

Buying into sustainability

Environmental and social challenges in Trading, Distribution and Retailing

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Executive summary

The trading, distribution and retailing sector is the interface between the production of goods and the consumer. This sector's purchasing power effectively allows it to influence environmental and social conditions in the production chain. Its proximity to the customer also gives it the opportunity to develop markets for environmentally friendly and socially responsible goods, and to pass on these requirements to the supply chain. A parallel concern in this industry is the environmental burden associated with energy consumption and emissions generated by retail stores and transportation, as well as companies' social responsibility towards a comparatively unskilled workforce that tends to be employed on a part-time or on-demand basis.

Wholesalers and traders of industrial goods, which are only in contact with end consumers indirectly, have so far not consciously exploited these opportunities, judging by published reports. Our study therefore concentrates on conditions in the retail industry. The analysis is based on a representative selection of 14 companies that operate food, department and specialty stores. Whole Foods Market, Coop Schweiz and Body Shop have the best sustainability rating, while Morrisons, Kroger and Wal-Mart have the worst.

While price still tends to be the dominant competitive strategy – and is certainly the main reason for the strong financial performance in particular of Wal-Mart Stores, the global leader in trading and retailing – it appears to be incompatible with many aspects of sustainability. Still, resource efficiency and good personnel management can help to cut costs and boost productivity. But companies have yet to fully exploit these partially congruent goals, because their network of locations is often large and the branches of the upstream supply chain tend to be widely dispersed. In some cases, however, certain large trading and retailing companies do seem to be making progress and taking a coordinated approach towards initiatives such as supplier audits or environmental impact studies for new locations. Where effectively implemented, these do tend to enhance a company's financial performance.

So far only a few companies have pursued a niche strategy built on quality that focuses equally on environmentally friendly and socially responsible products such as organic foods, energy-saving devices and fair trade goods. Demand in this still relatively small segment is booming, however, and the value growth of companies in this field, such as Whole Foods Market in the US or Body Shop in the UK, is good or even very good. Large food and specialty stores are thus increasingly including this product segment in the range of goods they stock. Wal-Mart is a classic example: many commentators believe it has probably reached the limits of its expansion in the US low-price segment, but since autumn 2005 it has been paying more attention to higher-earning consumers who are interested in sustainability. This could herald a shift towards competition based more on the sales proposition of environmental and social quality.

Introduction

A large portion of the budget of private households goes on consumer goods. Consumers ultimately decide whether products are developed and manufactured. They therefore also indirectly influence the technical, environmental and social conditions under which products are made.

Investors committed to sustainability are particularly interested in the extent to which the production and distribution of goods meet acceptable social standards, and how environmentally friendly these goods are to make and use. After all, many investors know that a large proportion of global consumer goods originate from “sensitive” countries with a rather fragile social fabric, where environmental protection traditionally has low priority.

Key role of trading, distribution
and retailing as an interface
between consumption and
production

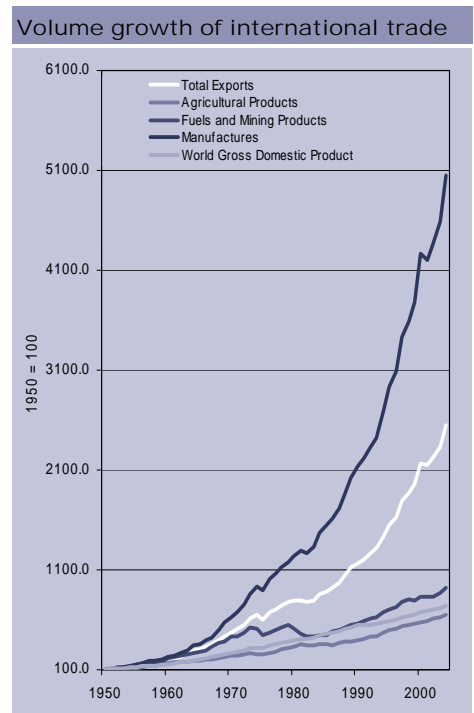
As an interface between consumption and production, the trading, distribution and retailing sector plays a key role:

It informs the end-user about product features and tests new developments on the market. Besides this, it keeps producers updated about consumer expectations, while in its position as purchaser and customer it can dictate the conditions of supply. It works with suppliers to encourage product development and process optimisation. It handles the rapidly expanding global exchange of goods.

To this extent it also plays a key role in shaping the global transportation of goods. Trading, distribution and retailing companies therefore have particularly good opportunities to encourage more socially acceptable and environmentally friendly production of goods and to influence the selection of goods via the product mix.

But nowadays there are many other stakeholders who are increasingly championing the environmental and social aspects of the flow of goods and services: Consumer organisations are pushing for product safety, the protection of young people and the avoidance of toxic substances; aid and international organisations campaign for fairness, work safety and environmental protection in the

protection in the manufacturing and supply chain of sensitive countries; and lastly, authorities strive to regulate health protection, social standards and environmental protection. Any companies (including those in trading, distribution and retailing) that do not meet these requirements run material risks, which even conventional investors should be concerned about, because of their impact on



Source: World Trade Organisation, International Trade Statistics, 2005

investment returns. It has to be said, however, that these risks often tend to be overlooked in traditional financial analysis or in the short-term view.

This report takes a closer look at the current environmental and social performance of trading, distribution and retailing companies and attempts to give investors some guidance for the informed, forward-looking management of their portfolio¹.

¹ For more detailed information on the selection and management of sustainable investments at Bank Sarasin, visit www.sarasin.ch/sustainability

Trading, Distribution and Retailing

Industry is highly fragmented

The industry is very fragmented because of the significant differences in goods categories, customer groups and sales channels.

Largest companies in the sector					
Company	Country	Sales 2005 EUR bn	Employees 2005 Thousands	Sub-Industry	Market capitalisation USD bn as of 12 May 2006
Wal-Mart Stores	USA	253.1	1800	Hypermarkets & super centres	196.72
Home Depot	USA	66.0	235	Home improvement retail	86.50
Seven & I Holdings Co	JP	25.0	14	Food retail	53.27
Lowe's Cos	USA	35.1	144	Home improvement retail	50.16
Tesco	GB	57.8	245	Food retail	47.57
Target Corp	USA	42.6	338	General merchandise stores	46.97
Carrefour	FR	74.5	410	Hypermarkets & super centres	41.36
Walgreen Co	USA	33.2	131	Drug retail	41.15
Mitsubishi Corp	JP	80.5	5	Trading companies and distributors	40.08
Cardinal Health	USA	59.0	55	Healthcare distributors	28.83
Hennes & Mauritz B	SE	6.6	35	Apparel retail	28.78
Mitsui & Co	JP	82.6	6	Trading companies and distributors	27.97
Inditex	ES	6.7	47	Apparel retail	26.56
Best Buy Co	USA	25.1	128	Computer & Electronics Retail	26.50
Costco Wholesale Corp	USA	41.7	65	Hypermarkets & super centres	26.49
CVS Corp	USA	29.8	148	Drug retail	24.33
Sears Holdings Corp	USA	39.8	317	Department stores	23.21
Federated Department Stores	USA	18.1	232	Department stores	20.63
Staples	USA	13.0	36	Specialty stores	19.73

Source: Morgan Stanley Capital International World Index; Bloomberg

The closer companies are to the customer, the more interested they tend to be in incorporating social and environmental aspects into the management of their business. The more actively they are engaged in serving the general public, the more transparent and comprehensible their actions are to the public eye. Retailers in particular therefore face a significant risk of damage to their image, costly legal proceedings or restrictive political regulation. So it is hardly surprising that in comparative terms retail companies are more conscious of their impact on the environment and on society. At the same time they are better prepared to manage this area more actively and to provide reporting on it. Information from external public sources is also more ample and detailed in the case of the retailing part of the industry.

