

Corporate governance and engagement update

First half of 2009



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Introduction

With more than A\$70 billion¹ invested in Australian and global equities, entities within the Colonial First State Global Asset Management division of the Commonwealth Bank of Australia² 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 firmly believe that there is a correlation between companies with good governance practices and strong, sustainable shareholder returns. Consequently, we seek to positively influence companies towards best practice governance for the ultimate benefit of our investors.

Following the recent turmoil in financial markets, investors are paying particular attention to shareholder resolutions. The areas of executive and non-executive remuneration are under particular scrutiny as shareholders take a heightened interest in how senior management are rewarded during times of share price underperformance, falling profits and governance failures.

CFSGAM welcomes increased scrutiny on company resolutions and supports the increased focus on executive remuneration as an important element of effective corporate governance.

Note:

1. As at 31 December 2009.
2. When we refer to CFSGAM in this update we are referring to these entities.

Proxy voting rights are an important component of shareholder responsibility, and so we vote on all resolutions at company meetings where we have the right to do so. 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 result from non-binding resolutions on companies' remuneration reports and financial accounts.

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 from next year.

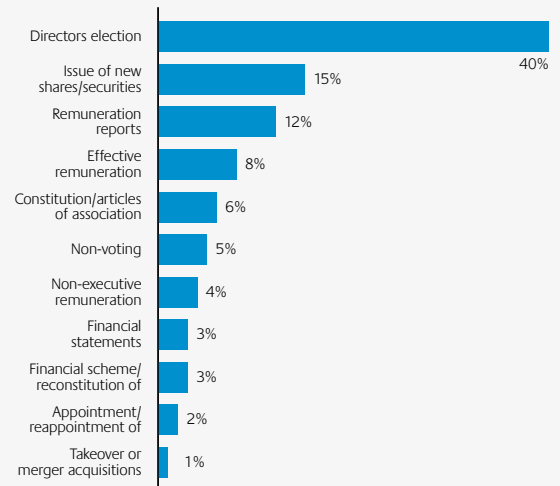
Aggregate voting history

The first half of 2009 saw the lowest proportion of resolutions supported in recent comparable periods. This is a disappointing result, but is likely to be a consequence of a demand from shareholders for best practice company management and corporate governance during the global financial crisis.

Categories of resolutions

Resolutions for the issue of new shares rose in the first half of 2009 following a number of equity capital raisings during the period. This followed subdued corporate activity in 2008 due to share market volatility, rising cost of corporate debt funding and risk. The chart below shows the proportion of resolutions that we voted on during the recent proxy voting season.

Categories of voting resolutions



Source: CFSGAM.

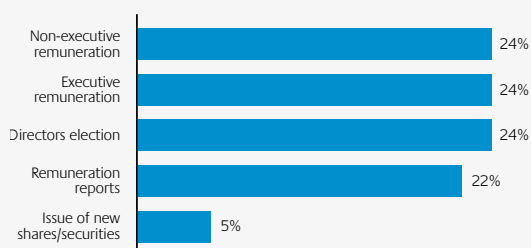
There has been a focus on executive remuneration and board composition in recent times to ensure that they are appropriate and in the best interests of the company and its shareholders. A significant number of 'against' votes were recorded during the first half of 2009, with remuneration and election/re-election of directors being the main areas of contention.

Aggregate voting history

	First half 2009	First half 2008	First half 2007	First half 2006	First half 2005
Company meetings	68	75	93	78	68
Resolutions voted on	369	442	457	394	289
Resolutions supported (%)	84	87	96	87	79
Resolutions against (%)	10	9	2	9	5
Resolutions abstained (%)	1	4	2	4	16
Resolutions non-voting* (%)	5	NA	NA	NA	NA

* From first half 2009 non-voting resolutions will be calculated separately.

Breakdown of CFSGAM 'against' votes



Source: CFSGAM. Figures don't sum to 100% due to rounding.

Although executive and non-executive remuneration makes up only 8% and 4% of resolutions respectively, these categories each make up 24% of our 'against' votes.

Director elections and re-elections

CFSGAM considers board composition fundamental to 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. It is important that the nominee is the most suitable person for the role and that the board is composed according to best practice. We are firmly of the view that boards should be made up of a majority of independent directors.

In light of a number of corporate collapses and sub-standard board performances during the global financial crisis, CFSGAM paid close attention to director election/re-election resolutions. The table below summarises how we voted.

