Pensions Committee

2.00pm, Wednesday, 11 December 2019

Statement of Investment Principles

Item number	**5.5**
Executive/routine	
Wards	**All**
Council Commitments	

1. Recommendations

The Pensions Committee is requested to:

1.1 agree the revised target weights and permitted ranges for the cash and gilts allocations for the Mature Employers Group (MEG) strategy; and

1.2 adopt the revised Statement of Investment Principles.

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

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Report

Statement of Investment Principles

2. Executive Summary

2.1 The report introduces the revised Statement of Investment Principles (SIP) for Lothian Pension Fund and Scottish Homes Pension Fund (the Funds). It replaces the SIP agreed by Committee in December 2018.

3. Background

3.1 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.

3.2 The SIP is an important part of the Fund's governance arrangements and provides the framework within which the Committee delegates the implementation of the investment strategy, as defined by the policy (asset class) groups, to officers with advice from the Joint Investment Strategy Panel. Committee retains responsibility for investment strategy.

4. Main report

4.1 The Statement of Investment Principles (SIP) is formally reviewed annually whether there are policy changes or not. It has been reviewed by officers and the Joint Investment Strategy Panel (JISP).

4.2 The revised SIP includes changes that are not material to the overall strategy of either Lothian Pension Fund or Scottish Homes Pension Fund. The main changes are:

a. The removal of Lothian Buses Pension Fund, which merged with Lothian Pension Fund at the beginning of April 2019 and now represents circa 7% of liabilities.

b. The addition of a new employer strategy at the time of merger – the Buses Strategy.

c. Adjustments to the Buses Strategy (unrelated to the merger) between April and September 2019 intended to reduce funding level volatility.

d. The renaming of the investment strategies.

Investment Strategy Updates

4.3 The asset allocation and investment performance of the Funds is reviewed in detail annually each June.

4.4 Lothian Pension Fund's updated actual and strategic allocations at 30 September are presented in the two tables below.

4.5 On a consolidated basis, its estimated market value has increased from £7.8bn at end March 2019 to £8.4bn at end September 2019.

4.6 The names given to the Lothian Pension Fund investment strategies have been amended in the Statement of Investment Principles to be consistent with terminology used in its annual report and accounts. There are now four strategies: Main Strategy (91% of assets), Mature Employers Group (MEG) Strategy (1% of assets), 50/50 Strategy (1% of assets) and Buses Strategy (7% of assets). The current target allocations for each strategy are shown in the table below.

Employer Strategies					
Policy Group	**Main**	**MEG**	**50/50**	**Buses**	**Total**
Equities	65%	0%	33%	35%	62.0%
Real Assets	18%	0%	9%	18%	17.7%
Non-Gilt Debt	10%	0%	5%	20%	10.6%
Gilts	7%	88%	48%	28%	9.6%
Cash	0%	12%	6%	0%	0.2%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

At end September 2019

Note numbers may not sum due to rounding

4.7 The Buses Strategy was created following the merger of the Lothian Buses Pension Fund with Lothian Pension Fund in April 2019. At inception, there was no change to the pre-existing investment strategy, which targeted a reduction in growth assets over the 2016-21 period in recognition of the employer's increasing maturity and its strong funding level.

4.8 Between April and September 2019, a meaningful reduction in growth assets was implemented for the Buses Strategy in line with the advice of the Joint Investment Strategy Panel. Equities were reduced from 51.5% to 35% alongside increased allocations to non-gilt debt and gilts, with the intention of reducing funding level volatility for the employer.

4.9 The MEG (Mature Employers Group) Strategy is highlighted in yellow in the table above for approval by the Pensions Committee. It is also highlighted in the SIP itself on page 10 of the Appendix to this paper. The change is required due to an oversight when the SIP was agreed last December. Due to the proximity of the JISP meeting and the Pensions Committee meeting, the table was not altered to reflect the correct mix of gilts and cash. The change is consistent with the investment objective and the current strategy implementation.

4.10 The MEG Strategy reflects the investment objective to generate sufficient cash to pay pensions as they fall due. As part of the strategy, the target weight of gilts and cash is set to broadly match the duration of the assets with the duration of liabilities. These weights will be revised in future when a material change in expected liability cash flows arises. This can happen when employers adopt or exit from the strategy or when the triennial Actuarial Valuation is undertaken.

4.11 There have been no changes to either the Main Strategy or the 50/50 Strategy, which fund approximately 92% of Lothian Pension Fund employer liabilities.

4.12 The impact of the change to the Buses Strategy (7% of Fund assets) on Lothian Pension Fund is shown in the final two columns of the table below. The actual changes over the period are shown in the other two columns, which reflect market movements, cash inflows and outflows and asset purchases and sales.

