SAM Sustainable Asset Management

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Submission to the

Parliamentary Joint Committee on Corporations and Financial Services, Parliament House, Canberra.

Corporate Responsibility Inquiry,
Hearing in Melbourne 5 April 2006

"Im a fashion model

not a role model"

Prepared by Francis Grey,
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Sustainable Asset Management Australia Pty Ltd
A wholly owned subsidiary of SAM Group Holding AG

Overview document on sustainability & corporations:
AuSSI – www.aussi.net.au - The Australian SAM Sustainability Index
DJSI – www.sustainability-indexes.com - Dow Jones Sustainability Index
SAM Group – www.sam-group.com - sustainability based investment management

Thank you for the opportunity to present to your Inquiry.

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Response to the Inquiry

Overview of the sustainability perspective on CSR & the role of government: "Im a fashion model not a role model"

In this brief summary I represent my own opinions and insight given the unique focus of the inquiry – in the supporting material herein and in the attached documents I am representing the shared opinion of my sustainability research colleagues at SAM and probably elsewhere.

In the following document I have outlined the sustainability research and index construction process that underpins the Dow Jones Sustainability Index (DJSI) and The Australian SAM Sustainability Index (AuSSI). If you are convinced, as are many of the worlds leading companies, that sustainability is a broad concept capable of creating significant value for companies and society, then you will not need to read the attached material. Similarly if you are aware that sustainability is somewhat broader concept than CSR, then you will only need to read this brief commentary.

Further details on sustainability are available at:

- www.sustainability-indexes.com
- www.aussi.net.au, and
- www.sam-group.com.

Other useful websites include:

- www.sustainability.com - Sustainability consulting group
- www.wbcsd.org - World business Council for Sustainable Development

In other attached documents I have included:

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- Performance data for the funds based on the AuSSI and the DJSI;
- An article prepared for the Property Council of Australia
- An article prepared for one our clients on sustainability;
- An article prepared for the Asia Society on sustainability in Asia;
- An overhead presentation briefly outlining some key characteristics;
- A second presentation covering similar ground but with a slightly different emphasis;
- A presentation provided to the World Economic Forum at Davos;
- A presentation on the SAM water fund by way of background;
- Corporate benchmarking reports on Westpac, Intel and the global oil industry sector
- Questionnaires from the banking, mining and oil/gas sectors;
- Copies of the energy technology report & the water report

A brief response to the Inquiry

The Inquiry is considering the role of Directors with respect to their fiduciary duties and the role of sustainability reporting, amongst other things in its consideration of CSR. Fundamentally the Inquiry is asking how government can enhance the uptake of CSR/sustainability and its positive outcomes (as opposed to negative outcomes). This is particularly difficult since there are three areas of our society that have virtually no grasp of the sustainability changes that are being wrought in the corporate world at least – and one those areas is government at all levels. The other two areas are consumers and the financial markets. For that reason it is useful to compare and contrast CSR and sustainability.

CSR is a poor cousin of the sustainability concept. It should also include corporate environmental and economic responsibility, at the same time it should also include corporate social, economic and environmental opportunity. If CSR did these things it would get close to the concept of sustainability. At SAM we use the terms interchangeably but we are aware that some observers do not see the rich content of sustainability when they consider CSR. Hopefully by discussing sustainability in some detail we can alter that view.

This idea of sustainability can be applied to any organization whether corporate, individual, small business, NGO or government. It is more easily understood in the context of corporations since we all have a unified understanding of these complex organizations. Sustainability when applied to a corporation implies that the corporation is working to reduce its negative economic, social and environmental externalities, but in a manner that increases the wealth of the corporation. This is the key insight of sustainability in a competitive market. It allows profit driven corporations to integrate the concerns of society with their own concerns as an organization. In this sense sustainability is to capitalism what democracy was to politics – a simple conceptual insight which reconciles an apparently timeless dilemma – how to make money and to be good.

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Economic, environmental and social challenges are numerous and never ending. The need to constantly reconcile the profit objective with other responsibilities is a permanent requirement of corporations. The chemical company that internalises a pollution spill (eliminates the spill) in a manner which creates shareholder value, is driving its industry to better environmental outcomes through the competitive leverage of the market. It has reconciled profitability with environmental responsibility. It has turned a responsibility into an opportunity that may well transform the global environmental impact of its industry. One company or business unit can save the world!

