

# Environmental, Social & Governance Activity Report

# Environmental, Social & Governance

- “The Pensions Committee believes that investing responsibly can affect the financial performance of companies”

*Statement of Investment Principles June 2015*

- Policy of constructive engagement
- Consistent with fiduciary duty

## Responsible Investment

# Voting & Engagement

- Baillie Gifford, UBS and State Street take direct responsibility
- Hermes Equity Ownership Services (EOS) for all other equity exposure
- Local Authority Pension Fund Forum (LAPFF)

## Effective Stewardship

# Hermes EOS Voting & Engagement

- Effective use of resources
- 26 person, multi-national team
- £146.6bn in assets under advice (Sep'15) for “some of the world’s leading pension funds”

*Hermes website*

## Effective Use of Resources

# Hermes EOS - Voting

- Hermes EOS voted on the Funds' behalf at 389 meetings on 5,772 resolutions in Q2 2015
- Voted against or abstained on 402 resolutions
- Often vote against management on
  - Board Structure
  - Remuneration
- Have ability to over-ride Hermes

## Effective Use of Resources

# Hermes EOS - Engagement

- Identifies issues amongst its holdings where engagement could reap benefits
- Screens across clients' aggregate holdings to target engagement activity
- Sets objectives before interacting with companies
- Measures progress towards objectives using milestones until completed or discontinued

## Client Driven Engagement

# Engagement by Issue

## Q3 2015

### Environmental 23%

- Biodiversity 5.9%
- Climate change/carbon intensity 58.8%
- Environmental management 11.8%
- Forestry 5.9%
- Oil sands 5.9%
- Waste 5.9%
- Water stress 5.9%

### Governance 35%

- Board structure 19.2%
- Other governance 3.8%
- Remuneration 38.5%
- Separation of chair/CEO 19.2%
- Shareholder communications 7.7%
- Succession planning 11.5%

### Social and Ethical 28%

- Access to medicine 9.5%
- Bribery and corruption 19.0%
- Community relations 9.5%
- Corporate culture 9.5%
- Employee relations 4.8%
- Health and safety 19.0%
- Licence to operate 4.8%
- Operations in troubled regions 4.8%
- Supply chain management 19.0%

### Strategy and Risk 14%

- Business strategy 30.0%
- Reputational risk 20.0%
- Risk management 50.0%

Source: Hermes EOS

## Broad Range of Issues

# Milestone Status

| Theme                    | Total engagement objectives | Engagement objective status |                |                      |                  | Completed engagement objectives |              |
|--------------------------|-----------------------------|-----------------------------|----------------|----------------------|------------------|---------------------------------|--------------|
|                          |                             | Objective set               | Concern raised | Concern acknowledged | Plan established | Completed                       | Discontinued |
| Environmental            | 37                          | 3                           | 4              | 12                   | 8                | 8                               | 2            |
| Social and ethical       | 73                          | 12                          | 7              | 18                   | 23               | 12                              | 1            |
| Governance               | 148                         | 12                          | 34             | 42                   | 29               | 26                              | 5            |
| Strategy and risk        | 43                          | 5                           | 6              | 16                   | 9                | 3                               | 4            |
| <b>Total engagements</b> | <b>301</b>                  | <b>32</b>                   | <b>51</b>      | <b>88</b>            | <b>69</b>        | <b>49</b>                       | <b>12</b>    |

