SUMMER 2024

ENGAGE

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LOTHIAN PENSION FUND

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WELCOME TO ISSUE 8 OF ENGAGE

Welcome to Engage Issue 8! We had an exciting start to 2024 as we welcomed colleagues into our new office at Haymarket Square. The new location facilitates more collaborative working, as well as enabling us to host more meetings in-house.

It's been a busy start to the year for our investment team with the completion of our triennial valuation exercise, a small change to our strategic asset allocation, and a new team structure.

This new structure clarifies responsibilities and provides greater resilience through the creation of new roles.

This issue of ENGAGE provides more details on these changes and an update on our most recent Responsible Investment (RI) activities, including our approach to the energy transition with companies through voting, policy engagement with regulators and supporting gender diversity in our industry.

I'm also pleased to announce that the Financial Reporting Council approved our latest Stewardship Report in February, confirming our continuing status as a signatory to the UK Stewardship Code.

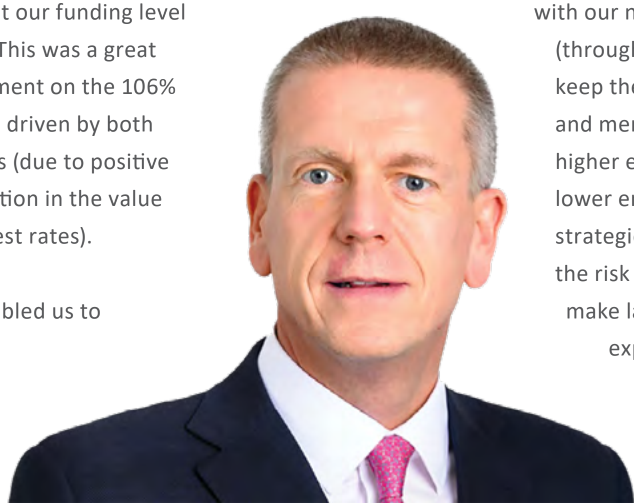
A huge amount of effort goes into the production of our Stewardship Report, which is available on www.lpf.org.uk and provides more information on all our RI activities to those interested.

We hope you enjoy this issue.

David Vallery
Chief Executive Officer
Lothian Pension Fund

INVESTMENT TEAM UPDATE

In March 2024, the Pensions Committee agreed a new Strategic Asset Allocation (SAA) for Lothian Pension Fund. The SAA review was conducted as part of the Investment Strategy Review alongside approval of a revised Funding Strategy Statement. It used the results of our 2023 actuarial valuation, in which the actuary estimated that our funding level was 157% as of 31 March 2023. This was a great result and a significant improvement on the 106% as of 31 March 2020. It has been driven by both an increase in the value of assets (due to positive investment returns) and a reduction in the value of liabilities (due to higher interest rates).



Our strong funding level has enabled us to reduce employer contributions for most of the employers in the Fund. However, the funding level only considers the ability of the Fund to pay benefits that have already accrued. As an open scheme with over 37,000 active members who will be accruing further benefits for decades to come, it's important that we balance the ability to pay accrued pensions with our need to cover future benefit accruals (through investing to grow our assets) and to keep the scheme affordable for employers and members. Investment strategies with higher expected returns are likely to require lower employer contributions, however such strategies can produce more volatility with the risk that employers may be required to make larger contributions if investments experience significant downside movements.

