



Pensions Committee

2.00pm, Wednesday 27 September 2023

Updates to Investment Governance arrangements

Item number 6.4

1. Recommendations

The Pensions Committee (Committee) is requested to:

- 1.1 note the contents of this report as they relate to documentation of roles and management of conflicts in relation to investment decision-making.
- 1.2 adopt the revised Statement of Investment Principles.

David Vallery
Chief Executive Officer

Contact: Jane McKeown, Head of Legal, Lothian Pension Fund
E-mail: lpfgovernancecomms@lpf.org.uk | Tel: 0333 996 1931

Updates to Investment Governance arrangements

2. Executive Summary

- 2.1 As a result of the expansion of services provided by LPFI to its Fife and Falkirk, and a recent regulatory compliance review of LPFI, changes are being made to the terms of reference of the Joint Investment Strategy Panel (**JISP**).
- 2.2 These changes enable better management and documenting of the known and accepted potential conflicts in the role of LPFI as both investment adviser and fund manager, whilst not changing the substance of the service delivery that is valued by LPF's strategic partner funds.
- 2.3 The changes have no bearing on the responsibilities of the Pension Committee for investment strategy, nor either the advice and oversight provided to LPF via the JISP and specifically the external advisers, nor to the responsibilities of Lothian Pension Fund's Chief Investment Officer (**CIO**) to implement the investment strategy as approved by the Committee.
- 2.4 As a result of these changes, references in the Statement of Investment Principles (**SIP**) should be updated. Other minor amendments to simplify and remove duplication within the SIP are also recommended.
- 2.5 The report presents the SIP for Lothian Pension Fund and Scottish Homes Pension Fund for approval.

3. Background

- 3.1 The Committee is reminded that:
 - 3.1.1 under the Committee's Terms of Reference, the Committee is responsible for determining LPF's investment strategy and for reviewing and monitoring investment arrangements.
 - 3.1.2 individuals (fund officers) have been delegated responsibility for implementing the investment strategy and for appointing, monitoring and reviewing managers and advisers. This is set out in a chain of documents collectively referred to as the 'Scheme of Delegation to Officers'. Authority delegated to officers is subject to Committee oversight.
- 3.2 Under LGPS Regulations, proper advice must be taken about pension fund investments. For this reason, an 'investment strategy panel' comprised of advisers appointed to support fund officers making decisions in relation to the investment

strategy was created. Since 2019, fund officers from Falkirk and Fife have used the same advisers under a joint engagement.

3.3 The JISP also provide services to the Committee through training and attending at least one meeting per year. These services will not change.

3.4 To date:

3.4.1 the Council's Service Director: Finance and Procurement has attended JISP meetings on behalf of LPF, under the authority sub-delegated to him from the Executive Director of Corporate Services under the Scheme of Delegation to Officers. This arrangement was described in the SIP.

3.4.2 LPFI Limited has been part of the JISP and the LPF CIO has attended JISP meetings as LPFI's representative.

3.5 The Committee is reminded that the decision to adopt the revised SIP presented to the June meeting of the Committee was deferred to this meeting so that Principle 11 could be updated in light of Councillor Burgess's comment.

4. Main Report

4.1 A recent review of the LPF group's investment governance arrangements identified the need to clarify responsibility for LPF's investment decisions under the current delegated authorities.

4.2 It is now proposed that LPF's CIO should attend the quarterly meetings with the JISP as LPF's representative (to be referred to as the 'Client Representative') in place of the Council's Service Director: Finance and Procurement. The authorities sub-delegated by the LPF CEO to the LPF CIO will expressly state that the CIO is responsible for *"Implementing the investment strategy of the pension fund with advice from the Joint Investment Strategy Panel (JISP) where appropriate"* as currently happens in practice.

4.3 This change will support improvements in LPF's investment governance arrangements in particular, conflict of interest management and the role of decision-makers with authority over the assets of LPF which should be clearly distinguished from the role of Council officers performing the functions of the local authority. This is particularly pertinent for the Service Director: Finance and Procurement (also the Council's s95 officer), whose responsibility for the finances of the Council (the largest scheme employer within LPF) could conflict with the interests of LPF relevant to investment decisions.

4.4 LPFI's position as an adviser which is part of the JISP will also be changed, to address a separate conflict identified in the investment governance review. As a result of such change, LPFI will not be attending the JISP meetings with Client Representatives

as an adviser. Previously LPFI appeared to be able to advise the Fife and Falkirk fund officers to transfer the management of assets to LPFI – a clear conflict of interests. Any such decision to transfer assets to LPFI’s management will be advised on solely by the external JISP advisers.

- 4.5 LPFI will continue to provide information and advice to external clients and the JISP meetings, but the documentation will be enhanced to clearly distinguish the nature of service and document any potential or actual conflicts.
- 4.6 An updated description of the advisory responsibilities of the JISP, including LPFI’s updated role, is set out in the latest JISP Terms of Reference. This is presented in Appendix 1 for noting.
- 4.7 The revised JISP Terms of Reference were discussed at the JISP meeting on 8 September with the changes broadly supported. Some minor feedback to add more context about the strategic intent that underpins the JISP meetings and emphasise the continuity of service from LPFI to both Fife and Falkirk has been requested. The expectation is that the three funds will formally adopt the revised JISP Terms of Reference at the December 2023 meeting.
- 4.8 The SIP contained sections which describe the ‘Governance’ and ‘Strategy implementation’. As a result of the changes described in paragraphs 4.2 and 4.4, these have been reviewed. It is recommended to delete details of the investment governance arrangements where these are not required or overlap with other documents.
- 4.9 In-line with this approach of removing superfluous or overlapping information, it is recommended that other parts of the SIP are removed. The suggested amendments are explained in the ‘schedule of explanatory comments of changes’ within the mark-up of the SIP which is presented in Appendix 2 for approval. A clean version of the SIP is also included in Appendix 3.
- 4.10 This version of the SIP also addresses the amendment to Principle 11 which was requested by Councillor Burgess at the Committee meeting in June 2023.

5. Financial impact

- 5.1 There are no direct financial implications of this report.