Sustainability is the process of getting from our unsustainable present to a more sustainable future, as fast as possible, whilst creating wealth along the way. Any organization that considers that it must create negative externalities in order to under take production is missing an opportunity to improve its business, which will probably be taken up by a competitor. Toyota's approach to hybrid cars is only a more recent example as they steal the market of their slower moving competitors.

Organisations don't live in a vacuum, they live in a world full of trends, threats and opportunities. The more astute organization knows this and actively seeks to exploit this situation, and leverage its own resources. By deploying sustainability as a tool companies like Westpac, BP, Shell, BHP-Billiton are seeking to grow their wealth by delivering for society and shareholders at once. Since corporations exist at the behest of the public, to serve the public interest, such behaviour builds brand loyalty and strength. Sustainability leading behaviour tends to create multiple leverage for its practitioners. Toyota's deployment of hybrid vehicles increases sales, reduces risk of future commercial weakness in a carbon constrained world, undermines competitors, increases public awareness of the brand through the 'BBQ-stopper' effect, opens up opportunities as countries like China introduce green taxes on cars, moves the company to the lowest point on the cost curve in hybrid vehicle production, boosts staff enthusiasm and productivity as the contribute to a producing better cars and cleaner environment etc.

Sustainability can be applied to any organization since it is clear that all organizations are dysfunctional. That is all organizations perform at a less than their optimal rate – in a competitive market what matters is that the organization is more effective (less dysfunctional) than its peers. Any organization seeking to ensure that it is receptive, productive, informed, agile, at the cutting edge of new, positive development will benefit from a sustainability approach. Corporations are better suited to the pursuit of sustainability than, say, governments, because they have one goal of profitability, instead of the multiple objectives of government. Having said that the sustainability approach can be applied in government, as in any organization, but it will raise significant challenges – but ones that are well worth overcoming.

In the SAM process we seek to identify the leading companies in each of 58 industry sectors worldwide. The questionnaire database focuses on questions that only leading companies can answer, allowing us to compare organizations – and identify the leaders and laggards. By asking across approximately 90 questions and about 20 different major themes we are able to get a clear pattern that identifies leaders and laggards. The leaders are considered more adept at organisational performance and hence more likely to outperform their peers over the medium (5 years) to long term (10 years), ceteris paribus [all other things being equal]. The directors of these leading companies can be considered as better at fulfilling their responsibilities to create healthy organizations that can then generate healthy profits at low risk.

The apparent dilemma over fiduciary responsibilities of directors is an example of the exactly the dilemma which sustainability should resolve. This document is headed "Im a fashion model not a role model" since that was the plaintive cry of a besieged PR person on behalf of her famous client. The same was recently said by a footballer – I'm a footballer not a role model. Of course parliamentarians would never say that they were just a parliamentarian and not a role model – because they know about the negative and positive externalities of their individual jobs. Managing directors would never say that were just a MD and not a role model (though maybe the Enron team might try this one). MD's are aware of their negative and positive externalities as individuals. MD's would never say that their companies are just profit making concerns but not role models – or would they? There is a temptation in the 'business does business, government sets the rules approach" to say exactly this. Yet this Inquiry knows, intuitively, that companies and organisations are massive role models and hence are required on a daily basis to satisfactorily reconcile profit and organisational missions with the negative externalities of their activities. This reconciliation is the ultimate responsibility of the Directors and the Board.

Sustianability says that the reconciliation of the negative impacts and profitability can be a wealth generating exercise and hence in the short, medium and long term interests of the company and society. The fiduciary responsibility of the Board to look after the best interests of the company is therefore compatible with reducing the company's negative impacts on society. Indeed it could be argued that the failing to account for the negative impacts of the

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company and how they are being leveraged to create wealth (sustainability reporting) is a breach of fiduciary responsibility.

The key element here, given the general shortage of crystal balls with which to perfectly predict the future, is the need for all company Boards to report on the negative short, medium and long term impacts of their companies, whilst also explaining how these negative impacts are being reduced in a manner that creates short, medium and long term wealth for shareholders, as a necessary component of their fiduciary responsibilities.

It is my view that smart companies are beginning to think like this. The rest will need encouragement by the example of government from individual MP's to entire departments and agencies. They will also need encouragement by having the relevant laws explained in greater detail – by setting fiduciary responsibility in the context I have outlined above.