During the first half of 2009, CFSGAM voted against the following companies' director elections/re-election resolutions:

- Lion Nathan
- APN News & Media

- Corporate Express Australia
- Oz Minerals (two votes)
- Sino Gold
- Australian Agricultural Company (two votes)
- OM Holdings

The against vote at Lion Nathan was due to a lack of confidence that the candidate had the ability to execute strategies which would deliver long-term shareholder value. The candidate had previously served as a director of Allco, which had entered bankruptcy and lost substantial shareholder value. While serving as a director at Allco, the board had recommended the Rubicon transaction which in our view contributed to the failure of the company. The candidate was also a board member of Multiplex at the time of the ill-conceived Wembley stadium construction.

The APN News & Media candidate was a director and former executive of Independent News & Media, which is the owner of 39% of APN News & Media. If all candidates seeking re-election were successful, this candidate would be one of seven directors (including the CEO) on the non-member APN News & Media board associated with Independent News & Media. In contrast, public shareholders, who own 61% of the company, are represented by only two independent board members. Consequently, we held serious concerns about the objectivity and independence of the APN News & Media board.

The candidate at Sino Gold was an affiliated non-executive director on a board where five of the eight seats are held by non-executive directors. If the candidate was elected, the board would no longer have a majority of non-executive directors. We voted 'against' this resolution because we believe it is best practice for a board to be constructed from a majority of non-executive directors.

Director elections/re-elections

	First half 2009	First half 2008	First half 2007	First half 2006
Company meetings involving director elections / re-elections	49	54	56	52
Company meetings (%)	72	72	60	67
Resolutions involving director elections / re-elections	149	160	148	130
Director elections / re-elections supported (%)	94	81	98	97
Director elections / re-elections against (%)	6	16	0	3
Director elections / re-elections abstained (%)	0	3	2	0

Executive remuneration

Executive remuneration has recently been the subject of significant media and investor focus and CFSGAM continues to follow remuneration developments carefully. Well defined and appropriate remuneration packages are vital to align the long-term interests of management and shareholders.

CFSGAM analyses remuneration resolutions carefully to ensure any increases or incentive payments are justified and will result in enhanced company and management performance. We will vote against remuneration reports containing contentious or inappropriate remuneration packages.

We require full disclosure of total remuneration packages together with appropriate justification in order to assess plans on their merit. During uncertain economic times, when companies are cutting dividends, reducing costs and downgrading profit forecasts, it is important that executives promote restraint by carefully considering their remuneration plans. Having said this, we also acknowledge that many company managers are making important contributions during these challenging times and consider this when assessing the need for an increase in remuneration levels.

We seek to actively engage with company management on remuneration, and many companies seek 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 first half of 2009, we voted on 31 company resolutions involving executive remuneration, supporting only 71% of resolutions. These results are a significant deterioration on recent periods and are as a result of a tougher stance following difficult economic conditions

and increased investor expectations that executive remuneration is appropriate and justified.

The table below shows that voting patterns over time have been mixed, although the first half of 2009 clearly has the lowest proportion of resolutions supported. As the high proportion of 'against' votes illustrates, there is still much work to be done with executives and board members to ensure they understand what we consider appropriate.

Resolutions opposed

Executive remuneration resolutions involving incentive payments make up the majority of resolutions dealing with executive remuneration. They are also the most contentious and where much of our time is spent analysing resolution details. Executive remuneration packages we voted against in the first half of 2009 included:

- Sino Gold
- Fortescue Metals
- Roc Oil (two votes)
- St Barbara
- Corporate Express (four votes)

Fortescue Metals failed to provide a satisfactory explanation of how its Incentive Option Scheme (IOS) fitted within its strategy to provide meaningful long-term incentives to the company's executives. The explanatory notes for this resolution failed to fully disclose details of the plans, including performance hurdles and vesting provisions. The IOS appeared to have vesting based on share price performance. This is inappropriate because it may inappropriately reward – or penalise – the executive as a consequence of market conditions, rather than as a result of the contribution of the executive. Furthermore, the minimum performance period for the IOS is only one year. Best practices advocates a minimum performance period of three years for long-term incentive plans.

Executive remuneration*

	First half 2009	First half 2008	First half 2007	First half 2006	First half 2005
Company meetings involving executive remuneration	21	39	21	15	16
Executive remuneration resolutions voted on	31	86	46	38	22
Executive remuneration resolutions supported (%)	71	87	85	95	77
Executive remuneration resolutions against (%)	29	12	15	5	23
Executive remuneration abstained (%)	0	1	0	0	0

* Does not include remuneration reports. CFSGAM reports on these resolutions separately. See below.

We voted against Sino Gold's grant of options to executive and non-executive directors with no performance hurdle. Companies which pursue best practice in governance should align executive and non-executive rewards with shareholder returns.

