Stewardship
21 YEARS OF UK ETHICAL INVESTMENT

Investing with care

A guide to ethical investments
from Friends Provident

FRIENDS PROVIDENT

This brochure aims to explain how **Stewardship** and ***reo***® work so that investors can identify which might be most appropriate for them, or how they might be used together to tailor a pension or investment portfolio to meet their investment and values based needs.

Contents

Introduction

The importance of investors to business

Business, especially big business, is becoming increasingly important in our everyday lives. Whether we are thinking about our own jobs, standards of living, the environment or even our hopes for the future, it is clear that business has a key role to play.

Investment is important to business, with the role of shareholders being particularly important to companies whose shares are quoted on stock markets. Such companies look to shareholders, their owners, to support their share values and as such tend to behave in ways that win favour with investors.

Investors are of course not the only important stakeholders in a business – customers, employees and their local communities are also important, but without the support of customers and shareholders, as well as other investors, a quoted company's future is likely to be difficult.

It is therefore incumbent on these groups in particular to express their values, in so far as it is practical, when buying products or making investments, for example when buying shares.

It logically follows that when individuals make an investment, they should be aware of the important role shareholders can play. For many people this means investing in a way that is aligned with their personal values and aspirations.

How does Friends Provident help investors to do this?

1) Friends Provident is committed to the principle that investors should accept a degree of responsibility for the actions of the companies they invest in. We realise individual investors will find it challenging to achieve this alone and this is why **Stewardship**, the UK's first ethical fund, was created in 1984.

   Stewardship enables like-minded people to group together to increase their own buying power and influence. It also gives concerned individuals a means to avoid investment in companies they would rather not be involved with and support companies that make a positive contribution to the world. Meeting the aspirations of such people is **Stewardship's** mission.

2) Friends Provident's capacity in Socially Responsible Investment (SRI) does not stop at **Stewardship**. The responsible engagement overlay (***reo***®) approach, which applies across all the Friends Provident funds that invest in shares, as well as **Stewardship,** is an additional approach. ***reo***® is a dialogue based strategy run by our fund managers F&C Asset Management plc - in whom Friends Provident has a 51% shareholding. ***reo***® aims to protect and improve shareholder value by encouraging companies to act more responsibly.

   reo® does not alter where funds can invest, but instead is simply an additional form of analysis and shareholder engagement that focuses on governance, social and environmental issues – which tend to be less well covered by traditional investment researchers. ***reo***® was launched in 1999 and adopted by the Friends Provident board in 2000. It was the first approach of its kind in the fund management industry.

In addition to **Stewardship** and ***reo***® our fund managers vote on all Friends Provident's shares at AGMs and EGMs, to ensure that we fully exercise our duties as responsible investors. Friends Provident was the first to publish a worldwide voting record - which is available on our website:

www.friendsprovident.com/sri

The Friends Provident **Stewardship** funds aim to stay true to their 21 year heritage, as envisaged by the funds founding fathers, as well as to build on the Friends Provident Quaker heritage which dates back to 1832. Our aim is to be robust, forward thinking and intelligent thereby offering the people who share our views options that enable them to join with us in *Investing with Care*.

> ***'Investors provide the life blood for our economy.... They have a clear and strong interest in encouraging companies to bolster long term success by behaving responsibly. By giving weight to environmental and social factors in investment decisions, investors can signal to companies the economic importance of those concerns.'***
>
> **Stephen Timms MP**
> Minister of State for Pension Reform
> Investing in the Future Conference; 1 Dec 2005

> ***'Good corporate practice on human rights, child labour and environmental pollution is good for society but it's also good for shareholders. As a large investor it is right that we use our influence with companies to encourage responsible business practices while serving the financial interests of our customers.'***
>
> **Keith Satchell,**
> Chief Executive of the Friends Provident Group

Aims - Stewardship

Stewardship is a strictly screened ethical fund which aims to offer a broadly based ethical approach for investors who care about social, ethical and environmental issues as well as investment performance.

Stewardship was launched in 1984 to give individual investors, who cared about more than simply investment returns, somewhere to invest their money. **Stewardship** was the first UK fund of its kind and was regarded as something of an oddity back then. With the benefit of hindsight however, this has come to be regarded as foresightedness - a vision that has created a fast growing investment area.

Since that time **Stewardship** has grown to hold the most retail funds under management of any UK ethical fund range. As of December 2004 this totalled £1.8 billion[1] of the £5.5 billion[2] UK retail ethical fund market. As of December 2005, Stewardship had £2.4[3] billion in funds under management.

The earliest aims of the fund remain, although they have been broadened over time and adapted to the wider range of investments that now sit within the **Stewardship** range of funds.

The earliest aims of **Stewardship's** pioneers were threefold:

1) to exclude companies that did not meet the ethical standards of the fund or harm society
2) to support good companies, that make a positive contribution to society, through buying their shares
3) to encourage better business practices through share ownership and dialogue.

Today's **Stewardship** funds invest in shares and loan stock (bonds) from a very wide range of companies. There are currently 953[4] companies around the world that the fund managers can choose from.

This international exposure brings constant challenges particularly when it comes to applying the ethical criteria to different cultures. However the funds take the view that we should not shy away from such challenges and the ethical criteria of the funds is applied as consistently as possible across the globe.

There is also an argument for supporting more international companies in the interest of encouraging responsible economic growth for the benefit of everyone worldwide.

