Ten years ago, these areas were not high on our investors' ethical thinking. However, strong corporate governance practices are now paramount for our ethical investors. Furthermore, our investors consider engagement as a vital tool to drive better corporate behaviour. An overwhelming 90% of our investors would support outright exclusion if systematic engagement to improve the corporate behaviour of a company should fail.

Further interesting trends that have emerged over the last 10 years have been around alcohol production, which now ranks quite low in our survey. Investors have become more concerned around how alcohol manufacturers price their products and their advertising practices, viewing these as an important part of these companies social responsibility.

Finally, there is support for not having an outright exclusion on nuclear energy, with an appreciation from our investors that nuclear energy is becoming a necessary part of a clean energy future. A decade ago, an outright exclusion of nuclear would have ranked highly. Today's investors are taking a more pragmatic view on future energy supplies and weighing up the environmental costs and climate change issues of nuclear versus fossil fuels. Overall, our ethical investors' social conscience remains at the forefront of how they want to invest. In addition, they do not want to sacrifice performance when taking their values into account in their investment decisions. In fact, they believe that responsibly managed companies are likely to generate outperformance over the longer term.

Lesley Duncan
UK Fund Manager

Environmental performance of our UK Ethical Equity Fund

Environmental data provider Trucost provides on online tool to enable the analysis of investment portfolios and calculation of their carbon and environmental footprint. Standard Life Investments decided to undertake this analysis for the UK Ethical Equity Fund, as at January 2014.

This analysis involved the measurement of the weighted carbon and environmental impact from individual holdings within the portfolio. The carbon footprint of the Fund was measured in terms of tonnes of greenhouse gas emissions (GHG) per US$ revenue, the environmental impact expressed in the US$ cost of environmental externality per US$ revenue (%). This weighted measurement was then compared to the footprint of the Fund's benchmark index, the FTSE All-Share Index. Further analysis showed to what extent the Fund's carbon or environmental performance was due to the relative sector or stock weights chosen by the manager.

The results of this process concluded that the UK Ethical Equity Fund had a carbon footprint measurement of 109 relative to the benchmark index measurement of 279. The Fund was shown to be 61% more carbon efficient than its benchmark index. With regard to environmental footprint, the UK Ethical Equity Fund was shown to be 54% less environmentally impactful than the benchmark overall.

While this modelling has certain limitations, it nevertheless provides a valuable insight into the carbon and environmental performance of Standard Life Investments' ethical funds.

Sustainable real estate

Latest solar PV installation

Our latest investment in renewable energy was finally commissioned during March when the Pooled Pension Fund had 30kWe of peak electric photovoltaic cells installed on the roof of Communications House, Staines.

Utilising all the electricity generated on site, the system will provide over 40% of the landlord's common areas electricity needs as well as generating a 15% IRR over the 20 years of the feed-in-tariff support.

A visual display unit in the reception area keeps tenants informed about how much electricity has been generated and how many carbon emissions have been prevented.

Graham Baxter
Sustainable Engineering Manager

Sustainability engagement

During the second quarter of 2014, we undertook significant engagement with a wide variety of companies regarding environmental and social issues. We outline below further details of some of these engagements in addition to a summary of all company meetings.

We use a matrix approach to identify the companies that we engage with. This considers a number of criteria, including internal mandates, specific client mandates and company performance. The key below provides details of the drivers for engagement with individual companies. Further details on our engagement approach can be found at:

http://www.standardlifeinvestments.com/sustainable_and_responsible_investing/index.html