Very little sustainability information available on wholesalers

Very little information on environmental and social performance is available for wholesale companies – especially in the field of industrial equipment and raw materials, which are geared towards a specialised trade audience. This may be due to the fact that owners (and the public) are not particularly interested in receiving information, or because there are actually no environmental and social initiatives. This segment of the Trading, Distribution and Retailing sector therefore requires separate in-depth analysis.

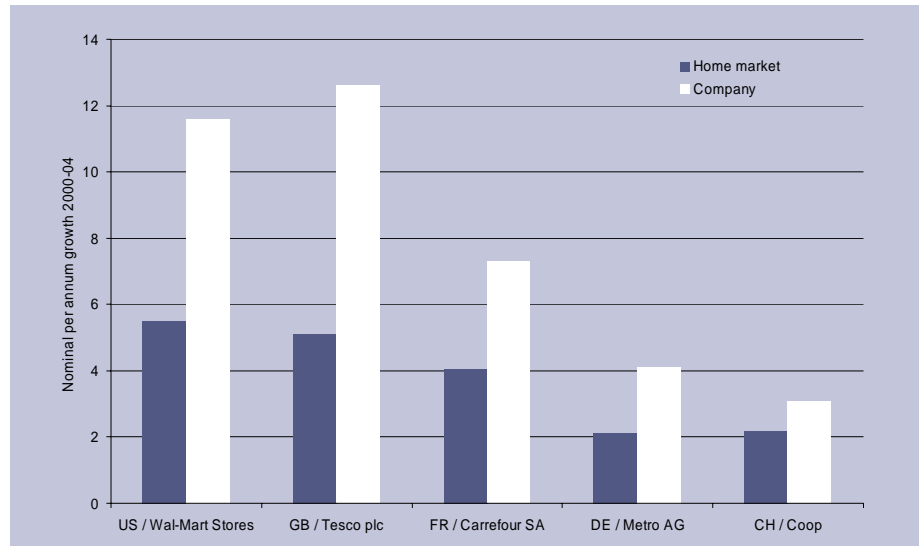
Focus on sustainability performance in retailing

This sector report therefore concentrates on assessing the performance of a selection of retail companies, half of which are active in the trading of cyclical goods (department and specialty stores), and the other half in non-cyclical goods (supermarkets and hypermarkets with a focus on food).

Competitive pressure in home markets where disposable incomes are high

In their mature home markets, where consumers' purchasing power is strong, most retailers are facing stagnant demand and intense competition. Despite this, big-name retail groups are growing much more rapidly than demand in their respective home markets.

Global sales growth of selected retailers vs. consumption growth in home market, average 2000 - 2004



US = USA; GB = Great Britain; FR = France; DE = Germany; CH = Switzerland
Source: Bloomberg:

There are a number of contributory factors here:

First, the drive to establish a second sales pillar by building up retail activities in rapidly expanding emerging markets – a strategy that nevertheless carries financial and institutional risks due to the lack of economic and political stability².

Technical and organisational change slashes costs

Another parallel trend therefore dominating the Trading, Distribution and Retailing sector is the attempt to use cost benefits and price cuts to win market share in the home market, or in some cases also in mature markets with slower growth rates. For some years now, technical change has dominated developments in the distribution of goods for the retail trade. This includes extensive automation of inventory management. Data from customer loyalty card programmes are also being analysed for direct marketing purposes and for tailoring ordering and logistical processes to current demand. This in turn helps to avoid left-over stock and keeps inventories at low levels. The pace of innovation here is extremely quick. New developments are expected from RFID³ technology, which will enable companies to track and control the flow of goods more accurately. As far as human resources are concerned, the Trading, Distribution and Retailing sector is seek-

² In recent years this has led to big corporations repeatedly pulling out of new markets again because they were unable to establish a strong enough foothold. Examples include Ahold withdrawing from South America in 2003-4, Carrefour from the Czech Republic and Slovakia in 2005 and from Korea in 2006, and Tesco from Taiwan in 2005.

³ RFID stands for radio frequency identification. This new technology makes it possible to locate and control tagged articles from a control centre, but for technical reasons it is still relatively expensive and subsequently more suited to tracking large transport enclosures. In the long term, however, this technology could be used for automatic checkouts in supermarkets (Metro AG already has a store trialling this system)

Companies, shops and
cooperative sourcing grow in
size

ing flexibility, in the form of more widespread use of part-time and casual workers – especially in countries where the labour market is heavily regulated.

At the same time the sector is restructuring itself into larger business entities. There is a trend for companies to centralise their purchasing at group level and to open retail outlets with large floor areas. In the food segment, companies are building up networks of standardised smaller convenience stores as a complement to large stores. There is also a parallel development for the formation of online purchasing platforms which give members extra negotiating power with suppliers.

Development of Internet-based cooperative sourcing in Retailing			
Platform		Launch date	Description
GNX	GlobalNetXchange	2000	Formed by the world's 8 biggest retailers from the US, France, the UK and Germany. Offering: standardised B2B network with online supplier and product information, plus price negotiation and auction procedures, especially for food retailing.
WWRE	WorldWide Retail Exchange	2000	Formed by 17 multinational retail groups from the US, France, the UK and Benelux. Offering: Freely accessible product information and supplier data as well as (between trading partners) price and discount information as a bargaining base for a broad selection of foods, textiles, drugstore goods and other non-food articles.
Agentrics	Merger between GNX and WWR	2005	Merger of GNX and WWRE. Network of almost 50 large retail companies and 250 direct suppliers with over 50,000 registered auction suppliers.

Source: Company documents, Internet

Regulation intensifies

At the same time, increasingly tough regulation is forcing the retail trade to leverage its technical expertise to develop sophisticated quality assurance systems that are fully integrated into the company's operating procedures. In many countries the standards for product safety, data protection and product declaration (e.g. GMO products or animal welfare standards) have improved significantly and are now on a comparable level across companies.

Given these developments, how does the retail trade live up to its potential role as a catalyst promoting sustainable development?

Sustainability aspects

Ultimately the answer depends on whether retail companies respond to the specific social and environmental challenges and how smoothly they integrate this response into their particular business strategy.

Main sustainability criteria for Trading, Distribution and Retailing	
Criteria	Current status
Social conditions in the supply chain	Imports from low-wage countries with poor adherence to minimum legal working standards; inequitable treatment of migrants as seasonal or temporary workers in the agricultural, processing or service sector of industrialised countries
Environmental protection in the supply chain	Sourcing products from emerging economies where environmental protection is given low priority
Composition of the product mix	To date only limited range and poor promotion of goods with proven environmental and social benefits. Price competition dominates – niche and quality providers have a difficult position
Working conditions in retail stores and distribution	Low wages for truck drivers, warehouse & sales staff as well as trend towards part-time and on-demand work in sales where the wage no longer meets the minimum subsistence level. New risks associated with entering emerging markets where there is intense supply-side pressure in the labour market
Environmental criteria in stores and distribution	Efficiency improvements in recycling and energy consumption cannot compensate for the extra environmental impact caused by growth; ongoing urbanisation as new locations are being built

Source: Bank Sarasin

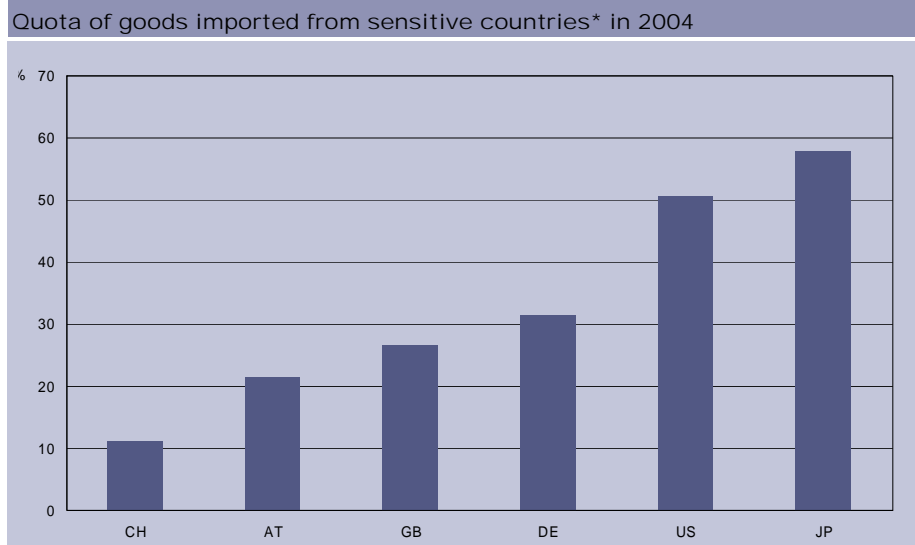
The most relevant aspects here are supply chain management, the treatment of employees, internal environmental management systems and product strategy:

Supply chain management

Precarious working conditions
in sensitive countries of origin

The proportion of goods imported from sensitive countries of origin⁴ already accounts for roughly a third of total imports in regions with high disposable incomes.