Stewardship aims to provide investment portfolios that are socially, ethically and environmentally sound. The companies whose assets are held in the funds are all approved by a panel known as the Committee of Reference, the majority of whom are external and independent, before they can be held in a **Stewardship** fund. It is the Committee's role to apply, interpret and regularly review the ethical policies and the investments held. The policies are outlined in the next section (or in detail on **www.friendsprovident.com/sri**) but in brief the funds aim to:

Positively view companies that	Negatively view companies that
Supply the basic necessities of life e.g. healthy food, clothing, water, and housing.	Own or operate nuclear power stations.
Provide high quality products and services which are of long term benefit to the community e.g. fair trade or locally sourced products, renewable energy, education and training.	Manufacture and sell weapons.
Conserve energy or natural resources e.g. by sourcing energy from renewable sources and companies involved in water-saving technologies.	Cause environmental damage/ pollution e.g. significantly contribute to and do not tackle climate change, destroy forests, manufacture PVC or endocrine disrupting chemicals, manufacture GM crops or seeds.
Have good relations with customers and suppliers.	Have poor practices towards customers, suppliers or communities e.g. irresponsible marketing of breast-milk substitutes and pesticides in emerging markets or poor community relations.
Have good employment practices e.g. in equal opportunities and diversity, professional development, rewards, participation and consultation.	Have poor employee management e.g. discriminate, have poor health and safety.
Have good practices in human rights e.g. support international human rights conventions and supply chain labour standards.	Have poor practices in human rights e.g. perpetrate human rights abuses, facilitate human rights abuses through significant links to an oppressive regime.
Have good practices in anti-corruption.	Trade with or have operations that sustain or support oppressive regimes.
Show strong community relations e.g. donations to charity, employee volunteering, community consultation.	Gambling.
	Produce pornography, harmful or offensive material.
	Produce tobacco or alcohol products.
	Unnecessarily exploit animals.

[1]Source: F&C Asset Management plc as at 31/12/04.
[2]Source: estimated by EIRIS at 31/12/04.
[3]Source: F&C Asset Management plc as at 31/12/05.
[4]Source: F&C Asset Management plc as at 31/12/05.

***reo*®** is an engagement only approach which applies across Friends Provident's assets held in shares. It aims to encourage more responsible business practices without altering where a fund can invest.

The ***reo*®** approach was created as a solution for pension scheme trustees, who wanted to embrace responsible share ownership, but not the ethical screening of their portfolios while protecting the financial interests of their beneficiaries.

The aim of responsible engagement overlay (***reo*®**) is to engage companies in dialogue about risks and opportunities that may have been missed as a result of focusing simply on standard short term financial issues. ***reo*®** aims to make the case for better business practices that are also in their best long term financial interests and those of their shareholders. Our fund managers F&C currently apply the overlay to £27 billion[5] worth of funds.

***reo*®** was created out of what was regarded by many as one of **Stewardship's** strongest attributes – the ability to influence companies through share ownership and dialogue – latterly, by virtue of its size. So, whilst ***reo*®** does not alter where fund managers can invest its reach is far broader than **Stewardship's** because it applies across all the company shares in all the Friends Provident funds we offer – as well as many corporate bonds. This means that ***reo*®** can be used as a tool to help tackle some of the most challenging issues facing the world today – in particular those which may have significant implications for business and shareholders e.g. climate change.

***reo*®** applies across all the Friends Provident funds that invest in shares. This means that any investment into a Friends Provident fund that holds shares is automatically covered by ***reo*®** at no extra cost.

We believe that ***reo*®** is in the best interest of Friends Provident policy holders as well as wider society and although performance gains are notoriously hard to measure, it is our view that ***reo*®** is consistent with long term shareholder value and as such is in the best financial interest of our policy holders.

Engagement programmes vary from year to year but tend to fall into the following three groups:

Social

This relates largely to how companies affect people. This includes the way they treat employees and the local communities that are affected by their operations.

Environmental

The way companies impact on nature and the environment, whether intentional or unintentional and as either a direct or indirect result of their operations.

Governance

The way companies manage their operations. This relates to the way the board operates, how open they are about the way they operate and how employees conduct their affairs.

[5]Source: F&C Asset Management plc as at 31/12/05

Approach of the Stewardship Funds

Stewardship is a range of strictly screened ethical funds. The funds exclude and include companies on the basis of how they compare against the **Stewardship** ethical policies.

Deciding the ethical values of the Stewardship funds and arriving at where the funds can invest is essentially a three step process; setting ethical policies, approving companies and company selection. This, as well as who is responsible for each area, is explained below.

Roles and Responsibilities

Set and review Stewardship ethical policies	**Stewardship Committee of Reference (COR)**	**Supported by Governance and SRI (GSRI) team**
Set approved list of Stewardship companies	**Investment Sub Committee (of COR)**	
Buy and sell from 'Approved List'	**Fund Managers**	

1) Ethical Policies - The **Stewardship** Committee of Reference (COR), the majority of whom are external and independent, reviews and takes decisions on the ethical approach of the funds across a wide range of issues. Policy decisions are informed by a combination of the members' own experience, information gathered and supplied by the GSRI team from a wide range of sources and their interpretation of investors' views. The COR meet quarterly.

2) Company Approval – The **Stewardship** Investment Sub Committee (ISC), a sub group of the COR, has responsibility for deciding whether or not a particular company meets the ethical policies of the fund as set by the COR. In many cases this is quite straightforward, but on some occasions the ISC is required to make delicate judgement calls. These are based on their interpretation of the policies, the recommendations and analysis supplied by the GSRI team and the independent research they use, their interpretation of investors' preferences and their consciences. The companies they approve form the **Stewardship** 'Approved List' of companies. The ISC also meet quarterly.

3) Company Selection - The **Stewardship** fund managers select companies from the 'Approved List' based on their expectations of the financial performance of the company. As such, the ethical approval and investment selection tasks are kept quite separate. Our fund managers aim to get the best possible performance in a way that is consistent with the stated risk profile of the fund. If and when the fund manager comes across a new company they would like to invest in they submit it to the GSRI team to be researched in preparation for submission to the ISC. The company may or may not be approved. If and when a company's situation changes or a policy changes so that a given company becomes 'unacceptable' the fund managers are given six months to sell their holding.

Approach of *reo*®

***reo*® requires us to have a good understanding of the companies we invest in as well as an expert grasp on many of the world's most complex on-going and emerging ethical or 'extra-financial' issues.**

This information is then used to identify the areas in which we may be in a position to help encourage positive change for the benefit of the company involved (or more specifically their share value), society, the environment and ourselves as shareholders. These relationships are complex and it can sometimes take months or years to persuade a given company to change on a specific issue. However, as a major investor, we are well placed to help build a business case for change and to influence companies.

