

Pensions Committee

2.00pm, Tuesday, 12 December 2017

Stewardship and Engagement

Item number	5.3
Report number	
Executive/routine	
Wards	All
Council Commitments	Delivering a Council that works for all

Executive Summary

This report provides the annual update on the activity of the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund (the Funds) in relation to the stewardship of the assets of the Funds, including the approach to environmental, social and governance (ESG) issues. The Funds pursue a policy of constructive engagement on such issues, which is consistent with fiduciary duties.

The Funds have been a signatory to the Principles for Responsible Investment (PRI) since 2008, and so participate in the PRI's Reporting Framework, an annual assessment of the Funds' responsible investment activities. This report summarises the PRI assessment and feedback for 2017.

The Funds are also involved in the activities of the Local Authority Pension Fund Forum (LAPFF), a collaborative shareholder engagement group with combined assets of over £200bn. Councillor Rankin joined the LAPFF Executive Committee in January 2017 as a representative of Lothian Pension Fund. This report provides an update on developments.

Stewardship and Engagement

1. Recommendations

Committee is requested to:

- 1.1 Note the contents of this report;
- 1.2 Agree to nominate Councillor Rankin to the LAPFF Executive; and
- 1.3 Agree to continue to lobby for governance improvements at LAPFF.

2. Background

- 2.1 Founded in 2006, the PRI (Principles for Responsible Investment) is the world's leading proponent of responsible investment. It is an independent, not-for-profit organisation (supported by the United Nations) that encourages investors to use responsible investment to enhance returns and better manage risks. Where consistent with fiduciary responsibilities, signatories commit to six principles, which are detailed in the main report. Lothian Pension Fund made a significant commitment to being active and responsible share owners by becoming a signatory to the PRI in 2008.
- 2.2 The Funds allocate meaningful resources to fulfil this commitment. A third-party provider of voting and engagement services (currently Hermes EOS), membership of the Local Authority Pension Forum (LAPFF) and a third-party provider of environmental, social and governance (ESG) research (currently MSCI ESG Research) are all components of the Funds' responsible investment policy implementation, which support the Fund's officers.
- 2.3 The Funds pursue a policy of constructive engagement, which is consistent with fiduciary duties. The Scheme Advisory Board of the Scottish Local Government Pension Scheme issued the legal opinion it had commissioned on the fiduciary duty responsibilities of Scottish Pension Funds in June 2016. The opinion essentially reaffirms the position taken by Senior Counsel in England & Wales, confirming that the advice is also applicable in Scotland. This in turn reinforces the approach taken by the Funds to date.
- 2.4 The Funds also participate in class action lawsuits in which a group sues another party to recover a loss in share value. The Funds have recovered \$736,000 since 2012.

3. Main report

Principles for Responsible Investment (PRI)

- 3.1 The Principles for Responsible Investment were developed by an international group of institutional investors to address the increasing relevance of environmental, social and corporate governance issues to investment practices.
- 3.2 Signatories to the PRI commit to six principles. The principles and the Funds' compliance with each of them are laid out in sections 3.3 to 3.8 below. An excerpt from the PRI website (www.unpri.org) describes the commitment thus:

“In signing the Principles, we as investors publicly commit to adopt and implement them, where consistent with our fiduciary responsibilities. We also commit to evaluate the effectiveness and improve the content of the Principles over time. We believe this will improve our ability to meet commitments to beneficiaries as well as better align our investment activities with the broader interests of society.”

3.3 Principle 1: we will incorporate ESG issues into investment analysis and decision-making

The Funds believe strongly that environmental, social and governance (ESG) issues affect the financial performance of the companies in which they invest. They are essential ingredients in the estimation of investment risk and opportunity, and so the Funds' investments are assessed in a holistic manner with ESG issues as an important part of that evaluation. Empirical evidence indicates that the shares of companies with improving ESG ratings are better investments than those that are simply highly rated. This supports the Funds' approach of engaging with companies to improve environmental, social and governance practices as this can lead to better long-term outcomes for the Funds and society as a whole.

The internal team integrates ESG issues into its actively managed fundamental portfolios as part of the formal due diligence process before investments are made. The analysis of ESG factors is supported by the research of a specialist third party service (currently MSCI ESG Research), which provides ESG specific data, analysis and research to help identify the risks and opportunities that companies face. This ensures that consideration of ESG factors can be applied to the investment process using data that has been collated in a consistent manner.