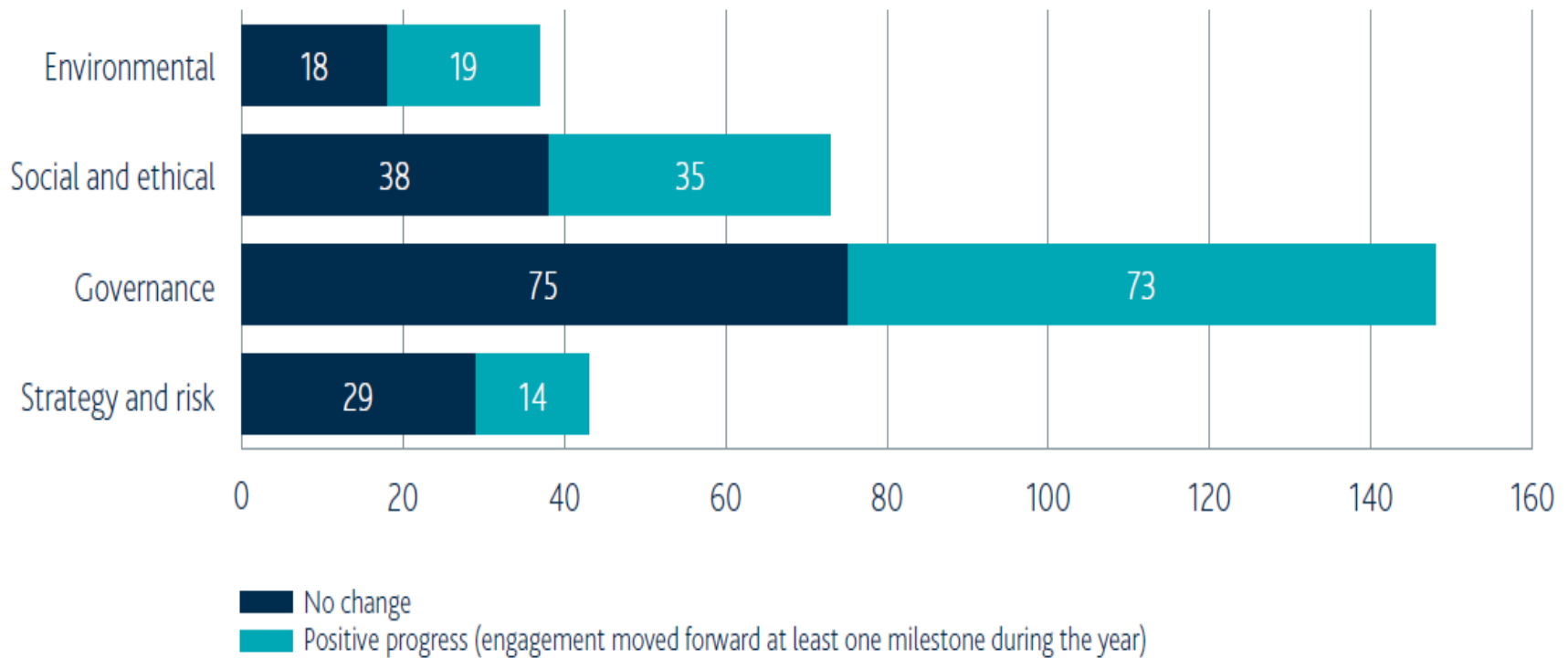
Source: Hermes EOS

## Objectives Measured





# Engagement Progress 2014



Source: Hermes EOS

## Objectives Measured

# Internal Equities & ESG

- UNPRI assessment highlighted scope for improved ESG integration for internal equities
- MSCI provide ESG specific company research and analysis, & highlight issues/areas for improvement
- “MSCI ESG Research is the world’s largest provider of ESG research.....work with 45 of the top 50 global asset managers”

*MSCI website*

## Positive progress over 2015

# Summary

- Investing responsibly can affect the financial performance of companies
- Policy of constructive engagement
- Enhanced internal resources in 2015 supplement external voting & engagement
- Refer to [www.lpf.org.uk](http://www.lpf.org.uk) for further information

## Responsible Investment

# Questions

# Investment Strategy

# Lothian Pension Fund

| Asset Category      | Investment Strategy 2012-17 % | Interim Strategy Dec 2015 % | Actual Allocation Dec 2015 % | Permitted Range % |
|---------------------|-------------------------------|-----------------------------|------------------------------|-------------------|
| Equities            | 65                            | 68                          | 67.5                         | 50 – 75           |
| Index-Linked Assets | 7                             | 7                           | 7.0                          | 0 – 20            |
| Alternatives        | 28                            | 24                          | 23.0                         | 20 – 35           |
| Cash                | 0                             | 1                           | 2.5                          | 0 - 10            |
| <b>TOTAL</b>        | <b>100</b>                    | <b>100</b>                  | <b>100</b>                   |                   |

