SUMMER 2020

ENGAGE

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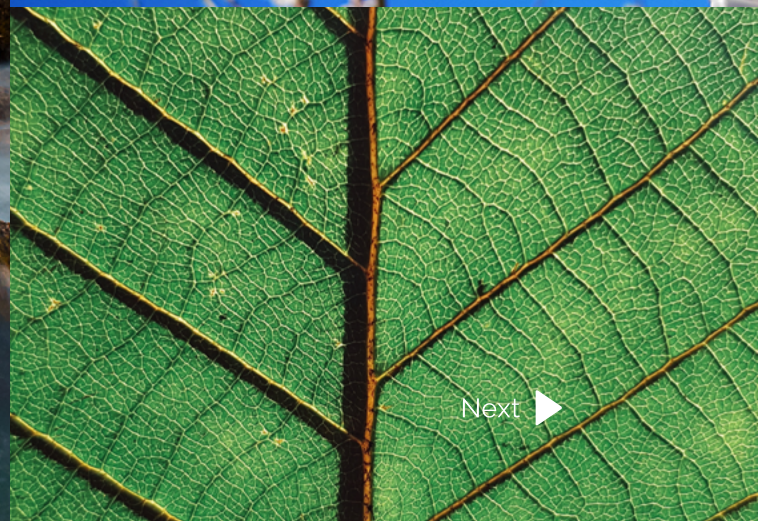
LOTHIAN PENSION FUND



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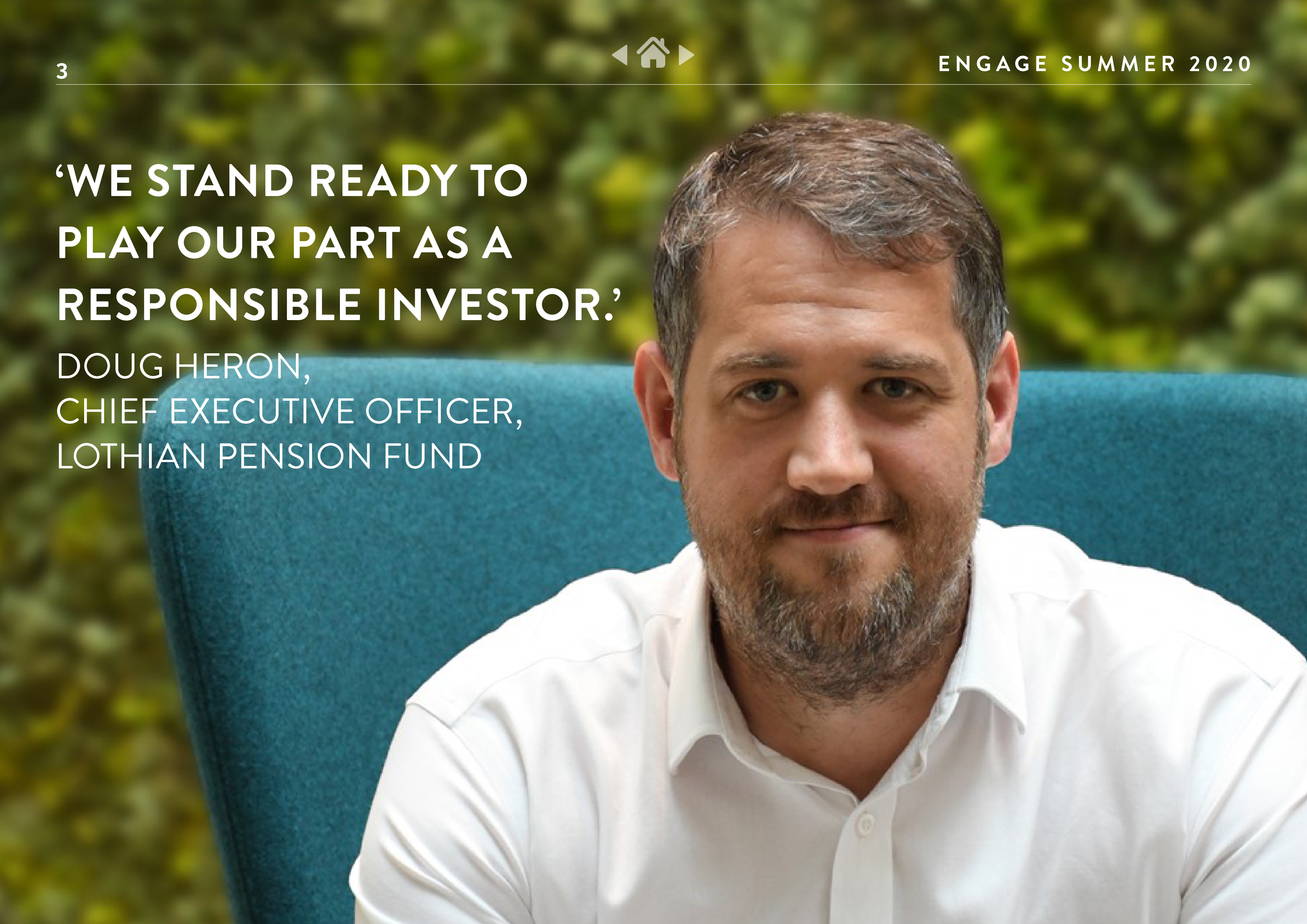
‘WE STAND READY TO PLAY OUR PART AS A RESPONSIBLE INVESTOR.’

