July 2020

Sustainability Report 2020

Sustainable capitalism in a post Covid world

Image credit: Rebecca Hendin

Foreword

The past year has been pivotal for sustainable investing, and one in which its role in shaping our economic and financial futures became more urgent.

The Covid-19 outbreak and lockdowns of entire economies around the world have sharpened the focus on companies' societal responsibilities: to their employees, to their customers and even to their suppliers. This is no brief moment in the spotlight, but a serious reappraisal of our system of capitalism, of how enterprises are run and for what purpose.

Capitalism has proved resilient for two reasons. First, a structured system of exchange is a natural, human way for us to value resources and get them to where they are wanted and needed. The marketplace has been central to all civilisations, large and small. Second, capitalism is a flexible system, one that adapts to changes in society and the world at large. It has been through many different stages of evolution to reach the form in which we find it today.

It appears as if capitalism is about to go through one of those periodic reinventions. One aspect of its current incarnation was largely shaped in the 1970s by Milton Friedman's shareholder doctrine, which held that a company should be run in the interests only of its shareholders. But, over the past half century, the world has changed.

The CEOs of many of the largest corporates, some of which appear almost to rival governments in their reach and influence, have said that running them solely for the benefit of equity owners is no longer an option. For a start, it risks alienating non-shareholders - including the customers and employees on whom every business depends - if the long-term impact of a business on the community and environment in which it operates is a negative one.

As an example, more than half of young people surveyed recently by Harvard said the current system of political economy is failing them. This doesn't mean that shareholders' interests are not important - they do matter and will continue to do so. But they are not the only interests that matter.

As capitalism develops, so will the way we invest. Any system that doesn't adapt to the times runs the risk of looking to the past for opportunities rather than the future. Several characteristics of this new approach to investing are relevant to asset managers such as Fidelity, but chiefly it focuses on engaging with company managements and assessing their ability to create a business model that is built to last, to be integrated into the transforming world around them, rather than be overcome by unpredictable social and environmental changes. In the long term, what is good for stakeholders is good for shareholders too. This is not a zero-sum game.

Today, we call it sustainable capitalism. You might even see it referred to as stakeholder capitalism or ethical capitalism or ESG. But, at some point in the near future, it will just be called capitalism.

Anne Richards
CEO, Fidelity International

[1]Source: A majority of millennials now reject capitalism, poll shows, Washington Post, 2016
https://www.washingtonpost.com/news/wonk/wp/2016/04/26/a-majority-of-millennials-now-reject-capitalism-poll-shows/

Contents

Sustainable investing offers hope in a post-pandemic world

The pandemic is driving profound changes in the role of business in society.

Jenn-Hui Tan
Global Head of Stewardship and Sustainable Investing

Welcome to our Sustainability Report 2020, in which we explore our engagements with investee companies over the year across multiple themes, as well as the continued expansion of our sustainable investment capabilities. In the context of our over-arching theme of sustainable capitalism, we also consider how Covid-19 has changed the way companies, investors and governments think about sustainability and what the future may hold.

Covid-19 and interest in ESG

Before the pandemic hit, interest in environmental, social and governance (ESG) investing was growing in all regions of the world, and the biggest issue for many was the impact of climate change and how to address it (cf. A watershed year for ESG).[2] After Covid-19 put the brakes on global growth, it was possible that ESG's rising tide would ebb. Some sceptics claimed that it would be a bull market phenomenon, and unlikely to remain a priority when entire industries were struggling to stay afloat.

The truth could not be more different. Covid-19 has brought ESG issues to the fore with unexpected urgency. Chief among them has been the rise of "S" (see our Analyst Pulse Survey on page 13), with a much greater focus on employee welfare and the societal responsibility of businesses in a global crisis. Priorities – for corporations, households and governments – have changed dramatically.

As the pandemic swept through Europe, luxury-goods giant LVMH, for example, switched from making perfume to producing hand sanitisers,[3] as both use alcohol. Ford diverted airbag-manufacturing capacity to making face masks[4] that may reduce the spread of infection. Meanwhile, in Australia, Qantas Airways leveraged its partnership with Woolworths to place furloughed workers[5] with the retail giant, redirecting vital labour to where it was most needed.

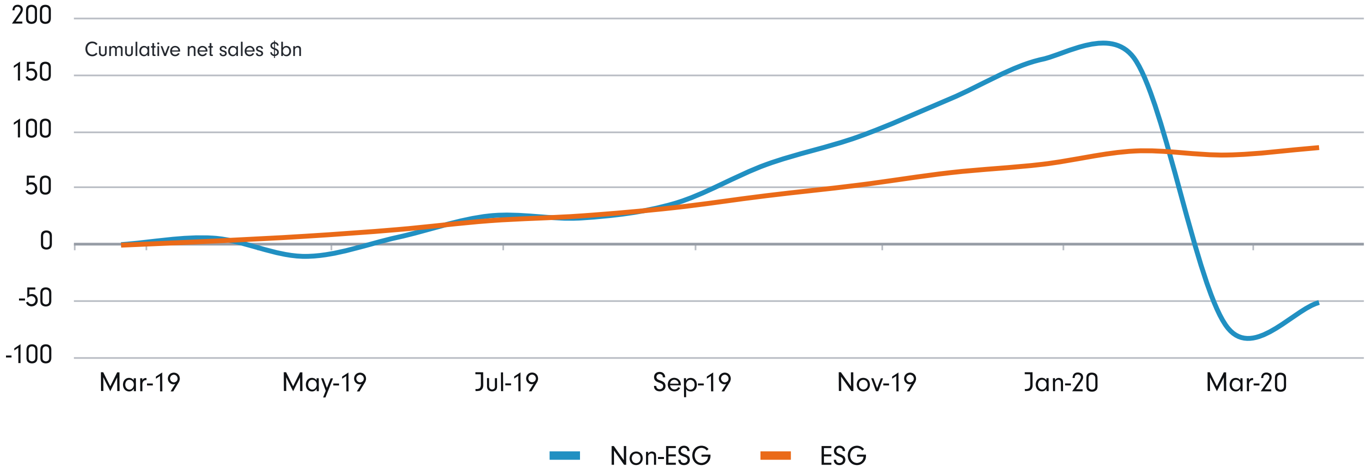
Sustainability outperforms during the crisis

These companies have redeployed their know-how and resources to help society, rather than to maximise short-term profit, often at their own cost. Companies that respond dynamically in this way protect their brand and business, and should have the agility to seize new growth opportunities as the pandemic is brought under control.

A growing body of evidence indicates that companies with high ESG standards are more resilient, typically have a lower cost of capital, and can offer higher quality, long-term returns. Both before and during the crisis, companies

[2]Source: https://www.fidelityinternational.com/editorial/article/analyst-survey-2020-a-watershed-year-for-esg-5fe27e-en5/
[3]Source: https://www.forbes.com/sites/richardkestenbaum/2020/03/15/lvmh-converting-its-perfume-factories-to-make-hand-sanitizer/#4d408eed4a9a
[4]Source: https://media.ford.com/content/fordmedia/fna/us/en/news/2020/04/13/ford-to-produce-respirators-masks-covid-19.html
[5]Source: https://www.afr.com/work-and-careers/workplace/woolworths-offers-jobs-to-laid-off-qantas-workers-20200319-p54br5

Chart 1: ESG funds spared from the sell-off



Source: Broadridge FundFile as at 30/04/2020. Funds sold cross-border only (includes active/passive funds and ETFs). Excludes fund of funds and money market funds

with higher ESG scores have outperformed the laggards, according to Fidelity research.[6] The analysis used Fidelity's own proprietary ratings rolled out over the past year to assess stock and bond performance during this short period (see page 11).

During the extreme volatility in March, with net outflows across financial markets, ESG funds continued to see steady inflows (see chart). From individuals to corporations and huge asset owners, investors are increasingly favouring companies that display positive social, climate and governance attributes.

Key ESG themes for 2019

Even before the Covid-19 crisis, the role of the corporation in society was already under the spotlight, with some of the largest US business leaders stating in 2019 that its purpose had to change. Activist shareholders, environmental groups and initiatives such as the Taskforce for Climate-related Financial Disclosure had all contributed to the rising influence of ESG issues. So had the considerable business opportunities in emerging low-carbon sectors such as renewables and electric transport.

During this period, Fidelity's sustainable investing agenda centred around five main themes: climate financing, supply-chain transparency, sustainability reporting, responsible palm oil and animal protein industries. This report contains many examples of our engagements with companies in these and other important areas such as data privacy in 2019 (see page 44).

Our engagement activity took place around the world, encompassing many different issues, from working with famous chocolate brands on palm oil concerns to discouraging Asian banks from financing new thermal coal projects to feeding into broader country conversations about improving corporate reporting.

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We believe that engagement is crucial to our role as stewards of client capital and, within that, to our active investment and ESG rating process - our Sustainable Investing team works closely with Fidelity analysts and portfolio managers when engaging with companies. It also forms part of our responsibility to run our own business in a sustainable way.

Key ESG themes for 2020 and beyond

In the wake of Covid-19, the world is a different place. While the emphasis on climate change persists in many

[6]Source: https://www.fidelityinternational.com/editorial/article/outrunning-a-crisis-sustainability-and-market-outperformance-2ce135-en5/

geographies, with calls for governments to "green" the recovery, many countries and companies are understandably focused on saving lives and livelihoods. In this context, our engagement with companies becomes ever more crucial to ensuring that their business models are sustainable, in all senses of the word.

So for 2020, our climate priority will be to work with companies to disclose scope 1, 2 and 3 emissions (i.e. direct emissions from operating activities and energy use, and indirect emissions within value chains) and set measurable targets to achieve decarbonisation. As part of the Climate Action 100+ group, we will lead on some of the engagements with the world's largest emitters, encouraging them to take necessary action on this issue.

We will also seek to engage on specific social themes such as employee welfare and to understand how companies are pivoting their business models towards greater social purpose. We have created a best practice guide for Fidelity portfolio managers and analysts to assist them when speaking to companies about how they are managing stakeholder relationships and maintaining board effectiveness, as a result of the virus.

It will be important to find ways to address inequalities that open up due to the pandemic and ensuing recession; stimulus packages typically benefit owners of financial assets, not workers. Huge income disparities inevitably lead to abrupt rather than progressive change, which can be damaging.

Following a range of successful engagements in 2019, we will continue to monitor how supply chains are changing, as we move from a pre-Covid world in which low-cost efficiency was paramount, to one in which resilience plays a bigger role. This could mean manufacturing moving closer to where customers are and paying more for labour. Lastly, as Covid-19 forces us to live more of our lives online, with more use of facial recognition and AI, we need fresh ideas on digital ethics to hold global tech giants to account.

Looking to the long term

Covid-19 and climate change are both planetary events that challenge the way we live. So far, the response to the pandemic has been largely national or regional, not global. But the economic damage has also robbed many governments of the illusion that we can go on as we are. If necessity is the mother of invention, we are confronted today with the mother of all necessities.

This presents an opportunity for companies and investors to embrace sustainable capitalism, think long-term and reset incentives for senior executives that are tied to achieving specific ESG goals. Sustainability factors are fundamentally a proxy for quality management, in my view. Corporate leadership teams that prioritise broader stakeholder outcomes are likely to be best placed to survive and thrive despite our twin health and climate crises, and offer the most stable and sustainable returns for shareholders.

Companies seek to protect staff as they return to work. (Photo by Kevin Frayer / Stringer Images via Getty Images)

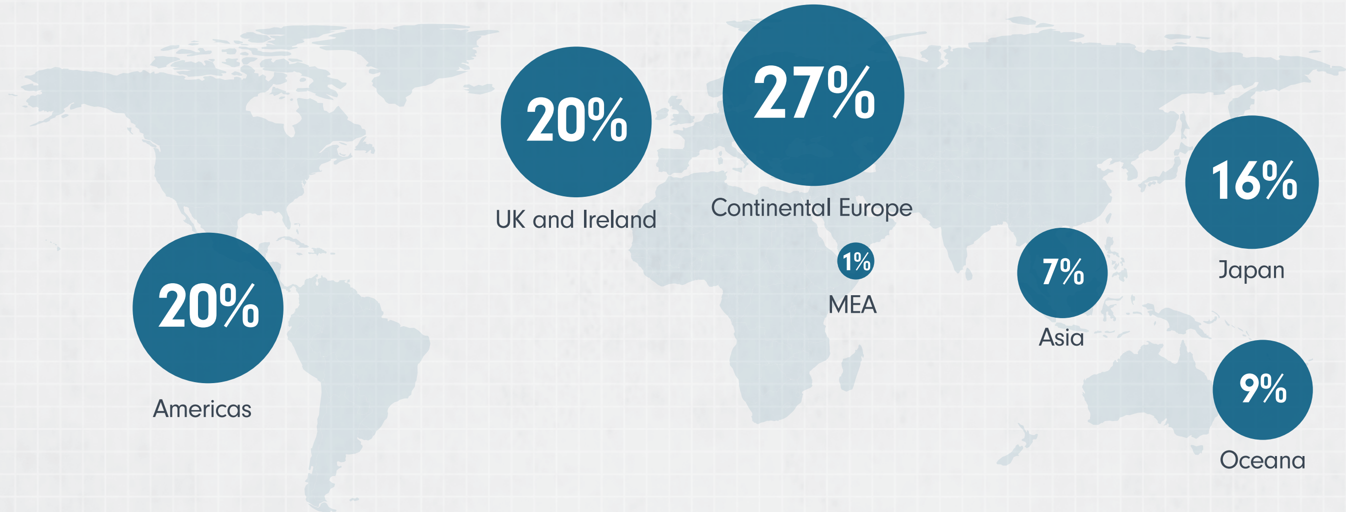
Engagement in 2019 at a glance

680+
Companies actively engaged with

4,300+
Shareholder meetings at which we voted

16,000
Meetings conducted with companies

Engagement by region



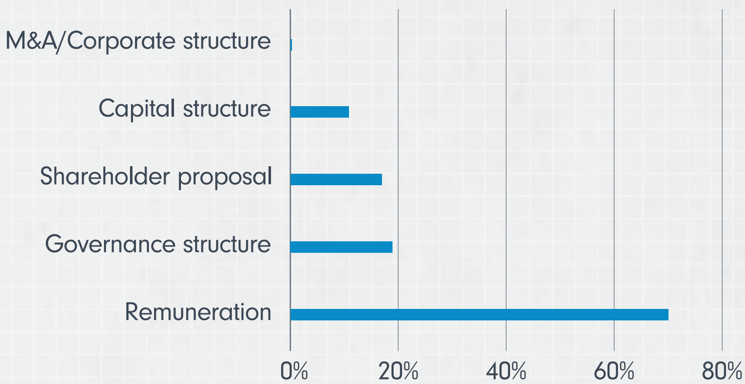
Non-voting engagements by theme

Engagements by category (non-voting)

Non-Voting engagements accounted for 40% of all engagements (275)
*UN Sustainable Development Goals

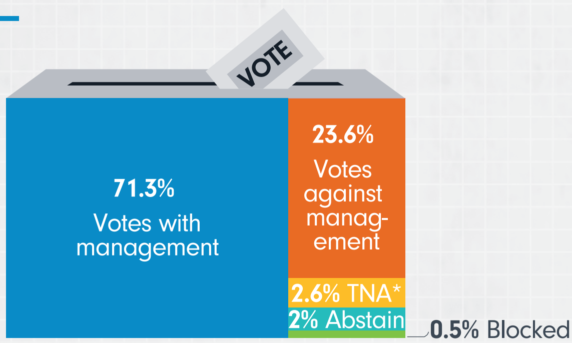
Voting engagements by theme

Engagements by category (voting)