As well as incorporating ESG issues into the analysis of internally managed portfolios, the internal team also monitors and engages with the Fund's external managers at least quarterly. Regardless of whether the managers vote and engage on behalf of the Fund or not, they are required to report on how ESG issues influenced their investment analysis and decision-making over the quarter.

The Fund has recently extended its access to MSCI ESG Research to include carbon emission data. At the time of writing, a carbon foot-printing exercise is being undertaken to better understand the potential risks and opportunities for the Funds' listed equities associated with the transition to a low carbon economy. This will be considered by the Investment Strategy Panel and an update will be provided to Committee in due course.

3.4 **Principle 2: we will be active owners and incorporate ESG issues into our ownership policies and practices**

The Funds' approach to Principle 2 is to vote all its shares and to engage with companies through its third-party provider and its portfolio managers, both internal and external. It also participates in class action lawsuits, in which groups of shareholders collectively sue a company to recover a loss in share value, or to exert influence on the company.

For the vast majority of holdings, Hermes Equity Ownership Services (EOS) votes and engages on behalf of the Fund, but Baillie Gifford also votes and engages in relation to the holdings in the long-standing equity mandate that it manages for Lothian Buses Pension Fund. State Street undertook these activities on behalf of the Scottish Homes Pension Fund until March 2017, but those assets are now managed internally.

Hermes EOS also engages at industry and country level, attempting to influence regulators, professional bodies etc by responding to relevant consultations, all with the aim of improving standards in the investment industry.

Voting

Details of the Fund's voting activity during the calendar year 2016 was reported in the Fund's 2016/17 annual report. For the first six months of calendar year 2017, Hermes EOS voted on behalf of Lothian Pension Fund at 422 meetings covering 6,223 resolutions. At 48% of meetings, all votes were cast in favour of management; at 2%, there were votes in favour of management by exception; and at 50% of meetings, at least one vote was cast in opposition to management. Hermes EOS voted against management on 499 occasions (8% of all voted resolutions). The points of opposition related to board structure (28%), remuneration (29%) and resolutions brought by other shareholders (24%). A complete summary of the voting statistics as well as a summary of voting disclosures, which explain the decisions to vote against management, are posted to the Fund's website quarterly and a link is provided at the end of this report.

Engagement

Details of the Fund's engagement activity during the calendar year 2016 was also reported in the Fund's 2016/17 annual report. For the first six months of calendar year 2017, Hermes EOS engaged on behalf of Lothian Pension Fund with 155 companies covering 398 issues. The engagements were allocated to the following categories: governance (47%), social and ethical (19%), environmental (mostly related to climate change) (17%) and overall strategy, risk and communications

(17%). Engagement activity is also undertaken by the Local Authority Pension Fund Forum, of which the Fund is a member (see later).

Class Actions

Following a court ruling in 2010, which narrowed the ability of investors to seek redress under US law, the Funds' class action activity and recovered compensation have fallen to a relatively low level. Recoveries over 2016/17 amounted to \$208,000, while recoveries this financial year to 30 October 2017 have been \$318,000. The latter figure represents 0.004% of the Funds' assets. Officers continue to monitor class action activity in relation to Fund shareholdings and collect compensation where it is economical to do so.

3.5 Principle 3: we will seek appropriate disclosure on ESG issues by the entities in which we invest

Engagement by Hermes EOS also seeks to enhance ESG disclosure by investee companies. One recent high-profile example of success in this area was its support for a shareholder proposal requesting that ExxonMobil "publish an annual assessment of the long-term portfolio impacts of technological advances and global climate change policies... This reporting should assess the resilience of the company's full portfolio of reserves and resources through 2040 and beyond and address the financial risks associated with such a scenario."

The resolution was supported by shareholders, including Lothian, marking a step-change in the requirements for disclosure by a major energy company as well as a notable success for proponents of company engagement. Chevron's shareholders also passed an identical resolution. Lothian's policy on voting and engagement contributed to this progress to greater transparency through cooperation with other responsible asset owners.

3.6 Principle 4: we will promote acceptance and implementation of the principles within the investment industry

Lothian promotes the fact that it is a PRI signatory in its communications and on its website. It reports publicly the results of the PRI's annual assessment.