Policy Group (%)	Proposed Strategy
Equities	55
Real Assets	20
Credit	8
Sovereigns	15
Cash	2
Total	**100**

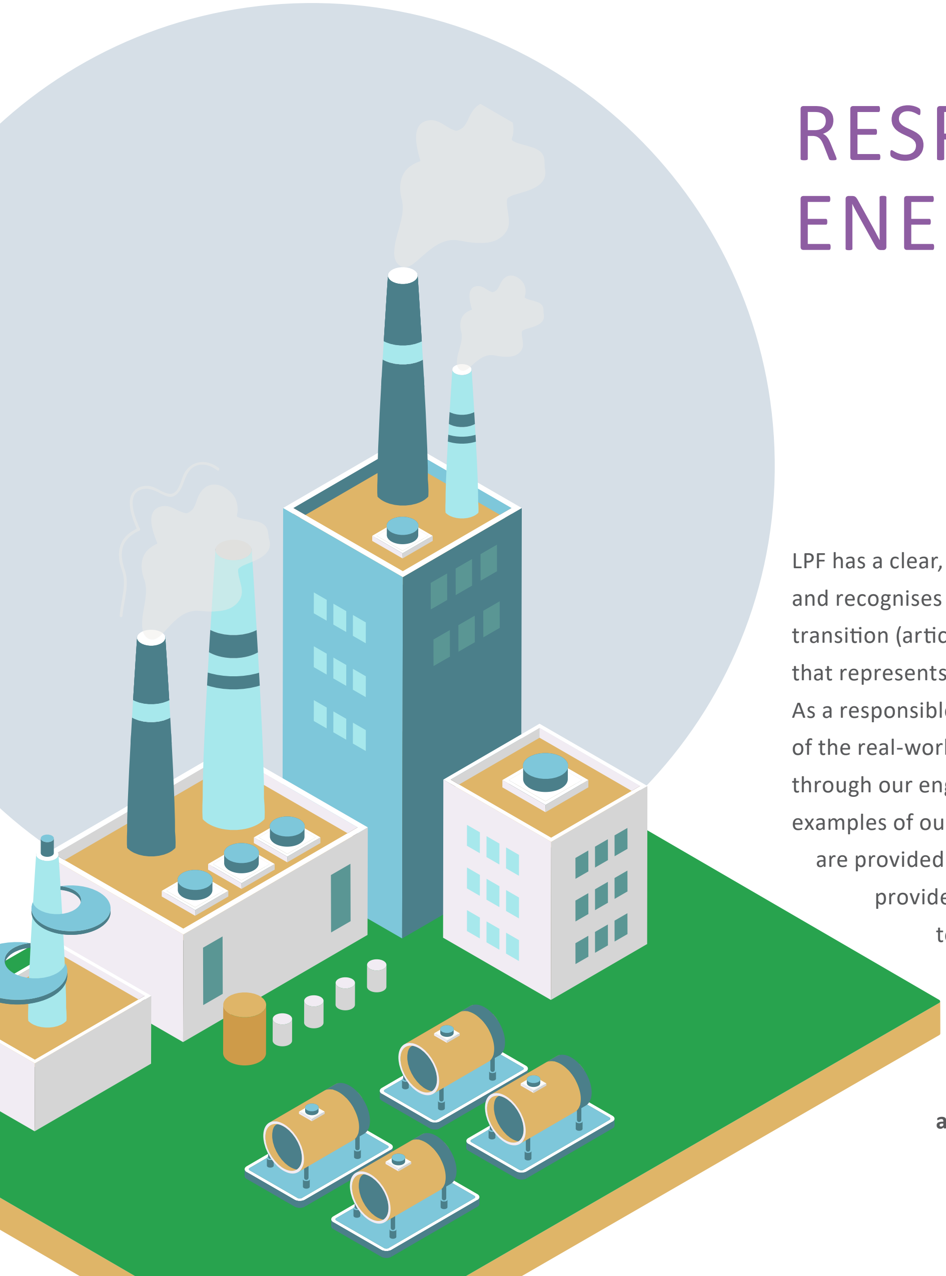
The new SAA for our Main Strategy (see chart) is based on expectations that the asset mix will generate long-term returns comfortably in excess of liabilities. It modestly reduces overall investment risk, via a 5% reduction in our equity investments and a 5% increase in our sovereign debt investments (and it includes a 2% allocation to cash, recognising the operational cash requirements of the Fund). Our internal investment team monitors actual asset allocation and adjusts exposures within the constraints of the permitted ranges where required or to make tactical investment decisions, with regular reporting on strategy to quarterly Joint Investment Forum meetings and the Pensions Committee.