Key

- Internal mandate
- Client mandate
- Performance based engagement

BAE Systems ●	BAE Systems requested a meeting with Standard Life Investments to discuss its current approach to sustainability. As referenced in our first quarterly report of 2014, we had previously engaged with the company to gain details of its approach to anti-bribery and corruption. We questioned what governance the company has in place to oversee sustainability risks and opportunities. BAE advised us that it had a board level committee which assesses sustainability issues. The committee is attended by the senior non–executive directors and meets five times a year, reporting directly to the board. The company also detailed a number of steps it had taken to ensure that senior executive objectives and remuneration are linked to the company's sustainability strategy. We questioned the company on its approach to supply chain risks and its exposure to conflict minerals. Conflict minerals are minerals extracted from conflict zones. The US Security and Exchange Commission (SEC) requires manufacturers to audit their supply chains and report conflict minerals usage from the Democratic Republic of Congo. BAE explained that it did not have exposure to conflict minerals. However, it does closely follow its supply chain which is key to providing services to its existing clients. The company operates a number of partnerships and joint ventures with its critical suppliers and carries out ongoing audits to ensure that standards such as the EU's REACH (Registration, Evaluation, Authorisation and Restriction of Chemicals) regulations are met. The defence sector faces a number of risks relating to bribery and corruption and supply chain issues. We believe that BAE Systems currently has a number of policies and practices in place to meet these challenges.

Sustainability engagement

Key

- Internal mandate
- Client mandate
- Performance based engagement

BHP Billiton	We met company representatives of BHP Billiton, including the Head of Group HSEC, Investor Relations and Governance. We discussed the company's broader sustainability strategy, with a specific focus on how it was assessing the risk of stranded assets in its business, in a low carbon environment. BHP Billiton is a large miner of coal assets, which poses particular challenges to its business. A member of the Responsible Investment Team asked the company a number of key questions on how these risks are being assessed in its business. BHP Billiton explained how it had carried out risk analysis and scenario planning. Under scenario planning, the company considers a number of different future scenarios and what they would mean for its business. This includes considering how it would be positioned in a low carbon future. One scenario was to plan for no coal by 2030. The company believes that its portfolio is balanced to offset the challenges a low carbon future would create in its business model, particularly as a coal miner. BHP Billiton views its portfolio as well balanced to offset carbon risk. For example, a low carbon future would be dependent on new nuclear power stations to provide base load energy that is currently provided by coal. As a uranium miner, BHP Billiton would benefit from this growth. In addition, some of the metals it mines are necessary for a range of renewable energy solutions. This would also help offset any potential reduction in demand for its coal. The company remains committed to assessing the risk of stranded assets to its business. It uses a cost of carbon in its business planning and project valuations. However, the company does not disclose the cost of carbon it uses as it believes this to be commercially sensitive. We encouraged the company to consider doing so, given others in the sector already disclose a cost of carbon. While BHP Billiton remains a sector leader, it will continue to face a number of environmental and social challenges from operating in the extractive industries sector. We were encouraged by the progress the company is making and will continue to dialogue with it on these matters.
Bodycote	We met with Bodycote, the UK-listed thermal processing company, to discuss its approach to managing sustainability matters. We asked the company about how it manages its energy use. Energy is a key input into Bodycote's processes and it has a financial incentive to reduce energy use. Bodycote's business model is well placed to help customers improve their energy efficiency. First, Bodycote is able to conduct thermal heat processing more efficiently than in-house systems. Second, the materials generated through thermal processing achieve efficiencies in use. For example, lighter materials used in cars, improvements to gearing ratios, extending material's useful life and enhancing corrosive resistance. We welcomed more communications on the energy-saving opportunities Bodycote offers to its customers. Health and safety is a key focus for Bodycote. It has detailed operational safety processes and polices as well as a full investigations process following any breaches that may have occurred. We believe that the company applies high health and safety standards to all operations across 26 countries.

Sustainability engagement

Key

- Internal mandate
- Client mandate
- Performance based engagement

CVS

CVS Caremark is an integrated pharmacy healthcare provider based in the US district of Columbia, Brazil and Puerto Rico. The company has made an industry leading move to withdraw tobacco from its 7,500 stores across the US. This policy, expected to be associated with $2 billion of revenue loss a year, better aligns the company's actions with its strategy to promote healthier communities and positive health outcomes.

