

Investing in an intangible world

What do climate change and the war for talent have in common? They are examples of intangible forces increasingly affecting company growth prospects. And they have major implications for traditional company valuation approaches.

20 years ago, company valuation was mostly about tangible assets – buildings, equipment and investments. But that’s just the tip of the iceberg. In the same way that most of an iceberg is hidden under water, according to our research, over 75% of the value of a typical Australian company is made up of unseen or intangible assets¹. These include a company’s corporate reputation, the way it attracts and retains its employees, occupational, health and safety practices, and its reputation and commitment to environmentally sustainable practices (see following chart).

Accelerating climate change

Climate change is on the move and so is its potential economic impact. The UN Intergovernmental Panel on Climate Change is now 90% confident that human activities contribute to global warming via greenhouse gas emissions². Carbon dioxide emissions from combustion of fossil fuels, for instance, are a major contributor. So how does this relate to company performance?

Last year AMP Capital Investors participated in the Carbon Disclosure Project. We asked large Australian companies to disclose what they are doing about climate change. While 94% of the survey participants recognised the potential for greenhouse gas emissions “to impact future earnings and increase the company’s general risk profile”, and 83% acknowledged the physical risks associated with climate change, only 9% demonstrated a clear understanding of the impact on their profitability³.

Trends in Australian emissions trading systems have the potential to significantly impact company profits. Measuring the effect can vary depending on how prepared each business is for climate change. Some will be winners and some losers – we will only have a better understanding by analysing the intangibles.

Winning the war for talent

So what’s sparking the war for talent? Our unemployment rate is at a long term low and with an ageing population, workers are becoming scarce. Generation Y – twenty year olds and teenagers – are heavily influenced by their friends’ views as well as information they source via the web.

Research shows that nearly 75% of 20 year olds will not apply for a job if they’re uncomfortable with the company values⁴. So not only are there shortages of talent but potential employees seem less committed to their employers. Companies will need to demonstrate to potential staff why they are ‘better’ employers. ‘Better’ employers are defined as companies where staff are more engaged, adopt

The iceberg effect



Source: AMP Capital Investors

effective measurable HR strategies and where there’s quality, cost-efficient training⁵. Global studies indicate that better employers have higher revenue, higher profit growth and higher investment returns⁶. Considering the average cost of re-employing someone who has left the organisation, including lost time and retraining, is about one year’s salary⁷, a key concern for investors is to understand which companies are managing their human capital well.

Throw away the company models?

A new intangible world requires new approaches to company valuation. One of the challenges is to include the impact of intangible factors within current valuation models. Discounted cashflow is one of the most common formulas used in company valuation.

Discounted cashflow analysis relies on understanding risks and growth opportunities confronting future cashflows. And any assessment which fails to address intangible issues will be incomplete. Two areas investors should spend a fair amount of time on are; what is the risk of the company; and what is the nature of the growth rate of cashflows? For example, are they high growth, low risk cashflows or vice-versa? And this is where factors such as a committed workforce, loyal customers, management quality and climate change come into play.

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The new intangible investment world requires a new approach to company analysis. Although traditional methods that focus on tangible assets are still relevant, increasingly the more savvy investors will be on top of analysing a company’s intangible assets and identifying the intangible trends impacting long term value.

- ASX Top 100 Companies, AMP Capital Investors Limited (2006)
- www.ipcc.ch
- Investor Group on Climate Change (2006), KPMG
- Hayes Best Employer Survey (2006)
- Mastering People Management (Survey), Linda Bilmes (2006)
- 2005 Summary of Findings Report, Hewitt Best Employers in Australia & New Zealand Study, Hewitt Associates (2005)
- Australian Financial Review, October 2006



AMP Capital corporate governance

A review and comparison of corporate governance practices suggests the corporate governance structure which exists in Australia demonstrates many leading international practices. AMP Capital Investors Corporate Governance Manager, Karin Halliday, recently reviewed the Australian, US, Canadian and UK financial markets.

Interestingly, while the core principles of corporate governance are similar, different regions are focusing their energies in different areas depending on their legal and cultural landscape. Karin found that in the US, corporate governance is very regulator-led or rules-based whereas in the UK, Australia and to a lesser extent Canada, the approach is more shareholder-led and principles-based.