The proposed grants to two directors at Roc Oil allowed for excessive levels of re-testing with two hurdles applied to equal portions of the grants; a relative total shareholder return hurdle, and a premium exercise price hurdle. Both hurdles were able to be re-tested on a daily basis from vesting to expiry, allowing for hundreds of re-tests. Furthermore, half of the proposed grants were subject to a premium exercise price hurdle. CFSGAM generally opposes the use of such hurdles as they allow executives to profit from unsustainable increases in share prices that are not related to outperformance, such as a spike in share prices due to takeover speculation.

Resolutions supported

CFSGAM believes that voting against resolutions is not the only way to convey our requirement for well defined and appropriately structured remuneration packages. By voting in favour of 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, by contrast, be supported.

Over the six-month period, we voted in support of executive remuneration resolutions for:

- Australand Property
- Integra Mining
- Aristocrat Leisure
- Spark Infrastructure
- Tower Australia
- AXA Asia Pacific
- Lihir Gold

We continue to monitor our voting patterns in relation to executive remuneration packages to see if the standard is improving. We are particularly interested in seeing whether a company where we voted against a resolution previously has reviewed its executive remuneration structure. We will continue to monitor executive remuneration packages where we have voted 'against' previously to ensure the message is getting through.

Non-executive remuneration

There was a pick-up in the first half of 2009 in votes against non-executive remuneration. This is partly the result of increased focus on company management in the face of deteriorating economic and profit conditions. The financial crisis put the spotlight on companies with poor management or sub-standard financing arrangements and these companies are now facing tough opposition from shareholders to have unwarranted executive remuneration increases or incentive payments approved.

Of these resolutions, we voted in favour of only 44%, which was a significant deterioration from previous years. This is disappointing and, while we understand that directors need to be rewarded for the important and specialised work they undertake, it is essential that their fees are appropriate and justified.

CFSGAM voted against the grant of incentive options to a director of Fortescue Metals. We are firmly of the view that the granting of options for non-executive directors should not occur and will typically vote against resolutions of this kind. Directors should hold the same type of securities as ordinary shareholders, as this will better align interests. We also voted against Sino Gold's grant of options with no performance hurdle to non-executive directors.

Non-executive remuneration

	First half 2009	First half 2008	First half 2007	First half 2006
Company meetings	9	24	21	14
Company meetings (%)	13	32	23	18
Resolutions involving non-executive remuneration	16	24	25	22
Non-executive remuneration resolutions supported (%)	44	96	96	91
Non-executive remuneration resolutions voted against	56	0	4	9
Non-executive remuneration resolutions abstained (%)	0	4	0	0

Remuneration reports

Remuneration reports set out a board's remuneration policy for employees, executives and directors. The proxy resolution is not binding but must be put to vote by shareholders. Since remuneration reports were introduced in 2005, CFSGAM has been monitoring their quality and we have high expectations for what we consider to be a satisfactory report. We require appropriate remuneration packages, policies and structures and full disclosure on all remuneration policies.

The table below provides a breakdown of how we voted compared to previous years. There has been a deterioration in the number of reports supported since the first half of 2008 and the number of 'against' votes is considerably higher than we would prefer.

In the case of 'against' votes, we will always attempt to relay our concerns to the company. This, in conjunction with our vote, sends an important message and should assist the company to improve its governance standards. We voted against the following companies' remuneration reports:

- Orica
- AWB
- Graincorp Preference Shares
- GPT Group
- Corporate Express Australia
- Oz Minerals
- Australian Agricultural Company
- Sino Gold

We voted against AWB's remuneration report because the company maintained a policy of paying staff in the 75th percentile relative to the peer group, despite the below average performance of the company.

We voted against GPT Group's remuneration report as the remuneration committee had replaced hurdles such as earnings per share (EPS) and return on equity (ROE) with total shareholder return. CFSGAM generally opposes the use of total shareholder return as a performance hurdle as it allows executives to profit from unsustainable increases in share prices that are not related to outperformance. Total shareholder return hurdles are not within management's control (unlike ROE and EPS) and therefore do not provide an appropriate incentive to employees. We conveyed our concerns to GPT Group and the company advised that remuneration hurdles would be reviewed.

We voted against Sino Gold's remuneration report due to a grant of options to executive and non-executive directors with no performance hurdle.

Remuneration Reports

	First half 2009	First half 2008	First half 2007	First half 2006
Company meetings involving remuneration reports	43	43	47	39
Company meetings (%)	63	57	51	50
Resolutions involving remuneration reports	43	43	48	39
Remuneration report resolutions supported (%)	81	90	94	77
Remuneration report resolutions voted against (%)	19	5	2	13
Remuneration report resolutions abstained (%)	0	5	4	10

Company engagement

CFSGAM actively engages with companies on a range of environmental, social and governance (ESG) issues. We publish an annual responsible investment report that outlines the important work we are doing in this area which can be found on the CFSGAM website.