***reo*®** involves working behind the scenes with companies sometimes for a number of years, building trust and understanding with companies. This enables us to identify and then convey beneficial improvements in social, environmental or governance practices and point out business risks and possible future impact on share values.

***reo*®** is applied across all our funds that have equity holdings, including **Stewardship**, so the choice of companies to engage with runs into the thousands.

It is the role of the fifteen strong GSRI team to identify the companies and the issues which are most important and where dialogue with shareholders stands a realistic chance of bringing about change. They normally identify issues that are most important to us by virtue of our exposure to a given company or group of companies.

The team's methods include meeting with senior executives, arranging seminars to explore emerging challenges, voting at AGMs and EGMs. We also sometimes table or support shareholder resolutions and work with groups including NGO's and other investors.

Activity is reported online in the Quarterly ***reo*®** Report. Additional reports are also produced on occasions in conjunction with business partners. The reports generally identify the business risks inherent in an issue, benchmark company performance and provide recommendations for good practice.

Engagement Approach:

Identify priority issues

Identify which holdings correspond with which issue

Identify engagement strategy – based on size of holding and relevance of issue to company

Engagement – meetings, seminars, voting, relationship building, working to influence company

Detailed dialogue, discuss concerns and possible solutions

Company change: in policies, performance or behaviour

Report activity in the Quarterly *reo*® Report

Stewardship Policies

Stewardship has a set of ethical policies, or standards, which companies must not breach if they are to be included within a **Stewardship** fund. These have developed over the 21 years of **Stewardship's** existence and continue to evolve.

Social Policies

Employee Relations

Equal Opportunities and Diversity – **Stewardship** will invest in companies that are committed to providing and promoting equal opportunities irrespective of race, ethnic background, religion, marital status, age, sex, sexual orientation, disability, health status or pregnancy. **Stewardship** favours companies that are aware of the benefits of a diverse workforce and can demonstrate awareness of this area. **Stewardship** will exclude companies with poor practices in this area.

Health and Safety – **Stewardship** will invest in companies that carry out risk assessment and mitigation and can evidence a health and safety culture that is relevant to their business. **Stewardship** will exclude companies that seriously fail in their duties in this area.

Professional Development – **Stewardship** will favour companies that can evidence a resourced commitment to effective training and development.

Rewards – **Stewardship** will favour companies that offer locally competitive pay and benefits, a transparent redundancy policy and a constructive approach towards representative bodies seeking collective bargaining.

Employee Participation – **Stewardship** will favour companies that involve employees in the running of their business through strong practices in employee communication, opportunities for participation and a consultative approach. **Stewardship** will exclude those that are poor in this area, especially in health and safety.

Whistleblower Protection – **Stewardship** believes "whistle blowing" (the practice of having internal processes for employees to report malpractice within the company) indicates commitment to good governance, transparency and accountability and will favour companies with good policies and practices in this area.

Human Rights

Security Forces – **Stewardship** recognises that companies may need to use security forces to protect their business operations and their employees and as such will not automatically exclude companies on these grounds. However, it expects companies operating in the extractive sectors to be signatories of the 'Voluntary Principles on Security and Human Rights', an International government, NGO and business initiative. **Stewardship** will exclude companies that persistently contract security forces that perpetrate human rights abuses.

Supply Chain and Labour Standards – **Stewardship** supports the 'International Labour Organisation (ILO) Fundamental Conventions' which cover freedom of association, the abolition of forced labour, equality and the elimination of child labour. **Stewardship** recognises that companies have varying levels of influence over their suppliers but also considers that those that have influence are able to make labour standards a pre-requisite for business. **Stewardship** expects that companies should support the core conventions of the ILO.

Oppressive Regimes - **Stewardship** will exclude companies whose operations directly or significantly contribute to the persistence of an oppressive regime and will exclude companies with significant links to these where their presence or activities may facilitate human rights abuses. **Stewardship** will only invest in companies that operate in countries designated as oppressive regimes if their operations do not generate a meaningful part of government income or if their practices are likely to promote human rights or be of benefit to the local community rather than the regime.

Business Environment

Customers – **Stewardship** supports consumer empowerment and will seek to invest in companies with strong ethical practices that respect consumer interests. **Stewardship** seeks to support the 'World Health Organisation's International Code of Marketing of Breast-milk substitutes' as well as other resolutions passed by the World Health Assembly. **Stewardship** will take into account consistent acts against consumer interests, misleading marketing or advertising, inadequate labelling or poor data protection and may exclude companies that risk the health of their consumers unless corrective action is evident.

Suppliers – **Stewardship** will favour companies that use their purchasing power appropriately, upholding competitive practices and fair treatment of suppliers.

Local Communities – **Stewardship** positively views corporate involvement in local charities and charitable giving. **Stewardship** will favour companies that are sensitive to the rights of local people and consults them on issues that affect quality of life. **Stewardship** will exclude those that persistently fail to respond to significant concerns of local communities or have poor relations with them.

Indigenous People - **Stewardship** will favour companies that respect the rights of indigenous and tribal peoples and exclude those which fail to adequately demonstrate respect for indigenous people's rights.

Corruption – **Stewardship** expects companies operating in countries where there is a high risk of bribery and corruption to have strong policies against participation in them. **Stewardship** favours companies that commit to anti-corruption procedures.

Environmental Policies

Atmosphere

Greenhouse gas emissions – **Stewardship** will not invest in companies that are high users of energy, fail to tackle climate change or others that perform poorly relative to their sectors. Airlines, for example, are excluded. For oil companies **Stewardship** will only invest in those that demonstrate they are working to reduce their direct contributions to emissions and provide evidence that the need to move towards a lower carbon economy is integrated into their business (and that do not breach the fund's other screens).
For automobiles **Stewardship** will only invest in companies that develop cars that are significantly more efficient than standard vehicles and are moving away from reliance on the standard combustion engine. These companies must demonstrate a real commitment to lessening their environmental impact. **Stewardship** positively regards companies providing public transport services and will not normally invest in companies for which road building is a significant part of their business.

