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ENGAGE

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LOTHIAN PENSION FUND

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'ASSET OWNERS WILL PLAY A MAJOR ROLE IN THE ENERGY TRANSITION AND OUR WORK WITH THE INSTITUTIONAL INVESTOR GROUP ON CLIMATE CHANGE, CLIMATE ACTION 100+, AND THE TRANSITION PATHWAY INITIATIVE DEMONSTRATE OUR CONTINUING COMMITMENT TO INCORPORATING CLIMATE ISSUES INTO OUR INVESTMENT DECISIONS.'

DAVID VALLERY, CEO,
LOTHIAN PENSION FUND

FOREWORD

Welcome to issue 4 of Engage, our bi-annual responsible investment newsletter. This is my first issue as CEO at Lothian Pension Fund, and I'm very keen to continue the strong legacy of active Stewardship that Doug Heron passed on to me. I think I've hit the ground running, signing our support of the Asset Owner Diversity Charter (discussed on page 6) and the 2021 Global Investor Statement to Governments on the Climate Crisis in my first few weeks in charge.

This November the eyes of the world will be on Scotland for the COP26 Climate Talks in Glasgow. At LPF we take our climate responsibilities seriously, and we'll be involved in a number of events during the course of the conference.

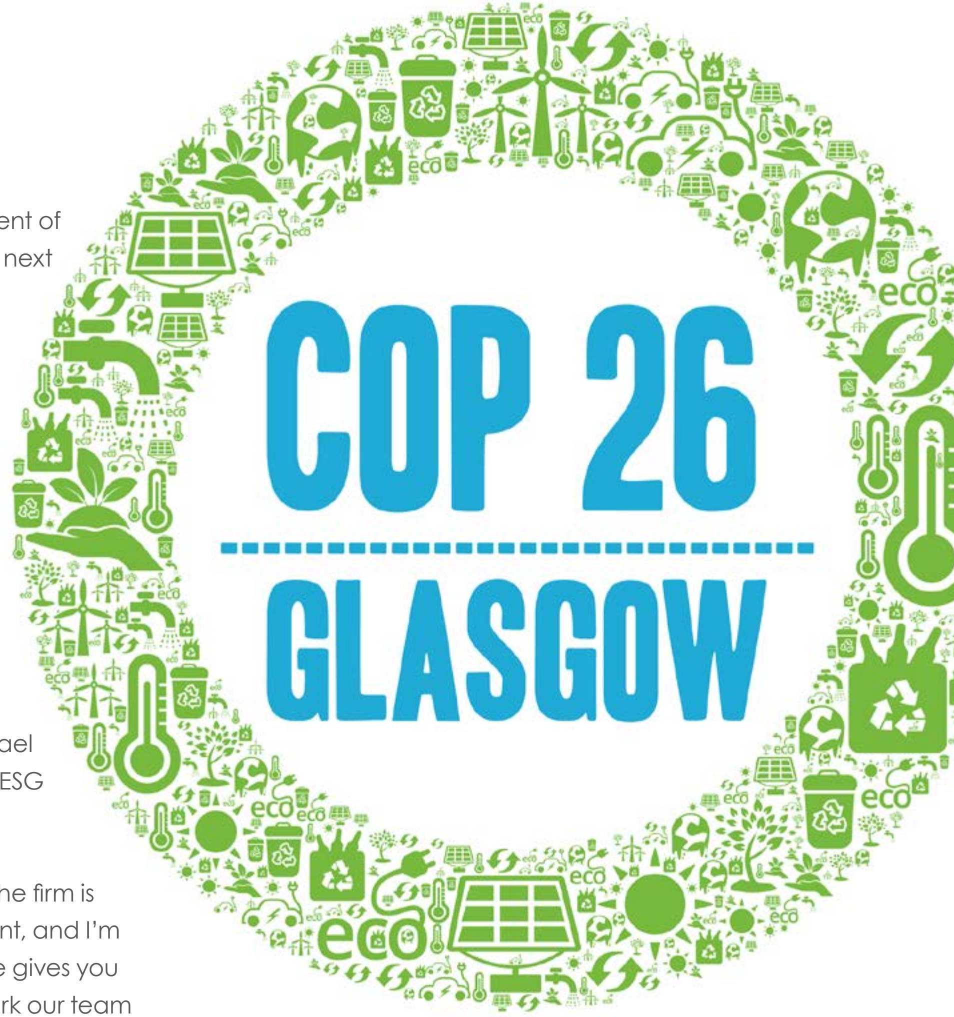
Asset Owners will play a major role in the Energy Transition and our work with the Institutional Investor Group on Climate Change, Climate Action 100+, and the Transition Pathway Initiative demonstrate our continuing commitment to incorporating climate issues into our investment decisions.

