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ENGAGE

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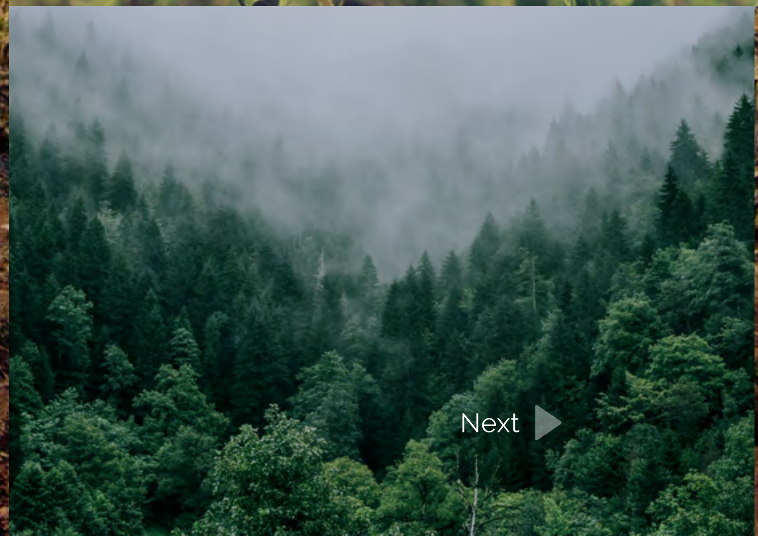
LOTHIAN
PENSION FUND



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FOREWORD

Our mission is to deliver a valued and sustainable retirement savings product for existing and future members of Lothian Pension Fund.

We take a holistic view in aligning our sustainable investing beliefs towards our investment activities. There's a clear recognition that each of the three factors: Environmental, Social and Governance (ESG) play an important role in driving the long-term value of the Fund's investment portfolio.

We believe that as a provider of responsible capital, the Fund should be an agent for positive change, engaging with the companies to help them maintain or adopt best business practices and sustainable business models.

I hope this first issue of ENGAGE gives you a greater understanding of our approach and insight in to just some of the Fund's investment activities and how this forms part of our longer-term strategy.

Doug Heron
Chief Executive Officer
Lothian Pension Fund

LPF KEY FACTS

- We administer the Local Government Pension Scheme in Edinburgh and the Lothians
- We're responsible for the safekeeping and investment of over £8 billion on behalf of our 84,000 members
- Our investment team manages over 85% of assets in-house within equity and bond portfolios and infrastructure investment
- We operate a regulated investment company providing resourcing, operational support, governance and deal execution for our private markets
- In March 2017, we became the first UK Local Government pension fund awarded accreditation for the Pensions Administration Standards Association and have held the Customer Service Excellence Award for the last 10 years.

RESPONSIBLE INVESTMENT

Lothian Pension Fund aims to deliver investment returns now and in the future. We act in our members' interests by positively contributing to a more sustainable and resilient financial system, supporting sustainable economic growth and a thriving and fairer society.

We've been a signatory of the UN-backed Principles for Responsible Investment (PRI) since 2008 and align our practices and processes to their six principles and definition of Responsible Investment.

Our approach is informed by our investment beliefs, policies and priorities, together with regulations and statutory guidance. The six principles are embedded in our investment processes and everyday activities.

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

PRI

‘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.’

OUR INVESTMENT PRINCIPLES

Responsible Investment is a core part of our investment policy and we always operate within the policy, legal and regulatory frameworks that apply to us. We invest on behalf of our members and their dependants and have a fiduciary duty to act in a financially prudent manner and to consider factors of ESG in the context only of the financial risk that arises from the investment.

As an asset owner in the public sector, striving for high standards of transparency within the constraints of commercial sensitivities, we're understandably subject to considerable scrutiny of our investments. Lobby groups often present ethical arguments for divestment of specific investments. They create adverse publicity to further their campaigns, sometimes being selective in their use of facts to raise awareness and to create impact, often with an incomplete understanding of the investments that they oppose.

The issues raised by lobby groups often centre on complex social, legal or moral issues, and while we're unable to divest investments for these reasons, we can use the views of lobby groups, where supported by credible evidence, to support our assessment of financial risk. As a responsible investor, LPF engages with companies in whom we invest to influence improved ESG outcomes and our belief is that doing so as an active investor is more responsible than divestment.