Policy Group	Actual Allocation 31 March 2019	Actual Allocation 30 Sept 2019	Strategic Allocation 31 March 2019	Strategic Allocation 30 Sept 2019
Equities	59.9%	60.9%	63.1%	62.0%
Real Assets	19.8%	19.3%	17.7%	17.7%
Non-Gilt Debt	5.2%	5.8%	9.9%	10.6%
Gilts	9.1%	7.3%	9.3%	9.8%
Cash	5.9%	6.7%	0.0%	0.0%
Total	100.0%	100.0%	100.0%	100.0%

4.13 There are no material changes to the Scottish Homes strategy – the Fund is entirely invested in gilts and cash to match liability cash flows as closely as possible.

4.14 The Joint Investment Strategy Panel (JISP) meets on 2 December 2019 and a verbal update of more recent developments will be provided to the Committee.

5. Next Steps

5.1 The SIP will be reviewed formally on an annual basis and when there are material changes requiring approval.

5.2 Appendix C of the SIP is a statement of compliance with the Financial Reporting Council's (FRC) UK Stewardship Code. The FRC has recently launched a substantial revision to the Code, which comes into effect in 2020. The compliance statement will be revised over the coming months to address the changes.

6. Financial impact

6.1 There are no direct financial implications of this report. Investment strategy is covered elsewhere on the agenda.

7. Stakeholder/Community Impact

7.1 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.

7.2 There are no adverse health and safety, governance, compliance or regulatory implications as a result of this report.

7.3 There are no adverse sustainability impacts arising from this report.

8. Background reading/external references

8.1 None.

9. Appendices

Appendix 1 – Statement of Investment Principles including:

- Appendix A – Investment Strategies (11 December 2019)
- Appendix B – Investment Strategy Implementation (11 December 2019)
- Appendix C – Statement of Compliance with UK Stewardship Code
- Appendix D – Statement of Compliance with the CIPFA Principles for Investment Decision Making in the Local Governance Pension Scheme

LOTHIAN PENSION FUND AND SCOTTISH HOMES PENSION FUND ('THE FUNDS')

STATEMENT OF INVESTMENT PRINCIPLES

1. INTRODUCTION

1.1 This Statement of Investment Principles (**SIP**) was agreed by the Pensions Committee (**Committee**) of the City of Edinburgh Council (**CEC**) on 11 December 2019. CEC is the administering authority for the Lothian Pension Fund and Scottish Homes Pension Fund (**the Funds**).

1.2 The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010 require administering authorities to prepare, maintain and publish a SIP. The SIP must be reviewed from time to time and revised within six months of any material changes in the Policy.

1.3 In preparing this statement, the Committee has taken professional advice from the Joint Investment Strategy Panel (**JISP**), which includes external advisers and members of the internal investment team who are FCA authorised individuals.

1.4 The SIP describes the objectives, policies and principles adopted by the Committee of CEC in undertaking the investment of fund monies. The SIP also discloses the extent to which the Funds comply with the six "Myners Principles" of investment practice.

2. GOVERNANCE

2.1 CEC has delegated responsibility for the supervision of the Funds to the Committee, which comprises five elected members from CEC and two co-opted members representing employer and beneficiary interests. The Committee is supported by a statutory Pensions Board consisting of five Trade Union and five employer representatives, which is responsible for ensuring that the Funds operate in accordance with the applicable laws and regulations. The Committee and Board are supported by an independent professional observer.

2.2 The Committee determines investment strategy based on proper advice from CEC's Executive Director of Resources. The Executive Director of Resources delegates this role to the Head of Finance taking advice from the JISP.

2.3 Responsibility for implementing the strategy is delegated to the Executive Director of Resources who delegates this role to the Head of Finance, taking advice from the JISP. Day to day management of the Fund's assets is undertaken by internal investment managers, and external investment managers whose activities are governed by Investment Management Agreements and the limits set out in Scheme regulations.

2.4 The SIP forms part of a governance framework that includes Statutory Regulations, the Pensions Committee, the Pension Board, the Joint Investment Strategy Panel, the Funds' Advisers and the Funds' Funding Strategy Statement.

3. HIGH LEVEL INVESTMENT PRINCIPLES

The following principles agreed by the Committee are designed to guide the Funds' governance, strategies and alignment with their agents and to support consistency in decision-making over the long term.