The internal team is continuing to work hard on incorporating industry best practice on climate, and further updates will be communicated in our reporting next year, along with updates to our Statement of Responsible Investment Principles (SRIP) due next summer.

While our primary responsibility is to pay our pension in full and on time, it's important that we do so without funding destructive practices, and our SRIP is explicit in how we avoid that. In this issue, you can read more about our approach to engagement to influence positive outcomes; how we work along with our private debt managers to integrate ESG analysis into the investment process; and we speak to Dalmore Capital's CEO, Michael Ryan on the importance of integrating ESG in infrastructure investment.

Coming in to LPF, I was pleased to see how the firm is considered a leader in responsible investment, and I'm keen to build on this position. I hope this issue gives you greater insight into just some of the great work our team have been doing.

David Vallery
Chief Executive Officer
Lothian Pension Fund



Q&A WITH DALMORE CAPITAL'S CEO: Michael Ryan on the importance of integrating ESG in an infrastructure investment

Tideway, one of LPF's infrastructure investments is upgrading London's sewer system to cope with its growing population. Once constructed, the 25km Thames Tideway Tunnel will intercept, store, and ultimately transfer sewage waste away from the River Thames so it can be treated.

LPF invested in Tideway through Dalmore, an external specialist infrastructure manager who continue to manage LPF's interests in Tideway. I had the pleasure of interviewing Dalmore Capital's CEO, Michael Ryan about the importance of ESG integration with Tideway.

Q1: How important is it to effectively integrate ESG in an infrastructure investment like Tideway?
We believe that seeking to maximise the socioeconomic and environmental benefits of infrastructure investments, while operating within appropriate governance frameworks, can enhance long-term returns. It's this philosophy that guides Dalmore's responsible approach to investment and aids selection of and monitoring of sustainable infrastructure projects such as Tideway.

Q2: How does the project provide environmental benefits? Tideway has an environmentally friendly purpose of creating a healthier environment for London by cleaning up the River Thames and reducing sewage discharge by over 15 million cubic metres a year. The tunnel has a significant carbon footprint due to the embedded carbon within the built asset. Throughout construction of the tunnel, Tideway has looked to reduce the carbon impact through innovation and intelligent design decisions. Tideway has also delivered various environmentally friendly initiatives, such as the implementation of the "More by River" strategy to increase the construction material transported by river as opposed to road, having avoided 23 million Heavy Good Vehicles kms to date and 14,500 tCO2e. [see page 9]

Q3: What impact has COVID-19 had on construction progress?
Like most construction projects in the UK, Tideway's operations were paused during April 2020 to ensure activities were safe and in line with COVID-19 social distancing guidelines. Operations have resumed and productivity has steadily increased. The construction programme schedule was impacted by six to nine months, with Handover now expected in March 2025.