DUE DILIGENCE

At LPF, we believe that ESG issues affect the financial performance of the companies in which we invest. They are essential ingredients in the estimation of investment risk and opportunity, and so our investments are assessed in a rounded manner with ESG issues as an important part of that evaluation.

Evidence indicates that the shares of companies with improving ESG ratings are better investments than those that are simply highly rated. This supports our approach of engaging with companies to improve ESG practices as this can lead to better long-term outcomes for both LPF and society.

The internal team integrates ESG issues into its actively managed fundamental portfolios as part of the formal due diligence process before investments are made.

STEWARDSHIP CODE

The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting transparency and integrity in business. It sets the UK's Corporate Governance and Stewardship Codes.

The UK Stewardship Code 2020 is a substantial revision to the 2012 edition of the Code. The new Code sets high expectations of those investing money on behalf of UK savers and pensioners. And in particular, it sets a clear benchmark for stewardship as the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.

There's a strong focus on the activities and outcomes of stewardship, not just policy statements. There are new expectations about how investment and stewardship is integrated, including ESG issues. The Code asks investors to explain how they have exercised stewardship across asset classes.

The Code consists of 12 Principles for asset managers and asset owners, and six Principles for service providers. These are supported by reporting expectations which indicate the information that should be publicly reported to become a signatory.

To become signatories to the code, organisations need to produce an annual Stewardship Report explaining how they've applied the Code in the previous 12 months. LPF plan to report in-line with the new Code from 2021, and we hope to be amongst the first cohort to be deemed compliant with the new Code.

OUR ESG IN PRACTICE

In this document we show how we're approaching ESG by reference to the following three areas:

Collaboration

Achieving long term change through collaboration on improving disclosure and policy advocacy.

Engagement

Influencing the behaviour of listed companies through meaningful and structured engagement with the management teams and boards of the companies that we invest in.

Voting

Influencing management by voting on the resolutions of 100% of the companies in which we're invested.

COLLABORATION

THERE ARE LIMITS TO THE INFLUENCE THAT WE ACHIEVE AS A SINGLE INVESTOR AND THE RESOURCES WE CAN REASONABLY COMMIT. WE RECOGNISE THAT PROGRESS CAN BE BEST ACHIEVED ON ESG ISSUES THROUGH COLLABORATION WITH OTHER INVESTORS AND ORGANISATIONS.

Read on for details of the organisations and initiatives that we're supporting.

THE FUND IS AN ACTIVE MEMBER OF SEVERAL GLOBAL AND INDUSTRY ESG INITIATIVES

Principles for Responsible Investment (PRI)

We've been a signatory to the PRI since 2008 and focus heavily on how to implement the six Principles of Responsible Investment into our everyday work to be good stewards of capital. PRI are an important partner, providing excellent guidance on responsible investment and we work closely with them on the future direction of the organisation.

Federated Hermes EOS

We've been clients of Hermes EOS since 2008 and they manage most of our voting and engagement activity. Our Internal Equities team work closely with Hermes EOS in our collective approach to engagement, reflecting the areas of stakeholder interest and concern. Through working collaboratively with Hermes EOS, and alongside Hermes EOS's international client base, we're able to have a stronger voice when engaging with our investee companies.

Climate Action 100+ (CA100+)

CA100+ is an international collaborative initiative encompassing investors representing over $35tn in assets. 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˚C 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˚C, and improve investment decision-making.

THE TRANSITION PATHWAY INITIATIVE (TPI)

The Transition Pathway Initiative (TPI)

TPI is a global initiative led by asset owners and supported by asset managers. Aimed at investors and free to use, it assesses companies' preparation for the transition to a low-carbon economy, supporting efforts to address climate change. TPI:

- Evaluates and tracks the quality of companies' management of their greenhouse gas emissions and risks and opportunities related to the low-carbon transition
- Evaluates how companies planned or expected future carbon performance compares to international targets and national pledges made as part of the Paris Agreement
- Publishes the results of this analysis online through a publicly-available tool hosted by its academic partner, the Grantham Research Institute on Climate Change and the Environment at the London School of Economics and Political Science (LSE).

We're a public supporter of TPI and the extremely useful data they produce.

