

# Corporate governance and engagement update

Second half of 2009



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Welcome to Colonial First State Global Asset Management's (CFSGAM's) Corporate governance and engagement update for the period 1 July 2009 – 31 December 2009.

CFSGAM has more than A\$70 billion invested in Australian and global equities at 31 December 2009. As Australia's largest investment manager, we are significant shareholders on behalf of our investors in many listed companies around the world.

Active ownership and engagement are amongst our top priorities as a fiduciary because we believe there is a correlation between companies with good governance practices and strong, sustainable shareholder returns. Consequently, we seek to positively influence companies, through voting and engagement, towards best-practice corporate governance for the ultimate benefit of our investors.

CFSGAM holds shares in companies globally and places the same emphasis on active ownership regardless of where the investment is held. This report provides an update on our proxy voting only for our Australian shareholdings and we expect to report on our proxy voting globally in future reports.

When we refer to CFSGAM in this document we are referring to the entities within the Colonial First State Global Asset Management division of the Commonwealth Bank of Australia.

## Six month summary

Market volatility and investor uncertainty continued in the second half of 2009. While conditions improved towards the latter part of the year, investors remained focused on company performance and corporate governance. Shareholder resolutions were under scrutiny and remuneration issues continued to be in the spotlight despite recovering share price performance and signs of improving governance.

CFSGAM welcomes increased investor engagement as we consider it to be an important element towards ensuring effective corporate governance. It is important that this engagement does not wane if market conditions continue to improve.

Investor sentiment towards the Australian share market remained reasonably fragile in the second half of 2009, but favourable economic data and an increase in corporate activity enabled the market to record a positive return for the period.

Investors were increasingly optimistic that the worst of the global financial crisis had passed and that corporate earnings would recover alongside an improvement in global economic conditions. The Australian economy grew in the period, which supported investor sentiment towards equities, with the S&P/ASX 200 Accumulation Index closing December on its highs for the year.

Although economic conditions brightened and equity prices have risen, companies suggest there has been little sign of improvement in corporate earnings or business conditions. Despite close attention from investors, few companies were willing to provide earnings guidance for the full year at Annual General Meetings, many of which were held in October.

There was an increase in corporate activity among Australian companies during the second half of 2009, which is reflected in a notable rise in the number of shareholder resolutions relative to comparable periods. QBE Insurance, Amcor, Woolworths, Macquarie Group and ANZ Banking Group were among companies to make strategic acquisitions during the period, AMP and National Australia Bank made competing bids for AXA Asia Pacific, while Transurban received a takeover approach from two of Canada's largest pension funds.

Capital raisings were also prominent, with Woodside Petroleum among companies to complete a capital raising. Almost A\$60 billion of new equity was issued by Australian companies during the period in order to reduce debt, strengthen balance sheets and finance future growth opportunities.

Proxy voting rights are an important part of shareholder responsibility and we aim to vote on all possible resolutions at company meetings. Prior to voting, the relevant investment manager and company equity analyst carefully consider each resolution, with guidance provided by our Guidelines and principles for corporate engagement on governance, environment and social issues and recommendations from a selection of independent corporate governance research houses.

CFSGAM is restricted from voting for the approval of share issues where it has participated in the placement, and these resolutions are recorded as 'no action'. The majority of our abstentions (recorded as non-voting) result from non-binding resolutions on companies' remuneration reports and financial accounts.

The corporate restructuring which took place in the second half of 2009 should be a positive factor for company profitability in the long term. Most companies significantly reduced their cost base during the global financial crisis and many should have improved leverage to an improvement in business conditions. This has been evident in the first stages of 2010 where company profits have begun to turn around although there is a mix of companies both upgrading and downgrading earnings expectations dependent on individual company performance.

### Aggregate voting history

The large drop in the number of supported resolutions can be attributed to number of non-voting resolutions, which have been calculated separately from the first half of 2009. The percentage of resolutions voted against has remained within a 3% range during the past five years.

It is encouraging to see the number of resolutions not supported drop from the comparable period last year, in light of the unprecedented market conditions we have experienced and higher expectations from shareholders for best practice corporate governance following the global financial crisis. It suggests that companies are reacting to shareholder demands for improved corporate governance and meeting their expectations accordingly.

There was an increase in the number of shareholder resolutions, which is a likely consequence of the increased corporate activity during the period. Companies quickly adapted to the unprecedented market conditions through capital raisings, strategic acquisitions, and issuance of new equity to reduce debt, strengthen balance sheets and finance future growth opportunities.