DOUG HERON,
CHIEF EXECUTIVE OFFICER,
LOTHIAN PENSION FUND



FOREWORD

Welcome to the second issue of our ESG ezine ENGAGE. It's only been a short time since the first issue of ENGAGE, but the world has changed more in those few months than usually happens in decades with the effect of the pandemic. Coronavirus has affected the lives of us all and never has there been a time more appropriately described as 'unprecedented'. Globally, we've seen:

- **Unprecedented contractions in the GDP of Western economies**
- **Unprecedented levels of government stimulus**
- **Unprecedented job losses**
- **Unprecedented hardship faced by so many in our community**

The shape of the economic recovery at home and around the world will be determined by the response from individuals, corporates and governments and we stand ready to play our part as a responsible investor.

For us, managing investments has always been about more than just buying and selling shares and collecting dividends. Our holistic approach involves reviewing ESG data, engaging with companies where there are issues of concern, and actively voting where material decisions are concerned.

We temporarily closed our office on 17 March and since then our team has been working from home. While you might think that we'd be forced to operate a skeleton operation while everyone is working remotely, this has been far from the truth. As well as meeting our key objective of paying all our pensions in full and on time, we've been able to expand our pensions administration team, taking on five new trainees to entry level roles, alongside a new compliance officer and a project manager.

We also kept up the momentum in our Responsible Investing activities. The team has been working on a new policy document called the Statement of Responsible Investment Principles, which sets out our approach to investing responsibly in all our asset classes and our position on climate change and the carbon transition. Not only was this completed during lockdown, it was adopted by the Pensions Committee during our first full meeting which was held virtually.

We discuss the impact of this on page 6, as well as looking at how our equity managers engage with the companies in their portfolios on pages 12 and 13. Finally, our direct property manager Nicola discusses how we've been managing the relationships with our tenants, most of whom have been adversely impacted by the COVID-19 crisis.

We also made a bold step in implementing a new stock recall facility where we have loaned some of our shareholdings to other market participants. The change allows us to vote our full holding and gives more weight to our influence. We hope others follow our lead here.

I hope this issue gives you greater insight into just some of the great work our team have been doing. I'm proud of the adaptations our entire team has made during this extremely difficult time, and I'm confident that we're managing the assets we hold on behalf of our members in the holistic way I describe above. We might still be working remotely, but we're still here working hard for our members' pensions and their future.

Doug Heron
Chief Executive Officer
Lothian Pension Fund

STATEMENT OF RESPONSIBLE INVESTMENT PRINCIPLES

At Lothian Pension Fund (LPF), our mission is to deliver a valued and sustainable retirement savings product for our existing and future members. We believe that as a provider of responsible capital, the Fund should be an agent for positive change, engaging with companies to help them maintain or adopt best business practices and sustainable business models.

The last few years have seen enormous growth in the acceptance of the importance of informed stewardship and responsible investment of the assets at LPF. We were therefore delighted when the Pensions Committee at City of Edinburgh Council adopted our new LPF Statement of Responsible Investment Principles (SRIP) on 24 June.

This SRIP complements our Statement of Investment Principles (SIP), which is a statutory requirement codified in the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010. The SRIP explains our approach to the oversight and monitoring of the Fund's investment activities from an RI and Stewardship perspective. It also sets out our approach to investing responsibly in all our asset classes, as well as our position on climate change and the carbon transition.

