Fundamentals

Economic and Investment Commentary
June 2009

"The shareholders have spoken"

As the dust begins to settle on a financial system shaken to its core, investors are rightly asking: What could have been done to avoid the recent banking crisis? Were the processes, policies and laws governing corporations inadequate? Should shareholders have been more involved?
In this issue of Fundamentals, Legal & General Investment Management (LGIM) discuss the key challenges facing the system, how they may be addressed and what LGIM has been doing to build a healthier corporate environment.

Clearly, the UK's corporate governance framework failed to prevent the recent financial crisis. Unfortunately, identifying exactly where the limitations of the system lie is anything but straightforward. Some criticise policies and procedures, arguing for greater regulation on how corporations operate. However, history has demonstrated that even the most robust controls are simply not enough to combat the evolving nature of risk. Others argue that in addition to having checks and balances in place, the financial system also needs the right individuals, with the right motivation, monitoring any developments within a company and taking preventative action exactly when it is needed.

In the following paper we discuss the role of the institutional shareholder in promoting sound corporate governance, and address the limitations which investors face in successfully influencing management teams to behave in the best interests of their shareholders. We also explain possible steps that could be taken to promote better corporate governance practices and protect shareholder value.

What is corporate governance and why is it important?

We define corporate governance as:

"The framework within which the board controls and monitors the business of the company. It focuses on the responsibility of directors for setting strategic aims, establishing financial policies and overseeing the implementation as well as

Inside:

Article Contd.

reporting to shareholders on the activities and progress of the company. We consider good corporate governance and effective management as vital to the successful implementation of a company's corporate objectives".

As the recent crisis has so clearly displayed, when corporate governance fails, the ramifications can be extraordinary. There are a number of areas in which corporate governance is analysed in great detail by investors. The two main areas that typically attract the most attention are the effectiveness of Boards and the remuneration of the executive directors.

With regards to the effectiveness of Boards, LGIM supports the UK Combined Code's approach, believing that a unitary Board (which includes a balance of both non-executive and executive directors) is the best structure to adopt in order to mitigate risk. In relation to a company's remuneration policy, LGIM has actively emphasised the importance of linking pay with long-term performance. We are convinced this promotes long term shareholder value and helps ensure that individuals are not rewarded if they fail.

It is clear that a range of shortcomings in corporate governance contributed to the banking crisis. However, before we discuss possible solutions which could build a stronger corporate governance structure, let us first examine our role as an institutional shareholder and the part we play in monitoring corporate governance.

Role of institutional shareholders

In the UK, institutional investors are responsible for the greatest proportion of the stock market, giving them the right motivation and the right level of access to the management teams running the UK's most influential corporations. As the largest investor in the UK stock market, LGIM has a vested interest in promoting a sound, effective corporate governance model.

Arguably, large institutional shareholders such as LGIM are in a better position to identify potential corporate governance risks than incumbent boards and management due to our ability as 'outsiders' to spot suboptimal governance structures. As external observers with no agenda other than the preservation of our own investment, institutional investors are appropriately motivated and incentivised to identify threats to a company.

We are also well placed to advise companies on market sentiment. With this information, companies gain a candid view of what investors think about the company's performance and can work on their weaknesses, with the aim of increasing shareholder value.

How do institutional shareholders respond to corporate governance concerns?

There are three reasons commonly cited by institutional investors for why they are not inclined to engage with companies on corporate governance issues.

1. Engagement does not form part of their investment process;
2. If they don't like how a company is operating, they can simply sell their stake and walk away; and
3. It is a waste of time and money.

The second of these reasons, investors 'voting with their feet', is the most commonly cited reason for a lack of engagement. However, while this action is possibly logical for shareholders who are not closely connected with the management of a company, we feel it misses the point. Investors typically start their engagement process by meeting a company before an investment is made. Prevention is the best way of solving corporate governance concerns and if investors wait until something has gone wrong before they start to engage, it will often be too late to solve the problem.

By engaging in a running dialogue with management, the most influential shareholders can challenge existing processes, identify potential issues facing a company and enhance the corporate governance framework as a whole.

