ENVIRONMENTAL SOCIAL AND CORPORATE GOVERNANCE (ESG)

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Papers with this report	None.

SUMMARY

This report supplements the training item from KMPG to discuss financial risks associated with Environmental, Social & Corporate Governance (ESG).

The report outlines the requirement for funds to have an ESG policy, the funds approach to ESG and the fund's investment manager's approaches to ESG including climate change.

RECOMMENDATIONS

It is recommended that Pensions Committee:

1. **Note fund managers current ESG policies**
2. **Note the fund is signed up to "The UK Stewardship Code"**
3. **Request Investment managers to advise whether they have signed up to UN Principles for Responsible Investment (PRI)**
4. **Request Investment managers to confirm that they have signed up to "The UK Stewardship Code"**

INFORMATION

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 require the Pension Fund Investment Strategy Statement (ISS) to include a policy on how social, environmental or corporate governance considerations are taken into account; in the selection, non-selection, retention and realisation of investments. The first version of the ISS was taken to Pensions Committee for approval in March 2017 and was discussed at Local Pensions Board in April 2017.

The Fund is required to make the pursuit of a financial return its predominant concern, as the fund has a fiduciary duty to its members to pay pension benefits. This principle is the leading focus of the fund's investment strategy. The Fund may also take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme. This is only where the fund has good reason to think that scheme members would support their decision. The Fund took the decision not to invest in tobacco in any segregated mandates as a result of this principle; the fund has not taken this approach on any other issue.

There has been a swing in recent years in the understanding of the ESG setting process, as a number of issues that were previously considered to be purely on a social agenda can have financial risk to investments. This can be from a number of routes, such as physical changes in the climate could create a risk to sectors such as food and beverages industry with increased costs of production or loss to farm land; natural disasters can increase the cost to insurance companies or costs to companies that are effected by loss revenue from down-time in production; there are also reputational damages which could result from poor governance and bad decision making. Climate change issues, unlike most other ESG issues, such as ethics or corporate governance, have much wider risk consequences as the impact is widespread across a range of sectors and can affect the fund's portfolio in wide reaching ways.

As part of the ISS the Fund recognises the importance of its role as stewards of capital and the need to ensure the highest standards of governance and promote corporate responsibility in the underlying companies in which it invests. This ultimately protects the financial interests of the Fund and its beneficiaries. The Fund has a commitment to actively exercise the ownership rights attached to its investments reflecting the Fund's conviction that responsible asset owners should maintain oversight of the companies in which it invests.

There is a requirement for all investment managers to integrate all material financial factors, including corporate governance, environmental, social, and ethical considerations, into the decision-making process for all fund investments. Managers are expected to follow good practice and use their influence as major institutional investors and long-term stewards of capital to promote good practice in the companies and markets to which the Fund is exposed. The Fund expects its managers to undertake appropriate monitoring of current investments with regard to their policies and practices on all issues which could present a material financial risk to the long-term performance of the Fund such as corporate governance and environmental factors.

As a result all the managers in which the Hillingdon Pension Fund invest have Responsible Investing and ESG policies which enable them to promote long-term shareholder value and protect the interest of shareholders by only investing in well governed companies.

There are two sets of principles which are widely accepted within investment circles as appropriate bases for the consideration of ESG issues as follows:

- The UN Principles for Responsible Investment (PRI)
- The Institutional Shareholders' Committee Code on the Responsibilities of Institutional Investors ("The UK Stewardship Code")

The Hillingdon Pension fund is signed up to the "The UK Stewardship Code" and expects its fund managers to have also signed up; it is recommended that they all be asked to confirm. Whilst the Fund may not expect all investment managers to have signed up to the PRI yet, it is likely a number of them have, as a result is recommended they all be asked to confirm.

Evolution of Practical Investor Strategies

There are a number of investor strategies to deal with ESG issues including Climate change and these have evolved over time and can overlap in their adoption.

- Divestment can be considered to exclude a whole sector or company on specific grounds;
- Risk management actioned through the investment decision such as the asset allocation strategy and manager selection to carry out strategies;
- Investment in solutions so making positive investments for example investing in renewable energy sources;
- Active ownership to engage with companies and managers investing on the funds behalf.

Divestment can be a difficult strategy for funds such as Hillingdon where investments are made within pooled and passive funds due to scale and cost. Pooled and passive funds are less concentrated, with passive funds holding a slice of all companies within an index allowing them to track the market and be significantly diversified, whereas active managers have conviction in the performance of a specific company and their actions. Divestment by an individual fund would likely result in neutral investors taking advantage of a temporary depression in market sentiment, so would require a whole scale disinvestment of markets to have a required impact. Divestment also removes the ability to engage within an industry to promote better standards and progression towards alternative fuel sources such as renewables, as you take away the ability to influence the decisions and actions of that company. Where divestment can be a good tool is in enabling investors to exclude individual companies and industries from their portfolios in the case where organisations fail to meet a minimum standard or fail to progress toward a lower carbon economy in line with the 2015 Paris agreement.

