SPRING 2023

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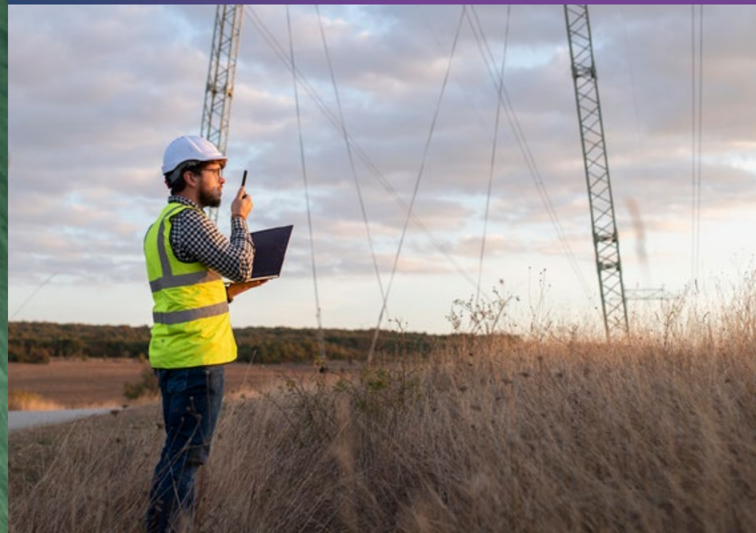
LOTHIAN PENSION FUND



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WELCOME

Welcome to Engage issue 6! 2022 was an exciting year for Lothian Pension Fund (LPF) as we welcomed our colleagues back into the office and reopened our phone lines to members.

It was also a very busy year for investments. In this issue, Bruce Miller, our Chief Investment Officer, reviews what moved investment markets and how our long term, responsible investment approach enabled us to navigate these stormy waters.

On pages 6-7 Gillian de Candole, our Responsible Investment lead, seeks to dispel some misconceptions about responsible investment and signposts to the publications we produce to explain and demonstrate examples of our approach. A huge amount of effort goes into the production of our Stewardship Report, which contains a wealth of detail and examples on the implementation of our responsible investment policies.

I'm pleased to announce that the Financial Reporting Council has approved this report, continuing our status as a signatory to the UK Stewardship Code.

Stewart Piotrowicz, one of our in house portfolio managers, provides some examples on page 8 of where environmental, social and governance (ESG) considerations have impacted our investment decision-making.

Finally, our Asset Manager, Lisa Pollock, talks us through the steps that the Property and Asset Management team at JLL took to transform one of our property portfolios, Neptune Park, into an award winning environmental initiative.

We hope you enjoy this issue.

David Vallery
Chief Executive Officer
Lothian Pension Fund

REVIEW OF 2022

Buffeted by geopolitical events and macroeconomics, 2022 was a challenging year for many investors, as fixed income and property investments provided little counterweight to weakness in global equity markets. However, LPF's long term, responsible investment approach enabled us to navigate these stormy waters. Our deliberate bias to low volatility and value equities outperformed, while our skilled in-house investment team were able to seek out opportunities during market dislocations.

To recap, capital markets had a shaky start to 2022 as expectations for faster, bigger rate hikes and slower economic growth overshadowed incrementally positive signals (including solid corporate earnings, low unemployment, and an improving COVID-19 outlook). Persistent inflationary pressure, initially from supply chain issues following the pandemic, was subsequently compounded by the war in Ukraine, increased energy costs, and fuel security concerns. This forced central banks in the UK, Europe and the US to raise interest rates faster than the market had anticipated, increasing borrowing costs and the risk of recession. Strict lockdowns in China exacerbated fears of a global economic slowdown.

On the geopolitical front, our thoughts remain with the millions of people who are directly impacted by the incomprehensible scale of destruction and human suffering in Ukraine, while we also recognise the far-reaching implications of the war for global commodities markets, given the significance of the region as a major exporter of energy, grains, and metals.