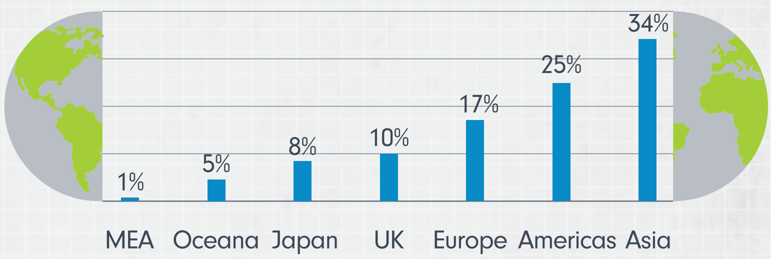


Voting engagements accounted for 60% of all engagements (407)

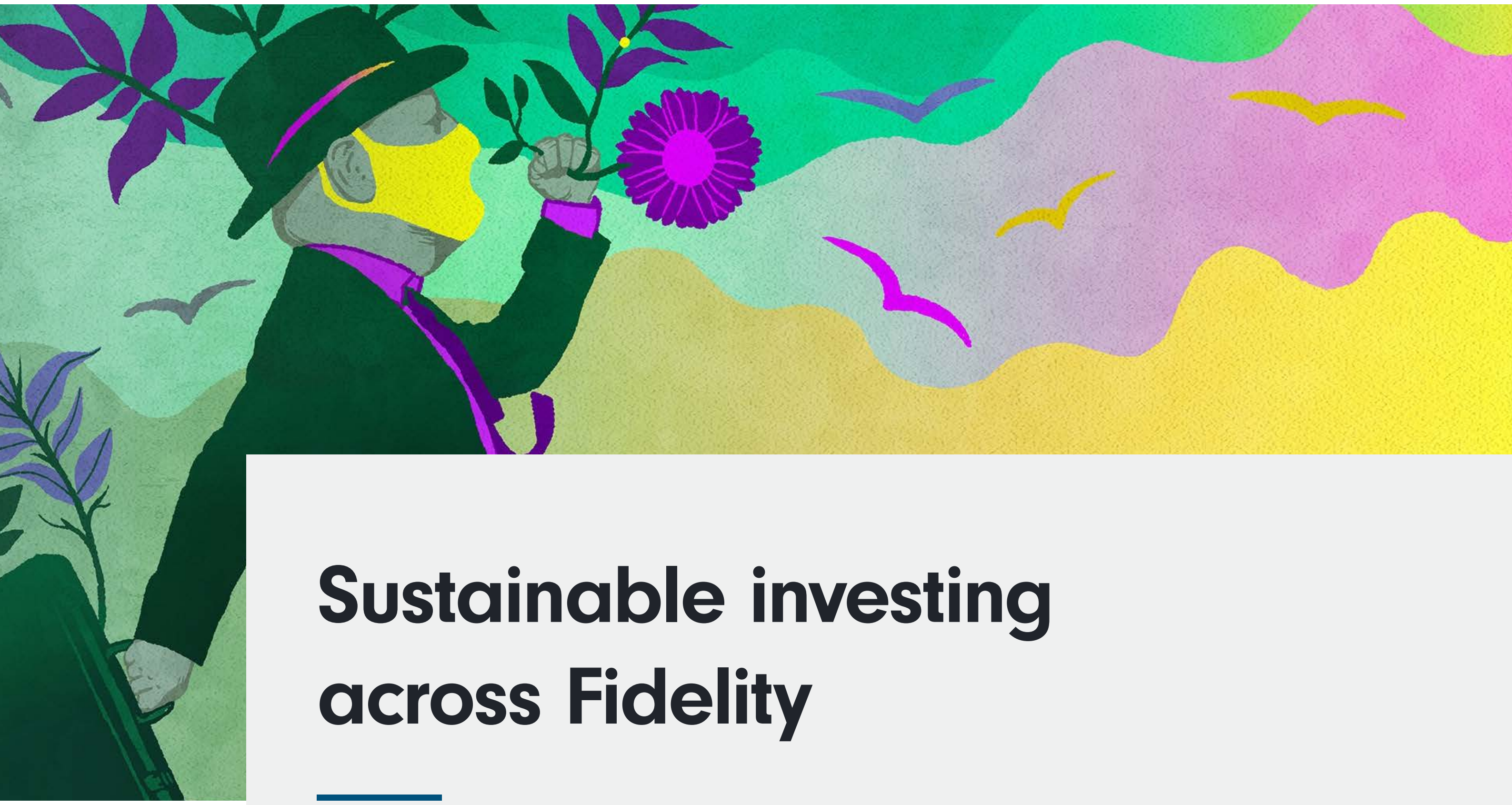
How Fidelity voted in AGMs



Breakdown of AGMs by region



*Took no action
Source: Fidelity International, June 2020.



Sustainable investing across Fidelity

Sustainable capitalism

Public and private combine to aid recovery

Companies and governments are working together to tackle the current crises and meet future challenges.

Andrew McCaffery
Global CIO, Asset Management

The Covid-19 pandemic has accelerated a shift in public discourse, making normal the ideas that were once thought radical. Among these is the move towards sustainable capitalism - the overall theme of this annual report. Sustainability has gone from being a fashionable buzzword to a tangible requirement. While governments' immediate priorities will be to control the virus and preserve jobs, we believe that public/private partnerships will strengthen as countries seek to develop better future policy approaches and become more resilient to future shocks.

Public and private spheres intertwine

In the summer of 2019, the influential Business Roundtable of US top executives rejected the idea of shareholder primacy and advocated embracing wider stakeholder interests. This was largely a statement of intent - until Covid-19. Customers are now demanding greater articulation of values in action on the part of corporates. And companies now see the health of employees, communities and suppliers as vitally important in their decision making, and are seeking to promote their social value. This is especially true where governments have taken stakes in private firms, or where companies have benefited from employee furlough schemes.

Governments have introduced these schemes, alongside measures such as grants, loans, and tax reliefs, in a rush of fiscal activism to combat the virus impact alongside huge monetary stimulus. However, the longer-term risks from these actions are significant given the enormous debt overhang at a level not seen since WWII, the record money supply growth, and the extended social welfare for a labour force still wary of returning to work.

Governments therefore have to think carefully about how to extract themselves from these commitments and get their economies moving again. To remain in power, they need to address the inequalities laid bare by the pandemic and mitigate climate change so as to avoid future instances of widespread disruption. Key to achieving this would be a closer relationship with the private sector.

Green deal for the EU

In the wake of Covid-19, some countries and regions have chosen to accelerate investment plans in public/private programmes that support job creation and sustainability goals. The EU, for example, has re-committed to rolling out its €1 trillion Green Deal over the next decade and becoming carbon-neutral by 2050. The plan - which has been explicitly linked to the EU Recovery Fund designed to help countries rebound from Covid-19 - will be directed at reducing carbon emissions while promoting renewables, electric transport, sustainable farming, and other emerging sectors.

The programme will be funded by the European Investment Bank (EIB) and a combination of public and private sector co-investments. While there is broad consensus among member states on the overall deal, agreeing how to apportion funds will require compromise. Countries with higher emissions and fewer skilled workers in cleaner industries, for example, will need more funds to make the transition than those that have already done so.

While investing in green projects is necessary to tackle climate change, defining what is and is not truly 'green' can be difficult. To help clarify this and prevent instances of "greenwashing", the EU has created a Taxonomy on Sustainable Activities that sits alongside the Green Deal.

This detailed classification aims to capture how projects align with positive environmental objectives and avoid negative effects, and is designed to ensure that investors can gear their funds appropriately to what is categorically defined as green.

Employment first, but sustainability too

In other parts of the world, governments have chosen to concentrate first and foremost on employment after devastating job losses and sharp falls in GDP growth. Nonetheless, political and societal pressure is mounting for those governments (and companies) to act sustainably and in a fairer way. In the US, the Democratic election platform will likely include a comprehensive green investment and jobs programme and, following the tragic death of George Floyd and the Black Lives Matter protests, the damage caused by racial inequality is being discussed directly and constructively for the first time by policy-making bodies such as the US Federal Reserve, as well as at corporate board level.

Better disclosure

Meanwhile, policymakers such as Mark Carney, the former Governor of the Bank of England (BoE), and Andy Haldane, Chief Economist of the Bank, have publicly called for society to adopt a more sustainable and equitable form of capitalism.[7] Carney is a co-founder and vocal proponent of the Taskforce for Climate-Related Financial Disclosure (TCFD), an attempt to improve the quality and consistency of disclosure from companies in relation to their climate-related financial risk.

At Fidelity, we see better disclosure as fundamental to improving sustainability within companies. We take the opportunity whenever we engage with companies to recommend that they consider TCFD-aligned disclosure, while also developing our own inaugural TCFD report, due for publication later this year.

Meanwhile, the EU has launched its Sustainable Finance Disclosure Regulation (SFDR), containing detailed and robust requirements for asset managers (among other financial firms) to report sustainability risks, policies and fund classifications. Such initiatives will only help to embed sustainable capitalism further into our economic and social structures. For these changes to be authentically adopted, however, public markets will have to take a longer-term view of the kind typically associated with private markets.

Ultimately, sustainable capitalism is coming of age because it matters to voters, customers and investors, and is likely to determine forthcoming elections. This leads us to believe that the move by businesses to consider the interests of all stakeholders, not just shareholders, is more than just a passing trend. And that sustainable capitalism will increasingly receive attention from all sides, as a means of driving the global recovery and ensuring resilience for economies and companies.

[7]Source: https://www.economist.com/by-invitation/2020/04/16/mark-carney-on-how-the-economy-must-yield-to-human-values https://www.ft.com/content/fbb1ef1c-7ff8-11ea-b0fb-13524ae1056b

European Commission President Ursula von der Leyen recommitted to the Green Deal amid the pandemic. (Photo by Bloomberg / Contributor Images via Getty Images)

Proprietary ESG ratings prove their worth

Businesses that perform well on sustainability were more resilient during the Covid-19 crash.

By Marty Dropkin Head of Asian Fixed Income, Ned Salter Head of Equities - Global Research & Asia Ex Japan Investment and Fiona O'Neill Director, Global Equity Research & Sector Investing

Environmental, social and governance (ESG) analysis has become integral to our investment process. Until recently, most finance professionals were trained to rely chiefly on company-specific financial analysis when making investment decisions. But the majority of studies show that sustainability factors, from climate risk to worker welfare and executive pay, can have a material impact on long-term profitability and, in turn, investor returns.

We have therefore integrated ESG considerations across our investment franchises over the past three years, in addition to launching a range of strategies for specific themes such as water and waste, and carbon reduction.

Creating forward-looking ratings

Dozens of ESG rating systems have sprung up over the past few years to help investors better understand the substance of companies' sustainable characteristics. Many of these providers deliver a solid, high-level overview of an issuer's sustainability. But every system has its own methodology, which can lead to different ratings for the same companies over different time horizons. Data is often self-reported, broad-brush and based on backward-looking disclosures.

We created our own ESG ratings because we needed a forward-looking assessment that could evaluate the opportunities that sustainability factors can create in detail, in line with our active approach. Our proprietary ratings focus on the core sustainability topics for each sector, explicitly tying these to our investment decision-making. Critically, these forward-looking ratings also link directly to our active engagement policy.

Our ratings are based on systematic analysis at the sub-industry level by our 150 equity and fixed-income analysts. Our investment teams interact with around 16,000 company management teams a year, working closely with our Sustainable Investing team to engage with companies on material issues. Our analysts combine these company-specific insights from those meetings with industry analysis, competitor analysis and perspectives from many external data providers. Together these demonstrate the impact of non-financial factors such as reputational issues, supply-chain management and regulatory change.

Our ratings are based on systematic analysis at the sub-industry level by our 150 equity and fixed-income analysts.

Fidelity analysts also formally indicate whether they think a company ESG's performance is improving, deteriorating or stable. This enables a thorough analysis of a company's likely future prospects, as action on these issues becomes increasingly correlated with financial performance.

This proprietary system has been used to rank 4,020 issuers for ESG since its launch in June 2019 and, significantly, recent research found that higher-rated companies outperformed their lower-ranked peers in the first broad-based market crash of the sustainable investing era.

Strong sustainability indicated better resilience during the Covid-19 crash

In the 37 days between 19 February and 27 March 2020, the S&P 500 fell 25 per cent. The shares of companies with the highest Fidelity ESG rating of A dropped, on average, by 23.1 per cent. Those rated B fell a bit more – in line with the broader market - while those rated C, D and E fell further still in a remarkably linear fashion (see table).

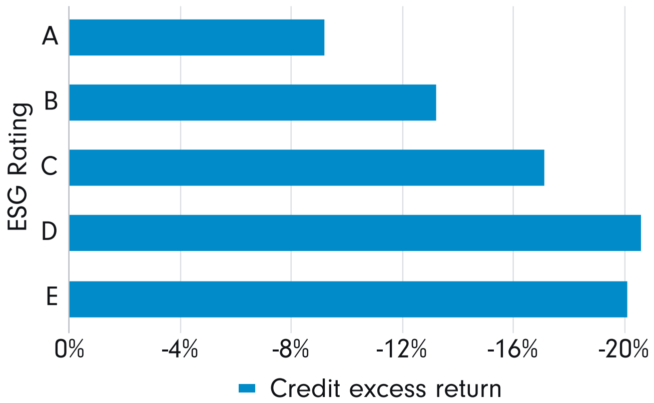
Table 1: Snapshot of stock returns during the crisis by Fidelity ESG rating

Fidelity ESG rating	% of total rated	Stock return (%)	Stock return vs S&P 500
A	12%	-23.1	+1.9
B	39%	-25.7	-0.7
C	33%	-27.7	-2.7
D	14%	-30.7	-5.7
E	2%	-34.3	-9.3

Source: Fidelity International, May 2020

On average, among the 2,689 companies analysed, each ESG rating level was worth 2.8 percentage points of stock performance versus the index during that period, demonstrating a strong correlation between sustainability factors and returns. The trend was similar across fixed income markets, where securities with higher ESG ratings performed over 10 percentage points better during the Covid crisis period.

Chart 2: High quality ESG leads to better fixed income returns



Source: Fidelity International, June 2020.

While this research only captures a very brief period, it bears out our hypothesis that companies with strong sustainability characteristics are likely to demonstrate greater resilience during downturns. We intend to carry out further analysis as the Covid-19 crisis evolves, and gradually build a more detailed picture of how each rating category performs.

Moving beyond "cheapest is best"

Incorporating ESG measures provides our analysts with a 360-degree stakeholder view that allows them to move beyond the idea that "cheapest is best". This is especially true in the era of coronavirus, in which the social element of ESG is in the spotlight.[8]

For example, a financial-only perspective of two grocery companies would favour one that was cutting costs, even if that meant making employees work long hours without PPE equipment, over another that prioritised worker and customer welfare through robust social-distancing policies and PPE provision. Yet, as more customers opt for quality and safety during the pandemic, the second company's long-term prospects look brighter.

A recent high-profile example of where our forward-looking ESG ratings have anticipated potential risks is Wirecard. Our analyst rated the issuer an E (the lowest possible) many months before the public scandal broke, on account of significant failings in corporate culture, the management of ethical risks and stewardship at board level. Another has been boohoo.com, whose stock fell on revelations of poor working conditions in its factories. Our analysts rated it a D in 2019 due to concerns about labour standards, low wages and fast fashion wastage. A third-party provider had rated it a double A.