While shareholders may be well placed to offer valuable outside perspectives to a management team, to be motivated to take action, the gains need to be larger than the cost of the effort. Openly opposing a management team may cost individual shareholders directly and be highly time consuming and because it may weaken the share price of the company, it could be counter-productive to shareholder interests.

Instead, the process of communicating concerns may be more successful for both parties if it is conducted behind closed doors and negative aspects are not displayed publicly. This quiet diplomacy is LGIM's preferred "modus operandi" and one where we have been very active in the lead up and throughout the recent financial crisis. During 2008 LGIM's senior executives and analysts met with 637 companies (out of these 133 were based purely on Corporate Governance) and made strong recommendations on everything to greater financial disclosure, challenging strategy and restructuring management teams.

Limitations to institutional shareholder influence

Whilst there is great value in institutional shareholder oversight, there are also a number of limitations to its effectiveness. These barriers are out of shareholders control and have emerged as a result of a natural consequence of the way the UK stock market has evolved.

Firstly, as institutional investors are analysing companies from the outside, they are not party to boardroom discussions. The actual decision making process is not seen and therefore investors are unable to judge how the board develops strategy and whether the appropriate stress testing scenarios have been correctly applied to mitigate risk. Furthermore, it is impossible to tell externally whether a board has an equal balance of

Article Contd.

power amongst its directors or whether one individual is dominating all the decisions because there is limited public information.

A second barrier to institutional investor activism is due to the fragmentation of equity ownership in the UK investment community, effectively allowing companies to 'divide and rule'. Most companies listed on the London Stock Exchange have a wide investor base with the total equity ownership from the largest shareholders having between 3%-5% each. Therefore, as each investor is pursuing their own goal and have their own agenda, they will act in the way they believe is right rather than how their fellow industry colleagues react to a situation. This means the impact of the decision made is small overall rather than if they collectively put their actions together.

Lastly, another barrier to institutional investor oversight is that the cost of monitoring is high which creates a 'free rider' problem. In practice, some institutional shareholders adopt a passive attitude because if they engage in monitoring corporate management, they will bear the whole cost of that activity and the rest of investment community and private shareholders will also benefit from this.

The only instance where an investor will be truly motivated to exert their rights is if their level of ownership is significant enough to ensure they receive sufficient benefit for the cost and effort involved.

During this banking crisis, shareholders have been criticised for being too passive and failing to challenge management, giving rise to a concept of companies being called "ownerless" corporations. However, the impact institutional shareholders can have on management relies critically on whether companies choose to listen to their advice.

Institutional shareholders often voice their opinions to boards and management teams. Indeed, in regards to the banks in particular, LGIM engaged extensively and saw on average one bank every two weeks during 2008. Our experience is that most of our concerns and issues were ignored.

LGIM's recommendations for positive change in corporate governance practice

- Annual re-election of Board Directors at general meetings to strengthen accountability.
- Nominations Committee to be chaired by the Senior Independent Director.
- Greater challenge on the Board from Non-Executive Directors including deeper probing into a company's affairs.
- Non-Executive Directors receiving more independent support from the Company Secretary for information and training requirements.
- An external performance evaluation to be conducted with a full audit report disclosed in the Annual Report & Accounts.
- An 'Investment Forum' where key parties can come together to voice their views and address any potential issues facing a company.
- Remuneration arrangements throughout the organisation to be considered by the Board and linked to risk management.
- International regulation and corporate governance standards in regulated industries to be consistent.

The Future – changes in the rules of engagement

LGIM is committed to building a healthier corporate environment. However, we firmly believe that unless there are changes in the way Boards are held accountable for their decisions, engagement will continue to have a limited effect. Critically, there needs to be a stronger mechanism in the market which upholds shareholders rights and ensures that when shareholders speak, management teams listen.

A few suggestions for future best practice are listed below.