In September, UK financial markets were rocked after the now ex-Chancellor announced a series of unfunded tax cuts. The pound rapidly plummeted close to an all-time low versus the US dollar and yields on longer dated gilts skyrocketed, necessitating intervention by the Bank of England. The turmoil prompted freshly elected UK Prime Minister Liz Truss to resign after just 45 days in office, paving the way for Rishi Sunak to be named her successor, which restored confidence across financial markets.

Markets stabilised in the final quarter of the year as government bond yields retreated from their peak, along with the US dollar, with a welcome deceleration in inflation in the US, and improved investor sentiment surrounding the relaxation of China's "zero-COVID" policy.

As we start the year, the depth and duration of an economic recession in 2023 is a hotly debated topic for market forecasters, with expectations of further interest rate hikes in the near term, to be followed by cuts in 2024 when inflation has been "tamed". We don't attempt to predict short-term market movements, instead we consider a range of possible scenarios in our asset allocation process with a patient, long-term perspective. Our focus on delivering good risk-adjusted returns served the fund well in 2022 with positive equity returns in a challenging environment.

While past performance is no guide to the future, we continue this approach to responsible investment which is informed by our investment beliefs, policies, and priorities, together with regulations and statutory guidance, which are detailed in our Statement of Investment Principles and Statement of Responsible Investment Principles.

Bruce Miller
Chief Investment Officer
Lothian Pension Fund

RESPONSIBLE INVESTMENT UPDATE

“Ethical Investment” and “Responsible Investment (RI)” are slightly different concepts that often get mixed up or are incorrectly used synonymously. Here we aim to outline the difference and why LPF focuses on being a responsible steward of capital for the purpose of paying our members’ pensions when they’re due.

Ethical Investment is an approach which is determined by an investor’s specific views, usually based on a set of personal values, and different ethical investors may pursue different forms of ethical investment depending on their own values (e.g. faith based investment exclusions). With Ethical Investment, these values can take precedence over financial considerations.

With a diverse stakeholder group, LPF shouldn’t be considered as either an “Ethical” or an “Unethical” investor, but as a responsible steward of capital. We’re guided in our roles as quasi-trustees, executive officers, and investment managers by the legal principle of fiduciary duty, which includes a requirement to take account of any financial factor which is relevant to the performance of an investment. These include risks to a company’s long-term sustainability, such as environmental, social or governance factors (often referred to as “ESG” factors). The management of ESG issues is a question of identifying and mitigating material financial risks, not a question of ethics.

RI is an approach to investing that aims to incorporate environmental, social and governance factors into investment decisions, to better manage risk and to generate sustainable, long-term returns. Our approach to RI is published on our website in our Statement of Responsible Investment Principles, which also includes details on our approach to climate change: LPF is committed to real world decarbonisation.

Stewardship is the responsible allocation and management of capital across the institutional investment community to create sustainable value for beneficiaries, the economy and society. As a signatory to the UK Stewardship Code, we produce an annual Stewardship Report which describes the implementation of our RI policies. This includes case studies on our engagement, escalation and voting activity.

There are limits to the influence that we can achieve as a single investor and the resources we can reasonably commit, but we believe progress can be achieved on ESG issues through collaboration with other investors and organisations and we take an active role in several industry RI initiatives and collaborations. While much of this activity is focused on climate change, in particular, pushing for improved transparency of corporate carbon emissions and transition plans, as well as advocating for more ambitious targets and policy implementation by governments, we recently joined a new initiative called Advance, which is focused on addressing egregious human rights and social issues. More information on this can be found here.

Gillian de Candole
Portfolio Manager and Responsible Investment Lead
Lothian Pension Fund

‘WE BELIEVE PROGRESS CAN BE ACHIEVED ON ESG ISSUES THROUGH COLLABORATION WITH OTHER INVESTORS AND ORGANISATIONS AND WE TAKE AN ACTIVE ROLE IN SEVERAL INDUSTRY RESPONSIBLE INVESTMENT INITIATIVES AND COLLABORATIONS’

Gillian de Candole, Portfolio Manager

IMPACT ON INVESTMENT DECISIONS OF ESG ISSUES OR CONCERNS

Looking specifically at our direct listed equity exposure, we manage portfolios in a variety of ways. While the core of the LPF equity exposure has a bias towards value and lower risk, we have other portfolios targeting different market anomalies. We also have a mixture of global and regional portfolios. Some of these portfolios are quantitative in nature and some are fundamental, stock-picking portfolios. In this short article, we'll give some brief examples of where ESG considerations have impacted our decision-making. Aware of sensitivities, we've made it deliberately unclear which specific companies we're referring to in the examples below.