6. Stakeholder/Regulatory Impact

- 6.1 The LGPS regulations relevant to the SIP have been reviewed to ensure the updated version continues to meet the regulatory requirements.

- 6.2 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. Background reading/external references

- 7.1 None.

8. Appendices

- 8.1 Appendix 1 – Joint Investment Strategy Panel Terms of Reference (draft)
- 8.2 Appendix 2 – Statement of Investment Principles (with tracked changes) including:
- Appendix A – Investment Strategies
 - Appendix B – Statement of Compliance with the CIPFA Principles for Investment Decision Making in the Local Governance Pension Scheme
 - Schedule of explanatory comments of changes
- 8.3 Appendix 3 – Statement of Investment Principles (clean version) including:
- Appendix A – Investment Strategies
 - Appendix B – Statement of Compliance with the CIPFA Principles for Investment Decision Making in the Local Governance Pension Scheme



Draft

Joint Investment Strategy Panel

Terms of Reference

August 2023

1. INTRODUCTION

Lothian Pension Fund, Falkirk Council Pension Fund and Fife Council Pension Fund (the "**Pension Funds**") use a panel of jointly appointed external, independent advisers known as the Joint Investment Strategy Panel ("**JISP**"). These terms of reference set out how the JISP operates.

Each Pension Fund retains responsibility for its own decisions and specifically:

- The Pensions Committee of each Pension Fund is responsible for **determining** the investment strategy and for reviewing and monitoring investment arrangements.
- Individuals (i.e. fund officers or "**Client Representatives**") have been delegated responsibility for **implementing** the investment strategy and for appointing, monitoring and reviewing managers and advisers.

2. PURPOSE OF THE JISP

As contemplated by the memoranda of understanding between the Pension Funds (whereby the Pension Funds agreed to collaborate with each other on a shared service basis), the JISP was established to promote collaboration between the Pension Funds by using shared advisers to provide an independent, expert view to support decisions in relation to investment strategy.

Under s11 of The LGPS (Management and Investment of Funds) (Scotland) Regulations 2010, the administering authority of each Pension Fund must obtain proper advice at reasonable intervals about its investments. This means that the investment decision-makers acting on behalf the administering authority have a duty to take advice. The JISP is used to provide this advice, supporting a key area of governance in the investment decision-making process.

3. RESPONSIBILITIES OF THE JISP

The Client Representatives are responsible for implementing the investment strategy of the Pension Funds. They have appointed the JISP to support their decisions in relation to investment strategy to benefit from the JISP's additional knowledge, experience and impartiality, including to support, challenge and scrutinise LPFI's advice to the Pension Funds (explained below).

The Client Representatives are required to implement the investment strategy in accordance with the Statement of Investment Principles ("**SIP**") maintained by the Pensions Committee of each Pension Fund. The SIP describes the principles governing decisions relating to the investment of fund money and therefore the JISP's advice should refer to the relevant fund's SIP.

The JISP's responsibilities to the Client Representatives are:

Investment Policy and Strategy

1. To advise on the content of each Pension Fund's SIP and the Statement of Responsible Investment Principles ("SRIP").
2. To provide advisory input on investment risk and return to support each Pension Fund's Pensions Committee in setting investment strategy.
3. To identify, analyse and advise on suitability of asset classes (policy groups) and benchmarks to be used by the Pension Funds.

Investment Implementation

4. To provide advice to Client Representatives on appropriate investment management styles, portfolio structures and implementation costs to achieve the Pension Funds' investment objectives.
5. To advise on appropriate objectives and restrictions for all portfolios of the three funds.
6. To provide advisory input on the selection and appointment process of external managers.
7. To review and discuss the potential impact of the investment environment on policy groups and investment strategies.
8. To review quarterly updates and outlooks for each policy group.
9. To advise on how to deal with any deviations from the Pension Funds' investment strategies, including the management of cash.
10. To advise on the use of stock lending services by the Pension Funds.

Monitoring

11. To monitor and review compliance with investment-related constraints and diversification objectives as set out in the SIP, in line with aggregate, policy group and individual mandate guidelines.
12. To monitor and review compliance with responsible investment policies, including:
 - evidence of environmental, social and governance (ESG) analysis within the processes of all investment managers, including LPFI
 - evidence of voting and engagement activity
13. To monitor the risk and return profile of the Pension Funds' investments at component and aggregate level, based on analysis of independent performance measurement providers.
14. To review analysis of the costs to support investment strategy implementation.
15. To monitor cash flow trends and advise on any implications for investment strategy.
16. To monitor manager performance (including LPFI's performance) based on a review of LPFI's advisory report.

The purpose of the JISP's monitoring described in paragraphs 11 - 16 is to inform their advice to the Client Representatives.

4. LPFI'S ADVISORY ROLE

As referred to above, LPFI Limited, a wholly owned subsidiary of Lothian Pension Fund, has been engaged by each Pension Fund to produce advisory reports for consideration at the JISP meetings. The

advisory reports contain advice collated from both the JISP and the LPFI advisers for consideration by the Client Representatives, highlighting any differences of opinion between the JISP and LPFI. The advisory reports also include supporting information and investment data.

LPFI provides its draft advisory report to the JISP approximately 9-10 days in advance of the quarterly JISP meeting. LPFI representatives then organise an “adviser briefing” with the JISP in the week before the JISP meeting, in order to address any points of clarification or provide more detail and context to the advisory report. The final version of the advisory report is issued to the Client Representatives prior the JISP meeting and reflects the matters discussed at the adviser briefing.

5. JISP MEETINGS

Attendees: Each JISP meeting will be attended by:

- Advisers that make up the JISP.
- Client Representatives from each Pension Fund and their deputies (or a nominated substitute). The Client Representatives are as follows:
 - Lothian Pension Fund: Chief Investment Officer
 - Falkirk Council Pension Fund: Chief Finance Officer
 - Fife Council Pension Fund: Head of Finance

Each Pension Fund may invite other officers involved in their day-to-day operations to attend a JISP meeting, to support the relevant Client Representative.

With the prior agreement of each Client Representative, the Independent Professional Observer (“**IPO**”) for any Pension Fund’s Pensions Committees can attend any JISP meeting to support/inform their role. It is anticipated that attendance by the IPO will be on an infrequent basis, and not happen more than once per year.

