SOCIALLY RESPONSIBLE INVESTMENT AT THE HEART OF THE FRR’S INVESTMENT MANAGEMENT

RESPONSIBLE INVESTMENT STRATEGY FOR THE 2013-2018 PERIOD

In 2013, the FRR’s Supervisory Board adopted a new Responsible Investment Strategy. The 2013-2018 strategy has four key components within a system of regular monitoring by the Responsible Investment Committee composed of members of the FRR’s Supervisory Board and experts.

<table>
<thead>
<tr>
<th>FRR RESPONSIBLE INVESTOR: REMINDER OF THE PRINCIPLES</th>
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</thead>
<tbody>
<tr>
<td>COMPONENT 1 INTEGRATION OF ESG1 FACTORS IN ASSET MANAGEMENT</td>
</tr>
<tr>
<td>This component consists in measuring and tracking changes with regard to specific FRR criteria. The aim is to disseminate the values upheld by the FRR by being as explicit as possible in the indicators collected, and to support the continuous improvement of the companies in which its invests.</td>
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<tr>
<td>COMPONENT 2 MANAGING SOCIAL RESPONSIBILITY</td>
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<tr>
<td>This component focuses on two approaches. The first deals with the activities of the companies in which the FRR invests and the way in which the said companies carry out their activities, in particular with regard to the Global Compact. The second concerns the impacts inherent in tax practices.</td>
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<tr>
<td>COMPONENT 3 EXERCISE OF THE FRR’S VOTING RIGHTS</td>
</tr>
<tr>
<td>The Supervisory Board has determined several principles with regard to the exercise of the FRR’s voting rights. Thus, the FRR’s shareholder rights at general meetings must be systematically exercised by each of the investment managers, in accordance with the guidelines established by the FRR, irrespective of the position held, the size of the company or its location.</td>
</tr>
<tr>
<td>COMPONENT 4 CONTRIBUTION TO RESPONSIBLE INVESTMENT RESEARCH AND SUPPORT FOR INTERNATIONAL INITIATIVES</td>
</tr>
<tr>
<td>The FRR’s objective via this component is to improve knowledge with regard to responsible investment and to ensure that the work is shared as widely as possible. In this context, the FRR supports the Sustainable Finance and Responsible Investment Chair (FDIR). The FRR also plays an active role in numerous international initiatives: the Principles of Responsible Investment (PRI), the Carbon Disclosure Project (CDP), CDP Water, the Extractive Industries Transparency Initiative (EITI), the International Corporate Governance Network (ICGN), the Montreal Pledge and the Portfolio Decarbonization Coalition (PDC).</td>
</tr>
</tbody>
</table>

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1Environmental, Social and Governance
THE FRR, A RESPONSIBLE INVESTOR

THE FRR EXCLUDES THE TOBACCO INDUSTRY

Tobacco is responsible for six million deaths a year worldwide, and generates considerable costs for healthcare systems and insurers. In response, the World Health Organization, governments and civil society are increasingly coming together to discourage tobacco consumption, and this could eventually weigh on these companies’ performance. The FRR also believes that dialogue with these companies cannot achieve anything, as the only question that can be asked of them is to quite simply give up their business. This is why the FRR decided to exclude the tobacco industry from its portfolio at the end of 2016.

THE FRR PROVIDES INFORMATION ON THE CARBON FOOTPRINT OF ITS EQUITY PORTFOLIO

The FRR calculated the environmental footprint of its portfolio for the first time in 2007, including the carbon footprint. The FRR has been evaluating its portfolio annually since 2013. In 2016, it made a call for tenders to select a service provider that could assess its emerging and developed market bond and equity portfolios’ environmental footprint for the next three years. The study covers emissions generated through companies’ and their direct suppliers’ business. S&P Trucost Ltd was selected to measure this footprint.

The FRR has chosen to measure its carbon footprint using two complementary methods: in terms of capital and revenue. The carbon footprint in capital terms, calculated in tonnes of CO₂ equivalent per EUR 1 million invested, represents the amount of emissions financed by the FRR’s assets, whereas the carbon footprint in terms of portfolio revenue, obtained by dividing companies’ annual CO₂ emissions (in tonnes) by their annual revenue in millions of euro, also shows the efficiency of the companies in which the FRR is invested. Within the latter measure, the FRR also distinguishes between the sector effect and the asset selection effect within each sector, relative to its composite index.

