

Background information for Tobacco Stocks Divestment

1 Responsible Investment Framework

- 1.1 The Guardians of New Zealand Superannuation (Guardians) have made considerable progress during the year in the development of their responsible investment framework. The Guardians approved their revised Responsible Investment Policy, Standards and Procedures, to encompass both the Guardians' ethical investment and voting requirements, with regards to the New Zealand Superannuation Fund (Fund).

The Responsible Investment Policy, Standards and Procedures clarified how specific responsible investment issues, such as tobacco, would be considered in a manner that is consistent with the Guardians' mandate. This is highlighted in the guidelines section 1.3 of the policy:

The Guardians consider responsible investment (RI) to be part of evolving best-practice investment management. This RI policy has been developed to help the Guardians to manage the Fund in a manner consistent with:

- Best-practice portfolio management;
- Maximising return without undue risk to the Fund as a whole; and
- Avoiding prejudice to New Zealand's reputation as a responsible member of the world community.

To the extent that it does not conflict with their obligations above, the Guardians, at their discretion, may consider other issues arising from the Fund's investments. In doing so, the Guardians may take into account factors including whether the issue is contrary to New Zealand law and New Zealand's international agreements, or is inconsistent with Crown actions.⁺

2 Board's assessment and divestment decision

- 2.1 As part of the Guardians' on-going review of a range of issues, the Guardians analysed if the Fund's investments in tobacco companies was inconsistent with their responsible investment standards. This analysis (as outlined in sections 1.3 and 3.2 of the Responsible Investment Policy, Standards and Procedures)¹ included:

- the nature of involvement by the company and the Fund;
- the materiality of the issue or breach of Responsible Investment standards;
- the regulatory environment, including international conventions and New Zealand law;
- the effectiveness of shareholder actions; and
- the impact on the Fund's portfolio.

The Guardians' decisions must not be inconsistent with their mandate, and therefore the analysis gave particular consideration to the impact of tobacco investment on the Guardians' requirements to: avoid prejudice to New

¹ Responsible Investment Policy, Standards and Procedures dated 27 June 2007

Zealand's reputation as a responsible member of the world community; and to maximise returns without undue risk to the portfolio as a whole (please refer to sections 5 and 6 of this document for more details).

- 2.2 Based on the Guardians' assessment, the Board decided to divest tobacco stocks from the Fund. Although the Guardians consider the active use of shareholder rights through engagement and voting to be the main mechanism for responding to responsible investment concerns², in the case of tobacco stocks such efforts would not be cost effective, and would risk the Fund being conflicted. Considering Crown action internationally, and at the domestic level, the unusual characteristics of the tobacco industry, particularly with regard to product safety and ethics, and the effectiveness of different shareholder responses, the Guardians concluded that divestment and exclusion of the Fund's tobacco holdings would be the most effective response.
- 2.3 The decision to divest from tobacco should not be seen as a precedent for future decisions or actions. The Guardians have a transparent framework for responsible investment procedures, and a range of options for action including engagement, divestment, and exclusion.
- 2.4 It is to be noted that there is not a uniform response to the issue of tobacco investments by investors with a Responsible Investment policy. There are clear divisions in the arguments on whether or not to hold tobacco investments, and there are also challenges in implementing engagement and voting actions.

On one hand, many investment funds take no action because:

- Tobacco is a legal product globally;
- Adult choice to buy a legal product is not disputed;
- There are legal bans on sales to minors;
- Some tobacco companies have now adopted new codes of conduct; and
- Most class action litigation against the tobacco industry has failed.

On the other hand, the following are also relevant to the Guardians' decision:

- Investment in tobacco stocks is inconsistent with New Zealand's international commitments, national legislation, and Crown actions. In particular the objectives of the World Health Organisation (WHO) Framework Convention on Tobacco Control (FCTC) and its extensive focus on the tobacco industry;
- The characteristics of the tobacco industry clearly delineate it from other industries facing controversy over social, environmental or governance issues;
- Engagement and voting on the issue of tobacco faces a significant conflict of interest between shareholder interests and the FCTC objectives;
- Engagement and/or voting in this sector will consume resources that could be used to better effect elsewhere; and

² Recent international experience in this area highlights that engagement with companies, in concert with other investors, is often the most effective means by which shareholders can play a role in improving company policies, products and practices,

- Divestment from the tobacco sector will have an immaterial effect on the expected efficiency (i.e. expected return for a given level of total portfolio risk) of the Fund's portfolio.