Part of LPFI’s role includes minute-taking at JISP meetings, therefore an LPFI Investment Administrator will also attend JISP meetings.

Additional attendees may attend JISP meetings where appropriate.

Chair: One of the Client Representatives will chair the discussions at JISP meetings, and the role of the Chair will rotate between the Client Representatives annually. The current Chair may appoint any other Client Representative as an alternative Chair. If the Client Representative who is scheduled to be Chair is absent, any other Client Representative can appoint itself as Chair.

Frequency: JISP meetings will take place quarterly and are expected to last up to half a day each in March, June, September and December each year. JISP meetings will take place at the offices of Lothian Pension Fund unless otherwise arranged in advance.

Reporting: LPFI's finalised advisory report (described above) will be distributed to the Client Representatives at least one week in advance of the JISP meeting (unless a shorter period is agreed by the Chair).

Minutes: LPFI will prepare minutes of each JISP meeting as a record of the discussions and any advice given by the JISP. Draft minutes will be forwarded to the JISP and the Client Representatives to confirm accuracy within ten working days of the JISP meeting. After this, LPFI will circulate copies of the minutes to the IPOs of each Pension Fund and the Conveners of each Pensions Committee. Minutes will be approved by the Client Representatives at the next JISP meeting.

6. TERMS OF REFERENCE REVIEW

These terms of reference will be reviewed by the Client Representatives and JISP annually and submitted to the Pensions Committee of each Pension Fund, for information.

August 2023

INTRODUCTION

This Statement of Investment Principles (SIP) describes the principles governing decisions of the Pensions Committee (Committee) of the City of Edinburgh Council (CEC) as administering authority of Lothian Pension Fund and Scottish Homes Pension Fund relating to the investment of fund money. It has been prepared in accordance with the requirements of the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010, as amended (the 2010 Regulations).

Commented [JM1]: Comment 1

The SIP should be read in conjunction with the Statement of Responsible Investment Principles (SRIP). The SRIP explains the Committee's approach to the oversight and monitoring of investment activities from a Responsible Investment (RI) and Stewardship perspective. This covers the Committee's policy on the extent to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and the exercise of the rights (including voting rights) attaching to investments.

Commented [JM2]: Comment 2

Commented [JM3]: Comment 3



HIGH LEVEL INVESTMENT PRINCIPLES

The following principles guide the investment strategy, including the investment objectives and investment policies, adopted by the Committee.

Commented [JM5]: Comment 5

Governance

Principle 1: Committee believes that investment decisions must give precedence to the fiduciary duty owed to members and employers.

Fiduciary duty is paramount. The Committee recognises the potential conflicts of interests inherent in a local authority administering a multi-employer pension fund. The objectives of the local authority are not necessarily the same when it is acting in its capacity as the administering authority of a pension fund. The primary objective of the pension fund is to ensure sufficient funding in the long term so that retirement benefits owed to members under scheme rules can be paid when they fall due. (The most recent legal advice on fiduciary duty for the Scottish Local Government Pension Scheme is available at <https://lgpsab.scot/fiduciary-duty-guidance/>.)

Principle 2: Committee believes that risk should be mitigated by ensuring alignment of interests wherever possible.

Agency costs are high in the financial services industry – agents are often motivated to act in their best interests rather than those of the principal (the pension fund). 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 pension fund 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.

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.

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 the investment returns received by the pension fund. 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 investment returns.

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 and oversight.

Implementation of more granular investment decisions (such as the selection/deselection of individual managers and assets) 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 pension fund and how investment decisions have contributed to such objectives.



Funding

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 investment strategy options available to scheme employers. The ultimate objective is to ensure long-term solvency so that retirement benefits owed 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.

Principle 7: Committee believes that requests for different investment strategies from employers with different objectives should be considered.

Employers have conflicting desires: on the one hand, they'd like to minimise the fluctuations in contributions and on the other hand, they'd like to minimise the overall amount they are asked to contribute to the pension fund. Committee believes in allocating employers to different investment strategies in a way which reflects their timescale for participation in the pension fund and their covenant strength. Employers may have different objectives, so they should be given the opportunity to request an alternative investment strategy. The Fund should consider such requests, taking account of issues such as the strength of the employer's covenant and implementation costs.

Commented [JM6]: Comment 6

Investments

Principle 8: Committee believes that the ability of the pension fund 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.

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).

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.

Principle 11: Committee believes that responsible investment should reduce risk and may improve returns.

The LGPS was designed with an important social purpose in mind – the provision of retirement income for individuals. The Committee's fiduciary duty means that the pursuit of financial return is its paramount concern, although it may also take purely non-financial considerations into account

Commented [JM7]: Comment 7

Commented [JM8]: Comment 8

provided that doing so would not involve significant risk of financial detriment. The 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.

Principle 12: Committee believes it should exercise its ownership rights in a responsible way, constructively engaging with companies to reduce risk.

The pension funds 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.

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 pension funds as they fall due, so monitoring activity is complex. The pension 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.



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.

PENSION FUND OBJECTIVES

The **primary objective** of the pension fund is to ensure that there are sufficient funds available to meet all liabilities as they fall due.

The **funding objectives** 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 the investment strategy and govern the allocation across various asset classes.

The **investment objectives** of the pension fund are to achieve a return on assets which is sufficient over the long term to meet the funding objectives outlined in the Funding Strategy Statement, i.e. to

pay liabilities and to make the scheme affordable to employers now and in the future, while minimising any increase in contribution rates.

Committee has set the 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.
- **Other Real Assets** 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 **timberland**. Income comes from dividends and rents.
- **Non-Gilt Debt** 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 either listed in the UK or overseas or are unlisted (private debt).
- **LDI** are gilts, which 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, albeit to a different measure of price inflation (the Consumer Price Index (CPI)). Some other governments also issue this type of debt, but in different currencies tied to price inflation in their own countries.
- **Cash** 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.

As the returns of the above investments aren't completely correlated, the pension fund should achieve diversification and better risk-adjusted returns by investing in assets from each policy group.

