AGENDA ITEM 5
REPORT NO. PC/02/18

HIGHLAND COUNCIL

Committee:	Pensions Committee
Date:	8 February 2018
Report Title:	Responsible Investing
Report By:	Director of Corporate Resources

1. Purpose/Executive Summary

1.1 Members are asked to consider the attached report by the Fund's Investment Advisors Aon Hewitt on Environmental, Social and Governance (ESG) issues.

2. Recommendations

2.1 The Committee is asked to consider and discuss the report on ESG in advance of approving item 6, Statement of Investment Principles.

3. Background

3.1 The Fund's Investment Advisors, Aon Hewitt presented the attached report on ESG issues to the Investment Sub Committee (ISC) on 21 November 2017.

3.2 The Statement of Investment Principles (Item 6) sets out the Fund's approach to Ethical, Social and Governance issues.

4. ESG report conclusions

4.1 The ESG report concluded that the approach that the Fund takes to integrating ESG into its decision making is in line with other LGPS.

The report also considers unintended consequences if wider ESG factors are adopted without a proper analysis of the impact on an investment portfolio and the consequential impact on risk and return of excluding certain stocks.

The report recommended next steps as follows:

- training session on ESG issues be delivered to ISC Members
- the assessment of ESG issue should be an ongoing process
- Members should continue to question the fund managers on ESG related issues when they present to the ISC.

Officers are in the process of incorporating these recommendations into future Pensions Committee, ISC meetings and training programmes.

5. Implications

5.1 The resource and risk implications are covered in the above report. There are no Legal; Equalities; Climate Change/Carbon Clever; Gaelic and Rural implications relating to this report.

Designation:	Director of Corporate Resources
Date:	30 January 2018
Author:	Catriona Stachan, Accountant

Aon Hewitt
Retirement & Investment

Highland Council Pension Fund

Date:	21 November 2017
Prepared for:	The Investment Sub Committee
Prepared by:	Kenneth Ettles, FFA Alex Martin

Environmental, Social and Governance ("ESG") issues – discussion paper

Introduction

In recent years, the discussion and implementation of ESG investment issues has evolved.

This is an extensive subject area, and we have suggested some additional follow up actions for the Investment Sub Committee ("ISC") and Officers of the Highland Council Pension Fund (the "Fund"), but in this initial discussion paper on the subject we discuss briefly:

- What the common approaches are and why these factors may be important in investment decisions with respect to LGPS;
- a recap of how the Fund currently incorporates these factors into the investment strategy, and how this compares to some other LGPS across the UK; and
- some possible actions the ISC and Officers could take to explore these matters further, if it was felt necessary.

Background to ESG

ESG is short-hand for the environmental, social and governance factors that investors, such as the Fund, may take into account when selecting investments.

Investors who consider ESG factors do so for different reasons. For some, it's for moral reasons, and so that their portfolio should reflects certain values and ideals.

For others, it's an economic argument, in the belief that investing in companies that follow certain principles or invest along certain themes present long-term performance advantages over those that don't.

The following table lists some of the commonly cited ESG factors:

Environmental	Social	Governance
Climate change	Diversity	Executive pay
Nuclear Energy	Consumer Protection	Business Ethics
Sustainability	"Sin" Stocks	Shareholder Rights
Conservation	Responsible Lending	Reporting/ Disclosure

Atria One | 144 Morrison Street | Edinburgh | EH3 8EX
t +44 (0) 131 456 6400 | f +44 (0) 131 456 6440 | aon.com
Aon Hewitt Limited is authorised and regulated by the Financial Conduct Authority.
Registered in England & Wales No. 4396810
Registered office:
The Aon Centre | The Leadenhall Building | 122 Leadenhall Street | London | EC3V 4AN
This report and any enclosures or attachments are prepared on the understanding that it is solely for the benefit of the addressee(s). Unless we provide express prior written consent no part of this report should be reproduced, distributed or communicated to anyone else and, in providing this report, we do not accept or assume any responsibility for any other purpose or to anyone other than the addressee(s) of this report.
Copyright © 2017 Aon Hewitt Limited. All rights reserved.

QAS Quality Assurance Scheme Institute and Faculty of Actuaries

Empower Results®

What is ESG investing?