3 Timetable for the Guardians' decision

Date	Actions
26 June 2007	The Board approved the revised Responsible Investment Policy, Standards and Procedures.
30 June 2007	The Fund held NZ\$37.6 million invested in tobacco stocks on its segregated portfolio, equivalent to 0.29% of total funds under management.
10 September 2007	The Board decided: <ul style="list-style-type: none"> • The Fund's investment in tobacco stocks is inconsistent with the Guardians' Responsible Investment Policy; • Having considered the effectiveness of different shareholder actions, the Board directed management to divest tobacco stocks from the Fund's segregated equity portfolio, and exclude tobacco stocks from future investment; • This decision was subject to the approval of a divestment and exclusion plan to be presented by the management
8 October 2007	<ul style="list-style-type: none"> • The Board approved the Fund's divestment and exclusion plan.
Beginning 23 October 2007	<ul style="list-style-type: none"> • The Guardians issue written Directives to their investment managers to divest companies classified under the Global Industry Classification Standard (GICS) Industry Tobacco, from the segregated portfolios they manage for the Fund³.

³ On receiving a written directive from the Guardians, investment managers are required to divest their holdings in a reasonable timeframe, preferably within four weeks. In addition, the Guardians' investment managers will be directed to exclude these companies from future investment by the Fund's segregated portfolios. To assist in this process the Guardians will provide a list of tobacco stocks to be excluded, which will be updated on a regular basis. The Guardians have no authority to issue directives across pooled funds.

Additional information considered by the Guardians in making their divestment decision in tobacco stocks

4 Tobacco synopsis

4.1 The tobacco sector

Tobacco products are legal. The freedom of informed adults who choose to smoke a legal product is recognised as an individual right. However, the tobacco industry is faced with a range of environmental, social and governance challenges, some of which are considered to be material to the Guardians' Responsible Investment Policy. There are two issues that are particularly significant for the tobacco sector - the safety of its products and its ethical business conduct.

4.2 Product-related issues

- Tobacco products are distinctive for being unsafe to the consumer if used as intended, and for being highly addictive.⁴ These factors are a key reason why tobacco-related illnesses are the second most common cause of death in the world.⁵ There is little dispute over the health risks of tobacco products with major tobacco manufacturers now conceding to this fact.
- The World Health Organisation (WHO) stated that tobacco use is the cause of a global pandemic in tobacco-related disease, and due to the use amongst young people it is also referred to as a paediatric pandemic.⁶ This issue has been a key factor in the development of the multilateral WHO Framework Convention on Tobacco Control (FCTC) (www.fctc.org).
- There are considerable public policies (including tax) and regulatory actions designed to discourage uptake of smoking, reduce prevalence of smoking addiction and promote cessation. This is especially the case with regard to youth. Most smokers begin smoking cigarettes as teenagers. As a consumer product cigarettes are widely accessible and, despite age restrictions on sales, a 1994 survey showed that 88% of smokers began smoking before the age of 18.⁷ In New Zealand, the average initiation age for 15-19 year old smokers is 14.6⁸.
- Tobacco is a legal product traded on an international basis. The high prevalence of tobacco use (a global average of 28%)⁹, coupled with established illegal smuggling networks, makes it difficult for governments to ban cigarette production and sales, i.e. make tobacco illegal. This would risk the creation of a significant illegal market in the product and would criminalise a significant percentage of the population.

⁴ WHO Website; Curbing the Epidemic, Governments and the Economics of Tobacco Control, Washington DC, The World Bank, 1999. (Page 22).

