Fundamentals:

Healthy debate.

The most successful companies evolve. It is the quality of the decisions made by the management team that shapes this evolution and that can propel a company successfully into the future. Fail to evolve and early business progress can come to a spectacular and grinding halt.

In this edition of Fundamentals, Sacha Sadan, Legal & General Investment Management's (LGIM) new Director of Corporate Governance, explains how the composition of a company's board of directors is critical to the quality of the decisions they make - and therefore inextricably linked to the long-term value of the business.

One individual can be highly influential in the initial stages of a company's corporate life. After all, the pace of growth and success of many businesses in their infancy is determined by the vision and acumen of their founders. In order for this success to have longevity as the business grows and matures however, the decisions of the incumbent leadership need to be continually challenged by fresh insight.

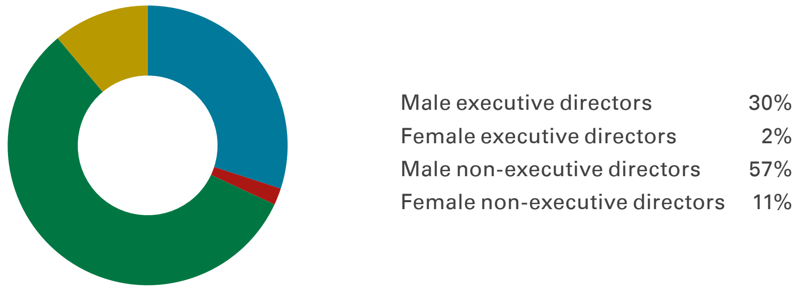
We believe strongly that it is only through persistent and rigorous debate that truly informed decisions can be made with any consistency. The balance of any company's board of directors is therefore absolutely crucial to the long-term success of the underlying business.

DEFINING DIVERSITY

The diversity of a company's board of directors is currently a hot topic in the world of corporate governance. While much of the debate surrounding the subject has focused on the important issue of gender, we believe that there is a great deal more to the story. We believe diversity is not just about quotas and checklists.

Legal & General INVESTMENT MANAGEMENT

Figure 1. Composition of FTSE 100 boards by gender and role



Source: Based on the data from The Female FTSE Board Report 2010

Rather, it is about optimising the balance and structure of a board to raise the level of debate, improve business decision making and to create long-term value for shareholders.

Nevertheless, there is still a role for numbers. Statistics can, and often do, reveal key shortcomings within a business and indicate where further analysis is required. In order to determine whether the decision-making process at the board level is truly diverse it must be evaluated in relation to where the company is based, where it operates and in relation to the stakeholders the business represents. In that context, we believe the issue of diversity is not simply limited to gender, but includes age, nationality and experience.

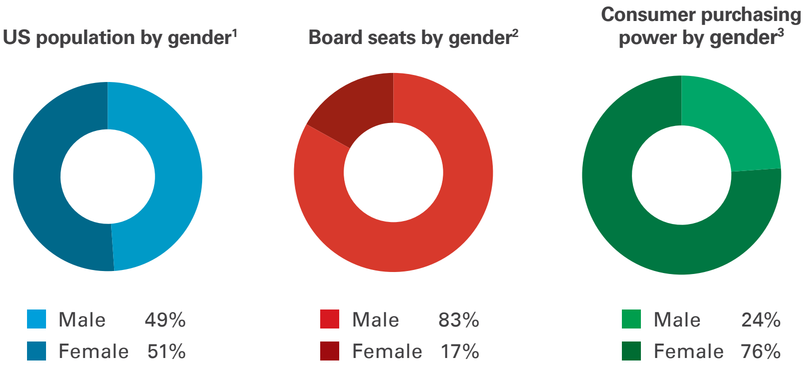
KEY ATTRIBUTES OF A DIVERSE BOARD INCLUDE:

- **Gender** – While gender is not the only aspect to diversity by any means, it is an important one. There is significant research available which shows that companies with a higher female representation on their boards have performed better than their peers. Given what is generally a low proportion of females to begin with (**figure 1**), the benefits to company performance may be explained by the greater insight this brings to many companies.