(i) Voting at general meetings, the annual re-election of directors and external board performance evaluations

Although remuneration votes are advisory and not binding on the company, LGIM still expects a 'no' vote of 15% or above to cause the company to reconsider and make appropriate amendments. Due to the fragmentation of the shareholder register in companies, a 15% opposition should be enough of a signal to demonstrate that a number of investors are unhappy with their proposals.

In addition, our experience has found, at times, that direct engagement has been ineffective and not worked to our expectations. LGIM feels that more accountability needs to be placed on certain positions on the Board in order to emphasise the importance of their role and their authority. Therefore, LGIM would prefer, as a minimum, that the Board Chairman, Senior Independent Director and Chairman of the Board Committees stood for re-election annually. This will enable shareholders to express their views on any decisions taken by the Board and their Committees. Ultimately, over the longer term, we would like to see all the directors being re-elected annually.

In order for investors to gain a clearer view on whether a Board operates efficiently, LGIM would like to see external formal appraisals being conducted, especially for large companies, and for the results to be independently assessed, signed-off and disclosed in the Annual Report & Accounts – much like an audit report. Such disclosure improves transparency and will aid investors in judging potential risks relating to the operational performance of the Board and its Directors.

(ii) Role of Non-Executive Directors

LGIM believes that independent Non-Executive Directors of a company play a crucial role in the oversight of executives and the safeguarding of shareholders' interests. As a result, Non-Executives have a very important task in the maintenance of corporate governance standards and are ultimately acting as the eyes and ears for investors in the boardroom.

Article Contd.

The current economic crisis highlights room for improvement in this area. The failure to notice flaws in strategies indicates the need for more focus on "boardroom performance, not conformance". Areas which need to be taken into account not only include experience and qualifications, but also the ability to scrutinise management and identify threats to business models. Having procedures and controls is simply not enough to combat the evolving nature of risk.

We expect Non-Executive Directors to be more committed, probe deeper into a company's affairs and spend more time in companies, in order to better understand the business models and the risks involved in pursuing strategy. Since we expect more from them, we also acknowledge the need for Non-Executive Directors to be remunerated for their added-value accordingly.

LGIM also believes that Non-Executive Directors should generally not be employed full time. They are not expected to run the company and in fact spending too much time with management actually may increase the chance of their independence being impeded. However, there may be exceptions to this if a company is more complex, the position itself is very demanding and the sector in which the company operates is highly regulated (e.g. the banking sector).

We take the view that Non-Executive Directors have a special responsibility to create a better understanding between management and shareholders. Effective engagement is crucial to building this long term relationship and trust on both sides is paramount to creating a sustainable connection. Only when this is achieved can we mitigate the risks that are damaging companies today.

Many directors have suggested that there is insufficient challenge to the Board Chairman because the Non-Executive Directors are concerned about being re-appointed. We believe that by passing the Chairmanship of the Nominations Committee to the Senior Independent Director, this issue would be resolved.

(iii) Collective action – a meeting of minds

LGIM has often found collective action (i.e. investors getting together) can be more effective than one-on-one meetings with a company. This is an argument for more united action between investors, in order to deal with high profile contentious issues. There is a need for an 'investment forum' where the key parties can come together to voice their views and address any potential issues facing a company.

In saying this, however, LGIM feels that relationship with companies is built on trust and understanding. Therefore, individual meetings between shareholders and the companies in which they invest should always be welcomed.

(iv) Role of government and regulators

LGIM believes that further government regulation may not be the most appropriate solution to tackling corporate governance short-comings in all industries. Government intervention may constrain innovation, lead to unnecessary burdens on companies and be difficult to enforce.

Rather, legislators should focus on tilting the institutions' incentives towards enhanced activism and reduce the cost of barriers to joint shareholder action. By doing this they can help to increase the effectiveness of shareholder 'voice' and engagement.

However, in saying this, LGIM recognises the importance of regulation in some institutions due to their impact on the wider international economy. In relation to the financial sector, supervision by regulators needs to be enhanced and harmonised to facilitate the observation of large banking corporations, which often involves complex and cross-border activities. Such co-operation between international governments will increase the efficiency and performance of regulation.