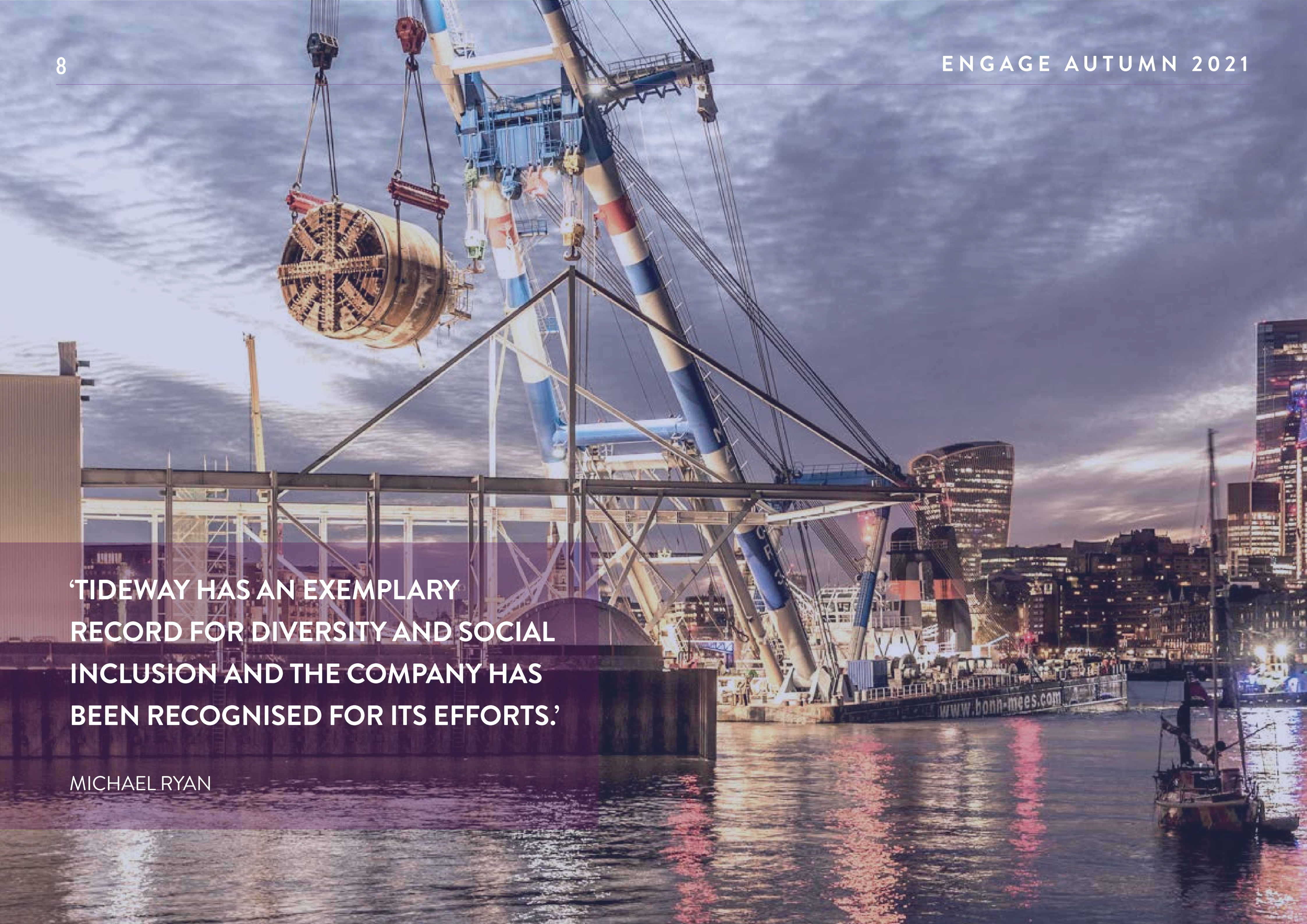
Q4: How socially diverse is Tideway's workforce?
Tideway has an exemplary record for diversity and social inclusion and the company has been recognised for its efforts by winning various accolades, including Company of the Year at the recent Global Good Awards. Tideway also supports gender diversity as evidenced by its core role in supporting "Women Into Construction" an independent not-for-profit organisation that promotes gender equality in construction. [see page 9]

Q5: What role does Dalmore take in ensuring that Tideway is delivered with a robust governance framework?
Dalmore seeks to implement and influence appropriate governance structures and robust risk management frameworks in all investments, and we promote responsible business ethics and integrity in all that we do. Dalmore has three representatives on the Board at Tideway and is well aligned with other shareholders on the company's vision. The governance framework is enhanced by the presence of five independent non-executives on Tideway's Board of 13 Directors who all bring a diverse range of experience to Board decisions.

Q6: How does the investment contribute towards meeting the UN Sustainable Development Goals?
Tideway's core environmental benefits will make a long-term direct contribution to SDG 6 Clean Water and Sanitation and SDG 11 Sustainable Cities and Communities. During construction, Tideway is making a significant contribution to eight other SDGs.

Q7: What preparations have you made in relation to the reporting of climate-related disclosures?
Both Dalmore and Tideway support the Taskforce for Climate-related Financial Disclosures (TCFD) and are committed to ensuring that our climate-related disclosures align with TCFD recommendations. During 2021, Tideway published its first standalone Climate Related Financial Disclosure report and Dalmore integrated TCFD recommendations in our annual ESG Highlights Report for the first time.