Continuous evolution

As the world evolves, so our ESG ratings will evolve with it. Over time, we will expand our ratings process and offer this capability to clients to use across their portfolios. Our range of sustainable ETFs deploy our ratings, and we are looking at other ways to harness their qualitative power within systematic, as well as active, portfolios.

Investors and society are more focused than ever on ESG, and in a manner that seems likely to last. As a result, we expect more capital to be allocated to companies and sectors that deliver both financial and social returns. With sustainability no longer an optional extra but embedded in investment analysis, Fidelity's ESG ratings provide our investment teams with a much richer data set that they can use to make better, more informed decisions on behalf of our clients.

[8]Source: https://www.fidelityinternational.com/editorial/article/fidelity-pulse-survey-societys-big-moment-8e0680-en5/

Analyst Pulse Survey

Society's big moment

Employee welfare and community impact are now key concerns.

The Covid-19 pandemic has put social issues top of mind for many businesses, according to the May 2020 Pulse Survey[9] which drew responses from 146 Fidelity analysts.

More than half the responses indicated that companies intend to step up their focus on workers, consumers and societal impact as a direct response to the pandemic. This change was most pronounced in EMEA/Latin America, with 75 per cent of respondents saying that Covid-19 will lead to a greater focus on social issues, followed by Asia (ex-Japan and China) at 63 per cent, albeit from a lower base as captured by the annual Fidelity Analyst Survey.[10]

Companies are prioritising the health of their staff, with businesses from just about every region and sector planning to devote more attention to employee safety, satisfaction and wellbeing. This is likely to take the form of better workplace conditions and, in some cases, higher pay. But changes will also run deeper and broader to embrace consumers and wider society.

For example, analysts reported that European telecoms companies have offered free data and devices to vulnerable people, as well as support to hospitals and governments. North American IT groups are ensuring priority access to technical equipment for healthcare providers. In Europe, meanwhile, firms involved in the production and supply of consumer staples are taking an increasing role in public hygiene initiatives.

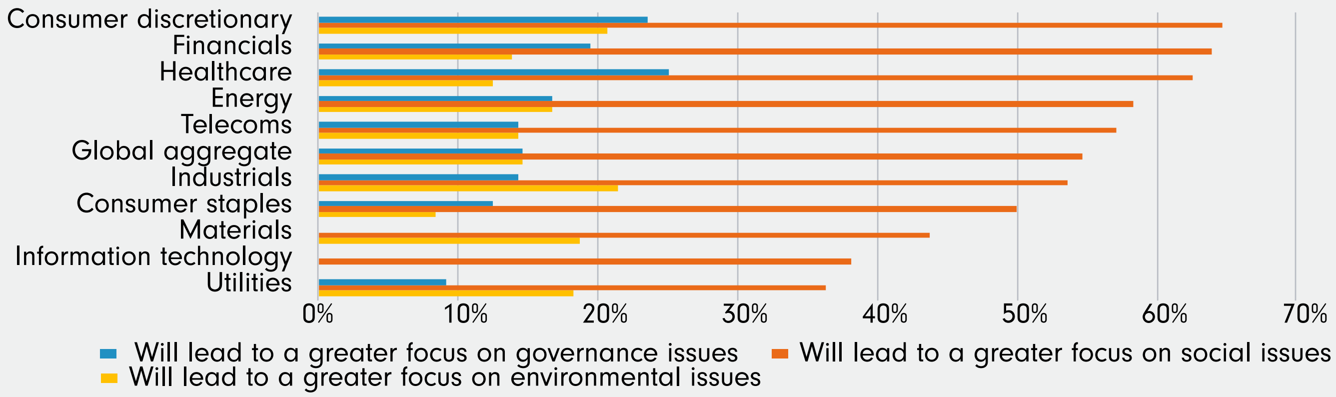
Healthcare and pharmaceutical companies have a difficult balance to strike. The pandemic has presented an obvious opportunity both to help society and lift sales, but firms are keen to avoid being seen as profiteering from the pandemic. As a result, a North America pharmaceuticals-industry analyst said: "Many of my companies are now developing vaccines, with plans to distribute the vaccines (at least initially) at cost (price). This could obviously be a large positive for ESG perception of the sector and may separate the more ethical players from those trying to profit from the situation."

The survey responses point to the pandemic accelerating a trend evident in the last few years of a broad tilt towards stakeholder capitalism, which is already leading many larger companies to prioritise the needs of society and their employees over shareholders. Being a good corporate citizen and supporting local communities are now seen as essential to building and sustaining brand equity.

What is more, many of the changes look set to remain in place after the coronavirus has gone. Nearly 70 per cent of our analysts expect some or all of the changes their companies are enacting to be permanent, raising the possibility that in years to come, the pandemic will be seen as a significant milestone on the path to companies taking a more prominent role in driving positive social change.

Chart 3: Social tops the agenda in the post-covid world

"How will the virus outbreak affect your companies' approach to ESG?"



Source: Fidelity International, May 2020.

[9]Source: https://www.fidelityinternational.com/editorial/article/fidelity-pulse-survey-societys-big-moment-8e0680-en5/
[10]Source: https://www.fidelityinternational.com/editorial/article/analyst-survey-2020-a-watershed-year-for-esg-5fe27e-en5/

Climate financing moves into the mainstream

Amid the Covid-19 pandemic, demand for climate finance is holding up, along with broader sustainability strategies.

By Kris Atkinson Portfolio Manager, Velislava Dimitrova Portfolio Manager and Cornelia Furse Analyst & Portfolio Manager

Climate financing is the bridge to a low-carbon economy as investment in sustainable businesses moves from strategic option to existential necessity. As a result, it is central to Fidelity's investment philosophy and process.

A rapidly growing market

Green finance is a rapidly growing market. Almost $400 billion of green, sustainability and social bonds were issued in 2019. The great majority were certified green bonds[11] – and sales were up by 53 per cent.[12] Almost $31 trillion of funds worldwide (encompassing a range of asset types) were held in sustainable or green investments[13] in 2018, up 34 per cent from 2016.

Early indications are that Covid-19 may further accelerate the shift towards green investment, via both equities and bonds. The pandemic has inflicted a huge shock to the global economy and forced companies and governments to rethink their strategies. Companies with proactive environmental, social and governance (ESG) strategies appear to have fared better during the crisis.[14] Recent IPO success and higher valuations for firms such as Beyond Meat appear to reflect the market's belief that these nascent industries will grow significantly. Many governments are adopting green recovery plans.

Fidelity's sustainable investment approach is to integrate climate considerations across our franchise. But we have also developed specific thematic strategies that invest in the new technologies helping to reduce climate impact, as well as companies that are actively making the transition to lower-carbon activities. In fixed income, while we invest in certified green bonds, our primary focus is on companies that have a broader strategy of decarbonisation. Our approach is intrinsically long-term for both equities and bonds, reflecting the fact that carbon-reduction strategies have target dates of between 2030 and 2050.

Rebuilding greener

We believe policy will continue to be an important driver of the climate finance market. This takes two forms. First, central banks and financial regulators are working on new rules and tools to help financial institutions understand and act upon the climate risks embedded in their balance sheets and investment portfolios. Second, more governments are committed to financing the greening of their economies. The EU, for example, is mobilising at least €1 trillion for sustainable investments over the next decade.[15]

Investing across the value chain

Within equities, Fidelity is concentrating on technologies and companies that are (or are close to) making a positive contribution to carbon reduction. This can be due to supportive policy incentives, consumer interest or because these technologies are more economic than legacy ones. For example, the electric vehicle (EV) sector is growing thanks to subsidies across Europe and Asia, and growth should accelerate over the next decade as the full cost of ownership of a battery-powered vehicle approaches that of a petrol or diesel one.

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[11]Source: https://www.climatebonds.net/files/reports/2019_annual_highlights-final.pdf
[12]Source: Fidelity, https://www.fidelityinternational.com/editorial/blog/how-to-avoid-the-bond-greenium-045928-en5/
[13]Source: Bloomberg, https://www.bloomberg.com/graphics/2019-green-finance/?sref=s3uske1y
[14]Source: Fidelity, https://www.fidelityinternational.com/editorial/article/outrunning-a-crisis-sustainability-and-market-outperformance-2ce135-en5/
[15]Source: https://ec.europa.eu/commission/presscorner/detail/en/qanda_20_24

We believe investment opportunities exist along the entire value chain of low-carbon technologies. In the case of EVs, this includes semiconductor manufacturers, battery material suppliers, battery manufacturers, charging infrastructure as well as car manufacturers. There are comparable opportunities within the value chains of renewable energy, industrial automation, construction materials such as insulation, alternative food products and recycling.

We believe climate investors should take a broader view. Many businesses in carbon-intensive sectors such as oil and gas are now pursuing transformational carbon-reduction strategies.

Taking a broader view

Within fixed income, there are significant opportunities in ordinary bonds issued by companies working to improve their environmental performance, in addition to those created by certified green bonds. Despite the growth in climate investing, only 6 per cent of investment-grade bonds issued in Europe are green. As a result, green bonds command a premium, reducing yield for investors.

We believe climate investors should take a broader view. Many businesses in carbon-intensive sectors such as oil and gas are now pursuing transformational carbon-reduction strategies. Climate investment needs to capture and support these transitions.

All sectors can contribute. For example, in the technology space, Microsoft announced not only that it would become carbon neutral by 2030 but that it would also aim to neutralise all of the company’s emissions since its founding in 1975, by 2050. We believe companies that demonstrate such game-changing ambition should be reflected in portfolios.

In 2020, corporate resilience has been severely tested, while ESG engagement has proved its value in the market as well as to society. The disruption unleashed by Covid-19 has highlighted how much worse the consequences of climate inaction could prove. Mind-sets across government, consumers and investors are changing and we expect climate finance, in its different forms, to move ever further into the mainstream.

Electrically powered Mercedes-Benz eActros. (Photo by picture alliance / Contributor Images via Getty Images)

China's recovery may be greener than before, if nascent trends continue

The shoots of China's post-Covid-19 recovery may be greener than before thanks to proactive government policy, calls from non-government entities and corporate and investor engagement.

Paras Anand
CIO, Asset Management, Asia Pacific

A paradox lies at the heart of China's remarkable economic growth. For years, it has been the world's biggest emitter of greenhouse gases as well as its biggest producer of renewable energy. As the Covid-19 crisis spurs major economies globally to launch huge stimulus programmes, which side of the environmental divide will China favour? The answer is complex.

From a careful reading of government policy, corporate commitments and investor pressure on ESG issues, there are signs that China's recovery from its Covid-19 ordeal may be significantly greener than its rebound from the global financial crisis a decade ago.

We are optimistic that China will seize the opportunity to move towards more environmentally-friendly growth than in the past, whilst seeking to repair social and economic dislocations.

Rebounding with some green characteristics

Like other countries, China's priorities are first to look after the health and welfare of its people and then to revive its economy, even as Covid-19 continues to resurface with a new outbreak in Beijing.

China's economy shrank 6.8 per cent[16] in the first quarter and the government has pledged significant investment in infrastructure and other projects in order to jumpstart its faltering industrial machine.

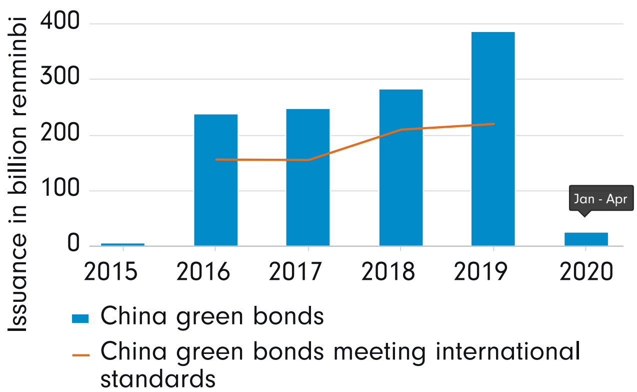
However, pressure is growing from corporations, financial markets, consumers, NGOs, think tanks, academics and economic planners to include green considerations in the economic rebound.

Government advisers are recommending an increase in the proportion of green projects, such as sustainable buildings and renewable technology, within government-funded infrastructure initiatives, which will lock in environmental impact for decades. The State Council of China has pledged to support a "green silk road" with high environmental standards for projects within its international Belt and Road strategy. There is also momentum to mandate minimum green credentials for projects not explicitly labelled as green.

Positive change through policy

Policy action gives further cause for optimism that China will gradually take more of a global leadership role on climate. One example is the People's Bank of China's decision to exclude "clean coal" (projects that make fossil fuel use more efficient) from its list of projects eligible for green bonds. This aligns China more closely with international standards, though it has yet to set carbon emissions thresholds for issuers. Nonetheless, green bond sales rebounded strongly from the March sell-off, demonstrating renewed appetite for this kind of financing, which has been growing in popularity since 2015.

Chart 4: China green bond sales in recent years



Source: Climate Bonds Initiative, Fidelity International, June 2020.

[16]Source: https://www.washingtonpost.com/world/as-coronavirus-exacts-a-heavy-economic-toll-china-declines-to-set-growth-target/2020/05/22/4826bd6e-9985-11ea-ad79-eef7cd734641_story.html

Another example is the rollout of electric vehicle subsidies for car dealers in some cities.

ESG disclosure too is an important piece of the puzzle. Many had expected that 2020 could be the year in which disclosure of ESG factors by listed companies and primary bond market issuers would be made mandatory. Such a move would allow global investors to assess more accurately how green Chinese companies are.

Greater disclosure requirements could now be delayed due to the coronavirus, but there are reasons to believe that China's commitment to greater transparency and stricter environmental enforcement will continue to grow. Its environment ministry is today invested with much greater authority than before.

The private sector steps up

The corporate sector is also engaging in China's recovery with innovation and an evolving ESG consciousness that could ultimately bear fruit in greener industries. Chinese companies already operate in a society where their social value is important. But now, more large investors such as insurance giant Ping An are signing up to the UN's Principles of Responsible Investing (to which Fidelity is also a signatory), and building in-house ESG teams and their own ratings system as more clients worry about the environment, food safety and pollution.

Meanwhile, tech giants such as Alibaba and Baidu[17] are deploying AI acumen to develop Covid-19 diagnosis and analysis tools, and making the technology available to researchers. Many other Chinese companies have acted to benefit society in the wake of the disease, and one example of stakeholder engagement comes from a ride-hailing platform. The firm has looked after its drivers by setting up hundreds of disinfecting stations during the pandemic, giving them two free masks per day and offering financial relief.

This kind of corporate social responsibility will be a force for change. Even though the contours of a post-Covid-19 world as yet remain undefined, a convergence of factors – from government action to global investor advocacy and a new corporate commitment to business-for-good – is sowing the seeds of hope for a green bloom in China that may be felt far beyond its borders.

[17]Source: https://www.cnbc.com/2020/03/04/coronavirus-china-alibaba-tencent-baidu-boost-health-tech-efforts.html

Floating solar aims to gain ground in China's coal country. (Photo by Kevin Frayer / Stringer Images via Getty Images)

Room for improvement in how investors assess real estate sustainability

For real estate to meet its carbon targets, sustainability metrics will be required that reflect potential as well as actual ESG value.

By Adrian Benedict Head of Real Estate Solutions, Mirjam Raschka Head of European Real Estate Asset Management, Ewan Montgomery Portfolio Manager, UK Real Estate

Real estate has led the pack when it comes to assessing sustainability. Investors can pick from an array of classifications to measure how sustainable buildings are and their impact on the climate. But the benchmark of choice, since its launch in 2009, has been the Global Real Estate Sustainability Benchmark (GRESB).