The rules-based approach in the US is an environment in which regulatory enforcement dominates over voluntary compliance. In contrast, regions operating under a more principles-based approach have more flexibility in their means of

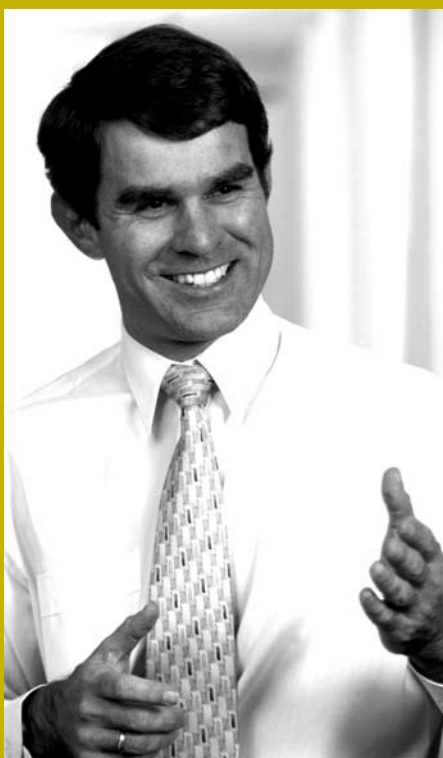
meeting best practice standards. These countries are able to outline areas where they may have not achieved compliance and describe how they are meeting the corporate governance objectives in another way.

The principles-based approach used by countries such as Australia also appears to be helping boards take more proactive responsibility for issues that have plagued US investors including poor executive remuneration structures and financial misstatements. Despite differences in the corporate governance systems, three key issues are present across all regions; the effectiveness of boards, remuneration structures and the trustworthiness of financial statements.

While investors globally believe that effective boards are key to a company's long term success, concern has been expressed about US practices which give shareholders limited power regarding the appointment and removal of directors. Australia, on the other hand, has a system which allows shareholders to have a much

greater say as the owners of the business. The Australian governance systems seem to demonstrate much more constructive and beneficial communication practices between board and shareholders as evident in recent remuneration reports.

So how does the Australian governance approach translate in practice? In 2006, AMP Capital voted on 2,068 resolutions at 413 company meetings. Most of these resolutions related to the re-election of directors and non-salary remuneration. After reviewing each resolution closely AMP Capital elected to support all resolutions at 64 per cent of meetings. The majority of resolutions not supported by AMP Capital Investors in 2006 were for executive incentive plans and remuneration reports. Resolutions seeking support for executive incentive plans were not supported at 33 per cent of meetings tabling such resolutions; reasons included poor or non-existent performance hurdles, the short term focus of the incentives and poor disclosure of terms.



profile

**Michael Anderson, BEc, GradDipTheol, FIAA
Director, Sustainable Alpha Funds**

With 22 years investment experience, Michael Anderson has an extensive background in investment management and especially in managing Australian shares. Michael has held a range of senior asset management positions within AMP Capital Investors beginning with his role of Head of Australian Industrial Share Research team in 1989.

Since then Michael has had a significant role in developing the business models and investment processes of many of the Australian Equity businesses. He has also led the Australian Equities group, and held the role of Director of Advanced Strategies where Michael was responsible for assisting the business incubate new investment capabilities and developing its hedge funds business.

Along the way Michael found time to take a year out to study Theology and Ethics and spend time with his wife and three daughters.

In recent years, Michael's key focus has been leading the Sustainable Alpha team from its formation in August 2000. With his team, Michael has been responsible for developing our Sustainable Alpha process. The team has a focus of adding value through analysing more dimensions of a company's performance with the goals of providing superior returns and meeting client values.



stock story

Tassal Group

Research and engagement

Our Sustainable Alpha investment process is an active, bottom up approach that systematically integrates environmental, social and governance factors with financial measures to gain deeper insights into a company's growth and risk elements. We have found that companies which are proactive in taking these factors into account are generally more successful, and subsequently have the potential to add greater investment value, than companies who do not place an emphasis on these factors.

Over the past 6 months, the team completed industry specific research on the Transport sector, and commenced research on Industrial Manufacturers and the Transport Infrastructure sectors. During February, the company reporting season gave us the opportunity to continue to raise the issue of OH&S in the workplace. In addition, the team has started to assess greenhouse gas liability for a number of companies, starting with the transport, coal and mining, oil and gas, utility and building material sectors. Both safety performance and exposure to greenhouse gas risks are important issues that they consider when making investment decisions.