Ozone Depleting Chemicals – **Stewardship** will only invest in companies that comply with the Montreal Protocol (phasing out CFCs by 2010) and will favour companies that have shifted towards more responsible alternatives.

Land

Deforestation – **Stewardship** will avoid investment in companies significantly involved in the sale or use of tropical hardwood if they do not have good practices in sustainable forestry. **Stewardship** will favour companies that are committed to using responsibly sourced timber e.g. Forestry Stewardship Council certified, and to improving their practices.

Persistent Organic Pollutants and Endocrine Disrupting Chemicals – **Stewardship** will avoid companies that are considered to have an irresponsible approach to manufacturing and marketing of such chemicals – including the most damaging pesticides and organochlorines including PVC.

Genetic Modification – **Stewardship** will avoid companies involved in the development or manufacture of GM crops or seed. **Stewardship** will however invest in companies that sell clearly labelled GM food products e.g. supermarkets.

Stewardship Policies

Water

This is a positive criterion. **Stewardship** supports companies that provide water, sanitation and sewerage services and those involved in water-saving technologies as well as those that seek to reduce water use and prevent pollution. However **Stewardship** will not invest in companies that demonstrate a lack of stakeholder involvement, poor performance in public-private partnerships or in managing their direct impact on the environment particularly in water use and pollution.

Energy

Nuclear Power – **Stewardship** will not invest in companies that own or operate nuclear power stations or nuclear waste management facilities. The funds will also avoid companies that derive over 3% of their revenues from selling related products or services except for when they are for safety or medical purposes.

Renewable Energy – This is a positive criterion. **Stewardship** seeks to support companies involved in research, development or provision of wind power, small scale hydro, bio-energy, solar thermal, geothermal, fuel cell, co-generation and liquid petroleum gas (LPG). The funds also positively view companies that seek to source energy from such sources.

Ethical Policies

Alcohol

Stewardship will not invest in companies that produce alcoholic beverages or derive more than 10% of their turnover from bottling, wholesaling or retailing alcohol.

Gambling

Stewardship will not invest in companies whose activities derive more than 3% of turnover from gambling e.g. betting shops. **Stewardship** may invest in companies that sell lottery tickets except where it accounts for more than 10% of turnover.

Tobacco

Stewardship will not invest in companies that manufacture tobacco (or related) products, or those which derive more than 10% of turnover from the sale of such products.

Military

Stewardship will not invest in companies that produce or sell weapons or weapon systems including nuclear systems, goods or services specific to such systems and products for strategic military purposes. **Stewardship** may however invest in companies that sell or manufacture standard goods and services that may be used for military purposes e.g. food and clothing etc.

Food

Stewardship favours companies that supply the basic necessities of life such as those that provide healthy food. (Subject to companies not breaching other criteria).

Harmful and offensive products, materials and services

Stewardship will not invest in companies involved in the production, distribution or retail of products, materials or services that are considered to be harmful, or those who derive more than 3% of revenues from those considered to be offensive. (E.g. violent, sexist, pornographic, racist or homophobic material – such as films, computer games or publications).

Animal Welfare

Fur - **Stewardship** will not invest in companies involved in any aspect of the fur trade e.g. rearing, hunting, processing, retailing etc, unless the retail is of a trivial nature.

Meat - **Stewardship** will only invest in companies that demonstrate robust policies and monitoring systems for animal welfare and will exclude companies where there is evidence of poor practice in the management of this.

Animal Testing - **Stewardship** will not invest in companies involved in unnecessary and cruel exploitation of animals.

Advertising

Stewardship will not normally invest in advertising agencies as a result of their likely promotion of unacceptable products.

Financial Services

Stewardship will seek to only invest in those companies that make a positive contribution to society and have good social responsibility practices. **Stewardship** does not invest in those involved in corporate lending, insurance and investment or project finance, as it is not always possible to get information to prove that activities are not damaging.

Stewardship money is invested in companies around the world and applying our policies consistently is a very real challenge for the fund. This means that although the funds' standards are extremely high, sometimes we have to make decisions based on the information that is available.

Information that a company publishes or is prepared to disclose is a function of local norms, often reflecting what the people who live within their host country are interested in. So, whilst deliberate non-disclosure and a refusal to be 'open' with us about the way a company operates is viewed with scepticism by the Committee there are instances when information is simply unavailable.

On rare occasions therefore the Committee is required to make decisions based on an assessment of a company, using their personal judgement. Detailed **Stewardship** policies are available on:

www.friendsprovident.com/sri

reo® programmes

reo® engagement programmes change annually. Each year one or two are added or end, others change direction and the remaining few continue on a similar basis from the previous year.

The following pages describe the way in which the F&C GSRI team work on ***reo®***. The work includes engagement on environmental, social and governance issues in specific industry sectors (such as the oil and gas sector), as well as looking across all industry sectors in relation to a particular issue (for example governance). Every issue or sector that is engaged will relate to the shareholder value focus of ***reo®***.

The GSRI team also produce reports on their sector work and these are publicly available to help inform public debate. See page 13 for examples of these.

Regular updates on current activity can be found on the Friends Provident and F&C websites in the form of the Quarterly ***reo®*** Report. This includes information on the companies that have been engaged, what they have been engaged on and a summary of the way shares have been voted on at AGMs and EGMs. A brief summary of ***reo®*** is also in the SRI Monthly Bulletin. For more information see:

www.friendsprovident.com/sri

Current programme areas:

Area	Engagement Programme	Company Benefits
Social	• Human Rights • Labour Standards - Working conditions - Employment practices • HIV/AIDS in the workplace	• Reputation and brand protection • Reduced risk of legal action and consumer protest • Protection of employees, supply chains and market position • Improved employee recruitment, retention and motivation examples
Environment	• Biodiversity, including forestry • Climate Change • Environmental Management • Better management of credit risk	• Protection against future liabilities and reduced risk of legal action • Improved likelihood of securing permits and contracts • Highlights business development opportunities examples
Governance	• Corporate Governance and Voting • Transparency and Performance • Anti-Bribery and Corruption	• Helps create better management structures • Produces stronger internal control mechanisms • Improved communication with external stakeholders • Provides greater trust by shareholders in the management of the companies • Support for management initiatives where votes are required. examples

Cross Sector Engagement: Governance

As part of ***reo***® F&C writes to all the companies we invest in annually, detailing the way we will vote at AGMs and explaining the standards we wish to see in companies we invest in. In 2005 our fund managers exercised voting rights at 3,164 meetings in 50 countries and voted against management at 9% of AGMs.