> For real estate to meet its carbon-reduction targets, and survive the onslaught of the Covid-19 pandemic, alternative sustainability metrics will be required that reflect potential as well as actual ESG value.

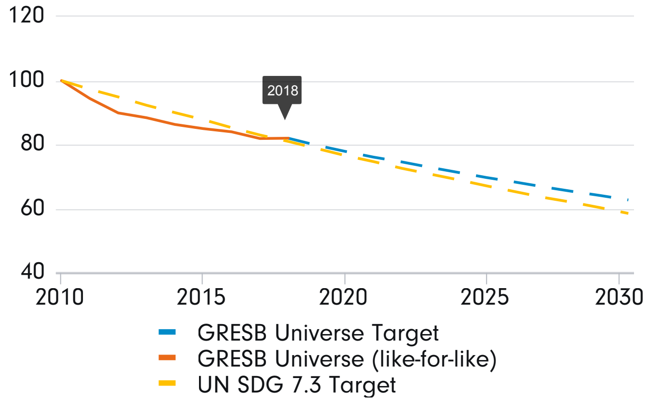
GRESB scores are a quick and easy way for investors to understand how sustainable their portfolio is. But they tend to focus investor attention on buildings with already high scores, not those that need improvement. For real estate to meet its carbon-reduction targets, and survive the onslaught of the Covid-19 pandemic, alternative sustainability metrics will be required that reflect potential as well as actual ESG value.

High scores could limit return and impact

Until now, asset managers and asset owners interested in sustainability have built real estate portfolios with the highest possible GRESB scores by choosing already green assets, often newly built. This gives them high ESG metrics at the time of asset acquisition, but leaves little room to improve the sustainability profile over the lifetime of the holding. It may even limit the return and impact potential of making an ESG-conscious investment in the first place.

Indeed, if investors continue to buy only buildings with the highest ESG scores and do not seek to increase the scores of existing stock, then the real estate sector - possibly among the industries most likely to be impacted by climate change - may fail to meet its UN Sustainable Development Goals. While the sector has begun to reduce carbon emissions, it has fallen behind on energy consumption and efficiency targets. SDG number 7.3 aspires to double energy efficiency improvement rates by 2030. To achieve this target, global energy efficiency has to improve by a 2.6 per cent compounded rate between 2010 and 2030.

Chart 5: Real estate sector is trailing UN Sustainable Development Goal 7.3 target



Actual like-for-like energy consumption by GRESB participants is falling behind the SDG target for the first time since 2010.

Aggregated energy efficiency targets for 2019-2030 are not ambitious enough to meet the SDG 7.3 target.

Source: GRESB 2019 Results – Sustainable Real Assets. Chart shows actual like-for-like energy consumption by GRESB participants falling behind the SDG target for the first time since 2010.

In 2019, GRESB cited a study by Carbon Risk Real Estate Monitor. It warned that "European commercial properties will need to reduce their carbon emissions by more than 80 per cent until 2050" if they are to help keep global warming below two degrees from pre-industrial levels, as outlined in the Paris Agreement.

The Fidelity Real Estate team believes there is an opportunity to contribute to sustainability in a different way. This involves not only analysing existing ESG metrics of a particular asset, but also undertaking due diligence on the ESG potential of that asset.

Simply buying more environmentally-friendly assets won't eradicate those assets with a poor ESG profile. Today, less than 2 per cent of European real estate assets in the investable universe have what would universally be considered strong ESG characteristics. The replacement rate, meanwhile, runs at somewhere between 1-2 per cent per annum. Therefore, it typically takes 50 years to completely replace the existing real estate stock in any one city. So, investors must do more now to tackle the buildings we already have.

A different way to increase sustainability

The Fidelity Real Estate team believes there is an opportunity to contribute to sustainability in a different way. This involves not only analysing existing ESG metrics of a particular asset, but also undertaking due diligence on the ESG potential of that asset. This should not only improve the asset's longer-term return profile, but more importantly its potential benefit to the environment and the wider population.

Improving ESG outcomes is not limited to environmental characteristics. The Covid-19 crisis has been an opportune time to see how managers can put the 'S' in ESG to work. The need to understand tenant sustainability, as well as the sustainability credentials of individual properties, is more important than ever. Landlords like Fidelity have sought to foster a collaborative partnership with tenants through a challenging time, providing rapid support through the use of more flexible rental payment terms, rent deferrals and rent reductions.

The trend towards tenants wanting more sustainable buildings has only been accelerated by the pandemic, both in terms of climate impact and employee welfare. With the number of extreme weather events on the rise and concerns about Covid persisting, future tenants will expect good climate management systems and employee facilities. Properties without such characteristics are likely to become out of favour and will quickly become unsellable – or 'stranded'. In addition, rising insurance premiums are likely as flooding and storm risks grow and insurers reflect risks aligned to more stringent climate-related legislation.

Building ESG profiles that capture potential

Asset managers can help make existing sites more sustainable by improving their ESG attributes and their reporting. At Fidelity, we report the data from the buildings where we have full control over the utility decisions, but also engage with tenants of other buildings where we do not. This helps us build a fuller picture of the ESG profile of similar assets. Once we have built a data set, we work with specialists to analyse the performance of a building and chart a path towards that asset's optimum operating profile. We look at key areas such as water, waste, electricity, CO_2 emissions and gas consumption.

We communicate this data to GRESB to achieve the appropriate scores, but also look for new ways to capture the potential within existing buildings, as well as supporting higher scoring developments. We work with clients to understand the metrics and time periods they are considering, and how we can better report the expected financial and social return from a particular investment. Below we outline two case studies that demonstrate our approach.

Case studies

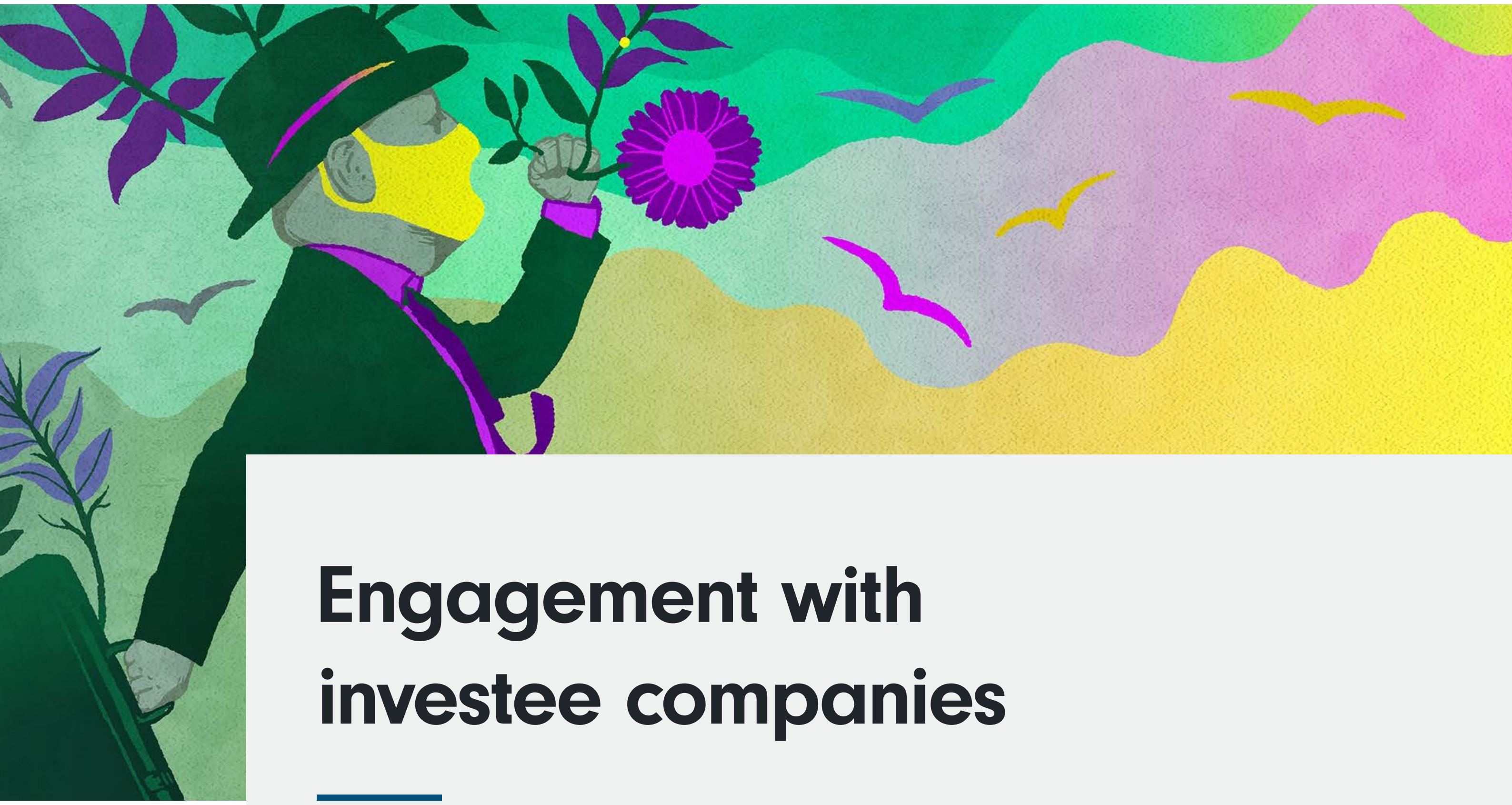
Using vacancy to upgrade offices in Cardiff

Our Real Estate team took advantage of a vacancy at an office site in Wales to make some significant changes. We embarked on a £6 million renovation that included introducing 82 new cycling spaces, eight shower and changing facilities and 14 electrical charging points. As part of the drive for greater efficiency, we also upgraded all the lighting to higher-performing LEDs, installed better hand driers and replaced WCs with low-flow cisterns. We removed gas supplies to the property and replaced outdated cooling systems. To meet demand for a better experience for employees, we created more chill-out zones outside and improved security systems. While offices have come under pressure during the pandemic, we believe buildings like these that offer better access for cyclists and more outdoor spaces will continue to attract tenants. We estimate that the refit has increased the potential rental income from £15 a sq foot to £22 a sq foot - a significant uplift on a 63,000 sq foot site.

Sustainable logistics development in Berlin

We invested in a sustainable logistics development in Berlin, which achieved a gold standard from the German Sustainable Building Council. The space configuration ensures that it can be used flexibly throughout the lifecycle of the asset - a useful attribute during the pandemic as more activity goes online and demand increases for high quality local warehousing. The development uses efficient gas-fired power, intelligent LED lighting and superior insulation to minimise its energy consumption. Areas around the site were also developed to protect bio-diversity and capture rainwater for irrigation. Finally, we joined forces with the tenant to introduce a food truck for onsite workers, which has been opened up to the public. The construction cost of the development was €21 million, and the estimated value is around €30 million.

Office site in Cardiff is refitted to make it more sustainable.



Engagement with investee companies

Why engagement matters

Jenn-Hui Tan
Global Head of Stewardship and Sustainable Investing

Many investment managers claim that engagement is important, but at Fidelity it is critical to the way we think and act. First, active engagement forms an integral component of our investment strategy. There is now plenty of evidence that non-financial risks – such as those related to ESG principles – can have a significant financial impact on a company over time.

Second, we take our role as a steward of client assets seriously, both on behalf of our clients and because we, like the companies in which we invest, have a broader duty to the communities and societies in which we operate.

As a result, we believe that continuous and in-depth engagement is the best way to exert a positive influence on corporate behaviour. When we make investment decisions, we think carefully about how we can engage with the companies we own to create better results for a range of stakeholders, including employees and suppliers, and build long-term social and corporate value.

There are several ways we engage with companies. It can be through direct dialogue with management and directors or through the efficient use of proxy voting and shareholder resolutions to effect change within a company. This does not always take place in isolation. From time to time, we may engage with companies in collaboration with other shareholders, and co-file shareholder proposals.

Engaging with managements enables us to raise any concerns we may have about a company's impact on the environment, its governance structure or how it affects society. It is only through this process that we can identify the risks and opportunities that do not show up on a company's balance sheet.

Our team of Sustainable Investing specialists works with portfolio managers and analysts to identify the highest priority issues and engagement objectives, while also keeping track of progress. We may select companies for engagement based on a number of different factors, including an ESG rating or a company's exposure to controversies or specific business risks.

Below we describe some of the ways in which we engage with companies and some of the themes we have focused on in 2019. These are then described in greater detail later in this report.

As we move through the Covid-19 crisis, we expect engagements with companies to take on an even bigger role both in terms of how we fulfil our social purpose as a fund manager and in terms of helping our clients achieve better financial and social returns from the companies in which they invest. (See *Sustainable investing offers hope in a post-pandemic world* above).

Ways we engage with companies

- **Company meetings and formal correspondence**
- **Shareholder resolutions**
- **Collaborative engagement**
- **Proxy voting**
- **Public policy**

Engagement themes in 2019

- **Financing climate change**
- **Animal protein**
- **Supply chain sustainability**
- **Responsible palm oil**
- **Corporate sustainability reporting**

Engagement and voting summary 2019

Engagement summary

Overview

Over the course of 2019, the Sustainable Investing team actively engaged with 681 (2018: 786) companies. This included 75 (2018: 193) related one-off meetings or conference calls with chairmen, independent directors and senior advisers. Over the same period, our team of analysts raised a host of material ESG issues with the companies they cover, in over 16,000 meetings.

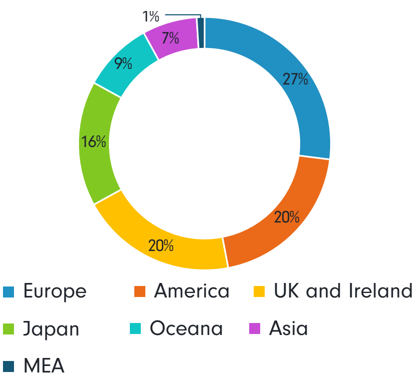
680+	4,300+	16,000
Companies actively engaged with	Shareholder meetings at which we voted	Meetings conducted with companies

Engagements were carried out across a number of different regions: 27% of meetings were based in Continental Europe, 20% in the UK and Ireland, 20% in the Americas, 16% in Japan, and the balance in other geographical regions. Of the engagements that took place during the year, 60% were related to voting activities and 40% to non-voting activities.

Fidelity has a long history of engaging with companies on corporate governance. In 2019, we broadened our engagement focus to address more environmental and social issues. Of the non-voting engagements that took place during the year, the most common matters raised were governance (56%), corporate strategy (52%), and climate change (29%), with the balance shown in the chart below.

Voting-related engagements most typically pertained to remuneration (70%), followed by governance structure/board composition (19%) and shareholder proposals (17%). Note that in many cases, multiple themes were discussed during a single engagement.

Chart 6: Engagement by region

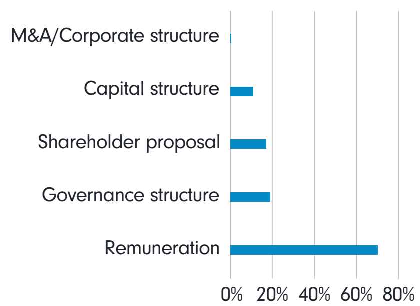


Source: Fidelity International, June 2020.

