Responsible Investment

The Pensions Committee publicly endorsed and adopted an approach to investing known as Responsible Investment (RI) over a decade ago - in 2008, the Fund became a signatory to the Principles for Responsible Investment (PRI), a United Nations-backed initiative.

"Responsible investment is an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns." PRI

This is the cornerstone of the Fund's investment approach, and over the years, the six principles have become increasingly embedded into its investment processes.

- **Principle 1**: We will incorporate ESG issues into investment analysis and decision-making processes.
- **Principle 2**: We will be active owners and incorporate ESG issues into our ownership policies and practices.
- **Principle 3**: We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- **Principle 4**: We will promote acceptance and implementation of the Principles within the investment industry.
- **Principle 5**: We will work together to enhance our effectiveness in implementing the Principles.
- **Principle 6**: We will each report on our activities and progress towards implementing the Principles.

PRI Annual Assessment

All PRI signatories agree to the PRI organisation undertaking a comprehensive annual assessment of their approach to RI. This independent appraisal is made publicly available on our website www.lpf.org.uk with a summary of Lothian's latest evaluation is shown below. It highlights that the Fund's processes and approach to Responsible Investment are rated at or above the median of asset owner signatories across all categories measured.

PRI rates Lothian's approach to RI highly

Summary Scorecard

AUM	Module Name	Your Score	Your Score / Median Score
	01.Strategy & Governance	A	A
Indirect - Manager Sel., App. & Mon			
<10%	02. Listed Equity	A	B
<10%	05. Fixed Income - Corporate Non-Financial	A	B
<10%	07. Private Equity	A	B
<10%	08. Property	A	B
10-50%	09. Infrastructure	A	A
Direct & Active Ownership Modules			
>50%	10. Listed Equity - Incorporation	B	B
>50%	11. Listed Equity - Active Ownership	A	B

Ethics and Lobbyist Activity

As a public sector asset owner, which strives for high standards of transparency within the constraints of commercial sensitivities, Lothian Pension Fund is subject to considerable scrutiny of its investments. Lobby groups often present ethical arguments for divestment of specific investments. They create adverse publicity to further their campaigns, sometimes being highly selective in their use of facts to raise awareness and to create impact, often with an incomplete understanding of the investments that they oppose.

Campaigners often imply or state that 'Responsible Investment' is synonymous with 'Ethical Investing'.

Lothian Pension Fund is not an 'ethical investor', and nor is it an 'unethical investor'. Rather, it is guided at all times by the legal principle of fiduciary duty and its Principles for Responsible Investment. It recognises that certain investments have the potential to be more contentious than others, but it does not operate a narrow or restrictive policy of excluding investments from its universe of potential investments. What it does do is assess the likely impact of controversial business activities and practices on investment returns by incorporating Environmental, Social and Governance (ESG) considerations into its decision-making processes.

In a world with often complex social, legal or moral issues, it would be impossible to invest efficiently in a manner that meets the expectations of each activist or campaigner. In the past year, special interest groups have demanded divestment of holdings in tobacco producers, defence companies, energy producers and banks.

In contrast to the baseline views of many typical activist representations the Fund does not finance these companies – the Fund is simply a shareholder – and it does not take sides in the moral debate on these investments, but it does recognise that many of the issues raised have the potential to affect financial risk. The information provided by campaigners or other interested groups will always be given due consideration as part of the risk management process and in line with its fiduciary duty to its members and employers. The Fund's purpose is to ensure that there are sufficient funds to pay pensions to members as they fall due.

Stewardship Code

Another foundation on which the Fund's Responsible Investment approach is built is the UK Stewardship Code. The premise on which the Code was established is that effective stewardship benefits companies, investors and the economy as a whole. As a large institutional asset owner with voting rights in UK listed companies, Lothian Pension Fund is expected to adhere to the Code on a 'comply or explain' basis. The Fund complies. Its close adherence to the Code means that it is classified as a Tier 1 signatory. "To protect and enhance the value that accrues to the ultimate beneficiary, Institutional investors should follow these principles:

- publicly disclose their policy on how they will discharge their stewardship responsibilities.
- have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.
- monitor their investee companies.
- establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value.
- be willing to act collectively with other investors where appropriate.
- have a clear policy on voting and disclosure of voting activity.
- report periodically on their stewardship and voting activities.

More information on the Code can be found on the FRC website at www.frc.org.uk.

Voting

As the UK Stewardship Code makes clear, responsible institutional shareholders must exercise their shareholder rights to vote at company annual general meetings (AGMs) and extraordinary general meetings (EGMs). Voting can send a strong message to company management about how it is conducting business.

