

# Pensions Committee

2.00 p.m., Monday, 27 June 2016

## Statement of Investment Principles

Item number	5.6
Report number	
Executive/routine	
Wards	All

### Executive summary

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This report introduces the revised Statement of Investment Principles (SIP) for Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund (the Funds). It replaces the SIP agreed by Committee in June 2015.

### Links

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Coalition pledges

Council outcomes [CO26](#)

Single Outcome Agreement

## Statement of Investment Principles

### Recommendations

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- 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 adopts the revised Statement of Investment Principles.

### Background

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- 2.1 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.

### Main report

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- 3.1 The Statement of Investment Principles is formally reviewed annually whether there are policy changes or not. It has been reviewed by officers and the Investment Strategy Panel. The strategic allocations and investment management structures of the three Funds have been updated to reflect the strategy reviews which were completed over the last year.
- 3.2 One material issue described below is a change to the limit permitted in 'partnership' investments.

#### **Investment Strategy Updates**

- 3.3 Lothian Pension Fund manages two investment strategies, which provide employers with access to a level of risk appropriate to their individual circumstances. The Statement of Investment Principles has been updated to reflect the two investment strategies that are currently available (see Appendix A). The Fund is exploring the feasibility of introducing further strategy options.
- 3.4 Most employer liabilities of Lothian Pension Fund are funded by Investment Strategy 2012-17 (Strategy 1). The strategy is diversified across a range of assets, but the majority of investments are in growth assets, including equities. Employer liabilities accounting for less than 1% of the Fund are funded by a gilts-only strategy (Strategy 2), which invests entirely in UK index linked gilts in order to reduce risk for these employers.
- 3.5 The Lothian Buses Investment Strategy approved by Pensions Committee in March 2016 is shown in Appendix A. The Executive Director of Resources has historically implemented strategy within the constraints of permitted ranges of

asset allocation. Proposed ranges for asset allocation, which were not defined in the strategy review, are now shown in Appendix A for Committee approval.

### Investments in Partnerships

- 3.6 One material change to the draft Statement of Investment Principles stems from the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Amendment Regulations 2016, which came into force on 1 April 2016. These regulations permit an increase in the proportion of funds that local authority pension funds can invest in partnerships from a maximum of 15% to a maximum of 30%.
- 3.7 The background to the change were the concerns expressed in some quarters that funds lacked sufficient flexibility to access suitable investment opportunities. The Local Government and Regeneration Committee of the Scottish Parliament noted that local authority pension funds may not be in a position to diversify their investments into vehicles established to take advantage of potential returns from investment in infrastructure. In particular, it was suggested that difficulties were caused by the 15% limit set by the Investment Regulations on investment in partnerships.
- 3.8 The regulations refer to the proportion “invested” in “partnerships”, which leaves room for interpretation. The term “invested” can be interpreted as the latest market value of the investment or, alternatively (and more commonly used by Funds), as the amount paid into Limited Partnerships less the amount received back as distributions. The interpretation affects the calculation of the proportion invested.
- 3.9 The ‘partnership’ investments of Lothian Pension Fund and Lothian Buses Pension Fund at 31 March 2016 are shown in the tables below, which demonstrate the importance of the method of calculation.

<b>Lothian Pension Fund</b>	<b>* Amount Invested</b>	<b>% of Total</b>	<b>Market value at 31 March 2016</b>	<b>% of Total</b>
	<b>£m</b>	<b>Fund</b>	<b>£m</b>	<b>Fund</b>
Private Debt	37	0.7%	38	0.7%
Infrastructure	307	5.7%	384	7.1%
Private Equity	24	0.4%	169	3.1%
Real Estate	12	0.2%	50	0.9%
Timberland	64	1.2%	125	2.3%
<b>TOTAL</b>	<b>444</b>	<b>8.2%</b>	<b>766</b>	<b>14.1%</b>

<b>Lothian Buses Pension Fund</b>	<b>*Amount Invested</b>	<b>% of Total</b>	<b>Market value at 31 March 2016</b>	<b>% of Total</b>
	<b>£m</b>	<b>Fund</b>	<b>£m</b>	<b>Fund</b>
Private Debt	3	0.7%	3	0.7%
Infrastructure	13	3.4%	18	4.6%
Timberland	4	0.9%	8	2.1%
<b>TOTAL</b>	<b>20</b>	<b>5.0%</b>	<b>29</b>	<b>7.4%</b>

\* ‘Amount invested’ is the amount paid into limited partnerships less the amount paid back in distributions.