On the engagement front, the team has been active with:

- **Corporate responsibility:** Nick Edgerton and Matthew Rey visited Metcash to discuss environment, health and safety systems and performance. Nick attended the Walkley Foundation discussion featuring Lord Hastings on Corporate Social Responsibility in the Media.
- **Reporting and disclosure:** Ian Woods visited ANZ for the launch of its Sustainability Report, and visited NAB to discuss ESG issues and discuss reporting. Ian provided feedback on the Wesfarmers sustainability report. Ian reviewed 20 company sustainability reports as a judge for the ACCA Awards for Sustainability Reporting. Nick presented to the Sustainable Business Forum on Sustainable Reporting from an investor's perspective.
- **OHS:** Ian visited Alesco to discuss OHS systems issues. Mike Murray visited Incitec Pivot and discussed OHS performance. Will Riggall visited Alinta, Australian Infrastructure (Perth Airport) and DUET and discussed safety performance.
- **Climate Change:** Ian was a stakeholder participant in meetings with the National Emissions Trading Taskforce. Mark O'Brien (AMPCI CIO) and Shane Oliver (Chief Economist) launched the CDP4 in Sydney and Melbourne. Ian and Nick attended AI Gore's presentation on An Inconvenient Truth. Ian attended a Green Capital event on Climate Change Policy and a conference on the status of Carbon Capture and Storage in the UK, Australia and worldwide, and issues associated with the EU Emissions Trading Scheme. Nick engaged with Macquarie Airports and Australian Infrastructure about climate change risks and airports.
- **Sustainability:** Ian presented at a Life Cycle Assessment (LCA) conference on the relevance of LCA to climate change impact assessment for investors. Ian and Nick prepared nominations for the Australian Sustainability Awards. Michael Anderson presented at the Ethical Investor Sustainable Human Capital Management Conference. Nick and Ian presented at an Agribusiness conference on climate change, water and land use in Melbourne and Sydney. Nick attended a report presentation by the Taskforce on Care Costs as well as the Green Cities conference.
- **Corporate governance:** Karin Halliday and Michael Anderson launched the January edition of the AMP Capital Corporate Governance report, including a section on the big issues in global governance, profiled in this newsletter.
- **Environmental performance:** Mike visited Orica and discussed groundwater pollution and contaminated site remediation.

Tassal Group (TGR) is a Tasmanian based salmon farming company involved in the production, marketing and distribution of Atlantic Salmon in Australia. TGR also exports to the Japanese market. Value added products by TGR include unsmoked fillets, unsmoked portion and portion offcuts, caviar (roe), smoked unsliced fillets, unsmoked salmon burgers, smoked sliced fillets and packs. Tassal's products are marketed nationally under brands such as Royal Tasmanian, Tasmanian Smokehouse, Tasmanian Supreme and Bruny Island.

The typical lifecycle of farmed Atlantic Salmon is approximately 24-36 months. Eggs are collected, fertilised and laid out in special incubator trays in the hatchery building. The fish are then transferred to large tanks in the on-growing area, where they spend the majority of their lives. After 8-14 months following hatching they are transferred to sea where most of the fish are held in fish cages at 'nursery' sites. Once they have reached around 1.5kg they are transferred to marine sites for up to 15 months, and are harvested once they grow to 3kg-4kg.

With many world fishery stocks plummeting due to overfishing and illegal fishing, aquaculture as an industry may be vital for future food and protein provision, but produces many questions around sustainability. Such questions include; what is the ratio of fish meal (fish used in feed) to fish grown? What sea temperature range can the fish survive in if sea temperatures rise? And if sea temperatures do rise, how will fish deal with invasive species or disease? What are the risks or benefits to human health from farmed fish? How are natural predators around these fish farms managed?

The Sustainable Alpha team engaged with TGR management to help ensure that the company is taking a responsible approach on these issues. Of note, TGR is active in reducing the fish conversion ratio, monitoring fish mortality and health, creating design elements to manage predators, promoting the health benefits of salmon, and ensuring independent quality systems certification.

Over the 12 months to 31 March 2007, TGR total return was 148%.

performance

The Sustainable Share Fund (The Fund) outperformed the Fund's benchmark of the S&P/ASX 200 over the last 12 months. In the year to 31 March 2007, the Fund returned approximately 23% against the benchmark return of approximately 21.8%.

Key sectors adding value included Diversified financials, Insurance and Healthcare sectors.