Chart 7: Non-voting engagements by theme

Source: Fidelity International, June 2020.
Non-voting engagements accounted for 40% of all engagements (275)
*UN Sustainable Development Goals

Chart 8: Voting engagements by theme



Source: Fidelity International, June 2020.
Voting engagements accounted for 60% of all engagements (407)

Voting summary

The Sustainable Investing team analysed 4,369 company meetings in 2019 and the topics that were to be voted on (2018: 4,274 company meetings). The tables below show a geographic breakdown of votes by region for the reporting period and an overview of how Fidelity voted on different topics.

Table 2: Votes against management by category (as a % of total votes by region and category)

Category	UK	Rest of Europe	Americas	Japan	Rest of Asia Pacific	Oceania	MEA
Auditors	0.0%	0.0%	0.1%	0.0%	0.1%	0.0%	0.0%
Board	0.7%	3.4%	1.4%	5.4%	1.6%	4.0%	3.9%
Capital structures	1.2%	11.2%	5.5%	0.0%	0.3%	0.0%	6.0%
Charter amendments	2.1%	2.3%	8.1%	6.0%	2.0%	0.0%	0.0%
Remuneration	10.2%	31.9%	22.6%	10.3%	2.2%	11.6%	8.4%
Routine business	0.3%	0.0%	1.5%	1.2%	0.3%	0.0%	0.0%
Strategic/Restructuring	0.0%	5.6%	1.0%	14.3%	2.7%	0.0%	2.4%
Takeover related	0.0%	46.7%	15.9%	100.0%	0.0%	0.0%	0.0%
Shareholder proposals	12.5%	2.5%	51.9%	15.7%	1.2%	24.2%	33.3%
Total	**1.4%**	**8.1%**	**5.6%**	**5.6%**	**1.2%**	**6.9%**	**4.9%**

Source: Fidelity International, 2020.

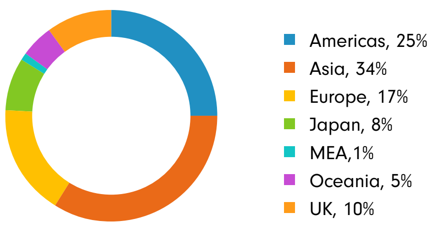
Fidelity voted in support of management on all resolutions at 71% (2018: 69%) of the meetings that were analysed. Fidelity voted against management on one or more of the resolutions submitted at 24% of the meetings analysed (2018: 27%). Fidelity did not vote its holdings at a further 2% of the meetings (2018: 1.4%), the majority of these because they were meetings of Fidelity's own funds.

Table 3: How Fidelity voted across different regions (by number of meetings)

	Votes With Management	Votes Against Management*	Abstain*	Blocked	Took no Action**	Total
Americas	645	412	9	1	7	1074
Asia	1397	81	16	2	7	1503
Europe	294	282	17	18	60	728
Japan	221	148	0	0	0	369
MEA	22	17	0	0	4	43
Oceania	144	35	11	0	7	197
UK	391	55	3	2	4	455
TOTAL	3114	1030	113	23	89	4369

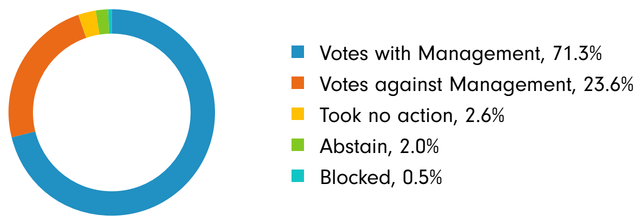
Source: Fidelity International, 2020.

Chart 9: Summary of meetings by region



Source: Fidelity International, June 2020.

Chart 10: How we voted across all shareholder meetings/resolutions



Source: Fidelity International, June 2020.

Voting activity highlights

Overview

Voting at company meetings is extremely important to Fidelity both as a steward of client funds and as an active investor. It is an essential tool for working with companies to help them pursue policies that lead to sustainable returns and increase value for a broad range of stakeholders.

A highlight of Fidelity's voting activities during the year was its co-filing of two shareholder resolutions at the AGM of a leading lens manufacturer. The shareholder resolutions were aimed at electing two non-partisan directors to the board for the purpose of breaking an impasse between two factions. The proposals were defeated at the AGM, but they received significant support from minority shareholders and are believed to have been influential in an eventual settlement between the two sides. (See *Governance* section below for more details.)

Executive pay remains a key topic

Executive remuneration continued to be an important theme around the world. In Europe, Fidelity voted against management on one or more resolution at 39% of meetings (2018: 47%) and in the UK at 12% of meetings (2018: 19%), largely due to concerns over executive pay recommendations that do not align with Fidelity's share retention guidelines.

In the Americas, Fidelity voted against management on one or more resolutions at 38% (2018: 44%) of meetings. A significant number of the votes against management were in relation to LTIPs with inadequate or no performance conditions.

In the UK, there has been an increasing year-on-year convergence with Fidelity's share retention guidelines. Following the recent update of the UK Corporate Governance code, which explicitly recommends a minimum retention period of five years for equity awards, we have experienced a reduction in votes against remuneration-related proposals in the UK.

In Europe, there were also a number of remuneration packages Fidelity did not support due to insufficient disclosure or lack of performance conditions attached to long-term incentive plans (LTIPs). Fidelity voted also voted against the election of a larger number of board members in these markets. This principally related to votes against chairs of remuneration committees where Fidelity was voting against the remuneration practices for the second consecutive year.

In the Americas, Fidelity voted against management on one or more resolutions at 38% (2018: 44%) of meetings. A significant number of the votes against management were in relation to LTIPs with inadequate or no performance conditions.

The decrease in votes against management in the Americas is explained by the decrease in our votes against remuneration-related proposals, as we keep familiarising issuers with Fidelity's voting policy on remuneration for the region, i.e. requiring at least 40% of all LTIPs to be performance-based in the US and Canada.

Voting on ESG issues in the US and Japan

Fidelity also voted against management's recommendations in favour of a number of shareholder-sponsored proposals in the US. These resolutions related to environmental and social issues, mainly revolving around climate change and diversity, and governance issues such as requiring the chairman to be independent, requiring companies to increase disclosure of political donations and giving shareholders the right to act by written consent in lieu of calling an extraordinary general meeting.

The low level of independent representation on Japanese boards continues to be the key issue in the Japanese market. Although changes during the last few years to corporate law, best practice codes and listing rules have sought to promote improvement, Fidelity has continued to vote against the appointment of internal statutory auditors and directors with oversight roles where the candidates did not possess a sufficient degree of independence from company management.

Fidelity abstained from voting on at least one of management's proposals in 2% (2018: 1%) of the meetings analysed during 2019.

Across Asia, Fidelity has voted against executive compensation proposals due to discounts attached to grants, concerns about dilution and excessive pay. Fidelity has also voted against proposals involving related party transactions where it was deemed such arrangements would not to be in the best interests of shareholders.

Abstaining to send a message

Fidelity abstained from voting on at least one of management's proposals in 2% (2018: 1%) of the meetings analysed during 2019. In general, Fidelity abstained where it did not have the necessary information to reach an informed decision, although on occasion Fidelity has also abstained in order to send a cautionary message to company management that it intends to vote against the proposal at future meetings if improvement is not seen.

In 2019, Fidelity did not vote its holding in 2.6% (2018: 1%) of meetings. This included meetings where Fidelity gave an instruction to 'Take No Action' in relation to meetings of Fidelity's funds or where it was concluded that the cost of voting outweighed the benefits. This figure also includes a small number of meetings where Fidelity's votes were rejected.

Casting a ballot. (Photo by BENJAMIN CREMEL / Stringer Images via Getty Images)

Engagement by theme

Supply chain sustainability

Engagement objectives

Concentrate on human rights and environmental footprint; increase transparency and encourage a more sustainable strategy

Focus industries

Textile and apparel manufacturers and retailers

Overview

Organisations face a number of reputational, operational and financial risks resulting from insufficient management of ESG factors and their impact along the supply chain. The global reach and operational complexity of modern supply chains have resulted in new risks emerging which require innovative solutions to manage them.

Fidelity believes that effective supply chain management can be a valuable way of securing a competitive advantage, enhancing reputation and brand, and improving operational performance.

One of the dangers for investors, alongside the practical issues of maintaining high welfare standards across global supply chains, is that activist campaigns are spanning a wider range of products. These include high-tech electronic goods, whose components come from an array of suppliers. These campaigns can potentially cause reputational and brand damage, which may impact the company's valuation.

Fidelity believes that effective supply chain management can be a valuable way of securing a competitive advantage, enhancing reputation and brand, and improving operational performance.

How we engaged on this issue

We continue to engage on this theme by concentrating on human rights and responsible sourcing across the supply chain. We have now engaged with all companies on our focus list and intend to arrange follow up meetings with the majority of these companies on the following matters:

- To speak to more employees within the company who are responsible for the supply chain, to gain more disclosure on the company's efforts regarding procurement and responsible sourcing.
- To follow up on requests for increased disclosure of how supply chains are managed.
- To encourage our investee companies to release a summary of their audit reports and any violations that have occurred with their suppliers, including any remedial steps they have taken with these suppliers.
- To speak to third-party supply chain auditors and other related parties to gain further insights into industry standards and improvements on supply chain management in the sector and region.

Below we set out a number of case studies that highlight engagement with this theme. In each case, our local portfolio managers, analysts or a member of the ESG team engaged with the company in question.

Case studies

Unreasonable hours and forced labour

A Malaysian rubber glove manufacturer was alleged by the Guardian newspaper in the UK to be involved in forced labour, unreasonable working hours and enforcement of recruitment fees. Unfortunately, these kinds of practices do occur in this sector, which is why we actively engage on this issue. The company was very open to engaging with us. It confirmed that it has now put in place mechanisms to ensure reduced working hours and will absorb the cost of recruitment fees from the end of 2018. It has since published an updated policy on these issues on its website. This gives us greater confidence that the company has addressed the allegations in the report and is improving their labour relations, but we continue to monitor the situation closely.

Labour rights and environmental footprint

We engaged with a Hong Kong-based clothing company on human rights and responsible sourcing in the apparel and textile industries. The company has a very thorough sustainability report which outlines their management of toxic chemicals and human rights in the supply chain. We spoke to the head of global social and environmental sustainability and got a clear picture of how they manage their suppliers when it comes to labour rights and environmental footprint. We believe they are a high performer in this category. Nonetheless, we intend to engage further with the company's environmental specialists on their monitoring of water and waste management in their supply chain.

Improving reporting

In a similar manner, we engaged with an international jewellery and accessory company with stores in 15 countries. It showed us how it audits its suppliers using a third-party provider to ensure that suppliers are in line with human rights legislation and responsible sourcing policies. The third-party auditor will work with the suppliers to improve their ethical standards and review them annually to ensure continued compliance. The company does not currently publish a sustainability report but intends to do so. We intend to engage further with the company regarding the key aspects of its third-party audits and also on the development of its sustainability reporting.

Lack of transparency

We engaged with a Chinese logistics and infrastructure company that has little disclosure on its supply chain management approach. The company's management said they were not inclined to increase reporting in this area as it involves confidential information. We explained why we felt it was important to publish more information about conditions across the supply chain and encouraged them to do so. They said they would consider making more information public, and will provide their clients with more information.

The company asks about human rights in its supplier questionnaires and runs on-site assessments of its biggest suppliers, which includes looking at working conditions. The company also looks at the environmental footprint of its suppliers and requires separate supplier environmental reports in China. We intend to engage further with the company's environmental specialists and procurement team and push for increased reporting on its supply chain management. These kinds of engagements tend to be long-term, but continued investor pressure and greater disclosure by peers is likely to make the company review its position and potentially publish more.

Good human rights disclosure, but more to do on environment

A Chinese manufacturing company we engaged with has thorough disclosure of its supply chain management. It runs regular on-site assessments of its suppliers, including criteria on child labour, forced labour, working hours, and health and safety. It does not have a systematic process for looking at the environmental footprint of its suppliers, but it does have a policy in relation to the handling of harmful chemicals. We intend to engage further with the relevant executives within the company regarding the environmental side of its supply chain management. We have also expanded the engagement to provide feedback on the company's overall sustainability reporting and how it can be improved.

Financing climate change

Engagement objectives

Improve climate finance policies, ESG standards in underwriting, TCFD reporting

Focus industries

Banks, insurers

Overview

Southeast Asia is a major market for coal, with over 100 coal-fired power plants (CFPP) at planning stage in the region. The region will not meet global climate change targets with the continued rapid expansion of CFPP. Globally, financial support is declining for coal projects, but in Southeast Asia the pipeline of financing for coal power is growing. Major Singaporean banks have a critical signalling effect for the region, and with the country seeking to develop its credentials for sustainable finance, these banks need to re-address their CFPP financing plans.

Over the years, Singaporean banks have introduced climate change and responsible finance policies with the aim of reducing their financing of coal-fired power generation where appropriate. However, in our view, the policies were not sufficiently specific and/or continued to permit new CFPP financing for emerging markets.

How we engaged on this issue

Fidelity's Asia banks analyst and the Sustainable Investing team engaged with the chief sustainability officer of a leading Singapore bank, to discuss its sustainability strategy and approach to CFPP financing. The bank committed to speaking with its lending partners in the region about their coal exposure and to report in accordance with the Taskforce on Climate-related Financial Disclosure (TCFD) recommendations.

In addition, we collaborated with several institutional investors through a Singaporean-based ESG consultancy, with the aim of encouraging all major banks in the country to forego short-term opportunities in coal and to improve their climate change strategies. Actions may well speak louder than words, but when enough people say the same thing at the same time, words can be powerful too.

Representatives from each asset manager, together with the consultancy, collaborated on a joint statement calling on Bank A, as well as other banks (B and C), to implement an outright ban on coal financing. Before the statement could be read out as intended at the banks' AGMs, Bank A announced it would no longer offer financing to coal-fired plants anywhere (except its current projects, to which it remains contractually obliged), thus conceding to the wishes of a significant proportion of its shareholders. Bank B quickly followed suit.

Bank C had no policy relating to coal financing. Our jointly-signed letter was sent to them and read publicly at their AGM in late April, encouraging more transparency on the issue and a blanket ban on financing coal-fired facilities. In mid-May, Bank C announced it would also stop funding coal-fired power plants and would focus on renewable energy projects instead.

We believe this is an excellent example of the good that can come from both constructive engagement and collaboration across the industry. We also intend to continue to promote consistent TCFD disclosure from all regional banks. We have expanded this engagement with Japanese banks in 2020, as they continue to finance coal-fired power plants, though the Japanese government has recently announced that the majority of inefficient coal plants will close by 2030.[18]

[18]Source: https://uk.reuters.com/article/uk-japan-powerstation-coal-idUKKBN24306U

Sustainable palm oil

Engagement objectives

Encourage compliance with RSPO standards, international reporting requirements, traceability and disclosure

Focus industries

Palm oil producers and traders

Overview

Sustainable palm oil has been a key engagement theme for Fidelity since 2018. As global demand for palm oil grows, the industry is still being linked to environmental destruction and human rights abuses. This could have a significant impact on companies across different sectors given the widespread use of palm oil in many products.

How we engaged on this issue

As part of this engagement, the Sustainable Investing team together with Fidelity's investment team engaged with various companies along the palm oil value chain as well as with industry experts and NGOs. We hoped to gain a better understanding of how the industry could work together to ensure sustainable palm oil production and to learn where we could play a part in these discussions.

We will continue our engagements to encourage best practices for sustainable palm oil production across the value chain. More specifically, we are exploring more collaborative engagements run by an NGO and the Principles for Responsible Investment (PRI) initiative with downstream buyers based in Asia to learn about their sustainable palm oil requirements and to encourage best practice in the region.