Lothian Pension Fund votes on the resolutions of 100% of the companies in which it is invested. Two of its external providers are charged with voting on the Fund's behalf based on pre-agreed policies. Baillie Gifford, who manage assets for Lothian, and Hermes EOS, the Fund's voting and engagement partner, do this. Their quarterly voting activity is available on Lothian's website www.lpf.org.uk/invest.

AGMs present asset owners with other way to influence management on important issues. Shareholders can file resolutions which allow all other shareholders to vote on matters that are not raised by management.

During 2018/19, Lothian co-filed a resolution for BP's AGM in May 2019 calling for greater transparency and disclosure on the company's approach to carbon emission and low-carbon transition planning. The resolution was backed by BP management and supported by 99.14% of investors. BP has since committed to provide investors with a new strategy consistent with the goals of the Paris Agreement, as well as providing further disclosure on capital expenditure and various company metrics and targets, including annual progress reports

Engagement

There is more to Stewardship and Responsible Investment than voting and filing resolutions. Monitoring and engaging with companies on matters of strategic importance is regarded as a key responsibility of institutional investors, which can improve corporate governance standards and protect shareholder value.

The Fund commits significant resources to engagement activity. Most is undertaken by the Fund's voting and engagement service provider and partner, Hermes EOS. What Hermes EOS brings to the Fund is a focus on and expertise in engagement activities as well as scale provided by its other like-minded clients. These allow Lothian to use its position as a shareholder more effectively as Hermes EOS engages on behalf of a wide shareholder base and is, therefore, more likely to influence management to enact positive change in investee companies.

Hermes EOS consults with its clients to develop an engagement plan so that it can prioritise engagement activity. The latest plan (available on the Fund's website) highlights 12 main themes for engagement over the three-year period 2019-21.

In this schematic, these themes surround the core subjects of engagement activity – environment, social issues, governance and strategy, risk and communication.

Each theme is described in detail in the engagement plan, including background information on the importance of each theme, the main outcome objectives, the methodology for tackling each engagement theme and Hermes EOS's description of best practice in each area.

Lothian stands behind Hermes EOS in achieving progress in each of these areas, and the internal team offers support and ideas where appropriate to Hermes EOS in carrying out this vital work.

Collaboration

Engagement activity is highly suitable for collaborative efforts. It is a complex area that benefits from scale. When Hermes EOS engages with companies, it can speak for asset owners with shareholdings worth up to £390bn. Lothian participates in other collaborative initiatives, which helps it fulfil its commitment to be an active and responsible asset owner:

- **LAPFF**, the Local Authority Pension Fund Forum, is a collaborative shareholder engagement group, comprising 80 UK local authority pension funds and 6 of the LGPS pension fund pools in England & Wales. The Convener of Lothian Pension Fund's Pensions Committee, Councillor Rankin, is on the executive board of LAPFF and has represented LAPFF and its member funds in high level engagement with company management.
- **The Cross-Pool RI Working Group** was one of several working groups formed when the England and Wales pools were being set up to take a leadership role in the process. The RI working group was formed to pioneer best practice in RI and share that across the pools. While Scottish funds are not involved in pooling, Lothian was invited to contribute

to the group. Participation in the group has been an invaluable source of knowledge and expertise that allowed Lothian to take a leading position amongst UK asset owners in implementation of RI policy.

- **Diversity Project Scotland**. The Diversity Project is "a cross-company initiative championing a more inclusive culture within the Savings and Investment profession." Lothian Pension Fund has long championed diversity in its investee companies and has committed to diversity in its own ranks. Both investment and human resources staff are participating in this initiative.
- **Climate Action 100+** is a collaborative investor initiative supported by PRI and Hermes EOS. Lothian Pension Fund has recently become a participant member. Signatories to Climate Action 100+ are requesting the boards and senior management of companies to:
    - Implement a strong governance framework which clearly articulates the board's accountability and oversight of climate change risks and opportunities;
    - Take action to reduce greenhouse gas emissions across the value chain, consistent with the Paris Agreement's goal of limiting global average temperature increase to well below 2 degrees Celsius above pre-industrial level;
    - Provide enhanced corporate disclosure in line with the final recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) to enable investors to assess the robustness of companies' business plans against a range of climate scenarios, including well below 2-degrees Celsius, and improve investment decision-making.

A proud participant of: Climate Action 100+ Global Investors Driving Business Transition

As a participant member, Lothian will be directly involved in company engagement with Climate Action 100+, not just through its service provider, Hermes EOS, but directly through the internal team. It is a clear signal that Lothian Pension Fund is focused on the long-term impact of climate change and regulatory pressure on existing business models from expert industry knowledge and from working with experienced engagers in this field.