Climate Change is undoubtedly one of the defining issues of our time. We've recognised this in our actions in recent years, including co-filing a successful climate resolution at BP's AGM last year, and in joining the collaborative engagement effort, Climate Action 100+, where we've become a key part of the team engaging with the Finnish utility company Fortum.

We've made some specific commitments going forward: to measure the carbon intensity of 100% of our assets by 2022; to cease any primary investment in companies that aren't aligned with the goals of the Paris agreement; and to continue engaging with non-Paris aligned companies until 2025 with any companies making little progress towards the goals likely being divested at this point.

You can view the full Statement of Responsible Investment Principles here.

‘THE MANTRA WE’LL FOLLOW FROM NOW ON IS VERY CLEARLY ‘ENGAGE OUR EQUITIES, DENY OUR DEBT’. AS A RESULT, WE’LL NO LONGER SUPPLY NEW FUNDING TO NON-PARIS ALIGNED COMPANIES EITHER THROUGH NEW BOND ISSUANCE OR THROUGH NEW EQUITY ISSUANCE.’

DAVID HICKEY, PORTFOLIO MANAGER AND ESG LEAD

KERING GROUP: PROVING PROFIT AND PURPOSE CAN GO HAND IN HAND

I've covered Kering for many years, meeting annually with the CEO Mr Pinault (below right) since 2014. While you may be unfamiliar with the name Kering, you'll no doubt know the brands owned by the company: Gucci, Yves Saint Laurent, Balenciaga, Alexander McQueen and many more. Since carving out the company's holding in Puma, the company has been a pure play luxury company. Kering is currently owned by LPF.

Mr Pinault was the final CEO I met before lockdown started. Despite being one of Europe's wealthiest men (net worth estimated at $37bn), he retains day to day control of the company his father founded and has an entrepreneurial attitude missing from many CEOs. With his family remaining as the largest single owner of the business at 42%, Mr Pinault is inextricably linked to the company. When buying a company such as Kering, one buys the managers as much as the company.

As always, we had a very dynamic discussion on sustainability issues at the group. The company believes that sustainable is the 'new normal', and that customers are becoming increasingly aware of the need for sustainability in their buying habits. It's considered that brands slow to adopt sustainable practices will erode over time, as customers switch, and legislative efforts force them to change. It's therefore far better to include sustainability as a key part of corporate culture, as Kering is trying to do.

Kering believe that just as fashion ideas filter down from the catwalks to the mass market, it's the responsibility of luxury brands to pioneer sustainable practices that will be adopted by mass market brands. A company is at risk of losing its "social license" to operate if it grows at over 10% per year with 30% margins and doesn't prioritise sustainability. An interesting attitude within Kering is that "sustainability should be open source" and the company is happy sharing best practice with competitors. This ties in with LPF's approach to collaborative working on Responsible Investment issues. We firmly agree with the Kering approach, and we endeavour to work with the wider industry to find best practice. Sustainability only works properly if everyone is doing it.

Since meeting with Kering in March the company has appointed three new directors to the board, all of whom are young with a huge diversity of backgrounds. Jean Liu, an expert in mobile commerce and distribution, is originally from Beijing. Tidjane Thiam, a black South African, was most recently CEO of Credit Suisse. Emma Watson is a UN WOMEN Global Goodwill Ambassador and founder of the HeForShe initiative and a passionate supporter of just outcomes for women. She's also a well-known actor, not least for her role as Hermione in the Harry Potter films.

Like all luxury companies Kering has been guilty of racial or nationalistic insensitivity in the past, but they've learned from these mistakes and put in new systems and processes to help prevent them in the future.

To learn more about the great work that Kering do on sustainability, climate and biodiversity visit their website and the sites of their brands (Gucci's Equilibrium programme in particular). The Kering Foundation is dedicated to halting violence against women.

Kering is a great example of how sustainability and good ESG practices go hand in hand with a company's success; profit needn't be at the expense of purpose.

David Hickey
Portfolio Manager & ESG Lead
Lothian Pension Fund

‘A COMPANY IS AT RISK OF LOSING ITS “SOCIAL LICENSE” TO OPERATE IF IT GROWS AT OVER 10% PER YEAR WITH 30% MARGINS AND DOESN’T PRIORITISE SUSTAINABILITY.’

DAVID HICKEY

ENGAGING WITH PERSIMMON FOR POSITIVE CHANGE

We've owned Persimmon shares for almost eight years and have met with the management many times. While we may not be considered significant in terms of the size of our underlying holding, the fact that we're long-term investors, and spent time developing our relationship with the company, provides us with great access to, and interaction with, senior individuals.