Some changes to the Investment team structure were announced recently to provide improved clarity of responsibilities and greater organisational resilience. Several new roles were created, including Head of Responsible Investment, Head of Equity, Head of Fixed Income, Head of Real Assets and Head of Investment Operations. The Fund benefits from having an internal investment team, which reduces the cost of investing (less leakage to external manager fees) and facilitates more efficient implementation (fewer intermediaries).

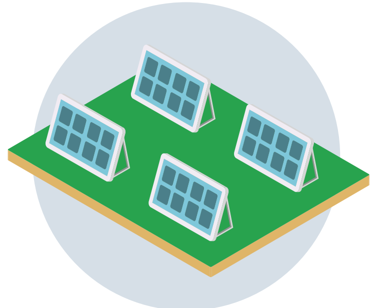
‘Having an internal investment team benefits the Fund by reducing the cost of investing (less external manager fees) and facilitates more efficient implementation.’

While everyone in our investment team is involved in responsible investment, having a dedicated Head of Responsible Investment recognises that leadership is needed to drive strategy and implementation, given the scale, complexity and evolving nature of best practice.

Emmanuel Bocquet,
Chief Investment Officer



RESPONSIBLE INVESTMENT UPDATE: ENERGY TRANSITION

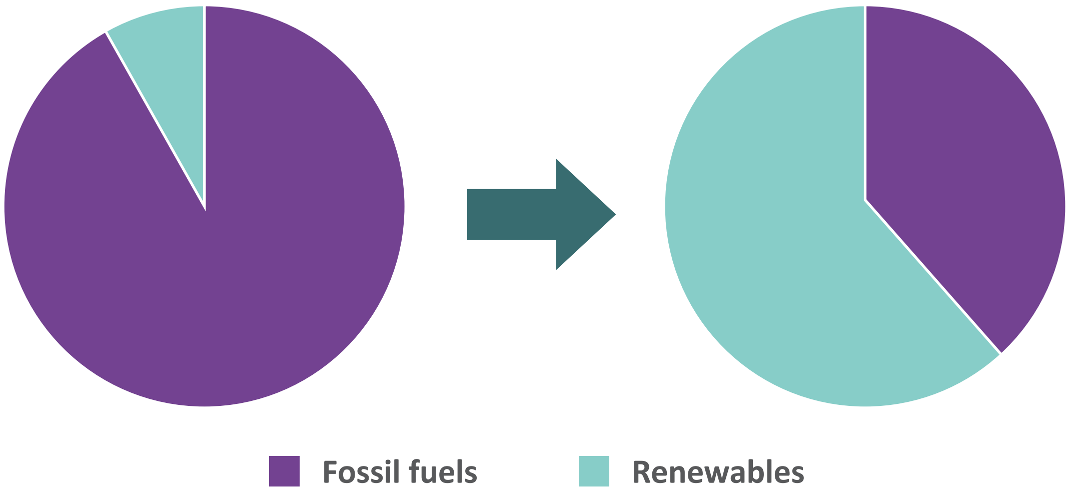


LPF has a clear, documented goal to be a responsible investor, and recognises that climate change and the need for an energy transition (articulated in the Paris Agreement) is creating change that represents both risks to, and opportunities for, the Fund. As a responsible steward of capital, we take action in support of the real-world goal to achieve net zero by 2050, in particular through our engagement and voting activities. Some examples of our engagement and voting activities are provided later in this issue, while this article provides an overview of our approach to climate change and the energy transition.

