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| Report to: | **Pension Committee** |
| Date: | **8 February 2016** |
| By: | **Chief Operating Officer** |
| Title of report: | **Environmental, Social, Governance and Investment Strategy** |
| Purpose of report: | **To ensure that members are aware of the legal position of trustees in respect of the investment in certain companies which might be considered to be 'ethically compromised'.** |

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**RECOMMENDATION**
**The Committee is requested to consider the contents of this report.**

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## 1. Background

1.1 The Local Government Pension Scheme (LGPS) regulations identify the County Council as the administering authority for the East Sussex Pension Fund (ESPF). The role of the administering authority is to manage the pension scheme on behalf of all the members of the scheme, their employers, and the investment strategy to secure the best realistic return over the long-term, given the need to control for risks.

1.2 The ESPF invested in various company shares and bonds, property and cash around the world. The rates achievable on long term investments allow them to ensure affordable employer contributions rates, enabling authorities to spend more money on front-line services.

1.3 With reference to the Committee previous deliberation on the Environmental, Social and Governance (ESG), i.e., ethical issues and investment strategy, it is appropriate for officers to put this paper forward to the Committee for consideration.

## 2. Fiduciary responsibility

2.1 This responsibility given to the County Council by the LGPS regulations is delegated by the Council to the Pension Committee. The members of the Pension Committee are required to act in the same way as trustees of pension schemes within other sectors of the economy and they have a fiduciary responsibility to protect the pension benefits of members by securing the best realistic return over the long-term, and keeping contributions affordable.

2.2 It would not be satisfactory merely to refer in a generalised way to ethical considerations being taken into account without giving an indication of how that is to be done. Such a policy will need to be limited by reference to an overriding requirement that it is not to risk material financial detriment or result in a failure to invest in a sufficiently wide range of investments. It would be appropriate to build in some regard for professional advice.

2.3 Article 18(1) of the IORP Directive requires assets to be invested in the best interests of members and beneficiaries and, in the event of a conflict of interest, in the sole interests of members and beneficiaries.

2.4 Nigel Giffin QC previously advised the LGPS Advisory Board that an administering authority for Local Government Pension Scheme Funds may choose to take into account, e.g., the public health implications of tobacco investment, but only if the result of such a choice is the substitution of those investments with assets producing a similar return.

## 3. ESPF approach to ethical investments

3.1 The investment strategy of the ESPF fund is detailed in its Statement of Investment Principles (SIP) and is broadly in line with that of other LGPS funds, i.e. to secure the best realistic return over the long-term, to meet pension commitments, within an acceptable level of risk, by ensuring there is diversification across all asset classes and keeping employer contribution rates stable. The fund pursues this strategy by appointing expert specialist investment managers who have an unconstrained ability to invest within their individual mandates.

3.2 The SIP also details the fund's policy on socially responsible investments. This states that the Fund is permitted to adopt a policy of socially responsible investment providing they treat the financial interests of scheme members as paramount and their investment policies are consistent with the standards of care and prudence required by law. The financial performance of the fund, proper diversification and prudence are paramount.

3.3 The Fund also requires their segregated fund managers to be active in their constructive shareholder engagement with companies regarding socially responsible investment issues and the proactive engagement of fund managers with these companies does influence positive change.

3.4 The Fund does not interfere in the day-to-day investment decisions of the Fund's investment managers, and does not actively invest or disinvest from companies solely or largely for social, ethical or environmental reasons. The Fund will listen to special interest groups that may oppose some of the Fund's investments, for example in tobacco, alcohol, fracking, gambling or pharmaceuticals, but are clear that this cannot detract from the Fund's duty.

3.5 The new investment regulations are like to result in the Fund taking a prudential approach, demonstrating that it has given consideration to the suitability of different types of investment, has ensured an appropriately diverse portfolio of assets and has ensured an appropriate approach to managing risk. The *new* investment strategy statement is required to cover the Fund's environmental, social and corporate governance policy.

3.6 In the Fund's view, simply disinvesting from a particular company is a denial of responsibility. The Fund believes that responsible institutional investors should seek to influence companies' environmental, human rights and other policies by positive use of shareholder power. The Fund does reserve the right to, on a case by case basis; apply ethical or environmental criteria to investments if it is considered relevant and appropriate.

3.7 This policy is enshrined within the Investment Objectives - Section 3 of the Fund's Statement of Investment Principles, extract is shown at appendix 1.

## 4. Local Authority Pension Fund Forum

4.1 The Fund is a member of the Local Authority Pension Fund Forum (LAPFF). LAPFF is a coalition of around 68 LGPS Funds, which seeks to engage with companies on behalf of their member funds. LAPFF actively considers the issue of ESG investments, in particular issues relating to poor labour practices, poor wage equality, the arms trade, tobacco and major oil companies.

4.2 The Fund is concerned about ESG, (including ethical investment) issues, and works both at a fund and a collective level through LAPFF to ensure engagement. The fund believes active engagement with investee companies is the preferred option to bring about change whilst managing overall investment risk issues. The approach of direct and collaborative engagement contrasts with blanket divestment. Once an asset owner divests, their ability to influence both the short and long-term direction of individual companies and the national and international energy sector is severely curtailed.

## 5. What are other LGPS funds doing?

5.1 A number of other LGPS funds have reviewed their policy on ESG and some funds have taken a different approach but have stayed within legal advice, e.g. an organisation recently switched their passive assets to “Carbon-tilt” indices, and some have put in place explicit responsible investment beliefs.