For example, **figure 2** emphasises the opportunity that greater gender diversification can bring to a company. In the US, while women comprise just over half of the US population, board seats are still dominated by men and this disparity is even more concerning considering that women control a significantly higher proportion of consumer purchasing power.

- **Demographics** – Age is important when considering diversity. Most surveys show the average age of a director in the UK being well into the late 50s while board chairmen are likely to be closer to their mid 60s. Given the rapid advancements in technology that continue to redefine markets and the fact that younger generations are far quicker to embrace these developments, we must question whether this decision-making group is the most informed. If a board's views are not aligned to the target demographic of the business, nor properly informed of the changing behaviour of their customers, then there is an increased risk of missing potentially significant growth opportunities and of losing overall market share.
- **Globalisation** – Country borders are becoming less and less important in the corporate world. Differing nationalities can bring vital insights to a board and raise the overall level of debate. For example, **figure 3** shows the clear lack of ethnic diversity on US boards. The UK could also do with greater diversity - around 24% of UK directors are from outside of the UK while some 70% of revenues for UK business come from outside of the UK.
- **Experience** – breadth rather than length of experience should be the focus here as differing executive skill sets can only benefit a company. For example, the addition of environmental expertise to any board can

Figure 2. US gender splits



Source: [1]US Census 2006. [2]Women and Minorities on Fortune 100 Boards, The Alliance for Board Diversity, 2008. [3]Buying Power, Catalyst, 2008

Figure 3. Number of US board seats by ethnicity

Source: Women and Minorities on Fortune 100 Boards, The Alliance for Board Diversity, 2008

be beneficial on many levels including new business wins and client retention, improving the sustainability of business practices and, therefore, strengthening the business franchise and exploiting changing consumer behavior. Toyota is a good example of this. The company's success with employing hybrid fuel technology in cars has enabled it to cash in ahead of a trend. The company will be seen as an innovator and market leader in hybrid technology for many years to come. Furthermore, as displayed in **figure 4**, experience can cover a number of key business characteristics which are essential for a healthy growing business.

WHY DIVERSITY MATTERS

Board diversity is just one part of the wider field of 'corporate governance' whose focus is on best business practice. Corporate governance involves protecting shareholders' interests and aligning those interests to those of the management team. However, the fundamental focus of corporate governance (and therefore board diversity) is the ability to improve business decision making, minimise business risk, improve the sustainability of profits growth and therefore maximise long-term returns for shareholders.

Indeed, the development of corporate governance as a discipline has been driven as much if not more by financial motivations as by the desire to 'do the right thing'. The simple reason is that many surveys have shown that companies with strong corporate governance outperform their more poorly governed peers over the long term.

Essentially, there are some crucial rules of thumb to direct a company towards achieving board diversity as part of broader good corporate governance:

- **Don't just look good, be good** - Much of the discussion surrounding the diversity of a board of directors focuses on the role of gender and points to quotas in order to establish that 'board diversity' is being achieved. This misses the point of corporate governance on a number of levels. Diversity must be measured in all its forms and qualitatively, not just through ticking off a checklist.

  Disclosure on how board diversity is being achieved by a company and the measures it has adopted should not be overlooked as these are important indicators for shareholders on how the company is approaching this important issue. UK companies are still not disclosing such information although this is likely to improve following the recent Davies Review.