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2 This ratio is expressed in tonnes of CO₂ equivalent (tCO₂ e) per million euro invested.
At the end of 2016, the carbon footprint of the FRR’s equity portfolio was 272.9 tonnes of CO₂ equivalent per million euro of revenue. It is 28.9% lower than that of the FRR’s benchmark index\(^3\). The difference widened again in 2016. Between 2013 and 2016, the FRR’s portfolio reduced its carbon footprint by 37.5%, whereas the benchmark’s fell by just 17.6%. This performance essentially results from the decarbonisation process under way since 2014 on passively managed equity portfolios.

\(^3\)15.9% MSCI Emerging Markets index +42.5% FTSE Developed All Cap Excluding Eurozone index +41.6% FTSE Developed Eurozone All Cap index.
For each million euro invested in the FRR’s portfolio in 2016, absolute emissions amounted to 232.6 tonnes of CO₂ equivalent, 28.4% less than for the benchmark.

By this yardstick, the FRR’s portfolio reduced its carbon footprint by 42.4% between 2013 and 2016, whereas the benchmark’s fell by just 31.6%.

Whichever method is used, the FRR’s portfolio is emitting less and less carbon year after year. It also emits less than its benchmark, and thanks to the FRR’s determined decarbonisation policy for its equity portfolios, it has extended its lead.

**Focus on the Energy Transition for Green Growth act**

Although not bound by the Energy Transition for Green Growth act, the FRR has adopted the framework set out in the new disclosure requirement for institutional investors regarding the incorporation of ESG criteria into their investment policy and practices, and specifically their management of climate-related financial risks (paragraph 6 of article 173 of the Energy Transition for Green Growth act, extension of article 224 of Grenelle II). Accordingly, the FRR has decided to detail its environmental, social and governance externalities in a separate document, independent of this annual report. The FRR is also working on new innovative metrics to assess its environmental impact.

**The FRR withdraws from coal**

The FRR has been firmly committed to the ecological and energy transition theme these past two years. It has signed up to several international initiatives aimed at reducing its portfolio’s greenhouse gas emissions. It has also joined a coalition of investors demanding greater transparency in how businesses approach energy transition.

To reflect this commitment, the FRR has implemented an ambitious policy aimed at reducing its portfolio’s CO₂ emissions through low carbon management. This is achieved through benchmarks that reduce CO₂ emissions by at least half relative to standard indices, and by asking passive managers on most of the other indices to implement a management process that seeks to reduce the portfolio’s carbon footprint. Going even further, in 2016 the FRR decided to exclude companies whose thermal coal mining or electricity generation business exceeds 20% of their revenue.

**The FRR’s international commitments**

**Involvement in drafting the United Nations Principles for Responsible Investment**

At the beginning of 2005, the Secretary General of the United Nations invited a few of the world’s biggest institutional investors, including the FRR, to come together and establish a number of principles for promoting the incorporation of socially responsible investment practices into financial management. After six working sessions, and with expert help from representatives of the various stakeholders (companies, NGOs, researchers, etc.), the “Principles for Responsible Investment” were established before being officially signed in New York and Paris during the spring of 2006.
The PRI now reflect the shared values of a group of investors having a long-term investment horizon and diversified portfolios, including insurers and reinsurers, pension funds and other private and public institutional investors. They are fully compatible with the FRR’s SRI strategy.

**ADOPTION OF THE CARBON DISCLOSURE PROJECT (CDP)**

Supported by the United Nations Environment Programme, the CDP is one of the most important international initiatives for the environment and climate change. Wanting better information on companies’ behaviour with regard to the environment, energy consumption and the effects of climate change, the FRR gave the CDP its backing in 2005, before the biggest 120 French companies were questioned.

**SIGNATURE OF THE MONTREAL PLEDGE**

Signed by 35 institutional investors at the Principles of Responsible Investment conference in Montreal on 25 September 2014, it is backed up by the PRI and United Nations Environment Programme Financial Initiative (UNEP-FI). The investors who signed the Montreal Pledge have undertaken to publish the carbon footprint of their equity investments each year.

**MEMBERSHIP OF THE PORTFOLIO DECARBONIZATION COALITION**

Launched in September 2014, this collaborative initiative aims to reduce greenhouse gas emissions by mobilising a critical mass of institutional investors committed to measuring and decarbonising their portfolios. The FRR is at the forefront of this coalition.