Governance

3.1 **Principle 1: Committee believes that their decisions, and those of officers, must give precedence to the fiduciary duty owed to members and employers.** Fiduciary duty is paramount. The Pensions Committee recognises the potential conflicts of interests inherent in a local authority administering a multi-employer pension fund. The objectives of the administering authority, its officials and officers and those of the pension fund are not necessarily the same. The primary objective is to ensure sufficient funding in the long term so that retirement benefits that employers promise to members under scheme rules can be paid when they fall due. (The legal view on fiduciary duty issued by the Scottish Local Government Pension Scheme Advisory Board is available at https://lgpsab.scot/fiduciary-duty-guidance/.)

3.2 **Principle 2: Committee believes that the Funds should mitigate risk by ensuring alignment of interests wherever possible.** Agency costs are high in the financial services industry – agents are often motivated to act in their own best interests rather than those of the principal (the Funds). Alignment of interests and partnering with similarly aligned organisations will help to reduce risk and address the principal-agency problem to the benefit of the Funds and partners. External resources should, therefore, be used where internal resources cannot be justified or obtained, or where an external perspective provides additional skills or insight into investment matters, and where suitable alignment can be established.

3.3 **Principle 3: Committee believes that it should work with like-minded partners to benefit from increased scale and greater resilience.** There are significant economies of scale in the business of managing investments, so working with like-minded partners with similar long-term objectives and liabilities can achieve lower costs and reduce operational risks with increased resilience.

3.4 **Principle 4: Committee believes that cost transparency aids decision-making.** The asymmetric structure of incentives in financial markets (upside participation in success without downside participation in failure) encourages strategies that may benefit agents (external managers and other financial intermediaries) and be detrimental to investor (Fund) returns. Agents often present fees and other charges in a way that obscures rather than illuminates. Full cost transparency should aid decision-making and so benefit Fund returns.

3.5 **Principle 5: Committee believes it should focus on policy setting, including high-level strategic asset allocation which defines risk and return objectives, with appropriate governance structure and oversight.** Implementation of more granular investment decisions (such as the selection/deselection of individual managers and investments) and regular monitoring should be delegated to suitably qualified and experienced individuals with sufficient time and other resources at their disposal. Appropriate delegation, constraints and reporting requirements should be in place. Reporting to Committee should focus on the long-term objectives of the Fund and how delegated decisions have contributed to these.

Funding

3.6 **Principle 6: Given future uncertainties, the funding strategy should be prudent and should reduce risk to employers of another employer defaulting on its pension obligations**. The Funding Strategy Statement expresses the funding objective, which informs the invested strategy options. The ultimate objective is to ensure long-term solvency so that retirement benefits that employers promise to members under scheme rules can be paid when they fall due, so full funding should be achieved in a prudent manner to ensure that liquid assets are available at the required time. This is important for members, employers and taxpayers as the scheme is ultimately state-backed.

3.7 **Principle 7: Committee believes that the Lothian Pension Fund should consider requests for different investment strategies from employers with different objectives**. Employers have conflicting desires: on the one hand, they would like to minimise the fluctuations in contributions and on the other hand, they would like to minimise the overall amount of contributions. Committee believes in allocating employers to different investment strategies reflecting their timescale for participation in the Fund and their covenant. Employers may have different objectives, so they should be given the opportunity to request a bespoke investment strategy. The Fund should consider such requests, taking account of issues such as employer covenant and implementation costs.

Investments

3.8 **Principle 8: Committee believes that the ability of the Funds to pay pension benefits when they fall due is more important than mark-to-market funding levels.** Committee recognises that there are various ways to measure the value of promised benefits in a defined benefit scheme. Committee believes that where employer circumstances allow, investment strategy should focus on delivering strong (real) returns that grow to cover cashflows over the longer term rather than focusing on protecting the funding level in the short term.

3.9 **Principle 9: Committee believes 'return-seeking' assets are likely to outperform 'risk-free' assets as the investment horizon lengthens, but this is not guaranteed.** Time horizons matter a great deal. The appropriate horizon for investment risk-taking depends on the duration of the liabilities, the profile of projected cash flows and the deficit recovery and contingency plans for the scheme (the sponsor covenant).

3.10 **Principle 10: Committee believes in owning a diversified portfolio of assets so that it is not overly exposed to any particular contingency.** Asset diversification can reduce risk where assets are not perfectly correlated. Committee recognises that the future is unpredictable and that real returns from investments are uncertain. Fund returns will be determined primarily by the high-level investment strategy allocation to different asset classes and the timing of material changes. Asset allocation balances diversified risks with the expected additional returns for these risks.