THE LOCAL AUTHORITY PENSION FUND FORUM (LAPFF)

LAPFF is a collaborative shareholder engagement group, comprising 80 UK local authority pension funds and six of the LGPS pension fund pools in England & Wales. A member of Lothian Pension Fund's Pensions Board, John Anzani, is on the executive board of LAPFF and has represented LAPFF and its member funds in high level engagement with company management.

LPF also work closely with other asset owners in several semi-formal working groups including:

- The Cross-Pool RI Working Group: a group comprised of the heads of responsible investment at the English and Welsh local authority pensions pools, alongside representatives of many of the underlying schemes and the Scottish local authority pension funds
- The UK Asset Owners RI Roundtable: a group comprised of several UK asset owners including the local authority pools, many corporate schemes including Railpen, NEST and Unilever, and faith-based funds including the Church Commissioners and the Church of England Pensions Board
- The Scottish Asset Owners RI Roundtable: a new collaborative initiative between Scottish Asset owners. Members include local authority funds, Universities, and corporate defined-benefit and defined-contribution pension schemes.
- All these groups aim to share best practice between asset owners with the aim of bringing up RI standards throughout the industry. We're very active in the initiatives of these groups.

ENGAGEMENT

We believe that the best way to alter listed company behaviour is through meaningful structured engagement with the management teams and boards of the companies that we hold.

The Fund commits significant resources to engagement activity, most of which is undertaken by the Fund's voting and engagement service provider and partner, Federated Hermes EOS (EOS).

FEDERATED HERMES EOS BRINGS A FOCUS AND EXPERTISE IN ENGAGEMENT ACTIVITIES, AS WELL AS SCALE PROVIDED BY ITS OTHER LIKE-MINDED CLIENTS.

As EOS engages on behalf of a wide shareholder base, they can effectively influence management to enact positive change in investee companies.

EOS consults with its clients to develop an engagement plan so that it can prioritise engagement activity. The latest plan (available on our website [**click here**]) highlights 12 main themes for engagement over the three-year period 2019-21.

In the diagram on page 12, the themes surrounding the core subjects of engagement activity are: 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 theme; and EOS' description of best practice in each area.

We stand behind EOS in achieving progress in each of these areas, and our Internal Equities team offer support and ideas to help them to carry out this vital work.

Our Internal Equities team undertake formal and informal engagements during their many company management meetings each year. The highest profile of these is the Fund's participant membership of Climate Action 100+, where the internal portfolio managers represent investors totalling $35tn of assets in engagement with a major European utility company.

VOTING

We vote on the resolutions of 100% of the companies in which we're invested. Two of our external providers are charged with voting on the Fund's behalf based on pre-agreed policies. This is done by Baillie Gifford, who manage assets for LPF, and EOS, our voting and engagement partner.

Annual General Meetings (AGM) present asset owners with another way to influence management on important issues. Shareholders can file resolutions which allow all other shareholders to vote on matters that aren't raised by management.

During 2018/19, we 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.

As reflected in our engagement plan, LPF has a great range of key issues that we focus on gaining a deeper understanding of, as this allows us to make a meaningful difference in our management of them. Our internal team champion specific issues and these form the core of our internal work and communication this year. More information can be found in the following pages.

GOVERNANCE CHAMPION

Bruce Miller,
Chief Investment Officer
for Lothian Pension Fund

My experience of ESG analysis began in the mid-1980s, except the acronym wasn't coined until many years later! There was, however, a clear understanding that the 'G' in (what would become) ESG could be an important driver of future investment returns. Corporate governance wasn't as clearly defined as it is today, but nobody doubted its relevance.

The 'E' and the 'S' were well established considerations too. The founding of both Greenpeace and the US Environmental Protection Agency in the early 1970s signalled growing environmental awareness at individual and governmental level, and the subsequent period of high price inflation had exposed social issues that manifested themselves in the three-day week and labour disputes.

Into the 1980s, and notable headlines early in my career included the Bhopal gas leak disaster, the Chernobyl nuclear reactor explosion and the Exxon Valdez oil spill – all examples of human and environmental disasters caused in some way by governance failures. It strikes me that most ESG issues seem to stem from poor governance.

Good corporate governance is about mitigating the conflicts of interest that arise between key stakeholders in a company, not least between shareholders and management. It's all about having good checks and balances and controls – things that were sorely missing in some of the great frauds and scandals of corporate history, including the collapses of the Maxwell publishing empire, the FTSE 100 conglomerate Polly Peck and the BCCI bank.