The transition of the Fund away from fossil fuels is already well underway

LPF's exposure to fossil fuel stocks is c.2% of the total Fund, however our exposure to renewables exceeds this at >3% of the total Fund. We don't have a specific goal to reduce our investments in fossil fuel companies or to correspondingly increase our investment in the transition to low-carbon energy and industry, however, the transition of the Fund away from fossil fuels is already well underway, ahead of the real economy. This reflects our existing responsible investing approach which integrates environmental, social and governance issues into investment decision-making, alongside financial metrics and portfolio construction considerations. We seek to engage with the companies in which we invest to encourage them to transition their businesses, and we assess their management of climate change risks and the ambition of their transition plan using the Transition Pathway Initiative's tools.

Global Primary Energy Consumption **Lothian Pension Fund Energy Holdings**



Sources: Global primary energy data from Reuters; LPF energy holdings data (listed equities and infrastructure investments) as at 31 March 2024

We don't consider it appropriate to exclude all fossil fuel stocks, as this approach would have no real-world benefit (merely transferring ownership to potentially less responsible owners), and it would potentially create a sub-optimal investment portfolio (less resilient to macro-economic shocks) given that the transition still has a long way to run. Fossil fuels provided over 80% of the world's primary energy needs in 2023 (Reuters). In comparison, only 40% of LPF energy sector investments are fossil fuel related.

We recognise that risks and opportunities related to the transition to the low-carbon economy arise at different times in different asset classes. In recent years we've made most of our investments in renewable energy through our infrastructure portfolio, rather than via the listed equity markets, where there's been a lot of volatility in renewable energy stock prices. However, renewables aren't the only way we invest in the transition to a low carbon economy. We've also found attractive investment opportunities in electricity transmission links (utilities), new electric or hybrid/electric train sets (transport) and energy from waste projects (environmental services). Approximately 40% of our £1.5bn infrastructure portfolio is invested in renewables and other energy transition assets (at 31 March 2024).

Gillian de Candole,
Head of Responsible Investment

‘APPROXIMATELY 40% OF OUR £1.5BN INFRASTRUCTURE PORTFOLIO IS INVESTED IN RENEWABLES AND OTHER ENERGY TRANSITION ASSETS (AT 31 MARCH 2024).’

Gillian de Candole, Head of Responsible Investment

ENGAGEMENT ESCALATION THROUGH VOTING

	Shell		TotalEnergies		Exxon	
	LPF	Vote Result	LPF	Vote Result	LPF	Vote Result
Climate strategy/progress	Against	78%	Against	80%		
Shareholder resolution	For	19%	Attempted co-filing	n/a		
Director re-appointment	For (Chair)	90%	Against (Lead Independent Director)	89%	Against (Lead Independent Director)	87%
Governance/remuneration	Against	95%	Against	92%		

Vote result indicates the percentage of votes recorded in favour of the item.

Background

Engagement is a key part of Lothian Pension Fund's responsible investment strategy. By engaging with the companies in which we own shares and exercising our voting rights, we strive to improve the sustainability of corporate strategy for the benefit of shareholders, our stakeholders and wider society.

Engagement with company management routinely includes discussion of how they'll align their businesses with the aims of the Paris Agreement, which aims to limit global warming to well below 2°C and encourages actions to be taken to limit the global temperature increase to 1.5°C. We believe that accurate measurement and disclosure of corporate emissions and clarity of strategic direction are key to accurately assessing the climate risk and potential for financial returns from our investments.

While climate change presents risks and opportunities across all sectors of the global economy, we use the Transition Pathway Initiative assessments to identify climate laggards and we escalate our engagement with climate laggards through our voting. For identified climate laggards, where we assess the company's existing climate strategy to be insufficient to meet the goals of the Paris Agreement, this may include:

- Voting against the reappointment of relevant directors
- Voting against management climate strategies/progress reports
- Voting against remuneration policies that appear misaligned to incentivising transition
- Filing/co-filing or voting for shareholder resolutions that call for robust target-setting, and a clear and credible strategy in place to achieve the stated targets.