3.11 **Principle 11: Committee believes that responsible investment should reduce risk and may improve returns, but that mechanistic divestment is inconsistent with the Funds' fiduciary duty to members and employers.** The Local Government Pension Scheme (LGPS) was designed with an important social purpose in mind – the provision of retirement income for individuals. The Funds' fiduciary duty means that the pursuit of financial return is its paramount concern, although it may also take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment. Committee believes that the decisions to invest in, or divest from, a particular company should be made by an investment manager based on a holistic analysis of financially material issues, including environmental, climate change, social and governance issues.

3.12 **Principle 12: Committee believes it should exercise its ownership rights in a responsible way, constructively engaging with companies to reduce risk.** The Funds' interests are better protected from adverse impacts by collaborating with like-minded investors to have greater influence in engaging with companies, government and regulators. Engagement aims to encourage responsible behaviour by companies in relation to environmental, climate change, social and governance issues.

3.13 **Principle 13: Committee believes that monitoring and assessment of investment success should be viewed on a long-term basis.** No asset mix provides a stream of cash flows that perfectly matches the liability payments of the Funds as they fall due, so monitoring activity is complex. The Funds are long term in nature and the success of a given investment strategy is likely to ebb and flow with changing investment environments in an unpredictable way. Investment monitoring is challenging and should be viewed through a long-term lens.

3.14 **Principle 14: Committee believes that peer group comparative analysis needs to be treated with care.** No two pension funds are identical, so peer group analysis should be undertaken with care as different funds can hold different investment beliefs, objectives and return and risk appetites.

4. RESPONSIBLE INVESTMENT

4.1 With liabilities extending decades into the future, it is in the Funds' interests to take their responsibilities as institutional asset owners seriously. To this end, the Funds' approach to responsible investment centres on effective stewardship of all their assets, with a particular focus on good corporate governance to deliver sustainable investor value.

4.2 To demonstrate and embrace an open and transparent approach, the Funds became a signatory of the Principles for Responsible Investment (PRI) in 2008. Signatories commit to six principles and, since 2014, to an annual assessment of their responsible investing practices, which is published on the Funds' website.

4.3 The first principle of the PRI is the cornerstone of the Funds' responsible investment approach: "We will incorporate environmental, social and governance (**ESG**) issues into investment analysis and decision-making". This means that the Funds consider a wide range of issues and what financial impact they could have on the assets that they own. The Funds' investment managers are charged with integrating ESG analysis into their decision-making, and a specialist third party is used for dedicated research to identify ESG risks and opportunities, including those related to climate change. Investment managers are selected and appointed after due consideration of their approach to integrating ESG considerations into their investment process.

4.4 Another key strand of the Funds' approach to responsible investment is voting and engagement. For listed equities, the Funds are committed to exercising their right to vote the shares that they own. They are also committed to engaging with and influencing companies, governments and regulators where appropriate. The Funds do not follow a policy of exclusion or automatic divestment, as such a policy has the potential to transfer ownership rights to investors without responsible investment policies.

4.5 To ensure that these issues are addressed appropriately, the Funds use a specialist third party to assist with voting and engagement activities for the shares that it holds. The Funds are also members of the Local Authority Pension Fund Forum (LAPFF), which engages with companies on behalf of a large proportion of the Local Government Pension Schemes across the UK.

4.6 The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting high quality corporate governance and reporting. 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 their appointed asset managers to do so too. Details of adherence to the Code are provided in Appendix B.

5. FUNDS' OBJECTIVES

5.1 The **primary objective** of the Funds is to ensure that there are sufficient funds available to meet all pension and lump sum liabilities as they fall due for payment.

5.2 The **funding objectives** for each Fund are documented in the Committee's Funding Strategy Statement, which is reviewed at least triennially. The funding objectives, together with the rates of return being targeted and levels of risk to be tolerated, are central to each Fund's investment strategy and govern the allocation across various asset classes.

6.1 The **investment objectives** of the Funds are to achieve a return on Fund assets which is sufficient over the long term to meet the funding objectives as outlined in the Funding Strategy Statement. Investment returns are generated by a combination of income (from dividends, interest and rents) and gains or losses on capital.

5.3 In effect, the Funds' objectives are to generate sufficient long term returns to pay promised pensions and to make the scheme affordable to employers now and in the future, while minimising the risk of having to increase contribution rates in the future.

5.4 Committee has set investment strategy with reference to the following **policy groups,** which are regarded as the key determinants of risk and return. The policy groups condense the vast array of investment choices into a manageable number of investment groups with broadly similar characteristics:

- **Equities** provide an equitable share in the assets and profits of companies. Income is provided through discretionary share dividends. Equities are listed in the UK or overseas, or are unlisted (private equity). Equities have historically produced returns above inflation.