We asked the company about its approach to responsible advertising. CVS stated that it was more conservative than peers and that the main concern related to pricing compliance. CVS Caremark operates 800 MinuteClinics across the US but has plans to expand this coverage. The clinics fill a gap in the supply of primary care and CVS Caremark represents 1.5% of market share. We questioned the company on its protocols around nurse prescribers' use of CVS branded treatments.

Data security is a key risk since the company holds information on 70 million active ExtraCare loyalty cardholders and many of its operations are dependent on information systems. The company confirmed that it does not sell any personal data and that customer profiles are deleted when the cards are cancelled. CVS Caremark has begun operations in Brazil following an acquisition of 45 pharmacies. Brazil is a growing and fragmented market and thus presents an opportunity for the company.

Fresenius Medical Care

Fresenius Medical Care is an integrated provider of products and services for individuals undergoing dialysis because of chronic kidney failure. We contacted the company to gain a better understanding of how it approaches sustainability matters in its business.

Largely, disclosure is limited and we were keen to learn how particular environmental and social issues were being managed. We spoke with a senior executive in the manufacturing division. We discussed some recent product issues that the company had experienced. The company provided an overview of its global approach to managing product standards. This includes how ISO standards are being achieved across the business. The company also explained how it monitored the feedback from its customers, using its complaints system to drive improvements in the business.

Given the global nature of the business, we were keen to understand how business ethics issues, such as anti-bribery and corruption, formed part of its business. This was particularly in reference to its operations in China, where the pharmaceutical sector has come under increasing scrutiny in recent years. Given the company's main business is to sell high-end equipment directly to hospitals, agents do not form a significant part of its business. As such, it did not face the same challenges as the pharmaceutical sector.

It outlined its approach to anti-corruption, including its adherence to the Foreign Corrupt Practices Act (FCPA). We also discussed access to healthcare issues with the company and encouraged it to consider a number of things. These included encouraging the company to improve the level of disclosure on how it manages these particular issues in its business. We also asked the company to formalise its approach to access to healthcare and provide robust business arguments for this. We will continue to monitor its progress against a number of key performance indicators.

Sustainability engagement

Key

- Internal mandate
- Client mandate
- Performance based engagement

GKN	GKN is a UK-based diversified company with operations covering automotive, aerospace, land systems, and powder metallurgy businesses. We contacted the company to discuss its approach to corporate responsibility and how it was managing major environmental and social risks in the automotive and aerospace industry. We questioned GKN on the way business ethics standards were applied across activities, particularly where the company is expanding activities in countries where ethical standards may not be as well established. GKN gave us reassurance on the robustness of its policies and monitoring processes in accordance with the UK Bribery Act. We encouraged the company to enhance reporting on important issues such as facilitation payments and monitoring of business partners. We also discussed with GKN its positioning on energy-efficient solutions in the automotive business within a context of more stringent environmental regulation around the globe. The company is well positioned to benefit from higher standards regarding carbon emissions of cars, both in mature and emerging markets. Energy efficiency is one of the main drivers of its innovation strategy in the automotive business. We questioned the company on its human capital strategy and the management of its supply chain. We believe the industry faces key social challenges to cope with higher competition and cyclicality of activities. The company has developed several programmes to attract and retain engineering skills and to keep an engaged and motivated workforce. We encouraged GKN to expand its reporting on social indicators such as age of workforce and the outcomes of employee engagement surveys. We also encouraged the company to provide better disclosure on the management of its supply chain, including how environmental, social and business ethics risks are taken into account.
London Mining	London Mining operates an iron ore mine in Sierra Leone. The company has plans to expand operations in Sierra Leone and open operations in Greenland. Oversight of sustainability is carried out at a board level. Remuneration for issues such as health and safety are applied at an executive level. Overall, the company has strong environmental and social practices at the Marampa mine in Sierra Leone. This is evidenced through an investment by the IFC in the project following rigorous environmental and social due diligence. The company outlined several ways in which it expected to cut operating costs in light of low iron ore prices. London Mining has received pressure from Christian Aid to pay more tax in Sierra Leone. We questioned the company on the regulatory uncertainty around tax in the country. We believe the company is well placed to manage this risk. The company has conducted thorough environmental and social due diligence of proposed operations in Greenland. Environmental and social impact assessments are reported on its website. Although Greenland presents some challenges as outlined in the impact assessments, we are confident that the company is well placed to manage these risks. We will continue to monitor developments with this project, in the event that it goes ahead.