Shareholder resolutions: Shareholders can request the inclusion of a shareholder resolution at an AGM. This could require the company to take certain actions or respond to specific concerns, for example, to set comprehensive greenhouse gas emissions targets that are consistent with the goals of the Paris Agreement. However, the company only has to respond to the shareholder resolution if sufficient shareholders support it. In addition, the rules on filing shareholder resolutions vary across countries. In the UK the concerned shareholder, or more commonly a group of shareholders, is required to meet one of the following thresholds:

- 100 members, who hold, on average shares with a nominal value of at least £100 or
- Members representing at least 5% of all voting rights.

2024 voting activity and outcome

The table summarises how we applied our policy to escalate engagement through voting on climate related items at Shell, TotalEnergies and Exxon Mobil's recent AGMs. Further information on our voting rationale is provided on the next page.

Shell (21 May 2024):

- We pre-declared and voted against Shell's Energy Transition Strategy 2024 and in favour of a shareholder proposal requesting that Shell aligns its medium-term emissions reduction targets (including greenhouse gas emissions from the use of its energy products) with the goals of the Paris Agreement as we were concerned about Shell's recent scaling back of ambition in its medium-term transition targets and the lack of indicators regarding alignment of its strategy to the Paris Agreement goals

- While we're concerned that Shell has fallen behind other European majors in terms of the range and ambition of its climate targets, we voted for the re-appointment of Shell's Chair, based on the existence of ongoing engagement and the ability to escalate these concerns via specific votes on the Energy Transition Strategy and the shareholder proposal

- We voted against Shell's remuneration report due to our assessment that the Energy Transition component of its long-term incentive plan isn't aligned to overall performance in this area. We were also concerned about the inclusion of growth in liquefied natural gas volumes as a new indicator under the future Energy Transition Strategy component of its awards.

Total Energies (24 May 2024):

- We pre-declared and voted against the company's Sustainability and Climate Progress Report. Although we recognised progress with some operational emissions reductions and investment in renewable energy generation, we were concerned about the continuing lack of disclosure related to project economics for the company's gas portfolio and pipeline which hinders investors' ability to assess alignment with credible decarbonisation pathways

- We participated in an initiative to co-file a consultative shareholder resolution at Total Energies AGM. The draft resolution called on the board to consider improving corporate governance by splitting the positions of Chair and Chief Executive Officer as we believe a more independent board could help to strengthen the company's approach to its climate change strategy and management of human rights risks. Unfortunately, the board didn't agree to include this consultative resolution on the AGM agenda, which raised concerns about the erosion of shareholder rights

- We pre-declared and voted against the re-appointment of the Lead Independent Director, holding him to account for the Board's refusal to allow shareholders a consultative vote on the above governance topic

- We voted against both the remuneration report and policy

as we had several concerns about the details, including the potential for overachievement in one year being used to offset underperformance in other years and the energy transition metrics in the policy not being ambitious enough.

Exxon Mobil (29 May 2024):

- Exxon didn't offer a vote on its climate strategy or progress
- We voted against the re-appointment of the Lead Independent Director, who chairs the company's governance committee, for inadequate management of climate related risks and to demonstrate our concern about the curtailment of shareholder rights due to Exxon's decision to sue Arjuna Capital (an investment firm) and Follow This (a non-governmental organisation of activist shareholders) for filing a shareholder resolution urging Exxon to increase action to reduce its greenhouse gas emissions. The lawsuit was subsequently dismissed following the withdrawal of the shareholder proposal and a commitment by Arjuna not to file similar climate resolutions at future Exxon AGMs
- However, we voted in favour of the environment, safety and public policy committee members (who received 96% support on average) to signal support for a number of positive climate-related actions including Exxon's withdrawal from the Independent Petroleum Association of America due to the organisation's lack of alignment with the company's climate policy, and publishing the 2024 Advancing Climate Solutions Report, which is a meaningful advancement in Exxon's reporting that includes a Scope 3 emissions disclosure.