- 3.10 In addition to Limited Partnership structures, Lothian Pension Fund has 0.5% invested in other unlisted legal structures at 31 March 2016. Lothian Buses Pension Fund has no other unlisted structures.
- 3.11 The Fund views the impact of unlisted investment structures on the liquidity of Fund investments as a more important issue than the definitions of “invested” and “partnerships”. Certain asset types and certain investment structures are illiquid. Whether that is an important issue will depend on the Fund’s requirement for cash to pay pension payments. The Fund monitors cashflow requirements and the liquidity of investments as a whole.
- 3.12 Committee is asked to approve the proposal to increase the Lothian Pension Fund and Lothian Buses Pension Fund maximum permissible proportion of funds invested in partnerships from 15% to 20% on the advice of the Investment Strategy Panel and the officers of the Fund. This increase will allow the implementation of the investment strategy (including further infrastructure and private debt investment) to proceed using the most appropriate legal structures without the concern that the Funds will breach the limit, particularly if interpreted using the current market value. The draft Statement of Investment Principles has incorporated this increase. The appropriateness of the limit will be kept under review.

### **Fiduciary Duty**

- 3.13 The Statement of Investment Principles Responsible Investment section refers to fiduciary duty. The Fund believes that Environmental, Social and Governance factors should be considered in investment making decisions as they may have a material financial impact. However investments will not be excluded solely on ethical grounds.
- 3.14 Investments will be made in order to obtain the best returns for the Funds while acting prudently. Investments will be made with the intention of achieving the best financial position for the fund whilst balancing risk and return considerations.
- 3.15 These principles are based on the current interpretation of fiduciary duty. Committee will recall that a legal opinion has been sought by the Scottish LGPS Scheme Advisory Board and it is anticipated that this will be available to funds in due course. The Statement of Investment Principles will be reviewed when the opinion is released to Funds.

### **Measures of success**

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- 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

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- 5.1 One potential financial implication of increasing the proportion of investments in partnerships is a reduced ability to liquidate assets quickly. However the Fund monitors cashflow requirements and the liquidity of investments as a whole and the Investment Strategy Panel takes this into consideration when advising on investment strategy limits for each Fund. It is entirely appropriate for long term investors, such as Lothian Pension Fund and Lothian Buses Pension Fund, to invest 20% of assets in partnerships.

## Risk, policy, compliance and governance impact

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- 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

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

## Sustainability impact

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- 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

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- 9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Funds.

## Background reading/external references

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None

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## Links

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The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010

<http://www.lgpsregs.org/timelineregs/scot/maninvst/SSI20100233/20100233.htm>

LGPS Regulations and Guidance, including The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Amendment Regulations 2016

<http://www.lgpsregs.org/index.php/scotland/sppa-circulars>

The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Amendment Regulations 2016 – SPPA Policy Note

[http://www.legislation.gov.uk/ssi/2016/74/pdfs/ssipn\\_20160074\\_en.pdf](http://www.legislation.gov.uk/ssi/2016/74/pdfs/ssipn_20160074_en.pdf)

### 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:  
Appendix A – Investment Strategy  
Appendix B – Statement of Compliance with UK Stewardship Code  
Appendix C – Lothian Pension Fund’s Compliance with the CIPFA Principles for Investment Decision Making in the Local Governance Pension Scheme