Case Studies

Dealing with allegations of deforestation

At the beginning of 2019, we engaged with a plantation company regarding its management of palm oil sustainability and to seek the management's view of NGO allegations made against them regarding historical deforestation of their plantations. The company confirmed that it is working closely with the Roundtable on Sustainable Palm Oil (RSPO) to ensure alignment with their requirements on sustainable palm oil production and it has also submitted new plans with deadlines up to 2024 for the certification of its plantations and mills.

We were encouraged by the company's work to improve the sustainability of its palm oil production, but we asked management to be more transparent in relation to their plantation transactions. There have been issues in the industry involving land being transferred to related parties within a company, allegations of that land subsequently being deforested and then bought back by the company. We are asking plantation companies to be more transparent about their related-party transactions, even if it is not required by law.

Supplier sanctions

As part of the due diligence carried out on the company and these allegations, we also engaged with a large buyer of the plantation company's palm oil to discuss the buyer's grievance approach when one of its suppliers is sanctioned by RSPO and how it works with suppliers to reach RSPO standards. The buyer stated that its engagement with the plantation company had been positive so far and it will continue to work with all suppliers to ensure increased sustainability in the production process. The buyer also stated that it had made some changes to its grievance procedure. From January 2019, if the buyer investigates and finds violations in its suppliers' production activities, the company will first suspend and then engage with the producer, creating a greater sense of urgency for companies to deal with any violations or allegations against them.

We also spoke with the sustainability team of a well-known US/UK chocolate and snack manufacturer, which was also mentioned in the NGO report as it sources palm oil directly from traders such as the large buyer mentioned above. The chocolate company is able to trace 96% of its palm oil back to the mills and 99% was from suppliers with sustainability policies aligned to its own. If there are allegations made about a producer company, the chocolate maker is willing to work together with the producer to come up with an action plan to resolve the issue instead of cutting ties with the producer immediately.

At the end of 2018, the chocolate manufacturer had excluded 12 upstream suppliers that had been involved in deforestation and faced a grievance from either the RSPO or from NGOs, and had not made sufficient progress in addressing the grievance. The company continues to engage with the large buyer as a direct supplier and believes that the buyer is a leader in sustainable policies for the palm oil sector. The chocolate firm has, therefore, so far left it to the buyer to deal with the allegations made against the plantation company. We think a collaborative approach across the industry is the best way to ensure palm oil production is sustainable. To further this, we continue to engage across the value chain to understand how each company is focusing on the issue itself and in conjunction with other businesses.

Achieving certification

Our Sustainable Investing team also engaged with the CEO of Singapore-based food business in relation to its responsible sourcing initiatives. The company confirmed that it expects all of its mills and crude palm oil suppliers to achieve Indonesian Sustainable Palm Oil Certification. It aims to have 100% traceability of all its palm oil supplies, whether these come from plantations owned by the business or from third-party plantations.

The company audits every plantation and refinery it works with twice a year and labour rights are systematically checked as part of the audits, including overtime and factory conditions. If there are any violations of labour practices, the company will issue a disciplinary letter and work with the supplier to improve standards. We asked the company to publish a summary of its audit reports, which it is considering.

From these engagements and others with industry experts, we have learnt that food producers are more willing to collaborate with companies along the palm oil supply chain to achieve sustainable palm oil production compared to some NGOs, which are more confrontational in their approach. This is mainly due to food companies being highly reliant on palm oil. Switching to other edible oils like soybean oil or sunflower oil can be challenging due to cost and the difference in physical properties of the oils. They also want to guard against unintended consequences: deforestation could be worse if they switch to other oils, as some are lower yielding than palm oil.

A staff member of chocolate manufacturer examines rows of chocolate bars. (Photo by Bloomberg / Contributor

Sector in focus

Insurance and climate risk

Overview

In 2019, we looked closely at the insurance sector, which faces ESG risks from many angles, most notably from underwriting risk and investment risk, but also from regulatory change.

In 2018, the executive director of the UN Environment Programme (UNEP) commented: "For generations, the insurance industry has served as society's early warning system and risk manager by understanding, reducing, pricing and carrying risk". Actions will have to be taken in the next 10 years by both governments and corporates to avoid a scenario in which climate change leaves us in a world that, in 2015, AXA's CEO already described as uninsurable.

Regulation is already acting as a push factor driving ESG up the agenda for insurance companies, and industry initiatives are rapidly gaining momentum. In February 2019, the UNEP Finance Initiative's Principles for Sustainable Insurance (PSI) group published a working draft of its paper 'Underwriting ESG risks in non-life insurance business'. This is the first ESG guide for the global insurance industry and, in May 2019, the Prudential Regulation Authority published 'A framework for assessing the financial impacts of physical climate change: A practitioner's aide for the general insurance sector'.

On top of this, consultants making calls on the sector-level impact (e.g. Mercer's 2019 update on climate risk) makes adopting a long-term approach that takes into consideration climate-related risk an urgent priority.

Fidelity research into ESG integration among insurers

We conducted an engagement project looking at ESG in the insurance sector, with a specific focus on the integration of ESG factors in asset allocation to future-proof insurers' balance sheets. We engaged with 10 European-listed insurers we invest in with market caps ranging from $3 billion to $37 billion, at quite different stages of their journey towards ESG integration. The study outlines the current state of the sector and provides a longer-term perspective on the viability of its business models.

The exercise allowed us to go beyond investee companies' current policies and practices and instead focus on their ambitions and plans for future implementation of ESG strategies. All companies we engaged with are facing similar problems to the ones we have found with regard to third party data providers, including differences in methodologies and ratings, and our proprietary approach to rating issuers on sustainability resonated very well with all investee companies within the scope of this project.

The two key areas in which ESG risks touch insurers operations are underwriting and investment.

Underwriting

The systematic integration of ESG considerations into the underwriting process is important for managing losses. For some insurers, ESG considerations are manifest in the creation of specific products protecting customers against ESG risks; for others, it is exclusion policies (e.g. the widely adopted decision to stop underwriting coal risk).

While these are a step in the right direction, if materiality is to be an important principle, then niche products or specific exclusion policies are not nearly as crucial as the systematic consideration of 'extra-financial' factors in underwriting decisions to ensure the quality of the book and the appropriateness of reserves.

The integration of environmental considerations in underwriting is already highly sophisticated for those insurers whose businesses touch catastrophe-exposed lines, but the 'social' aspect has been less accounted for. Recently, the importance of these factors in the underwriting process has been highlighted in the US by the emergence of the opioid crisis and the lifting of the statute of limitation on child abuse claims. Insurers are potentially on the hook for huge sums owed to victims.

Investment

The materiality of ESG risks to insurers is most pertinent on the asset side. Given the long-term investment horizon of insurers, particularly life insurance, climate-related regulatory developments are certain to hurt net present values (NPVs). The insurance industry's core business is to understand, manage and carry risk and it should be bringing this same scrutiny to the sustainability of its own investments. Balance sheets are not only exposed to physical and transition risks, but also to liability risk (the intersection of environmental and social considerations).

> Today, companies in the sector have excluded a range of investments from controversial weapons to coal to sovereign bonds issued by countries with human rights violations.

A key risk for insurers is impairments driven by stranded assets. Notably, assets may be stranded much earlier than anticipated. As the governor of the Bank of England noted in 2015: "The UK insurance sector manages almost £2 trillion in assets to match liabilities that often span decades. While a given physical manifestation of climate change – a flood or storm – may not directly affect a corporate bond's value, policy action to promote the transition towards a low-carbon economy could spark a fundamental reassessment."

Reputational risk should also be a consideration. Climate-awareness is largely being driven by civil society, highlighted by social movements (such as Extinction Rebellion and the Greta Thunberg-led school strikes) calling for divestment from fossil fuels and the cessation of underwriting coal-fired power infrastructure. And, at the time of writing, the Covid-19 pandemic is demonstrating what happens in a global crisis.

This risk is financially material on two sides. Firstly, such factors can accelerate the rate at which regulatory change occurs, leading to asset write-downs, and, secondly, negative press coverage influences customer decision-making and those insurers behind the curve could see themselves ceding clients to more socially responsible peers.

Reputational risk is not limited to the exposure of insurers' balance sheets to polluting industries. For example, health insurers will struggle to justify exposure to tobacco companies. Today, companies in the sector have excluded a range of investments from controversial weapons to coal to sovereign bonds issued by countries with human rights violations. Going forward, we expect coal exclusion policies to become the norm. Beyond this, we anticipate further scrutiny of non-coal fossil fuel investments, resulting in more stringent exclusion criteria.

ESG is no longer an optional consideration for insurers. The risks of not acting are high, while the positive impact of stronger ESG policies can meaningfully improve access to capital streams and lower the cost of capital applied by the market, with a positive knock-on effect on share prices. Our own research, using our proprietary ratings, showed that ESG leaders outperformed laggards during the Covid-19 crash and as markets recovered, adding weight to our belief that better-rated companies can outperform through the cycle (see *Proprietary ESG ratings prove their worth* above). We therefore expect most insurers to implement the following policies:

- Ensure ESG oversight is assigned to C-suite
- Conduct TCFD reporting and 2-degree portfolio alignment analysis by testing the 'warming potential' of corporate bonds and equities - leading to greater 1.5-degree alignment
- Minimum ESG score requirement for investments
- Assess asset managers' ESG policies where assets are being run by external parties
- Invest in renewables/green bonds/sustainable buildings/green infrastructure
- Implement a Real Estate ESG policy

We were positively impressed by the level of ESG integration already in place at a number of firms we engaged with and our findings demonstrated that market capitalisation needn't be a barrier to adopting a forward-thinking ESG strategy.

Even the laggards we identified in our engagements are aware of ESG issues and under pressure from stakeholders to improve and implement their ESG strategies.

Most positive was the level of future ambition, with scenario analysis of different levels of warming coming up time and again as an area that warrants more attention. Additionally, there was a real appetite for knowledge sharing and collaborative action, and a recognition that players across the sector are facing the same difficulties when it comes to benchmarking, with a framework for measuring impact highlighted as the next big challenge.

From a Fidelity perspective, we will continue to monitor the sector closely, and assign our proprietary ESG ratings to each company based on their progress. Our aim is to identify the long-term winners which are successfully transitioning towards more sustainable business models.

Case study

In addition to the ESG research project, we engaged with a reinsurer to assess how the company is integrating climate risk within its underwriting and investing practices. On the liability side, the focus is on green infrastructure/renewables. The company is underweight carbon intensive insurance liabilities and overweight green/low carbon insurance liabilities. It has developed one of the most advanced proprietary natural catastrophe models in the reinsurance industry to assess the physical risk of its liability portfolio, and the company is one of the few in the industry which leverages its natural catastrophe model to look at risks to the asset base, for example on its real estate investments which might be exposed to physical risk.

Its responsible investment approach is divided into three pillars: (i) Enhancement, focused on advancing ESG integration within the investment process (ii) Inclusion, where the focus is on green investments as well as engagement, and (iii) Exclusion, which focuses on risk management. The company has committed to a net zero portfolio by 2050 and an increased focus on climate change engagement. Another key element of improvement will be the development of a more granular Paris-aligned scenario analysis. They are talking to various data providers, but have yet to get sufficient information to use for portfolio management. The company wants to make progress despite challenges with data and will be working more next year on 1.5-degree analysis.

This engagement on ESG integration with one of the reinsurance industry leaders provided us with an important knowledge sharing opportunity and we agreed to reconvene in 12 months' time to compare notes on each other's progress, specifically in the area of integrating sustainability considerations within our respective investment processes.

House to let sign ironically rises above the floodwaters in Catcliffe Village. (Photo by Gideon Mendel / Contributor

Country in focus

Japan

Overview

Fidelity's Head of Engagement in Japan continued to initiate engagements and projects with investee companies, alongside our analysts and portfolio managers, in a period in which corporate governance issues moved higher up the country's agenda. During the year, we met with company boards about a range of issues. We also met with members of the audit and supervisory boards and non-executive directors responsible for monitoring the companies.

Environmental and social issues have also been among the topics addressed in 2019. The focus on these factors has rapidly increased compared to 2018, amid growing awareness of ESG and the UN's Sustainable Development Goals (SDGs) among Japanese companies. In many cases, companies sought our feedback on the content of their disclosure such as their Integrated Reports.

We prepare and provide companies we meet with a "value creation diagnosis report" to share our view of the issues they need to recognise, prioritise and address, particularly around capital allocation. In addition to sharing our engagement agenda with companies, we promote dialogue through open questions and an active approach. We try to make the progress of our work and effort visible, traceable and measurable and focus on achieving good outcomes.

Case Studies

Governance is good for health

Acquisitions can be good or bad for value creation. Our Tokyo team wanted to ensure that when a major Japanese pharmaceutical company acquired an international business, there was transparency around management value-add and the move towards better corporate governance in Japan was being taken seriously. In the past 16 months, we had a series of meetings with the company to assess progress against our expectations.

We engaged with the pharma company at the request of the portfolio manager who was concerned that the newly introduced level of compensation for the CEO appeared to be far above those of domestic competitors, and hard for investors to fathom due to inadequate disclosure. Just before the AGM in June 2019, the chairman of the board, a high-profile person in the business community, sent a letter in response to shareholders, including us, who had raised concerns about the plan to retain the incumbent CEO and to increase his remuneration.

In October 2019, together with the portfolio managers and research analyst, we met with the chairman and informed him that we believed the level of remuneration disclosure did not meet the requirements of the recently revised rules on disclosure, to which Fidelity had contributed. We provided him with some examples of good practice among Japanese and global peers, and communicated our expectations that long-term incentives for management should be aligned with long-term shareholders' interests.

In addition to sharing our engagement agenda with companies, we promote dialogue through open questions and an active approach. We try to make the progress of our work and effort visible, traceable and measurable and focus on achieving good outcomes.

We also wanted to ensure the appropriateness of long-term incentives, for example, with specific KPI targets. In our view, the company had fallen far short of those standards. The chairman responded that while the KPI targets for the CEO's compensation were not disclosed to investors, they had never been intentionally lowered. He also reiterated that the CEO has been invaluable to the success of the integration of the international acquisition, and that the bulk of the rewards had come from this. He also admitted that they could improve their disclosure and promised to do so.

After this meeting, we also shared our view with the HR function and general counsel. In May 2020, the company contacted us again and explained the rationale for the increase in executives' remuneration. This significantly improved the level of disclosure and included a number of the KPI targets that we had requested. We believe that this improved disclosure level should drive management performance and facilitate more constructive dialogue between the company and shareholders going forward.

Getting to net zero by 2050

Our Tokyo-based team engaged with a Japanese gas company in relation to their long-term management vision. They revealed plans to achieve net-zero greenhouse gas emissions by 2050. As a first step, they aim to reduce emissions, including customer emissions, by around 10 million tonnes by 2030, which exceeds Japan's country target of reducing emissions by 26% (from 2013 levels) by 2030. We think this ambitious vision could win widespread recognition and encouraged the company to set out a range of steps it could take to achieve this goal. After the meeting, it published concrete 2022 KPIs, including those that related to renewable energy transaction volumes, in a new medium-term management plan.

Using hydrogen to lower carbon emissions

Our team also engaged with a Japanese petroleum and metals conglomerate in relation to the development of new businesses that contribute to the resolution of social challenges. The company believes that its intention to grow its hydrogen business could contribute to lowering carbon emissions. It is focusing on hydrogen as an alternative to oil and plans to use innovative technologies to overcome existing challenges and collaborate with overseas business partners. We saluted the company's efforts and communicated that having the right business model in place for this new venture would be key to making it a success.

