# Pensions Committee

## 2.30 p.m., Wednesday, 24 June 2015

# Statement of Investment Principles

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| **Item number** | 5.7 |
| **Report number** | |
| **Executive/routine** | |
| **Wards** | All |

## Executive summary

The City of Edinburgh Council agreed on 12 March 2015 to ask the Convener of the Pensions Committee to request a report on the potential impact to the Funds of divesting in fossil fuels. This report addresses this request.

It also presents an updated Statement of Investment Principles for the Lothian Pension Fund, Lothian Buses Fund and Scottish Homes Pension Fund (the Funds') for agreement by Committee.

## Links

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| **Coalition pledges** | |
| **Council outcomes** | CO26 |
| **Single Outcome Agreement** | |

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THE CITY OF EDINBURGH COUNCIL

# Report

## Statement of Investment Principles

### Recommendations

1.1 That Committee invites the Pension Board to raise any relevant matters or concerns which the Committee should consider.

1.2 That the Committee notes the potential impact of divesting in fossil fuels.

1.3 That the Committee adopts the revised Statement of Investment Principles.

### Background

2.1 At its meeting on 12 March 2015, the City of Edinburgh Council decided the following:

"This Council:

1. Notes the recent decision by the City of Oslo to partially divest from fossil fuel investments, and further notes that Oslo joins a growing number of cities and institutions around the world, including Oxford City Council, Dunedin City Council in New Zealand and the University of Glasgow, to agree to partially or completely divest from fossil fuels;

2. Notes the report to Corporate Policy and Strategy Committee on 3 December 2013 on Lothian Pension Fund Engagement Activities which set out the current arrangement for reviewing the social and environmental impact of the three Local Government Pension Funds under the Council's administration which concludes that the fiduciary duty must be paramount in all decision making around the funds;

3. Notes that recent studies, including by Impax Asset Management, have found that fossil fuel-based funds may underperform funds which exclude fossil fuels, and further notes reports including from business leadership think-tank Ceres which identify substantial unreported risks in fossil fuel funds, which suggest the fiduciary duty may be best served by divestment from fossil fuels;

4. Notes recent clarification from Cabinet Secretary for Finance John Swinney MSP that local authorities may decide that fulfilment of their Public Bodies Duties under the Climate Change (Scotland) Act 2009 requires them to reduce the carbon emissions associated with their funds and investments;

5. Calls for a report to Corporate Policy and Strategy Committee within three cycles setting out the feasibility, costs and benefits of introducing a partial or complete fossil fuel divestment strategy.

6. Asks the Convener of the Pensions Committee to request a report, on the potential impact to the fund of divesting in fossil fuels, to be brought forward to that Committee in the next quarter.

7. Instructs the Head of Finance to review these proposals in the context of the Council's ethical investment policy."

2.2 This report addresses the request for a report under item 6 above on "the potential impact to the fund divesting in fossil fuels".

2.3 The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010 require administering authorities to prepare, maintain and publish a written Statement of Investment Principles (SIP). This report also presents an updated SIP.

## Main report

**Divestment in Fossil Fuels**

3.1 In advance of UN climate talks in Paris in December 2015, groups concerned about the potential effects of climate change have been campaigning for institutional investors, such as pension funds and university endowment funds, and other investors to sell their investments in fossil fuel companies.

3.2 The debate centres on "stranded assets", the risk that the fossil fuel reserves of companies are devalued by future carbon regulation. The issue is whether fossil fuel companies will be able to extract and monetise their oil, gas and coal reserves if climate regulation is increased. If the reserves cannot be extracted they will become "stranded assets" and form a "carbon bubble".

3.3 Some institutions have adopted varying degrees of fossil fuel divestment goals and other institutions have rejected divestment. The Council's decision refers to the decisions of several public bodies and institutions, which have agreed to partial or complete divestment. It is reported that:

- City of Oslo committed to selling its pension fund investments in coal companies[1];
- Oxford City Council pledged to make no direct investments in fossil fuel companies for ethical reasons. The Oxfordshire Pension Fund Committee manages the scheme on behalf of over 100 employers, including the county and city councils. The Committee determined that there was no clear financial justification for divesting in fossil fuel companies.[2]

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[1] http://www.theguardian.com/environment/2015/mar/02/oslo-divests-from-coal-companies
[2] http://www.oxfordshireguardian.co.uk/petition-calls-on-county-council-to-start-divesting

- Dunedin City Council in New Zealand voted not to invest in fossil fuel extraction companies as part of an ethical policy that also excludes munitions, tobacco, gambling and pornography industries. It committed to divest the Waipori Fund, a Council fund, of any such investments within two years.[3]
- The University of Glasgow has committed to fully disinvesting from fossil fuel industry companies over a 10 year period, subject to reassurance that the financial impact for the University is acceptable.[4]

3.4 In addition, Council noted clarification by John Swinney MSP around local authorities' fulfilment of their Public Bodies Duties under the Climate Change (Scotland) Act 2009. However, to date no change has been made to the guidance provided by Scottish Ministers to Public Bodies under the Climate Change (Scotland) Act 2009.

**Fiduciary Duty**

3.5 The Council noted a 3 December 2013 report highlighting that fiduciary duty must be paramount in all decision making around the (pension) Funds. This is embodied in the Fund's Statement of Investment Principles.

