Investment Strategy Statement – a primer for discussing and agreeing an approach to responsible investment

Purpose of this paper

The purpose of this paper is to brief the Investment Steering Committee (ISC) on the requirements to review the Fund's Investment Strategy Statement ('ISS'), with a focus on Responsible Investment. This paper should be read in conjunction with our separate paper 'Investment Strategy Statement Summary: Timeline and Decision Tree'.

In particular this paper focuses on the Responsible Investment ('RI') aspects of the ISS as this is an area of increased scrutiny and potentially an area of wide ranging debate.

There are no decisions required by the ISC from this paper, it is intended solely a primer to prepare for the discussions in the upcoming ISC meetings.

Introduction & purpose of the ISS

The ISC Terms of Reference require the ISC to maintain an ISS that sets out their principles for governing the Fund's assets. The ISS is subject to periodic review at least every three years and the next review is scheduled for the February 2020 ISC meeting.

The principles covered by the ISS include:

1. The investment strategy and process for determining suitability
2. Risk measurement and management
3. Asset pooling
4. Approach to Environmental, Social and Governance (ESG) considerations

To an extent, areas 1 to 3 above are documentation of process and agreed best practice.

However, area 4 is far more subjective as, amongst others, it takes into account personal views around ethical practice. It is also a high-profile area where we have seen significant levels of media comment and action by environmental groups.

This paper therefore unpacks some of the areas around item 4 in preparation for subsequent discussions.

Current ISS wording relating to RI

The current ISS statements in relation to RI are set out in the Appendix 1.

Points we would highlight in particular are:

- The fundamental responsibility of the Fund is to ensure that it has adequate monies available to pay pensions as they fall due in a cost-effective way;
- The ISC does not place restrictions on investment managers in choosing investments in quoted companies except in limiting the size of single investments;
- The ISC has determined that restricting investment may be of financial detriment to the Fund depending on price and outlook;

- The Fund has instructed its Fund Managers to vote in accordance with their in-house policies and practices;
- The Fund fully supports the UK Stewardship Code;
    - The Fund expects its investment managers to take account of social, environmental and ethical considerations in the selection, retention and realisation of investments as an integral part of the normal investment research and analysis process;
    - Instead of divesting, the ISC believes that they will have greater influence on the future direction of companies if they remain invested. Divestment reduces the Fund's ability to influence how big companies change in the future;
    - As part of this regular manager monitoring, the ISC will challenge their managers on how they consider and manage all financial risks faced by their investments, including those that arise from ESG considerations.

Main concepts on Responsible Investment

RI is an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance (ESG) factors, and of the long-term health and stability of the market as a whole. RI can be seen as having two key dimensions:

- **Sustainable investment**: investors should recognise the potential financial impact of ESG factors in investment decision making; and
- **Stewardship and governance**: investors should act as responsible and active owners, through considered voting of shares, and engagement with company management when required.

ESG factors

There are a number of potential ESG factors that could affect the value of an individual investment. The table below illustrates some of these issues:

Environmental	Social	Governance
Climate Change Resource Scarcity Water Availability Greenhouse Gas Emissions (GHG) Pollution Energy Efficiency	Stakeholder Relations Supply Chains Working Conditions Diversity Health & Safety Population Growth Weapons	Board Structure Accounting & Audit Executive Remuneration Bribery & Corruption Shareholder Rights Transparency

The ISC members have a fiduciary duty to act in the best interests of their members, as well as acting prudently, responsibly and honestly. Within the context of these duties, which include controlling risks, they must aim to achieve the best realistic risk adjusted return over the long term. Acting as a responsible investor is consistent with this aim.

Ethical views

Non-financial matters have been described as the views of members and beneficiaries including (but not limited to) their ethical views and their views in relation to social and environmental impact and present and future quality of life of the members and beneficiaries of the trust scheme.

Exclusions of companies from certain industries (i.e. weapons, tobacco, oil and gas) or involved in certain activities (i.e. modern slavery) can be considered.

Stewardship

This relates to how the managers and/or ISC members engage with companies on matters such as performance, strategy, risks, social and environmental impact and corporate governance, as well as the exercise of any rights (such as voting rights) that come with particular investments.

One argument against constraining a portfolio is that the best way to influence companies and drive changes in society is to remain invested and use the power of voting and engaging to address issues.

What others are doing

Private Sector

There are new regulations issued by the DWP in relation to trustees' Statement of Investment Principles ("SIP", which is the private sector equivalent of the ISS). The DWP require trustees to update their SIPs to reflect the new regulations by 1 October 2019. The amendments must include the following:

- How financially material considerations, over and appropriate time horizon, are taken into account (including, but not limited to, ESG factors, including climate change).
- Extent (if at all) to which non-financial matters are taken into account.
- Policies on stewardship of assets, including exercise of voting rights and undertaking engagement activities

LGPS

The DCLG Guidance on preparing and maintaining an Investment Strategy Statement from June 2017 states that:

- The law is generally clear that schemes should consider any factors that are financially material to the performance of their investments, including social, environmental and corporate governance factors, and over the long term, dependent on the time horizon over which their liabilities arise;
- Although schemes should make the pursuit of a financial return their predominant concern, they may also take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision;
- The long-term investment interests of administering authorities are enhanced by the highest standards of corporate governance and corporate responsibility amongst the companies in which they invest. Poor governance can negatively impact shareholder value;
- Stewardship aims to promote the long term success of companies in such a way that the ultimate providers of capital also prosper.