Multi-year engagement with Kirin

To find out more about how Fidelity engages on a multi-year basis with investee companies in Japan, please visit our website here[19] to watch a video in which we discuss various issues with a Japanese beer company.

[19]Source: https://www.fidelityinternational.com/editorial/article/successful-shareholder-engagement-is-a-long-journey-ed9ff2-en5/

Fidelity meets with Kirin. (Image via Fidelity International)

Engagement by E, S and G

E: Climate change

Overview

Climate change poses risks to the long-term profitability and sustainability of companies. Investors are exposed to downside risks as a result of the direct physical impacts of climate change (e.g. extreme weather events affecting agriculture and food supply, infrastructure and water supply) and the impacts of policy measures aimed at reducing greenhouse gas emissions from certain industry sectors.

Climate change also presents innovative opportunities for investment in areas such as renewable energy and energy efficiency solutions. The narrative on climate change continued to develop during 2019 amid growing climate activism around the world, with implications for both investment and engagement. Looking ahead, some countries are likely to use the coronavirus pandemic as an opportunity to reset their climate ambitions, while others may take longer to get to their previous targets while they deal with the outbreak and its aftermath. (See *Sustainable investing across Fidelity* section.)

Monitoring sustainability practices in the oil sector

One of our ESG analysts held a second call with an oil and gas exploration and production company regarding its sustainability practices and report. This US company participates in industry initiatives to reduce methane emissions and has adopted an emissions intensity reduction target. To achieve this goal, the company is expanding leak detection programmes to more facilities and replacing high-bleed pneumatic controllers with low or zero-emitting devices.

The company has also made progress in terms of climate risk reporting and governance. It is aware of TCFD recommendations and committed to continuous progress on this front. We encouraged the company to enhance disclosure of scope 3 emissions (i.e. those produced along the value chain), its efforts to reduce methane emissions and the assumptions and results of its climate scenario analysis, and to consider a carbon emissions reduction target. The company has yet to commit to setting carbon targets but is looking into enhancing disclosure on scope 3 emissions, which should be included in the 2020 report, due to be published in 2021.

Reducing flaring and using renewables instead of oil-field gas

We engaged with an oil and gas services company's strategy director regarding the company's sustainability practices, including efforts to reduce carbon emissions. As part of its overall sustainability strategy, the company is 'tweaking' the designs and procedures of existing FPSO (floating production storage and offloading) to reduce flaring and energy consumption. The company is also looking to design future FPSOs with the aim of using renewable energy sources instead of gas from the oil field. This can be achieved by using cabling that connects its power supply onshore.

We encouraged the company to enhance disclosure of scope 3 emissions, its efforts to reduce methane emissions and the assumptions and results of its climate scenario analysis, and to consider a carbon emissions reduction target.

Additionally, the company anticipates it will be able to connect an FPSO to a nearby floating wind turbine in the future. The company has also been investing in R&D to develop a wave energy converter and expects field testing to begin in 2021, as well as a sea water intake riser to make the water-cooling system more efficient. Overall, the company's greenhouse gas emissions per unit of production reduced by 39% over the period 2015-2018.

Switching to renewable diesel

We engaged with a US-based petrochemical and gas company about its approach to climate change. The company has not adopted carbon reduction targets but has reduced its emissions intensity per barrel by 40% from 2012. It published a 'Review of Climate-Related Risks and Opportunities' in September 2018 where it presented the potential risks and opportunities arising from a scenario analysis conducted against the IEA 450 scenario.

We engaged with a US-based petrochemical and gas company about its approach to climate change. The company has not adopted carbon reduction targets but has reduced its emissions intensity per barrel by 40% from 2012.

The company concludes that under a 2-degree scenario, efficiency improvements will be required and market conditions on the US West Coast will be challenging for its refining business. To mitigate transition risks, the company has been investing in renewable diesels, taking inedible corn oil, used cooking oil and recycled animal fats and turning them into low-carbon diesel that is compatible with existing engines and infrastructure. It is also working on its supply chain to mitigate the physical risks associated with climate change. The company has also committed to improved disclosure and its next sustainability report will be aligned with a recognised international framework such as the Global Reporting Initiative.

Iron ore subject to both transition and physical climate risks

One of Fidelity's materials analysts met with the chairman of a large, global mining company and discussed the company's efforts to reduce carbon emissions. While it is challenging to reduce emissions in the aluminium smelting process, the company has been pressed by clients to offer recycled or low carbon aluminium. In 2018, it formed a partnership with Apple and other stakeholders to develop technology that would remove GHG emissions from smelting.

Around 71% of the company's electricity consumption comes from renewable sources. But the bulk of the company's scope 2 emissions (i.e. those from the energy required to produce products) come from aluminium and titanium assets that rely on coal power. As the power contracts come to an end, the company will be considering renewable alternatives where possible.

Regarding scope 3 emissions the company highlighted the difficulty of reducing emissions in the steel industry which uses its iron ore. Earlier in the year, the company published its first climate change report including the results of its 2-degree scenario analysis. Under the IEA Sustainable Development Scenario, its Pilbara iron ore would be subject to both potential transition and physical risks associated with climate change.

Steel company seeks to go carbon neutral by 2050

We met with the sustainable development manager of one of the world's largest steel producers to discuss the progress made by the company on several ESG issues. The company published its first Climate Action Report in May 2019 where it outlined six low-carbon technologies that could become alternatives to coal in the steel production process.

The company's objective is to assess the viability of these technologies over the next year. It only slightly missed its previous carbon emissions intensity reduction target and achieved a 6% reduction in 2018 against a 2007 baseline. It has set a new target to reduce its average carbon footprint intensity by a further 2% by 2020. Next year the company will be publishing a 2030 target which is likely to be a science-based target. The company's ambition is to achieve carbon neutrality in Europe by 2050.

All aboard for efficiency

A Fidelity portfolio manager and ESG analyst engaged with a manufacturing and service company on its sustainability practices. Among other issues, we discussed the opportunities arising from the International Maritime

Organisation's regulatory cap on the sulphur content of ships' fuel from 2020. The company has seen a sharp increase in its order book for 2019 as a result, and expects demand to continue to grow. Many clients are interested in energy efficiency and the company's offering also includes life cycle assessments, ranging from optimal maintenance of the vessel to how to use connectivity and data to gain efficiency.

Greater emissions disclosure in agri-services

Our portfolio managers and analysts asked the CEO and CFO of an agri-services group about the company's carbon disclosure. While the company has been measuring its carbon footprint for some time for certain operations, it currently does not disclose its carbon emissions at company level. The company committed to report on scope 1 and 2 emissions in its 2019 annual report, and to aim to unveil carbon reduction targets in its 2020 annual report. It has also hired an external consultant to engage with various stakeholders and validate key sustainability issues for the company. Fidelity subsequently held a call with the company's Sustainability Officer and the consultant and highlighted material issues for shareholders.

Getting a flavour of scope 3 emissions

Members of our portfolio management, analyst and Sustainable Investing teams discussed sustainability practices with the chief sustainability officer of a German producer of flavours and fragrances. The producer is one of only a few companies with carbon reduction goals approved by the Science Based Target Initiative.

At each plant, a manager is responsible for implementing reduction targets. As most of the company's carbon emissions are scope 3, this also involves collaborating with suppliers of raw materials and encouraging them commit to their own carbon reduction targets by 2020. The company has various initiatives in place to source raw materials responsibly using a supplier vetting process and local partnerships. It is also conducting various scenario analyses in line with TCFD recommendations and has committed to report on the results in the future.

Evolution of power in the utility sector

Spain: A Fidelity ESG analyst had a call with a Spanish electric and gas utility, to discuss sustainability issues, including energy efficiency and the development of its generation portfolio. The company has been working to improve the energy efficiency of its gas infrastructure and its shipping fleet, allocating €50 million per year to R&D and innovation projects in this area. It has an ambitious carbon emissions target in place, both on an absolute and intensity basis, and has set a goal to be carbon neutral by 2050.

This ambition is also reflected in the development of its generation assets portfolio, with the company announcing in December 2018 the planned closure of all its coal plants and a recent write down of its thermal generation assets, which it plans to phase out. The company has recently reached an agreement with the Spanish government for an orderly closure of its remaining nuclear assets and, going forward, the companies will focus on strengthening its renewables and gas generation capacity.

UK: Our analyst had a call with a British electric utility to discuss the company's actions to reduce scope 1 & 2 GHG emissions while preparing for potential future regulations on climate change. The company has always been proactive in this area. It has been consistently meeting or overachieving its short-term goal to reduce scope 1 and 2 emissions and is currently on track to meet its 2030 targets.

The company has also started tracking scope 3 emissions, a large chunk of which is made up of the consumption of gas sold. However, it expects these to decrease over time as a result of decarbonisation plans pledged by the UK government. Also, in accordance with UK rules, it will decommission all of its coal plants by 2020 and plans to replace the lost capacity through additional investments in energy efficient natural gas assets and an increased presence in renewables. With regards to natural gas, the company announced its plan to develop a next generation Combined Cycle Gas Turbine (CCGT) power station, which will be the most energy efficient of its kind in Europe.

US: Our analyst had a call with a North American electric utility to discuss its decarbonisation plan, among other topics. The company informed us that it is now planning to phase out coal earlier than the end of 2020 as previously expected (5 facilities are still operating). Reduction in coal-based electricity generation will be mainly covered by gas and solar, increasing the company's solar power generation capabilities from 300MW to 600MW. While the company is optimistic about solar, it still expects natural gas to play a key role until technology improves the intermittency and storage issues of renewables. The company has made significant investments to upgrade some ageing infrastructure and as a result was able to decrease NOx emissions substantially.

Real estate wrestles with extreme events

Our ESG and equity analysts had a call with a US real estate company to discuss the company's approach to sustainability, and how this approach feeds into its asset management strategy. The company recognises the contribution of the building sector to climate change, both at the development and asset management stages, and the challenges associated with it. The company has experienced first-hand the disruption that can be caused by extreme weather events, when a hurricane resulted in more than $3 million of damage at two of its campuses in Florida last year.

The company affirms that integrating sustainability considerations has always been part of its ethos and is fully embedded into its core activities. It also recognises that this has not yet been reflected in public disclosure. It is in the process of formalising this approach, evidenced by the recent creation of an ESG committee at board level and the announcement of the publication of a 'Letter of Commitment' which will outline its approach to ESG. Energy efficiency enhancements, building certifications, physical risk and promotion of low carbon mobility are the ESG considerations where the company is already showing a strong awareness of potential risks and pro-active management of associated opportunities.

Replacing plastics in packaging

Our portfolio management, analyst and Sustainable Investing teams all engaged with the chairman of a supplier of plastic and fibre products. The company is introducing a sustainability committee at board level to accelerate its sustainability efforts. The company recognises that it can do more in terms of disclosure and practices. We encouraged the chairman to introduce a carbon emissions reduction target and link executive remuneration to sustainability objectives. The company is also proactively looking at replacing plastics in its components and packaging segments. The company expects customers to ask for alternative materials in the future.

Chewing gums in plastic-free and biodegradable packaging. (Photo by picture alliance / Contributor Images via Getty

S: Supply chain and labour management

Overview

As supply chain management was a key theme for the Sustainable Investing team in 2019, many of the case studies can be found in the Engagement by theme section above, in Supply chain sustainability and Sustainable palm oil. Below we set out a range of other engagements around different themes in the social category, with a core focus on child labour and poor working conditions.

Following the arrival of Covid-19, the S in ESG has taken on a new prominence (see above for *Analyst Survey: Society's Big Moment*) and we have seen more companies thinking carefully about their employees, and their impact on the communities in which they operate.

Visibility on labour conditions in barley fields

An ESG analyst and several global portfolio managers met with representatives from a drinks and brewing company to discuss its sustainability practices, in particular, human rights in its supply chain. Agricultural procurement of barley crops can be labour intensive, which raises the risk there might be violations of policy. The company reported strong visibility along its supply chain and described how it has employed over 200 advisors who visit farmers, identify violations and conduct training with suppliers to reduce the likelihood of these violations.

We discussed the company's efforts to help provide traceability of the gems' supply chain, including social and environmental practices, and its ESG disclosure. We will continue to engage with the company on these issues.

The company does not take a black and white approach to breaches of policy; rather it outlines findings, sets expectations and showcases good practice. Gender bias in harvesting is a key issue for the company as compensation is cash-based, so there may be less visibility over final payments. To combat this issue, the company has set up an SMS communication channel with farmers to tell them how much of their product has been bought and at what price.

Community issues in Mozambique

We met with a natural resources company's CEO and head of sustainability. Among other things, we discussed the actions taken by the company following the settlement of claims brought on behalf of individuals living near a mining concession in Mozambique in February 2019. While the company maintained it was not liable for the alleged incidents, it recognised that instances of violence have occurred on and around the site and these were not reported to the head office.

The company introduced an independent operational grievance mechanism and a group-wide incident log with clear reporting lines, depending on the severity of the incident. The company continues to face issues regarding illegal miners entering the site. We also discussed the company's efforts to help provide traceability of the gems' supply chain, including social and environmental practices, and its ESG disclosure. We will continue to engage with the company on these issues.

Avoiding conflict minerals in electronics production

Our information technology analyst and Sustainable Investing team engaged with a multinational electronics manufacturer to discuss its supply chain management policies, specifically in relation to the monitoring of conflict minerals in its supply chain. The company confirmed that it requires all of its suppliers, new and old, to sign a code of conduct, a declaration on conflict minerals and it runs a background survey on all suppliers in line with the principles outlined by the Responsible Business Alliance (RBA). The RBA principles include human rights and labour standards.

The company tracks and audits its suppliers closely on an annual basis to ensure conflict minerals are not used in production and that there are no violations against its code of conduct or the RBA principles. If violations are identified, they are treated as a high priority, and a certain amount of time is given to suppliers to make improvements to their processes. The company has an internal 'Supplier Corrective Action Request' programme which allows violations to be reported easily and dealt with speedily.

Adhering to an ethical code in retail

Our consumer discretionary analyst engaged with a Hong Kong-based retailer about its supply chain management initiatives, specifically in relation to the environmental and social risks in its supply chain. The company expects all suppliers to comply with its 'Core Ethical Sourcing Requirements', which cover child labour, forced labour and prison labour in any part or aspects of its facilities. The requirements also ensure that its suppliers do not use any abusive behaviour and do not contravene any local environmental laws and regulations. Suppliers must also provide a safe and healthy work environment for workers and comply with any corrective action expected of them. All suppliers are subject to on-site audits of product quality, and if there are quality issues, the retailer will suspend deliveries until corrections are made or, if necessary, cancel the supplier's status as a qualified supplier.

Managing risks further down the supply chain

We engaged with an Australian conglomerate on their supply chain management. The company has strong supplier policies which incorporate scrutiny of human rights adherence and the environmental footprints of suppliers. The company is very transparent about its policies and also discloses a summary of audits, the amount of violations that occurred during the year, details of the violations and remedial actions taken. Allegations of exposure within its supply chain to Xinjiang camps were proven true and the company has since cut ties with that tier 4 supplier. The company is aware that it is exposed to potentially high risks across its tier 2, 3 and 4 suppliers that are not currently covered by its supplier policies, but it is working on new initiatives to monitor these suppliers more closely.

Encouraging rather than compelling supplier change

Our Sustainable Investing team engaged for a second time with a Chinese manufacturing company following previous discussions with the company about its supply chain management policy. In our previous engagement with the company, we had formally requested that the board consider providing more public disclosure regarding the auditing of its suppliers and the systematic monitoring of their supplier's environmental footprint.