Andrew Imrie
Portfolio Manager



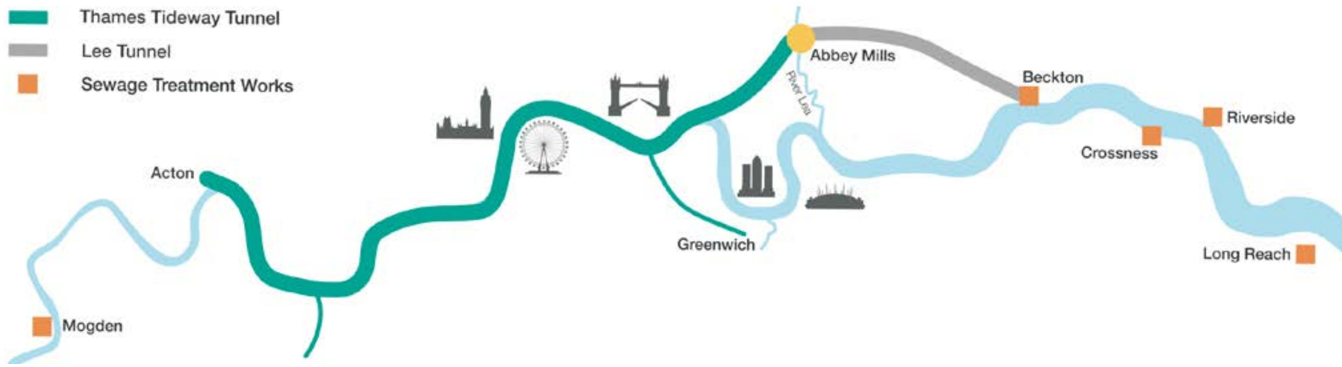
'TIDEWAY HAS AN EXEMPLARY RECORD FOR DIVERSITY AND SOCIAL INCLUSION AND THE COMPANY HAS BEEN RECOGNISED FOR ITS EFFORTS.'

MICHAEL RYAN

Figure 1.

Thames Tideway Tunnel (accompanies Q2)

Route selection led to 19% reduction in material use through the selection of a shorter route.



Source: https://www.tideway.london/media/5098/j0114_-climate-related-financial-disclosure-report-vis5-2.pdf

Figure 2.

Diversity Statistics (accompanies Q4)

	Aim	Achieved
Apprentices	1 in 50 employees	1 in 43 employees
People with convictions	1 in 100 employees	1 in 166 employees
London Residents	25% of workforce	26% of workforce
Females	40% of workforce	36% of workforce

'I'M LOOKING FORWARD TO THE DAY WHEN THOSE WORKING IN THE FUND MANAGEMENT INDUSTRY FULLY REPRESENT THE DIVERSITY OF OUR ECONOMY.'

DAVID HICKEY

ASSET OWNER DIVERSITY CHARTER

The summer of 2020 was marked by outrage around racial injustice brought to a frenzy by the murder of George Floyd. George Floyd joins a long line of black men and women whose mistreatment or death has sparked outrage in civil society, without bringing about the change promised in the aftermath of those tragic events. I remember as far back as the Rodney King riots and note that, despite seeing similar stories repeatedly, the inequalities my black friends and colleagues face don't seem to significantly reduce.

Fund management is a particular area where diversity is an issue. There are many thousands of professional portfolio managers in the UK, but there are only 13 who are black. Women get slightly more representation, though the statistics show there are more fund managers called Dave or David than there are female fund managers in the UK. The industry is very white, and very male. This is problematic, as it would suggest that strong candidates from female or ethnic minority talent pools are being overlooked in favour of white men further down the bell curve. Likely named Dave.

This particular David has been working on diversity initiatives for many years, supporting the Diversity Project, Future Asset, and the Talk About Black initiative. It was during the tumultuous summer last year that a call to action on diversity by Lothian Pension Fund was met by other asset owners, and the Asset Owner Diversity Charter was born. Helen Price of Brunel Pension Partnership and I co-chaired the working group that developed the charter in an attempt to better understand our asset managers' approaches to diversity in the workplace, particularly the well-paid fund management roles. We strive to identify industry best practice and nudge our managers to build more inclusive workforces.

After many months of consultation with numerous industry groups, asset managers, asset owners and pension consultants, we launched the charter at the beginning of August with an exclusive in the Financial Times. I'm pleased to say that asset owners and consultants, who together represent over £1tn in assets have committed to the charter. It focuses on:

- Embedding diversity and inclusion questions into the procurement process, ensuring it forms part of the scored criteria

- Embedding diversity disclosure requirements into investment management agreements and annual manager monitoring (through a diversity questionnaire)

- Leadership and collaboration to develop industry best practice

More details of the charter can be found at our website here. I'm looking forward to the day when those working in the fund management industry fully represent the diversity of our economy and there are as many Dianes, Dembas and Dings in front office roles as there are Davids!

David Hickey
Portfolio Manager

ESG IN CREDIT INVESTMENT

Equity has been the dominant asset class when it comes to ESG integration, as shareholders can engage firm managements directly and through voting rights. Bondholders, by definition, don't have these ownership mechanisms. ESG, however, is essential for bond investors too as healthy ESG behaviours help companies sustain long-term profitability and protect them from certain risks. As the upside is capped for bond investors, stability in cashflows and risk mitigations are key to returns.