⁵ WHO website

⁶ Ibid note 5

⁷ National Household Surveys on Drug Abuse (NHSDA) 1991. Cited in: Preventing tobacco use among young people. A report of the Surgeon General US DHHS, Atlanta, 1994

⁸ New Zealand Tobacco Use Survey 2006

⁹ Tobacco Control Country Profiles Second edition 2003

- Price and tax increases have proven effective in reducing consumption, and preventing initiation, particularly amongst young people and in developing countries, and are a key element in all tobacco control programmes.

4.3 Business practice issues

- The tobacco sector's reputation regarding business ethics was damaged by revelations during the wave of litigation in the US which began in the mid-1990s. Tobacco company files made public during this litigation showed the tobacco industry had a good understanding of the addictive nature of nicotine from the 1960s, and reveal they used this knowledge in product development, and marketing strategies including those targeting teenagers.¹⁰
- A number of companies have adopted new Codes of Ethics. British American Tobacco (BAT) is seen as the sector leader in Corporate Social Responsibility (CSR) in areas such as labour practices, environmental management, and child labour issues. Other tobacco companies have followed by adopting Codes of Conduct which commit to meeting strict marketing standards internationally, and by improving their CSR reporting. However, it is difficult to assess if industry practices have changed significantly, given a constant flow of conflicting reports between companies, and other organisations, over initiatives such as youth education programmes. In a report by the WHO's Tobacco Free Initiative, CSR in the tobacco industry is described as an inherent contradiction.¹¹ The contradiction for the industry is caused by the intrinsic conflict of interest between increasing tobacco sales revenue and reducing tobacco-related disease.
- The tobacco industry has been resilient against most litigation, particularly regarding individuals or class actions. A key reason has been the difficulty of proving that a plaintiff's disease was caused by a tobacco company's cigarettes and not by other factors. In November 1998, 46 states reached the Master Settlement Agreement with tobacco manufacturers, in order to recoup Medicaid dollars spent on treating smoking-related illnesses. This required the tobacco industry to pay US\$246 billion over 25 years but protected it from most future US State litigation. Litigation outside the US is low, but recent law suits by the Canadian State of British Columbia and the Nigerian Government State of Lagos may signal a new trend in non-US litigation.
- Financial analysts now see regulation as a greater threat to the industry than litigation. Morgan Stanley estimates that the tobacco sector will achieve a small amount of growth to 2015,¹² after which average global per capita consumption, and therefore industry growth, will decline, mainly as a result of increasing regulation. It can be seen that product safety concerns which are driving this regulation place limitations on the sector's ability to maximise shareholder return.
- Analysts also see most of the growth in the industry coming from the emerging markets. This has intensified concerns over corporate sales and marketing practices globally, particularly to youth or populations with

¹⁰ Various from Tobacco papers published during trial litigation on www.tobacco.org & Report & Recommendations of the Ad Hoc Advisory Committee on Tobacco Investments; University of Michigan; March 17, 2000

¹¹ Tobacco industry and corporate responsibility, an inherent contradiction. WHO 2004

¹² Morgan Stanley Late to the Party 2007

a high level of illiteracy. An estimated 70% of tobacco-related deaths will be from the developing markets by the year 2020.¹³

5 Guardians' mandate: Avoiding prejudice to New Zealand's reputation as a responsible member of the world community

5.1 In assessing if tobacco investment is inconsistent with avoiding prejudice to New Zealand's reputation as a responsible member of the world community, the following factors were considered:

- the legal status of the product,
- international censures against the industry;
- New Zealand's international agreements; and
- international comment on institutional investments.

5.2 Tobacco is legal in every country, and there are significant barriers to making it illegal. Most government funds still hold tobacco stocks, despite a wave of divestment from many State pension funds in the US. At the international level, the tobacco industry has faced significant international censure. This has in part led to the WHO FCTC to which New Zealand is a signatory.

5.3 The Guardians concluded that the Fund's investment in tobacco stocks was unlikely to prejudice New Zealand's reputation as a responsible member of the world community, primarily because most government funds still hold tobacco stocks. In addition, tobacco is a legal product, traded globally. The FCTC does not cover the issue of institutional investment. However, the Guardians also recognised that the Government's international commitment to the FCTC, the active engagement between countries under the FCTC, the international censure of the industry, and the Guardians' status as a Crown entity, means that reputational risk arising from the Fund's holdings in tobacco stocks from an international perspective, could not be completely discounted.