The Fund currently approach management of ESG within its strategy through engagement, asset allocation and manager selection or allocation to specific managers through sub funds within the London CIV pool.

Hillingdon Fund manager's stance on ESG & Climate change

Adams Street

Adams Street is committed to employing investment and other personnel who share values of honesty, integrity, and transparency. They believe that their principled approach to due diligence and ongoing monitoring of Adams Street's investments is likely to result in positive social and economic development.

Adams Street has developed checklists for use by investment teams in considering ESG factors during investment diligence and post-investment monitoring. Criteria considered in evaluating prospective investments include:

- Character and integrity of the leadership of the fund or portfolio company
- The fund's or portfolio company's governance practices
- The quality, sustainability and transparency of operations
- Impacts of the fund's investments or portfolio company's business (e.g., human rights and environmental impacts)

AEW

AEW UK is committed to responsible property investment which will result in a positive, measurable and immediate contribution to CO2 mitigation in all areas of its real estate portfolio and wider business practice.

At the heart of asset management approach is a partnership with all tenants. Buildings are maintained with consideration for the surrounding environment and community. During asset enhancement, construction and preventative maintenance programmes, they encourage the use of environmentally friendly materials and supplies, if they are cost and quality equivalent to other options. For example, for all demolition work we endeavour to recycle and re-use aggregates on site, rather than transport building waste elsewhere. Annual audits are carried out which aim to ensure buildings comply with all current regulations and protect the health and safety of our tenants and visitors.

Epoch (through LCIV) (investment from November 2017)

As active managers, ESG considerations are inherent in the Epoch thought process and integrated into fundamental analysis of individual companies. Epoch has adopted an ESG Policy to ensure firm-wide consistency in our approach and communication. The investment process takes ESG issues into account when, in their view, these issues have a material impact on either investment risk or return. Within the context of the Global Equity Shareholder Yield strategy, our analysts are primarily concerned with the potential impact of ESG factors on the individual company's future cash flow generation and on the company's commitment to consistently return cash to shareholders.

Epoch spend a significant amount of time meeting with senior management of the companies they invest in on behalf of clients. Epoch do not look to exclude companies or sectors from the investable universe, but rather to analyze and monitor

ESG issues that may have an impact on financial performance in the near and long term. Some of the companies in which they invest are involved in operations or businesses which may have environmental or social impact that may create financial risks for the company. They follow these issues and evaluate each company's risk exposure, amount of disclosure and standards of conduct. The companies often have policies or strategic plans in place focused on long-term sustainability such as reducing carbon emissions or investing in renewable energy. There is consideration within the fundamental analysis of each company as climate change/fossil fuels have the potential to impact the future cash flows of the business.

JP Morgan

As part of the commitment to delivering superior investment performance to clients, JP Morgan expect and encourage the companies to demonstrate the highest standards of corporate governance and best business practice. They examine the share structure and voting structure of the companies, as well as the board balance, oversight functions and remuneration policy. These analyses then form the basis of proxy voting and engagement activity.

JP Morgan manages the voting rights of the shares entrusted to it as it would manage any other asset and vote shares held in its clients' portfolios in a prudent and diligent manner, based exclusively on our reasonable judgement of what will best serve the financial interests of the beneficial owners of the security. So far as is practicable they will vote at all of the meetings called by companies in which we are invested.

JP Morgan met Members of the ESG Team of 21 companies specifically to discuss governance issues, including Glencore, Arcelormittal, ING Groep, Henkel, LafargeHolcim and Akzo Nobel, bringing the total number of engagements for the year (not counting scheduled one-to-one meetings) to 204, of which 79 were meetings to discuss corporate governance issues at investee companies. 51 were remuneration consultations and 44 were to discuss social and environmental issues at portfolio companies.

LGT Capital

In thier multi-manager offerings, which include private equity, hedge funds and select long-only strategies, LGT focus on how our managers integrate ESG considerations into their investment approach. In bond and equity portfolios, securities are selected based on robust ESG criteria, and focus on the ESG attributes of issuers of securities. Given the central place of ESG considerations in these portfolios, they make up the sustainable bond and equity offerings. Looking across these various approaches and portfolios, LGT see significant progress this year in how ESG is taken into account in portfolios.

LGIM

LGIM consider their role is to help bring positive change to the companies in which they invest. Corporate governance is not just about company engagement or voting;

it also involves collaborating with regulators and other investors to help improve markets. LGIM's new Climate Impact Pledge sends a powerful message – one that came about as a result of clients increasingly pushing for action in this area. ESG issues, LGIM consider that ESG issues are a part of long-term risk management and therefore a fundamental part of clients' fiduciary duty.

M&G

M&G's approach to stewardship is set out in their 'M&G and the UK Stewardship Code' document. An active and informed voting policy is an integral part of the investment philosophy. Voting should never be divorced from the underlying investment management activity. By exercising votes, they seek both to add value to clients and to protect our interests as shareholders. M&G consider the issues, meet the management if necessary, and vote accordingly.