Scrutiny of investment portfolios includes the consideration of the principles, including how ESG issues are incorporated into the investment process, voting, engagement and the level of reporting. This applies to both internal and external portfolios, both at inception and on an ongoing basis.

3.7 Principle 5: we will work together to enhance our effectiveness in implementing the principles

Lothian collaborates with other investors to enhance effectiveness of implementing the principles. It does this in two ways: 1) by employing a third-party service provider (currently Hermes EOS, which has a client base of £311 billion); and 2) through membership of the Local Authority Pension Fund Forum (LAPFF), which comprises approximately 70 local authority pension fund members in the UK with combined assets of over £200bn. LAPFF's mission is *"to protect the long-term investment interests of beneficiaries by promoting the highest standards of*

corporate governance and corporate responsibility amongst investee companies.”
(See later for a further update on LAPFF).

These organisations represent many asset owners and when their shares are aggregated, the holdings are often significant enough that they can influence company boards. These collaborative efforts are beneficial to the Funds as relatively small asset owners, but they are also beneficial in encouraging the implementation of the principles more widely.

On occasion, Lothian’s internal team also instigates collaborative engagements and at the time of writing is engaging with other shareholders in a listed private equity investment where it has corporate governance concerns.

3.8 Principle 6: we will each report our activities and progress towards implementing the principles

As a signatory, the Fund is obliged to report on its responsible investment activities annually through the PRI’s Reporting Framework. This ensures accountability of signatories through a standardised transparency tool and promotes future development of responsible investment through annual feedback provided by the PRI. The PRI annual assessment report for 2017 is summarised below.

In addition to PRI reporting, all the Fund’s voting and engagement activity is made available on the website every quarter. In these reports, Hermes EOS presents progress to their engagement milestones and Baillie Gifford describes the detail of its engagement activity.

The Pensions Committee also regularly considers reports stewardship and engagement and receives presentations from providers. The most recent presentation was from LAPFF at the internal investment seminar in October.

3.9 PRI Assessment Report 2017

The assessment report is designed to provide feedback to signatories to support ongoing learning and development. It measures progress against the PRI principles and allows comparison with peers.

The Fund’s 2017 report and scores are available on its website and a link is provided at the end of this report. The results are summarised below.

Assets Under Management	Module Name	LPF 2016	LPF 2017	Change	Peer Median 2017
	Strategy & Governance	A	A+	Positive	A
Indirect - Manager Selection, Appointment & Monitoring					
<10%	Listed Equity	A	A	No Change	B
Direct & Active Ownership Modules					
>50%	Listed Equity - Incorporation	C	A	Positive	A
>50%	Listed Equity - Active Ownership	A	A	No change	B
10-50%	Fixed Income	Not reported	E	N/A	B

The Funds were scored “A” or “A+” in all modules with the exception of Fixed Income. These scores are at, or above, the median for the peer group.

The improvement to the score from “C” to “A” for Listed Equity – Incorporation follows efforts to improve communications with the approach to ESG integration within the internal equity management processes now being shared publicly on the Funds’ website.

A lower “E” rating was assigned to Fixed Income. This stemmed from a misunderstanding of the assessment criteria. The Fixed Income section was not previously assessed because it was not actively managed. The Funds mistakenly submitted the response to the PRI that it did not consider ESG issues for fixed income bonds. This was because the Funds own only government bonds, which have no voting or engagement possibilities. However involvement in public policy discussions relating to all its assets should have been disclosed. PRI has confirmed that this would be given a higher score for this module and this will be addressed in next year’s assessment.

The PRI also indicated that a rebasing of scores will occur in the 2018 assessment. The aim is to make the achievement of each grade more difficult, so median scores can be expected to fall. This should permit greater differentiation amongst higher scoring institutions.

Local Authority Pension Fund Forum (LAPFF)

- 3.10 Towards the end of 2016, the LAPFF reviewed its constitution and a revised version was put to the Annual General Meeting (AGM). It contained a number of improvements, but did not address some key governance issues. As an advocate for high standards in governance in the corporate world, the Funds believe that LAPFF’s governance should be of the highest standard. Accordingly, through Councillor Cameron Rose, who sat on the LAPFF Executive Committee, the Fund proposed the following amendments to the AGM:

- The introduction of a maximum tenure for members on the Executive. Best practice in the corporate world is to ensure the independence of board members and to limit the period that individuals serve on a board. The Fund believes that LAPFF should adopt an equivalent standard.
- The removal of the current two-tier membership of the Executive, which distinguishes between ‘trustees’ and ‘officers’. Such a system could impact on the performance of individual members and the Executive in its entirety. The Fund argued that individual local authority funds should decide on their nominees for the Executive Committee and for members of LAPFF to elect representatives, irrespective of their status.
- The appointment to the secretarial role of an individual who is independent from the Research and Engagement partner. The Fund argued that this would provide greater oversight and scrutiny of the research and engagement partner and would help to manage conflicts of interest.