While our investment itself has been very successful, Persimmon has experienced some high-profile issues, in particular surrounding executive remuneration and product quality. This came to a head in late 2018 resulting in the departure of the CEO, an appointment of a new CEO with a remit to focus on quality of customer care, and the announcement in early 2019 of a full-scale independent review.

Around that time, we attended Persimmon's Capital Markets event, where we were able to discuss our views on a range of issues with senior management, non-executive directors and the Chairman. These included the above issues alongside:

Succession – we discussed with the Chairman our view that internal promotion to CEO seemed important at such a difficult time.

Disappointment – we made it clear that while we understood the reasons behind it, we were disappointed that the long-term incentive plan had moved from a ten-year horizon to a three-year one.

Diversity – we discussed the lack of diversity within the senior leadership team and Board and were informed of the creation of a new Diversity Panel to address this.

Environment – we spoke about the timeline to zero-carbon, the issues (and solutions) around no longer being allowed to install gas boilers in new homes from 2025 and Persimmon's initiatives in this area.

Additionally, we visited their new brickworks facility which produces around two thirds of the company's requirements. The bricks aren't made of clay, don't use kilns and producing them actually absorbs CO2.

So why mention something that happened in 2018? Surely things have moved on? The answer to this comes in two parts . . .

Firstly, although late 2018 was just over 18 months ago, it's a short period of time relative to our investment horizon. This was an important episode that has shaped their recent past.

Secondly, yes, we've moved on but many of the things we engage on now are the same themes we engaged on in late 2018 (and even back in 2012!). Our discussions with Persimmon over the last 18 months have updated us on many areas including:

Customer care – various initiatives all designed with

achieving a more positive experience for the end customer e.g. being more conservative on delivery timeframes; installing their own full fibre to the home; digitalising the customer experience.

Diversity – signs of improvement in certain areas, particularly planning, but also education initiatives at school that will take time to bear fruit.

Environment – increasing use of timber frames, modern methods of construction and ongoing research surrounding the use of ground/air-source heaters.

It's encouraging to see the improvements that have been made, culminating in Persimmon improving their Home Builders Federation star-rating which is evidence of positive change. But there's still more to be done.

Our long-term ownership and regular engagement allow us to get a clearer picture of how things are evolving, and this helps shape both our future engagement with the company and our investment case.

Stewart Piotrowicz
Portfolio Manager
Lothian Pension Fund

PERSIMMON

THE IMPACT OF COVID-19 ON COMMERCIAL PROPERTY

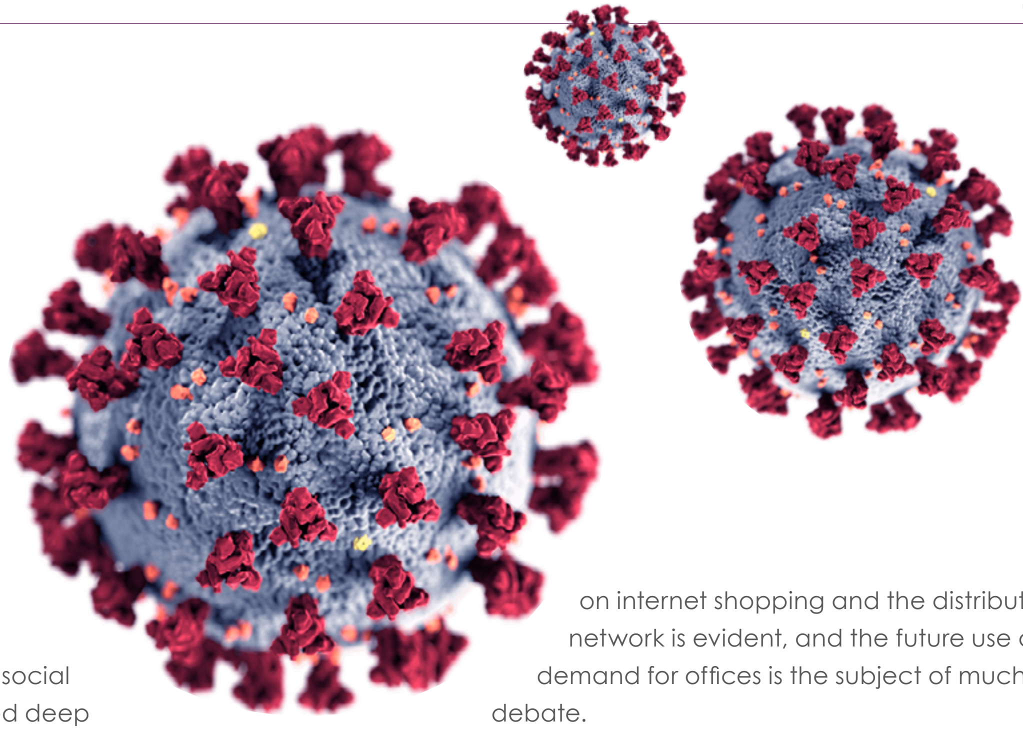
The COVID-19 pandemic continues to have a profound impact across the globe. UK commercial property has been hard hit since lockdown was imposed on 23 March when all but essential retailers were forced to close their doors and the workforce was directed to stay at home. As a commercial property portfolio owner, LPF has faced many new and challenging headwinds to safeguard the future prospects of the portfolio beyond the current crisis.