Sustainability engagement

Key

- Internal mandate
- Client mandate
- Performance based engagement

National Express	We met with National Express, the UK-listed bus operator, to discuss the social issues raised by the shareholder resolution that was sponsored by Teamsters, one of the company's unions. The shareholder proposal called for greater oversight of National Express' human capital strategy, the application of a company-wide workplace human rights policy and annual disclosure on the progress of the strategy. In recent years, National Express has implemented several organisational and operational steps to monitor social challenges. National Express has seen continuous improvement in its health and safety indicators over the past few years, which has business implications given safety is increasingly a crucial aspect to win and retain contracts. The company reviewed its people strategy in 2013 and the new policy is currently being implemented. We encouraged National Express to enhance its social reporting in order to evidence the impact of this new strategy, including disclosing KPIs on employee turnover, training and development. We supported the company by voting against the shareholder resolution. We will continue to monitor the company, its processes and how these changes may result in improvements in managing its workforce.
Petrofac	Standard Life Investments provided feedback on the latest CSR section of Petrofac's annual report. This included reviewing the rating of environmental and social risks used for the materiality assessment. Although the company has a good level of disclosure, we encouraged greater transparency in several areas. We will follow up through further engagement with the company on its wider sustainability performance.

Sustainability engagement

Key

- Internal mandate
- Client mandate
- Performance based engagement

Repsol	Repsol is a global energy company with activities in upstream (exploration and production of hydrocarbons) and downstream (refining, chemical and green energy projects) energy operations. We asked the company how it was assessing the risk of stranded assets in its business, in a low carbon environment. The company outlined a number of steps it is taking to address the issue including the use of a 'shadow carbon price' to generate future price predictions and assumptions. The company also highlighted a number of steps it is taking to reduce GHG emissions across its business. In addition to these measures, Repsol is putting a number of adaptation techniques in place to minimise future environmental changes. We raised our concerns regarding the company's activities in the Gulf of Mexico. We were encouraged to learn of the re-organisation of the regulatory structure in the area including the establishment of the Bureau of Safety and Environmental Enforcement. Repsol has taken a number of steps to ensure best practice in the area including the bolstering of drilling safety and workplace safety standards. The company has significant onshore operations in South America and we questioned its approach to impacted communities and its application of the Principles of Free Prior and Informed Consent (FPIC). The company outlined the steps taken to integrate the Caipipendi project in Bolivia, which included the drilling of seven wells and installation of two pipelines in remote locations that impacted indigenous communities. The project applied various measures to ensure the minimum impact on the environment, in addition to extensive engagement with local communities and steps taken to ensure both social and economic benefits for impacted stakeholders. We are comfortable with the policies that the company has in place to address impacts on indigenous communities. However, we highlighted the need to ensure that each community is dealt with on an individual basis and the importance of consulting third parties.