Responsible Executive Remuneration

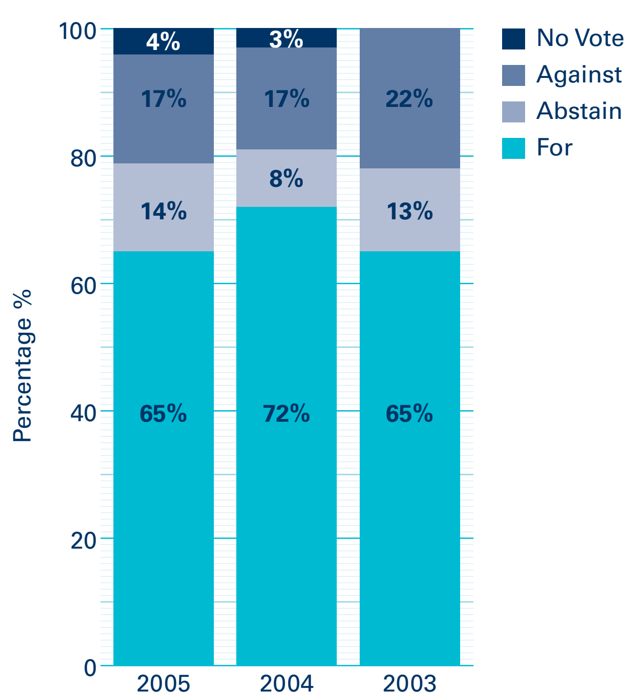
Across the world, executive remuneration continues to attract intense scrutiny, with growing protests against "rewards for failure" and demands for "pay for performance".

Governments and regulators joined the debate, but generally shunned legislated pay ceilings, preferring to force better disclosure and to rely on investors to intervene.

F&C's aim is to seek alignment between the interests of management and shareholders over the long-term. As such they assess each aspect of remuneration policy in light of the company's long-term business strategy.

As well as voting, we also aim to encourage movement towards best practice. This includes the design of long-term incentive schemes, expensing of stock options and integration of social, ethical and environmental issues into remuneration policies.

Remuneration votes 2003-5



Industry Engagement: Oil and Gas sector

Although F&C analyse a wide range of issues, they focus on five key environmental, social and governance issues for the oil and gas sector:

- Corporate governance: including transparency and disclosure on environmental, social and governance issues
- Health and safety
- Environmental management: including climate change and biodiversity
- Human rights: including security, community relations and consultation, and the implications for business of operating in countries where there are human rights abuses
- Bribery and corruption: including internal controls and systems; political influence; payments transparency (the Extractive Industries Transparency Initiative – EITI).

F&C has undertaken research on several of these issues, including:

"Are Extractive Companies Compatible with Biodiversity?" *(February 2004) and* ***"Investors' Statement on Payments Transparency in the Extractive Sectors"*** *(revised March 2005)*

F&C place these environmental, social and governance issues in the context of three strategic challenges for the sector:

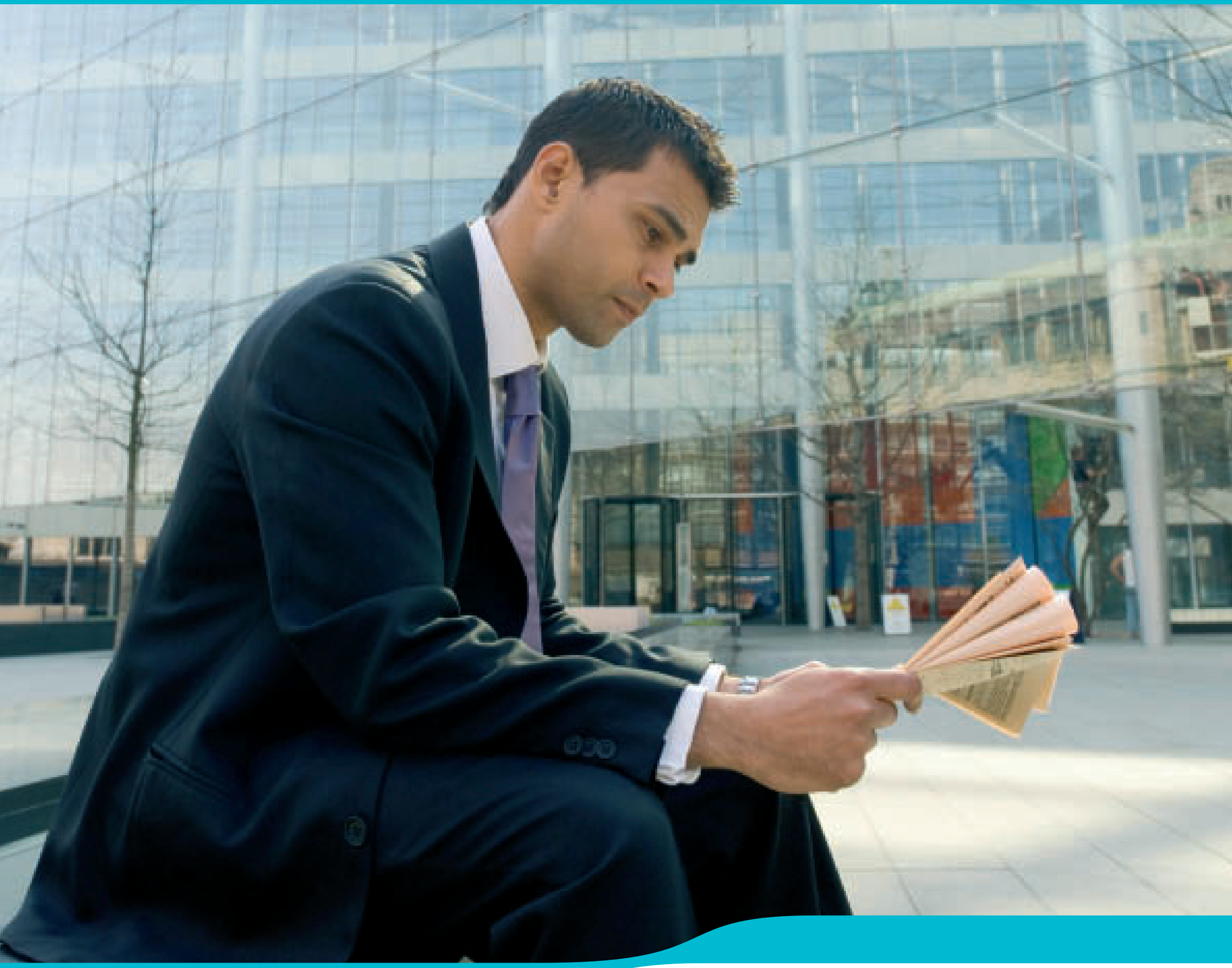
1) Difficult access to reserves
2) The move to a low-carbon economy
3) The emergence of 'national champions' from oil-hungry developing countries.