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

**STATEMENT OF INVESTMENT PRINCIPLES (June 2016)**

**1. Introduction**

- 1.1 This Statement of Investment Principles was agreed by the Pensions Committee of the City of Edinburgh Council on 27 June 2016.
- 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 and revised within six months of 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 Pension Board
  - The Investment Strategy Panel
  - 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 Pensions Committee sets the investment strategies 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 allocations are provided in Appendix A.
- 3.4 In order to provide suitable investment strategies for differing requirements of employers, Lothian Pension Fund currently operates two investment strategies. Most employer liabilities are funded in Strategy 1, which invests in a diversified portfolio of assets. Employers (with the exception of Transferee Admitted Bodies) that are close to leaving the Fund are funded in Strategy 2, which invests in a portfolio of UK index linked gilts to reduce investment risk for these employers. These employers account for less than 1% of the Fund's liabilities.
- 3.5 In addition, it is recognised that there may also be demand from individual employers for other investment strategies 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.
- 3.6 The Lothian Pension Fund **Strategy 1** 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.
- 3.7 The Lothian Pension Fund **Strategy 2** adopts a lower risk approach for some employers (typically those which have a short expected duration in the Fund) and invests in index-linked government bonds to reduce the degree of short-term change in funding level and employer contribution rates.
- 3.8 The investments in Lothian Pension Fund Strategy 1, Lothian Buses Pension Fund and Scottish Homes Pension 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. The investment objectives of the Lothian Pension Fund Strategy 1, Lothian Buses Pension Fund and Scottish Homes Pension Funds are to achieve the same return as the strategic allocation over the long term economic cycle (typically five years or more). Over shorter periods, the Funds should perform better than the strategic allocation if markets fall significantly. The investment objective of Lothian Pension Fund Strategy 2 is to invest in low risk assets that minimise funding level risk.



## **4. Investment Management Structure**

- 4.1 The Funds employ a combination of managers and mandates with the aim of delivering, in aggregate, the objectives of each Fund. Each Fund employs different types of managers and mandates 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 its benchmark. For external managers, the details are included in formal Investment Management Agreements; similarly, internal mandates have formal objectives and constraints. Both external and internal managers' risk and return are measured by an independent performance measurement specialist. Performance and mandate implementation is monitored by the Investment Strategy Panel 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 external investment managers complies fully with European Union directives on competitive tendering.
- 4.5 The internal investment team manage transitions and specialist transition managers can be employed to manage more complex changes in investment strategy and/or manager(s) if required.
- 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, Money Market Funds and Secured Investments);
  - 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. The Executive Director of Resources, with advice from the Investment Strategy Panel, implements the investment strategy, including mandate design and investment manager appointments.
- 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 With the exception of Strategy 2, 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 benchmarks. 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 and the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Amendment Regulations 2016.

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 the limits applicable to the Funds' investments in partnerships be raised in order to accommodate the allocation to unlisted investments, including infrastructure, timber, property, equity and debt. The limits agreed by Committee are:

- All contributions to any single partnership 5% (which compares with the statutory maximum of 5%)
- Contributions to all partnerships be raised from 15% to 20% (which compares with the statutory maximum of 30%)

The Committee took proper advice in respect of these limits from the Investment Strategy Panel and from officers. The limits will apply for the period during which the Funds' strategic allocations include investments 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 1**

	<b>Interim Strategy 01/04/16 (%)</b>	<b>Long Term Strategy 2012-2017 (%)</b>	<b>Permitted Range (%)</b>
<b>Total Equities</b>	<b>67</b>	<b>65</b>	<b>50 – 75</b>
<b>Index-Linked Assets</b>	<b>7</b>	<b>7</b>	<b>0 – 20</b>
<b>Alternatives</b>	<b>25</b>	<b>28</b>	<b>20 – 35</b>
<b>Cash</b>	<b>1</b>	<b>0</b>	<b>0 – 10</b>
<b>TOTAL</b>	<b>100</b>	<b>100</b>	

Long Term Strategy, initially agreed by Committee in October 2012 and reaffirmed in December 2015, is being implemented gradually, subject to financial market developments.