⁴ For comparative analysis in the Trading, Distribution and Retailing sector, this is defined as the group of developing economies in IMF reports. In establishing the chart, the oil-producing emerging countries were excluded.



CH = Switzerland; AT = Austria; GB = Great Britain; DE = Germany; US = USA; JP = Japan

* See footnote 4 on page 8

Source: IMF, Bank Sarasin calculations

By “sensitive” countries, we mean those where environmental issues are subordinate to the priority of bringing the economy up to speed, where the pressures of the labour market undermine compliance with internationally recognised employment standards, and where rule of law and the efficiency of political institutions are still inadequate. The proportion of goods purchased by retail companies from sensitive countries is just as high, or even higher, depending on the range of goods in question and the quality offered. Special diligence is therefore required to ensure humane work conditions in the production chain and fair business practices when dealing with authorities and vendors in these countries. The discovery of abuses in the supply chain by increasingly active and better researched pressure groups and the media could result in damage to a company’s image – a risk that increases in proportion to the size and public profile of the retail company in question. This is particularly true of the world’s biggest retailer, Wal-Mart, which has again been accused in September 2005, and has this time actually taken to court, by a human rights organisation, the International Labour Rights Fund, on behalf of workers who have been treated inhumanely and illegally in countries such as China, Bangladesh, Nicaragua and Swaziland.⁵ Another recent example is Actionaid’s campaign in Britain on behalf of crop workers on South African fruit plantations who used to have fixed employment contracts and their own housing on the plantations, but now, as a result of heavy cost pressure from retailers such as Tesco, increasingly have to earn a living as seasonal workers on an hourly wage, without the security of long-term agreements with farmers.⁶

Imposition of conditions on suppliers is almost standard practice now

Many retailers have followed the example of the textile industry⁷ and introduced ethical codes of conduct for suppliers. This type of code sets down minimum standards for working conditions – for example a ban on child and forced labour and health and safety guarantees in the workplace – and in some cases the pre-

⁵ Corporate Watch. The 14 Worst Corporate Evildoers. 12 December 2005

⁶ Actionaid. Rotten Fruit, Tesco profits as women workers pay a high price. April 2006

⁷ See also the Sarasin Sustainability Report by Makiko Ashida: “Just Do It” – but responsibly, March 2006.

scription of environmental management systems for supplier companies as well. In its basic form this serves as a screening tool for suppliers and, if included in the supply agreement, transfers the responsibility for complying with the standards to the direct supplier, especially for businesses positioned upstream in the supply chain. This enables retailers to bar suppliers from future business if abuses are subsequently detected, on grounds of breach of contract. To give an example: the Spanish company Inditex, the parent company of the fashion chain Zara, outsourced the manufacture of some of its fashion collection to suppliers in sensitive countries. After a general review of its suppliers, it banned almost half from further collaboration due to gross social abuses, which were in many cases virtually impossible to remediate. The Dutch retailer Ahold and Britain's Morrisons have also taken this line in the past.

Varying commitment to
enforcing standards

These minimum standards are typical for most large suppliers of branded goods, which may in turn apply their own supply standards and enforce them locally. But in cases where these standards are also applied to contract manufacture (as with fashion houses) or direct purchase from sensitive countries (e.g. toys), they tend to contribute very little to the sustainable development of the working environment and ecological equilibrium of the supply chain, as long as there are no authorities to conduct on-site inspections to check whether standards are actually being upheld in practice.

Quite a number of retailers are already assuming more responsibility here:

- ◆ They are setting higher minimum standards by incorporating minimum wages and encouraging the payment of a living wage, introducing rules on overtime, as well as respecting the right of employees (or even encouraging them) to belong to a trade union.
- ◆ They not only reserve the right to inspect the supply chain or have independent experts inspect it without advance notice, but also tend to systematically exercise these rights.
- ◆ When they discover abuses, they usually try not to break off business relations, but rather to seek verifiable targets for improvements with the managers of the contract manufacturers, thereby ultimately assuring employees job security as well as better working conditions.
- ◆ Increasingly, their tactic is to use educational measures and collaborative pilot projects in order to raise the awareness of contract manufacturers' managers of the productivity improvements achievable through better time and operational management.
- ◆ They are more willing to consider cooperation within the industry in a bid to reduce the multitude of required standards and of inspection procedures that incur additional costs for supplier companies.

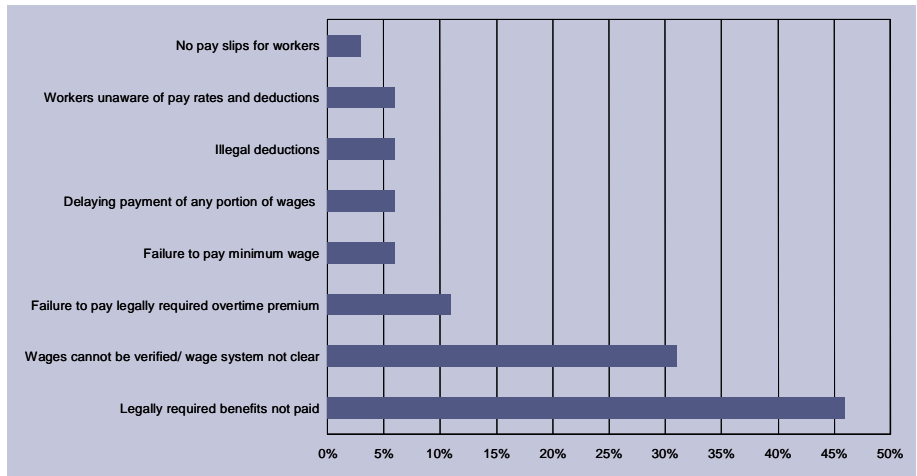
Sector cooperation to ensure good working conditions in the retail supply chain	
ETI	Ethical Trading Initiative
Country	United Kingdom
Established	1998 by British companies, NGOs and trade unions.
Activities	Members implement a code of conduct for suppliers which includes monitoring, improvement plans and progress reports. The minimum recommended standard is the ETI Base Code*. A range of practical training courses is offered. Persistent failures to meet the relevant standards in the supply chain may lead to the member being asked to leave the ETI. Establishment of a shared database for supplier audits (Sedex).
ICS	Initiative Clause Sociale
Country	France
Established	1998 by the French association of retailers, Fédération du commerce et de la distribution
Activities	All members agree to abide by the ICS Code of Conduct, which is based on the US SA8000 standard*. Implementation by independent accredited inspectors as per phased plan. Refrainment from competition with measures for checking social conditions at suppliers.
BSCI	Business Social Compliance Initiative
Country	Belgium/EU
Established	2003 by the European Foreign Trade Association, based on earlier initiatives of the German foreign trade association
Activities	All members give a minimum undertaking to implement the BSCI code of conduct for suppliers*. Implementation following phased plan. Regular checks by independent SAI-accredited inspectors. Establishment of shared database with list of supplier audits. Collective training and research projects.
* Reference institution for all initiatives for safeguarding social conditions in the supply chain:	
SAI	Social Accountability International
Country	USA
Established	Drafting of SA8000 standard 1997. Non-profit-making institution.
Activities	SA8000 is based on relevant UN and ILO conventions and is reputed as a strict benchmark. Standards: Respecting local employment and health & safety laws, as well as human rights (ban on child and forced labour as well as degrading disciplinary measures), freedom of assembly and negotiation, a living wage and commensurate rest periods. SAI updates the standard, provides information and training, offers accredited inspectors and collaborates with a network of researchers, economists, charities and trade unions.

