

Half-yearly ESG report to members

Welcome to the second half-year report to members on Environmental, Social and Governance (ESG) issues. It is worthwhile reiterating that the welfare of many members in retirement will depend significantly on the superannuation benefit they receive, which is substantially determined by the returns that are generated on their contributions. We strongly believe that an in-depth understanding of the material risks and opportunities of our investments is an inherent requirement of meeting our fiduciary duty to our members. Amongst a range of other factors, we consider ESG risks, impacts and opportunities when making investment decisions in order to protect and manage members' retirement savings. All other things being equal, managers, companies and governments that best manage ESG factors are more likely to be financially sustainable in the long term.

Australian Shares

During the six months to 30 June 2012 Sunsuper voted on 350 resolutions at 77 meetings of listed Australian entities. It is noteworthy that Sunsuper voted against approximately 21 per cent of remuneration reports and 39 per cent of equity incentive grants. Many of these grants had poor or non-existent performance benchmarks, reflected a timeframe that was overly short-term or were proposed to be granted to non-executive directors.

Resolution Type	For	Against	Abstain
Remuneration Report	38	8	0
Equity Remuneration	57	22	0
NED Remuneration	1	0	0
Director Election	120	7	0
Changes to Capitalisation	58	3	8*
Other	28	0	0
TOTAL	302	40	8*

Table 1: Majority votes during period

* Abstentions were generally made in circumstances where the manager was a party to the transaction.

Proxy Vote Categories

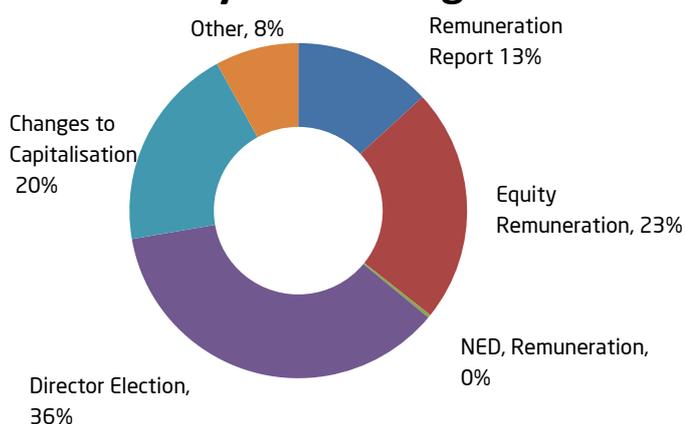


Chart 1: Categories of votes during period

How Sunsuper Voted

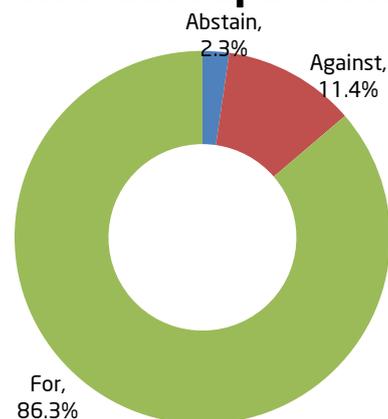


Chart 2: How Sunsuper voted during period

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ASX Listing Rule amendments

In May 2012 the Australian Securities Exchange (ASX) proposed a number of changes to its Listing Rules, concerning relaxation of capital raising requirements for companies with under \$300 million market capitalisation. Sunsuper provided feedback to Australian Securities and Investment Commission (ASIC) on the proposals prior to its submission to the exchange.

The ASX subsequently announced the results of its consultation process, following regulatory clearance by ASIC of new measures that apply from August 1, 2012.

The revised Listing Rules have addressed the major concerns raised by Sunsuper. In particular:

- The new capital raising rules will only apply to companies that have below \$300 million market capitalisation and are outside the S&P/ASX 300 Index.
- The approval threshold for the new measures has been raised from an ordinary resolution at a company's AGM to a special resolution, requiring consent of at least 75 per cent of the company's existing shareholder base.
- Company boards will now have to explain their rationale for seeking access to the additional capital raising mechanism rather than utilising a pro-rata capital raising mechanism such as a rights issue.

Carbon Tax Impacts

The impact of the carbon price on the portfolio has not yielded any major surprises. Potential issues being monitored include:

- The ability to pass through costs to consumers in this economic climate: Initial assumptions may have underestimated the difficulty of some consumer-facing firms to simply increase their prices to pass on the carbon tax.
- The debate over the use of international credits when the Emission Trading Scheme is implemented: Up to 50 per cent of the liability may be met by foreign credits, however there is increasing pressure to lift this proportion.
- The debate over the 2015 floor price: Previously set at A\$15, the originally mooted floor price was substantially above the spot price in Europe (A\$8) and New Zealand (A\$3.50). Policy changes are likely to reduce this disparity, to the benefit of investee companies.
- The readiness of companies, auditors and the regulator: The regime is based on self-assessment and self-reporting, and involves a newly-created regulator. Teething issues may ensue.
- Stranded assets: Acceleration of the replacement of coal may lead to a revision of the value of coal reserves that may never be mined, which may have implications for the value of some miners.