At LPF, we've always taken the active engagement approach in ESG investing. In the public market, we work along with our fund managers to integrate ESG analysis into the investment process and promote industry-wide collaboration on disclosure standardisation for both companies and asset managers. More importantly, through our investment in private credit funds, we're able to have a more sophisticated incorporation of ESG to compel or encourage companies to achieve specific standards or targets through restrictive covenants and financial incentives linked to ESG performance.

For example, our direct lending funds have

introduced an ESG-linked ratchet in the interest rate of the loan, so that meeting the agreed ESG KPIs will result in a reduced interest rate of 5-15 basis points. The KPIs are carefully chosen and negotiated so they're relevant and core to the business, are measurable, and can be externally verified and benchmarked, effectively reducing the risk of green or sustainability washing we see in the public market. The KPIs are not only related to environmental issues but can also address the 'social' and 'governance' elements of ESG. Examples of the KPIs include:

- Obtaining and maintaining B Corp certification which requires commitment to high standards of verified social and environmental performance, public transparency, and legal accountability to balance profit and purpose
- Reduction in greenhouse gas emissions and energy consumption
- Employee satisfaction rate and gender diversity by ensuring a balanced ratio of female to male managers.

We believe that ESG integration with a strong focus on returns shouldn't be mutually exclusive. Thoughtful and well-designed mechanisms will be mutually beneficial for companies and investors, and this is the key to make ESG investing sustainable. We continue to work hard to lead and innovate to achieve this goal.

Miko Zhou
Senior Investment Analyst

‘THROUGH OUR INVESTMENT IN PRIVATE CREDIT FUNDS, WE’RE ABLE TO HAVE A MORE SOPHISTICATED INCORPORATION OF ESG TO COMPEL OR ENCOURAGE COMPANIES TO ACHIEVE SPECIFIC STANDARDS OR TARGETS THROUGH RESTRICTIVE COVENANTS AND FINANCIAL INCENTIVES LINKED TO ESG PERFORMANCE.’

MIKO ZHOU

ENGAGEMENT NOT DIVESTMENT

"Fossil fuels are bad, net zero is good" has become a frequent political orthodoxy. In the ongoing carbon debate, no one credibly disagrees any more with the goal to get to net zero. But whilst political slogans such as "divest fossil fuel shares" come with feelgood virtue signalling of lower theoretical carbon footprint, in practice it's more likely to prolong, rather than reduce, fossil fuel use.

The key point is that owning a share is the same as owning a house. If you sell ("divest") your house someone else then owns it, but it's still there, unchanged by the new financial ownership. This is equally true of fossil fuel shares. The actual carbon emission by fossil fuel companies is entirely unaffected by whose names are on the shareholder register spreadsheet. If anything, the management of the fossil fuel companies are happy to see troublesome shareholders divest to be replaced by supportive holders, or Private Equity, or even buybacks of these shares by the company itself.

At LPF, we fully support net zero and understand divestment isn't effective, but engagement is. Here's an example of this in practice with a stock Lothian Pension Fund owns: Exxon.

Exxon is the world's fifth largest producer of greenhouse gas (GHG) emissions (after coal from China, Saudi Aramco, Gazprom, and National Iranian Oil) and two thirds of its emissions come from countries that have pledged to reach net zero emissions by 2050. But the management refused to change and a lack of transformative energy experience on the Board left Exxon as an emblematic "fossil fuels dinosaur" unwilling to evolve. What was the solution? Divest? Just sell the shares and walk away? Hand the shares to someone else who would vote to continue to support the Exxon directors? No.

Lothian Pension Fund (alongside EOS at Federated Hermes) filed a solicitation notice with the US Securities and Exchange Commission (SEC) to propose four new Exxon directors, to bring a track record in innovation and development of low carbon business models and add significant, fresh perspective to the Exxon board to help reshape the company for the coming transition decades.

Exxon predictably fought the proposal, but in June, three of the four were successfully elected to the Exxon Board. This megalith of corporate power was brought to account by the actions of those who owned, and voted, its shares.

What if transforming Exxon had been left to those institutions who showcase how green they are, and how low the carbon footprint of their portfolio is, by divesting Exxon? They had no vote and clearly achieved nothing. Arguably if they'd sold their shares to other holders who voted to support the management, their actions would have helped to prevent the positive real-world, real-life outcome we achieved.

The slogan "Divest fossil fuels" is itself the dinosaur that needs to evolve. Perhaps more appropriate is "Fossil fuels are bad, voting fossil fuel stocks is better"?

Jeff Saunders
Portfolio Manager

‘AT LPF, WE FULLY SUPPORT NET ZERO AND UNDERSTAND DIVESTMENT ISN’T EFFECTIVE, BUT ENGAGEMENT IS.’

JEFF SAUNDERS

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

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