Source: www.ethicaltrade.org, www.novethic.fr, www.bsci-eu.org, www.sa-intl.org

Inditex in particular has already made good progress: The company is currently working closely with its pared-down supplier base and with non-governmental organisations in the area of labour rights. It also supports commendable projects for the promotion of women, education, health and the support of human rights in respect of their supplier base in Morocco and Peru.

The standard of reporting on the findings of supplier inspections varies enormously, however, and relies on case studies, which make it difficult to assess progress across the entire procurement chain. One interesting point is that Wal-Mart, which is accused most frequently of abuses in the supply chain, actually provides an unusually detailed report, compared with its peer group, on the findings of its own internal auditors from inspections of its direct suppliers.

Wal-Mart: frequency of poor compensation practices in the supply chain*



* Observations among 5,300 directly-sourced factories
Source: Wal-Mart: 2004 Report on Standards for Suppliers

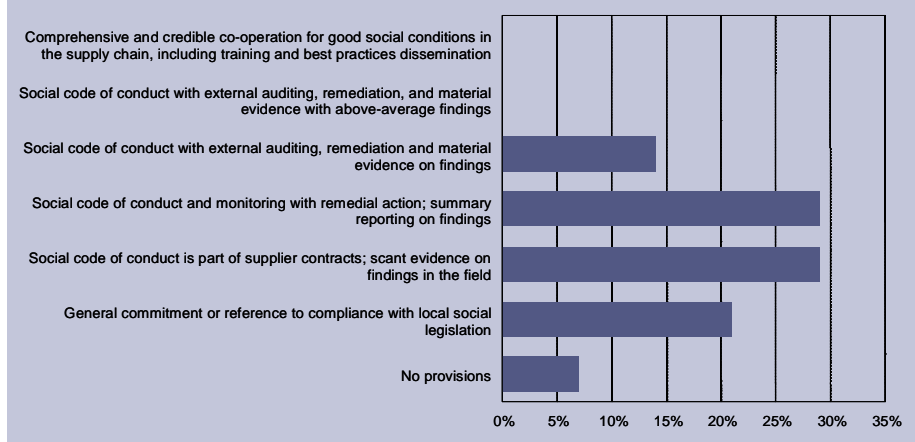
On the other hand, the findings do reveal frequent abuses that bear out the criticisms directed at the company by human rights organisations.⁸

Social responsibility competes
with cost pressure in the supply
chain

Despite all the initiatives – as the example of Wal-Mart clearly shows – the critical question is still how to achieve a compromise between the strong pressure on retailers’ purchase prices and the growing need for shorter delivery times on the one hand and the social standards asked of suppliers on the other. Companies prepared to pass comment claim that it is the suppliers’ responsibility to make provisions in their bids for the cost of meeting social standards. Where inspections are conducted by independent third parties, suppliers usually have to bear the inspection costs themselves. While corruption during price negotiations for purchasing is unlikely to be very common since it would conflict with purchaser’s own objectives, it could play a role when it comes to the parent company’s requirement for social standards to be met. Since NGOs repeatedly report cases where improvements in the supply chain were only sustained for the duration of an inspection, or where companies put pressure on workers not to make any critical statements to inspectors, it seems reasonable to assume that in many a case the conflict between cost pressure and social standards in the supply chain is still resolved to the detriment of the employee, even where the retail company in question is committed to sustainability.

⁸ See footnote 5.

Social management of the supply chain – performance* of retailers
examined



* The rating includes an assessment of credibility⁹
Source: Bank Sarasin

Indeed, we found that none of the retailers studied had in practice managed to achieve comprehensive and effective interaction with the supply chain.

Environmental commitment still
rare in the supply chain

In the retail industry, the issue of environmental protection in every aspect of the supply chain is mostly overlooked, except in so far as it already exists in the application of increasingly strict guidelines on product safety (avoidance of toxic substances) or the purchasing of organic food and of agricultural produce from Integrated Production, which minimises the use of artificial fertilisers and pesticides. Most retailers are starting to review their social standards with precise inspection catalogues. Even though these standards contain a brief reference to environmental responsibility, the reports seldom provide information on whether data for emissions, wastewater, waste, noise pollution and landscape protection are recorded during supplier inspections, or details of the findings of such inspections.

Risky work environment for
seasonal workers in Europe and
the USA

In the past very little attention has been given to responsibility for social standards in small service companies and suppliers used by retailers in mature markets. These include security and cleaning firms, tradesmen and small suppliers of local fresh produce. The same applies to the work environment for seasonal workers in farming and food processing, both in Europe and the US. There are frequent reports of illegal recruitment and subsequently a lack of decent statutory employment rights. Some companies in the sector are now addressing this problem in internal projects or at industry level¹⁰.

Composition of the product mix

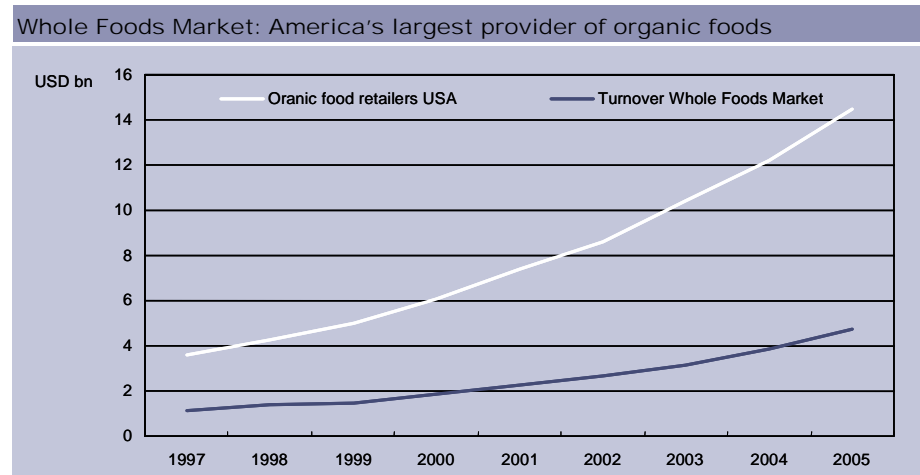
Market niches for fair trade and
eco-label products

If the trading, distribution and retailing sector wants to leverage its role as the interface between production and consumption to promote sustainable principles,

⁹ If, despite initiatives by the company, there are external reports of abuses, the rating level is reduced by 0.5 or even 1 level.

¹⁰ The British supermarket chains Morrisons and Tesco, for example, are actively supporting the new push by the authorities to require gangmasters to abide by minimum standards in the area of worker's rights. Tesco is involved through the ETI (see box on p.11), and Ahold through the European BSCI, in projects to improve the working conditions for temporary staff, especially in the sensitive area of farm labouring.

the most consistent approach is to ensure that due attention is given to sustainability criteria when designing the product mix. So far only a handful of companies have had the conviction to implement this as part of their business strategy. Companies such as Whole Foods Market, whose entire sales come from natural and organic products, and Coop Schweiz, which has built up its own product lines for organic foods, organic cotton used in its garments, and fair trade articles, manage to exploit this potential with different strategies.