Leading the debate

Corporate governance is an imperfect science. The topic is subjective in nature and without a 'one size fits all' solution, obtaining an optimal structure for a company that creates the best value for shareholders and minimises risk is something of an art form.

Instead, corporate governance should be viewed as an evolving process which needs to be explained fully and embedded within the value of the firm. Simply conforming to the rules and procedures are not enough.

If there is one clear message from the corporate scandals and failure of business models which have recently shaken the financial system and some of the UK's largest firms, it is that observing companies from the outside is just not enough. Change needs to come from the inside, which includes reviewing Non-Executive Director participation and Boards being more accountable for their actions.

As an institutional shareholder, LGIM has induced changes in governance structures and activities of firms by actively pressuring companies through ongoing engagement and dialogue. We believe that amidst the financial turmoil we have taken significant actions to preserve the long term value of shareholders and delivered on our duty as a leading institutional shareholder. However, unless directors of boards can say the same, the corporate governance environment will be left wanting.

The unprecedented events of the past two years have provided an opportunity for the financial industry to identify areas of weakness in its framework and restructure appropriately. So far this year, we have already witnessed a number of events where shareholders are starting to speak up and put their foot down. We firmly believe that by ensuring changes are also made to the way in which Boards are held accountable for their decisions, shareholder views will be more successfully implemented and adequate strides taken to revolutionise the corporate governance framework.

Market Overview

Recent economic data has generally continued to surprise market participants with its strength. Despite the fact that the economic backdrop remains weak, tentative signs of recovery have provided significant support for financial markets. Surveys which measure investor sentiment have continued to improve as global manufacturing production has started to pick up again. This activity, coupled with further evidence that credit conditions have improved has created stronger demand for home and car sales, particularly in economies with high savings rates.

However, while the economic picture is improving, financial markets have already significantly adjusted to the changing market environment, with equity markets having rallied significantly over the past few months. Major equity markets across the globe moved higher (in sterling terms) during the past three months and while they remain highly volatile, it appears likely we have seen the lowest points from equity markets for this recessionary period. However, the sustainability of recent market strength has been brought under question, with any further gains hinging on the sustainability of the economic recovery.

Equity Overview

UK

Gradual recovery

UK equities rose 3.7% in May, as tracked by the FTSE All Share price index. This follows a 9.5% gain in April and a 2.8% rise in March. Recent market strength has now paired back the losses experienced in the first months of the year, and the UK equity market ended May 2% higher than where it began the calendar year.

We are anticipating a stronger second half to 2009 for the UK economy as manufacturers restart production and world trade picks up. This should offset renewed concerns that consumer spending will be weaker as real incomes decline (due to lower wage growth and potentially higher taxes and inflation going forward).

While we believe UK economic growth should be positive next year, it is likely to remain below average during 2010 and equity market conditions are likely to remain volatile, with a wide spread of returns across market sectors. Businesses with strong franchises whose incomes are less tied to the economic cycle are likely to perform better in this environment.

US

Lagging the UK

The American equity market declined -2.3% in sterling terms during the month of May (measured by the FTSE All-World North America price index). This follows gains of 7.9% and 6.3% in March and April respectively. Since the start of 2009 US equities are down -7.1% in sterling terms. The significant appreciation in the sterling against the US dollar over the first five months of 2009 account for this negative return to UK based investors. In local terms the US equity market has increased 3.3% in the calendar year to date.

US economic data has continued to improve over the past month. Lending conditions have been better than expected and look likely to strengthen even further if house prices stabilise and corporate profitability improves. If retail sales, industrial production and home sales stabilise, it is possible that we see US economic data strengthen significantly over the summer.

The innovative efforts taken by the Federal Reserve (Fed) are continuing to support credit markets and are beginning to help households and businesses obtain loans again which should continue to support the US economy. However, as support from the government fades (following the boost to income from the Obama tax credits) consumer spending may falter. Job losses should ease later during the year, however job creation is unlikely before the end of 2010. In addition the recent rise in bond yields has resulted in a rise in mortgage rates which poses a risk for the US consumer recovery, therefore we are less optimistic about the prospects for the US economic recovery versus the UK.