**6. Conclusion and recommendations**

6.1 The cornerstone of the ESPF’s policy on ethical investment is their interpretation of the legal position. The Committee should take into accounts ethical, environmental, governance, or any other non-commercial policy when considering investments generally or selecting fund managers. The Fund would seeks to use its influence as a corporate investor to positively influence company behaviour, although it reserves the right to apply ethical or environmental criteria on a case by case basis if considered relevant and appropriate.

6.2 Trustees and the fund managers have a duty to consider the full range of investment options open to them and their decisions should be based on the expected investment performance of the asset. The primary objective of the pension fund is to secure the best realistic return over the long-term to meet future commitments to beneficiaries, while keeping employer contributions as low as possible.

**KEVIN FOSTER**
**Chief Operating Officer**

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Local Member(s): All

**BACKGROUND DOCUMENTS**

East Sussex Pension Fund - Statement of Investment Principles

**Appendix 1**

## An extract from the ESPF Statement of Investment Principles

### *Overall Responsibility*

East Sussex County Council is the designated statutory body responsible for administering the East Sussex Pension Fund (Fund) on behalf of the constituent Scheduled and Admitted Bodies.  The local Government Pension Scheme (Management and Investment of Funds) (Amendment) Regulations 2009 require administering authorities of pension funds to prepare and review, from time to time, a written statement setting out the investment policy for their Fund. Any material change in investment policy must be included in a revised Statement of Investment Principles (SIP) within six months of the change.

### 3 Investment Objectives

### 3.1 Funding objectives

The Committee will translate its objectives into a suitable strategic asset allocation benchmark for the Fund (the current asset allocation can be found on Page 4). The strategic benchmark is reflected in the investment structure and this comprises a mix of segregated and pooled (both active and passive) manager mandates. The Fund benchmark is set to be an appropriate balance between generating a satisfactory long-term return on investments whilst taking into account of market volatility and risk and the nature of the Fund’s liabilities. The Committee monitors investment strategy relative to the agreed asset allocation benchmark.

### 3.2 Investment Managers

The investment managers appointed to manage the Fund’s assets are summarised on page 4.  The investment managers will be given full discretion over the choice of individual stocks against their respective benchmarks and are expected to maintain a diversified portfolio.

### 3.3 Kinds of investments to be held

The Fund may invest in quoted and unquoted securities of UK and overseas markets, including equities, fixed interest and index-linked bonds, cash and property (not direct), using pooled funds where agreed.

The Fund may also make use of contracts for differences and other derivatives either directly or in pooled funds investing in these products, for the purpose of efficient portfolio management to hedge specific risks.

The current limits are set out in the Policy Guidelines for Investment (Page 4). The strategic asset allocation of the Fund includes a mix of asset types across a range of geographies in order to provide diversification of returns.

### 3.4 Balance between different kinds of investments

The asset allocation benchmark (see page 4) and performance target is based on consideration of the liability profile of the Scheme.

The appropriate balance is required between maximising the long-term return on investments and minimising short-term volatility and risk. Within each major market the investment managers will hold a diversified portfolio of stocks or will invest in pooled funds to achieve this diversification.

**3.5 Risk**

The adoption of an asset allocation benchmark (as described above) and the explicit monitoring of performance relative to a performance target, constrains the investment managers from deviating significantly from the intended approach, while permitting flexibility to manage the Fund in such a way as to enhance returns.

The appointment of more than one Investment Manager introduces a meaningful level of diversification of manager risk and provides some protection against one manager producing poor investment returns.

**3.6 Expected return on investments**

The investment performance achieved by the Fund over the long term is expected to exceed the rate of return assumed by the Actuary in funding the Fund on an ongoing basis.

**3.7 Realisation of investments**

The majority of assets held by the Fund are quoted on major stock markets and may be realised quickly if required. Property investments, which are relatively illiquid, currently make up a modest proportion of the Fund's assets and are all invested through property unit trusts or life funds. However some of the Fund's alternative assets in Private Equity and Infrastructure are invested via Fund of Fund managers and are of an illiquid nature to provide better performance in the long term.

**3.8 Social, environmental and ethical considerations**

Issues surrounding socially responsible investment have been considered and an 'Active Shareholder Approach' to encourage companies has been adopted to promote best ethical and environmental principles without jeopardising the investment performance of the Fund. When selecting investments for purchase, retention or sale, Fund Managers are able to invest in all companies, subject to the specific restrictions set out in the Policy Guidelines (page 8) in order to achieve their performance targets. But they have been encouraged to engage in constructive dialogue on behalf of the Fund and to use their influence to encourage companies to adopt best practice in all key areas of business. The key areas are:

- Corporate governance
- Employment standards
- Human rights and
- Environmental standards
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**3.9 Exercise of voting rights**

Strong Corporate governance has been promoted and the Fund has delegated the exercise of its voting rights to the Fund Managers (subject to the Fund’s guidelines) on the basis that voting power will be exercised by them with the objective of preserving and enhancing long term shareholder value. The Fund Managers base their corporate governance policies on the Stock Exchange Combined Code and provide the Fund with a copy of their policy from time to time. The Fund Managers are encouraged to vote in line with its guidelines in respect of all resolutions at annual and extraordinary general meetings of companies. In February 2014 the Fund resolved to subscribe to the Local Authority Pension Fund Forum (LAPFF). LAPFF is the UK’s leading collaborative shareholder engagement group. The Forum provides a unique opportunity for Britain's local authority pension funds to discuss investment issues and shareholder engagement.