**SIGNATURE OF THE CLIMATE CHANGE DECLARATION AT THE UN SUMMIT HELD ON 23 SEPTEMBER 2014**

In signing this initiative, the FRR committed to:

- Collaborate with the authorities to take measures that encourage financing of energy transition towards a low-carbon economy;
- Identify and assess low-carbon investment opportunities;
- Develop investors’ ability to assess risks and opportunities linked to climate change, and incorporate this into investment methodologies;
- Foster dialogue on the issue of climate change with companies included in the portfolios;
- Publish the initiatives taken and progress made.

**LIST OF COLLABORATIVE INITIATIVES SUPPORTED BY THE FRR**

The FRR continued its involvement in several collaborative initiatives in 2016, and joined two new ones.
MANAGING RISKS LINKED TO THE SUPPLY CHAIN IN THE TEXTILE INDUSTRY – PRI

Despite the efforts made by companies within the sector, poor working conditions and violations of human rights are still recurring problems in the supply chain. Realising this, seven French institutional investors, including the FRR, decided to launch a joint initiative in 2014 organised by Mirova for managing risks relating to the supply chain in the textile industry.

The main aims of this were to improve transparency, map social risks, develop long-term relations with suppliers, and participate in sector initiatives.

CLIMATE LOBBYING – PRI/IIGCC

In spite of their claims to support climate policies, numerous listed companies are indirectly involved in lobbying against these very policies through their professional associations. This dialogue focuses on this inconsistency and aims to improve the transparency of listed companies’ lobbying activities by demanding greater transparency from energy companies in their lobbying on issues related to global warming. This initiative has been backed by 50 investors, representing EUR 4.4 trillion in assets under management (IIGCC Initiative on EU Company Climate Lobbying).

HUMAN RIGHTS IN THE EXTRACTIVE SECTOR – PRI

This project seeks to understand how policies relating to human rights are applied by extractive companies, especially in the context of partnerships with local companies or governments.

EXTRACTIVE INDUSTRIES TRANSPARENCY INITIATIVE (EITI)

This initiative seeks to increase the transparency and responsibility of companies operating in extractive industries, by checking and publishing all payments made by companies, as well as all income received by governments, as a result of mineral, oil and gas extraction. In supporting the EITI, the FRR invites all companies directly or indirectly concerned by the above, and in which it holds shares, to contribute. It also encourages those companies already committed to supporting the initiative to play an active role in its implementation.

STATEMENT ON ESG IN CREDIT RATINGS (APRIL 2016)

Alongside six rating agencies, including S&P and Moody’s, and 100 international investors representing assets of USD 16 trillion, the FRR signed a joint declaration on more systematic consideration of ESG criteria in assessing issuers. This is an important stage in the integration of ESG factors in asset management.

GLOBAL INVESTOR LETTER TO THE G20 (JULY 2016)

Along with 129 institutional investors, the FRR signed a letter addressed to the G20 leaders before a summit held in China on 4 and 5 September 2016. This letter invited the G20 to adopt measures for combatting climate change.
COMMITTED STAFF

Olivier Rousseau, member of the Management Board, sits on the steering committee of the Portfolio Decarbonization Coalition.

Anne-Marie Jourdan, the FRR’s Senior Legal Counsel, is a member of the International Corporate Governance Network board of governors.

NON-FINANCIAL RISKS TO THE PORTFOLIO

In 2008, the FRR adopted a system to monitor and prevent non-financial risks that could have an impact not just on its investments but also its reputation. Risks to the FRR may arise from companies in which it invests failing to comply with universally recognised principles, such as those of the United States Global Compact and of good governance, as well as international conventions ratified by France, in particular the Ottawa⁴ and Oslo⁵ Conventions.

A call for tenders in 2016 led to the selection of a new service provider to assess non-financial risks to the FRR’s portfolio. Accordingly, Vigeo Eiris analysed the portfolio for the first time at the end of 2016.

ANALYSIS OF THE PORTFOLIO BY REGION

The 2,481 securities in the FRR’s consolidated portfolio and covered by Vigeo Eiris’s research are divided into two zones: developed countries and emerging markets. The former comprises three continental regions: North America, Europe and Asia Pacific. North America is the most strongly represented, and is also home to the heaviest concentration of controversial companies.

ANALYSIS BY COUNTRY

All regions combined, of the 10 countries home to the largest number of highly controversial companies, nine are developed, with five in Europe (United Kingdom, France, Germany, Italy and Spain), two in North America (Canada and the United States) and two in Asia Pacific (Australia and Japan). At number nine, South Korea is the only emerging country in this ranking.