EUROPE

Opportunistic investing

European equities, as measured by the FTSE AW – Developed Europe (ex UK) Price Index, rose 1.4% in sterling terms during the month of May. Together with gains experienced in March (8.2%) and April (10.3%), the market is now only -6.6% lower than at the start of the 2009 calendar year.

Economic growth across Europe has been weaker than we expected and we believe that this will ultimately be countered by even stronger gains once growth resumes. On the positive side car sales across key European markets have recovered from the lows they hit during the final quarter of 2008. Improving car sales data during the month of April has now come through from Germany, France, Italy and Spain.

Major Equity Markets – Total Returns £ 2008/2009

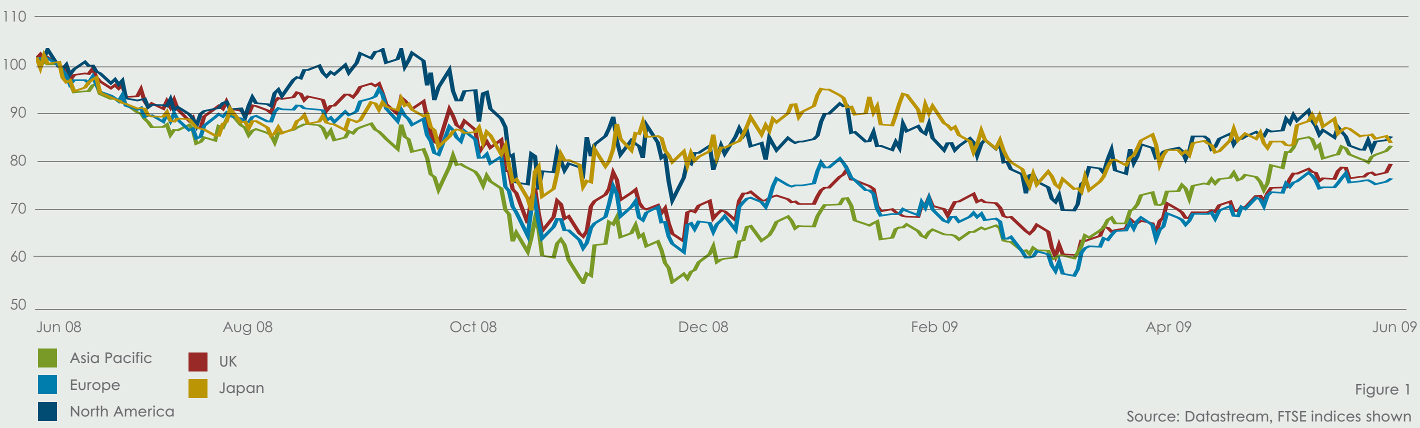

Figure 1

Source: Datastream, FTSE indices shown

Equity Overview Contd.

EUROPE (CONT/D.)

Opportunistic investing

The European Central Bank (ECB) cut official rates during the month of May to 1% and has recently taken the first steps towards quantitative easing by agreeing to purchase covered bonds. While economic conditions remain difficult, fears of deep recession have been replaced during the past month by opportunistic investing, as tentative signs of economic activity and growth have emerged.

Global trade ground to a halt last year as the credit crisis spread. More recently, global trade has begun to stir again. Shipping volumes are recovering slowly and demand (particularly from China) has begun to pick up. This has been positively received by many major European firms whose businesses rely heavily on exports.

JAPAN

Positive surprise in store?

The Japanese equity market rose 1.3% during the month of May (as measured by the FTSE AW – Japan total return index in sterling). After declining significantly in February, the market has now risen for three months in a row in sterling terms.

The rebound in equity markets across the developed world and tentative signs of strength from the global economy have supported Japanese equities during the past couple of months.

Japanese firms cut production extremely sharply during the past six months to reduce inventory levels. We believe that as world trade rebounds and government stimulus package kicks in, the Japanese economy should strengthen by more than most economists are anticipating, and GDP growth for 2010 may be significantly higher than average market projections suggest.