Occupier Engagement

All the main property sectors have been affected to varying degrees by the pandemic. Leisure and retail have been the hardest hit and the majority of occupiers have ceased trading from physical property since lockdown. Retailers with a strong e-tailing platform have fared better than others, but turnover is at a fraction of normal levels (with some notable exceptions e.g. supermarkets and Amazon). Offices have been shut with staff either furloughed or working from home. Many tenants, particularly those in or affiliated with the retail and hospitality sectors, are experiencing difficulties with short term cashflows and are struggling to pay rents.

As a UK balanced property portfolio owner, LPF has tenants across the main sectors and we've received numerous requests for rent holidays, deferments and other concessions to assist occupiers through this difficult period.

On a practical level the property team is engaging directly with tenants to review individual requests. Where appropriate, we seek to reach agreements that will assist vulnerable tenants' businesses now and maximise tenant retention beyond the current crisis and, where possible, extend contracted income through the removal of break options or lease term extensions. Each request is reviewed on its individual merits to assess where there's a genuine need for assistance including covenant checks, management account reviews and discussions around business plans. This has created a



unique opportunity to engage directly with tenants. We hope and expect that the relationships we're building with our direct and pragmatic approach will be mutually beneficial in the future.

Recovery Strategy

We've put plans in place for each of the portfolio's multi-let assets to prepare for the gradual return to offices, and the re-opening of shops, industrial estates, retail and leisure parks. These comply with government guidelines and our own property initiatives to ensure a safe working environment for LPF's tenants and visiting members of the public.

The plans include social distancing in common areas and mitigating actions including: the addition of signage to direct footfall; installation of protective screens at office receptions; hand sanitising stations at frequent touch points; restricted use of lifts and stairwells to comply with social distancing; and increased deep cleaning regimes.

At multi-let parks, additional signage has been installed and queuing systems for cars and pedestrians over shared footpaths and carparks has been agreed. LPF's property management consultants have coordinated this initiative and engaged with individual tenants at each site to provide practical advice.

From an investment perspective, there are many unknowns and there's a long way to go before the full impact of COVID-19 on commercial property is clear. Structural changes arising from an increased reliance on internet shopping and the distribution network is evident, and the future use and demand for offices is the subject of much debate.

There will undoubtedly be occupiers whose businesses won't survive this crisis, but by engaging early with our tenants and adopting a pragmatic and collaborative approach to find solutions to ease the financial stress that some are experiencing, we believe that we'll mitigate short term void risks arising from tenant failures. This will protect the rental income returns for the future and strengthen tenant relationships to add value over the longer term.

Nicola Barrett
Portfolio Manager
Lothian Pension Fund

'BY ENGAGING EARLY WITH OUR TENANTS AND ADOPTING A PRAGMATIC AND COLLABORATIVE APPROACH TO FIND SOLUTIONS TO ALLEVIATE THE FINANCIAL STRESS THAT SOME ARE EXPERIENCING, WE BELIEVE THAT WE'LL MITIGATE SHORT TERM VOID RISKS ARISING FROM TENANT FAILURES. THIS WILL PROTECT THE RENTAL INCOME RETURNS FOR THE FUTURE AND STRENGTHEN TENANT RELATIONSHIPS TO ADD VALUE OVER THE LONGER TERM.'

NICOLA BARRETT, PORTFOLIO MANAGER, LPF

LOTHIAN PENSION FUND

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

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