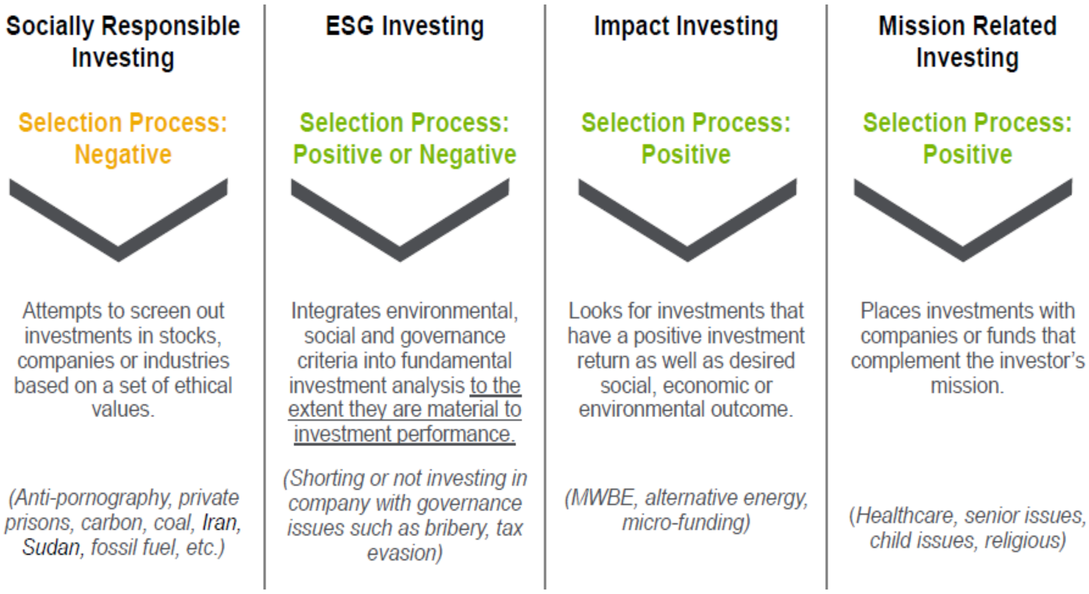
ESG Investing

The consideration of ESG issues in investing is not a new phenomenon, and there are global organizations supporting its wider adoption and development, such as the UN sponsored Principles for Responsible Investment ("PRI"), a set of global guidelines on ESG issues, published in 2006.

Signatories to the PRI pledge to "incorporate ESG factors," along with financial data, when making investment decisions and are required to provide detailed public information representing their approach to responsible investment.

Various labels…but some similar issues and objectives?

Various labels are used to describe investments that consider ESG issues and a range of approaches and naming conventions have developed over time. We like to think of the common approaches collectively under the **"Responsible Investing"** banner and broken down into the four main components shown below:



The common theme underlying the various labels is an emphasis on ESG issues, though there are some distinctions.

SRI tends to be the area with which most investors are familiar, as it is the oldest of the four broad categories. SRI uses a negative selection process to exclude certain sectors or investments from a portfolio.

ESG Investing, Impact Investing and Mission Related Investing typically focus more on positive investment inclusion criteria rather than on negative screening. ESG Investing, however, is fundamentally different from its Responsible Investment peers. Instead of being driven by personal or organizational values, investment decisions are directed by the fundamentals of the company.

Integrating ESG

General approaches

Pension schemes can take a number of approaches to integrate ESG factors into their investment decision making depending on the extent to which they believe they have a material impact on risk and return, and also how they have interpreted their fiduciary duties. In very broad terms, pension schemes can be categorised as:

1. **No integration** – those who believe that ESG factors are not relevant / material to meeting their objectives and / or fiduciary duties – and may even harm performance **–** and so will not integrate ESG factors.
2. **Some integration** – those who believe that ESG factors are relevant, to some extent, to meeting their objectives and / or fiduciary duties and will integrate to broader goals e.g. to the extent they impact corporate valuations (and so financial performance) or, perhaps, including some wider beliefs (e.g. excluding tobacco stocks).
3. **Full integration –** those who believe that they have a financial responsibility to support global economic health and ESG factors are important to manage risk and drive returns (e.g. they are not "non-financial" factors).

   They will typically align their portfolio with ESG goals. An example of this might be the Environment Protection Agency's (EPA) pension scheme, which is seen as a leader in the UK in ESG investing matters.

What are other LGPS doing

Our experience is that most UK pension schemes, including those in LGPS, will tend to fall into the second category at present. They will encourage their fund managers to engage on ESG issues with the companies they invest in, recognising that they may have an impact on long term performance.

This is the approach taken to date by the Fund, which is in line with the approach taken by most other LGPS.

For example, Baillie Gifford believes that company management and their approach to governance is one of the key factors in driving the long-term success of a company. Analysing management quality, behaviour and motivations are therefore an essential part of their research process. Whilst they say they take this endeavour seriously, they caution that it is not easy as new information is always accumulating.