INVESTMENT STRATEGIES

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 the pension fund. The 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.

Commented [JM10]: Comment 10

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

- **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 94% of employers' assets are invested in the Main Strategy.
- **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.
- **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. Less than 1% of employers' assets are invested in the 50/50 Strategy.
- **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. It represents 5.5% of Fund assets.

Scottish Homes Pension Scheme was fully funded at the most recent actuarial valuation in March 2020. 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.

STRATEGY IMPLEMENTATION



With advice from the Joint Investment Strategy Panel, the CIO and senior members of the investment team identify the combination of investment managers and mandates within the policy groups to deliver the objectives of the pension fund. The investment strategies are listed in Appendix A. Both external and internal managers are used, recognising that there are cost and alignment advantages of an in-house investment team.

To reduce the risk that the investment objective is not met, 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.

The internal 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 advisers on a quarterly basis.

OTHER INVESTMENT CONSIDERATIONS

Realisation of investments

Most of the pension fund investments are in liquid markets and can be expected to be sold relatively quickly if required. A proportion of the 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 the assets is considered in the light of potential demands for cash.

Stock Lending

The pension fund lends a proportion of their investments to generate income from share ownership. Stock lending is conducted within parameters prescribed in the 2010 Regulations. Stock lending doesn't 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 strict parameters on the credit-worthiness of potential borrowers.

Underwriting

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

A derivative is a security or contract that derives its value from its relationship with another asset. The Committee has approved the use of derivatives, subject to compliance with relevant legislation and control levels outlined in investment management agreements. The pension fund 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 pension fund to reduce risk from currency fluctuations and equity futures allow the pension fund to reduce risk during major portfolio rebalances/transitions.

Voting and Engagement

The approach to exercising ownership rights attached to investments (including voting rights) is described in the SRIP.

Safekeeping of Assets

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

Commented [JM14]: Comment 14



COMPLIANCE WITH 2010 REGULATIONS

Increased Investment Limits

The 2010 Regulations contain limits on the percentage of a pension fund that may be invested in certain types of investment including partnerships. Partnerships are commonly used as the fund vehicle through which the pension fund makes an investment into assets such as infrastructure, timber, property, private equity and private debt (also referred to as unlisted investments). In accordance with the 2010 Regulations and based on proper advice from the JISP advisers, the Committee have agreed the following increased limits applicable to the pension fund's investments in partnerships to accommodate the allocation to unlisted investments:

- All contributions to any single partnership: 5% (statutory maximum of 5%)
- All contributions to)partnerships: 20% (statutory maximum of 30%)



The increased limits will apply for so long as the pension fund has an allocation to unlisted investments. This decision is compliant with the 2010 Regulations.

Commented [JM15]: Comment 15

CIPFA Principles for Investment Decision Making

The 2010 Regulations require the Committee to publish the extent to which it complies with guidance issued by Scottish Ministers. This includes the six *Principles for Investment Decision Making and Disclosure in the Local Government Pension Scheme in the United Kingdom 2009* published by the Chartered Institute of Public Finance and Accountancy (CIPFA) and based on the Myners principle, as updated in 2008. Details of the CIPFA principles, and how the Committee complies with such guidance, is provided in Appendix B.

Review of SIP

The Committee will review this statement annually and, in the case of any material change in the Committee's policy, before the end of a period of six months beginning with the date of that change. The Committee will consult with such persons as it considers appropriate and take proper advice when revising this statement.

APPENDIX A – INVESTMENT STRATEGIES (27 SEPTEMBER 2023)

Commented [JM16]: Comment 16

Strategy name	Investment objective	Investment strategy description																					
Lothian Pension Fund																							
Main	To generate returns sufficient to pay pensions as they fall due.	<p>To invest in the following exposures:</p> <table> <tr> <th>Policy group</th><th>Target weight 2021-2024</th><th>Permitted range</th></tr> <tr> <td>Equities</td><td>60%</td><td>50-70%</td></tr> <tr> <td>Real Assets</td><td>20%</td><td>10-30%</td></tr> <tr> <td>Non-Gilt Debts</td><td>10%</td><td>0-20%</td></tr> <tr> <td>LDI (Formerly Gilts)</td><td>10%</td><td>0-20%</td></tr> <tr> <td>Cash</td><td>0%</td><td>0-15%</td></tr> <tr> <td>Total</td><td>100%</td><td></td></tr> </table>	Policy group	Target weight 2021-2024	Permitted range	Equities	60%	50-70%	Real Assets	20%	10-30%	Non-Gilt Debts	10%	0-20%	LDI (Formerly Gilts)	10%	0-20%	Cash	0%	0-15%	Total	100%	
Policy group	Target weight 2021-2024	Permitted range																					
Equities	60%	50-70%																					
Real Assets	20%	10-30%																					
Non-Gilt Debts	10%	0-20%																					
LDI (Formerly Gilts)	10%	0-20%																					
Cash	0%	0-15%																					
Total	100%																						
MEG (Mature Employers Group)	To achieve a return in line with gilts that match the duration of the liabilities.	To invest exclusively in UK Gilts and Cash matching the duration of employer liabilities with the duration of the invested assets.																					
50/50	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.	<p>To invest 50:50 investment in the Main Strategy and the MEG Strategy which results in the following exposures:</p> <table> <tr> <th>Policy group</th><th>Target weight 2021-2024</th><th>Permitted range</th></tr> <tr> <td>Equities</td><td>30%</td><td>25-35%</td></tr> <tr> <td>Real Assets</td><td>10%</td><td>5-15%</td></tr> <tr> <td>Non-Gilt Debts</td><td>5%</td><td>0-10%</td></tr> <tr> <td>LDI (Formerly Gilts)</td><td>55%</td><td>45-65%</td></tr> <tr> <td>Cash</td><td>0%</td><td>0-10%</td></tr> <tr> <td>Total</td><td>100%</td><td></td></tr> </table>	Policy group	Target weight 2021-2024	Permitted range	Equities	30%	25-35%	Real Assets	10%	5-15%	Non-Gilt Debts	5%	0-10%	LDI (Formerly Gilts)	55%	45-65%	Cash	0%	0-10%	Total	100%	
Policy group	Target weight 2021-2024	Permitted range																					
Equities	30%	25-35%																					
Real Assets	10%	5-15%																					
Non-Gilt Debts	5%	0-10%																					
LDI (Formerly Gilts)	55%	45-65%																					
Cash	0%	0-10%																					
Total	100%																						