3.6 In April 2014, the Local Government Association on behalf of the Local Government Pension Scheme (LGPS) Shadow Scheme Advisory Board in England and Wales obtained legal opinion[5] on fiduciary duty. One of the conclusions was that "the precise choice of investment may be influenced by wider social, ethical or environmental considerations, so long as that does not risk material financial detriment to the fund."

3.7 The Law Commission (England & Wales) also produced a report on "Fiduciary Duties of Investment Intermediaries"[6] in 2014. The Law Commission concluded that, while the pursuit of a financial return should be the predominant concern of pension trustees, the law is sufficiently flexible to allow other, non-financial, concerns to be taken into account provided trustees have good reason to think that scheme members share their view, and there is no risk of significant financial detriment to the fund.

3.8 Whilst these developments do not strictly speaking apply to the Scottish Local Government Pension Scheme (LGPS), it can be reasonably concluded that the developments will have a strong influence. The workplan for the LGPS Scheme Advisory Board in Scotland includes consideration of fiduciary duty.

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[3] http://www.odt.co.nz/news/dunedin/302183/agreement-ethical-investment
[4] http://www.gla.ac.uk/news/headline_364008_en.html
[5] http://www.lgpsboard.org/images/PDF/Publications/QCOpinionApril2014.pdf
[6] http://lawcommission.justice.gov.uk/docs/lc350_fiduciary_duties.pdf

3.9 Following the Law Commission report, the UK government launched a consultation[7] on the Occupational Pension Schemes (Investment) Regulations ("The Investment Regulations"), which closed on 24 April 2015. The government response is expected later in 2015.

The Fund will continue to monitor developments in the interpretation of fiduciary duty and potential changes to investment regulations. For example, how can funds conclude that members share a particular view and balance this against complying with their fiduciary duty and the potential challenges.

**Current Investment Approach**

3.10 Currently, the Fund's primary approach is to appoint investment managers who are expected to judge each investment on a number of factors, such as risk and return. As responsible investors, environmental, social and governance (ESG) issues are included in this process.

3.11 The Funds do not have a policy of disinvestment or exclusion. Rather, the policy is to consider ESG issues in the investment considerations. Further, the Fund engages with companies in order to manage any ESG risks, encourage greater transparency and encourage positive change as a shareholder. The Funds collaborate with other investors to improve the chances of successful engagement. The Funds also vote on all their shares.

3.12 Engagement provides the opportunity for the Fund to gain greater disclosure of a company's risk of exposure to low carbon scenarios and potentially stranded assets. It also provides the opportunity to influence companies' consideration of capital expenditure and lobbying against climate change policy.

3.13 For example, the Funds recently supported the "Aiming for A" resolutions on climate change resilience at the BP, Shell and Statoil AGMs. These special resolutions called for further reporting on ongoing operational emissions management, asset portfolio resilience to the International Energy Agency's scenarios, low carbon research and development and investment strategies, relevant key performance indicators and executive incentives, and public policy positions relating to climate change.

3.14 Arguably divestment would remove that access to company management and would not change global levels of supply and demand of fossil fuel production. Divestment results in shares being sold to other investors, who may be less concerned about climate change and less inclined to engage with management to change behaviour for the better.

[7] https://www.gov.uk/government/consultations/changes-to-the-law-on-investments-in-occupational-pension-schemes

### Investment Considerations

3.15 From an investment perspective, the Funds own shares in companies as part of their strategies to achieve the primary goal of paying pensions over the life of the Funds. For example, equity investments constitute approximately two thirds of Lothian Pension Fund's assets and they generate a return from capital growth and the payment of dividends.

3.16 There is no recognised list of "fossil fuel" companies proposed as targets for divestment by campaigners. Analysis of the Fund's holdings using two different industry classifications shows that the Lothian Pension Fund and Lothian Buses Pension Fund own shares in:

- 29 companies in the GICS energy sector worth approximately £151m (equivalent to 3%);

or using an alternative classification:

- 19 companies in the Carbon Underground 200 worth approximately £113m (equivalent to 2%). (These companies overlap).

3.17 The Funds appoint managers to invest in companies using a number of different investment strategies in order to achieve a diversification and the 'fossil fuel' companies (noted above) are held across a number of portfolios, managed both internally and externally. Managers are not compelled to hold any specific shares. Some managers undertake fundamental analysis of individual companies including forward-looking projections including consideration of ESG issues. Other managers select companies using quantitative analysis which is, by its nature, based on historic information.

3.18 It is also worth noting that the Funds also hold renewable energy investments. The Fund made its first investment in renewable/clean energy in 2006. At 31 December 2014, it had committed over £20m to renewable energy focused funds and approximately 28% of the Fund's infrastructure investments (£268m) are in renewable energy projects, including wind, water, solar, biogas and waste management. Two further commitments have been made to renewable energy investments this year. The Fund also invests in sustainable timberlands with Forest Stewardship Council or equivalent certification, having made over £80m of commitments since 2010.

### Impact of Disinvestment from Fossil Fuels

3.19 As the Fund's primary aim is to pay pensions, its primary concern is the financial impact of divesting. There are three main types of costs of divestiture.