### Aggregate voting against comparable periods

	2H 09	2H 08	2H 07	2H 06	2H 05	2H 04
# Company meetings	279	241	268	248	236	278
# Resolutions voted on	1989	1315	1455	1366	1286	1526
% Resolutions supported	64%	84%	87%	90%	83%	86%
% Resolutions against	7%	10%	7%	8%	8%	9%
% Resolutions abstained	1%	2%	6%	2%	5%	5%
% Resolutions no action	1%	0%	0%	0%	0%	0%
% Non-voting resolutions*	27%	4%				

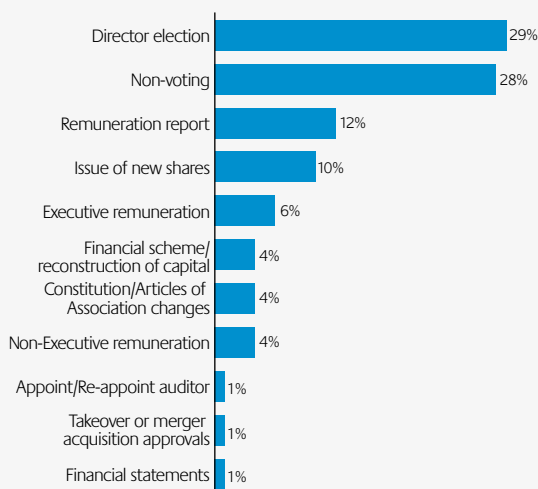
\* From first half 2009 non-voting resolutions have been calculated separately. 'Non-voting resolutions' relate to Financial Statement resolutions which are found heavily in the second half of the year, and proposals at company meetings that don't require a vote. 'Resolutions no action' relate to Commonwealth Bank of Australia resolutions, which CFSGAM is ineligible to vote on.

### Categories of resolutions

The issue of new shares rose to 10% all of resolutions in the second half of 2009 following a number of equity capital raisings during the period. This compares starkly to the same period in 2008, where there were no similar resolutions following subdued corporate activity due to share market volatility, the rising cost of corporate debt funding and low risk appetite.

The chart below shows the proportion of resolutions that we voted on during the recent proxy voting season.

### Percentage breakdown of voting resolutions by category



### Where we said no: aggregate voting

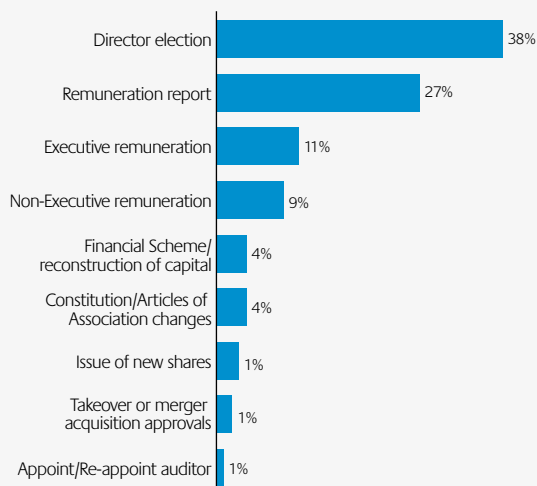
When we vote against a resolution we will always seek to relay our concerns to the company prior to casting the vote. We believe this engagement, in conjunction with our vote, sends a powerful message to the company and can assist in improving governance standards.

The shareholder focus on board composition and executive remuneration continued during the second half of 2009 with a significant number of 'against' votes recorded in these areas.

There was a drop in the number of against votes in 'Executive remuneration', down from 24% in the second half 2008 to 11% in the second half 2009. This trend is encouraging and suggests that companies are proposing more appropriate remuneration structures for executives.

Against votes in other areas were comparable with the same period in 2008, notwithstanding a slight upturn in votes against 'Remuneration reports', up from 23% to 27%.

### Percentage breakdown of resolutions not supported by category



### Director elections and re-elections

Best practice board composition is vital to ensure effective corporate governance. We examine all directorship nominees within the context of other board members to determine whether the individual is a suitable candidate given their industry experience, skills, background and responsibilities.

In light of a number of corporate collapses and sub-standard board performances, director election/re-election resolutions were under close scrutiny to ensure best practice composition. The table below summarises how we voted.

During the second half of 2009, CFSGAM voted against 53 resolutions involving director elections/re-elections. A number of these resolutions were voted against given poor board composition with insufficient representation from independent directors. Under Investment and Financial Services Association (IFSA) guidelines, a board should hold a majority of independent directors, with an independent director as chairman.