In recent communications with the company, it stated that, as it has recently restructured the company into three groups, it now plans to optimise supply chains to enhance efficiency, and will disclose more details on its upgraded supply chain management process once the process has been finalised. The company has considered systematically incorporating environmental matters into its supplier assessment process. However, as good and stable suppliers in China are currently hard to find, it would prefer to encourage rather than compel them to incorporate environmental initiatives. The company did state that it would prioritise orders with those suppliers embracing environmental standards.

Supermarket suspends orders after allegations of forced labour

A factory in China has denied it used forced labour after a girl found a message from a factory worker inside a charity Christmas card bought from a leading UK supermarket. The company halted production at the factory because of the message, allegedly written by prisoners claiming they were forced to work against their will. The card supplier in China and the Chinese foreign ministry have said the allegation was untrue. The supermarket launched an on-site investigation at the factory before suspending the site and communicating this decision to factory management. The UK company is continuing to investigate the matter but has not placed any orders with the factory since the allegations were made.

In our retail analyst's recent review of the company's supply chain management, she commented on the company's human rights standards for its tier 1 suppliers and how it is focusing on the most serious risks to workers through the supply chain and working with NGOs, unions and others to both identify the issues and remediate them. Beyond tier 1, the company's top 10 supply chains are mainly related to produce (e.g. bananas, berries etc.) and the company has multiple certifications such as 'Rainforest Alliance', 'Better Cotton Initiative' and 'Certified Sustainable Seafood'.

Lawsuit over alleged child labour in Malawi

A leading tobacco company faces legal action over the alleged use of child labour in its supply chain. Lawyers are pursuing compensation initially for 350 child labourers working on tobacco crops bought by the company in Malawi. In response, the company has said that it told farmers children must not be used as unpaid labour, but the lawyers argue that the families cannot afford to work the fields otherwise, because the price paid for their crops is so low.

Tobacco companies are under increasing pressure to increase their scrutiny of tobacco growers and also identify poor labour practices in remote parts of their supply chain. Our consumer analyst was concerned about the child labour allegations made against the company and stated that although the company is seeking to address the issue through the industry-wide Sustainable Tobacco Program, she is not yet sufficiently convinced that the matter has been fully addressed. She states that the company has been dealing with child labour allegations for years, with some occurrences in the US, and there have been other labour related issues with African migrant workers in Italy. She recognises that the company is increasing its focus in this area and will continue to monitor it in her engagements and analysis.

Impact of telecoms provider ban on Asia supply chain

And finally, Fidelity's IT analyst responded to the US banning equipment from a major Chinese telecoms provider by analysing the implications for the Asia supply chain. The analyst looked at three key areas in the supply chain that may be impacted – network equipment, PC/servers and smartphones. In Asia, the suppliers are mostly concentrated in the smartphone supply chain and the analyst identified the key companies with significant exposure to the ban while highlighting who is in a position to gain from it.

Workers assemble smartphones on the production line. (Photo by SOPA Images / Contributor Images via Getty

G: Data privacy, cyber security, pay and independent boards

Overview

Governance has been a key issue for investors for many years. The reputational and financial risks that arise from poor management practices or lack of board oversight have long been a threat to company operations and scrutinised by regulators. Companies with good governance tend to generate better financial performance and have greater longevity, and to be better at dealing with environmental and social considerations as well.

We continue to engage with companies on some of the key elements that we always have, in particular, executive remuneration and board composition, as well as shareholder interests and reporting. But as technology has developed, data privacy and cyber security issues have also risen up the agenda. Below we highlight several case studies of engagement on these issues, and we begin with one where we go into greater detail to demonstrate our role in the proceedings.

Key case study: Merger of two lens manufacturers

Two lens companies merged, creating the world's leading supplier of ophthalmic (i.e. corrective) lenses, with complementary businesses in non-prescription sunglasses and reading glasses. The merger was beset by delays and questions over the future governance of the combined entity, so the two sides maintained separate management teams while the combined entity pursued integration.

As per the merger agreement with the majority shareholder of one of the companies, the combined board of directors was comprised of eight members designated by one company and eight designated by the major shareholder of the other company. The board's rules of procedure gave the executive chairman and vice chairman equal powers, with neither having a tie-breaking vote, to ensure parity.

In March 2019, the two CEOs of the pre-merged companies released separate statements in the press which exposed a bitter rift between the two camps on the board. With the impasse causing continued delay to the appointment of a group CEO, Fidelity engaged in talks with other concerned shareholders. Fidelity concluded that the best course of action was to co-sponsor two independent director nominees to the board for the purpose of breaking the deadlock and to increase representation of minority shareholders. Fidelity met with the majority shareholder in May 2019 to discuss the proposals.

Three days before the AGM, the two sides announced a settlement, setting aside all current disputes and confirming that the future group CEO would be unaffiliated with either party. At the AGM, Fidelity voted in favour of its director nominees. Both candidates were voted down despite receiving substantial support from minority shareholders. However, the proposals were seen as a likely factor in getting the two sides to the negotiating table to reach their agreement, which represented a positive result.

Other case studies: Data privacy and cyber security

Protecting nuclear plants from cyberattacks

Our ESG analyst met with a French electricity company to discuss various sustainability topics, including cyber security. Cyber security is seen as a high risk to nuclear plant safety. In 2018, the company committed to do in-depth risk assessments, with findings due to be published in the latter part of 2019. A board member was assigned responsibility for cyber security and the cyber security department was tasked with looking into further enhancements. All nuclear plants are controlled locally, so the risk that a cyberattack could affect their operations is considered low at present, but is being monitored.

Using tokenisation to enhance security

We met with the CFO and general counsel of a UK-based maker of promotional merchandise to discuss topics related to corporate culture, human capital, supply chains, cyber security and executive remuneration. Cyber security is a topic which has always been on the board's agenda, given the CEO's background in IT. The CFO informed us that currently one-third of capex goes into enhancements to IT infrastructure. The company was among the first in the industry to adopt tokenisation for credit card data, which is the only type of sensitive customer data they retain: tokenisation is the process of substituting a sensitive data element with a non-sensitive equivalent, referred to as a token, that has no extrinsic or exploitable meaning or value. Additionally, the CFO informed us that the company holds all relevant certifications in the cyber security space and that it consistently runs training programs to familiarise all employees on this topic.

Ensuring data privacy of patients

We met with the director of investor relations at a Spanish pharmaceutical and chemical maker. The company described a robust process for ensuring the traceability of its products from plasma collection to distribution. Fidelity inquired about the controls that the company has in place to ensure the data privacy of its patients. The company broadly described its information technology capabilities and protocols, as well as a recent review of its processes in light of the GDPR data privacy regulation. The company has also taken out cyber security insurance. In future discussions, we will follow up with requests for further detail regarding the company's IT oversight, risk management and risk escalation procedures.

Airline aims to ensure staff are aware of risks

Our team met with the head of investor relations of an airline company regarding its approach to cyber security. The company highlighted its efforts to learn from other companies' experiences with breaches, even beyond the airline industry. The company is a member of the Aviation Information Sharing and Analysis Center (ISAC) through which it collaborates with other airlines to combat cyber security attacks. Staff training and phishing tests are regular components of the company's approach to ensuring staff are equipped to identify cyber security risk. In addition, the company has invested significant sums in upgrading its technology platform in recent years. The company's chief technology officer reports directly to the CEO. We will continue to engage with the company and others within the airline industry to better understand their preparedness for and response and resilience to cyber security attacks.

Cyber security comes to Hollywood

Our ESG and equity analysts had a call with a leading US entertainment and film company to discuss several ESG-related topics, including executive remuneration, data privacy, human capital and supply chain risk. The company has suffered a couple of data breaches and has been accused of wrongfully collecting minors' data in the past. It now sees the area of data privacy and cyber security as a material risk for the company. Data privacy sits with the chief information security officer (enterprise wide), reporting directly to the CEO. However, the investor relations team could not confirm whether any board member has specific skills or a background in cyber security, the extent to which this topic is discussed at board meetings, nor whether the company's IT Infrastructure has been externally certified. The company assured us that all employees are trained in cyber security tailored to their functional area, demonstrating a pro-active approach in reducing the human risk factor, which is a key contributor to cyber security risk.

We also engaged on named executive officers' remuneration and a shareholder proposal encouraging the board to look at the feasibility of including cyber security risk measures in senior executive compensation metrics. Three days after an initial written exchange in which Fidelity expressed views on several elements of the CEO's pay, the company filed a disclosure announcing the cancellation of several planned increases to the CEO's variable remuneration elements. In the engagement, the company emphasised the robustness of its oversight of data security and privacy-related matters, and noted that data security and privacy was included as an accomplishment for one senior executive in the 2018 proxy shareholder documents.

Bank recognises new set of cyber risks

Our ESG analyst, together with a fund manager, met with a Spanish bank to discuss several sustainability topics, including its approach to cyber security and the quality of its IT infrastructure. The company recognises that it is increasingly exposed to cyber security risk. The push for digitalisation and focus on technological innovation as a source of competitive advantage within the financial services industry has created a whole new set of risks and opportunities. The company claims to have best-in-class IT infrastructure, which is ISO certified and externally audited. Employees are trained specifically on the topic, according to their specific function; the company also employs an external agency to simulate cyberattacks and monitor the resilience of its systems. The company prides itself on never having suffered a material data breach.

Telecoms giant collaborates with government on security

Our ESG analyst and two portfolio managers met with a telecoms giant to discuss topics related to corporate strategy, governance and risk management. Given that one of the conclusions from last year's board review was a need and desire for more board training on issues like cyber security, we questioned how confident the chairman was about the board's ability to provide good oversight of the company's cyber security management. Given the company's extensive collaboration with GCHQ, a governmental intelligence and security agency, as part of the fibre infrastructure deployment, the board held several meetings with GCHQ representatives during the year to discuss global trends in cyber security. The company also had its cyber practices externally reviewed and received very positive feedback. The chairman stated that he is generally confident in the board's ability to successfully tackle this risk.

We also met with the outgoing chairman of the company to discuss many topics including capital allocation and strategy, the regulatory environment, customer satisfaction, board refreshment, and executive remuneration. Fidelity questioned the remuneration committee's decision to grant equity awards with the same face value as it had the previous year despite a 30% fall in the share price, in part due to a dividend cut. Many UK investors expect equity award grants to be reduced when the share price falls significantly so as to avoid the possibility of windfall gains.

Renumeration

'Boundless greed'

The CEO and remuneration committee chair of a banking group answered questions before the UK parliament's work and pensions select committee in June 2019 after senior MPs accused the bank of 'boundless greed' over its executive pension arrangements in a strongly-worded public letter the previous month. The CEO's 2018 pension contribution was £573,000 (corresponding to c. 46% of his base salary), which was paid to him in unrestricted cash as his accumulated pension benefits exceed the lifetime savings limit.

The bank announced that for 2019, the CEO had voluntarily given up a portion of his pension so that it would be reduced to 33% of base salary in order to bring it closer to that of the workforce, but MPs questioned why his contribution remained higher than other employees' maximum contribution of 13% and drew comparisons with a rival, which cut executive pension contributions from 30% to 10% of base salary following shareholder criticism. The company's defence of its executive pension practices drew critical coverage in the financial press.

Fidelity questioned the remuneration committee's decision to grant equity awards with the same face value as it had the previous year despite a 30% fall in the share price, in part due to a dividend cut.

Two months prior to the hearing, Fidelity's equity analyst and corporate governance analyst had met with the company's remuneration committee chairman and other representatives to discuss the remuneration report and had raised the issue of the CEO's pension arrangements, noting that some peers had already made moves to align executive pensions with the workforce. Fidelity was told that the bank would be conducting a review of its director remuneration policy following the AGM season and that a review of the executive pension entitlements would be on the agenda.

Integrating drug-pricing risks into compensation design

Our corporate governance analysts held a teleconference with representatives of an international pharmaceutical group to discuss a shareholder proposal asking the board to report on integrating risks related to drug pricing into senior executive compensation. Fidelity told the company that it considers drug pricing practices to be a material ESG risk for companies in the pharma sector and that we would generally encourage boards to take such risks into consideration in the context of executive compensation design.

The company explained that it conducts a risk assessment, which includes an assessment of drug price-related risk, which is disclosed annually in its 10-k filing, but that it does not conduct a specific assessment on the interaction between drug pricing risk and compensation design. However, it considers its current remuneration structure sufficiently flexible to allow the compensation committee to exercise discretion and account for distortions related to drug pricing.

Refocusing the business and changing the long-term pay structure

Our ESG and equity analysts met with a US software company to discuss recent changes to the executive team, the resulting change of strategy and updates to executive remuneration. Following the appointment of a new CEO, after years of disappointing performance in which the firm grew through acquisitions to become an amalgamation of disparate businesses, the company has now decided to dispose or spin off some of its non-core assets and focus on its most valuable IP around voice recognition.

After years of excessive pay with an overly short-term focus, the company, following the appointment of the new CEO, has taken several steps to address shareholders' concerns by strengthening the pay structure, improving transparency on the annual bonus plan and the stretchiness of performance metrics, and extending the vesting period for the long-term incentive portion of pay. We will keep executive remuneration as a key area of scrutiny going forward. Additionally, the company has recently introduced the right for shareholders to call special meetings, which is still not common market practice in the US - a further signal of positive change from a governance perspective and of increased accountability to shareholders.

Corporate governance

Catching up on ESG integration

We met with an international bank's incoming chairman in March 2019 and followed this up with a further discussion in July 2019 to discuss ESG and board matters. The board was planning a refresh and was already in the process of interviewing candidates with greater domain knowledge and diversity. The chairman acknowledged that the bank had been a laggard with regards to ESG integration, recognising that client and investor expectations have moved on with regard to exclusion frameworks and ESG due diligence on bank lending. The bank has hired a new sustainability head and is working on a revised ESG framework, having already released statements announcing it would end all new thermal coal financing and would implement enhanced checks on arctic oil and gas exploration or extraction. The bank plans to conduct a shareholder outreach later in the year to discuss further developments to their ESG framework and disclosures.

Identifying material ESG factors

Our ESG analyst met with the investor relations team of an Italian oilfield services company to discuss its approach to sustainability, how it identifies the material factors relevant to its business model and how this is then reflected in the firm's strategy. The company informed us that it has been looking at materiality for more than 10 years and has also now published a detailed materiality matrix. It has been integrating stakeholders' and investors' input and this matrix also drives management goals for senior executives.

The strategy is set by the sustainability committee, which includes both executive and non-executive directors. Their ongoing materiality assessment demonstrates that the themes of climate change and low carbon transition have become increasingly material for the company year after year. This is also increasingly being seen as an opportunity, not just a risk, as we can see from its increasing involvement in large scale offshore wind farms and big investments into carbon capture & storage (CCS) technology.

Gender diversity at board level

Our senior governance advisor, equity analyst, corporate governance analyst, and several portfolio managers met with the chairman of an insurance company to discuss governance and strategy. There has been a strengthening of the board over the past year with the addition of directors with backgrounds in property and casualty (P&C) insurance, digital and productivity improvements.

The board has good gender diversity and contains several directors with financial services experience, but previously none with P&C managerial experience. In future, the board may consider adding more geographic diversity (e.g. directors from Asia) or 'generational diversity' given the company's focus on capturing millennial customers. It is also considering whether it needs to add macroeconomic and transactional/legal experience, though the board believes it could potentially fill this knowledge gap by engaging external advisors. We also discussed executive succession planning, remuneration, and the company's workforce gender diversity initiatives.

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