Buses	To generate sufficient returns to pay pensions owed to members formerly employed by Lothian Buses as they fall due.	<p>To invest in a proportion of the MEG Strategy and the Main Strategy that reflects the maturity of liabilities. This is currently 45:55. Based on the Main Strategy, the Buses Strategy will have the following exposures:</p> <table> <tr> <th>Policy group</th><th>Target weight 2021-2024</th><th>Permitted range</th></tr> <tr> <td>Equities</td><td>33.0%</td><td>28-38%</td></tr> <tr> <td>Real Assets</td><td>11.0%</td><td>6-16%</td></tr> <tr> <td>Non-Gilt Debt</td><td>5.5%</td><td>0-11%</td></tr> <tr> <td>LDI (formerly Gilts)</td><td>50.5%</td><td>40-60%</td></tr> <tr> <td>Cash</td><td>0.0%</td><td>0-10%</td></tr> <tr> <td>Total</td><td>100%</td><td></td></tr> </table>	Policy group	Target weight 2021-2024	Permitted range	Equities	33.0%	28-38%	Real Assets	11.0%	6-16%	Non-Gilt Debt	5.5%	0-11%	LDI (formerly Gilts)	50.5%	40-60%	Cash	0.0%	0-10%	Total	100%	
Policy group	Target weight 2021-2024	Permitted range																					
Equities	33.0%	28-38%																					
Real Assets	11.0%	6-16%																					
Non-Gilt Debt	5.5%	0-11%																					
LDI (formerly Gilts)	50.5%	40-60%																					
Cash	0.0%	0-10%																					
Total	100%																						
Scottish Homes Pension Fund																							
Scottish Homes	To match cash flows from gilt income and redemption payments as closely as possible with the expected liability payments of the pension fund to minimise the risk of additional employer contributions being required.	To invest all assets in UK gilts and cash. As some liabilities are fixed in nature and some are inflation-linked, in the strategy is to invest in both nominal and index-linked gilts to match cash flows with liability payments one year beyond the next actuarial valuation. Longer dated liability payments are duration matched.																					

APPENDIX B – COMPLIANCE WITH CIPFA PRINCIPLES

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 Committee focuses on setting the strategy for the pension fund 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.
- Fund officers are responsible for the provision of the training plan for Committee members to help them to make effective decisions and to ensure that they are fully aware of their statutory and fiduciary responsibilities.
- The Committee's Training and Attendance Policy is available on the website. It applies to both members of the Committee and the Pensions Board and is intended to support their knowledge to enable them to evaluate and challenge the advice they receive. Standards relating to the administration of the Committee's business are strictly upheld.
- The Committee 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 JISP advisers advise the client representative (currently the LPF CIO) on the implementation of the investment strategies, reviewing structure, funding monitoring, performance and risk and asset allocation. The JISP meets at least quarterly and includes independent advisers who are experienced investment professionals.
- The fund's in-house investment team undertakes day-to-day monitoring of the investment. The team includes personnel with suitable professional qualifications and experience to provide the necessary skills, knowledge, advice and resources to support the JISP meetings and the Committee.
- Conflicts of interest are managed actively. At each Committee meeting, elected members of the 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 and includes the Compliance Policy, which ensures conflicts of interest are highlighted and managed appropriately.

Commented [JM17]: Comment 17



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 SIP and the Funding Strategy Statement define the primary funding objectives of the pension fund.
- Asset-liability modelling is undertaken with the help of external advisers to aid the understanding of risks and the setting of investment strategy.
- Employers' attitude to risk is specifically considered in the setting of strategy, and employers can request a bespoke investment strategy.
- The setting of the Funding Strategy includes specific consideration of the desire to maintain stability in employer contribution rates.
- Reviews of investment strategy focus on the split between broad asset classes (equities, real assets, non-gilt debt, LDI and cash).
- External managers are appointed under investment management agreements which set clear benchmarks and risk parameters and include the requirement to comply with the SIP.
- The arrangements for advisers appointed to support the pension funds are reviewed regularly under a robust supplier management framework.



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 Committee take advice from the scheme actuary regarding the nature of the pension fund's 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.
- The Committee recognises that employers' circumstances vary and an alternative investment strategy may be deemed suitable for them. Requests for an alternative strategy will be considered, subject to practical constraints on implementation and, if appropriate, a review of the employer's contribution rates. It's not practical to offer individual employers full flexibility on asset allocation.

- The funding objectives for the pension fund are expressed in relation to the solvency and employer contribution rates. The covenants of participating employers are regularly assessed.
- The LPF CEO is responsible for ensuring the appropriate controls are applied to the pension fund. Controls are subject to internal audit, and results of audits are submitted to the Pensions Audit Sub Committee and/or the Committee.
- A risk register is maintained, and 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.

- Analysis of the performance and risk of the pension fund's investments 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 at the JISP. The JISP advisers assess the performance and risk of both internal and external investment managers on a regular basis (typically quarterly).
- Contracts with advisers are regularly market tested.
- The JISP advisers assess their own performance on a regular basis and report to Committee on their activities, typically annually.
- Training and attendance of members of the Committee and the Pensions Board is 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 Committee's approach to responsible investment is described in the SIP and the SRIP, both of which can be found on the website.
- A description of how the pension fund adheres to the principles of the FRC's Stewardship Code 2020 is set out in the Stewardship Report submitted annually to the FRC and available on the website.
- Details of the voting and engagement activities are available on the website. The pension fund's Annual Report and Accounts includes a summary of the 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 Committee are open to the public. Members of the public are entitled to make a deputation at Committee meetings. Committee papers are available on CEC'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.
- Policy statements are maintained regularly. Stakeholders are consulted on changes. Documents are available on the website.

The full report of the pension fund's Annual Report and Accounts is available on the website and is sent to members on request. Regular newsletters for members are produced, as well as an annual benefit statement. Regular briefings are provided to employers. The website is updated regularly.