A copy of relevant section of the Fund's Statement of Investment Principles ("SIP") documenting the Fund's approach to ESG is included Appendix A. Again, our experience is that the wording of the Fund's SIP is consistent currently with other LGPS (particularly Scottish LGPS).

However, many investment sub committees are giving increased attention to their approach and policies in this area.

Beware unintended consequences

Adopting wider ESG factors without a proper analysis of the impact on an investment portfolio can lead to unintended consequences.

An example of this might be investing in a passive index such as the FTSE4Good US Select Index, which is a socially responsible investment (SRI) index of US stocks that excludes companies with certain business activities (such as weapons and tobacco) but additionally includes companies that meet *"… a series of stringent environmental and social criteria in areas including environmental management, labor rights, human rights, health and safety, and diversity"*.

The top 10 stocks of this index are shown below as at 31 October 2017 (*source: FTSE Russell*).

Top 10 Constituents (by MCap)

Constituent	Country	ICB Sector	Net MCap (USDm)	Wgt %
Apple Inc.	USA	Technology Hardware & Equipment	880,719	5.50
Microsoft Corp	USA	Software & Computer Services	623,019	3.89
Facebook Class A	USA	Software & Computer Services	419,647	2.62
Johnson & Johnson	USA	Pharmaceuticals & Biotechnology	375,417	2.35
JPMorgan Chase & Co	USA	Banks	355,295	2.22
Alphabet Class A	USA	Software & Computer Services	307,032	1.92
Alphabet Class C	USA	Software & Computer Services	306,940	1.92
Bank of America	USA	Banks	269,614	1.68
Wells Fargo & Company	USA	Banks	251,797	1.57
Procter & Gamble	USA	Household Goods & Home Construction	220,737	1.38
Totals			**4,010,217**	**25.06**

Recently, the FCA fined US bank Bank of America Merrill Lynch c. £34m for breaking a reporting rule put in place to boost transparency after the financial crisis. This is not the first time the bank has been fined by the FCA (*source: The Telegraph*). So, whilst a company might perform well in one area, it might not in others – and investors need to be comfortable with the approach they've taken.

Another example might be to exclude certain stocks (e.g. tobacco) without consideration of the impact on risk and return for the portfolio and whether the additional investment constraint can be adopted by an existing fund manager (or if a new fund manager or structure are required).

Pyrford, for example, do hold tobacco stocks in their Global Equity Strategy. They make up around 5.5% of the portfolio, a moderate holding. Pyrford hold these because they favour defensive, high quality stocks. They view Tobacco stocks as generally defensive in nature, performing particularly well in uncertain, low growth and low interest rate markets. They also believe Tobacco stocks have very attractive investment characteristics; high dividend yields through strong cash generation and low levels of debt, two key characteristics they look for when selecting stocks.

Summary and possible next steps

Summary

In our experience, the Fund's current approach to ESG issues is consistent with the majority of LGPS. However, we are seeing a much increased interest from UK pension schemes (both trust based and

LGPS) wanting to better understand:

- what the issues are and how they have evolved (e.g. Climate Change risks);
- how they relate to their investment beliefs and investment strategy; and
- how the market has evolved (and is expected to) in order provide more choice for institutional investors like pension schemes.

This is not unexpected and is partly due to shifts in demographics, climate change, as well as to changes in guidance and investor-led initiatives.

Possible next steps

This is very wide subject matter. In terms of next steps we would recommend:

- a training session for the ISC and Officers delivered by Aon Hewitt and also one of the Fund's managers.
- In advance of the training, the ISC could complete Aon Hewitt's ESG Questionnaire, which we have developed to explore and express implied beliefs covering these issues.

  This would help discussion around whether the current approach is still meeting with the Fund's overall investment objectives and whether any changes might be merited. Alternatively, this process might simply validate that the current approach remains appropriate.
- The assessment of ESG issues should be an ongoing process – new risks can arise and evolve over time; regulations may change; and new investment solutions may develop.
- Continue to question the fund managers when they present (a set of broad ESG related questions that the ISC could ask any of their fund managers is included in Appendix B).

We look forward to discussing this with the ISC and Officers.

Appendix A – Statement of Investment Principles - ESG

14. Social, Environmental and Ethical Considerations

14.1 The Fund recognises that social, environmental and ethical considerations are among the factors which Investment Managers will take into account, where relevant, when selecting investments for purchase, retention or sale. However, the over-riding consideration for Pension Committee members is their fiduciary duty to the scheme employers and scheme members.

14.2 The Scheme Advisory Board (SAB), set up by the Scottish Government to regulate Scottish LGPS under the 2015 Local Government Pension Scheme (Governance)(Scotland) Regulations 2015, obtained advice from legal counsel on the fiduciary duty of Pensions Committees.