3.20 **Trading Cost**: disinvestment involves selling shares and buying other shares, both of which involve the payment of broker commissions, bid-ask spreads (the difference between the price to sell and the price to buy the same share), exchange fees and taxes, such as stamp duty. The Fund's experience and industry studies show that processing and execution costs[8] and the price impact[9] of trading £150m of shares (selling £150m existing shareholdings and buying £150m of other shares) are significant. Some of the costs are fixed and some depend on market conditions at the time of trading. Total trading costs are estimated to be in the region of £1.5m and £2.5m. This would be a one-off cost.

3.21 **Compliance Cost**: as there is no definition of a 'fossil fuel' company, there could be significant cost involved in identifying shares to be sold, new shares to be bought and ongoing monitoring of shares to be included or excluded as investment criteria/exclusions are changed. Whilst a simple divestment programme could be instigated, there are practical issues. Individual companies' climate impacts change over time. Many of the obvious targets for divestment also invest in renewable energy; and other companies produce products that are complements for fossil fuels, such as car manufacturers and companies that provide support for fossil fuel production, such as banks. These complexities could be overcome by employing additional resource to develop and monitor 'fossil fuel' criteria or by appointing such specialist investment managers. This is an ongoing cost, which would depend on implementation approach.

3.22 **Diversification Cost**: according to widely-accepted financial theory, investors lose the benefits of diversification and suffer a lower investment return for a given level of portfolio risk whenever a category of shares is removed from a portfolio. To calculate this cost requires calculating the correlation of the category of shares with the rest of the portfolio over the long term. In a study[10] (financed by the Independent Petroleum Association of America) Professor Daniel Fischel shows that the energy sector's low correlation with other sectors suggests that diversification costs could be high. This is necessarily a backward looking study (1965-2014), which showed that the diversification cost of divesting energy stocks was approximately 0.5% per year risk-adjusted. Over the fifty year period, the divested portfolio would have lost 23 percent due to divestment.

3.23 Of course, the future diversification cost cannot be known in advance as correlations and future performance will change. However, this is a potential cost and an ongoing cost, and as such all other things being equal, if investment performance disappoints, employer contributions would need to be higher.

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[8] Elkins/McSherry Bundled VWAP Global Universe 4Q12 Estimates.

[9] Louis K.C. Chan & Josef Lakonishok (1995) "The Behavior of Stock Prices Around Institutional Trades," *Journal of Finance*, (4):1147-1174, at p. 1148.

[10] http://divestmentfacts.com/pdf/Fischel_Report.pdf

**Conclusion**

3.24 Fiduciary duty remains paramount in all decision making around the pension funds. There have been some recent developments in the interpretation in fiduciary duty. However, they reinforce that the approach currently adopted by the Funds in incorporating environmental, social and governance issues in decision making is appropriate. It will be important to continue to monitor future developments in this area.

3.25 While the precise impact of divestment from fossil fuel companies is unknown, certain costs are guaranteed and the overall impact could be significant. To the extent that divestment reduces the Funds' investment return in the future as compared to one that retains the ability to invest in the shares of fossil fuel companies, there is risk to the employer contributions. Such an occurrence could be challenged, for example by employers and/or taxpayers to whom the financial burden would fall. This is a significant risk for the Funds.

3.26 Accordingly the revised Statement of Investment Principles (SIP), which is provided in the Appendix for approval, is largely unchanged from that agreed by Committee in June 2014. The SIP is formally reviewed annually whether there are policy changes or not. Changes are modest and include:

- updates in the investment management benchmarks, objectives and structures of the Funds reflecting the evolving investment strategies;
- the role of the new Pension Board, which replaced the Consultative Panel on 31 March 2015;
- the wording regarding responsible investments has been updated.

## Measures of success

4.1 Success of the investment strategies will, among other things, be measured by the achievement of the investment and funding objectives of the Funds.

## Financial impact

5.1 There are no direct financial implications as a result of the Statement of Investment Principles report.

5.2 The report highlights that there is potentially a significant financial impact from divestment of fossil fuel companies.

## Risk, policy, compliance and governance impact

6.1 The Statement of Investment Principles details how the risks, compliance and governance aspects of the Funds are managed. Such a statement is required under the Local Government Pension Scheme Regulations. Appendix C of the Statement illustrates compliance with the CIPFA principles.

## Equalities impact

7.1 There are no equalities implications as a result of this report.

## Sustainability impact

8.1 The Statement sets out the Funds' approach to responsible ownership and details how voting, engagement and other Environmental, Social and Governance activity will be undertaken. Compliance with the Statement is expected to contribute to the sustainability of the Funds' investments.

## Consultation and engagement

9.1 The Pension Board, comprising member and employer representatives, is integral to governance. The Statement is published on the Funds' website.

## Background reading/external references

None


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## Links

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|---|---|
| **Coalition pledges** | |
| **Council outcomes** | CO26 - The Council engages with stakeholders and works in partnerships to improve services and deliver agreed |
| **Single Outcome Agreement** | |
| **Appendices** | Appendix 1 – Statement of Investment Principles including:<br>Appendix A – Investment Strategy<br>Appendix B – Statement of Compliance with UK Stewardship Code<br>Appendix C – Lothian Pension Fund's Compliance with the CIPFA Principles for Investment Decision Making in the Local Governance Pension Scheme |

**Appendix 1**

**LOTHIAN PENSION FUND, LOTHIAN BUSES PENSION FUND and SCOTTISH HOMES PENSION FUND ('the Funds')**

**STATEMENT OF INVESTMENT PRINCIPLES (June 2015)**

## 1. Introduction

1.1 This Statement of Investment Principles was agreed by the Pensions Committee of the City of Edinburgh Council on 24 June 2015.