Assessment

We decided to pre-declare some of our votes for Shell and TotalEnergies to increase transparency. It enabled us to immediately communicate our positions to our stakeholders and the wider public (in the news section on LPF's website), including the rationale for our voting decisions. Pre-declaration is encouraged by the Principles of Responsible Investment as it provides timely insight into the implementation of investors' stewardship policies.

Pre-declaration can additionally encourage others to support environmental, social and governance related proposals. Our voting record shows that LPF is part of a significant minority of "climate aware" investors pushing for more ambitious transition planning by oil and gas companies. While much more progress is needed on these companies' business transformation, their recent commitments (and actions) to reduce operational methane emissions reductions are nonetheless important to recognise as important positive outcomes of engagement activities. If all climate aware investors were to divest from all oil and gas stocks, there's a risk that there would be little further progress due to a lack of accountability to climate aware investors.

Natalie Drysdale,
Responsible Investment Analyst

POLICY ENGAGEMENT WITH REGULATORS ON CLIMATE CHANGE

Through our collaboration with other investors, LPF aim to have a more significant impact on the companies who need to transition their current operations and future investment spending to climate-friendly adaptions, but that's not the limit of where we can help drive positive change. Governments and regulators are also important stakeholders, with vital interests in addressing the risks and opportunities presented by climate change.

Our main collaborative venture is through Climate Action 100+ (CA100+), which aims to get companies to disclose vital information, allowing shareholders and other stakeholders to hold them to account, and its benchmark is a key tool for assessing whether companies across sectors and industries with the highest emissions are meeting best practices. CA100+ is coordinated by five regional investor led networks, with the Institutional Investors Group on Climate Change (IIGCC) being the body LPF are members of as part of this.

Through our relationship with IIGCC, we became aware of working groups focussing on issues such as Accounting. IIGCC's working groups are an opportunity for participants to share knowledge and respond to areas of interest using an array of perspectives from different asset owners, managers and stakeholders. Topics cover specific sectors of the economy, public policy, asset classes and more.

Alongside Accounting, LPF participate in the Utilities working group, and co-lead a CA100+ engagement informed by this. Within the Accounting working group, collaborators are kept informed of the evolving array of tools at our disposal to assess climate risk, how specific engagements are developing, and raise awareness of any live issues where collective effort can be leveraged more effectively.

'In late 2023, the Accounting working group started to assess the viability of influencing the key UK banking regulator, the Bank of England.'

In late 2023, the Accounting working group started to assess the viability of influencing the key UK banking regulator, the Bank of England, in its role as the Prudential Regulatory Authority (PRA), whose purpose is to ensure sufficient capital and risk controls are in place across the banking, insurance and investment sectors.

Banking regulation covers many aspects of how banking institutions are governed, from how they protect customers, through to how they ensure there's the capacity to absorb shocks from global and local macroeconomic volatility.

CAPITAL ADEQUACY

The availability of sufficient capital is referred to as 'Capital Adequacy' and lack of transparency on this was one of the key reasons why the Great Financial Crisis spread so rapidly, as banks were unsure whether there was enough money within the system to absorb losses, as the assets they lent against plunged in value.

Over the following 15 years, regulators have worked globally to tighten and raise standards over the quality and amount of safe assets banks must hold to be able to cope with economic volatility.

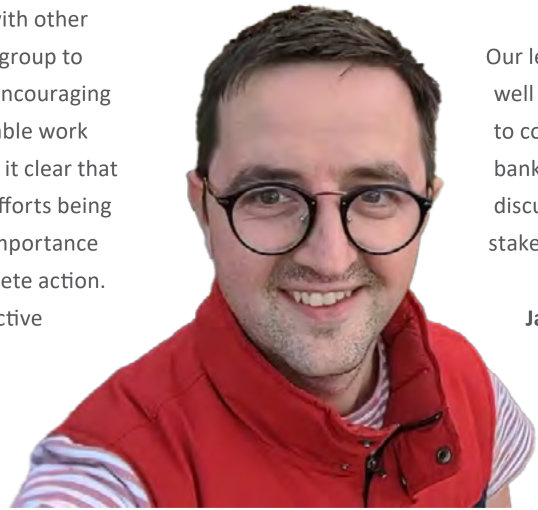
To ensure this, regulators – and investors – must have sufficient detail on the types of assets, and how their values are assessed to be able to have confidence that there's enough resilience system-wide and with individual banks.