We are an active shareholder through our proxy voting and our direct discussions with company management and directors. CFSGAM's scale and reputation in the investment management industry provides our investment managers with the valuable opportunity to engage in dialogue with individual companies on 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. This is in keeping with Principle 2 of the United Nations Principles for Responsible Investment, of which we are a signatory.

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

Case studies

Stockland

Stockland invited CFSGAM to provide feedback on its sustainability report from an investor's perspective. We believe it is a positive step by Stockland to seek direct feedback on its ESG management and a CFSGAM analyst was pleased to provide the following key points where it was felt there could be improvements in the sustainability report.

- The report effectively captures ESG initiatives that Stockland has undertaken during the year to address sustainability issues; however the outcomes of these initiatives could be provided in more detail.
- Summary data at the beginning of the report and a downloadable spreadsheet of metrics would be useful for investors.
- More transparency is needed on quantifying the cost of raising properties' NABERS energy ratings, and the cost savings that would be realised by improving asset efficiency. Stockland will aim to provide discussions and case studies on these points in future reports.
- It would be useful for Green Star ratings to be disclosed for new properties and developments.

We also provided feedback to Boral and James Hardie during the period on their sustainability reporting. This dialogue should help companies understand what CFSGAM, as an investor, would like to see in ESG reporting. Over time, this will enhance the transparency and usefulness of ESG reporting more broadly so investors can better consider companies' ESG credentials when making an investment decision.

Platinum company

A small platinum producing company with its assets located in South Africa was raising money to repay a US\$40 million facility that had very high interest costs from a local South African bank. CFSGAM's Global Resources team liked the quality of the resource, the projects and operational management.

However, the team had reservations with the company's corporate governance and treatment of minority shareholders. The controlling shareholder was a private equity firm that owned 51.8% of the company and had two seats on the board. This company has additional interests in a number of tenements that could potentially be sold into the company at a later date, to add additional feed stock for the centralised plant. Whilst this should be beneficial for the long-term valuation, we were concerned that the terms of these future deals might not be deemed fair for the minority shareholders.

The Global Resources team held several discussions with various levels of management, including the Chairman and Managing Director, who pointed out that they are also minority shareholders, each with a significant holding in their own right. Consequently, it transpired that their interests are completely aligned with our own.

They advised us that any future transactions between the company and associated companies of the major shareholder will be done at arm's length, based upon independent valuations and using industry standard metrics such as \$/oz per category of resources. All such transactions will be put to the Board for approval and related parties will not be eligible to vote. Although corporate governance risks remain, we now have more comfort and the stock's position in the Global Resources portfolios reflects this risk/reward balance.

Esprit

The consumer analyst in CFSGAM's Global Equities team met with the Chief Operating Officer and Investor Relations Manager of Esprit, a luxury brands maker and retailer, at its offices in Germany. During the course of the meeting, the analyst noted that the business was predominately European but that the company maintained its Hong Kong listing. The analyst observed that Esprit shares had higher relative volatility compared to its closest peers; H&M and Inditex. The analyst noted that a consequence of this higher volatility was a higher cost of equity and therefore a potentially lower share price. The analyst urged Esprit management to consider this issue of share volatility as it was hampering a more positive view and rating on the stock.

At a follow-up meeting, CFSGAM analysts presented data showing Esprit's higher beta compared to that of H&M and Inditex, which Esprit management found interesting. Our analysts suggested that more frequent communication with the market might help reduce some of the volatility, as Esprit reports results only semi-annually whilst some peers report quarterly earnings and monthly sales. Esprit management expressed its desire to improve the overall level of communication with market participants. The idea of more frequent sales disclosure was well received and Esprit is now considering providing these results on a quarterly basis going forward.

CFSGAM hopes that this engagement will lead to improved disclosure as well as reduced stock volatility, both of which would dispose us more favourably to the shares.

AGL

The Australian Equities – Core team has a long history investing in AGL and consequently has a long standing relationship with company management.

At a meeting last year, the Head of Australian Equities – Core highlighted the importance of ESG considerations to AGL and questioned why the safety slide was not the first slide in the presentation pack. There was a lot of talk from AGL about renewable energy and sustainable development, but its level of commitment appeared low. This meeting highlighted a deficiency to AGL and triggered a complete review of the company's approach to sustainability and the way it was reported.

In recent briefings with AGL it has become apparent that there has been a clear improvement in this area, suggesting a genuine change in culture. This type of ongoing engagement with company management demonstrates how active engagement can help change corporate behaviour by encouraging companies to focus on areas and improve on key issues.