### Where we said no: director election/re-election

Below are examples of why director election/re-election resolutions were not supported.

#### Straits Resources

The resolution to re-elect a director was voted against. The nominee was one of two executive directors on a board where independent non-executive directors held two out of five board seats. We would prefer to see a greater balance of independent and non-independent directors on the Board.

#### Virgin Blue Holdings

We voted against the re-election of a director. As one of two Virgin Group representatives on the Board, the nominee was perceived to be an affiliate on a board with a minority of independent directors. We would prefer to see a greater balance of independent and non-independent directors on the Board. Furthermore, the director in question missed almost half of his scheduled meetings during the previous year suggesting he was not fully committed to the role.

#### Wesfarmers

We voted in favour of the re-election of all Directors with one exception, reflecting our concerns over the remuneration structure at Wesfarmers. While the director in question is not on the Remuneration Committee at the company, he had previously been involved with the design of remuneration incentive structures at Telstra which we did not perceive to be in the best interests of all shareholders.

### Director elections/re-elections voting against comparable periods

	2H 09	2H 08	2H07	2H 06
# company meetings involving director elections/re-elections	267	214	224	214
% company meetings	87%	89%	84%	86%
# resolutions involving director elections/re-elections	584	541	529	543
% director elections/re-elections supported	90%	89%	94%	94%
% director elections/re-elections against	9%	9%	6%	4%
% director elections/re-elections abstained	1%	2%	0%	1%
% director elections/re-elections no action*	0%	0%	0%	1%

## Executive remuneration

Executive remuneration resolutions involving incentive payments make up the majority of resolutions. They are also the most contentious and where much of our time is spent analysing resolution details.

Executive remuneration continued to be the subject of particular scrutiny as investors demanded that remuneration plans were appropriate and deserved. It was pleasing to see shareholders calling for remuneration packages that clearly aligned their long-term interests with the management of companies in which they invest.

CFSGAM analyses remuneration resolutions carefully to ensure any increases or incentive payments are justified and will result in enhanced company and management performance. We require full disclosure of total remuneration packages together with appropriate justification in order to assess plans on their merit.

Despite the spotlight on contentious or inappropriate remuneration packages, it is important to acknowledge that most company managements act in the best interest of shareholders and make important contributions to the long-term success of the businesses they manage. While we will always vote against inappropriate remuneration packages, we will consider managers' contribution when assessing the need for an increase in remuneration levels.

To assist in our assessment we actively engage with company management and we welcome companies seeking our views on remuneration structures before resolutions are constructed. Through this dialogue we are able to convey our expectations for remuneration packages which, in turn helps to improve the overall standard of resolutions put forward at company meetings.

During the second half of 2009 we voted on 126 resolutions involving executive remuneration and supported 87% of these. This is an improvement on the first half of 2009, where only 71% were supported and the comparable period in 2008 when 77% were supported. It is pleasing to see these results improving in an environment of increased scrutiny and higher expectations of executive remuneration standards.

As shown in the table below, voting patterns have been mixed over time, although the levels in the second half of 2009 rose from the lows reported in the same period in 2008. Despite this, there is still much room for improvement and we will continue our work with executives and board members to ensure they understand what we, and other shareholders, consider to be appropriate.

### Where we said no: executive remuneration

Below are examples of why executive remuneration resolutions were not supported.

#### Pharmaxis Ltd

We voted against the grant of share options to a director, as the company milestone performance hurdles applicable to these options were not disclosed to shareholders. Rather, the hurdles were reviewed by the remuneration and nomination committee. We encourage all companies to publicly disclose milestone performance hurdles for all directors.

#### Straits Resources

The company's Remuneration Committee exercised its discretion to allow shares which were awarded to two directors to vest immediately upon issue. Performance hurdles were effectively waived, which we did not believe was in the interests of all shareholders.

## Executive Remuneration voting against comparable periods

	Second half 2009	Second half 2008	Second half 2007	Second half 2006
# company meetings involving executive remuneration	76	89	58	69
% company meetings	27%	37%	22%	28%
# executive remuneration resolutions voted on	126	179	166	181
% executive remuneration resolutions supported	87%	77%	90%	78%
% executive remuneration resolutions against	12%	18%	10%	22%
% executive remuneration abstained	0%	5%	0%	0%
% executive remuneration no action	1%	0%	0%	0%

### Resolutions supported

Voting against resolutions is not the only way to convey our requirement for well defined and suitably structured remuneration packages. By voting in favour of appropriate executive remuneration proposals, we send a clear signal to the company and the broader market about practices we will support. It also demonstrates to companies that receive a high proportion of 'against' votes that appropriate packages will be supported.