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BACKGROUND

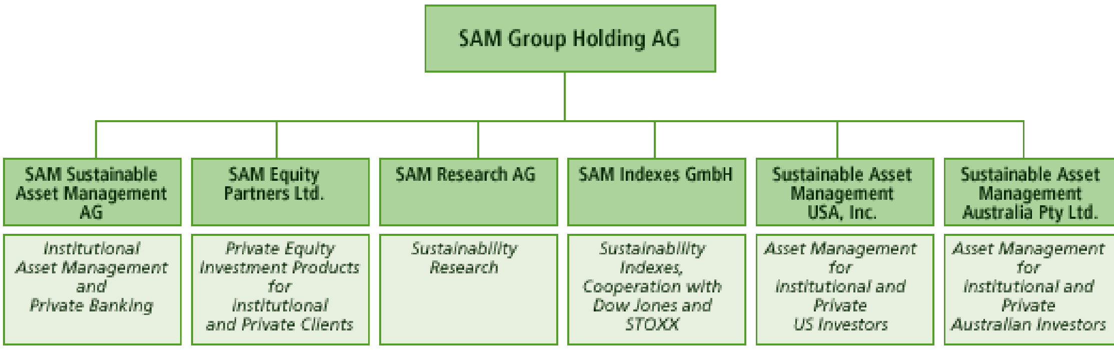
Provide a brief history of your organisation, including a description of the ownership structure and the breakdown of SRI Australian Equities managed.

SAM Sustainable Asset Management (SAM) is a wholly owned subsidiary of SAM Group Holdings AG, which was founded in 1995 and is based in Zurich, Switzerland. SAM established an office in Melbourne in February 2000 and registered as a foreign company (ARBN 101 554 778). A new subsidiary, Sustainable Asset Management Australia Pty. Ltd., became the holder of a dealer's licence.

SAM focuses solely on sustainability investing and is a pioneer and world leader in this field. SAM offers individually managed portfolios for clients in Australia and New Zealand and, in partnership with Vanguard Investments Australia (Vanguard), established two Sustainability Leaders Funds that are registered in Australia (an Australian equities product and an International equities product). Both funds have been running since November 2001. In February 2005 SAM launched, in conjunction with The Australian newspaper The Australian SAM Sustainability Index (the AuSSI). It was launched with a $10,000 grant contribution from the Victorian Environment Protection Authority. The AuSSI index is published on the front page of the business section of The Australian newspaper.

In Australia SAM has gained six superannuation fund clients and manages assets of A$442.1 million, of which A$180.8 million is in Australian Equities managed against the AuSSI index and $261.3m are in international equities managed against the DJSI (ex-Australia). In total SAM's global assets under management are in the order of A$2.5 billion. The Dow Jones Sustainability Index (DJSI) has $5 billion managed under its licenses with 55 licensees. Recent new indices include the Dow Jones Islamic Markets Sustainability Index and the United States and North American Sustainability Indexes.

SAM Corporate Structure Diagram



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INVESTMENT PHILOSOPHY

Briefly outline your investment philosophy as it relates to SRI Australian equities, highlighting why you believe you can add value over time.

The concept of corporate sustainability performance aims to increase long term shareholder value. For this reason it is very attractive to corporate management as they become increasingly aware of the potential of sustainability to lift organisational performance on a continuous basis. This outcome is also what attracts shareholders with a medium to long term investment horizon. Sustainability-driven companies achieve their business goals by utilising economic, environmental and social challenges as opportunities to increase wealth creation and reduce risk, whilst also improving outcomes for the broader society. These sustainability leading companies pursue these opportunities in a pro-active, cost-effective and responsible manner today, so that they will outpace their competitors and become tomorrow's winners.

Sustainability companies not only manage the standard economic factors affecting their businesses but also the environmental and social factors as well. There is mounting evidence that their financial performance is superior to that of companies that do not adequately, correctly and optimally manage these important factors.

The quality of a company's strategy and management, and its performance in dealing with opportunities and risks deriving from economic, environmental and social challenges can be quantified and used to identify and select leading companies for investment purposes.

The SAM corporate assessment process seeks to identify the sustainability leading companies from the lagging companies. The leading companies are relatively better at integrating sustainability with their business management and development. Over the medium to long term, all other things being equal, this should translate into greater value creation than that which occurs at lagging companies.

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PROCESS

Describe, briefly, your style/approach & process for investing in Socially Responsible Investments (SRI) for Australian & Interntional Equities. Highlight the critical steps in your process.

PROCESS for constructing the AuSSI index

Sustainability investing is a new investment style that is neutral with respect to either growth or value characteristics. It combines elements of growth and value investing whilst also creating a unique approach of its own. Hence there are 'value' companies and 'growth' companies that have leading sustainability characteristics.