Source: Bloomberg; Organic Trade Association (USA); figures up to 2003. www.oekolandbau.de

Other large food retailers now have organic lines and also offer fish from sustainable sources as an alternative, although sales are usually limited to a small segment and represent a percentage of turnover, which is still well below the market average for fair trade and eco-label products sold to end consumers¹¹. Supply bottlenecks in farming and fishing are partly to blame for this situation, as these industries tend to show a delayed response to growing demand for organic products. By contrast, food retailers often tend to concentrate on the purchase of fresh products from integrated production as part of their quality own-label produce, which has a positive influence on relieving the impact of agricultural production on the natural environment.

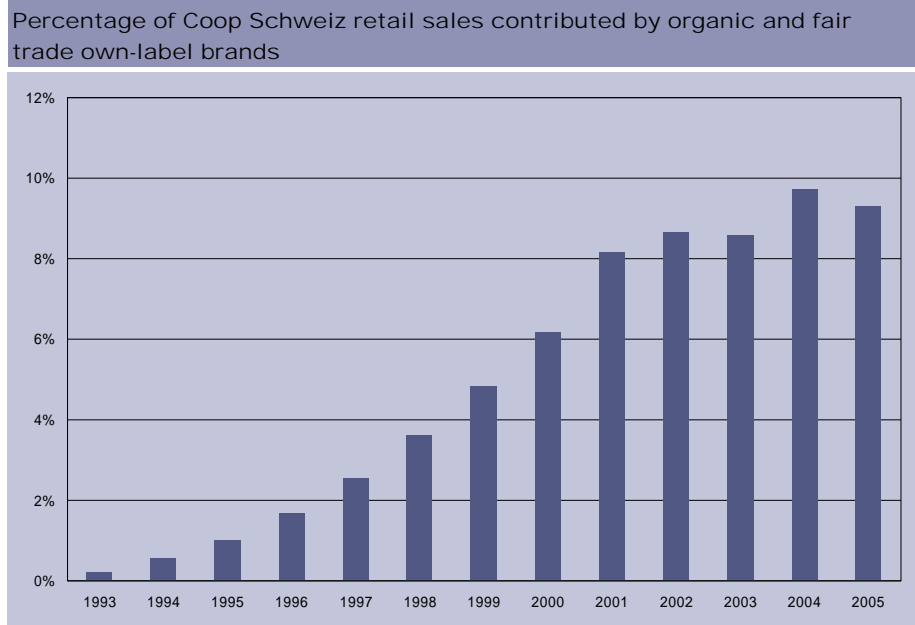
In non-food specialty stores, the segment of timber products certified as originating from sustainable forestry sources (e.g. FSC label¹²) plays an increasingly important role, and not only in the segment of home improvement stores. In countries that have cost-conscious customers and government sponsoring, most retailers include energy-saving electrical equipment and light bulbs, as well as water-saving household devices, as part of their standard product range. Quite surprisingly, specialty stores provide no information on what percentage of turnover comes from sales of these 'green' alternatives.

Environmentally and social
responsible products have good
market potential

As the example of Coop Schweiz shows, targeted advertising of socially responsible and environmentally friendly products can stimulate market growth

¹¹ According to Marketing Magazine (edition 3.8.2003) "ethical" products account for 4% of consumer spending in the UK.

¹² Forest Stewardship Council. There are other labels, some of them less credible, as well as companies' own control systems for the source of materials.



Source: Coop Schweiz

even further, despite initial signs of saturation in this segment of the Swiss market¹³. As far as we know, none of the mainstream retailers in other global markets with affluent consumers has been as focused as Coop Schweiz in pursuing these opportunities.

Working conditions within companies

Low-wage industry with a high proportion of part-time workers

Compared with other industries, retailing is one of the sectors that pays relatively low wages. The percentage of semi-skilled workers is comparatively high, as is the fluctuation rate of sales staff. There also often tends to be a high proportion of people in part-time and on-demand work, some of them unable to earn a living wage by working in retailing alone. One connected factor is that in countries with large ethnic minorities there are sometimes major linguistic and cultural differences in the workforce that can pose a real challenge to personnel management.

Employee participation and good fringe benefits can increase worker loyalty

The salaries and benefits packages offered can vary considerably not just between companies, but between locations as well. Here too, however, some companies have a good track record. One of the key factors is not just the level of wages, which tends to be a little higher in workforces where trade union membership is common, but above all the working environment. Another decisive aspect here is how attractive the benefits packages are, and whether part-time and casual workers receive them as well. Furthermore, companies can command greater loyalty and increase motivation by introducing structures which involve their employees in the running of the day-to-day business and informing them and listening to them – via staff representative councils – whenever important decisions (such as restructuring) have to be made. This in turn leads to lower staff fluctuation rates. A prime example of this is (once again) Whole Foods Mar-

¹³ Discussion with the Head of Business Policy/Sustainability on 30 March 2006

Limited support in the areas of
healthcare, safety and
education

ket, where individual store teams can influence the product range and pricing policy, and help to decide on the recruitment of new colleagues. Attempts by US labour unions to organise the company's workforce have been unsuccessful so far, despite repeated and in some cases high-profile campaigns. In spite of this, since 1998 the company has been consistently voted one of the top 100 best employers in the USA¹⁴ and in 2006 moved up to 15th rank.

Compared with the manufacturing industry, reporting on workers' health and safety in retailing companies is either rare and/or only programmatic. In view of the risk of accidents in the area of warehousing and logistics, and the increasing pressure imposed by work on demand, there are special risks in terms of labour costs, loyalty and productivity. Companies like Inditex, which are vertically integrated to some extent and not only carry inventories for distribution but also have their own production facilities, generally tend to monitor accident and absenteeism rates more closely (as is the custom in the manufacturing industry) and can therefore exert a positive influence on them.

In the trading, distribution and retailing sector, training measures are often limited to new staff acquiring skills on the job, supplemented as necessary by specialised training in product know-how. Some retailers in German-speaking countries, such as Metro, run apprentice programmes in their home market and in transitional economies, thereby making an important contribution to vocational training. Some Anglo-Saxon companies, such as Tesco in the UK and TJX in the US, participate in commendable programmes to integrate employees from sections of society marginalised by factors such as migration, age, unemployment or social origin, by providing jobs and mentors in their own company.

Environmental management

Internal environmental
management is not very
formalised

Internal environmental management systems are still astonishingly underdeveloped in the retail sector compared with manufacturing industries. At best, a formal environmental management system accredited to recognised standards (such as ISO 14 001 or EMAS) is used locally to monitor the environmental impacts of specific distribution centres or own production facilities, but not for the operation of the network of retail outlets or transportation of goods. Companies do at least recognise that waste reduction and materials recycling, as well as limitation of energy consumption and emissions at stores and distribution centres, are important aspects of a conscious environmental management policy. Many companies are therefore attempting to collate the relevant figures, but often fail to provide data covering the entire group or to supply environmental indicators that can be compared over time.

Lack of information on the eco-
efficiency of transportation

The environmental impact of transportation triggered by purchasing and distribution operations, which has particular importance for sustainability, is however not always given due attention and is even less often recorded in figures – even

¹⁴ See the annual list of "Fortune® 100 Best Companies to Work For" published by the US Fortune Magazine.

though companies should theoretically be able to report improvements in eco-efficiency thanks to recent technical advances in route optimisation and vehicle design.

Viewed overall, retailers with their own processing facilities have the edge in recording and optimising the environmental impacts associated with specific locations and also with logistics. Retailers from countries such as the UK and Germany with greater public awareness and stricter environmental legislation also score better in a global comparison.

Problems with landscape
protection

A number of retail companies are engaged in pilot projects for energy-saving building design in a bid to optimise their energy consumption. With the multiplication of big shopping malls, environmental protection has become a very thorny issue for practically all listed retail companies as they seek to expand their business. Even so – and despite local protest campaigns against new development projects – a comprehensive environmental impact study is only performed when choosing a location if local law requires it. Exceptions include a number of British retailers, such as Sainsbury's, Marks & Spencer and Tesco, who have voluntarily adopted the UK BREEAM standard¹⁵.

