

# Pensions Committee

2.00pm, Wednesday, 12 December 2018

## Stewardship and Engagement

Item number	5.7
Report number	
Executive/routine	
Wards	All
Council Commitments	<a href="#">Delivering a Council that works for all</a>

### Executive Summary

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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 2018.

The Funds also participate in collaborative shareholder engagements through our partners and service providers, the Local Authority Pension Fund Forum (LAPFF) and Hermes EOS (EOS), who act on behalf of asset owners with combined assets of over £570bn. The Fund continues to be represented on the LAPFF Executive Committee. This report provides an update on developments.

## Stewardship and Engagement

### 1. Recommendations

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Committee is requested to:

- 1.1 Note the contents of this report;
- 1.2 Agree to continue to monitor governance arrangements at LAPFF.

### 2. Background

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- 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, and it remains a signatory.
- 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 Funds' 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 recovered £380,000 during the 17/18 financial year.

### 3. Main report

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#### 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](http://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 Funds' external managers at least quarterly who are required to report on how ESG issues influenced their investment analysis and decision-making.

The Fund also began tracking its carbon footprint during the year. This was reported to Committee in June 2018. The Fund will continue to monitor carbon-related risks, which will direct the engagement activity of the internal team.

### 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.

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

#### Voting

Details of the Funds' voting activity during the calendar year 2017 was reported in the Fund's 2017/18 annual report. Hermes EOS collates voting and engagement data for the Funds and reports this for calendar year periods. During calendar year 2017, the Funds voted at the annual meetings of the 517 companies in which it was invested. There were votes on 7,446 resolutions, and the Funds opposed 614 of them. In addition, Hermes EOS engaged on the Funds' behalf with companies across the world on topics such as board structure, executive compensation and climate change. 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 Funds' 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 2017 was also reported in the Fund's 2017/18 annual report. A full breakdown of the engagements performed by Hermes during 2017 can be found below.



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

### **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 2017/18 amounted to £380,000, while recoveries this financial year to 30 October 2018 have been £17,400. Officers continue to monitor class action activity in relation to the Funds' 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 EOS also seeks to enhance ESG disclosure by investee companies. An example of this was Lothian's support for an engagement with BP following a 2015 shareholder resolution which called for enhanced reporting on the company's management of climate change risks, including GHG emissions. Continued engagement with the company resulted in it publishing its new strategy, Advancing the Energy Transition, which describes its plan for the transition to the low-carbon economy in April 2018. It set three targets for reducing the company's direct emissions, namely (i) 3.5 million tonnes carbon dioxide or equivalent of sustainable GHG emissions reductions by 2025; (ii) zero net growth in operational emissions up to 2025, with a commitment to offset any increase above 2015 levels that is not covered by its sustainable reductions activity; and (iii) targeting methane leak-intensity of 0.2% and holding this below 0.3%. This is significantly below estimates of the industry average of 2%. These targets are important for the oil and gas industry as a whole, showing a strong and clear path for limiting emissions under a company's direct control, regardless of business growth.

Our partners EOS continue to engage with the company on climate change, including on how the company can take greater responsibility for the emissions from end-customer use of its products, and seek clarity on the scale of capital allocation to low-carbon investments.

#### **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 £346 billion); and 2) through membership of the Local Authority Pension Fund Forum (LAPFF), which comprises 79 local authority pension fund members in the UK, plus 5 of the English and Welsh pools with combined assets of over £230bn. 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 below 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.

### **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 2018 is summarised below.

In addition to PRI reporting, all the Funds' 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 Fund held an event on the 29 October to share details on its responsible investment activities with stakeholders. Presentations on Fiduciary Responsibility, Approach to Responsible Investment, Climate Change and Carbon Footprinting were delivered by the Fund's internal team. Hermes EOS presented on their future engagement plans, and Principle for Responsible Investment (PRI) discussed their work and successes in collaboration. A recording of the event is available on the Fund's website.

### **3.9 PRI Assessment Report 2018**

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

The Fund's 2018 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 2017	LPF 2018	Peer Median 2018
	Strategy & Governance	A+	A	A
<b>Indirect - Manager Selection, Appointment &amp; Monitoring</b>				
<10%	Listed Equity	A	A	B
<10%	Fixed Income - Corporate Non-Financial	Not reported	A	C
<10%	Private Equity	Not reported	A	C
<10%	Property	Not reported	A	C
<10%	Infrastructure	Not reported	A	C
<b>Direct &amp; Active Ownership Modules</b>				
>50%	Listed Equity - Incorporation	A	B	B
>50%	Listed Equity - Active Ownership	A	A	A

The Funds were scored “A” or “B” in all modules. Lothian Pension Fund expanded its reporting in 2018 to include alternative asset categories, including property, infrastructure and private equity.

2018 saw changes to the assessment criteria, which saw slight negative revisions in some scoring areas. Subsequent discussions with PRI have identified areas where scores can be improved, and it is hoped that next year it will be possible to further improve scoring through better action and more accurate reporting.

The PRI have indicated that assessment scores will continue to be rebased in 2019 to make the achievement of each grade more difficult. Consequently, median scores can be expected to fall, permitting greater differentiation amongst higher scoring institutions, with a view to driving standards higher.

### **Local Authority Pension Fund Forum (LAPFF)**

- 3.10 As previously reported to Committee, the Fund has been looking to make changes to the LAPFF constitution. During the March 2018 AGM constitutional amendments were made allowing English & Welsh LGPS investment pools to join LAPFF. The constitution also removed the requirement for the Research and Engagement partner to undertake the secretarial function but it fell short of requiring the secretary to be independent. Additionally, there were no amendments introducing a maximum tenure for members on the Executive or to remove the distinction

between trustees and officers on the Executive (changes with the Fund has previously lobbied for).

- 3.11 At a second AGM in July, the Fund held back from proposing an amendment to introduce a maximum tenure for Executive members due to the need for stability as it evolves with the creation of the pools.
- 3.12 The Fund successfully proposed an amendment, consistent with the corporate governance code, as follows: *'When more than 20 per cent of votes have been cast against a resolution, the LAPFF Executive should explain, when announcing voting results, what actions it intends to take to consult members in order to understand the reasons behind the result. An update should be published no later than six months after the vote including what impact the feedback has had on the decisions the Executive has taken and any actions or resolutions now proposed.'* This gives assurance that the Executive will have to respond to resolutions in the future.
- 3.13 Councillor Alasdair Rankin was re-appointed to the LAPFF Executive in July 2018, which was ratified by the City of Edinburgh Council in August.

#### **4. Measures of success**

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- 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**

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- 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, but is currently in a pre-action settlement process with a British listed company.

#### **6. Risk, policy, compliance and governance impact**

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- 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

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- 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

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- 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

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- 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

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- 10.1 The Funds' 2018 PRI assessment report is available at:  
[http://www.edinburgh.gov.uk/lpf1/downloads/file/902/pri\\_annual\\_assessment\\_2018](http://www.edinburgh.gov.uk/lpf1/downloads/file/902/pri_annual_assessment_2018)
- 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](http://www.edinburgh.gov.uk/lpf1/downloads/file/801/internal_equity_management_esg_integration)
- The CalPERS Effect  
<http://www.mondovisione.com/news/calpers-effect-continues-to-improve-company-performance-shareholder-engageme/>
- Lothian Pension Fund: [http://www.lpf.org.uk/info/68/responsible\\_investment](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/>

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## 11. Appendices

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None