These examples refer to a global quantitative portfolio which rebalances on an annual basis.

Over the last couple of rebalances there have been examples of stocks that were either sold or not purchased (despite meeting the quantitative criteria for inclusion). The tables opposite show two examples of each.

Sold

- A chemical company based in Asia. This stock had looked increasingly worse within the MSCI ESG ratings (which aim to measure a company's management of financially relevant ESG risks and opportunities) with MSCI specifically highlighting "multiple concerns related to the company's corporate governance" and "its initiatives to reduce toxic emissions lag those of industry peers as it appears to lack a quantitative reduction target". In addition to this, the company's toxic emissions had actually increased over the preceding three years

- A financial company based in Asia. The MSCI ESG rating was low and highlighted that the company "continues to lack efforts in integrating responsible investment principles into its investment process... portfolio vulnerable to long-term ESG risks."

Not Purchased

- Telecom company in the Middle East which was consistently rated lowly by MSCI ESG which highlighted "limited measures to address key ESG risks"

- Asian utility where MSCI noted "moderate efforts to increase renewables and mitigate emissions". Furthermore, it was clear the company had recently increased their use of coal and were therefore moving in the wrong direction from a climate-related perspective.

Stewart Piotrowicz
Equity Portfolio Manager
Lothian Pension Fund

GREEN APPLE AWARD



LPF has a direct property portfolio of around £400m, which we actively asset manage. This means we work closely with our consultants, facilities managers and tenants on a wide array of matters including environmental initiatives.

One of our property assets, Neptune Park, is managed by the Property and Asset Management team at JLL. This industrial setting near Dartford Crossing is a busy area of trading estates and heavy industrial and commercial activity, and not where you'd think to find an award-winning environmental initiative.

We were extremely proud when the park was awarded the Green Apple Environment Award last year. This award recognises, rewards and promotes environmental best practice around the world.

The trading estate is surrounded by green space and trees that attract birds and insects looking for habitat. This gave JLL plenty of opportunity to look at how they could help encourage more wildlife.

They installed insect hotels and bird nesting boxes around the site, as well as natural log piles (created from necessary tree works following nasty storms in February 2022) to provide homes for insects, birds and small animals. Wildflowers were also planted on the grass bank at the main entrance to provide a warm welcome to occupiers and visitors alike. These wildflowers will continue to flourish and provide a habitat for pollinators, increasing the visual and ecological benefits year on year.

The wildlife is not the only one to benefit as greenery and wildlife have been shown to have a significant positive influence on our mental health. The tenants at the site can see the bird boxes and insect hotels from their units and watch the inhabitants interact in their new environment.

What's been installed is low cost and effective and shows that anywhere, even if the site is primarily industrial, can have an impact on the local ecosystem and environment. JLL plan to adopt these additions at other trading estates and commercial sites where possible.

Katie Dickerson, Facilities Manager at JLL says of the project: "Initially we thought it's a challenge to bring anything green to an industrial estate amongst a largely industrial area and within a stone's throw from the M25 and Dartford Crossing, but everywhere deserves some biodiversity to enjoy and ecosystems exist in all forms in all places.

"I think the fact that it's an industrial and largely concrete area makes Neptune Business Park a worthy winner as it stands it out from the crowd and shows we can be environmentally aware regardless of the contradictory challenges we face on a site."

Lisa Pollock
Asset Manager
Lothian Pension Fund

‘IT STANDS IT OUT FROM THE CROWD AND SHOWS WE CAN BE ENVIRONMENTALLY AWARE REGARDLESS OF THE CONTRADICTORY CHALLENGES.’

Katie Dickerson, Facilities Manager at JLL

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If you'd like more information on our ESG activities, please visit our website www.lpf.org.uk.

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