ASIA / EMERGING MARKETS

Strong gains amidst uncertainty

Emerging equity markets rallied significantly during the past month. As a whole the Asian equity market rose 3.2% in sterling terms (as measured by the Asia Pacific Ex Japan price index), with a wide dispersion of returns experienced across regional equity markets. For example, the Korean equity market rose only slightly over the month while Indian equities soared more than 30% higher. Other emerging markets also experienced stellar gains in the past month - the Russian equity market spiked as well and Brazilian equities produced double digit returns.

Emerging equity markets have strengthened considerably over the past few months as tentative signs of improvement in the global economic backdrop have emerged and global trade begins to stir. While growth from some Baltic countries continues to deteriorate, the Russian and Polish economies appear to be stabilising. There have also been some signs of improving domestic demand from many emerging economies, which suggests that financial markets and credit mechanisms have begun functioning more effectively.

Fixed Income

2008 was the year for government bonds as investors sought out capital preservation while the credit crisis played out and the global economy went into decline. After being shunned last year, there has been a renewed interest in corporate bonds in 2009 as investors have been attracted by their historically high yields in an environment of ultra-low gilt yields.

The recent performance from credit markets may indicate that the worst is now truly behind us. Lehman Brothers and the reckless lending of Icelandic banks is yesterday's news, and as green shoots of economic recovery seem to be poised to emerge, it is possible that the greatest fixed income returns this year will be found in corporate bond markets.

Major Bond Markets – Total Returns £ 2008/2009

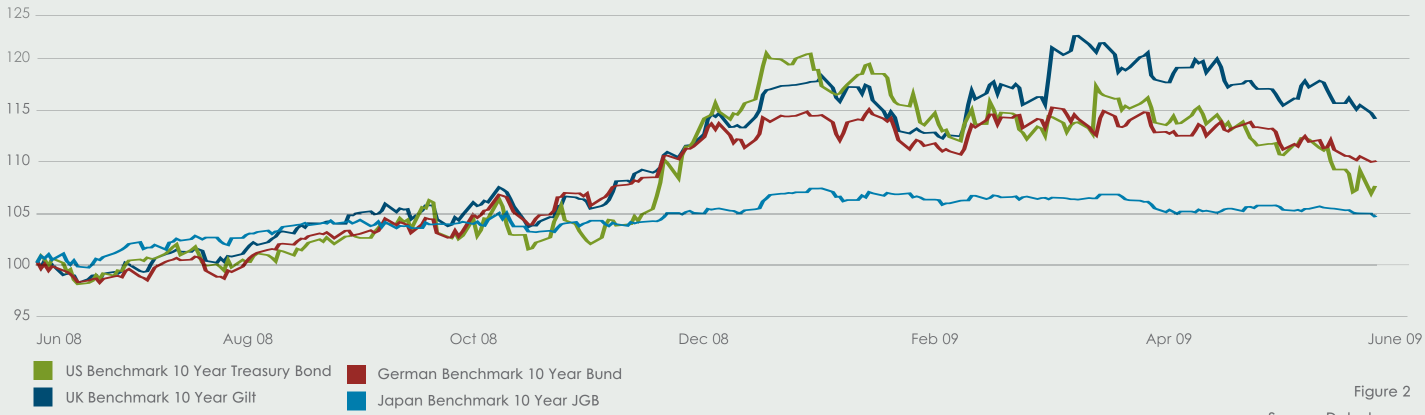

Figure 2

Source: Datastream

Snapshot

End of an empire

Emerging economies appear to be weathering the current economic storm better than developed ones. Capacity utilization rates in manufacturing have risen in recent months and are broadly in line with previous economic downturns. By contrast, developed world utilization rates have fallen much sharper than ever before and have yet to reach a bottom. This has surprised many sceptics who believe growth in emerging economies has only been driven by exporting goods to the beleaguered US consumer. Instead, there appears to be few signs of a consumer credit crunch in Brazil, India or China where car sales have rebounded to record highs. We believe the downturn in these economies in late 2008 was as much to do with policy tightening to combat soaring food and energy prices as it was weaker exports to the US.