The objective of the corporate sustainability assessment (CSA) is to measure and verify the corporate sustainability performance of the companies in the investable universe. High sustainability performers are more likely to have high levels of organisational competence, and hence a greater capacity to create shareholder value over the medium to long term. The objective of the corporate sustainability assessment (CSA) is to measure and verify the corporate sustainability performance of the companies in the investable universe. The SAM CSA process invites the largest listed companies in the Australian universe to participate in the assessment. Around 40 to 50 Australian companies participate each year. The remaining companies (approximately 140) are assessed on their publicly available information. The assessment is conducted by SAM's Australian research analysts based in the Melbourne office. They operate in conjunction with their Zurich and Indian colleagues.

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Each company is allocated a questionnaire accessible in the online database known as the Sustainability Information Management System (SIMS). The questionnaire is composed of approximately 70 to 90 questions which assess the sustainability performance of these Australian companies across three dimensions – economic, environmental and social. The questionnaires focus on leading edge questions that allows the SIMS scoring system to separate leading from laggard companies. Each company is allocated an overall score based on its answers and any additional documentation it provides. The companies are then ranked, in their 21 SAM AuSSI industry sectors, by score order from highest to lowest. AuSSI industry sectors are based on the Australian market conventions to closely reflect market expectations.

All companies identified as leaders are then assessed for their media stakeholder performance. That is, each company's record in daily life as recorded in the media, by financial analysts and stakeholders such as government and NGO's is reviewed, to ensure that the company behaviour lives up to the sustainability assessment. Where companies are found wanting their scores can be reduced or they can be excluded.

The leading 10% of companies in each industry are then chosen as the sustainability leaders for their industry sector. The leaders from each sector are aggregated to form the AuSSI, which forms the basis for the SAMSLAF. The AuSSI is reformulated each year with the changes announced in October. All companies chosen for the indices are constantly monitored via Factiva for activities that might mitigate their leadership position. Where such activities are detected the company can be excluded.

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The AuSSI rulebook, membership and reporting etc. is available from the AuSSI website at www.aussi.net.au.

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PROCESS for constructing the Dow Jones Sustainability Index (DJSI)

Sustainability investing is a new investment style that is neutral with respect to either growth or value characteristics. It combines elements of growth and value investing whilst also creating a unique approach of its own. Hence there are 'value' companies and 'growth' companies that have leading sustainability characteristics.

The objective of the corporate sustainability assessment (CSA) is to measure and verify the corporate sustainability performance of the companies in the investable universe. High sustainability performers are more likely to have high levels of organisational competence, and hence a greater capacity to create shareholder value over the medium to long term. The SAM CSA process invites the largest 2500 listed companies in the Dow Jones Global Index to participate in the assessment. In 2004 522 global companies participated in the assessment. Another 500 companies are were identified from industry knowledge as having some sustainability performance. These latter companies are assessed on their publicly available information. The assessment is conducted by SAM's research analysts operating in conjunction with a team of analysts from India.

Each company is allocated a questionnaire accessible in the online database known as the Sustainability Information Management System (SIMS). The questionnaire is composed of approximately 70 to 90 questions which assess the sustainability performance of these Global companies across three dimensions – economic, environmental and social. The questionnaires focus on leading edge questions that allows the SIMS scoring system to separate leading from laggard companies. Each company is allocated an overall score based on its answers and any additional documentation it provides. The companies are then ranked, in their 60 SAM/DJ industry sectors, by score order from highest to lowest. The 10% of companies with the highest score are then nominated to become members of the DJSI.

All companies nominated as leaders are then assessed for their media stakeholder performance. That is, each company's record in daily life as reported in the media, by financial analysts and stakeholders like government and NGO's are reviewed, to ensure that the company behaviour lives up to the sustainability assessment. Where companies are found wanting their scores can be reduced or they can be excluded.

The leading 10% of companies, by score order, are chosen as the sustainability leaders for the their industry sector. The leaders from each sector are aggregated to form the DJSI, which forms the basis for the SAMSLIF product. The DJSI is reformulated each year with the changes announced in early September.

The DJSI rulebook, membership and reporting etc is available from the DJSI website at www.sustainability-indexes.com. All companies chosen for the indices are constantly monitored via Factiva for activities that might mitigate their leadership position. Where such activities are detected the company can be excluded. A detailed description of the investment process can be found in Appendix II of this document.

PROCESS continued

Please describe your SRI process or overlay. For example, exclusion/screening of stocks, pro-active process (if any).