The internal investment management team already regularly engages with company managements in the normal course of doing due diligence on companies as shareholders or potential shareholders. These meetings, or engagements, are an opportunity to discuss the key factors affecting company performance and strategy, and, of course, these include any significant ESG issues pertinent to that company. Further information on Climate action 100 is available at www.climateaction100.org.

Climate Change

Climate change has become the global issue of our time. As of February 2019, 184 states and the EU (representing 88% of global greenhouse gas emissions) had ratified or acceded to the Paris Agreement of the United Nations Framework Convention on Climate Change. Under this agreement, each country must determine, plan and regularly report on the contribution it undertakes to mitigate global warming. The three key aims of the agreement are:

- Holding the increase in the global average temperature to well below 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5°C above pre-industrial levels, recognising that this would significantly reduce the risks and impacts of climate change;
- Increasing the ability to adapt to the adverse impacts of climate change and foster climate resilience and low greenhouse gas emissions development, in a manner that does not threaten food production;
- Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.

Separate to this, but part of the overall worldwide change in culture with regards to greenhouse gas emissions, the Financial Stability Board (FSB) of the Bank of England launched the Taskforce on Climate-Related Financial Disclosures (TCFD). TCFD aims to "develop voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders." Further information is available at www.fsb-tcfd.org.

As asset owners, Lothian has been engaging with the companies in its portfolios to enhance disclosures on emissions in line with the recommendations of TCFD, as well as working alongside peer organisations to promote the aims of the TCFD and reporting the Fund's approach to climate change-related risks and opportunities in its PRI reporting.

As part of the TCFD resources, investors and asset owners also have guidance on how to report their approach to climate-related risks and opportunities. These recommendations are split into four key areas of reporting.

Governance relates to the organisation's governance and climate-related risks and opportunities.

Strategy relates to the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning.

Risk management relates to the processes used by the organisation to identify, assess and manage climate-related risks.

Metrics and Targets relates to metrics and targets used to assess and manage relevant climate-related risks and opportunities.

The TCFD is in its relative infancy and Lothian Pension Fund is challenging companies to improve their disclosure and rapidly integrating the specifics of climate change into the risk management and governance of the Fund. Over the few years, it has undertaken substantial work on the issue.

Climate Change - Governance

In accordance with Scheme Regulations, the Pensions Committee and Pension Board are required to undertake a minimum of 21 hours training. Each year, the Fund's provider of voting and engagement services is invited to present to and interact with the Committee and Board. During 2018/19, they received specific training on climate change-related risks and opportunities. This was followed up with the first climate-specific reporting for the Committee, a carbon footprint of the Fund's equity holdings in June 2018. The simplicity of output of a single carbon footprint number belied the complexity of the subject matter, and the following recommendations were agreed:

- Reaffirm the Fund's commitment to integrate environmental, social and governance (ESG) considerations, such as carbon efficiency trends, into its decision-making
- Note that the Fund scrutinises and engages with investment managers to ensure that they are taking ESG issues, including climate change and carbon risk, into account in their investment decision-making
- Reaffirm the Fund's policy of not divesting solely on the grounds of non-financial factors
- Note that the Fund will monitor research on the link between ESG factors (including carbon-related factors) and financial performance to inform future investment strategy, such as stock selection criteria for quantitative strategies; and
- Agree that the Fund should aim to influence engagement activity based on its shareholdings of companies that perform poorly on carbon efficiency measurements.

The carbon footprint report will be updated on an annual basis as part of an annual review of climate-related risks and opportunities.

More broadly, the Committee and Board considers a paper on the Fund's approach to Stewardship on an annual basis. This also covers climate related issues. During 2018/19, the Pension Fund organised an event on responsible investing, to which major stakeholders and elected officials of local authority employers were invited to review the Fund's approach, with the opportunity for discussion with the investment managers, legal professionals, representatives from PRI and Hermes EOS and Committee and Board members. For those unable to attend the event and for those that require to understand the Fund's approach because they receive attention from lobbyists on a range of issues, a recording of the event has been made available on the Fund's website.

Climate-related risks and opportunities are an integral part of the overall investment process for Lothian Pension Fund, and so the Pensions Committee delegates investment decision-making to officers and investment managers with advice from the Joint Investment Strategy Panel. Climate-related risk management is reviewed as part of the regular monitoring process, which includes analysis of ESG integration in the investment mandates. For Real Estate and Infrastructure managers, the Fund has recently incorporated GRESB data into the monitoring process to better assess climate-related risk within the Fund.

Climate Change - Strategy

The Fund recognises the contribution that some specific sectors and industrial activities have towards climate change. While many prefer to label companies in carbon-intensive industries 'bad' and those in low-carbon and alternative energy businesses as 'good', in reality investment is more nuanced than this. The Fund has a policy of engagement rather than blanket divestment, which allows us to exert influence on companies to improve their business practices, align with the Paris goals, and disclose internal climate-related risk and opportunity management with TCFD compliant reporting. Recent academic research commissioned by Lothian Pension Fund* suggests that divestment at best is ineffective, and at worst provides a clear disincentive for management to change.