- **Think outside the box** - For a business to make the best decisions possible, the best quality information is required

Figure 4. Board skills representation

Snapshot of 15 Fortune 100 Companies with high levels of diverse representation
Scale: 1 to 5; 5 = strong skill, 3 = moderate skill, 1 = weak skill

Company	Executive management experience	Accounting & finance knowledge	International experience	Co. specific industry knowledge	Customer experience	Legal knowledge
Aetna	5	1	1	2	1	1
Alcoa	5	1	2	2	1	1
CitiGroup	5	1	3	2	1	1
Deere & Co	5	1	2	2	2	1
Dow Chemical	5	1	3	5	1	1
DuPont	5	1	3	5	1	1
General Electric	5	1	2	2	1	1
The Hartford	5	1	1	3	1	1
Honeywell	5	1	2	2	1	1
IBM	5	2	3	2	1	1
Mass Mutual	5	1	1	3	2	1
PepsiCo	5	2	2	2	2	1
Wal-Mart	5	1	2	3	1	1
The Walt Disney Co.	5	1	2	2	1	1
Wells Fargo	5	1	3	3	1	2

Source: Virtcom Consulting analytics

alongside rigorous debate. This rigour is only achieved through a diverse board whose members offer truly fresh insights from a variety of perspectives.

- **Seize the day** - Diversity is not simply about protecting the business from risks, it is equally about identifying and capturing opportunities. A diverse board also has a greater potential to attract high quality employees from a far wider range of fields and backgrounds. This 'virtuous circle' serves to further strengthen and sustain the business.
- **Lead by example** - Part of the potential to attract new employees directly links to the reputation of the company and how it promotes diversity both internally and externally. Diversity in the boardroom may signal to more junior employees that the company encourages change, is open and fair. These attributes may help retain highly skilled staff and attract high quality employees from a far broader selection of candidates.

DIVERSITY FINALLY ON THE AGENDA…

As one of the UK's largest investors, LGIM is highly active in challenging the composition of boards and bringing diversity into the broader discussion on board nominations and succession planning. For the 2011 calendar year to the date of this publication, LGIM has engaged with over 200 companies regarding corporate governance and the role of board diversity has been raised at a majority of these meetings. Most promisingly, in all cases the discussions have been welcomed by the companies, who recognise that further progress in this respect will only strengthen their business over time.

Encouraging developments include the fact that even the traditional UK bookmaking company, William Hill, has recently taken strides to expand the diversity of the board through appointing two women on the basis of their strength in media and retail experience.

…YET STILL EARLY DAYS

While these developments are encouraging, greater pressure needs to be put on boards to improve diversity on many levels. In particular, boards should consider:

- **Greater networking** - Companies need to leverage on the relationships they have with other businesses in their industry to help identify candidates with suitable skills and industry knowledge.
- **Widen the recruitment net** - Individuals who may not yet be CEOs but who hold high leadership positions should also be considered in the pool of candidates.
- **Ground roots** - Companies need to interact with head hunters to extend the diverse pool of candidates for the recruitment of key people. Key investors have a role to play here in interacting with head hunters and investment advisors. LGIM has been involved in this area playing an educational role from the start. We have seen companies increasingly looking for our input in recruitment and we are becoming more and more involved in finding the right people.
- **Pipeline and succession planning** - The board nomination committee needs to change the way it seeks new candidates – the future requirements of the company should be analysed and a truly diverse selection of qualified candidates should be put forward ahead of board vacancies.
- **Organic growth** – The talent of a company should be nurtured - internal recruitment is far cheaper, and often a better cultural fit.

THE BOTTOM LINE

Quotas and checklists are not the answer to achieving board diversity. While non-executive directors educated on the merits of diversity can help challenge the executives on board composition and help improve matters, there is a crucial role for large, long-term shareholders to monitor and drive change through time.

Sound corporate governance is a business practice that should never be viewed as an afterthought, or a series of external checks and balances that have to be done rather than should be done. To have the greatest positive long-term impact on a business it must be encouraged and fostered from within the very core of a company.

Market overview:

The bounce back

October saw a sharp rebound in global equity markets on growing optimism that there would be decisive action to address the European sovereign debt crisis, although scepticism about the lack of clarity in the measures and political obstacles resurfaced as the month drew to a close.