Key stocks included emerging financial market players, MFS and HGI which benefited from buoyant capital market conditions, as well as QBE which continued to add value through acquisitions and operational performance. The Fund benefited from overweights in the Healthcare sector, including Vision Systems and Mayne Pharmaceuticals, gaining from the realisation of embedded value through takeovers. Incitec Pivot, a key pick in the Fund also added strongly to performance as industry rationalisation and fertiliser price increases drove the stock to all time highs.

Looking to industries of the future, the Fund's investment in Vision System's cancer detection equipment saw it finish the year up over 100%, with a bid for the company by global competitor, Ventana Medical Systems. Blood products company CSL achieved an annual return of about 50%. Pharmaxis, a company involved in the development and clinical management of chronic respiratory and auto-immune diseases, met significant milestones and subsequently outperformed.

On the negative side, the Fund's underweight in the Telecommunications industry detracted from performance as Telstra outperformed post T3. The Fund's underweight position in Woolworths also negatively contributed to performance as the company increased their market share as the Coles Group operationally underperformed.

Looking ahead, we continue to seek out industries of the future companies as well as mainstream leaders.

Performance to 31 March (before fees and taxes)

	1 year	2 years	3 years	4 years	5 years
SFAS*	23.09%	28.62%	28.02%	28.51%	19.46%
S&P/ASX 200	21.78%	26.00%	25.87%	25.25%	16.73
Relative	1.31%	2.63%	2.15%	3.26%	2.73%

Source: AMP Capital Investors, Mercer.
* SFAS refers to the Sustainable Share Fund.

news

At AMP Capital we have taken our 'corporate responsibility strategy' a step further by signing the UN Principles for Responsible Investment (PRI). As a business we take environmental, social and governance issues seriously in our investment decision-making practices as evident by our strong equity proxy voting policy, work on considering the investment risk of climate change and our Sustainable Alpha process. The UN PRI aim to provide an internationally agreed framework to help institutional investors, incorporate environmental, social and governance issues into investment decision-making and ownership practices.



An initiative of UNEP Finance Initiative and the UN Global Compact

The AMP Capital Sustainable Share Fund uses an innovative approach to seek out the hidden value in companies and invest in those we believe are more likely to succeed now and into the future. First established on 20 March 2001 for institutional investors only, this fund is now available to private clients through a new class of units.

IPCC was established in 1988 by the World Meteorological Organisation and the UN Environment Programme to assess scientific, technical and socio-economic information relevant for the understanding of climate change, its potential impacts and options for adaptation and mitigation. It is currently finalising its Fourth Assessment Report "Climate Change 2007", after reporting previously in 1990, 1995 (providing key input to the Kyoto Protocol), and 2001.

Meanwhile, CDP continues to grow as the world's largest institutional investor collaboration on the business implications of climate change, representing 284 institutional investors with assets of US\$41 trillion under management. On 1 February 2007, the fifth request (CDP5) for disclosure of information on Greenhouse Gas Emissions was sent to over 2400 companies, including 100 Australian and 50 New Zealand listed companies. Again AMP Capital Investors is a signatory to CDP5 and working with the Investor group on Climate Change on assessing Australian and New Zealand companies.

In sustainability reporting, the Association of Chartered Certified Accountants "Australia and New Zealand Awards for Sustainability Reporting 2006" were recently announced. Dr Ian Woods of the Sustainable Alpha team was one of the seven judges to award the Listed Company best practice reporting prize to BHP Billiton.

AMP Capital Sustainable Share Fund

The AMP Capital Sustainable Share Fund is available to Australian investors. The overall objective of the Fund is to deliver superior returns to our clients by investing in companies that contribute to, benefit from and best adapt to the shift to an environmentally sustainable and socially responsible global economy.

Further information can be found on our website:
www.ampcapital.com.au/sustainable

Important note: Investors should consider the product disclosure statement available from AMP Capital Investors Limited (ABN 59 001 777 591) for the Sustainable Share Fund before making any decision regarding the Fund. Neither AMP Capital Investors, nor any other company in the AMP Group guarantees the repayment of capital or the performance of any product or any particular rate of return referred to in this document. Past performance is not a reliable indicator of future performance. While every care has been taken in the preparation of this document, AMP Capital Investors makes no representation or warranty as to the accuracy or completeness of any statement in it including, without limitation, any forecasts. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. An investor should, before making any investment decisions, consider the appropriateness of the information in this document, and seek professional advice, having regard to the investor's objectives, financial situation and needs. This document is solely for the use of the party to whom it is provided.