The Fund's approach to engagement relies heavily on our engagement and voting partner, Hermes EOS. Hermes EOS engages with companies on a range of engagement issues including climate change. The internal management team also engages with company management on a regular basis as part of company roadshows and investment conferences.

**University of Edinburgh Master's in Economics Dissertation, "In response to the recent Paris Agreement, how might pension funds contribute to helping reduce global climate change through investment policy?", Cooper, 2019*

In addition, the Fund has joined the Climate Action 100+ investor initiative and is actively participating in engagement with one of the 167 target companies in the list of systemically important carbon emitters produced by the initiative.

Regular training and development for all staff on climate related issues is provided. This includes governance functions, management, investment decisions makers, and pensions administration staff. This creates an internal culture that is serious about the risks to capital posed by the carbon transition.

The holdings of the Fund can be broadly classified under three approaches: fundamentally managed equity, quantitatively managed equity, passively managed government debt and externally managed funds (covering all asset classes). As part of the stock selection process for the fundamentally managed portfolios, any fundamentally material climate-related risks and opportunities (such as carbon pricing and the low carbon transition) are individually assessed by the managers and monitored in the portfolio holdings. Both the fundamental and quantitively managed equity funds utilise engagement with managers to improve practices. The selection and monitoring process for external managers incorporates ESG elements, and this is continuing to be refined.

The internal managers continue to monitor opportunities in the green energy and future technology space, both in the public and private markets. Much of the public spending on green energy is being done by the incumbent energy providers (the diversification of carbon-extractive companies and carbon burning utilities).

Climate Change - Risk Management

The Fund produces annual carbon footprints for listed equities. Individual companies within this exercise can have their weighted average carbon intensity measured, allowing a look through into the concentration of carbon emission risk associated with each company. This has been useful in helping to guide engagement efforts and highlighting companies that could pose a capital risk in the event of an acceleration in the low carbon transition. To date, no divestment due to outsized climate-related risks have been made. Specific research budget has been allocated to data services associated with ESG and climate-related risks and opportunities.

Climate Change - Monitoring and Metrics

The Joint Investment Strategy Panel, Committee and Board all receive regular papers on general ESG (including climate related) issues and on specific climate-related risks and opportunities. The internal management team has a suite of tools available to them. Within equities, the team utilises MSCI ESG tools, including Carbon Metrics. This allows the managers in depth assessment of ESG risks and individual carbon emissions data for all the underlying companies enabling the Fund to produce annual carbon footprints for the equity portion of the Fund.

Recent additions of data from the Transition Pathway Initiative and Carbon Action 100+ are being incorporated into the equity management process.

Recent access to GRESB data in the infrastructure and real estate asset classes is being assessed and will be incorporated into reporting in these areas over time. Support for the Carbon Disclosure Project also allows access to useful research that is considered during due diligence on investments.

Manager Selection and Monitoring

While most of Lothian Pension Fund assets are equities and bonds that are managed internally, a proportion of investments are managed by third party managers. These external managers transact in public and private markets, investing in the equity and debt of infrastructure-related, corporate and property assets. One of the core elements of due diligence in the appointment process of managers centres on their approach to ESG issues. After appointment, Lothian continues to monitor the managers quarterly and as part of this quarterly reporting and monitoring cycle, managers are obliged to provide information on ESG related issues arising and how the managers are reacting to them.

Impact

An emerging theme in global responsible investment is Impact Investing – the provision of capital to address social and/or environmental issues. Investments are made in projects that aim to generate both a positive financial return and a non-financial return – the latter is often referred to as an environmental dividend or a social dividend.

These non-financial positive impacts can be linked to the aims of the United Nation's Sustainable Development Goals (SDGs), which can be viewed at https://sustainabledevelopment.un.org and are a collection of 17 global policy areas identified to provide the greatest transformational potential to society. While these SDGs were written for policymakers, some investment professionals have begun to adopt them to target specific non-financial outcomes from their investment activities.

Lothian Pension Fund is regularly presented with these types of investment, and while not targeting Social and Environmental Impact alone, it will invest in them where they are expected to deliver an appropriate risk-adjusted return. The Fund makes investments in Private Equity, Private Debt, Infrastructure and Real Estate, which involve the deployment of capital into new projects, which are expected to have a positive impact, such as wind farms and other clean energy and modern, sustainable, energy efficient buildings. In this way, the Fund's capital creates jobs, cutting edge new environments, and the clean energy that society will need in a low-carbon future – and all while providing sustainable risk-adjusted returns for the Fund.