In addition, they closely monitor significant new projects – such as **BP's** BTC pipeline, **Royal Dutch Shell's** Sakhalin II project in Russia and **Woodside's** Mauritanian field – as success or failure in these projects has a disproportionate influence on company valuations and success is often linked to environmental, social and governance issues.

Overall, F&C view the major oil companies as some of the best-performing companies on environmental, social and governance management relative to all other sectors. However, the goalposts are continually shifting: the media, pressure groups, banks and investors insist on best practice, policy debates are moving quickly and performance actually onsite often lags the policy set at headquarters.

Examples of change in specific areas in which F&C has had involvement are:

- Extractive Industries Transparency Initiative (EITI): over 20 companies have signed up to support this; among those directly engaged by F&C are **BP, Shell, Statoil, Chevron, ExxonMobil, Petrobras, Premier Oil, Repsol YPF, Total, Woodside Petroleum** and **Unocal.**
- Biodiversity: Companies that have improved their policies, disclosure or management practices since we published our biodiversity report in February 2004 include **ExxonMobil, Cairn Energy, Repsol YPF, Total** and **BHP Billiton.**



The provision of electricity is seen as positive and indeed viewed as a basic necessity for most. However the impact of this sector from greenhouse gases and air pollutants remains a concern. Scottish and Southern Energy stand out as a leader in this sector with a strong commitment to sustainability and good environmental management alongside strong reporting which is independently verified.

Their environmental performance has made significant climate change related improvements. In 2002 the government introduced the Energy Efficiency Commitment (EEC). This required achieving targets for promoting domestic energy efficiency. The company beat their energy savings target by 65% for the period 2002 - 2005. This is equivalent to the carbon dioxide emissions of a typical 210MW gas-fired power station[6]. The company is currently the UK's largest generator of renewable energy.

www.scottish-southern.co.uk

The car industry presents a dilemma for Stewardship. Stewardship's view, which was endorsed by investor research in 2002 is that the funds should only invest in companies with leading environmental practices. Toyota is one of only a small number of such companies to meet this standard. In 2002, Toyota adopted "Global Vision 2010," a programme promoting innovation for the future.

The company follows environmental principles based on its "Toyota Earth Charter." Its principles cover product design, procurement, manufacturing and recycling end of life vehicles. One of Toyota's goals is to achieve top fuel efficiency in each country and region. In 1997 Toyota launched the Prius, the world's first mass-produced gas/electric hybrid car, which was fully model-changed in 2003 with upgraded Toyota Hybrid System adding superior driving performance to environmental friendliness. Cumulative sales of hybrid vehicles exceeded 400,000 as of October 2005.

www.toyota.co.jp

Vodafone Telecommunications company Vodafone offer what is seen as a broadly positive product which provides telephone services for voice and data transfer and is invaluable for emergency and remote area communication. Vodafone has recognised the potential health risks of mobile phones and helped develop the 'Electro-Magnetic Frequency Transparency Initiative' to research radio-frequency emissions and communicate accurate information to the public.

The company has taken an industry lead in standards of content and established a ban on illegal and age restricted content. Vodafone also has robust environmental management systems and has developed a 'Code of Responsible Purchasing' for supply chain labour standards.

www.vodafone.com

MARKS & SPENCER Marks and Spencer's core products are viewed positively by Stewardship as is their strong commitment to social responsibility. Marks & Spencer Café Revive was the first national chain to sell 100% Fair Trade coffee. They also demonstrate good practices in animal welfare, employee relations, supply chain labour standards, environment, health and safety.

In response to recent public concerns, Marks & Spencer has taken a lead within its sector in reducing greenhouse gas emissions caused by transporting its goods, in replacing chemicals and pesticides used in its products with safer alternatives and in improving nutritional content and food labelling.

Their successful community programme, the largest of its kind, provided 2,635 work experience placements for people with disabilities, the homeless, the young, unemployed and others in 2004, 30% of whom found work as a result. They also donate 1% of pre-tax profits to charity[7].

www.marksandspencer.com

RENEWABLE ENERGY In February 2005 Stewardship participated in the IPO (Initial Public Offering) of Renewable Energy Holdings Plc on the AIM index. The company is a diversified portfolio of renewable energy technologies. The company plan to acquire and operate a number of established renewable energy projects in Europe. The projects will include wind farms, wave energy generators off the coast of the UK and run-of-river hydro projects which do not require the construction of a dam.

www.reh-plc.com

China Sun manufacture corn-based additives for the production of environmentally-friendly fuels. The company operate in China and is listed on the Singapore Stock Exchange. China Sun has demonstrated commitment to the responsible management of its social, ethical and environmental impacts, as the company has developed basic employee related policies and environmental management systems. Although these are not as robust as those of its European or US peers, China Sun's policies are remarkably good for a Chinese company.

www.chinasungroup.com

PEARSON Pearson publish various financial newspapers, journals and books worldwide. The company operate three business units; The Financial Times, Pearson Education and Penguin. They were also a founding member of the UN Global Compact. The publication of education related materials has significant social benefits and Pearson is viewed as a positive company.