Sustainability engagement

Key

- Internal mandate
- Client mandate
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Royal Bank of Scotland	Our meeting formed part of our ongoing engagement with both the company and the banking sector as a whole. The sector continues to face challenges regarding its approach to conduct risks and improvements to corporate culture. RBS recently appointed Ross McEwan as it new CEO, who has publicly stated that he will seek to instil cultural change within the company and streamline its practices to increase efficiency and reduce bureaucracy. This will entail a reduction of the current seven divisions within the company to three and improvements in its processes, particularly its information technology systems. The bank is currently facing a number of allegations related to its previous conduct. This includes a review by a Treasury Select Committee into allegations that RBS pushed its SME (small to medium-sized enterprises) customers into receivership to boost its own profits. An independent review commissioned by the company and carried out by Clifford Chance LLP, a London-based law firm, found there to be no evidence of such allegations. RBS, in addition to a number of other banks, has also been accused of mis-selling interest rate hedging products (IHRPs) to SMEs. The bank is currently reviewing potentially mis-sold products and will ensure that customers that were mis-sold products receive appropriate redress. Conduct risk, particularly from legacy issues, has been an ongoing issue for the sector and a cause for concern for a number of investors. We welcome the company's disclosure of payments as a result of conduct risks and believe that it is one of the most transparent banks on this issue within the sector. We will continue to monitor the progress of RBS and its new CEO.
Santander	As part of our ongoing collaboration with fellow members of the Principle for Responsible Investment (PRI), we met with Santander to discuss the current steps it is taking to implement anti-bribery and corruption measures. Santander has used robust anti-bribery guidance and procedures to create its internal anti-bribery mechanism, including the UK Bribery Act, the Foreign Corrupt Practices Act and the Wolfsburg Principles. The approach taken is applied across all of its operations with individual countries taking responsibility for the implementation of the company's anti-bribery measures. Santander has also committed to publish further details on its internal codes of conduct which we believe to be a positive step.

Sustainability engagement

Key

- Internal mandate
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- Performance based engagement

Shell	We attended Shell's Annual Responsible Investor event and met with a number of representatives from the company including its Chief Executive Officer, Chairman of its Socially Responsibility Committee and its Vice President of Global Business Environment. We discussed Shell's operations in North America and Western Canada, specifically its oil sand operations and the running aground of the Kulluk Rig in Alaska. Shell is currently reviewing its operations in the Alaska region of North America and at present no further projects are planned in the region. The company continues to carry out the extraction of oil sands and has begun testing carbon capture and storage technologies in the area. The company was assessing the risk of stranded assets in its business, in a low carbon environment. Shell identified a number of steps it has taken to assess the potential impacts of stranded assets, including the measurement of energy scenarios over the next 40 years and the potential impacts of carbon pricing on various projects. Various challenges face the company in Nigeria, including the increase in thefts of crude oil, environmental impacts as a result of illegal oil tapping and the increased number of company employees that have been kidnapped. The company detailed steps which it is taking to address these issues including working more closely with regulators, developing environmental restoration programmes and supporting its employees who are at risk of kidnap. There are a number of social and environmental issues facing the company and we will continue to engage with Shell to promote best practice and monitor the progress it is making.