The governance failings at these companies caused permanent impairment to shareholders' capital, and so it's for that reason that we pay so much attention to the 'G' in ESG.

IMPACT CHAMPION

Doug Heron,
Chief Executive Officer
for Lothian Pension Fund

After taking on the CEO role in February 2019, an early priority was to learn how the various stakeholders in our Fund see our responsibilities as global investors. In particular, how they'd like the active management of our assets to drive real-world impact.

Impact investing is an emerging field and covers two separate but closely connected things:

- **Investing for impact involves looking at a specific area to generate positive outcomes through investing in and driving money into that area. As this is a relatively new frontier of investment, there's mixed evidence about how well investment can be targeted, and whether returns are compromised in the process.**
- **Looking at the impact of your investments. We maintain a broad portfolio of investments across different asset classes, many of which have specific and measurable real-world impacts.**

We already measure the carbon footprint of our equity portfolio and plan to expand that measurement to the entire portfolio in the coming years. Our infrastructure portfolio includes windfarms and hydroelectric schemes that generate low-carbon electricity and help towards the UK's transition to a low carbon economy. We provide loans to housing associations to help allow them to build and maintain vital social housing, and we invest in schools and hospitals throughout the UK. While we're not making these investments for impact alone, it's clear that in providing this capital there's a host of useful real-world impact stemming from them.

This year I plan to look at how to measure this impact more formally and bring you further detail of the great things your pension capital is doing, while still providing a financial return that supports sustainable and secure pension benefits.

CLIMATE CHANGE CHAMPION

David Hickey, Responsible Investment lead at Lothian Pension Fund

I've developed LPF's RI approach since 2015, with a particular focus on climate change. As there's a lot of information and misinformation out there, it's a very difficult subject to tackle. One thing is clear though; that human activity is extremely likely to be the main cause of climate change, and left unchecked, it could cause irreparable damage to the world.

From an investment point of view, there are major risks. The first relates to the need to reduce greenhouse gas emissions in line with the UN's Paris Agreement. Companies involved in industries extracting fossil fuels and those who create a lot of greenhouse gas emissions during production (such as cement and steel) could be vulnerable.

The second issue is physical risks to our assets stemming from environmental changes. Do we own property at risk of increased flooding in a world with higher sea levels? Will weather patterns change and affect the performance of our wind and solar assets? We must be prepared for these long-term threats.

We deal with climate change risks in two ways – through our investment selection process and through our engagement activities. In our day-to-day meetings with company managements, we always discuss how they propose to align their business with the aims of the Paris Agreement, and we also encourage external managers to do likewise.

And we commit considerable time and effort to our engagement activity on climate change. We're a participant member of Climate Action 100+. This means we represent investors with USD $40 trillion of assets under management in our regular contact with a large European company with the aim of mitigating risk for our investments and for the planet. I didn't expect to be doing that when I joined LPF.

INFLUENCING CHANGE

We've had great success working with BlackRock, the world's largest asset manager. Alongside collaborative colleagues Faith Ward at Brunel Pension Partnership, Edward Mason at the Church Commissioners and Kaisie Raynor at Lloyds Banking Group, we were able to influence wholesale changes to voting and engagement policy at BlackRock. This included stating alignment with the aims of the Paris Agreement, and committing their $6tn in assets under management to the goals of Climate Action 100+.

This work by small but committed asset owners, representing the views and interests of their stakeholders, has changed the direction of the largest asset manager in the world.

"THE COLLABORATION OF ASSET OWNERS AND ASSET MANAGERS – AND INDEED ALL FINANCIAL MARKETS PARTICIPANTS – IS GOING TO BE HUGELY IMPORTANT AS WE ADDRESS THE MANY DIFFERENT CHALLENGES POSED BY CLIMATE CHANGE. LOTHIAN PENSION FUND'S SUPPORT FOR BLACKROCK'S EFFORTS IN THIS AREA IS ENORMOUSLY APPRECIATED, AS IS THEIR LEADERSHIP ON THE CLIMATE-RELATED QUESTIONS FACING OUR INDUSTRY."

Rachel Lord, Head of Europe, Middle East and Africa, BlackRock