- 3.11 The Executive Committee decided not to support the amendments and the proposals were not agreed. However the proposed amendments did receive 42%, 36% and 42% of members’ votes respectively. Such support at a corporate AGM would be seen by shareholders as very significant and changes by the company would be forthcoming. The Funds were encouraged by the Executive Committee’s commitment to consider further revisions to the LAPFF constitution.
- 3.12 During 2017, the LAPFF Executive have invited all members to provide comments on the constitution and the Funds responded asking that the above principles are considered. Amendments to the constitution are expected to be agreed at the AGM early in 2018.
- 3.13 Committee is asked to agree that the Funds should continue to lobby for enhanced the governance standards at the LAPFF.
- 3.14 Councillor Cameron Rose stepped down from, and Councillor Alasdair Rankin was appointed to, the LAPFF Executive Committee at the AGM in June 2017. The Committee is asked to nominate Councillor Rankin to the LAPFF Executive at the AGM in January 2018, as a representative of Lothian Pension Fund. If elected to the Executive, the appointment will need to be approved by the City of Edinburgh Council.

4. Measures of success

- 4.1 Success of engagement with companies is very difficult to measure. The Funds’ approach is essentially qualitative and is wide ranging. While the impact is very difficult to quantify, the California Public Employees’ Retirement System (CalPERS), the largest public pension fund in the US, states that the companies it targeted for engagement activity (approximately 188 of them since 1987) have outperformed an appropriate benchmark by a large amount over the five years after engagement was initiated. This has become known as the “CalPERS Effect”.

- 4.2 The Funds are signatories to PRI and complete the annual self-assessment process which compares the Funds' ESG activities with those of peers.

5. Financial impact

- 5.1 There is no financial impact as a result of this report. The costs of the Funds' stewardship activities are included in the pension funds' budget. US class actions are conducted on a "no win no fee" basis. The Funds are not involved in any non-US actions.

6. Risk, policy, compliance and governance impact

- 6.1 The stewardship activity of the Funds complies with the Statement of Investment Principles. The Funds' policy is 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 and employers. The Funds' policy of being responsible, informed and involved investors is expected to reduce risk.

7. Equalities impact

- 7.1 As much of the engagement activity is on equalities issues, it is expected to have a positive impact and also to contribute to the sustainability of the Funds' investments.

8. Sustainability impact

- 8.1 As much of the engagement activity is on sustainability issues, it is expected to contribute to the sustainability of the Funds' investments.

9. Consultation and engagement

- 9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Fund and they are invited to comment on the relevant matters at Committee meetings.

10. Background reading/external references

- 10.1 The Funds' 2017 PRI assessment report is available at:
http://www.edinburgh.gov.uk/lpf1/downloads/file/820/pri_annual_assessment_2017
Hermes public engagement reports are available at:
<https://www.hermes-investment.com/uki/stewardship/eos-literature/>

Lothian Pension Fund's internal equity management ESG integration approach:
http://www.edinburgh.gov.uk/lpf1/downloads/file/801/internal_equity_management_esg_integration

The CalPERS Effect

<https://www.calpers.ca.gov/page/newsroom/calpers-news/2014/company-performance>

Lothian Pension Fund: http://www.lpf.org.uk/info/68/responsible_investment

United Nations Principles for Responsible Investment <http://www.unpri.org/>

Local Authority Pension Fund Forum <http://www.lapfforum.org/>

Stephen S. Moir

Executive Director of Resources

Contact: Bruce Miller, Chief Investment Officer, Lothian Pension Fund

E-mail: bruce.miller@edinburgh.gov.uk | Tel: 0131 469 3866

Contact: David Hickey, Portfolio Manager, Lothian Pension Fund

E-mail: david.hickey@edinburgh.gov.uk | Tel: 0131 469 3611

11. Appendices

None