Financially relevant risks and opportunities

From the investor's perspective, it is vital that companies are aware of risks and opportunities and incorporate them in their calculations. As we already explained, it is clear that neglecting environmental and social management can expose companies to concrete financial risks on the one hand. Conversely, a company can create new market opportunities by making sure it optimises the environmental and social aspects of its business operations at an early stage. The next table summarises the factors that apply to the retail trade in particular.

¹⁵ The Building Research Establishment Environmental Assessment Method was launched over a decade ago and versions adapted for offices were published in 1991 and for supermarkets in 2003. See www.breeam.org



Financial risks and opportunities associated with sustainability		
Topics:	Risks	Opportunities
Social criteria in the supply chain	Frequent supply bottlenecks due to poor quality. Damage to image and risk of boycott if abuses are discovered	Improved productivity secures favourable purchasing prices. Loyal and experienced workers produce better quality
Work conditions in own facilities	Costs incurred by absence through illness, staff fluctuation, work-to-rule, accident liability, strike action. Legal costs for equal opportunities cases	Customer loyalty thanks to friendly service, constant presence and product / product mix know-how in sales. Improved image. This allows companies to sustain higher margins. Creative contribution to improving efficiency in operational procedures, serving the market and formulating the strategy. Good public acceptance when entering emerging markets
Environmental criteria in own facilities	Liability and legal costs in the event of pollution. Loss of image and possibly legal costs from local campaigns against new locations. Intensive start-up costs and rising costs when environmental regulations and taxes are introduced, which increase in proportion to the amount of pollution measured	Cost savings through energy efficiency in retail stores and logistics and through recycling waste. Good public acceptance when entering emerging markets
Inclusion of environmentally friendly and socially responsible goods in the product range		Tapping into a rapidly growing niche market where consumers have high disposable incomes. Strategic leeway thanks to higher margins in this segment

Source: Bank Sarasin

The interplay between the different sustainability aspects and the financial performance of an individual company hinges to a large extent on its chosen business strategy:

Price competition is the dominant growth strategy in the retail sector

As already mentioned, one factor at work is that the sales growth achieved by the big-name retailers is outstripping demand in their home market. This trend would seem to gratify the interests of shareholders. It is achieved through forays into emerging markets, but above all through price competition. This gives rise to a common dilemma in the retail industry:

As a core strategy, price competition with subsequent short-term cost savings can in fact be compatible with sustainable business development in a number of ways. This is true, for example, of cost-cutting measures such as optimisation of fuel consumption in transportation, reduction of staff days off for sickness and productivity improvements through regulated workflows in the supply chain.¹⁶

Even so, a short-term cost-cutting strategy is in many ways not particularly compatible with the requirements of long-term sustainable development.

Short-term cost-cutting targets incompatible with sustainability

In mature markets, such a strategy leads to industry consolidation with low prices but poor selection opportunities for customers and loss of jobs or wage cuts for employees. Pressure to cut costs encourages more part-time work and casual labour on demand, as well as pressure on staff to work overtime. Faced with cost pressure, both local and global suppliers are in danger of flouting envi-

¹⁶ The retail industry has not yet fully exploited the potential for more effective optimisation in these areas. One example is the possibility of improving productivity by reducing overtime in the Asian supply chain as explored in a pilot project sponsored by UK companies and which retailers such as the fashion chain Next have signed up to. See Ethical Trading Initiative. Report on the ETI Biennial Conference 2003. Chapter 5.

ronmental and social standards. The same applies to retailers themselves, when selecting and setting up new locations.

Failure to give due consideration to sustainability aspects can expose a company to risks that incur additional costs in the long run and inadvertently create new barriers to market entry in particularly wealthy customer segments, as illustrated by the example of the world's biggest retailer, Wal-Mart.

Wal-Mart: wasted opportunities and risks with potential repercussions on the cost side

The world's largest retailer has grown in size by serving America's small and mid-sized rural communities where its low-cost concept has always been successful, but is now experiencing resistance as it tries to push into larger conurbations where the educated middle classes tend to have a stronger voice. Here local pressure groups are forming to campaign against new supermarkets because they fear the consequences for the natural landscape and the environment, as well as extra traffic congestion, light and noise pollution, public safety issues and unfair competition for smaller shops in the city centre.

In addition, American society is becoming more aware of the social costs of the low-price / low-wage concept, and is currently trying to introduce new local laws which require better health insurance cover for employees, for example.

Due to the company's financial clout and its high public profile lawyers may reckon that class actions against the company have good chances of success. If found to be negligent in upholding standards – particularly those required under employment law – Wal-Mart may face hefty legal and settlement costs.

Non-governmental organisations fighting for fair and safe working conditions in the supply chain have discovered abuses by Wal-Mart and deliberately and effectively brought them to the public's attention to champion their cause.

Sustainability analysts have given Wal-Mart a low rating for environmental management due to the company's failure to exploit the potential for a well-organised optimisation process supported by its purchasing power.

The image thus conveyed that the company's expansion drive has negative consequences for the environment and local communities alienates affluent and educated middle-class customers in particular.¹⁷

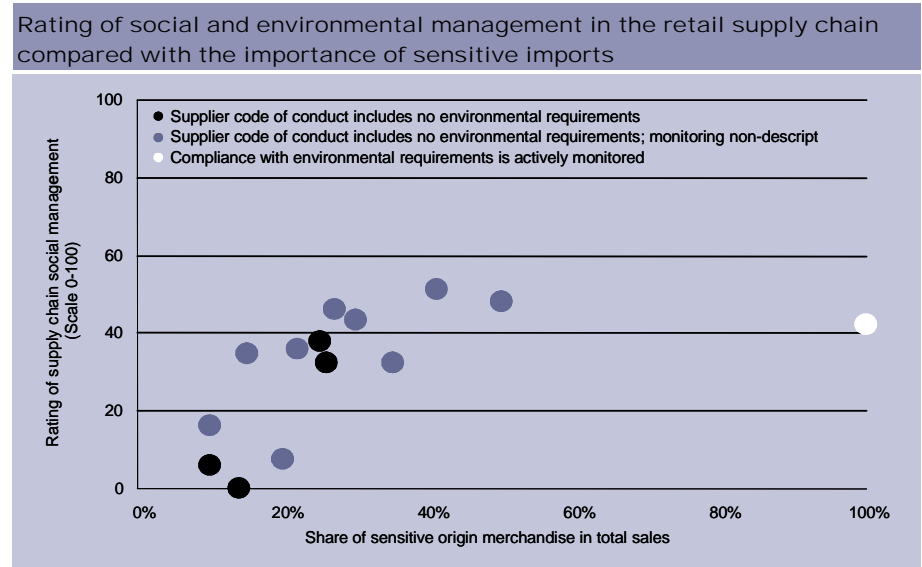
Sustainability management
pays off in emerging markets

Expansion into emerging markets offers an alternative source of growth which is only lucrative in the short term if pursued through a strategy of price and cost competition. But this is exactly where conflict with sustainability criteria tends to arise. Precisely because the legal framework in these countries is not quite as robust due to their pressing social problems, a new retailer runs particularly high risks: The discovery of abuses at foreign subsidiaries or in local supply chains which are perhaps typical of the local market – but still illegal – can be very damaging to a company's image or result in legal costs¹⁸. This risk is growing as

¹⁷ See Ylang Q. Mui: Wal-Mart Says It Will Improve Health Benefits, The Washington Post, 24.2.2006. Kris Hudson: Suit Targets Laws Aimed at Wal-Mart, The Wall Street Journal, 8.2.2006. Jonathan Birchall: Wal-Mart picks a shade of green, Financial Times 7.2.06. Editorial: Hot Topic: Is Wal-Mart Good for America?, 3.12.2005. Kris Maher and Ann Zimmermann: Wal-Mart Activists Claim Headway. The Wall Street Journal, 1.12.2005. Amy Joyce and Ben White: Wal-Mart Pushes to Soften Its Image; The Washington Post, 29.10.2005. Milton Moskowitz: how the law of unintended consequences hit Wal-Mart. ethical performance January 2006.