Through the assessment of economic, environmental and social challenges and trends, corporate sustainability criteria are developed. Criteria are identified for each dimension and for all industries. In addition, the criteria are defined as either general criteria applicable to all industries or industry specific criteria. All criteria are based on widely accepted standards, best practices and audit procedures (Global Reporting Initiative, Global Compact, SA8000, ISO, OECD Multilateral Guidelines, ILO Guidelines, Sectoral initiatives, etc.) as well as extensive input from industry specialists and consultants. The industry specific criteria differ between industry groups whereas the general criteria are the same for each industry group.

Both the general and industry specific criteria used in the Corporate Sustainability Assessment are addressed in the online sustainability questionnaire of SAM Research. The questionnaire is divided into three separate and distinct sections, covering the economic, environmental and social dimensions.

Economic, Environmental and Social Dimensions

Economic

Economic criteria not only reflect the financial robustness, strategic planning processes and governance of a company but also how a company adapts to changing market demands, sustainability trends and macro-economic driving

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forces. These criteria measure a company's ability to identify and make use of the economic benefits from sustainability opportunities and risks.

Environmental

Environmental criteria cover the environmental management and performance of a company. These criteria reflect a company's efforts to reduce and avoid environmental pollution. Furthermore companies may focus on benefiting from the new developments and technologies aimed at reducing resource use and environmental impacts.

Social

Social criteria cover both internal (employee relations, labour practices) and external (stakeholder, community relations) aspects of the company. Social criteria are based on worldwide minimum standards and best practices. How companies deal with human rights issues, internally, in their supply chain and in the communities in which they operate is also taken into account.

General and Industry Specific Criteria

General

General sustainability criteria are identified for each dimension and are applied to all industries. They include standard management practices applicable to all Industries, such as corporate governance, financial robustness, environmental management and performance, human rights, supply chain management, risk and crisis management and labor practices. Since these criteria address major global challenges applicable to all industries, the general criteria are weighted at approximately sixty percent of the assessment score.

Industry Specific

Industry specific criteria take into account the challenges and trends affecting specific industries. They reflect the economic, social, ecological, legal and technological forces driving the sustainability performance of a particular industry group and are weighted to approximately forty percent of the assessment.

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Process continued

What research or database information do you use in selecting or excluding stocks under your SRI process? Is your information internally/externally sourced?

Information Sources for Corporate Sustainability

Company Questionnaire

All companies are invited to participate in our online questionnaire. Questionnaires specific to each of the AuSSI industry groups are made available via the SAM website (www.sam-group.com) to the Chief Executive Officers (CEOs) and heads of investor relations of all the companies in the AuSSI investable stocks universe. The completed company questionnaire, sometimes signed by the CEO, is the most important source of information for the assessment.

Company Documentation

Documents analysed include:

• Sustainability reports;

• Environmental reports;

• Health and safety reports;

• Social reports;

• Annual financial reports;

• Special reports (e.g. on intellectual capital management, corporate governance, R&D, employee relations);

• Financial analyst's reports;

• All other sources of company information; e.g. internal documentation, brochures and website;

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• Media, stakeholder reports, and other publicly available Information; and

• Factiva.

Analysts review media, press releases, articles, and stakeholder commentary written about a company over the past two years.

Personal Contact with Companies

Each analyst personally contacts individual companies to clarify open points arising from the analysis of the questionnaire and company documents. This contact is made either via telephone, company visits, and meetings with the company at either the SAM office, company offices or at public events.

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PROCESS continued

How are “SRI” decisions regarding the portfolio or particular sectors/stocks made and implemented in the portfolio construction process?

The Corporate Sustainability Assessment enables a sustainability performance score to be calculated for each company. Reviewing, assessing and scoring all available information in line with the corporate sustainability criteria determines the overall sustainability score for each eligible company in the AuSSI investable universe. The objective of the corporate sustainability assessment is to measure and verify the corporate sustainability performance of the companies in the investable universe.

A company’s strategy, management and ability to meet industry challenges and trends are assessed through the SAM online questionnaire, a financial soundness check and reviewing company documents. A company’s track record and incidents and crisis management are verified by analysing media, company documents and stakeholder reports.

All information used in the Corporate Sustainability Assessment is collected in SAM’s Sustainability Information Management System (SIMS). SIMS not only calculates a final score for all answers provided in the questionnaire, but it also enables the analyst to enter comments related to specific questions, calculates performance data normalised to sales and production levels and provides predetermined relative scores for selected qualitative questions.

Performance

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A company's corporate sustainability performance is calculated through the questionnaire, which includes qualitative and quantitative information, a financial robustness check, incidents assessment, quality of public reporting and verification through media and stakeholder analysis, and company documentation.