- **Gilts** are debt instruments issued by the UK Government. Typically, these provide interest payments on a regular basis over the life of the loan until capital is repaid at maturity. Some gilts provide interest payments and capital repayment value that is directly linked to price inflation (the Retail Price Index (RPI)). These are known as Index Linked Gilts and they provide the closest match to the Funds' liabilities, most of which are inflation-linked. Some other governments also issue this type of debt, but in different currencies tied to price inflation in their own countries.

- **<u>Non-Gilt Debt</u>** instruments are issued by a range of borrowers to finance their activities in various sectors of the economy, which means that they carry varying degrees of credit risk. Income is provided through interest, which is typically paid to the lender on a regular basis until the loan capital is repaid, generally at par by the issuer at a pre-determined date. Bonds can pay a fixed, variable or inflation-linked rate of interest. Bonds are listed in the UK or overseas, or are unlisted (private debt).

- **<u>Other Real Assets</u>** are typically investments in a share of income and capital appreciation of tangible assets, including **property** (land and/or buildings for commercial or residential use), **infrastructure** (assets deemed essential to the orderly functioning of daily life, such as renewable energy generation and transmission assets, water utilities, airports and toll roads) and **timberlands**. Income comes from dividends and rents.

- **<u>Cash</u>** is also a form of investment used to provide instant or short-term liquidity, and can be held in both sterling and foreign currencies (including Treasury Bills, Money Market Funds and Secured Investments). Cash generates interest income, but typically at a lower rate than bonds and other debt.

5.5 As the returns of the above investments are not completely correlated, the Funds expect to achieve diversification and better risk-adjusted returns by investing in assets from each policy group.

6. FUNDS' STRATEGIES

6.1 The Committee's agreed investment strategies (presented in Appendix A) are expressed in terms of allocations to various policy groups (or asset classes). These reference portfolios are expected to generate the required return with a reasonable probability of success. The rate of return being targeted and the level of risk to be tolerated are central to the determination of the investment strategy (or asset mix) of each Fund.

6.2 To provide suitable investment strategies for differing requirements of employers, **Lothian Pension Fund** currently operates four investment strategies, as follows:

6.3 **Main Strategy** is a diversified portfolio, mostly invested in long-term, return-seeking assets, such as equities, due to the long-term nature of the pension liabilities. Approximately 91% of employers' assets are invested in the Main Strategy.

6.4 **MEG ("Mature Employers Group") Strategy** invests in a portfolio entirely invested in UK gilts and cash to reduce investment risk for employers (except for Transferee Admitted Bodies) that are close to leaving the Fund. These employers have a low tolerance for risk and this strategy protects them from short-term changes in funding level and employer contribution rates. Less than 1% of employers' assets are invested in the MEG Strategy.

6.5 **50/50 Strategy** invests in a portfolio comprising 50% of the Main Strategy and 50% of the MEG Strategy for employers with a 'medium' tolerance for investment risk. Approximately 1% of employers' assets are invested in the 50/50 Strategy.

6.6 **Buses Strategy** is a diversified portfolio of assets tailored to suit the risk appetite of the Lothian Buses company**.** The Lothian Buses Pension Fund merged with Lothian Pension Fund in Q1 2019. This strategy was agreed by Committee in March 2016.

6.7 There may also be demand from individual employers for other investment strategies. 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.

6.8 **Scottish Homes Pension Scheme** achieved full funding at the most recent actuarial valuation in March 2017. Its investment strategy protects this closed and mature scheme from short-term changes in funding level and increases in contribution rates by investing in UK gilts and cash.

6.9 The Funds' investment strategies are measured against strategy-specific benchmarks by an independent performance measurement specialist, and these are reported to Committee annually with reference to asset market returns as well as liability valuations. The Executive Director of Resources is responsible for monitoring investments and investment activity and he delegates this function to the Head of Finance taking advice from the JISP, which meets at least quarterly.

7. STRATEGY IMPLEMENTATION

7.1 The Committee delegates implementation of strategy to the Executive Director of Resources, who delegates the role to the Head of Finance, taking advice from the JISP. The Head of Finance operates within the parameters agreed by the Committee, investing the Funds' assets in the policy groups within the permitted ranges.

7.2 The Head of Finance, advised by the JISP, identifies the combination of investment managers and mandates within the policy groups to deliver the objectives of the Funds. The investment managers and mandates are listed in Appendix A. The Lothian Pension Fund employs both external and internal managers, recognising that there are cost and alignment advantages of an in-house investment team.

7.3 To reduce the risk that a Fund does not deliver its objective, controls are set around policy group allocations and each manager/mandate. For external managers, these are detailed in formal Investment Management Agreements; and similarly, formal investment objectives and constraints are set for internal mandates. The investment managers are responsible for the selection of individual holdings.