85% of the most controversial companies originate from these 10 countries. The United States is the country with the highest number of companies subject to controversy by absolute value. The presence of US companies has a substantial impact on the portfolio at a consolidated level. They account for 33% of companies, 41% of the most controversial companies, and 43% of controversies. One possible explanation for this lies in the predominant culture and existing legislation of the United States, in which citizens, alone or together, have easy, frequent access to justice. This would naturally increase the number of controversies heard in court.

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⁴ Convention on the prohibition of the use, storage, production and transfer of anti-personnel mines and on their destruction.

⁵ Convention on the prohibition of the use, storage, production and transfer of cluster bombs and on their destruction.
Though they account for just 3.4% of companies in the consolidated portfolio, the 85 most controversial companies in the FRR’s portfolio are responsible for 28.5% of controversies. All sectors combined, 47% of identified controversies related to Market Behaviour\(^\text{6}\) and 16% to Corporate Governance. All fields combined, Chevron is the most controversial company with a total of 56 controversies, including 26 regarding the environment alone (10% of controversies identified for this). The FRR gives special consideration to this company in its investment strategy. It entered into direct correspondence with the company in 2015, and is continuing its dialogue through collaborative initiatives stemming from the PRI platform as well as through its investment managers.

83 of the 85 most controversial companies were the subject of at least one controversy regarding Market Behaviour, 65 for Corporate Governance, 63 for the Environment, 61 for Societal Commitment\(^\text{7}\), 60 for Human Rights and 47 for Human Resources.

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\(^\text{6}\) This area includes product security, responsible disclosure to clients, responsible orientation of contracts, lasting cooperation with suppliers, consideration of environmental and social factors in the supply chain, anti-corruption measures, anti-trust measures, and the transparency and integrity of influence practices and strategies.

\(^\text{7}\) This includes commitments to the economic and social development of the country in which a company is located, consideration of the societal impact of the products and services developed by the company, and the contribution to public interest causes.
Financial companies account for the most controversies within the FRR’s investment universe. They are followed by the Oil & Gas sector and then Industry. Financial companies were not subject to so many controversies in the past. Their predominance in the 2016 analysis results from both the new service provider’s analysis method, and the increase in controversies within this sector over the past few years.

**Split between developed/emerging countries**

The controversy divide goes against developed countries. 80 companies in this zone, or 3.98% of the companies analysed, are considered to be highly controversial.

Just five companies, or 1.07% of those analysed, in emerging countries are considered to be highly controversial. This is a quarter of the total in developed countries. The portfolio’s lesser coverage of this zone largely explains the difference. Corrected for this effect, the ratio nonetheless remains 1:4.

**Exclusions linked to prohibited weapons**

Each year, the FRR publishes an exclusion list approved by the Supervisory Board’s Responsible Investment Committee. This list is updated during the first half of each year, and published on the FRR’s website.
The FRR added two new companies to its exclusion list in 2016, and took two off. On 31 March 2016, the Responsible Investment Committee decided to add China Poly Group Corporation and S&T Dynamics to the FRR’s exclusion list for their involvement in the manufacture of anti-personnel mines and cluster bombs. At the same time, the Committee decided to remove Singapore Technologies Engineering and Temasek Holdings from the list.

**The FRR’s exclusion list at 31 March 2016**

<table>
<thead>
<tr>
<th>Company</th>
<th>Country</th>
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<tbody>
<tr>
<td>Aerotech</td>
<td>USA</td>
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<tr>
<td>Alliant Techsystems</td>
<td>USA</td>
</tr>
<tr>
<td>Aryt Industries</td>
<td>Israel</td>
</tr>
<tr>
<td>China Aerospace Science and Technology Corp</td>
<td>China</td>
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<tr>
<td>China North Industries Corporation</td>
<td>China</td>
</tr>
<tr>
<td>China Poly Group Corporation</td>
<td>China</td>
</tr>
<tr>
<td>General Dynamics</td>
<td>USA</td>
</tr>
<tr>
<td>Hanwha Corporation</td>
<td>South Korea</td>
</tr>
<tr>
<td>Hellenic Defense Systems</td>
<td>Greece</td>
</tr>
<tr>
<td>Israel Military Industries</td>
<td>Israel</td>
</tr>
<tr>
<td>L-3 Communications Holdings</td>
<td>USA</td>
</tr>
<tr>
<td>Larsen &amp; Toubro</td>
<td>India</td>
</tr>
<tr>
<td>Lockheed Martin</td>
<td>USA</td>
</tr>
<tr>
<td>Motovilikhsieya Zavod</td>
<td>Russia</td>
</tr>
<tr>
<td>Poongsan Holdings</td>
<td>South Korea</td>
</tr>
<tr>
<td>Raytheon</td>
<td>USA</td>
</tr>
<tr>
<td>Roketsan</td>
<td>Turkey</td>
</tr>
<tr>
<td>S&amp;T Dynamics</td>
<td>South Korea</td>
</tr>
<tr>
<td>Tata Power</td>
<td>India</td>
</tr>
<tr>
<td>Textron</td>
<td>USA</td>
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Exercise of voting rights