Even though there is no comprehensive summary of what each LGPS Fund is doing, we can provide the following information:

- A number of LGPS funds have excluded direct investment specific holdings, such as tobacco;
- Some LGPS funds are using passive equity benchmarks that take ESG factors into account (such as the MSCI World Low Carbon Target Index and the FTSE All World ex Controversial Weapons Climate Balanced Factor Index);
- The UN Principles for Responsible Investment (UNPRI) is being utilised to determine managers approach to ESG factors.

Areas for consideration

- ISC views and whether likely to be shared by membership/employers.
- Current ISC policy
- Appointed managers approach to implementing current policy
- Engagement versus exclusion
- Impact on investment return/risk of policy

Next steps

A full review of the RI policy is required with the following steps:

- Training; training will be provided at the additional October 2019 ISC meeting;
- An investment beliefs session to confirm the ISC members' views on Responsible Investment to take place at the additional October 2019 ISC meeting;
- The LAPFF will provide a presentation on a collaborative approach to RI at the November ISC meeting.
- ISS approval and issue for consultation at the February 2020 ISC meeting;
- A review of managers' ESG and voting policies and how responsible investment is incorporated in their investment process to be presented at the March 2020 ISC meeting.

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Appendix 1 – RI considerations in the ISS

Environmental, Social & Governance Considerations

Fiduciary duty

The fundamental responsibility of the Fund is to ensure that it has adequate monies available to pay pensions as they fall due. This objective must be achieved in a cost effective way for members, employers and the taxpayer. Moreover, in reaching decisions, the Fund must comply with its fiduciary responsibilities.

Policy

The ISC does not place restrictions on investment managers in choosing investments in quoted companies except in limiting the size of single investments. The ISC expects investment managers to place their primary consideration on financial factors when selecting investments for inclusion in the portfolio, as an assessment of appropriate ESG capability is made before the manager is appointed.

However, the ISC will allow investment managers to consider non-financial factors in selecting investments providing that such decisions are not expected to:

1 be financially detrimental to the Fund (either in terms of expected return or risk) or;

2 represent significant opportunity cost if not held.

In general the ISC expects the selection of stocks based on a significant degree of non-financial reasons to be extremely rare and reserves the right to intervene on a case by case basis. Intervention is likely to be extremely rare as companies are aware of the increasing sensitivity of investors.

The ISC has determined that restricting investment may be of financial detriment to the Fund depending on price and outlook. Hence pursuing divestment goes against the Committee's fiduciary duty and responsibilities to maximise returns and manage costs for participating employers who ultimately bear the investment risk should a shortfall arise.

Exercise of voting rights

The Fund has instructed its Fund Managers to vote in accordance with their in house policies and practices.

The Fund fully supports the UK Stewardship Code and requires those of its investment managers who hold shares on its behalf to comply with it or to provide the ISC with an explanation of why it is not appropriate to do so, in the exercise of the mandate that they have been given, and how they will instead achieve and demonstrate the same level of responsible share ownership.

The Fund's equity investment managers are signatories to the UK Stewardship Code and have all gained a Tier 1 status (demonstrating a good quality and transparent description of their approach to stewardship and explanations of an alternative approach where necessary).

Engagement

The Fund expects its investment managers to take account of social, environmental and ethical considerations in the selection, retention and realisation of investments as an integral part of the normal investment research and analysis process. This is insofar as these matters are regarded as impacting on the current and future valuations of individual investments. The Fund believes taking account of such considerations forms part of the investment managers' normal fiduciary duty.

Instead of divesting, the ISC believes that they will have greater influence on the future direction of companies if they remain invested. Overall engagement activities are viewed by the Committee as a key element of the broader approach to responsible investment. Remaining invested provides the Fund with a voice on how companies are generating their revenues and how they will change in the future.

The Fund is a long term investor and therefore has an interest in the long term direction and success of the companies in which it invests. Divestment reduces the Fund's ability to influence how big companies change in the future.

Ongoing Monitoring

The Committee actively monitors the Fund's investment managers' approaches. As part of this regular manager monitoring, the ISC will challenge their managers on how they consider and manage all financial risks faced by their investments, including those that arise from ESG considerations. The Committee also strives to improve and develop their knowledge and understanding on how ESG factors will impact the Fund's investments in the future.

Stock Lending

The policy on stock lending (below) reflects the nature of the mandates awarded to investment managers by the ISC, which include both pooled and segregated mandates:

Segregated Investments

The Fund does not participate in stock lending schemes nor allow its stock to be lent.

Pooled Investments

In regard to the Fund's pooled investments, where the Fund is buying units in a pooled vehicle, stock lending is outside the control of the Fund and undertaken at the discretion of the pooled fund manager.