Given the likelihood that consumer borrowing is likely to remain subdued in the developed world in coming years as households rebuild their balance sheets, the fate of developing economies will be increasingly important to financial markets. Between 2000 and 2010, we believe half of world growth will have come from emerging economies (Figure 1). This contrasts with just 13% in the decade 1990-2000 as unprofitable industries closed down following the collapse of communism.

Emerging economies have contributed around half of world growth over the last decade

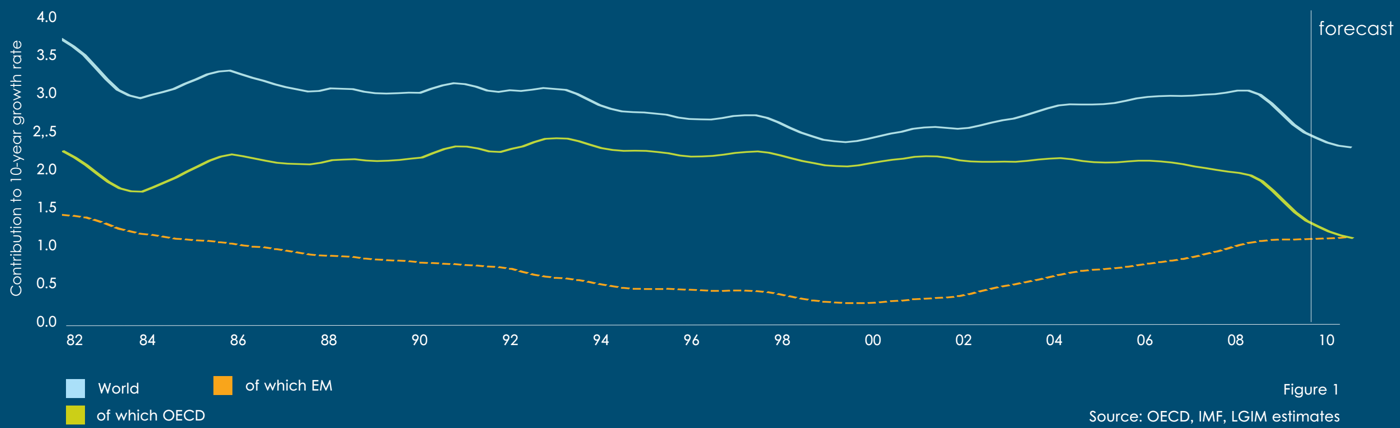

Figure 1
Source: OECD, IMF, LGIM estimates

Since then, technological transfer will have boosted productivity and real incomes. While export industries have clearly improved as a result of this, we believe the benefits of increased productivity have spread to the broader economy. In fact, we believe consumer goods sales have grown faster in emerging economies than in the developed world. For example, global car sales have remained stagnant over the past decade as a 33% reduction in the developed world sales has been offset by a doubling in emerging economy sales. Similarly, in volume terms, mobile phone growth has been around 7 times faster in emerging economies than in the developed world (Figure 2). For televisions, emerging economy sales have grown around 10 times faster. For personal computers, the growth rates have been similar. In other words, the emerging economy consumer is as – if not more – important than their developed world counterpart.