¹⁸ Companies like Tesco, Metro or Carrefour procure up to 80-90% of the food and daily produce they sell in their foreign supermarkets from local suppliers.

local environmental and social standards are gradually being tightened and brought into line with those of mature markets. Squeezing traditional local small retailers out of the market can also create local resentment against the foreign competitor¹⁹.



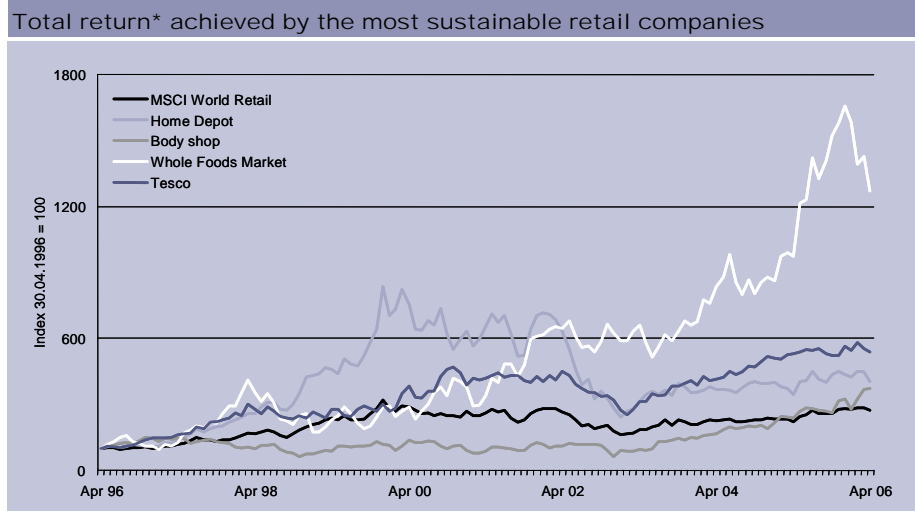
Source: Bank Sarasin estimates

The higher the proportion of goods sourced from sensitive or socially fragile countries, the more effort companies actually make to ensure the good social management of their supply chain, as the above chart shows. It has to be said, however, that as yet the systems are not really comprehensive enough in any of the companies analysed.

Quality and niche strategies
tend to be more compatible
with sustainability

By comparison, the higher margins provided by a strategy geared to quality also gives leeway for extensive environmental and social optimisation of products and processes which helps to avoid long-term risks. An explicit niche strategy that specifically targets sustainably minded customers is the best business approach for retailers wishing to exploit their unique position as buyers and suppliers to further sustainable development.

¹⁹ This is a real risk when trying to break into the Indian market – a move which several bigger retailers are currently contemplating. The retail industry in this country is traditionally heavily fragmented, but could be opened up to foreign competition, which is already encouraging big players like Wal-Mart, Tesco and Metro to make initial moves. See: Harter Wettstreit in der indischen Handelsbranche, FAZ 8.3.2006



* Total returns including dividend payouts
Source: Datastream

It seems that giving consideration to environmental and social aspects does pay off for retailing and trading companies overall: One of the four most sustainable companies has comfortably outperformed the sector over the course of the last economic cycle – and even during the last stock market crisis that ended in 2003. It should also be noted that none of the four companies' posted a sub-par financial performance.

It therefore looks as if the sustainability strategy of these companies has helped them to curb their business risks and exploit appropriate opportunities. Further improvements are expected in future since, as things stand, none of the sector's sustainability leaders have yet fully exploited the potential for environmental and social measures that boost efficiency and reduce risks.

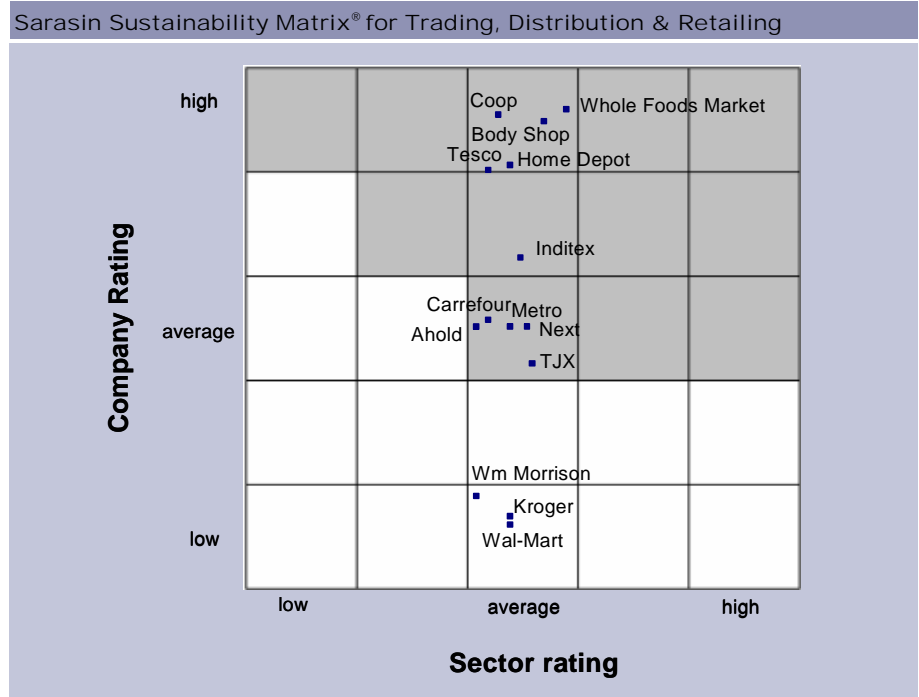
One of the top four sustainability leaders, Body Shop, which has gradually recovered from the crisis in 2003 triggered by over-rapid expansion, was the target of a friendly take-over by L'Oréal this year, precisely because of the success potential of its environmentally friendly and ethical business strategy. There are parallels to this trend in other industries as well²⁰. This indicates that even the big industry players are now starting to take the rapidly growing market niches for ethical products²¹ seriously. Unlike Body Shop and Whole Foods Market, however, this segment is still relatively small for most retailers, so its expansion has very little impact on earnings performance for the time being – although there is clearly potential for future growth²².

²⁰ See: L'Oréal deal raises debate on "ethical" firm takeovers, ethical performance, May 2006

²¹ R. Swan: "Get ready for Green; Sustainable attitudes are going mainstream, influencing consumer lifestyles, the marketing of products and the landscape of our cities", Article in Display & Design, 1.7.2005. Adrian J. Smith: Fair Trade Draws Buyers, Study Says. The Harvard Crimson. 21.3.2006

²² These products were estimated to account for 4% of UK consumer spending in 2003 (see footnote 11, page 14). At Coop Schweiz this percentage was well over 9% of sales in 2005, and according to findings quoted by R. Swan in the above article, roughly 32% of adults are currently interested in these products.

Results of the company evaluation



Source: Bank Sarasin

Sustainability rating dictated by
strategy

The position of companies in the Sustainability Matrix shows that companies which tend to compete mainly on price have a lower sustainability rating than the rest of the sector. This group includes the world's biggest retailer Wal-Mart Stores Inc., the US supermarket and department store group Kroger Corporation and (for the time being) the UK supermarket chain Morrisons. After taking over the relatively bigger Safeway plc in 2004, Morrisons suspended Safeway's sustainability strategy and concentrated on price competition instead, but now it seems to consider revising this tactic.