We continue to monitor our voting patterns in relation to executive remuneration packages to see if standards are improving, and whether companies where we have previously voted against have reviewed their executive remuneration structure. We will continue to monitor executive remuneration packages where we have voted against to ensure our expectations are being addressed.

### Non-executive remuneration

The percentage of non-executive remuneration resolutions supported is largely consistent with the previous year. While this figure remains lower than we would like to see, it is encouraging that the figure has remained steady in the face of deteriorating economic and profit conditions and increased shareholder opposition to get unwarranted executive remuneration increases or incentive payments approved. It is also pleasing to see a significant improvement in support on the first half of 2009, where we voted in favour of only 44% of non-executive remuneration resolutions.

### Where we said no: non-executive remuneration

Below are examples of why non-executive remuneration resolutions were not supported.

#### Whitehaven Coal

We voted against the award of options to a third party which we did not believe warranted such an award.

#### IOOF Holdings

The company proposed granting share options to a former Chief Executive Officer. We did not believe was in the interests of shareholders to award options to an executive which had left the company.

### Non-executive remuneration voting against comparable periods

	Second half 2009	Second half 2008	Second half 2007	Second half 2006
# company meetings	42	60	95	60
% company meetings	15	25	35	24
# resolutions involving non-executive remuneration	73	76	129	70
% non-executive remuneration resolutions supported	82	83	95	90
% non-executive remuneration resolutions voted against	18	16	5	10
% non-executive remuneration resolutions abstained	0	1	0	0

### Remuneration reports

Remuneration reports typically set out a board's remuneration policy for employees, executives and directors. We have high expectations for remuneration reports and require appropriate remuneration packages, structures and full disclosure on all remuneration policies. While this proxy resolution is not binding, it must be put to vote by shareholders.

The percentage of remuneration reports we have voted against has remained steady during the past three comparable periods, but is still at a higher level than we would prefer.

### Where we said no: remuneration reports

Below are examples of why remuneration report resolutions were not supported.

#### United Group

The remuneration report set out in the company's 2009 annual report highlighted substantial increases to base salary and potential bonuses for the Chief Executive Officer. No clear explanation for these increases was provided, which prompted us to vote against the resolution. Furthermore, we were concerned about the payment of 'retention' bonuses to senior executives which had failed to meet performance hurdles for short-term incentive payments.

#### Felix Resources

The company proposed the grant of a significant number of zero exercise price options as well as a substantial increase to base salary to the Chief Executive Officer, subsequent to announcing that it had received a takeover offer. We did not believe these awards were in the best interests of all shareholders and therefore voted against the resolution.

#### Cabcharge Australia

We do not believe the company's remuneration practices satisfy investor expectations. The Chief Executive Officer receives remuneration which we perceive to be excessive relative to comparable companies of similar market size, and we believe the company provides insufficient disclosure in relation to performance based pay.

#### Metcash

It appeared that the company's only criterion for the award of long-term incentive payments to directors was the achievement of earnings per share growth targets. This structure is not necessarily difficult to achieve in a geared company structure. There is also no long-term incentive structure associated with performance relative to peers, whereas our preference is to have this type of incentive structure in place.

#### Asciano Group

The company's short-term incentive structure resulted in the Chief Executive Officer receiving a large bonus payment in 2008-09 despite significant share price underperformance. We therefore voted against the remuneration report and would prefer to see the award of short-term incentive payments linked to total shareholder returns and performance relative to peers.

#### Wesfarmers

Long-term incentive payments were being awarded based on return on equity measures. We believe incentives linked to performance relative to peers and total shareholder returns are more appropriate ways of measuring the effectiveness of management and so we voted against the company's remuneration report.

#### Valad Property Group

The remuneration report failed to disclose policies and structures around the award of short-term incentive payments. We require full disclosure on remuneration policies and so voted against the report.

#### Primary Health Care

We were comfortable with physical stock being awarded as part of the company's overall remuneration structure, but we voted against the award of share options to directors. There was a lack of clarity about options which was a cause for concern.