6 Guardians' mandate: Best-Practice Portfolio Management

6.1 The Guardians' Responsible Investment Policy must be consistent with the Fund's mandate to adopt best-practice portfolio management and maximise returns without undue risk to the portfolio as a whole. In relation to tobacco holdings, the Guardians considered the impact of divestment on the Fund's portfolio, the investment practices of peers, and breaches of corporate standards incorporated into the Responsible Investment Policy, Standards and Procedures.

6.2 Impact of exclusion

- The Guardians utilised information from two external investment managers to analyse the impact on the efficiency of the portfolio (that is, the expected return for a given level of risk), if tobacco stocks were to be excluded from the Fund's portfolio.

6.3 The conclusions from this analysis was that exclusion of tobacco stocks from the portfolio does not alter the efficiency of the portfolio in a material

¹³ <http://www.afro.who.int/regionaldirector/speeches/rd20060531.html>

sense and is not inconsistent with maximising returns without undue risk to the portfolio as a whole. However, in considering multiple exclusions across the Fund, for example, of other sectors, there could be a cumulative effect.

6.4 Peer decisions

- Divestment of tobacco stocks amongst government funds has mainly occurred in the US but is rare amongst government funds elsewhere. However, it is also rare for government funds to have specific legal mandates to adopt ethical or responsible investment policies, (although voluntary adoption of RI policies is becoming more common).

6.5 Responsible Investment Standards

- Tobacco companies have been widely criticised for breaching standards on business ethics and product safety¹⁴. Although there has been an improvement in the industry with regards to business ethics, with a number of companies adopting codes of ethics, product safety and conflict of interest remain inherent risks.

6.6 The Guardians concluded that investment in tobacco stocks was not inconsistent with best-practice portfolio management or maximising returns without undue risk to the portfolio as a whole, but, neither was divestment and exclusion of tobacco stocks.

7 Regulatory Environment

7.1 The regulatory environment is an important factor in analysing issues against the Responsible Investment Policy guidelines, in particular relevant New Zealand international agreements, New Zealand law, and New Zealand Crown actions.

7.2 International regulation

- New Zealand is a signatory to, and has ratified, the WHO FCTC;
- The Guardians considered the FCTC a significant international agreement, and relevant to their analysis, for the following reasons:
 - It is a multilateral convention with 168 signatory countries and ratified by New Zealand;
 - It is influential to New Zealand and other governments' laws and actions;
 - The FCTC has a comprehensive and extensive focus on an industry sector and it is a sector in which the Fund is invested; and
 - The objective of the FCTC in Article 3 is, at the national, regional and international levels, to *reduce continually and substantially the prevalence of tobacco use and exposure to tobacco smoke*.
 - In addition, unusually, the signatories commit to mutual cooperation including affording assistance, as appropriate, to other parties on legal proceedings for compensation.

¹⁴ For example, such standards include the OECD Guidelines for Multinational Enterprises.

7.3 New Zealand regulation and Crown actions

- Successive New Zealand Governments have introduced legislation aimed at reducing the prevalence of smoking in the New Zealand population. The New Zealand Government's international commitment to the FCTC is backed-up by significant domestic regulation and action programmes. National tobacco control actions include the Smoke-free Environments Act, fiscal controls i.e. taxation, and Ministry of Health programmes, in particular Clearing the Smoke+ the 5-Year Plan for Tobacco Control in New Zealand (2004-2009).

7.4 The Guardians consider the Fund's investment in tobacco stocks to be inconsistent with the Government's international commitment under the FCTC *to reduce continually and substantially the prevalence of tobacco use and exposure to tobacco smoke*. In addition, actions arising from the FCTC obligations may have a material negative impact on the long-term growth and profitability of the tobacco industry, and therefore runs counter to the aims of the industry and its shareholders. Tobacco investment is also inconsistent with major Government actions, including the 5-Year Plan for Tobacco Control.