14.3 This advice is published on the SAB website and concludes that:

"Pensions Committees in Scotland owe a fiduciary duty to the scheme

employers and the scheme members in general and specifically in relation to investment matters. Those duties should be exercised in the best interests of the beneficiaries and in relation to investment decisions, should aim to achieve the best financial position for the fund, balancing risk and return in the usual way."

http://lgpsab.scot/wp-content/uploads/2016/06/Report-National-Scheme-Advisory-Board-v4-updated-23_2_16.pdf

14.4 Whilst recognising its over-riding fiduciary duties the Fund will continue to encourage its managers to engage on issues with companies in which it holds investment as the Fund believes that environmental, social and corporate governance (ESG) issues will have a significant effect on the performance of investment portfolios through time. The key areas of ESG will be Employee Care, Human Rights, Sustainability and the Environment.

14.5 Engagement in this context is to involve the Investment Managers in:

- Meeting and corresponding with Companies on relevant issues;
- Working with the representatives of other shareholders, where appropriate;
- Voting against adverse proposals at Company AGM/EGMs;
- Reporting regularly on actions taken in this regard.

The managers will be instructed to summarise this engagement activity in their quarterly Investment Reports.

14.6 Where it is consistent with its fiduciary duty, the Fund would follow the principles below:

- Incorporate ESG issues into investment analysis and decision-making processes – this would require to be done by the investment managers and monitored by the Fund.
- Be an active owner and incorporate ESG issues into ownership policies and practices - this will be mainly achieved by exercising voting rights and the engagement activity of managers.
- Seek appropriate disclosure of ESG issues by entities in which the Fund is invested - this will be achieved through investment manager engagement.

Appendix B – Ask your fund managers about their Responsible Investment approach

Sample questions

Below are 5 simple questions you can ask your asset managers next time you meet them to understand how they will use this area – whatever they call it - to help benefit your pension Fund assets:

1. **What is your approach to Responsible Investing and how do you believe that will add value or reduce risk?**
   The answer to this will tell you whether they are thinking about this area at all. And if they are whether they are thinking short term or long term and whether there are specific topics they are focusing on from climate change to human rights.

2. **Are you a signatory to the UN Principles for Responsible Investment (UNPRI)?**
   The UNPRI is a set of 6 principles and if they do sign up to them then you can ask the follow up question about seeing their latest transparency or assessment reports.

3. **Do you have people who are dedicated to Responsible Investment?**
   This will start to tell you if they are serious about this area when you compare how many people work on this compared to other research.

4. **How do you incorporate Responsible Investment into your investment decision-making for my portfolio?**
   This is when they tell you in theory what they do.

5. **Give me some examples of how you have incorporated Responsible Investment views into your investment decision-making.**
   This is when you really find out what they mean in practice.

From these 5 questions you can start to see whether the asset manager it likely to get those marginal gains that can have a big impact when compounded over time.

Disclaimer

This document and any enclosures or attachments are prepared on the understanding that it is solely for the benefit of the addressee(s). Unless we provide express prior written consent, no part of this document should be reproduced, distributed or communicated to anyone else and, in providing this document, we do not accept or assume any responsibility for any other purpose or to anyone other than the addressee(s) of this document.

Notwithstanding the level of skill and care used in conducting due diligence into any organisation that is the subject of a rating in this document, it is not always possible to detect the negligence, fraud, or other misconduct of the organisation being assessed or any weaknesses in that organisation's systems and controls or operations.

This document and any due diligence conducted is based upon information available to us at the date of this document and takes no account of subsequent developments. In preparing this document we may have relied upon data supplied to us by third parties (including those that are the subject of due diligence) and therefore no warranty or guarantee of accuracy or completeness is provided. We cannot be held accountable for any error, omission or misrepresentation of any data provided to us by third parties (including those that are the subject of due diligence). This document is not intended by us to form a basis of any decision by any third party to do or omit to do anything.

Any opinions or assumptions in this document have been derived by us through a blend of economic theory, historical analysis and/or other sources. Any opinion or assumption may contain elements of subjective judgement and are not intended to imply, nor should be interpreted as conveying, any form of guarantee or assurance by us of any future performance. Views are derived from our research process and it should be noted in particular that we cannot research legal, regulatory, administrative or accounting procedures and accordingly make no warranty and accept no responsibility for consequences arising from relying on this document in this regard.

Calculations may be derived from our proprietary models in use at that time. Models may be based on historical analysis of data and other methodologies and we may have incorporated their subjective judgement to complement such data as is available. It should be noted that models may change over time and they should not be relied upon to capture future uncertainty or events.