Pearson has policies, management and monitoring systems in place addressing employee rights, governance and environmental management as well as journalist and author ethics. As part of their human rights and labour standards policy they endorse the Universal Declaration on Human Rights and the key ILO conventions.

www.pearson.com

[6] Source: Scottish and Southern Sustainability Environment Report 2005
[7] Source: Marks and Spencer Corporate Responsibility Report 2005

Promoting industry-wide initiatives

Banking Sector - The Equator Principles

In 2003 our fund managers, F&C, became involved in an emerging banking sector led initiative - the Equator Principles. The initiative seeks to encourage multinational banks to adopt and implement standards for assessing and mitigating the social and environmental impacts of financing large projects, such as oil and gas pipelines, dams and power stations.

F&C participated in the consultation on early drafts of the Principles, primarily with **Citigroup** and **Barclays**, two of the original ten signatories at the June 2003 launch. During 2004 and 2005, F&C engaged over 25 international banks to encourage them to adopt the Principles.

Institutions adopting the Principles agree to apply social and environmental compliance standards of the International Finance Corporation (IFC) and World Bank Group, and integrate them into the loan agreements of large project finance deals. Failure of a borrower to comply with key social or environmental performance standards will trigger a default. The Principles are a powerful signal that banks are recognising the potentially negative implications of the projects they finance, and are prepared to take greater responsibility for mitigating or avoiding them.

There are now 40 (as of January 2006[8]) financial institutions that have committed to applying the Equator Principles. These institutions account for more than three quarters of the total project financing in the world. We welcome the Equator Principles, because they have been developed by banks for banks and place compliance with environmental and social standards at the heart of the business drivers of finance – in the loan agreements. The prospect of non-compliance and loan default has prompted tighter standards and has resulted in some deals not proceeding.

However, we do not underestimate the challenges that lie ahead in implementation. Some of the key issues include the need for additional staff training potentially resulting in slower loan completion and fewer approvals, lack of internal capacity for social and environmental risk assessment, performance monitoring and maintaining market share ahead of competitors. These issues are likely to keep our fund managers actively involved in dialogue with the Equator banks, and keep the banks themselves in the spotlight.

[8] Source: www.equator-principles.com

Promoting industry-wide initiatives to encourage better labour standards

Lindt & Sprueungli

A market leader in premium quality chocolate - who recently joined the World Cocoa Foundation to work towards eliminating forced and harmful child labour on West African cocoa farms.

Promoting industry-wide initiatives to encourage better product sourcing

Whittard of Chelsea

The fine tea and coffee specialist informed F&C they will encourage tea suppliers to join the Ethical Tea Partnership.

Example Industry Reports

ICT Sector

"Waste and Workers in the Tech Sector: The Information and Communication Technology Giants on their Supply and Disposal Chains" a report by F&C involving **Canon, IBM, Sharp, Siemens, Dell, Electrolux, Motorola, Philips, Sony, HP** and **Nokia**, January 2004. This report provides a thorough overview of the responsibility issues IT companies face addressing workers labour rights and the environmental implications of their supply and disposal chains. Since its publication the industry has taken some important steps. In December 2004 a new industry-wide code was launched by **Dell, HP** and **IBM** entitled the Electronics Industry Code of Conduct. The EICC sets labour and environmental standards for the industry's supply chain. **Cisco Systems, Intel** and **Microsoft** have since announced their commitment.

Financial Sector

"Banking on Human Rights - Confronting Human Rights in the Financial Sector" a report published in September 2004 by F&C and KPMG analysed the increasingly recognised role of the financial sector in its function in providing funding for projects that are associated with human rights abuses. Key concerns it highlights relate to employee rights, security of staff, supply chain management, litigation, loan default and reputational risk resulting from being seen to be complicit with human rights abuses committed by customers. Since its publication banks have advanced significantly in the area of environmental credit risk, with rather more modest progress in human rights. Most importantly, there is now widespread recognition that their most significant social and environmental impacts occur via their lending portfolios. See page 16 for information on the Equator Principles.

Climate Change and General Electric

International concern about climate change is growing, with pressure increasing on companies to take measures to address the issue. Our fund managers F&C have been one of the leading investors who have sought to use their position as shareholders of companies to encourage improved company practices.

One of the companies F&C has been engaging with for some years is General Electric (GE), one of the world's largest companies. In May 2005 GE grabbed international headlines by launching 'Ecomagination', its new strategy to help its customers cut carbon dioxide (CO_2) emissions through developing and marketing climate friendly technology.

Clearly a range of factors influenced this bold development but we are delighted with their move, which has followed five years of occasionally slow moving dialogue between F&C and GE.

The table below outlines the engagement that took place:

March 2000	First attempt at dialogue with GE: information sought to inform proxy voting decisions, but company did not respond.
April 2002	Further questions posed about GE's climate change strategy, which were not answered.
August 2002	F&C commend board's voluntary corporate governance improvements and decision to expense stock options.
October 2002	GE approached F&C to ask them to advise several senior managers on corporate social responsibility as part of GE's training course for fast-tracked executives.
November 2002	F&C meeting with GE investor relations pointed to lack of integrated company-wide strategy on climate change.
November 2002	F&C joins Catholic Healthcare West and other investors to file resolution calling for GE to carry out a greenhouse gas (GHG) inventory and report publicly on results. The resolution won an unprecedented 23% of shareholder support.
February 2003	GE began dialogue with investors and agreed to measure its emissions. The company later committed to report data publicly and set GHG intensity reduction target.
May 2005	GE launched "Ecomagination". Announced voluntary target for capping its own GHG emissions and a comprehensive strategy to grow profits by offering clients new solutions to conserve energy and water. Committed to double its research and development investments in "cleaner technologies" to \$1.5 billion annually by 2010. Predicted doubling of revenues from products with significant environmental advantages, such as clean coal and desalinisation. Pledged to cut group-wide GHG emissions by 1% by 2012 over 2004 levels. This is a significant move because under business-as-usual, GHG emissions had been projected to grow by 40%.
May 2005	F&C met with environmental director to commend GE progress, discuss parameters of GHG inventory and offer continued dialogue