EQUITY OVERVIEW

As at 31 October 2011

Total return (denominated in £)		
Country	Monthly return (%)	2011 year-to-date (%)
UK	7.9%	-3.9%
US	7.0%	-2.7%
Europe	8.2%	-10.7%
Japan	-3.8%	-13.1%
Asia	9.6%	-9.6%

Source: Datastream, FTSE® indices shown

UK

Back to the printing press

The Bank of England opted to resume its quantitative easing (QE) programme, announcing it would pump a further £75 billion into the economy, mainly through further purchases of gilts in an attempt to revive credit growth.

The worsening situation in the euro zone and weaker domestic economic indicators had been the catalyst for this latest move, although most had anticipated the Bank would wait at least until November for further clarification on the economic background. Significantly, Bank officials subsequently indicated they stood ready to carry out further QE if necessary.

UK GDP growth for the third quarter came in ahead of expectations although the closely-watched PMI manufacturing survey, and the important new orders component, signalled a contraction going forward. The UK equity market was led higher by cyclical sectors – chiefly leisure goods, engineering and mining. Amongst the latter, leading resources stocks such as Vedanta and Xstrata rallied on higher metal prices. Utilities and construction stocks were the main laggards.

US

Good news travels fast

Banking and highly cyclical materials stocks led the rally in the US equity market, with the S&P 500 Index posting its biggest monthly gain since 1991. Progress at the EU summit in late October, where European leaders agreed a sovereign debt and bank recapitalisation deal, was the catalyst for a relief rally in US banks. An encouraging monthly purchasing managers' index survey from China triggered a rebound in materials stocks such as Alpha Natural Resources, which supplies China with coal for use in steel production, and copper producer Freeport McMoran.

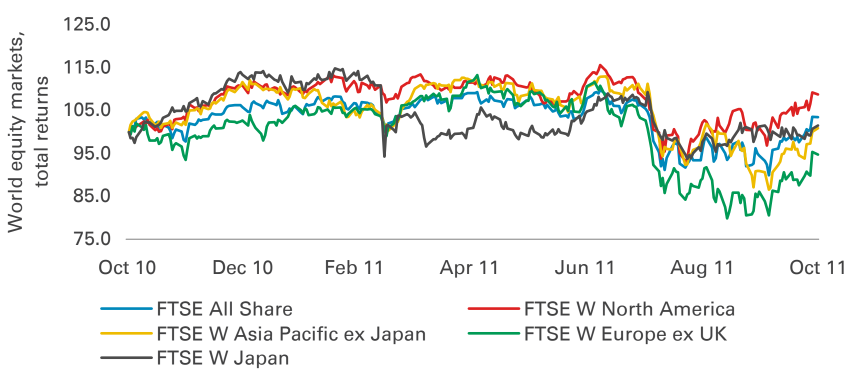
The majority of third quarter earnings announcements were encouraging for investors. Construction and mining equipment manufacturer Caterpillar delivered its best ever quarterly sales figures over the three months to end of September, with its order backlog at an all-time high. The latest US GDP data, which showed the economy expanded by 2.5% during the third quarter in line with expectations, also provided some reassurance for investors. Technology stocks were boosted by further merger and acquisition activity with business software group Oracle announcing a $1.5 billion deal to acquire online customer service company RightNow Technologies.

EUROPE

Time for a haircut

A series of agreements designed to address the deepening sovereign debt crisis was the catalyst for European equities to erase much of their summer losses, although they remain firmly in negative territory year-to-date. At the EU summit in late October, private investors agreed to a 50% 'haircut' on holdings of Greek

Figure 1. Major equity markets – total returns (denominated in £)



Source: Datastream, FTSE® indices shown

sovereign debt, while euro-area banks are now obliged to raise €106bn in capital by June 2012.

Two options were also proposed for beefing up the EFSF – an insurance scheme providing additional credit enhancement for new bonds issued by sovereign states, and a Special Purpose Investment Vehicle (SPIV) combining public and private capital to extend loans and buy bonds in the primary and secondary market. French banks, some of which are heavily exposed to Greek debt, led the rally amongst financials. Overall, cyclical sectors such as steel, autos, mining and energy stocks led the October rebound while traditionally defensive areas such as household goods, food producers, utilities and pharmaceuticals lagged.