Sustainability engagement

Key

- Internal mandate
- Client mandate
- Performance based engagement

Company	Engagement
Soco International	Following on from our conversations with the company in the first quarter, we joined a group of investors to meet the Chairman and Senior Non-Executive Director of Soco International. Discussions focused on research on the company that had been commissioned from Eiris and Soco's operations in the Democratic Republic of Congo (DRC). WWF has accused the company of breaking international conventions by operating in a World Heritage site, the Virunga National Park. WWF believes that Soco's exploration for oil will threaten Virunga, create civil unrest and put pressure on local people. WWF also highlighted the impact on wildlife and biodiversity. The OECD Guidelines for Multinational Enterprises provides implementation mechanisms through the National Contact Point (NCP) system. WWF filed a complaint against the company in 2013 through the UK NCP, alleging the company's oil exploration activities violate the environmental and human rights provisions of the Guidelines. At the time of meeting, the NCP was attempting to mediate and broker a dialogue between WWF and the company. Eiris highlighted a number of key risks relating to Soco International's activities in the DRC. These include biodiversity issues, potential breach of international law, risk of corruption in the DRC, human rights and political instability. Soco's exploration consists of scientific studies to assess the petroleum resource potential of the region, under a contract with the DRC government. This activity is confined to about 1% of Lake Edward located in the Virunga National Park. It has a contractual commitment with the DRC government to carry out approved exploration activities. The company explained how it applied the same standards to its projects, as required by the World Bank. The Chairman confirmed that seismic drilling has been conducted and was nearly finished. It would be around 18 months before the results of this analysis came to any conclusion as to whether there are any natural resources in the region. He was keen to state that no drilling has been planned by the company. The Chairman outlined some of the community initiatives and Soco's broad approach to sustainability matters in the DRC. The company demonstrated a strong willingness to engage and listen to the feedback from both Eiris and its shareholders. The company welcomed the recommendations made by Eiris and outlined how these would help management in driving a more transparent strategy around its corporate responsibility going forward. Standard Life Investments encouraged greater transparency from the company, on environmental and social matters, including a clear articulation of the company's policy and how this is implemented through setting and managing key performance indicators. We will continue to monitor the situation and plan to meet with the company again in the autumn. Subsequent to meeting the company, we were comforted to learn that WWF and Soco reached an agreement in relation to WWF's complaint to the UK NCP. Soco has made a commitment to complete its existing seismic programme in Virunga and then not to undertake or commission any exploratory or other drilling within Virunga National Park, unless UNESCO and the DRC government can agree that such activities would not be incompatible with its World Heritage status. Soco also committed not to conduct any operations in any other World Heritage site. WWF has agreed to cease its campaign against the company, so long as it remains committed to this statement.

Sustainability engagement

Key

- Internal mandate
- Client mandate
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Tesco	The Head of Responsible Investment joined the Head of Governance & Stewardship at a meeting with the Chairman of Tesco. This allowed us to ask for an update from the company on its approach to embedding corporate responsibility issues. The Chairman outlined the progress of the Corporate Responsibility Committee, which he had set up and had been chairing. He outlined how its corporate responsibility strategy was part of building a good brand reputation over the coming years. We asked the company about any changes that had been made in its supply chain, particularly after incidents such as the Bangladesh factory collapse. The Chairman believed the company had made the most progress in its non-food supply chain. He outlined how Tesco is working to improve the standards of its suppliers, rather than find new suppliers. This had also helped improve efficiencies within the business. Standard Life Investments discussed the continued challenges in managing sustainability matters in Tesco's food business. We were comforted by the approach the company now takes. In particular, the Chairman recognises the need to build long-term relationships with its suppliers as a key to a sustainable business strategy.
Vedanta	We have continued to engage with Vedanta to promote better practices within its operations and believe that the company has made significant steps to improve. We questioned the company regarding its new CEO (Tom Albanese) and his approach to sustainability. The company advised us that its new CEO was committed to promoting best practice and had become an active member of the company's Sustainability Committee. The Sustainability Committee operates at a board level and includes senior executives. We questioned the company on various projects that are currently or have been subject to regulation as a result of poor sustainability practices. Vedanta detailed advances that it had made at its mining operations in Goa, refining facilities in Lenjigarh and smelter facilities in Tuticorin. It also detailed a number of steps taken to improve environmental and social impacts at other facilities along with details of the progress it has made in relation to the URS (Scott Wilson) report. The URS report was carried out in 2010 by various financial institutions to review Vedanta's sustainability practices and set a number of goals to achieve best practice in relation to international standards. We were encouraged by Vedanta's adoption of these goals and its level of progress. We will continue to engage with the company.