1.2 The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010 require administering authorities to prepare, maintain and publish a written Statement of Investment Principles (SIP). The SIP must be reviewed from time to time in accordance with any material changes in the Policy. In preparing this statement, the Committee has taken professional advice from the Investment Strategy Panel, which includes external advisers.

## 2. Governance

2.1 The City of Edinburgh Council (CEC) is the administering authority for the Lothian Pension Fund, the Lothian Buses Pension Fund and Scottish Homes Pension Fund.

2.2 The Pensions Committee ("the Committee") of the City of Edinburgh Council has delegated responsibility for the supervision of the Funds.

2.3 This SIP sets out the principles governing decisions about the investments of the Funds. The Committee recognises the importance of environmental, social and corporate governance (ESG) issues in ensuring the long term financial performance of the companies in which they invest.

2.4 The SIP forms part of a framework that includes
- The Statutory Regulations
- The Pensions Committee
- The Investment Strategy Panel
- The Pension Board
- The Funds' Advisors
- The Funds' Funding Strategy Statement.

## 3. Investment Objectives & Benchmarks

3.1 The primary aim of the Funds is to ensure that all members and their dependants receive their benefits when they become payable.

3.2 The funding objectives for each Fund are documented in the Committee's Funding Strategy Statement.

3.3 The Funds seek to control risk through investing in a diverse range of investments. The Pensions Committee sets an investment strategy for each Fund, taking into account the funding status and liabilities. The strategies are subject to regular review. Details of each Fund's strategic asset allocation are provided in Appendix A.

3.4 The Funds' focus within the strategic asset allocation is on risk, income and capital protection. The Funds are assessed relative to a benchmark, but success is also measured in terms of the level and growth of income and the volatility of absolute performance.

3.5 The investment objectives of the Funds are to achieve the same return as the benchmark over the long term economic cycle (typically five years or more). Over shorter periods, the Funds should perform better than the benchmark if markets fall significantly.

3.6 The Lothian Pension Fund adopts a long-term investment strategy, aiming to maximise the investment return within reasonable and considered risk parameters and hence minimise the cost to the employer. However some employers (typically those which have a short expected duration in the Fund) will be assumed to be invested in lower-risk investments i.e. index-linked government bonds. This aims to reduce the degree of short-term change in employer contribution rates in the period prior to an employer leaving the Fund. In addition it is recognised that there may also be demand from individual employers for a lower-risk investment strategy for their section of the Fund. The Fund will consider such requests subject to practical implementation of such strategies and if appropriate, a review of employer contribution rates. It is not practical for the Fund to offer individual employers full flexibility on asset allocation.

## 4. Investment Management Structure

4.1 The Funds employ a combination of managers with the aim of delivering, in aggregate, the objectives of each Fund. Each Fund employs different types of managers depending on the requirements of the Fund.

4.2 To reduce the risk that a Fund does not deliver its objective, performance and risk targets and controls are set for each manager relative to their benchmark. The details are included in formal fixed term Investment Management Agreements. In addition, managers and their performance are monitored on a regular basis.

4.3 The investment managers are responsible for the selection of individual holdings within each type of investment category within the parameters set out in their agreement.

4.4 The selection of investment managers complies fully with European Union directives on competitive tendering.

4.5 Specialist transition managers are employed to manage complex changes in investment strategy and/or manager(s).

4.6 Details of the Funds' investment managers are provided in Appendix A.

## 5. Underlying Investments

### Types of Investment

5.1 The Committee has approved the use of the following different types of investment and income generating mechanisms to achieve their overall investment objectives:

- Listed and Unlisted Equities (including Managed Funds, Unit Trusts, Investment Trusts, Open Ended Investment Companies and Exchange Traded Funds),
- Bonds including index-linked and fixed interest bonds, issued by both government and corporations;
- Alternative investments (including Infrastructure, Property, Timber, Agriculture, Currency and other asset classes as agreed by the Investment Strategy Panel),
- Cash (including Treasury Bills and Money Market Funds),
- Derivatives,
- Stock lending,
- Commission recapture,
- Underwriting.

### The Balance Between Different Types of Investments & Risks

5.2 The Pensions Committee sets investment strategy for each Fund, taking into account the funding status and liabilities. The strategies are subject to regular review.

5.3 Asset liability modelling techniques, which measure the risk of the Fund relative to the liabilities, are used to assist in the strategy reviews, as appropriate.

5.4 The Funds seek to control risk by investing in a diverse range of investments both domestically and globally. All investments are assessed consistently and include consideration of environmental, social and governance issues which affect financial risk and returns.

5.5 The risk of the Funds performing differently to their benchmarks is monitored using an independent performance and risk specialist. The internal investment team and the Investment Strategy Panel monitor risks on a quarterly basis.

**Expected return on investments**

5.6 Each Fund expects its investments to produce a return over the long term above that of the investment return assumed in the actuarial valuation.