Engagement

Over the period we directly engaged with companies on 24 occasions relating to environmental, social and governance issues. Similar to the prior half, governance issues dominated discussions. Also during the period discussions were held with a number of China-based investee companies held in Sunsuper's international equities portfolio. This engagement included a discussion of ownership and governance structures.

Hedge Funds

An assessment has been made of the issue of 'jumbo directors' identified by our hedge fund consultant. These directors are said to have rubber stamp services rather than genuine directorial responsibilities and are typically Cayman Islands-based. They are identified as having multiple directorships, sometimes many hundreds. Sunsuper's hedge fund portfolio has largely avoided investments in funds with jumbo directors on their boards.

Property

The prior half-year report discussed the positive relationship between office property valuation and green star environmental ratings. Sunsuper has collated the available data on the portfolio's green star ratings, which average a commendable 3.8 stars. Most notably, one of our flagship office buildings (and Sunsuper's headquarters) achieved an increase in rating to 5.5 stars, one of the highest rated buildings in the state.

Our ESG focus issues

There is a broad spectrum of environmental, social and governance considerations that can have an impact on investment returns, which we have narrowed into five key issues. These Sunsuper ESG Focus Issues are:

1. Board quality (Governance)
2. Proxy voting (Governance)
3. Coal seam gas (Environmental)
4. Workplace safety (Social)
5. Sustainability reporting (Environmental)

Board Quality: High quality boards are critical to the success of the firm. Conversely, poor quality boards can pose an unnecessary risk on shareholder value. Over recent years there has been a large amount of empirical research into the relationship between board gender diversity and financial performance. The results are telling. The most recently published research by Credit Suisse has found that:

- Large sized stocks with women board members outperformed those without women board members by 26 per cent over the past six calendar years, with the strongest outperformance over the past four years
- For smaller stocks, the outperformance was 17 per cent over the same period
- The average return on equity of companies with at least one woman on the board over the period was 16 per cent, four percentage points higher than all-male boards
- The amount of debt held by companies with all-male boards was higher than those with female representation. Profit growth for companies with women on the board averaged 14 per cent, compared to 10 per cent for all-male boards
- The incidence of bankruptcy of companies with all-male boards is 20 per cent higher than those with at least one female director.

A number of reasons for this performance have been proffered, all backed by research:

- People are likely to do more preparation when they know it is going to involve working with a diverse rather than homogenous group
- A wider range of topics are likely to be debated in a diverse setting
- The proportion of female graduates across the world is 54 per cent, and females tend to achieve better results. Therefore, achieving gender diversity will more likely tap into a wider pool of talent
- Females tend to better understand consumer preferences and trends.

Given this consistent, meaningful and multidimensional relationship, our major holdings within the Australian Shares and International Shares asset classes have been reviewed, and engagement with some male-dominated boards is planned.

Proxy voting: Voting our considerable holdings at shareholder meetings represents one aspect of Sunsuper's involvement in the governance process of listed companies. Sunsuper is participating in an important new research project on proxy voting that is being commissioned by the Australian Council of Superannuation Investors (ACSI). The purpose of the project is to ascertain how many votes get lost within the 'proxy plumbing' - the somewhat antiquated process that delivers votes to the company registry. This data will then be used to develop a detailed, evidence-based case for regulatory reforms and technological innovations in Australia's proxy voting system.

Coal seam gas (CSG): CSG investment represents a considerable opportunity for both the state of Queensland and companies involved in CSG extraction, some of which are investee companies of Sunsuper, including Santos, Origin Energy and AGL. The efficacy of CSG in a transition to a low-carbon world continues to polarise the community. The abundance of coal methane has made it more cost-effective and the location of gas reserves arguably improves energy security for many developed nations. On the other hand there remains a sizeable degree of project risk attendant to Australian gas manufacture and developing research on fugitive emissions has questioned the environmental benefits of CSG. We are continuing to monitor and engage.

Workplace safety: Workplace safety is recognised as one of the primary social issues facing companies that can have a substantial impact on employee wellbeing, company reputation and, ultimately, financial results. Workplace safety results are typically reported to the market alongside financial results (i.e. after year-end), however we expect further improvements in safety metrics in Australia. Australian companies with foreign operations are more likely to adopt higher (Australian) standards and actively educate consumers about safety.

Quality of sustainability reporting: ACSI has produced its fifth Sustainability Reporting Practices Report, the highlights of which are:

- More than half of ASX200 companies fail to provide meaningful sustainability disclosure
- Many companies make statements about their commitment to sustainability but fail to provide details disclosure of their performance in this area
- However, 18 per cent of ASX200 companies are considered by ACSI to be 'Best Practice' sustainability reporters, and most of these fall into the ASX50
- The number of companies structuring their sustainability reporting to the Global Reporting Initiative (GRI) has stalled in the past three years.

All but one of Sunsuper's ten largest equity holdings have the highest ACSI rating of 'Best Practice'.

Outlook

Proxy voting will take the spotlight in the second half of 2012, with the major Annual General Meeting season due to commence in October.

The impact on the portfolio of the carbon tax and any tweaks it undergoes will continue to be monitored, and engagement with the fund's largest Australian equities holdings will continue.

We are also considering which other alliances Sunsuper should commit to in order to best meet members' expectations. Finally, we will be working with managers in asset classes outside of listed equities to better integrate ESG considerations into their investment processes.