Schedule of explanatory comments of changes

Comment 1: The wording of the SIP has been edited to more accurately align with the requirements under the 2010 Regulations. Content which is not required under the 2010 Regulations has been omitted.

Comment 2: The SRIP is incorporated by cross-reference but content in the SIP which overlaps with SRIP has been taken out.

Comment 3: These are the requirements of the 2010 Regs.

Comment 4: As explained in [the Committee paper on JISP changes], the delegations have been updated so this section was inaccurate. As there is no requirement to include a description of governance in the SIP, it has been removed instead of being amended.

Comment 5: The substance of the Principles which Pensions Committee formulated based on advice from the JISP advisers is unchanged, but some of the wording has been edited for clarity. References to actions or decisions of the 'Funds' now refer to the Committee as the body responsible for the decisions. The Principles continue to be aligned with the Principles which have been adopted by the Pension Committees of Falkirk and Fife.

Comment 6: For consistency with the FSS, the word 'bespoke' has been replaced with the word 'alternative'.

Comment 7: Further to comments raised at the Committee meeting of June 2023, the reference to mechanistic divestment being inconsistent with fiduciary duty has been removed.

Comment 8: BM and GdC discussed and agreed removal of this wording with Cllrs Ross and Burgess (11/8/23)

Comment 9: As mentioned above, the SRIP is incorporated by cross-reference in the introduction but content in the SIP which overlaps with SRIP has been taken out.

Comment 10: Wording has been moved from later para.

Comment 11: This is not required to be included in the SIP, it is more appropriate for the FSS. Principle 7 is still included and addresses a similar point, therefore this para has been deleted.

Comment 12: References to responsibility for implementing the strategy have been updated to accurately reflect the authorities delegated to fund officers.

Comment 13: It is not necessary to include this wording.

Comment 14: This has been added for clarity, as the 2010 Regs specifically require the policy to include this.

Comment 15: The limits are unchanged. The 2010 Regs require the period during which the increase will apply to be stated, and this has been updated for accuracy.

Comment 16: This table replaces the text that was previously included but the content is unaffected.

Comment 17: Reference to the Training and Attendance policy means that these details are not required.

INTRODUCTION

This Statement of Investment Principles (SIP) describes the principles governing decisions of the Pensions Committee (Committee) of the City of Edinburgh Council (CEC) as administering authority of Lothian Pension Fund and Scottish Homes Pension Fund relating to the investment of fund money. It has been prepared in accordance with the requirements of the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010, as amended (the 2010 Regulations).

The SIP should be read in conjunction with the Statement of Responsible Investment Principles (SRIP). The SRIP explains the Committee's approach to the oversight and monitoring of investment activities from a Responsible Investment (RI) and Stewardship perspective. This covers the Committee's policy on the extent to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and the exercise of the rights (including voting rights) attaching to investments.



HIGH LEVEL INVESTMENT PRINCIPLES

The following principles guide the investment strategy, including the investment objectives and investment policies, adopted by the Committee.

Governance

Principle 1: Committee believes that investment decisions must give precedence to the fiduciary duty owed to members and employers.

Fiduciary duty is paramount. The Committee recognises the potential conflicts of interests inherent in a local authority administering a multi-employer pension fund. The objectives of the local authority are not necessarily the same when it is acting in its capacity as the administering authority of a pension fund. The primary objective of the pension fund is to ensure sufficient funding in the long term so that retirement benefits owed to members under scheme rules can be paid when they fall due. (The most recent legal advice on fiduciary duty for the Scottish Local Government Pension Scheme is available at <https://lgpsab.scot/fiduciary-duty-guidance/>.)

Principle 2: Committee believes that risk should be mitigated by ensuring alignment of interests wherever possible.

Agency costs are high in the financial services industry – agents are often motivated to act in their best interests rather than those of the principal (the pension fund). 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 pension fund 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.

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.

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 the investment returns received by the pension fund. 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 investment returns.

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 and oversight.

Implementation of more granular investment decisions (such as the selection/deselection of individual managers and assets) 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 pension fund and how investment decisions have contributed to such objectives.



Funding

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 investment strategy options available to scheme employers. The ultimate objective is to ensure long-term solvency so that retirement benefits owed 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.

Principle 7: Committee believes that requests for different investment strategies from employers with different objectives should be considered.

Employers have conflicting desires: on the one hand, they'd like to minimise the fluctuations in contributions and on the other hand, they'd like to minimise the overall amount they are asked to contribute to the pension fund. Committee believes in allocating employers to different investment strategies in a way which reflects their timescale for participation in the pension fund and their covenant strength. Employers may have different objectives, so they should be given the opportunity to request an alternative investment strategy. The Fund should consider such requests, taking account of issues such as the strength of the employer's covenant and implementation costs.

Investments

Principle 8: Committee believes that the ability of the pension fund 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.

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).

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.

Principle 11: Committee believes that responsible investment should reduce risk and may improve returns.

The LGPS was designed with an important social purpose in mind – the provision of retirement income for individuals. The Committee's 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. The 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.

Principle 12: Committee believes it should exercise its ownership rights in a responsible way, constructively engaging with companies to reduce risk.

The pension funds 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.

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 pension funds as they fall due, so monitoring activity is complex. The pension 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.



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.

PENSION FUND OBJECTIVES

The **primary objective** of the pension fund is to ensure that there are sufficient funds available to meet all liabilities as they fall due.

The **funding objectives** 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 the investment strategy and govern the allocation across various asset classes.

The **investment objectives** of the pension fund are to achieve a return on assets which is sufficient over the long term to meet the funding objectives outlined in the Funding Strategy Statement, i.e. to

pay liabilities and to make the scheme affordable to employers now and in the future, while minimising any increase in contribution rates.

Committee has set the 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.
- **Other Real Assets** 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 **timberland**. Income comes from dividends and rents.
- **Non-Gilt Debt** 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 either listed in the UK or overseas or are unlisted (private debt).
- **LDI** are gilts, which 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, albeit to a different measure of price inflation (the Consumer Price Index (CPI)). Some other governments also issue this type of debt, but in different currencies tied to price inflation in their own countries.
- **Cash** 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.