By comparison, companies that are active in niche markets or follow quality-based strategies tend to have better sustainability ratings. It is interesting to note that of all the companies examined, the sector leader is Coop Schweiz, a cooperative company not listed on the stock exchange. Other strong performers include Whole Foods Market with its range of organic and natural products, Home Depot, a home improvement chain that has been purchasing its timber from sustainable forestry sources since the nineties and systematically sells and promotes green product alternatives, and Body Shop International plc, which sells natural cosmetics designed without animal testing.

Sector could become a
sustainability champion

One particularly interesting development is the recent shift in the strategic approach of the world's largest retailer, America's Wal-Mart Stores Inc.:

As already reported, the company has in the past been the target of widely publicised accusations from non-governmental organisations and lawsuits claiming inadequacy of workers' social benefits, poor working conditions in the company's

own facilities and the violation of human rights in the supply chain. Over the last two years the management, faced with limited opportunities for expansion, seems to have recognised the signs of the times particularly in its home market (see box on p. 19).

Over the course of 2005 the company announced a series of commendable initiatives to improve environmental and social performance. These include, for example, initial steps to underpin the existing obligation on the part of suppliers to adhere to minimal working standards by introducing a credible and externally verified process of collaboration with the management in the supply chain. Wal-Mart has also voluntarily made a public commitment to improve the fuel efficiency of its own truck fleet by 25% within 3 years and by 100% within 10 years. Industry experts and the media are following the implementation of these new measures very closely. After all, the industry leader is deliberately leveraging its purchasing and market power to achieve more sustainable business practices. Significant changes at Wal-Mart could see a major shift in the way the sector exercises its power in controlling the production of goods, as long as shareholders support the move. The current dominant pattern of competing purely on price would be modified to include more competition on the basis of environmental and social quality, possibly at the expense of slightly less dynamic sales growth.

Appendix

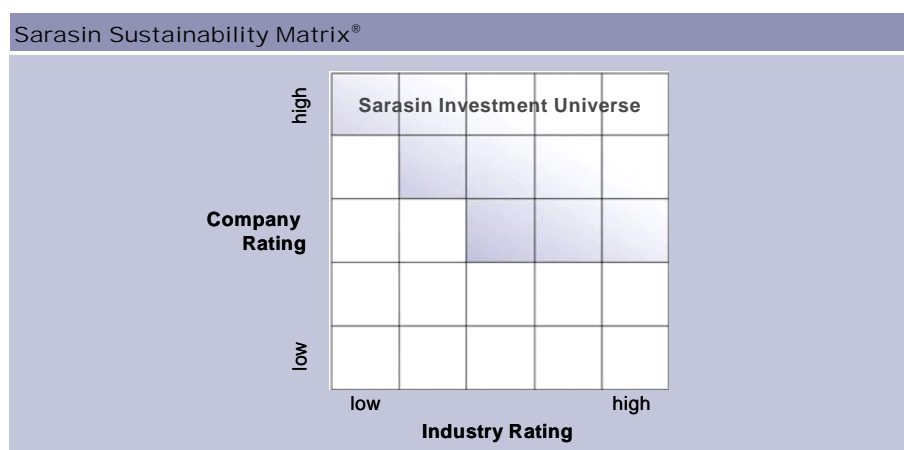
Sustainability analysis methodology

Matrix combines industry and
company rating

Our environmental and social analysis of companies is based on a proprietary valuation method developed by Bank Sarasin. It incorporates two dimensions which are combined in the Sarasin Sustainability Matrix®:

- ◆ **Industry rating:** Comparative assessment of industries using selected environmental and social criteria,
- 1. **Company rating:** Comparative environmental and social analysis of companies within their industry.

Only the companies positioned in the Sarasin investment universe (shaded) qualify for Sarasin sustainability funds.



Source: Bank Sarasin

Main criteria for the industry
rating

The industry rating is an aggregated assessment of the extent to which an industry creates environmental and social risks. We examine a total of four risk categories:

- ◆ Consumption of resources: Use of natural resources (especially fossil fuels and water)
 - ◆ Emissions: Emission of air pollutants and creation of waste
 - ◆ Potential internal sources of social conflict: Influence on employment and work conditions (health & safety, salaries, employee rights)
2. Other potential external sources of social conflict: impacts on society as a whole, especially harmful and ethically controversial production methods and products, political lobbying and exercising of financial power, corruption and business ethics, activity in countries with low social standards.

The industry risk exposure is derived from the characteristic product spectrum of an industry. We take the entire life cycle of products into account here, from the production of raw materials to the manufacture, use and eventual disposal of the product.

Environmental and social risks in Trading, Distribution and Retailing			
Phase in the product life cycle			
Risks:	«Pre-production»	Production	Use & Disposal
Consumption of resources	●		
Emissions	●		
Internal conflict potential	●●	●●	
External conflict potential	●	●	

Source: Bank Sarasin

Overall industry rating

The industry's sustainability rating is "average". The sector's main impact point on society and the environment occurs in the upstream supply chain (pre-production). For reasons of cost, merchandise is often sourced from countries with poor working conditions (low wages, inadequate health and safety standards, excessive overtime) and an institutional framework that is prone to corruption. They also tend to have poor environmental standards: lack of controls on emissions and effluent, energy wastage, soil erosion and threat to biodiversity in the agricultural sector. This is compounded by the risks presented by working conditions in shops and logistical facilities that compare unfavourably with other industries (low wages, part-time and on-demand work, redundancies brought about by restructuring). Finally, the trading, distribution and retailing sector is particularly exposed to a number of external conflicts associated with its own business operations: As an interface between technology and the general public, the sector is sensitive to issues such as GMO products, food safety and computer analysis of customer data on the one hand. On the other, the sector's site related decisions may be in conflict with local community interests when positioning large retail stores, during restructuring and upon closure of local facilities.

The fine-tuning of the sector rating for each company is geared towards the product range they carry and the industry rating of the respective manufacturing sectors.

Main criteria for the company rating

Sample criteria and weights for the environmental rating of trading, distribution and retailing companies			
	Main criteria	Weight	Key indicators
Environmental profile 50%	Strategy & management	20%	Integration of environmental criteria into business strategy, organisational structure and management processes; quality of reporting
	Pre-production	40%	Inclusion of environmentally friendly goods in the product mix; implementing environmental standards, controls and findings in the supply chain
	Production	20%	Reduction of energy consumption and emissions in retail stores and logistics; waste management; landscape protection
	Products & Services	20%	Promotion of green products; provision of environmentally friendly services

Source: Bank Sarasin

Sample criteria and weights for the social rating of trading, distribution and retailing companies

	Main criteria	Weight	Key indicators
Social file 50%	pro- Strategy and management	20%	Integration of social criteria into business strategy, organisational structure and management processes; quality of reporting
	Govt. and general public	15%	Correct and cooperative attitude in dealings with authorities and the general public, charitable contributions, promotion of knowledge and labour market integration; controversial business activities (e.g. offensive advertising)
	Investors	5%	Independence and competence of supervisory bodies; voting rights; compensation for executives and non-executive directors; quality of financial reporting
	Suppliers	25%	Fairness in dealings with suppliers; standards, controls and findings concerning working conditions in sensitive countries of origin and sectors
	Employees	15%	Job security and work-life balance; employee participation and equal opportunities; wages and fringe benefits, training
	Clients	10%	Product safety; customer information and data protection; price/quality relation
	Competitors	10%	Hostile takeovers and price fixing; participation in industry initiatives; competitive strategy

Source: Bank Sarasin

Controversial activities

Certain business activities not considered to be compatible with sustainable development (e.g. armaments, nuclear energy, tobacco, pornography) can lead to the exclusion of companies from the Sarasin sustainable investment universe. The Fund's Advisory Council makes this selection for our retail funds. In the case of the retail industry, no exclusion criteria apply. In view of the content or target group (children), advertising that causes public offence is deemed to be controversial, however.

Information sources

The company rating is based on the company's own details, a worldwide press search and information from independent institutions. We do not use standardised questionnaires.

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