**Realisation of investments**

5.7 The majority of each Fund's investments are quoted on major stock markets and may be realised relatively quickly if required. A proportion of each Fund's investments (such as property, private equity and infrastructure) would take longer to be realised. The overall liquidity of each Fund's assets is considered in the light of potential demands for cash.

**Stock Lending**

5.8 Lothian Pension Fund and Lothian Buses Pension Fund lend a proportion of their investments in order to maximise additional income. Stock lending is conducted within the parameters prescribed in the regulations. Stock lending does not prevent any investments from being sold. Safeguards are in place to reduce the risk of financial loss in the event of default. These safeguards include receiving liquid collateral in excess of the value of the loan, indemnity agreement with the lending agent and regular reviews of credit-worthiness of potential borrowers.

**Responsible Investment**

5.9 The Pensions Committee believes that investing responsibly can affect the financial performance of companies. It has a responsibility to take environmental, social and governance issues seriously and where appropriate, to act upon them in a manner which is consistent with the paramount fiduciary duty to provide the highest standards of stewardship on behalf of the members, employers and tax-payers.

5.10 The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting high quality corporate governance and reporting.

5.11 As long term investors the Funds recognise the importance of promoting responsible stewardship and long term decision making. The Funds seek to adhere to the FRC'S UK Stewardship Code, and encourage our appointed asset managers to do so too. Details of adherence to the Code are provided in Appendix B. The Funds' voting and engagement policies promote good governance and stewardship of companies.

### Safekeeping of Assets

5.12 The services of a global custodian are employed to ensure the safekeeping of investments.

### Performance measurement

5.13 An independent provider is employed to calculate performance for the Funds. Each quarter, the Investment Strategy Panel considers the performance of the combined assets and each manager's portfolio against their respective benchmark. The Pensions Committee reviews performance on an annual basis.

## 6. Compliance

### Regulations and Investment Limits

6.1 The Funds are compliant with the statutory restrictions set out in the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010.

The Regulations contain limits on the percentage of a pension fund that may be invested in certain asset types and provide for the limits to be raised, subject to certain requirements being met. The Committee have agreed that the limits applicable to the Funds' investments in partnerships be raised in order to accommodate the strategic allocation to Alternative Investments, including infrastructure and to private equity. The Committee decision was that:

- The limit in respect of all contributions into any single partnership be raised from 2% to 5%.
- The limit in respect of all contributions into partnerships be raised from 5% to 15%.

The Committee took proper advice in respect of this decision from the Investment Strategy Panel and from officers. This decision will apply for the period for which the Funds' strategic investment benchmarks include allocations to investments which involve investment in partnerships, unless investment considerations require an earlier review. This decision is compliant with the Regulations.

### CIPFA Principles for Investment Decision Making in the Local Government Pension Scheme

6.2 Regulations require administering authorities to publish the extent to which they comply with guidance issued by the Scottish Ministers, which in turn refer to guidance issued by Chartered Institute of Public Finance and Accountancy. The Funds' compliance with the guidance is provided in Appendix C.

## 7. Review

7.1 The Pensions Committee will review this statement annually or more frequently if appropriate. The Committee will consult with such persons as it considers appropriate and take proper advice when revising the statement.

## Lothian Pension Fund

### Investment Strategy

| | Interim Strategy 01/04/15 (%) | Long Term Strategy 2012-2017 [1] (%) | Permitted Range [1] (%) |
|---|---|---|---|
| **Total Equities** | **68** | **65** | **50 – 75** |
| **Index-Linked Assets** | **7** | **7** | **0 – 20** |
| **Alternatives** | **24** | **28** | **20 – 35** |
| **Cash** | **1** | **0** | **0 – 10** |
| **TOTAL** | **100** | **100** | |

[1] Revised strategy agreed by Committee October 2012, which will be implemented gradually over time.

### Investment Management Structure at 30 April 2015

- 6 Global Equity Managers (external: Nordea, Cantillon, Harris; internal: 3 mandates)
- 6 Regional Equity Managers (external: Mondrian and UBS for Emerging Markets; internal: UK All Cap, UK Mid Cap, US and Europe ex-UK)
- Private equity investments in a range of direct funds, fund-of-funds and listed vehicles, some of which are managed internally.
- 1 Index-Linked Manager (Internal)
- Alternative Investments include a range of direct funds, fund-of-funds and listed vehicles invested in infrastructure, debt, property and timber, some of which are managed internally.
- 1 Currency Manager (internal)
- 1 Cash Manager (managed alongside CEC cash)

The breakdown of assets by manager is provided in the Fund's Annual Report & Accounts which can be found at www.lpf.org.uk.

## Lothian Buses Pension Fund

### Investment Strategy

| | Interim Strategy 01/04/15 (%) | Long Term Strategy 2012-2017 [1] (%) | Permitted Range [1] (%) |
|---|---|---|---|
| **Equities** | **60.5** | **55** | **45-65** |
| **Index-Linked Assets** | **12.0** | **15** | **10-30** |
| **Alternatives** | **27.5** | **30** | **10-35** |
| **Cash** | **0** | **0** | **0-10** |
| **TOTAL** | **100.0** | **100** | |

[1] Revised Strategy agreed by Committee in October 2012. The revised strategy will be implemented gradually.