7.4 The Funds' investment managers and mandates are measured against mandate-specific benchmarks of risk and return by an independent performance measurement specialist. Performance and mandate implementation is monitored by the JISP on a quarterly basis.

7.5 The Funds collaborate with other investors to benefit from increased scale and cost sharing arrangements. The Funds obtained regulatory approval from the Financial Conduct Authority (FCA) to facilitate this element of strategy implementation.

8. OTHER INVESTMENT CONSIDERATIONS

Realisation of investments

8.1 Most of the Funds' investments are in liquid markets and can be expected to be sold relatively quickly if required. A proportion of the Funds' investments (such as property, private equity, private debt and infrastructure) have less or limited liquidity and would therefore take longer to be sold. The overall liquidity of each Fund's assets is considered in the light of potential demands for cash.

Stock Lending

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

Underwriting

8.3 Managers are permitted to underwrite and sub-underwrite stock issues subject to the security being deemed attractive on a medium-term view and subject to the application being limited to an amount the manager would wish to hold over the medium term.

Derivatives

8.4 The Committee has approved the use of derivatives, subject to prevailing legislation and control levels outlined in investment manager agreements. A derivative is a security or contract that derives its value from its relationship with another asset. The Funds may make use of contracts for differences and other derivatives either directly or in pooled funds investing in these products for efficient portfolio management or to hedge specific risks. For example, forward currency contracts allow the Funds to reduce risk from currency fluctuations and equity futures allow the Funds to reduce risk during major portfolio rebalances/transitions.

Safekeeping of Assets

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

9. COMPLIANCE

Regulations and Investment Limits

9.1 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.

9.2 The Regulations contain limits on the percentage of a pension fund that may be invested in certain asset types. In accordance with the Regulations, the Committee have agreed the limits applicable to the Funds' investments in partnerships 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 partnerships: 5% (statutory maximum of 5%)

- Contributions to all partnerships: 20% (statutory maximum of 30%)

The Committee took proper advice in respect of these limits from the Joint 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

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

Review of SIP

9.4 The 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.

APPENDIX A – INVESTMENT STRATEGIES (11 DECEMBER 2019)

LOTHIAN PENSION FUND: MAIN STRATEGY

Investment Objectives: to achieve a return of at least gilts +2.8% per annum and generate sufficient cash to pay pensions as they fall due.

	Reference Portfolio			
Policy Group	**Current Target 11 December 2019**	**Target Weight 2019-24**	**Permitted Range**	**Long Term Expected Return**
Equities	65%	65%	50% - 70%	Gilts +3.5% p.a.
Real Assets	18%	18%	10% - 25%	Gilts +2.5% p.a.
Non-Gilt Debt	10%	10%	0% - 20%	Gilts +1.0% p.a.
Gilts	7%	7%	0% - 20%	Gilts +0.0% p.a.
Cash	0%	0%	0% - 10%	NA
Total	**100%**	**100%**		**Gilts + 2.8% p.a.**

LOTHIAN PENSION FUND: MEG ("Mature Employers Group") STRATEGY

Investment Objective: to achieve a return in line with gilts and generate sufficient cash to pay pensions as they fall due.

	Reference Portfolio			
Policy Group	**Current Target 11 December 2019**	**Target Weight 2019-24**	**Permitted Range**	**Long Term Expected Return**
Equities	0%	0%	NA	
Real Assets	0%	0%	NA	
Non-Gilt Debt	0%	0%	NA	
Gilts	88%	88%	80% - 100%	Gilts +0% p.a.
Cash	12%	12%	0% - 20%	NA
Total	**100%**	**100%**		**Gilts + 0% p.a.**

LOTHIAN PENSION FUND: 50/50 STRATEGY

Investment Objective: to achieve a return in line with a 50:50 investment in the Main Strategy and the MEG Strategy and generate a return that pays pensions as they fall due.

LOTHIAN PENSION FUND: BUSES STRATEGY

Investment Objective: to achieve a return of gilts +2.1% - 2.4% per annum and generate sufficient cash to pay pensions as they fall due.

	Reference Portfolio			
Policy Group	**Interim Target 11 December 2019**	**Target Weight 2016 - 21**	**Permitted Range**	**Long Term Expected Return**
Equities	35%	40%	interim weight +/- 10%	Gilts +3.5% p.a.
Real Assets	17.5%	18%	interim weight +/- 10%	Gilts +2.5% p.a.
Non-Gilt Debt	20%	22%	interim weight +/- 10%	Gilts +1.0% p.a.
Gilts	27.5%	20%	interim weight +/- 10%	Gilts +0.0% p.a.
Cash	0%	0%	0% - 10%	NA
Total	**100%**	**100%**		**Gilts + 2.1% - 2.4% p.a.**

SCOTTISH HOMES PENSION FUND

Investment Objective: to match cash flows from gilt income and redemption payments as closely as possible with the expected liability payments of the Fund to minimise the risk of additional employer contributions being required.