Qualitative assessment

While the questionnaire is designed to ensure objectivity by limiting qualitative answers through predefined multiple-choice questions, certain open questions have been asked. Open questions enable companies to provide more information about key strategic issues, management practices and policies. To facilitate fair and impartial scoring each open question has a predefined set of answers outlined in SIMS.

Quantitative assessment

Quantitative questions track the performance of a company's environmental emissions, waste management, employee turnover, lost time due to injury, safety records, etc. All information requested is normalised to sales or production levels in order to assess the overall trend and not the absolute output levels.

Public reporting

In this stage, the analyst assesses how the implementation of policies and management systems is documented across the entire company. A company's public availability of information and documentation is evaluated for each dimension: economic, environmental and social. This evaluation covers all publicly available documentation as well as information provided to SAM Research for the AuSSI assessment.

Incident assessment

An incident assessment is used to measure the sustainability performance of a company and is completed through a Media and Stakeholder Analysis (MSA). This assessment scores the impact and number of critical incidents a company was involved in during the past two years.

Verification

The verification process assesses whether or not a company implements and commits to its stated policies and management practices. Analysts review media, press releases, articles and stakeholder commentary written about a company and if necessary, direct interaction and clarification with the company is also undertaken. This review verifies a company's track record and involvement in critical incidents.

The crisis assessment follows the same procedures as defined for the Corporate Sustainability Monitoring process. The review focuses on the 12 months preceding the publication of the AuSSI review results. The crises of a company are reviewed through this exhaustive media and stakeholder analysis which is in part based on Factiva – an online media service provided by Dow Jones, which provides access to over 6000 global media sources.

In addition, the analysts meet with a wide range of different external stakeholders, such as NGOs (e.g. WWF, Pro Natura, Amnesty International),

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universities, inter-governmental organisations (e.g. UNEP, World Business Council for Sustainable Development, World Bank), independent think-tanks (e.g. Wolfsberg Institute, Wuppertal Institute) and government taskforces (e.g. UK government task force on the Development of Alternative Energy). If a company fails to meet its stated policies and management practices, as found through the review, scores in the related performance question are reduced or entirely deleted for whole criteria or specific individual questions. Additionally, related management scores may be deleted. In extreme cases, the verification process may exclude companies from the eligibility list.

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PROCESS continued

What differentiates your team and process from other Australian Equity managers? What do you view as your key advantage? In what circumstances is your process likely to underperform?

The SAM approach is provides a capacity to coherently and systematically assess the organisational competence of the top 200 listed companies. An investment process with medium to long term horizons seeks to know which companies are more likely to have delivered greater shareholder value at some point in the future. Sustainability performance provides an insight into which companies will be most likely to achieve that outcome.

Leading sustainability behaviour tells us that the company has relatively higher levels of organizational competence. For example a relatively faster response to providing audit integrity would tend to indicate the company is more competent than its peers, all other things being equal. Hence, all other things being equal, more competent companies are expected to outperform less competent companies.

On this basis we believe that SAM's corporate sustainability assessment tool is one of the most comprehensive, coherent and sustainable techniques for identifying future shareholder value. This is our key advantage! It also relies on the insight that better social, economic and environmental performance are strongly correlated with longer term value creation enabling us to take a more complete view of an organization than that afforded by the more narrow tools used elsewhere. Consequently the wider view afforded by sustainability provides us with more data to make investment decisions on. This

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challenges the view that SRI can only be a niche product. We believe that sustainability will gradually become a mainstream approach.

Since our process selects medium to long term winners our product is likely to underperform whenever the market takes a view that certain company, sector etc is 'the latest new thing'. We have seen this effect with the Commonwealth Bank which has had its share price driven up by the market whilst admitting to cultural problems that need resolving. We can see this outcome in our assessment and hence have chosen other banks by the scoring mechanism. The market, however, has bought the story that the bank is going to change whilst we will assess the fact of change when and if it happens. In the medium to long run the facts about Commonwealth Bank will determine its average long term value. During these experiences the product can underperform and has done so in recent times solely because of the Commonwealth Bank. Similarly if the market overweights small caps or other parts of the universe the SAMSLAF can underperform.

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PORTFOLIO CONSTRUCTION

Describe the typical composition of your SRI pooled vehicle, including:

We have discussed under each of the headings provided.