M&G aim to vote on all resolutions at general meetings of companies held in M&G's actively managed and UK passive portfolios. Typically, M&G votes by proxy at general meetings, but on occasion attend a general meeting where clients' interests are best served.

MACQUARIE

Macquarie's infrastructure funds are committed to environmental, social and governance issues when making new investments and managing existing portfolio companies. Globally, through its Macquarie Infrastructure and Real Assets (MIRA) division, Macquarie manages approximately 100 infrastructure businesses across the world, in sub-sectors such as renewable energy, water and waste, toll roads, airports. These businesses provide essential services to over 100 million people around the globe daily, thus demonstrating the importance of responsible management. Being a trusted owner of these assets is integral to the ongoing success of MIRA's business and therefore it puts environmental and social as a core part of its philosophy.

Macquarie has adopted a suite of Corporate Governance policies across all its funds, including an Environmental and Social Governance policy. They also have a Sustainability and Environment Officer as an internal resource who develops sustainability policies and coordinates relevant activity across Macquarie. The Sustainability and Environment Officer is supported by a Sustainability Advisory Committee of senior Macquarie executives, whose business roles or compliance functions intersect with ESG issues. The committee operates as a Macquarie-wide review board for ESG policy development and plays an important role in guiding Macquarie's ESG approach by making recommendations to Macquarie's Executive Committee.

Newton (disinvested November 2017)

Newton's approach to responsible investment is founded on protecting and enhancing the value of its clients' holdings. Newton is committed to ensuring that companies, in which it invests, adopt the highest standards of practice with regard to environmental, social and governance (ESG) matters. Newton exercises clients' voting rights globally and engages with companies where material concerns exist.

And example of ESG engagement is Newton engaging National Grid on various ESG issues including climate change, on which national Grid board was questioned on how the company and board were stress testing their stated strategy against the global policy initiative of limiting global temperature rises below two degrees and increase in electric vehicle (EV) usage. The company has tested the business against a range of future energy scenarios and has established 2020-2050 emissions and performance targets.

PERMIRA

Permira believes that a focus on sustainability is an important part of building lasting value in the funds' portfolio companies. Environment, social and governance ("ESG") and sustainability considerations are embedded throughout the investment process and are expected to be a key part of the governance of the funds' portfolio companies. Permira expects the funds' portfolio companies to deploy sound ESG practices in their operations. Permira also engages with portfolio company management teams post investment and through the investment period to understand how ESG risks and opportunities are being managed by the Permira Funds' portfolio companies.

Ruffer (through LCIV)

Ruffer has the share ownership rights of investments in this product and exercises these rights, through company engagement and proxy voting, to manage, protect and enhance the value of clients' investments.

Ruffer supports the UK Stewardship Code and has been assessed as tier 1 meaning 'signatories provide a good quality and transparent description of their approach to stewardship and explanations of an alternative approach where necessary.' Ruffer also became a signatory to the Japan Stewardship. Ruffer supports and is a signatory to the UN Principles for Responsible Investment (UN PRI) as part of our approach to good stewardship.

Ruffer monitors companies through statements and third party reports as well as being able to engage the board and senior management of investee companies directly. They actively seek to integrate environmental, social and corporate governance (ESG) issues into the investment process. They believe that ESG factors are often a signal of management quality, particularly over the long term. Ruffer employs a dedicated manager for responsible investment and ESG issues.

UBS

UBS Asset Management's stewardship policy is the commitment to act as good stewards of assets held and managed on behalf of clients. UBS recognise that clients' expect them to ensure the alignment of approach with their own investment beliefs, policies and guidelines. UBS seek to be active shareholders by encouraging good governance and a high standard of corporate practices.

UBS regard voting as an important part of the engagement process. Wherever practical they vote at all company meetings globally. The exceptions are in markets where voting restrictions apply.

Further to their launch of the UBS Climate Aware Strategy in Q1 2017, the manager reviewed its' voting principles and policy with regards to climate related reporting proposals at shareholder meetings. UBS now expect companies to have a strategy for reducing greenhouse gas emissions, to be clear about goals, and to report on progress.

The manager will support proposals that requires an issuer to report to shareholders, at a reasonable cost and excluding proprietary information, information concerning their potential liability from operations that contribute to global warming, their goals in reducing these emissions, their policy on climate risks with specific reduction targets where such targets are not overly restrictive.

The manager will also support proposals that require, or request, information regarding an issuer's adoption of, or adherence to, relevant norms, standards, codes of conduct or universally recognised international initiatives, or that seek to promote greater disclosure and transparency in a standardized format their corporate environmental policies, including information on GHG or toxic emissions, in particular as outlined in the recommendations of the Task Force on Climate Related Disclosures (TCFD).

Since the review UBS have supported proposals presented to shareholders at various meetings including those at Chevron and Exxon Mobil.