**Committee approved strategy in October 2012**



# Strategy Review Considerations

- Actuarial valuation (funding level)
- Membership trends (contributions/cash flow)
- Expected returns (investment income/cash flow)
- Covenant

# State Street Observations

Performance Measurement Expert

## Size Can Be Beneficial

Access to broader investment pool (building blocks)

Opportunity for internal management

## Active Management Can Add Value

But timing of manager change remains elusive

## Diversification Has Reduced Risk

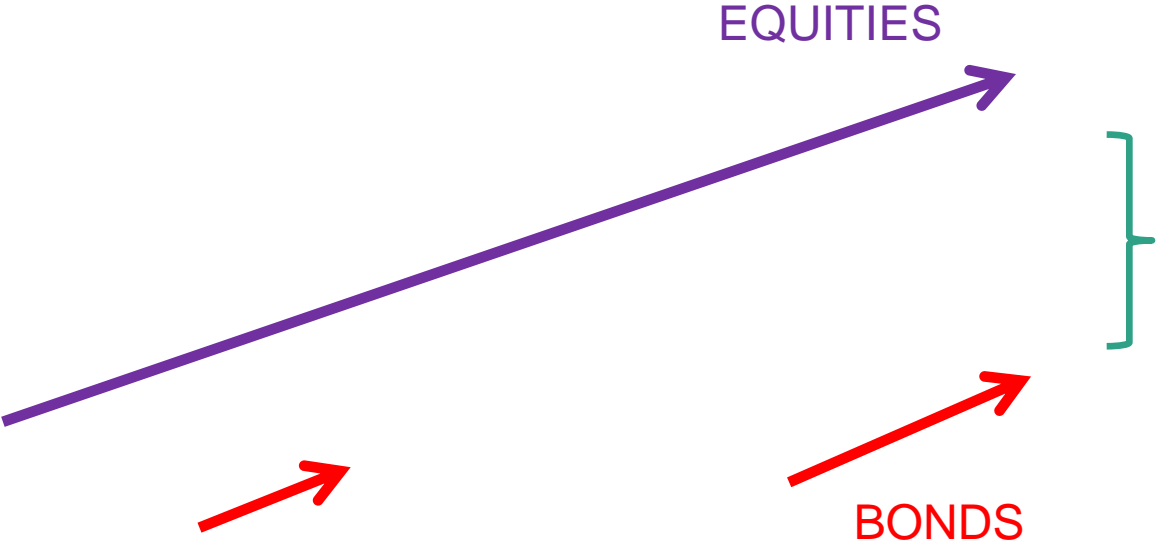
But for most funds, accompanied by reduction in return

## Cost Savings and Return Generation Matter

Focus should be on value for money



# World Real Returns since 1900



“Triumph of the Optimists”