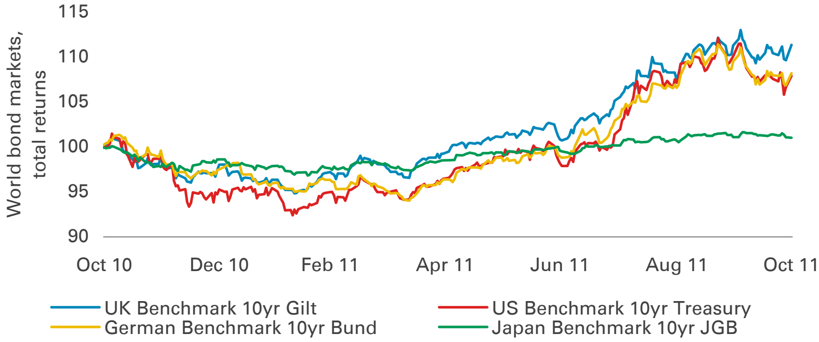
JAPAN

Caution continues

Japanese equities underperformed other international markets during October. Although the leading Nikkei 225 Index gained ground in local currency terms, the weakness of the yen translated into losses for UK-based investors. Significantly, turnover in the Japanese equity market was relatively low, signalling an underlying mood of caution amongst investors. The Bank of Japan intervened on the foreign exchange markets to weaken the yen, as a counterweight to what were cited as speculative moves that do not reflect the fundamental economic outlook.

Indicators released during October painted a mixed picture of activity. The third quarter Tankan survey of business confidence was broadly positive but after five months of consecutive gains since the March earthquake, industrial production fell back in September.

Figure 2. Major bond markets – total returns (denominated in £)



Source: Datastream

ASIA PACIFIC/EMEA

Fearful investors flee

Asia Pacific and emerging markets (EM) rebounded sharply in October, encouraged by signs of progress in addressing the European sovereign debt crisis and the release of indicators which highlighted the continued strength of the Chinese economy. The latest Chinese industrial production figures for September were slightly stronger than expected as electricity production rebounded, while business confidence indicators remain robust. The Chinese authorities also signalled their intention to keep the renminbi relatively stable to protect exporters.

The Thai stock market recorded double-digit percentage gains in local currency terms despite serious flash-flooding in Bangkok, while the turnaround in commodity markets boosted Australian equities. In the EM space, we saw strong performance from Central and Eastern European markets, which had fallen back heavily during the third quarter as the euro zone's difficulties intensified. Significantly, recent weakness in EM currencies has also corrected as foreign exchange markets became less volatile and funding strains eased.