As the returns of the above investments aren't completely correlated, the pension fund should achieve diversification and better risk-adjusted returns by investing in assets from each policy group.

INVESTMENT STRATEGIES

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 the pension fund. The 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.

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

- **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 94% of employers' assets are invested in the Main Strategy.
- **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.
- **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. Less than 1% of employers' assets are invested in the 50/50 Strategy.
- **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. It represents 5.5% of Fund assets.

Scottish Homes Pension Scheme was fully funded at the most recent actuarial valuation in March 2020. 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.

STRATEGY IMPLEMENTATION



With advice from the Joint Investment Strategy Panel, the CIO and senior members of the investment team identify the combination of investment managers and mandates within the policy groups to deliver the objectives of the pension fund. The investment strategies are listed in Appendix A. Both external and internal managers are used, recognising that there are cost and alignment advantages of an in-house investment team.

To reduce the risk that the investment objective is not met, 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.

The internal 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 advisers on a quarterly basis.

OTHER INVESTMENT CONSIDERATIONS

Realisation of investments

Most of the pension fund investments are in liquid markets and can be expected to be sold relatively quickly if required. A proportion of the 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 the assets is considered in the light of potential demands for cash.

Stock Lending

The pension fund lends a proportion of their investments to generate income from share ownership. Stock lending is conducted within parameters prescribed in the 2010 Regulations. Stock lending doesn't 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 strict parameters on the credit-worthiness of potential borrowers.

Underwriting

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

A derivative is a security or contract that derives its value from its relationship with another asset. The Committee has approved the use of derivatives, subject to compliance with relevant legislation and control levels outlined in investment management agreements. The pension fund 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 pension fund to reduce risk from currency fluctuations and equity futures allow the pension fund to reduce risk during major portfolio rebalances/transitions.

Voting and Engagement

The approach to exercising ownership rights attached to investments (including voting rights) is described in the SRIP.

Safekeeping of Assets

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

COMPLIANCE WITH 2010 REGULATIONS

Increased Investment Limits

The 2010 Regulations contain limits on the percentage of a pension fund that may be invested in certain types of investment including partnerships. Partnerships are commonly used as the fund vehicle through which the pension fund makes an investment into assets such as infrastructure, timber, property, private equity and private debt (also referred to as unlisted investments). In accordance with the 2010 Regulations and based on proper advice from the JISP advisers, the Committee have agreed the following increased limits applicable to the pension fund's investments in partnerships to accommodate the allocation to unlisted investments:

- All contributions to any single partnership: 5% (statutory maximum of 5%)
- All contributions to)partnerships: 20% (statutory maximum of 30%)



The increased limits will apply for so long as the pension fund has an allocation to unlisted investments. This decision is compliant with the 2010 Regulations.

CIPFA Principles for Investment Decision Making

The 2010 Regulations require the Committee to publish the extent to which it complies with guidance issued by Scottish Ministers. This includes the six *Principles for Investment Decision Making and Disclosure in the Local Government Pension Scheme in the United Kingdom 2009* published by the Chartered Institute of Public Finance and Accountancy (CIPFA) and based on the Myners principle, as updated in 2008. Details of the CIPFA principles, and how the Committee complies with such guidance, is provided in Appendix B.

Review of SIP

The Committee will review this statement annually and, in the case of any material change in the Committee's policy, before the end of a period of six months beginning with the date of that change. The Committee will consult with such persons as it considers appropriate and take proper advice when revising this statement.

APPENDIX A – INVESTMENT STRATEGIES (27 SEPTEMBER 2023)

Strategy name	Investment objective	Investment strategy description																					
Lothian Pension Fund																							
Main	To generate returns sufficient to pay pensions as they fall due.	<p>To invest in the following exposures:</p> <table> <tr> <th>Policy group</th><th>Target weight 2021-2024</th><th>Permitted range</th></tr> <tr> <td>Equities</td><td>60%</td><td>50-70%</td></tr> <tr> <td>Real Assets</td><td>20%</td><td>10-30%</td></tr> <tr> <td>Non-Gilt Debts</td><td>10%</td><td>0-20%</td></tr> <tr> <td>LDI (Formerly Gilts)</td><td>10%</td><td>0-20%</td></tr> <tr> <td>Cash</td><td>0%</td><td>0-15%</td></tr> <tr> <td>Total</td><td>100%</td><td></td></tr> </table>	Policy group	Target weight 2021-2024	Permitted range	Equities	60%	50-70%	Real Assets	20%	10-30%	Non-Gilt Debts	10%	0-20%	LDI (Formerly Gilts)	10%	0-20%	Cash	0%	0-15%	Total	100%	
Policy group	Target weight 2021-2024	Permitted range																					
Equities	60%	50-70%																					
Real Assets	20%	10-30%																					
Non-Gilt Debts	10%	0-20%																					
LDI (Formerly Gilts)	10%	0-20%																					
Cash	0%	0-15%																					
Total	100%																						
MEG (Mature Employers Group)	To achieve a return in line with gilts that match the duration of the liabilities.	To invest exclusively in UK Gilts and Cash matching the duration of employer liabilities with the duration of the invested assets.																					
50/50	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.	<p>To invest 50:50 investment in the Main Strategy and the MEG Strategy which results in the following exposures:</p> <table> <tr> <th>Policy group</th><th>Target weight 2021-2024</th><th>Permitted range</th></tr> <tr> <td>Equities</td><td>30%</td><td>25-35%</td></tr> <tr> <td>Real Assets</td><td>10%</td><td>5-15%</td></tr> <tr> <td>Non-Gilt Debts</td><td>5%</td><td>0-10%</td></tr> <tr> <td>LDI (Formerly Gilts)</td><td>55%</td><td>45-65%</td></tr> <tr> <td>Cash</td><td>0%</td><td>0-10%</td></tr> <tr> <td>Total</td><td>100%</td><td></td></tr> </table>	Policy group	Target weight 2021-2024	Permitted range	Equities	30%	25-35%	Real Assets	10%	5-15%	Non-Gilt Debts	5%	0-10%	LDI (Formerly Gilts)	55%	45-65%	Cash	0%	0-10%	Total	100%	
Policy group	Target weight 2021-2024	Permitted range																					
Equities	30%	25-35%																					
Real Assets	10%	5-15%																					
Non-Gilt Debts	5%	0-10%																					
LDI (Formerly Gilts)	55%	45-65%																					
Cash	0%	0-10%																					
Total	100%																						