Typical number of stocks under detailed research and in the portfolio

AuSSI

For the AuSSI and the SAM Sustainability Leaders Australia Fund typically 200 stocks are under detailed research. They are broken into 21 industry sectors which are analysed in the Corporate Sustainability Assessment. The top 20% from each industry sector are selected for inclusion in the portfolio. This usually consists of approximately 70 stocks.

DJSI

Typically 1000 stocks are selected globally (from amongst 2553 in 2004) for detailed research via the SAM Corporate Sustainability Assessment process. They are broken into 60 industry sectors. The top 10% from each Industry sector are selected for inclusion in the portfolio. This usually consists of approximately 300 stocks.

Index to compare performance against

S&P/ASX 200 for the AuSSI and Morgan Stanley Capital Index World ex-Australia (MSCI) for the DJSI.

Turnover

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AuSSI

Each year around October the Corporate Sustainability Assessment process culminates in a revised portfolio. Average turnover at the last changeover was in the order of 13% which is lower than that for most active managers.

In addition, during the year all stocks are assessed daily to ensure they do not breach the results of their sustainability assessment and inclusion in the portfolio. In the case where a breach is found, the stock can be removed. This has been an infrequent occurrence over the life of the portfolio thus far.

DJSI

In the early years of SAM's work on Corporate Sustainability Assessment many companies were not used to providing social, environmental and economic data to their investors, having been used to the traditional market analyst focus on the next quarterly return. As a result, the increase in this kind of data each year has been dramatic and has enabled SAM to compile the world's largest database on corporate sustainability. (For this reason SAM data was used in the recent book on sustainability launched by the World Business Council of Sustainable Development entitled "Walking the Talk" at the Johannesburg Earth Summit and again recently at the Davos World Economic Forum where the 2005 Leading Edge study was launched).

Because of the high volume increase in data each year we believe that the average turnover in the early years has been higher than in future years. Nevertheless average turnover at the last changeover was in the order of 10% which is lower than that for most active managers.

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Tracking error targets/constraints - AuSSI

From an implementation perspective, Vanguard's mandate is to manage SAMSLAF in line with the Australian SAM Sustainability Index (AuSSI) respectively

The AuSSI is constructed by Dow Jones Indexes using an optimiser originally designed by Vanguard. The optimiser provides control over the size risk and sector risk associated with the AuSSI. It essentially controls the size and sector allocations to ensure the AuSSI reflects the underlying size and sector allocations of the Australian market.

Portfolios are monitored monthly, when cash flows take place (+/-) and/ or when the index changes occur. Most of Vanguard's Funds receive daily cash flows and therefore are monitored daily versus the targeted benchmark.

The Sustainability Leaders Australia Fund currently has an ex-ante tracking error to the S&P/ASX 200 of about 1.5%. Vanguard tracks the AuSSI with an ex-ante tracking error of about 0.2%.

Tracking Error Targets & constraints - DJSI

From an implementation perspective, Vanguard's mandate is to manage the Sustainability Leaders International Fund (SAMSLIF) in line with the DJSI

World ex-Australia. Overall portfolio risk is monitored and controlled using Barra's Global Equity Model. The common factors in Barra's global equity model are countries, currencies, industries and a number of risk factors including size, success (a momentum measure), value (P/B and P/E) and volatility in markets. The number of useful (and data manageable) risk factors is lower in comparison to a single market model with the addition of the country and currency factors.

Given the exposures of stocks to these factors and the returns of the stocks, Barra uses regression analysis to determine the variance/covariance matrix for the common factors.

With the mapping of the portfolio and index to the common factors and a set of residual exposures (stock specific components), the variance/covariance matrix can be used to estimate tracking error. The objective function is to minimise estimated tracking error by manipulating stock weights.

Portfolios are monitored monthly, when cash flows take place (+/-) and/or/when the index changes occur. Most of Vanguard's Funds receive daily cash flows and therefore are monitored daily versus the targeted benchmark.

Compared to MSCI Ex-Australia the Sustainability Leaders International Fund currently has an ex-ante tracking error of 3.5% and it has maintained a tracking error close to this figure since inception.

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Please provide a full listing of the stocks held in your SRI pool as at 31 March 2005. Please provide and explain two examples of stocks your portfolio does not hold for SRI reasons.

A full listing of the stocks held in the SAM Sustainability Leaders Australia Fund (based on the AuSSI) can be found in Appendix 1 of this document. A full listing of the shares held in the SAM Sustainability Leaders International Fund (based on the DJSI) can be found in Appendix 2 of this document.