**Investment Management Structure at 31 May 2016**

- 5 Global Equity Mandates (external: Nordea, Harris; internal: Global Low Volatility, Global Value, Global High Dividend Yield)
- 4 Regional Equity Mandates (internal: UK All Cap, UK Mid Cap, US and Europe ex-UK)
- 1 Private Equity Mandate (invests in a range of direct funds, fund-of-funds and listed vehicles)
- 1 Index-Linked Asset Mandate (internal: UK Index-Linked Gilts)
- 1 Property Mandate (external: Standard Life)
- 1 Real Assets Mandate (internal: invests in a range of direct funds, fund-of-funds and listed vehicles invested in infrastructure and timber)
- 1 Other Bonds Mandate (internal: invests in a range of direct debt funds and listed sovereign and corporate bonds)
- 1 Currency Mandate (internal: hedges currency exposure of overseas equities to reduce volatility of returns)
- 1 Cash Mandate (managed alongside City of Edinburgh Council cash)

**Investment Strategy 2**

A lower-risk, gilts-only strategy with a 100% allocation to UK index linked gilts (internally managed). This is primarily to reduce the degree of short-term change in funding level and employer contribution rates in the period prior to an employer leaving the Fund.

The breakdown of assets by manager is provided in the Fund’s Annual Report & Accounts which can be found at [www.lpf.org.uk](http://www.lpf.org.uk).

**Lothian Buses Pension Fund**

**Investment Strategy**

<b>Asset Category</b>	<b>Interim Strategy Allocation 01 April 2016 %</b>	<b>Long Term Strategy Allocation 2016-21 %</b>	<b>Permitted Ranges %</b>
Equities	58.5	40	±10% interim strategy
Index-Linked Assets	14.0	20	±10% interim strategy
Other Real Assets	27.5	18	±10% interim strategy
Fixed Income Assets		22	±10% interim strategy
Cash	0.0	0	0%-15%
<b>TOTAL</b>	<b>100</b>	<b>100</b>	

Long Term Strategy agreed by Committee in March 2016 will be implemented gradually, subject to financial market developments.

**Investment Management Structure at 31 May 2016**

- 2 Global Equity Mandates (internal: Global High Dividend Yield; external: Baillie Gifford Global Alpha)
- 1 Listed Private Equity Mandate (internal: listed funds)
- 1 Index Linked Gilts Mandate (internal: UK Index-Linked Gilts)
- 1 Property Mandate (external: Standard Life pooled fund)
- 1 Real Assets Mandate (internal: invests in a range of direct funds, fund-of-funds and listed vehicles invested in infrastructure and timber)
- 2 Fixed Income Assets Mandates (external: Baillie Gifford corporate bond pooled fund; and internal: invests in a range of direct debt funds and listed sovereign and corporate bonds)
- 1 Cash Mandate (managed alongside City of Edinburgh 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](http://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:

<b>Equity Allocation %</b>	<b>Funding level</b>	<b>Note [1]</b>
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 2016 is shown in the table below.

	<b>Strategy at 30/04/2016 %</b>
<b>Equities</b>	<b>30.0</b>
<b>Bonds</b>	
<i>UK Fixed Interest Gilts</i>	<i>13.1</i>
<i>UK Index Linked Gilts</i>	<i>51.9</i>
<b>Subtotal</b>	<b>65.0</b>
<b>Property</b>	<b>5.0</b>
<b>Cash</b>	<b>0.0</b>
<b>TOTAL</b>	<b>100.0</b>

**Investment Manager Arrangements at 31 May 2016**

- 1 Equity Mandate (external: State Street Global Advisers Global Equities)
- 2 Bond Mandates (external: State Street Global Advisers Gilts; and internal: Index-Linked Gilts)
- 1 Property Mandate (external: Schrodgers pooled fund)

The breakdown of assets by manager is provided in the Fund's Annual Report & Accounts which can be found at [www.lpf.org.uk](http://www.lpf.org.uk).