FIXED INTEREST

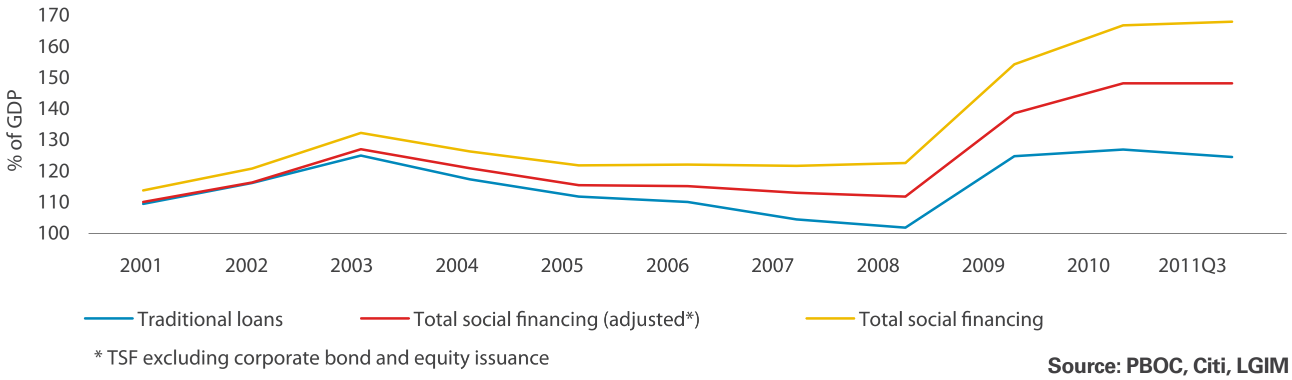
High yield corporate bonds and EM debt rebounded in October, reflecting an improvement in investor sentiment as global economic indicators were broadly encouraging and progress was made on negotiations to address the euro zone debt crisis. Significantly benchmark 10-year yields in the core markets of US, Germany and the UK, considered to be relative 'safe havens' in times of crisis, rose over the month. Although UK gilts found some support from a further round of QE, it was significant that the Bank of England's latest auction of 25-year securities was only covered 1.06 times, highlighting the risks for the gilt market with yields at historic lows. Internationally, all eyes were on developments in Europe. Although the agreement outlined at the EU summit lent support for peripheral bond markets in the region, 10-year Italian government bond yields climbed to just below 6.2% in late October. This is dangerously close to the 6.5% threshold that markets believe could trigger a call by Italy to follow Greece, Ireland and Portugal in seeking an EU bailout. Italy needs to rollover over more than €250 billion next year to finance its debt burden amounting to 120% of GDP.

Snapshot:
China – firm landing

Fears of a hard landing in China have risen during the past month as slowing world trade has accompanied increasing evidence that monetary tightening is taking a grip on the domestic economy. While the external shock appears far less severe than late 2008 - when annualised GDP growth dipped well below 5% – current concerns have been fuelled by the sharp run-up in leverage that China has experienced during the last three years.

Aggressive policy stimulus kick-started the process in early 2009, but credit expansion then became deeply entrenched in banks' behaviour, to the extent that 2010 and the first half of 2011 saw a sharp rise in 'off-balance sheet' lending as banks sought to circumvent the authorities subsequent efforts to cool the economy. This entailed the expansion of wealth management products and entrusted loans as a means of offering depositors interest rates above officially capped rates and getting around loan quotas. Bank lending including these off-balance sheet items rose to 148% of GDP at the end of 2010, significantly higher than the previous peak in 2003 (**figure 1**).

Figure 1. China: Bank credit and off-balance sheet lending

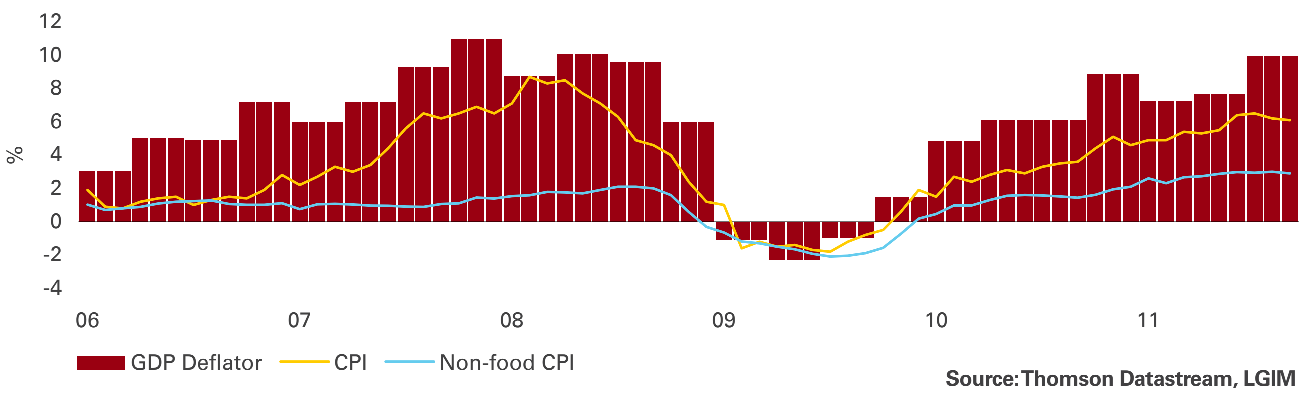


Source: PBOC, Citi, LGIM

Higher credit levels amplify the impact of monetary policy tightening on the economy. And as the authorities have recently sought to clampdown on off-balance sheet lending, financing pressures have emerged in the small and medium sized enterprise and property sectors and in the informal 'kerb-lending' market.