Buses	To generate sufficient returns to pay pensions owed to members formerly employed by Lothian Buses as they fall due.	<p>To invest in a proportion of the MEG Strategy and the Main Strategy that reflects the maturity of liabilities. This is currently 45:55. Based on the Main Strategy, the Buses Strategy will have the following exposures:</p> <table> <tr> <th>Policy group</th><th>Target weight 2021-2024</th><th>Permitted range</th></tr> <tr> <td>Equities</td><td>33.0%</td><td>28-38%</td></tr> <tr> <td>Real Assets</td><td>11.0%</td><td>6-16%</td></tr> <tr> <td>Non-Gilt Debt</td><td>5.5%</td><td>0-11%</td></tr> <tr> <td>LDI (formerly Gilts)</td><td>50.5%</td><td>40-60%</td></tr> <tr> <td>Cash</td><td>0.0%</td><td>0-10%</td></tr> <tr> <td>Total</td><td>100%</td><td></td></tr> </table>	Policy group	Target weight 2021-2024	Permitted range	Equities	33.0%	28-38%	Real Assets	11.0%	6-16%	Non-Gilt Debt	5.5%	0-11%	LDI (formerly Gilts)	50.5%	40-60%	Cash	0.0%	0-10%	Total	100%	
Policy group	Target weight 2021-2024	Permitted range																					
Equities	33.0%	28-38%																					
Real Assets	11.0%	6-16%																					
Non-Gilt Debt	5.5%	0-11%																					
LDI (formerly Gilts)	50.5%	40-60%																					
Cash	0.0%	0-10%																					
Total	100%																						
Scottish Homes Pension Fund																							
Scottish Homes	To match cash flows from gilt income and redemption payments as closely as possible with the expected liability payments of the pension fund to minimise the risk of additional employer contributions being required.	To invest all assets in UK gilts and cash. As some liabilities are fixed in nature and some are inflation-linked, in the strategy is to invest in both nominal and index-linked gilts to match cash flows with liability payments one year beyond the next actuarial valuation. Longer dated liability payments are duration matched.																					

APPENDIX B – COMPLIANCE WITH CIPFA PRINCIPLES

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 Committee focuses on setting the strategy for the pension fund 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.
- Fund officers are responsible for the provision of the training plan for Committee members to help them to make effective decisions and to ensure that they are fully aware of their statutory and fiduciary responsibilities.
- The Committee's Training and Attendance Policy is available on the website. It applies to both members of the Committee and the Pensions Board and is intended to support their knowledge to enable them to evaluate and challenge the advice they receive. Standards relating to the administration of the Committee's business are strictly upheld.
- The Committee 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 JISP advisers advise the client representative (currently the LPF CIO) on the implementation of the investment strategies, reviewing structure, funding monitoring, performance and risk and asset allocation. The JISP meets at least quarterly and includes independent advisers who are experienced investment professionals.
- The fund's in-house investment team undertakes day-to-day monitoring of the investment. The team includes personnel with suitable professional qualifications and experience to provide the necessary skills, knowledge, advice and resources to support the JISP meetings and the Committee.
- Conflicts of interest are managed actively. At each Committee meeting, elected members of the 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 and includes the 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 SIP and the Funding Strategy Statement define the primary funding objectives of the pension fund.
- Asset-liability modelling is undertaken with the help of external advisers to aid the understanding of risks and the setting of investment strategy.
- Employers’ attitude to risk is specifically considered in the setting of strategy, and employers can request a bespoke investment strategy.
- The setting of the Funding Strategy includes specific consideration of the desire to maintain stability in employer contribution rates.
- Reviews of investment strategy focus on the split between broad asset classes (equities, real assets, non-gilt debt, LDI and cash).
- External managers are appointed under investment management agreements which set clear benchmarks and risk parameters and include the requirement to comply with the SIP.
- The arrangements for advisers appointed to support the pension funds are reviewed regularly under a robust supplier management framework.



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 Committee take advice from the scheme actuary regarding the nature of the pension fund’s 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.
- The Committee recognises that employers’ circumstances vary and an alternative investment strategy may be deemed suitable for them. Requests for an alternative strategy will be considered, subject to practical constraints on implementation and, if appropriate, a review of the employer’s contribution rates. It’s not practical to offer individual employers full flexibility on asset allocation.

- The funding objectives for the pension fund are expressed in relation to the solvency and employer contribution rates. The covenants of participating employers are regularly assessed.
- The LPF CEO is responsible for ensuring the appropriate controls are applied to the pension fund. Controls are subject to internal audit, and results of audits are submitted to the Pensions Audit Sub Committee and/or the Committee.
- A risk register is maintained, and 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.

- Analysis of the performance and risk of the pension fund's investments 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 at the JISP. The JISP advisers assess the performance and risk of both internal and external investment managers on a regular basis (typically quarterly).
- Contracts with advisers are regularly market tested.
- The JISP advisers assess their own performance on a regular basis and report to Committee on their activities, typically annually.
- Training and attendance of members of the Committee and the Pensions Board is 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 Committee’s approach to responsible investment is described in the SIP and the SRIP, both of which can be found on the website.
- A description of how the pension fund adheres to the principles of the FRC’s Stewardship Code 2020 is set out in the Stewardship Report submitted annually to the FRC and available on the website.
- Details of the voting and engagement activities are available on the website. The pension fund’s Annual Report and Accounts includes a summary of the 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 Committee are open to the public. Members of the public are entitled to make a deputation at Committee meetings. Committee papers are available on CEC’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.
- Policy statements are maintained regularly. Stakeholders are consulted on changes. Documents are available on the website.

The full report of the pension fund’s Annual Report and Accounts is available on the website and is sent to members on request. Regular newsletters for members are produced, as well as an annual benefit statement. Regular briefings are provided to employers. The website is updated regularly.