Dimson, Marsh, Staunton

# Asset Allocation Decisions

## Investment Strategy Panel

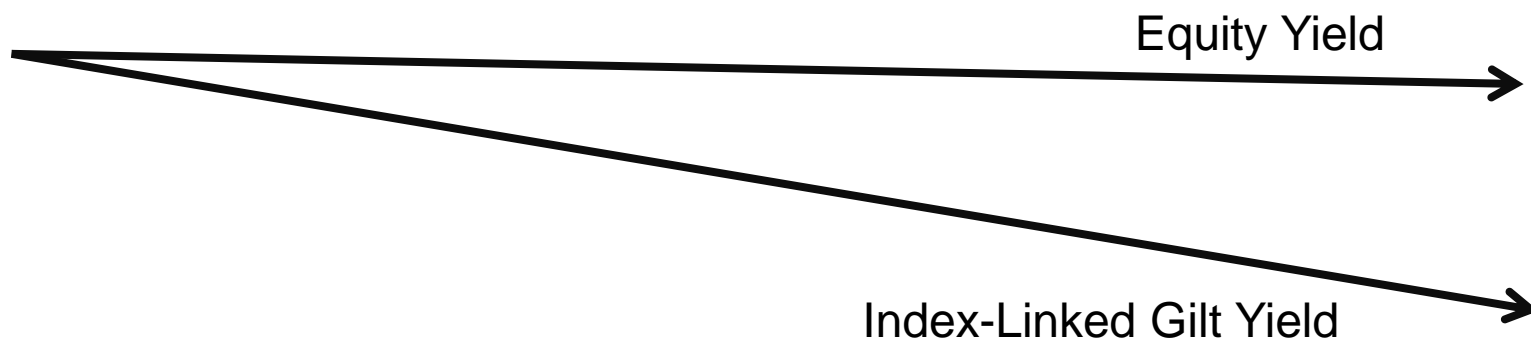
### Regular Items

- 4 Investment Monitoring (traffic lights)
  - a) Overall Funds' changes, including net new money
  - b) Externally managed portfolios
  - c) Internally managed portfolios
  - d) Governance of in-house team
  
- 5 Asset/Liability Context - Investment Markets
  - a) Multi-asset strategy/perspectives
  - b) Equity strategy/perspectives
  - c) Bond strategy/perspectives (see item 3e)
  - d) Real Asset strategy/perspectives
  - e) Currency strategy/perspectives
  - f) Adviser ideas/perspectives
  
- 6 Investment Strategy Implementation
  - a) LPF: funding level, cash flow summary, current position/deviation from strategy, manager allocations, planned changes
  - b) LBPF: funding level, cash flow summary, current position/deviation from strategy, manager allocations, planned changes
  - c) SHPF: funding level, cash flow summary, current position/deviation from strategy, manager allocations, planned changes

**Framework Reviewed Quarterly**

# UK Equities DY same as I-L Yield in 1994

## Now, approx. 4% higher



**Valuation change over last 20+ years**

# Asset Allocation Decisions

## Investment Strategy Panel

Regular monitoring informs asset allocation

One example of perspectives: Income yields relative to each other and relative to their own histories

**Valuation: 15 year perspective**

# Risk-adjusted Returns Empirical Evidence

| Stock Market                 | Weighting Scheme                | Return<br>% pa | Volatility<br>% pa |
|------------------------------|---------------------------------|----------------|--------------------|
| <i>US (1967 to 2012)</i>     | Capitalisation weighted         | 9.8            | 15.4               |
|                              | Equally Weighted Low Volatility | 11.8           | 12.7               |
|                              |                                 |                | 82%                |
| <i>Global (1987 to 2012)</i> | Capitalisation weighted         | 7.6            | 15.8               |
|                              | Equally Weighted Low Volatility | 10.6           | 11.8               |
|                              |                                 |                | 75%                |

Source: Journal of Portfolio Management, Summer 2014

## Lower Risk and Higher Return

# Lothian Pension Fund Listed Equities

## Ex-post Risk

|                       | 1yr   | 3yr   | 5yr   | Since Apr '07 |
|-----------------------|-------|-------|-------|---------------|
| <b>Fund</b>           | 10.1  | 8.9   | 10.2  | 14.6          |
| <b>Benchmark</b>      | 10.9  | 9.5   | 10.6  | 14.9          |
| <b>Fund/Benchmark</b> | 92.7% | 93.7% | 96.2% | 98.0%         |