Statement of Compliance with UK Stewardship Code

<p><b>Principle 1</b> Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.</p>	<p>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. In practice our policy is to apply the Code through</p> <p>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.</p> <p>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.</p> <p>Engagements undertaken by Hermes EOS on our behalf are guided by the Hermes Responsible Ownership Principles  <a href="http://www.hermes.co.uk/Portals/8/The_Hermes_Ownership_Principles_UK.pdf">http://www.hermes.co.uk/Portals/8/The_Hermes_Ownership_Principles_UK.pdf</a></p> <p>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.</p> <p>b) As well as Hermes EOS, two of our Fund Managers, Baillie Gifford and State Street, 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.</p> <p>Details are available at:-  <a href="https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code/UK-Stewardship-Code-statements.aspx">https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code/UK-Stewardship-Code-statements.aspx</a></p> <p>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.</p>
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Statement of Compliance with UK Stewardship Code

<p><b>Principle 2</b> Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.</p>	<p>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 <a href="http://hermes.yellowtailcms.co.uk/Portals/8/Conflicts_of_interest_policy.pdf">http://hermes.yellowtailcms.co.uk/Portals/8/Conflicts_of_interest_policy.pdf</a>.</p> <p>We also encourage the asset managers employed by the Funds to have effective policies addressing potential conflicts of interest.</p> <p>In respect of conflicts of interest within the Funds, Pensions Committee members are required to make declarations of interest prior to Committee meetings.</p> <p>Our policy of constructive engagement with companies is consistent with the Funds' fiduciary responsibilities.</p>
<p><b>Principle 3</b> Institutional investors should monitor their investee companies.</p>	<p>Day-to-day responsibility for monitoring our equity holdings is delegated to Hermes EOS, Baillie Gifford and State Street. 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.</p> <p>LAPFF also monitors and engages with companies and provides an 'Alerts' service which highlights concerns over corporate governance issues.</p> <p>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.</p>

Statement of Compliance with UK Stewardship Code

<p><b>Principle 4</b> Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value.</p>	<p>As highlighted above, responsibility for day-to-day interaction with companies is delegated, including the escalation of engagement when necessary.</p> <p>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 and State Street to disclose their guidelines for such activities in their own statements of adherence to the Code.</p> <p>We may also propose escalation of activity through the Local Authority Pension Fund Forum.</p> <p>Consistent with our fiduciary duty to beneficiaries and in order to encourage improved conduct in future, we consider participating in shareholder litigation where it appears likely that the Fund will recover losses (net of costs) sustained because of inappropriate actions by company directors.</p>
<p><b>Principle 5</b> Institutional investors should be willing to act collectively with other investors where appropriate</p>	<p>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:</p> <ul style="list-style-type: none"> <li>- membership of the Local Authority Pension Fund Forum, which engages with companies over environmental, social and governance issues on behalf of its members.</li> <li>- 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 Pensions and Lifetime Savings Association (PLSA). Hermes EOS seeks to work with these organisations and also alongside other individual investors to effect change most efficiently.</li> <li>- being a signatory of the PRI in our own right.</li> <li>- 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.</li> </ul>

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<p><b>Principle 6</b> Institutional investors should have a clear policy on voting and disclosure of voting activity.</p>	<p>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.</p> <p>Our preference is for managers to vote on the Funds' behalf and for responsible stewardship to be integral to the investment decision making process.</p> <p>We are comfortable with delegation of voting to Baillie Gifford 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.</p> <p>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.</p> <p>Underpinning voting decisions are Hermes EOS Regional Corporate Governance policies which can be found at the "How we invest" section of our website.</p> <p>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.</p> <p>We disclose in arrears so that we are transparent and accountable but dialogue with companies in our portfolios is not compromised.</p>
<p><b>Principle 7</b> Institutional investors should report periodically on their stewardship and voting activities.</p>	<p>We report annually on stewardship activity through a specific section in the Funds' annual report and accounts and on our website.</p> <p>We also report annually on stewardship issues to the Pensions Committee.</p> <p>We have reviewed this Statement in June 2016. We will review the Statement annually.</p>
	<p>For further information please contact Marlyn.McConaghie@edinburgh.gov.uk</p>

### **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 the knowledge to enable them to evaluate and challenge the advice they receive. Standards relating to the administration of the Committee's business are strictly up-held.
- The Fund has appointed an Independent Professional Observer to strengthen governance. The role of the Observer is to provide the Committee with an impartial, additional source of experience and technical knowledge.
- 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 Executive Director of Resources. The Executive Director of Resources 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 Executive Director of Resources 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 Executive Director of Resources 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 assesses 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. 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.