### Remuneration report voting against comparable periods

	Second half 2009	Second half 2008	Second half 2007	Second half 2006	Second half 2005
# company meetings involving remuneration reports	237	201	207	196	164
% company meetings	85%	83%	78%	79%	70%
# resolutions involving remuneration reports	237	201	207	196	164
% remuneration report resolutions supported	84%	82%	81%	92%	57%
% remuneration report resolutions voted against	16%	15%	18%	7%	9%
% remuneration report resolutions abstained	0%	3%	1%	0.5%	34%

CFSGAM is an active shareholder through our proxy voting and our direct discussions with company management and directors. Our scale and reputation in the investment management industry provides our investment managers with the opportunity to engage in dialogue with individual companies on environmental, social and governance (ESG) issues.

We seek to highlight areas for potential improvement, encourage disclosure on ESG issues and recognise companies that are making progress in addressing ESG considerations. Through this engagement we seek to positively influence companies towards ESG best-practice for the ultimate benefit of our investors. Our engagement practices are in keeping with Principle 2 of the United Nations Principles for Responsible Investment, of which we are a signatory.

During the second half of 2009, our investment teams in Australia and overseas undertook private collaborative engagement, primarily on corporate governance, and we supported engagement undertaken as part of the corporate governance research process by RiskMetrics for Australian companies.

Examples of ESG issues we engaged in included:

- activities in conflict zones
- benefits and compensation
- bribery and corruption
- climate change
- distribution of fair trade products
- human rights
- labour issues
- social licence to operate
- management quality, and
- occupational health and safety.

We believe that active engagement with companies is key for achieving ESG improvements. We have collaborative initiatives with third-party engagement providers to help gather necessary information to help us get maximum value from engagement.

## Engagement examples

Examples of our active ownership and how these have influenced our investment decisions, are detailed below.

### Vedanta Resources

CFSGAM received correspondence from Amnesty International in relation to concerns about Vedanta Resource's approach to ESG issues. While we only have very minor holdings in Vedanta Resource's and subsidiaries, we contacted the company and requested clarity on the concerns that had been raised.

The Global Equities team attended a workshop sponsored by BankTrust and Amnesty International in London. Various stakeholders attended including 14 non-government organisations and several representatives of financial institutions that are either investors or have provided financial services to Vedanta. The Global Equities team's sector specialist attended along with an external consultant.

In response to the Global Equity team's query and those of other investors, Vedanta Resources drafted a response to some of the claims and allegations of the non-government organisation community. We have had several subsequent interactions with Vedanta Resource's investor relations personnel on these claims and we continue to monitor the company and its approach to ESG issues.

### **Kingboard Chemical**

The Global Emerging Markets team undertook a lengthy engagement process with Kingboard Chemical, a company which produces printed circuit boards for computers. This company is not held within our Global Emerging Markets Sustainability Fund, although it is held in other CFSGAM funds. Following the publication of a Greenpeace report which accused the company of polluting the Pearl River, our team in China embarked on a lengthy set of meetings with the Chairman, Chief Executive Officer, Chief Financial Officer, key independent directors and Greenpeace to raise our concerns.

### **Chinese coal company**

The Global Resources team sold out of a Chinese coal company due to ESG concerns. The coal company's share price had performed well, but the first half result showed that their cost control was poor and they downgraded their full year production after underperforming guidance in the first half of the year. The rise in the number of fatalities also concerned the team.

The Global Resources team began to question the credibility of management, who had a track record of failing to achieve production guidance. The Global Resources team decided that they would switch their holding into another Chinese coal producer that had larger, more mechanised mines and a more visible production growth profile.

The discussion with the management of the Chinese coal company after our sell down provided the Global Resources team with comfort on ESG concerns and operational progress. The team will continue to monitor the company and could potentially re-invest at some time in the future dependent on its relative valuation, operational performance and improving corporate governance.

### **APN News & Media**

The Australian Equities, Core Small Companies team has been an investor in APN News & Media for a number of years and has established a good relationship with senior management.

Recently, the proportional ownership of Independent News & Media, the parent company which is based in Ireland, has been reduced to 39%, although directors associated with Independent News & Media still hold seven board seats. Public shareholders, which collectively controlled 61% of the company, were only represented by one fully independent director.

We expressed our concern to the company that this board representation was inappropriate for the current ownership structure and that we would encourage a greater representation of independent directors. Indeed, we had voted against the re-election of associated directors at the previous annual general meeting.

During a meeting with a managing director, we again highlighted our concerns regarding corporate governance. We stated that we would be voting against the re-election of two directors at the upcoming annual general meeting, as they were both perceived to be affiliated with Independent News & Media. The managing director agreed that a greater representation of independent directors would result in improved corporate governance. We believe that our engagement with management over this period has contributed to management's increasing commitment to pursue corporate governance best practice.

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