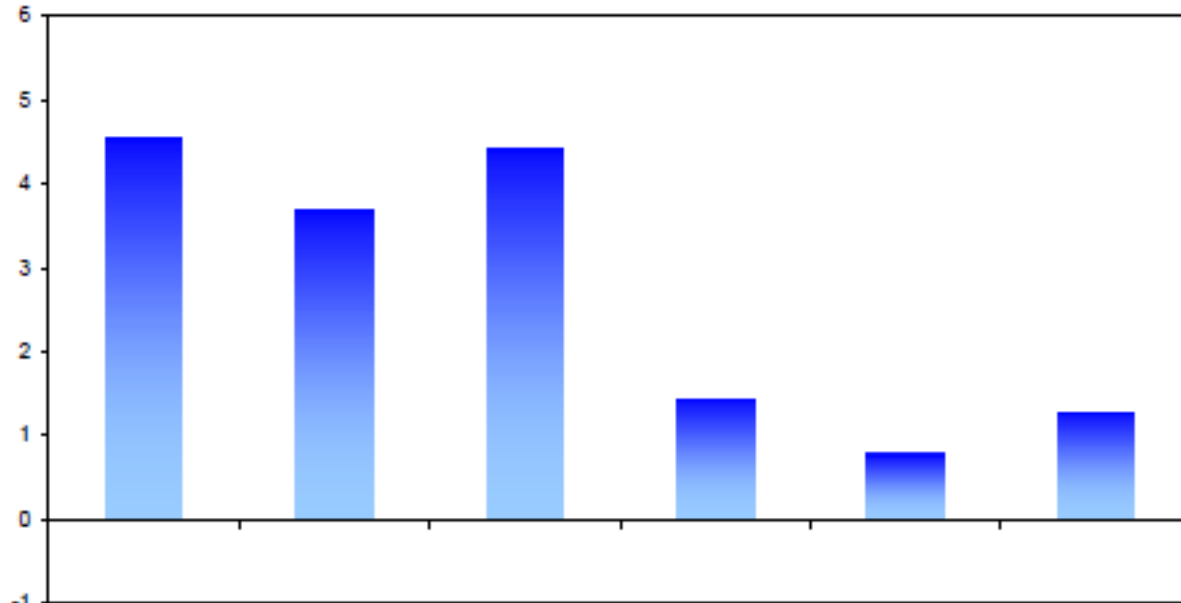
To end September 2015

Source: Portfolio Evaluation

## Lower Risk Equities

# Lothian Pension Fund Listed Equities

## Excess Returns %



|                  | QTR  | YTD   | 1 Yr | 3 Yr | 5 Yr | Since Apr 07 (p.a.) |
|------------------|------|-------|------|------|------|---------------------|
| Excess Return    | 4.5  | 3.7   | 4.4  | 1.4  | 0.8  | 1.3                 |
| Portfolio Return | -1.9 | -7.3  | 3.8  | 10.4 | 7.8  | 6.5                 |
| Benchmark Return | -6.4 | -11.0 | -0.7 | 8.9  | 7.0  | 5.2                 |

All returns for periods in excess of 1 year are annualised.

Source: Portfolio Evaluation

# Lothian Pension Fund

## Total Fund

### Ex-post Risk

|                       | 3yr   | 5yr   | 10yr  | Since Apr '07 |
|-----------------------|-------|-------|-------|---------------|
| <b>Total Fund</b>     | 6.3   | 7     | 7     | 10.5          |
| <b>Benchmark</b>      | 6.8   | 7.1   | 7.1   | 11.1          |
| <b>Fund/Benchmark</b> | 92.6% | 98.6% | 98.6% | 94.6%         |

To end September 2015

Source: Portfolio Evaluation

## Lower-than-benchmark Risk





# Lothian Pension Fund Equity Risk & Return

| <b>Quarter Ending</b> | <b>Fund Return %</b> | <b>Benchmark Return %</b> | <b>Relative Return %</b> |
|-----------------------|----------------------|---------------------------|--------------------------|
| Dec 2014              | 4.3                  | 3.6                       | 0.7                      |
| Mar 2015              | 7.3                  | 7.7                       | -0.4                     |
| June 2015             | -5.6                 | -4.9                      | -0.7                     |
| Sept 2015             | -1.9                 | -6.4                      | 4.5                      |

**6 month return -7.3% vs -11.0%;  
12 month return +3.8% vs -0.7%**

# Lothian Pension Fund

## Total Fund Risk & Return

| Quarter Ending | Fund Return % | Benchmark Return % | Relative Return % |
|----------------|---------------|--------------------|-------------------|
| Dec 2014       | 4.7           | 3.5                | 1.2               |
| Mar 2015       | 5.8           | 5.7                | 0.1               |
| June 2015      | -3.6          | -3.3               | -0.3              |
| Sept 2015      | 0.3           | -3.9               | 4.2               |

**6 month return -3.3% vs -7.0%;**  
**12 month return +7.1% vs +1.7%**

# Questions