### Investment Management Structure at 30 April 2015

- Global equities: internal and Baillie Gifford
- Listed Private equity: internal
- Index Linked Gilts: internal and Baillie Gifford
- Corporate bonds:  Baillie Gifford
- Property: Standard Life
- Alternative Investments include a range of direct funds, fund-of-funds and listed vehicles invested in infrastructure, debt, property and timber, some of which are managed internally.
- 1 Cash Manager (managed alongside CEC cash)

The breakdown of assets by manager is provided in the Fund's Annual Report & Accounts which can be found at www.lpf.org.uk.

## Scottish Homes Pension Fund

### Investment Strategy

Committee approved a change to the investment strategy in December 2014 whereby the equity and bond allocations are adjusted depending on the funding level in accordance with the following table:

| Equity Allocation % | Funding level | Note [1] |
|---|---|---|
| 35 | 89.5% | 2011 TFL |
| 30 | 91.5% | 2014 TFL |
| 25 | 93.0% | 2017 TFL |
| 20 | 94.5% | 2020 TFL |
| 15 | 95.5% | 2023 TFL |
| 10 | 96.5% | 2026 TFL |

**[1]** Target Funding Level as per the Guarantee

The strategy at 30 April 2015 is shown in the table below.

| | **Strategy at 30/04/2015 %** |
|---|---|
| **Equities** | |
| UK | 5.6 |
| US | 7.7 |
| Europe (ex UK) | 5.0 |
| Pacific inc Japan | 4.7 |
| Emerging markets | 2.0 |
| **Sub-total** | **25.0** |
| **Bonds** | |
| UK Fixed Interest Gilts | 14.1 |
| UK Index Linked Gilts | 55.9 |
| **Subtotal** | **70.0** |
| **Property** | **5.0** |
| **Cash** | **0.0** |
| **TOTAL** | **100.0** |

### Investment Manager Arrangements at 30 April 2015

Equities: State Street.
Bonds:  State Street and internal
Property: Schroders.

The breakdown of assets by manager is provided in the Fund's Annual Report & Accounts which can be found at www.lpf.org.uk.

| Statement of Compliance with UK Stewardship Code | |
|---|---|
| **Principle 1**<br>Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities. | We acknowledge our role as an asset owner under the Stewardship Code and therefore seek to hold to account our fund managers and service providers in respect of their commitments to the Code.<br>In practice our policy is to apply the Code through<br><br>a) The appointment of Hermes Equity Ownership Services (EOS) to assist in fulfilling our fiduciary responsibilities as long term shareholders. We believe that the monitoring of shareholdings by Hermes EOS enables us to provide the highest standards of stewardship on behalf of the beneficiaries of the pension funds.<br><br>Hermes EOS has the expertise in corporate engagement to carry forward this work on an international basis. Their aim is to bring about positive long-term change at companies through a focussed and value-oriented approach.<br><br>Engagements undertaken by Hermes EOS on our behalf are guided by the Hermes Responsible Ownership Principles http://www.hermes.co.uk/Portals/8/The_Hermes_Ownership_Principles_UK.pdf<br><br>Besides engagement on an individual company level, through Hermes EOS, we also work to establish effective regulatory regimes in the various markets in which we invest to encourage governance structures that facilitate accountability of companies to their owners, give companies the certainty they need to plan for the future and to level the playing field to ensure companies are not disadvantaged for prioritising long-term profitability.<br><br>b) As well as Hermes EOS, three of our Fund Managers, Baillie Gifford, State Street and UBS, take direct responsibility for stewardship issues, voting and engagement, in the funds which they manage on our behalf. These managers publish Statements of Compliance with the Stewardship code.<br><br>Details are available at:-<br>https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code/UK-Stewardship-Code-statements.aspx<br><br>c) Through our membership of the Local Authority Pension Fund Forum (LAPFF), we keep informed of potential issues of concern at both individual companies and across the market as a whole, which leads to collaborative engagement. |

| Statement of Compliance with UK Stewardship Code | |
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| **Principle 2** Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed. | Our relationship with Hermes EOS enables us effectively to manage conflicts of interest in relation to our stewardship work. Hermes EOS conflicts of interest policy, which explains how it manages conflicts on our behalf, can be found at http://hermes.yellowtailcms.co.uk/Portals/8/Conflicts_of_interest_policy.pdf.<br><br>We also encourage the asset managers employed by the Funds to have effective policies addressing potential conflicts of interest.<br><br>In respect of conflicts of interest within the Funds, Pensions Committee members are required to make declarations of interest prior to Committee meetings.<br><br>Our policy of constructive engagement with companies is consistent with the Funds' fiduciary responsibilities. |
| **Principle 3** Institutional investors should monitor their investee companies. | Day-to-day responsibility for monitoring our equity holdings is delegated to Hermes EOS, Baillie Gifford, State Street and UBS. We expect them to monitor companies, intervene where necessary, and report back regularly on activity. Details are provided quarterly on the Funds' website. This includes both the total number of company meetings where the Funds have voted and details of individual companies where we have voted against company management.<br><br>LAPFF also monitors and engages with companies and provides an 'Alerts' service which highlights concerns over corporate governance issues.<br>The internal investment management team adhere to the Funds' compliance policy on insider information. In order to foster a positive working relationship with an individual company and to build trust, Hermes EOS may be willing to become an insider. In such circumstances, the relevant information will not be passed to the internal team until after it is no longer inside information. |