Sustainability engagement

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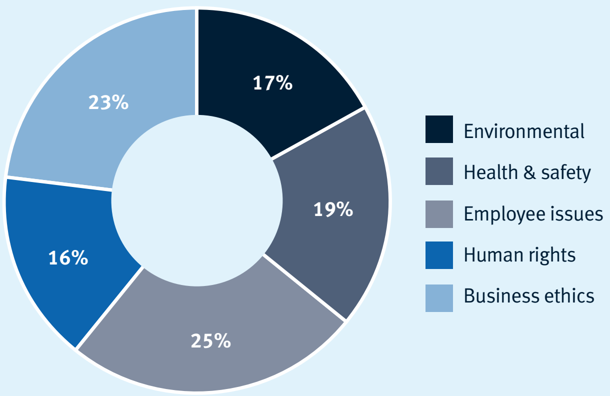
Pharmaceutical Investor Day	We met with a number of pharmaceutical companies including AstraZeneca, Novartis, Novo Nordisk and Shire as part of a responsible investment engagement day. We questioned these companies on a range of issues, particularly their exposure to potential bribery and corruption in areas such as China, where GlaxoSmithKline has recently faced a number of bribery allegations. All of the companies we spoke with had policies in place to deal with bribery and corruption. However, companies such as Shire had less exposure to emerging markets. We were encouraged by the policies that were presented and encouraged the companies to consider adopting employee incentive schemes that were not solely focused on sales. We also encouraged the adoption of the appropriate 'whistle blowing' mechanisms across different geographies where the companies operate. We sought details from these companies on sustainable pricing and programmes they had in place to support access to affordable medicines. The companies highlighted that access to healthcare is a global issue that has different challenges in established and emerging markets. Established markets often have robust healthcare coverage. However, they also face issues relating to appropriate pricing for medicines. Emerging markets lack the same healthcare coverage and it is often difficult to promote access to public funding and healthcare system support.

Sustainability engagement summary

Company	Environmental	Health & safety	Employee issues	Human rights	Business ethics
Anglo American	•	•	•		
AstraZeneca		•	•	•	
BAE Systems	•		•		•
BHP Billiton	•	•	•		
Bodycote	•	•	•		
BP			•	•	•
CVS Caremark			•		•
Fresenius Medical Care	•	•	•		•
G4S			•	•	•
GKN	•	•	•		
London Mining	•	•		•	
National Express		•	•	•	•
Novartis			•	•	•
Novo Nordisk			•	•	•
Petrofac	•	•			•
Royal Bank of Scotland			•		•
Repsol	•	•	•	•	•
Rio Tinto	•	•		•	
Santander					•
Shell	•	•	•	•	•
Shire			•	•	•
Soco International	•				•
Tesco		•	•		•
Vedanta	•	•	•	•	•

Engagement summary Q2 2014



Total voting on sustainability issues

	Direct and indirect environmental impact disclosure	Fracking and tar sands	Operations in high risk geographies	Stranded assets	Animal welfare	Tobacco and childhood obesity education	Tax transparency and fair lending	Human capital/ diversity	Charitable contributions	Digital regulation
Abbott Laboratories	1									
Wells Fargo & Company							1			
Verizon Communications Inc										1
Occidental Petroleum Corporation		2								
EOG Resources Inc		1								
Kraft Foods Group Inc	2				2					
Philip Morris International Inc					1					
Dominion Resources	2	1		1						
Reynolds American Inc					1					
Anadarko Petroleum Corporation				1						
Statoil		1	2							
Altria Group Inc						1				
Google Inc							1			
National Express Group plc								1		
Lorillard Inc						1				
The Charles Schwab Corporation								1		
Mondelez International Inc	1									
The Home Depot Inc								1		
Facebook Inc	1					1				
Chevron Corporation		1							1	
Exxon Mobil Corporation	1							1		
WPP	1									
Total votes	9	6	2	2	4	3	2	4	1	1

Details of companies where we have voted against management or abstained on resolutions can be found at our voting disclosure website: **http://www.standardlifeinvestments.com/governance_and_stewardship/what_is_corporate_governance/our_voting_records.html**

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