1. Overall data on votes cast by the FRR during the 2016 season

The FRR voted on 2,176 shares in 36 countries during 2016.
This represented 72,314 resolutions at 2,610 general meetings.
The FRR attended 99.4% of general meetings, being absent from just 16, which equates to 0.6% of the total.
The difficulties encountered by the FRR’s managers, and any lack of vote, often resulted from the specific characteristics of local regulations, in particular the blocking of shares before a general meeting, or in the event of split voting. It is also worth remembering that although the investment managers are systematically required to vote on shares held in the portfolio, in the absence of a periodic “rebalancing” of indices through index-linked management, it may be that they are unable to vote on a share due to it being blocked several days before the general meeting. The main countries giving rise to rejected votes were:

- Germany (blocking share),
- Italy (blocking share),
- Norway (blocking share),
- Luxembourg (blocking share),
- Switzerland (blocking share),
- Portugal (split voting),
- Spain (another reason).

Although the FRR’s investment managers are required to avoid not voting, their attendance at general meetings is subject to the rebalancing and holding of the share in benchmark indices. This is the main reason for the high percentage of these mandates in the votes rejected.

In terms of voting breakdown, the number of votes FOR resolutions has been relatively stable over time, at 86.8% in 2016. This figure can be explained by the regional diversification of the FRR’s investments. Therefore, even if a country has a stormy general assembly season, the other countries would not necessarily be affected, which explains this relatively stable percentage of votes in favour within the FRR’s portfolio.

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8 Situation in which more than one investment manager must simultaneously vote on the same share. Only a few countries ban split voting.
2. **Breakdown of the FRR’s portfolio within the context of general meetings in 2016**

As an institutional investor, the FRR is invested in the world’s leading markets, and therefore attends local issuers’ general assemblies in the portfolio’s 36 countries. Governance practices for small and mid-cap companies are different from those for large caps. This diversification of investments automatically makes it harder to compare one company with another, for example regarding the composition and diversification of the board of directors. Various trends may therefore be taken into account: at an overall portfolio level, where they are not very suggestive but reflect macro trends likely to be shared by the markets; and locally, where they are more similar.

Different trends appear if we look at the situation from a small or large-cap perspective. Disagreement over small caps is often clearer. This is because they are often less transparent, especially for determining the performance criteria that will unlock variable remuneration (award of stock options or bonus shares). This category of resolutions also happens to be the most disputed. Resolutions concerning limits on capital increases are hotly debated as small and mid-cap companies often want more flexibility. Also, regulated agreements between companies and any holding structures may seem opaque, and prompt a “no” vote from investors. Yet small and mid-cap companies are increasingly taking governance standards into account.

Some countries, such as Germany, have seen votes against pay rises become much more commonplace, with a rejection rate close to that of 2010.

Unlike small and mid caps, the average approval rate for large caps’ say-on-pay resolutions was up in 2016 (CAC 40 index).
With the amendment to the Sapin 2 act aimed at limiting director pay, voting by shareholders attending the general meeting will now be binding on the board of directors. This constitutes real progress and a proper restraining influence by shareholders. We will just have to see how things pan out in 2017.

The incorporation of environmental issues also seems to be taking root, and companies are showing an increasing tendency to highlight their environmental and social responsibility. The integration of these new issues into a company’s global strategy reflects the beginnings of performance based on more long-term criteria, perhaps showing greater awareness of the risks associated with ecological and energy transition. This is another positive move worth highlighting.

The tendency towards greater equality on boards of directors also continues. Although the FRR supports this, it has not forgotten that a board of directors must be staffed by competent, available directors (problem with the accumulation of mandates).