| Statement of Compliance with UK Stewardship Code | |
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| **Principle 4** Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value. | As highlighted above, responsibility for day-to-day interaction with companies is delegated, including the escalation of engagement when necessary.<br>We expect the approach to engagement on our behalf to be value orientated and focussed on long term sustainable profitability. We expect Hermes EOS, Baillie Gifford, State Street and UBS to disclose their guidelines for such activities in their own statements of adherence to the Code.<br>We may also propose escalation of activity through the Local Authority Pension Fund Forum.<br>Consistent with our fiduciary duty to beneficiaries, we also participate in shareholder litigation. We pursue compensation for any losses sustained because of inappropriate actions by company directors in order to encourage improved conduct in the future. |
| **Principle 5** Institutional investors should be willing to act collectively with other investors where appropriate | We seek to work collaboratively with other institutional shareholders in order to maximise the influence that we can have on individual companies. We do this through:<br>- membership of the Local Authority Pension Fund Forum, which engages with companies over environmental, social and governance issues on behalf of its members.<br>- the appointment of Hermes EOS also signals our commitment to the benefits of collective shareholder engagement. Hermes EOS pools together investors' resources to create an engagement service which aims to protect and enhance shareholder value. Hermes EOS represents us at many national, regional and global organisations through which we seek to enhance our effectiveness by working collaboratively with other institutions. Among these are: the Principles for Responsible Investment (PRI) and its Clearinghouse for engagements (as well as a number of more localised PRI initiatives); the International Corporate Governance Network; the Asian Corporate Governance Association; the Canadian Coalition for Good Governance , Eumedion and the NAPF. Hermes EOS seeks to work with these organisations and also alongside other individual investors to effect change most efficiently.<br>- being a signatory of the PRI in our own right.<br>- being a signatory since 2009 to the Carbon Disclosure Project (CDP) Information Request. The information gathered by CDP forms the largest database of corporate climate change information in the world. |

| Statement of Compliance with UK Stewardship Code | |
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| **Principle 6** Institutional investors should have a clear policy on voting and disclosure of voting activity. | The emphasis of our voting policy is to promote best practice. We seek to vote on all shares held. The Funds have an active stock lending programme but consider recalling stock from a loan where it appears that this would be an appropriate way to safeguard the Funds' financial interests.<br><br>Our preference is for managers to vote on the Funds' behalf and for responsible stewardship to be integral to the investment decision making process.<br><br>We are comfortable with delegation of voting to Baillie Gifford and UBS for the funds they manage. State Street vote on our behalf because the investment is in a pooled fund. The managers' voting policies can be found at the websites mentioned above.<br><br>For the remaining funds, Hermes EOS votes consistently, across the portfolios it covers, and makes voting decisions based on a thorough analysis of publicly available information and always take account of a company's individual circumstances. Hermes EOS informs companies where it has concerns and seeks a resolution prior to taking the decision to vote against management. In this way, it uses our votes as a lever for positive change at companies.<br><br>Underpinning voting decisions are Hermes EOS Regional Corporate Governance policies which can be found at the "How we invest" section of our website.<br><br>We disclose our historic voting information on our website. This includes the total number of companies where the Funds voted and details of individual companies where we have voted against company management.<br>We disclose in arrears so that we are transparent and accountable but dialogue with companies in our portfolios is not compromised. |
| **Principle 7** Institutional investors should report periodically on their stewardship and voting activities. | We report annually on stewardship activity through a specific section in the Funds' annual report and accounts and on our website.<br>We also report annually on stewardship issues to the Pensions Committee.<br>We have reviewed this Statement in June 2015. We will review the Statement annually. |
| | For further information please contact Marlyn.McConaghie @edinburgh.gov.uk |

**Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund (the Funds), Compliance with the CIPFA Principles for Investment Decision Making in the Local Government Pension Scheme.**

The Funds comply with the six CIPFA Principles.  Details of the principles and the Funds' compliance are described below.

**Principle 1 – Effective decision making**
*Administering authorities should ensure that decisions are taken by persons or organisations with the skills, knowledge, advice and resources necessary to take them effectively and monitor their implementation*; and
*Those persons or organisations should have sufficient expertise to be able to evaluate and challenge the advice they receive, and manage conflicts of interest.*

- The Funds' Trustee Training Policy (comprising a compulsory training seminar for all new trustees and ongoing training of at least three days per year for all members of the Pensions Committee and Pension Board) provides knowledge to be able to evaluate and challenge the advice they receive. Standards relating to the administration of the Committee's business are strictly up-held.

- The Pensions Committee focuses on setting the strategy for the Funds and monitoring performance. The Pension Board also attends Committee meetings and is responsible for assisting the Committee in securing compliance with relevant regulations and other legislation.

- The Committee delegates the day-to-day running of the Funds to the Director of Corporate Governance. The Director of Corporate Governance is responsible for the provision of the training plan for Committee to help them to make effective decisions to ensure that they are fully aware of their statutory and fiduciary responsibilities, and to regularly remind them of their stewardship role.

- The Investment Strategy Panel advises the Director of Corporate Governance on the implementation of the agreed strategies, reviewing structure, funding monitoring, performance and risk and asset allocation. The Investment Strategy Panel meets quarterly and is made up of experienced investment professionals, including independent advisers.