In 2022 the PRA itself was in contact with key bank leaders, CEOs and CFOs, underlining that climate risk needs to be incorporated effectively into valuations for the assessments banks must make of their exposures and available capital to absorb losses.

Later, in early 2023, the Bank of England concluded that there's a real need to assess risk from climate change in a more forward-looking manner, as the impacts are long term, uncertain and in need of action to prepare and adapt with some urgency.

Both developments point to the necessity of clearer and more rigorous disclosures by banks so that investors can complete their duties to conduct diligent research into the risks embedded in portfolios and engage with companies accordingly. Collectively, we saw a need to support the work being undertaken by the regulators, as the key users of the improved disclosures are asset owners like LPF and the broader asset management sector.

We spent time working with other members of the working group to adapt a proposed letter encouraging the PRA to take this valuable work further forwards, making it clear that we entirely support the efforts being made, but underlining the importance of turning these insights into concrete action. In particular, we asked to see proactive enforcement of existing rules to ensure that capital adequacy is properly being assessed with realistic negative outcomes on the values of the assets that banks lend against. We asked for the regulator to also consider disclosure of climate stress-testing exercises.



Our letter, co-signed with 20 other investors, was well received by the Bank of England, and we intend to continue taking this issue forwards with other banking regulators, through collaboration and open discussion with our peers and all current and future stakeholders.

James Brooks,
Portfolio Manager

SUPPORTING GENDER DIVERSITY IN THE INVESTMENT SECTOR

Gender diversity is an area where the investment industry sadly falls short. Not only is the sector burdened with an outdated image of testosterone-fuelled trading floors, but it hasn't done nearly enough to attract and develop female talent. As a result, women make up only 12% of fund managers in the UK.

At LPF, we're mindful of our responsibility to help bring about a more inclusive investment industry. We do this both through promoting a culture of diversity, equity and inclusion among our own colleagues, as well as supporting a variety of external initiatives focused on building a fairer and more representative future.

Future Asset partnership

One such initiative that we're proud to support is our partnership with Future Asset, a charity based in Scotland that aims to inspire high-school-age girls to discover what the investment sector has to offer as a potential career choice. Future Asset runs many excellent events, including its flagship 'Growing Future Assets' investment competition where teams from across the country vie to present the best stock pitch.

This year, I had the privilege of mentoring two teams from Broxburn Academy, which was participating in the competition for the first time. Both teams impressed, with one earning a 'Highly Commended' award for their excellent research on US chocolate manufacturer Hershey, while

‘As well as offering valuable insight into what investing careers are really like, the competition helps team members to build important skills that will serve them well regardless of the direction they choose.’

the other group saw off dozens of rivals to make it to the live finals in Edinburgh where their exceptional stock pitch on Greggs earned them the runners-up prize.

As well as offering valuable insight into what investing careers are really like, the competition helps team members to build important skills that will serve them well regardless of the direction they choose. Participation in the competition has grown each year, reaching over 1,000 girls since 2020.

Supporting the next generation

It’s important to remember that addressing the investment industry’s gender diversity gap is a significant challenge. While there are signs that the industry is moving in the right direction, the rate of change is far too slow. One estimate suggests that parity in the numbers of UK male and female fund managers won’t be achieved until 2215 at the current pace.

However, by directly acting to develop the next generation of female investment professionals, there’s cause for optimism that we can accelerate the process of breaking down barriers and building a more diverse workforce. Judging by the excellent efforts of the Future Assets teams, the future is in good hands.

Mark Dobbie,
Portfolio Manager

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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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