The AuSSI reviews the largest 200 listed companies on the Australian market. Companies are divided into 21 industry sectors and assessed based on the SIMS database The assessment process allocates a score to each company that then allows a ranking to be developed. Within each industry sector, in broad terms, we select the top 20% of companies each year. This ensures that the AuSSI comprises the leading companies. In many ways the AuSSI process is like the Olympics for corporations – selecting only the best in each event. As a result the assessment process excludes approximately 128 companies and includes 72 leading companies.

Exclusion is primarily by score. That is excluded companies are not chosen because their scores are lower than those achieved by their peers in the same industry. In some special cases companies are excluded based on specific issues that they face, and failed to deal with appropriately.

In 2004 we publicly excluded James Hardie from our portfolio. In previous years James Hardie has been included in our portfolio. It had, by definition,

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scored well when compared to its peers. Its handling of the asbestos issue began to raise concerns when the issue came to light in October 2003. Previously it was considered that the company had been handling the asbestos issue in a manner, similar to other companies with this risk. They had elected, so it appeared, to pay out their liabilities as these fell due on a case by case basis.

In October 2003 it began to emerge that the company had adopted a different approach. It is our opinion that the CEO and CFO at the time, decided to cap the payouts to asbestos vicitims via the use of a Foundation. It is also our opinion that the board were not fully aware of the implications of the scheme, and were not necessarily supportive of it either. The company engaged us in conversation and we engaged them a questions about their process, though we allowed the Jackson inquiry to run its course as a means of ensuring procedural fairness. From the Inquiry and the company's failure to respond to the opportunities to reverse previous poor judgement in a timely manner, we concluded that the company lacked the leadership required to maintain its position in the SAMSLAF portfolio and hence was not chosen for the inaugural AuSSI index.

In the Australian banking sector Westpac is the leading company. In 2000 Westpac was a member of the SAMSLAF but ranked relatively lowly. Through time the bank has developed its sustainability process and continues to lead its local peers in implementing sustainability practices. By contrast the Commonwealth Bank was a member of the SAMSLAF portfolio until October 2003. At changeover the portfolio it had become clear that St George Bank and Bendigo Bank, were raising their performance in this area. They displaced the Commonwealth from the SAMSLAF portfolio. The

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scoring process behind the SAM questionnaire provides a wide range of leading questions that examine corporate behaviour, performance and aspirations from corporate governance to environmental performance to remuneration practices. These questions ensure that a leader must perform across the whole range of its activities to be selected for the Index. Non-inclusion on the basis of score, indicates that an organization relative, to its peers is lagging in its development.

DJSI selection process

The DJSI reviews the largest 2,500 listed companies. Companies are divided into 60 industry sectors and assessed based on the SIMS database The assessment process allocates a score to each company that then allows a ranking to be developed. Within each industry sector only the top 10% of companies are chosen each year. This ensures that the DJSI comprises the leading companies. In many ways the DJSI process is like the Olympics for corporations – selecting only the best in each event. As a result the assessment process excludes approximately 2200 companies and includes 330 leading companies.

Exclusion is primarily by score. That is excluded companies are not chosen because their scores are lower than those achieved by their peers in the same industry. In some special cases companies are excluded based on specific issues that they face, and failed to deal with appropriately.

The global banking sector comprises approximately 300 banks. Of these the DJSI chooses approximately 30 for the Index each year. Westpac leads the global banking sector. In 2000 Westpac was a member of the DJSI but ranked relatively lowly. Through time the bank has developed its sustainability process and now leads it global peers in implementing sustainability practices. By contrast the Commonwealth Bank has never been a member of the DJSI, whilst the ANZ and NAB, more recently, have begun to compete explicitly in this area. The ANZ and NAB have become members of the DJSI. The scoring process behind the SAM questionnaire provides a wide range of leading questions that examine corporate behaviour, performance and aspirations from corporate governance to environmental performance to remuneration practices. These questions ensure that a leader must perform across the whole range of its activities to be selected for the Index. Non-inclusion on the basis of score, indicates that an organization relative, to its peers is lagging in its development.

In the global mining sector the DJSI has chosen BHP-Billiton and Rio Tinto as opposed to Xstrata, who is not included. Once again the SAM sustainability assessment scoring process comes into play. Having sampled the available data from each company the system allocated a better relative performance to Rio Tinto and BHP-Billiton. As a result they scored more highly and were selected in the top 10% of their industry sector. A copy of the mining industry questionnaire from 2004 has been attached to the email accompanying this document.

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Appendix 1

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Appendix 2

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Appendix 3 – DJSI and AUSSI press releases and presentations

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