Mobile phone sales have grown 7 times faster in emerging economies

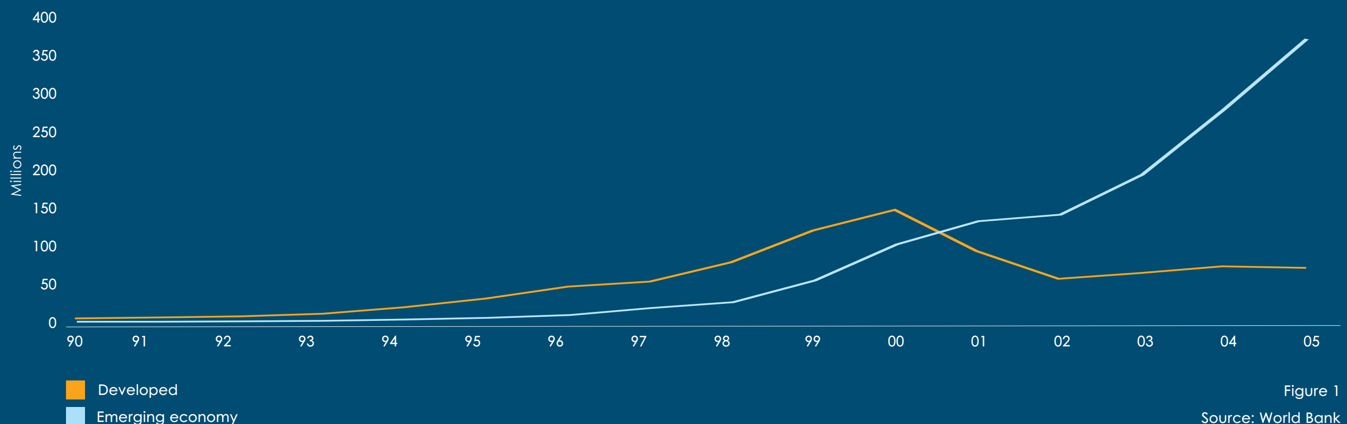

Figure 1
Source: World Bank

UK Forecast

More positive than the market

UK Economy	Price Inflation (HICP)		GDP (Growth)		10 Yr Gilt Yields		Base Rates		$/£		£/Euro	
	Average 2009	Average 2010	Average 2009	Average 2010	End 2009	End 2010	End 2009	End 2010	End 2009	End 2010	End 2009	End 2010
Market participants forecasts	%	%	%	%	%	%	%	%				
High	2.40	2.30	-3.40	1.90	4.10	4.10	1.00	1.50	1.86	1.90	0.95	1.06
Low	1.00	1.00	-4.60	-0.10	2.75	2.75	0.50	0.50	1.30	1.40	0.78	0.72
Median	1.65	1.50	-4.10	0.35	3.67	3.92	0.50	0.50	1.55	1.66	0.86	0.80
Last month median	1.30	1.50	-3.70	0.30	3.08	3.55	0.50	0.50	1.51	1.60	0.88	0.80
Legal & General Investment Management	**2.00**	**2.20**	**-3.30**	**1.90**	**3.50**	**4.00**	**0.50**	**0.50**	**n/a**	**n/a**	**n/a**	**n/a**

Source: Bloomberg and LGIM estimates

Amidst the current volatile environment, the table has been altered to extend the range of forecasts to capture a greater sample size. This now reflects more up-to-date adjustments. 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.

Our forecasts remain largely in-line with last month. However, as other market participants have made downward revisions, we now find ourselves significantly more optimistic on UK economic growth than the average forecaster.

While our fears surrounding UK GDP growth during the first half of this year were justified, our forecasts indicate a much stronger second half to 2009. Given the extent of recent policy initiatives which have been coordinated across the globe, we believe stabilisation of manufacturing output and recovery in housing will stimulate the UK economy. This month the median forecast from a Bloomberg survey of market participants shows the UK contracting -4.1% in 2009 and picking up only slightly in 2010 (at 0.35%). Alternatively, we anticipate a recovery of the magnitude of 1.9% for 2010 following a decline of -3.3% this year.

We continue to anticipate higher inflation than the median forecaster, in the magnitude of 2.0% for 2009 and 2.2 in 2010. While energy price cuts remain lacklustre and import prices are rising we feel that the Bank of England will need to revise their inflation expectations higher. However, we remain confident that inflation will be subdued in 2011, as weak profits will keep wages suppressed.

For further information on Fundamentals, or for additional copies, please contact Harriet Moore at harriet.moore@lgim.co.uk
For all IFA enquiries or for additional copies, please call 0845 273 0008 or email cst@landg.com
For an electronic version of this newsletter and previous versions please go to our website http://www.lgim.com/media-centre/fundamentals.shtml

Legal & General Investment Management Ltd, One Coleman Street, London, EC2R 5AA
www.lgim.com
Authorised and regulated by the Financial Services Authority