APPENDIX B: INVESTMENT STRATEGY IMPLEMENTATION (11 DECEMBER 2019)

The investment strategies in Appendix A are implemented by investing in a range of mandates managed by external or internal investment managers. The current mandates and managers for the Funds are presented in the table below:

Policy Group	Mandate	Manager
Equities		
	UK All Cap	Internal
	UK Mid Cap	Internal
	Europe ex-UK	Internal
	US	Internal
	Global Low Volatility	Internal
	Global High Dividend	Internal
	Global Multi-Factor	Internal
	Global Growth	Baillie Gifford
	Global Stable	Nordea
	Global Value	Harris
	Private Equity	Internal/Various
	Currency Hedging	Internal
Real Assets		
	Property	Internal
	Infrastructure	Internal/Various
	Timberland	Internal/Various
Non Gilt Debt		
	Sovereign Bonds	Internal
	Corporate Bonds	Baillie Gifford/LGIM
	Private Debt	Internal/Various
Gilts		
	Index-Linked Gilts	Internal
Cash		
	Cash	Internal/Various

APPENDIX C – STATEMENT OF COMPLIANCE WITH UK STEWARDSHIP CODE

The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting transparency and integrity in business. It sets the UK's Corporate Governance and Stewardship Codes. The Funds' Statement of Compliance with the UK Stewardship Code is presented below:

***Principle 1: Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities*.**

We acknowledge our role as an asset owner under the UK Stewardship Code and 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 a) the appointment of Hermes Equity Ownership Services (EOS); b) membership of the Local Authority Pension Fund Forum (LAPFF); c) the work of Baillie Gifford, an external investment manager; and d) the work of the internal investment team.

We believe that Hermes EOS enables us to provide the highest standards of stewardship on behalf of the beneficiaries of the Funds through their monitoring of shareholdings, so that we can fulfil our fiduciary responsibilities as long-term shareholders.

- Hermes EOS has the expertise to undertake corporate engagement on an international basis, and they do this for us. Their aim is to bring about positive long-term change at companies through a focused and value-oriented approach. Engagements undertaken by Hermes EOS on our behalf are guided by the Hermes EOS Corporate Governance Principles.
- 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.

Through our active membership of LAPFF, we keep informed of potential issues of concern at both individual companies and across the market, which leads to collaborative engagements in which the Funds sometimes participate. An elected member of the Pensions Committee has been a member of the Executive for several years.

Baillie Gifford takes direct responsibility for stewardship issues, including voting and engagement, in the funds which it manages on our behalf. Baillie Gifford has published its own Statement of Compliance with the Stewardship code.

The internal investment team integrates environmental, social and governance (ESG) issues into its decision making, in line with the Principles for Responsible Investment to which the Funds are a signatory. The internal team also engages directly with companies in which the Funds invest.

Principle 2: Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.

The Funds' efforts to manage its potential conflicts of interest can be summarised below:

- We are supported in effectively managing conflicts of interest in relation to our stewardship work by Hermes EOS. Hermes EOS explains how it manages conflicts of interest on our behalf in its Stewardship conflicts of interest policy document.

- We also encourage the asset managers employed by the Funds to have effective policies addressing potential conflicts of interest.

- In respect of conflicts of interest within the Funds, Pensions Committee members are required to make declarations of interest prior to Committee meetings.

- Our policy of constructive engagement with companies is consistent with the Funds' fiduciary responsibilities.

Principle 3: Institutional investors should monitor their investee companies.

Day-to-day responsibility for monitoring our equity holdings is delegated to Hermes EOS and Baillie Gifford:

- We expect them to monitor companies, intervene where necessary, and report back regularly on activity.

- Activity is reported on the Funds' website quarterly, including the number of company meetings at which the Funds have voted and how the Funds have voted.

LAPFF also monitors and engages with companies and provides an 'Alerts' service, which highlights concerns over corporate governance issues.

The internal investment management team also monitors its investee companies regularly, on an ongoing basis. It adheres 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.

Principle 4: Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value.

As highlighted above, responsibility for day-to-day interaction with companies is delegated, including the escalation of engagement when necessary.

- We expect the approach to engagement on our behalf to be value-orientated and focused on long term sustainable profitability. We expect Hermes EOS and Baillie Gifford to disclose their guidelines for such activities in their own statements of adherence to the Code.