This change of heart by GE demonstrates that:

- Shareholder influence can work
- Shareholder influence needs to be exercised over a long period
- Big companies can see the business case for environmental improvements
- Big companies can change
- F&C is one of many influences – but an important one

Stewardship and *reo*® compared	Stewardship 21 YEARS OF UK ETHICAL INVESTMENT	*reo*®
Type of Approach	Screened ethical fund links available via pension and investment products.	Engagement only – dialogue based approach applied to all equity assets, across all Friends Provident funds.
Date Started	June 1984.	April 2000 (Friends Provident adopted)
Company Research	Specialist GSRI team who work with third parties and external research companies to make recommendations based on their analysis.	Specialist GSRI team who work with third parties and analyse priority issues for shareholder engagement.
Deciding social, ethical and environmental policies	**Stewardship** Committee of Reference.	GSRI team.
Approving companies for investment	Committee of Reference makes approval decisions.	Not applicable – Screening does not occur so this does not impact stock selection.
Selecting companies for investment	Fund Managers can only choose from "Approved List" set by the Committee of Reference.	Fund Managers. (No restrictions).
Engaging with companies to encourage change	GSRI team as part of the ***reo***® strategy or on behalf of the Committee of Reference.	GSRI team on behalf of all Friends Provident funds and may work in collaboration with other groups.
Impact on investment strategy	Reduces the number of allowable investments.	No direct impact although it does increase information flow.
Example issues	Examples of screening (see page 4) Positive Criteria: - Supporting the basic necessities of life - Good equal opportunities record - Conserve energy and natural resources Negative Criteria: - Manufacture and sales of weapons - Environmental damage and pollution - Produce tobacco products	Example engagement areas (see page 5) Social: - Labour standards - Human rights Environment: - Climate change - Forestry Governance: - Corporate governance and voting - Anti-bribery and corruption

Stewardship and ***reo®***

Investment implications differ between ***reo®*** and **Stewardship** because ***reo®*** does not impact where funds can invest, whereas **Stewardship** does. The following outlines the key influences on the performance of the **Stewardship** range of funds.

The **Stewardship** fund management team is made up of three experienced fund managers, who are supported by a well resourced in-house GSRI team and other analysts. Across the **Stewardship** funds we apply some of the strictest screens of any ethical funds available to individual investors in the UK today. This means that the funds are truly actively managed and gives investors the benefit of exposure to companies that are less often available through mainstream funds.

Three main issues dictate where the **Stewardship** funds can invest:

- The geographic remit of the fund
- The asset mix of the fund
- The ethical screens

The geographic remit of the fund directs what regions of the world the funds can invest in – such as UK or International. The asset mix of the fund dictates the investment vehicles the fund can use – such as shares selected for their growth potential, shares selected for their income potential, bonds or cash. (**Stewardship** does not invest in Government Securities).

Ethical screening has the effect of favouring some companies and excluding others – particularly larger companies that by virtue of their size are more likely to breach one of the ethical screens. The wider the geographic remit of the fund the less likely this is to have a substantial impact.

The nature of the **Stewardship** ethical screens means that certain industry sectors like banks, oil companies and pharmaceutical companies tend to be under-represented in the funds (relative to un-screened funds) whilst others, such as leading food retailers, energy companies and companies developing new technologies tend to be favoured.

There are currently almost 1000 companies available worldwide for the **Stewardship** fund managers to invest in and new companies being added to the 'Approved List' all the time, so having sufficient investment options is not an issue.

The performance of the fund ultimately reflects a combination of these three areas - as well as the views and experience of our expert fund management team.

Further information on where the funds invest is available in our SRI Monthly Bulletin via:

www.friendsprovident.com/sri

Corporate Responsibility is about the positive things companies can do to meet their responsibilities to people and to the world in which we live. The development of Corporate Responsibility, similarly to Socially Responsible Investment, has grown alongside the social movements and public interest in the environment, human rights and animal welfare.

Friends Provident has a good record on Corporate Responsibility. Our Quaker origins have placed ethics at the heart of our business for over 170 years and provide the basis for our longstanding commitment to social responsibility.

We have a 'Statement of Business Principles' developed in conjunction with our stakeholders that sets out our core values, outlines our responsibilities and explains how we will live up to our principles.

These principles are; 'integrity in all we do', 'value people, deal fairly', 'co-operate to achieve', 'take personal responsibility' and 'every customer counts'.

The arguments for practising good corporate responsibility include improved employee morale, reducing operational costs and generating new ideas and opportunities for business development.

"Friends Provident has focused effort on reducing the carbon dioxide emissions associated with running its business. Over the last five years Friends Provident has reduced energy-related emissions by 80%."

Friends Provident Corporate Responsibility Report 2004

Friends Provident seeks to adhere to the standards it promotes. As a result Friends Provident has recently been audited by corporate responsibility experts "Forum for the Future" to recommend further changes.

We publish detailed explanations of our Corporate Responsibility policies, management systems, activities and performance on our website – as well as the way we vote on all our shares.

www.friendsprovident.com/responsibility

Corporate Responsibility - Awards and Achievements in 2004

- Achieved membership of the Dow Jones World Sustainability Index, which represents the top 10% of companies across 34 countries and 60 industries assessed for their leading position in sustainability
- Membership of the FTSE4Good Index
- Voted one of the 50 Best Workplaces in the UK as published by AccountAbility and Great Place to Work® Institute Europe in the Financial Times.

Friends Provident Corporate Responsibility Report 2004

Friends Provident set up an independent Foundation in 2004 with a £20m endowment. The Foundation gives grants to charities working in the Financial Exclusion area. See the below website for more information and case studies of projects that have been funded:

FRIENDS PROVIDENT Foundation

www.friendsprovident.com/foundation

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