Renewed large-scale monetary policy easing seems some way off given that broader macroeconomic activity appears to be holding up quite well. Even more importantly, inflation pressures stoked by the credit boom are proving sticky. Whole economy unit labour cost growth is approaching 10% and GDP deflator inflation was still rising during the third quarter of 2011 (**figure 2**).

Figure 2. China: Inflation indicators



Source: Thomson Datastream, LGIM

Despite these hurdles, healthy household income growth and a large-scale government sponsored social house-building programme should help support the outlook for domestic demand. Also, China's high national savings rate, exceptionally strong external finances and fiscal flexibility mitigate against a very sharp slowdown in growth. Nevertheless, with both real estate investment and exports set to slow significantly, GDP growth is expected to fall below 8% next year, well short of the 10% to 11% pace averaged over the past decade.

UK forecast:
Walking a fine line

UK economy	Price inflation (HCP)		GDP (growth)		10 year Gilt yields		Base rates		$/£		£/€	
Market participants forecasts	2011 %	2012 %	2011 %	2012 %	2011 %	2012 %	2011 %	2012 %	2011	2012	2011	2012
High	4.80	3.30	1.10	2.00	3.10	2.81	0.50	0.50	1.63	1.81	0.92	0.95
Low	4.00	1.70	0.60	0.40	2.00	3.20	0.50	0.50	1.40	1.43	0.85	0.80
Median	4.50	2.80	0.90	1.30	2.30	2.75	0.50	0.50	1.56	1.63	0.87	0.85
Last month median	4.40	2.55	1.10	1.70	2.60	3.47	0.50	0.50	1.56	1.65	0.86	0.85
Legal & General Investment Management	**4.50**	**2.80**	**1.00**	**0.50**	**2.30**	**2.75**	**0.50**	**0.50**	**n/a**	**n/a**	**n/a**	**n/a**

Source: Bloomberg L.P. and LGIM estimates

The forecasts above are taken from Bloomberg and represent the views of between 20–40 different market participants (depending on the economic variable). The 'high' and 'low' figures shown above represent the highest/lowest single forecast from the sample. The median number takes the middle estimate from the entire sample.

According to the preliminary estimate from the Office for National Statistics (ONS), the UK economy grew by 0.5% during the third quarter of 2011. While this was higher than many market participants anticipated, the ONS suggested this was mostly due to the bounce back following the loss of a working day in the second quarter which the UK enjoyed thanks to the Royal Wedding. With survey data deteriorating, however, the UK economic recovery remains very fragile and continues to be at risk of dipping back into recession. Private sector activity remains very weak and unemployment continues to rise while we are still to see the full impact of government austerity measures.

While Chancellor Osborne has come under increasing pressure to slow or reverse the government's austerity programme in order to boost the economy, fear of a Greek-style crisis has kept the government focused on reducing their deficit. We believe that government debt will continue to rise and while the recent announcement of further quantitative easing (QE) provides some support to the economy, the effectiveness of further QE coupled with harsh government austerity measures remains highly uncertain.

Inflation remains at more than twice the Bank of England's 2% target and we believe this will remain sticky at elevated levels for the rest of the year due to the lagged effects of higher energy and other import prices experienced earlier in the year. We believe inflation will subside in 2012, however, once the impact of higher VAT falls out of the headline calculation and amidst a weak growth environment. The UK's significant surplus of skilled labour is also likely to keep labour costs low. As a result, both our reading and the median market participant's forecast show inflation easing to 2.8% in 2012.

For further information on Fundamentals, or for additional copies, please contact william.lea@lgim.com

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