- The in-house team undertakes day-to-day monitoring of the Funds. The team includes personnel with suitable professional qualifications and experience to provide the necessary skills, knowledge, advice and resources to support the Investment Strategy Panel and the Pensions Committee.

- Conflicts of interest are managed actively. At each Committee meeting, elected members (acting as 'trustees' of the Funds) are asked to highlight conflicts of interest. A Code of Conduct applies to members of the Committee and the Pension Board. The Funds have a Compliance Policy which ensures conflicts of interest are highlighted and managed appropriately.

**Principle 2 – Clear Objectives**
*Overall investment objectives should be set out for the fund that take account of the scheme's liabilities, the potential impact on local council tax payers, the strength of the covenant of the participating employers, and the attitude to risk of both the administering authority and the scheme employers, and these should be clearly communicated to advisers and investment managers.*

- The Statement of Investment Principles and the Funding Strategy Statement define the Funds' primary funding objectives.

- Asset-liability modelling is undertaken with the help of external advisers to aid the setting of investment strategy in order to understand risks. Each Fund has a scheme-specific investment strategy.

- The attitude to risk of employers is specifically taken into account in the setting of strategy.

- Reviews of investment strategy focus on the split between broad asset classes (equities, bonds and alternative investments).

- Investment Management Agreements set clear benchmarks and risk parameters to achieve and include the requirement to comply with the Funds' Statement of Investment Principles.

- Appointments of advisers are reviewed regularly. Investment and actuarial advisers are appointed under separate contract. Procurement of advisers is conducted within European Union procurement regulations.

- The setting of the Funding Strategy included specific consideration of the need to maintain stability in employer contribution rates.

**Principle 3 – Risk and liabilities**

*In setting and reviewing their investment strategy, administering authorities should take account of the form and structure of liabilities.*
*These include the implications for council tax payers; the strength of the covenant of participating authorities; the risk of their default, and longevity risk.*

- The Funds take advice from the scheme's actuary regarding the nature of its liabilities. Asset-liability modelling is undertaken periodically to aid the setting of investment strategy, and these exercises specifically take account of covenant strength and longevity risk.

- It is recognised that within Lothian Pension Fund, employers' circumstances vary and a lower-risk investment strategy for their section(s) of the Fund may be deemed suitable. The Fund will also consider such requests subject to practical implementation of such strategies and if appropriate, a review of employer contribution rates. It is not practical for the Fund to offer individual employers full flexibility on asset allocation.

- The Funding objectives for the Funds are expressed in relation to the solvency and employer contribution rates. The Funds regularly assess the covenants of participating employers.

- The Director of Corporate Governance is responsible for ensuring appropriate controls of the Funds. Controls are subject to internal audit and results of audits are submitted to the Pensions Audit Sub Committee and/or the Pensions Committee.

- The Funds maintain a risk register which is reviewed on a quarterly basis.

**Principle 4 – Performance assessment**

*Arrangements should be in place for the formal measurement of the performance of the investments, investment managers and advisers. Administering authorities should also periodically make a formal policy assessment of their own effectiveness as a decision-making body and report on this to scheme members.*

- The Funds' performance and risk analysis is produced by an independent external provider.

- The internal investment team assesses the external investment managers' performance and risk on a regular basis. The Investment Strategy Panel assess the performance and risk of the internal and external investment managers on a regular basis.

- The Funds' contracts with its advisers are regularly market tested.

- The Investment Strategy Panel assesses its own performance on a regular basis and reports to Committee on its activities, typically annually.

- Training and attendance of members of the Pensions Committee and the Pensions Board are monitored and reported on a regular basis. The composition of the Committee and Pension Board is reviewed on a regular basis.

**Principle 5 – Responsible ownership**
*Administering authorities should adopt, or ensure their investment managers adopt, the Institutional Shareholders' Committee Statement of Principles on the responsibilities of shareholders and agents.*
*A statement of the authority's policy on responsible ownership should be included in the Statement of Investment Principles.*
*Administering authorities should report periodically to members on the discharge of such responsibilities.*

- The Funds' policy on responsible ownership is included in the statement on the FRC's Stewardship Code (see Appendix B of the Statement of Investment Principles).
- Details of the Funds' voting and engagements are available on the Funds' website. The Funds' annual report and accounts includes a summary of the Funds' approach to responsible investment. A summary of the report and accounts is sent to members. The full report is available on the website and is sent to members on request.

**Principle 6 – Transparency and reporting**
*Administering authorities should act in a transparent manner, communicating with stakeholders on issues relating to their management of investment, its governance and risks, including performance against stated objectives; and Provide regular communication to members in the form they consider most appropriate.*

- Meetings of the Pensions Committee are open to the public. Members of the public are allowed to provide deputations at Committee meetings. Committee papers are available on the City of Edinburgh Council's website. The Pension Board joins the Committee at all meetings.
- The Committee's remit covers wider pension scheme issues, other than the management and investment of funds.
- The Funds' policy statements, including the Communications Strategy, Statement of Investment Principles and Funding Strategy Statement are maintained regularly. Stakeholders are consulted on changes. Documents are available on the Funds' website.
- The Funds produce an Annual Report & Accounts, a summary of which is sent to members. The full report is available on the website, and is sent to members on request.
- The Funds also produce regular newsletters for members as well as an annual benefit statement. Regular briefings are also provided to employers. The Funds' website is updated regularly.