- The internal team also monitors investee companies and escalates engagement activity directly with investee companies as required.

- We may also propose escalation of activity through the Local Authority Pension Fund Forum.

- Consistent with our fiduciary duty to beneficiaries and to encourage improved conduct in future, we consider participating in shareholder litigation where it appears likely that the Funds will recover losses (net of costs) sustained because of inappropriate actions by company directors.

Principle 5: Institutional investors should be willing to act collectively with other investors where appropriate.

We seek to work collaboratively with other institutional shareholders to maximise the influence that we can have on individual companies. We do this through:

- the appointment of Hermes EOS, whose engagement service pools asset ownership with the aim of protecting and enhancing shareholder value. Hermes EOS represents us and other like-minded asset owners globally using its expertise to enhance our effectiveness in communicating with companies, industry bodies, regulators and legislators.

- membership of the Local Authority Pension Fund Forum, which is a collaborative effort of approximately 70 local authority pension funds. It engages and lobbies for positive changes on environmental, social and governance issues on behalf of its members. See http://www.lapfforum.org/ for more details.

- being a signatory of the PRI in our own right. See https://www.unpri.org/ for more details.

- 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. See https://www.cdp.net/en for more details.

Principle 6: Institutional investors should have a clear policy on voting and disclosure of voting activity.

The emphasis of our voting policy is to promote best practice.

- We seek to vote on all shares held. The Funds have an active stock lending programme but consider recalling stock from a loan where it appears that this would be an appropriate way to safeguard the Funds' financial interests.

- Our preference is for managers to vote on the Funds' behalf and for responsible stewardship to be integral to the investment decision-making process. We are comfortable with delegation of voting to Baillie Gifford for the funds they manage. The manager's voting policies can be found at the website mentioned above.

- For all other mandates, Hermes EOS votes consistently across the portfolios it covers, and makes voting decisions based on a thorough analysis of publicly available information and always taking 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. Underpinning voting decisions are Hermes EOS Regional Corporate Governance policies, which can be found in the following link:

  https://www.hermes-investment.com/uki/about-us/policies-and-disclosures/

- We disclose our historic voting information on our website. This includes the total number of votes cast at which company meetings and whether the votes were cast for or against company management. We disclose in arrears so that we are transparent and accountable but dialogue with companies in our portfolios is not compromised. See http://www.edinburgh.gov.uk/lpf1/info/77/voting_and_engagement_record for full details.

Principle 7: Institutional investors should report periodically on their stewardship and voting activities.

We do report on our stewardship and voting activities:

- We report annually on stewardship and voting activity in the Funds' annual report and accounts and quarterly on our website.

- We also report annually on stewardship and voting activity directly to the Pensions Committee.

We reviewed this Statement of Compliance with the UK Stewardship Code in December 2019. We will review the Statement annually.

APPENDIX D – CIPFA PRINCIPLES FOR INVESTMENT DECISION MAKING AND DISCLOSURE

The Chartered Institute of Public Finance and Accountancy (CIPFA) published six Principles for Investment Decision Making and Disclosure in the Local Governance Pension Scheme in the UK in 2012. 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. 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, who in turn delegates to the Funds' officers. 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 Joint 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 Joint Investment Strategy Panel meets at least 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 Joint Investment Strategy Panel and the Pensions Committee.

- Conflicts of interest are managed actively. At each Committee meeting, elected members of the Pensions Committee and Pensions Board 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 understanding of risks and the setting of investment strategy. Each Fund has a scheme-specific investment strategy.
- Employers' attitude to risk is specifically considered in the setting of strategy, and employers can request a bespoke investment strategy.
- Reviews of investment strategy focus on the split between broad asset classes (equities, gilts, non-gilt debt, real assets and cash).
- Investment Management Agreements set clear benchmarks and risk parameters 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 includes specific consideration of the desire 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.
- Lothian Pension Fund recognises that employers' circumstances vary and an alternative investment strategy for their section(s) of the Fund may be deemed suitable. The Fund will consider requests for such alternatives, 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 the 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 monitors the external investment managers' performance and risk on a regular basis and reports this to the Joint Investment Strategy Panel. The Joint Investment Strategy Panel assesses the performance and risk of both internal and external investment managers on a regular basis (typically quarterly).
- The Funds' contracts with its advisers are regularly market tested.
- The Joint 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' approach to responsible investment is described in the Statement of Investment Principles and on the Funds' website.
- The Funds' policy on responsible ownership is included in the statement on the Financial Reporting Council's Stewardship Code (see Appendix C 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 entitled to make a deputation 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 provided to employers. The Funds' website is updated regularly.