8 Delineating factors in the tobacco industry

8.1 The Guardians' analysis is focused on the tobacco sector, that is, the main tobacco manufacturers generally responsible for product development, manufacture, branding, and sales. It does not include retailers such as supermarkets or corner shops, or companies with indirect involvement, such as equipment suppliers.

8.2 Many other products and industry sectors give rise to social concerns. The tobacco sector is delineated by a unique combination of factors. Cigarettes are highly addictive, inherently unsafe for their intended use and cessation is difficult. The tobacco sector's record on business ethics is poor with a history of misleading the public and evidence of past campaigns to deliberately target a teenage population.¹⁵ Despite improvements in the policies and practices of a number of tobacco companies, there remains an insurmountable conflict of interest between reducing smoking-related disease, and maintaining long-term sales growth. Such growth depends on smoking initiation, and the promotion of a company's brand, amongst a new generation of customers, a significant proportion of whom are likely to become addicted as minors.¹⁶

9 Implementation: shareholder response and Responsible Investment procedures

9.1 In the case of tobacco investments the Guardians assessed different shareholder responses: no action; divestment and exclusion; or engagement and voting.

9.2 The Guardians determined that the seriousness of the product safety and business ethics issues, which clearly delineated the tobacco industry, meant that the no action+ option was not an adequate response under the Responsible Investment Policy.

¹⁵ Ibid 10

¹⁶ Ibid note 7&8

- 9.3 Engagement is challenging in this sector. Reports from some US funds refer to a lack of responsiveness from the industry over a long period.¹⁷ On the other hand, BAT is an example of a company that has responded to stakeholder, including shareholder, engagement, and improved a range of corporate policies and practices. However, there is a lack of consensus on what constitutes good corporate practice for a tobacco company, with conflicting information from companies and key groups involved in tobacco-control, particularly relating to marketing and sales activity in developing countries. This makes monitoring and analysing corporate performance resource intensive. Crucially, engagement will have very limited impact on product safety, which is the core issue, regardless of the resources employed. The main aim of tobacco companies, and indirectly their shareholders, is to grow sales revenue from tobacco products, through expanding and renewing the customer base. This is contrary to New Zealand's objectives under the FCTC which aims to significantly reduce the prevalence of tobacco use. The effectiveness of engagement and voting, in the Fund's case, is compromised due to conflicts of interest between shareholder and FCTC objectives.
- 9.4 Divestment and exclusion of tobacco stocks from the Fund's portfolio were assessed to have an immaterial impact on the expected efficiency of the Fund's portfolio as a whole. The Fund's segregated portfolio accounts for the majority of the Fund's assets under management. Directives to divest cannot be applied to pooled assets.
- 9.5 Given the decision to take action, the resources required, and conflicts of interest inherent, in an engagement approach, and the minimal impact on the portfolio from exclusion, the Guardians concluded that divestment and exclusion of tobacco companies from the segregated portfolio was the Fund's most effective course of action.

¹⁷ Report and Recommendations of the Ad Hoc Advisory Committee on Tobacco Investments; University of Michigan; March 17, 2000; & Cogan DG, ed. (2000) Tobacco Divestment and Fiduciary Responsibility: A Legal and Financial Analysis. Washington, D.C.: Investor Responsibility Research Center Inc.;

Appendix 1 – Exclusion List for Tobacco Companies (current)¹⁸

Tobacco Company	MSCI Index
Altadis SA	World
Atria Group Inc	World
British American Tobacco PLC	World
Imperial Tobacco Group	World
Japan Tobacco	World
Swedish Match	World
Alliance One International	Small Cap
Gallaher Group	Small Cap
Carolina Group	Small Cap (New York Stock Exchange)
Reynolds American	Small Cap
Rothmans Inc	Small Cap
UST	Small Cap
Vector Group	Small Cap
Gudang Garam Tbk PT	Emerging market
ITC Ltd	Emerging market
KT&G Corporation	Emerging market
Philip Morris CR AS	Emerging market
Souza Cruz	Emerging market
Eastern Tobacco	Emerging market
Universal Corporation	S&P 400 midcap

¹⁸ List to be updated on six-monthly basis