LOTHIAN
PENSION FUND

THE STEWARDSHIP REPORT

Covering the year to 31 December 2020

LOTHIAN PENSION FUND

CONTENTS

A MESSAGE FROM OUR PENSIONS COMMITTEE

As a member of the Pensions Committee, my job is simple: it is to ensure that the pension fund is run in a sound and sustainable manner that guarantees that we deliver on our pensions promise to our beneficiaries. We do this through investing prudently and carefully. We also do this through ensuring that the companies and assets we invest in are well governed and well managed, that they minimise their negative impacts on society and the environment, and that they make a positive contribution to our societies and our communities.

This does not happen by accident. It requires us to use our voice and influence, to challenge companies when they fall short of the standards that we expect, and to stand with them and support them when they are developing and implementing strategies that enhance their long-term sustainability and resilience.

Our work to support good governance and engagement is underpinned by our belief in the power of our voice, often alongside others, to lead to positive change, that sustains and drives value for our members today and in the future.

The Pensions Committee has a critical role to play. We want LPF to take meaningful action on a range of issues, notably corporate governance and climate change. We have encouraged the fund to be at the vanguard of asset owners who are committed to moderating climate change. That LPF proved pivotal in the decision by Blackrock, the world's largest investment company, to join the CA100+ initiative is tangible evidence of the impact we can have and something of which LPF is justly proud.

On behalf of the Pensions Committee, we welcome this report as a record of LPF's efforts, outcomes and areas where it will continue to improve. It gives me great pride to see LPF emerging as a leader in responsible investment within the wider financial system on which our members and future members rely. We continue to encourage, support and commend LPF's work in this critically important area, for our members, for a resilient financial system, and for a better world.

Councillor Maureen Child
Member of the Pensions Committee
Lothian Pension Fund

A MESSAGE FROM OUR CEO

As a responsible investor, LPF has a long-established commitment to stewardship. This is our first report prepared in accordance with the standards of the Stewardship Code 2020. As a leader in responsible investments amongst LGPS funds, we've chosen to prepare and submit this report to demonstrate the nature of our commitment to stewardship, for the benefit of our stakeholders.

We think hard about our approach to stewardship and we hope this report confirms our adherence to the standards of the 2020 Code. We realise the evolving role and expectations of investors in shaping the future of our society and continue to assess how to exert our influence as asset owners where this supports our ultimate purpose of providing retirement income to members. We recognise that we need to strengthen our engagement with our stakeholders, to ensure that concerns are reflected in the way in which we invest. Ultimately, we need to deliver a valued and sustainable retirement savings product for our existing and our future members, through driving the long-term value of our investment portfolio, and contributing towards the long-term health of the financial system.

David Vallery
CEO, Lothian Pension Fund

STEWARDSHIP IN PRACTICE: **CREATING LONG-TERM INVESTMENT VALUE**

Our Duties and Our Purpose

At LPF, our purpose is to deliver a valued and sustainable retirement savings product for our members. Our fund is the second largest Local Government Pension Scheme (LGPS) in Scotland, which is a funded, defined benefit, statutory occupational pension scheme.

LPF's stakeholders are the people and entities with an interest in the assets and activities of LPF. That includes the members of the pension scheme (existing and future), their dependants and beneficiaries, as well as the participating employers who contribute to the assets of the fund, and our governing bodies. Legally, and morally, we have a fiduciary duty to act in a financially prudent manner and to act in the best interests of our stakeholders.

It's this duty that defines our approach to stewardship. We need to manage our investments responsibly and sustainably so that we can pay pensions and benefits because they'll fall due over many decades to come. We need to ensure that the risks to our investments are effectively managed as we know that Environmental, Social and Governance (ESG) factors are fundamental considerations in driving the long-term value of our investment portfolio. They matter to society, so they matter to us.

Stewardship as an Investment Function

So, what does this mean in practice? At its heart, it means that we see stewardship as an investment function. Our core responsibility is to invest in a way that takes full account of the downside risks and the upside opportunities presented by ESG factors. We need to be properly compensated for risks, avoid over-paying for opportunities, and we need to manage and mitigate these risks in our investment portfolio.

This emphasis on the investment implications of ESG issues is reflected in our approach to stewardship. We're unusual among UK asset owners in that responsibility for stewardship sits with our investment teams. It's our portfolio managers and investment analysts who are responsible for engaging with companies and with investment managers. It's our portfolio managers who lead our work with collaborative initiatives, such as the Institutional Investors Group on Climate Change.

Stewardship as a Collaborative Activity

As an asset owner acting alone, our potential for direct influence is relatively modest. While direct company engagement is important and can be influential in situations where we have a significant holding, our biggest impact comes through working with others.

Our approach to stewardship therefore includes:

- Collaboration with our industry peers. Later in this report, we refer to an example case study involving the Finnish utility company Fortum
- Engagement with our investment managers. We challenge our managers on their approach to responsible investment and ESG
- Supporting collaborative engagement through Hermes EOS, which derives considerable influence from representing owners of assets worth more than $1tn.

"The collaboration of asset owners and asset managers – and indeed all financial market 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,
Senior Managing Director, Chair and Head of Asia Pacific, BlackRock.

LOOKING FORWARD

Our aim, in all our stewardship efforts, is to ensure that the companies we invest in are sustainable and successful over the long-term and create enduring value for us as investors.
We have a long track record of voting and engaging on what are often referred to as the traditional corporate governance issues, such as executive remuneration and board independence. These issues remain of central importance. Governance failures can lead to major financial losses for investors, to avoidable job losses or harm to employees or to unpaid suppliers and creditors.

However, the world has changed profoundly. Environmental and social issues have risen up the agenda that shapes our present and our future; the threat of climate change, the harm caused to our environment by plastics and pollution, and the social and political tensions resulting from inequality and discrimination. These issues and our collective response to them will affect our ability to deliver retirement savings for our existing and future members. As asset owners with a long-term horizon, we take these global issues seriously, we exercise our ability to vote and engage and we exhort others to do the same.

We believe the most effective way is to: **'Engage Your Equity, Deny Your Debt'.**

'Engage your equity, deny your debt'

As an organisation, we've made a commitment that we'll not provide any new financing to companies which aren't aligned with the goals of the Paris Agreement on Climate Change. While the trading of equities (shares) doesn't affect the capital position of a company, subscribing to new bonds and new equity does provide companies with funding. Within our equity portfolio we engage with our holdings, and that engagement includes using the tools and strategies we have at our disposal to influence companies to commit to align with the goals of the Paris Agreement. In our debt portfolios, we aim to deny funding to those non-aligned companies.

This approach is unusual in the financial markets and has generated a great deal of interest, with other asset owners approaching us to ask how they might implement a similar policy.

OUR PRIORITIES FOR 2022

Our main priority is to continue strengthening our stewardship approach on environmental and social issues, in particular climate change, while maintaining our focus on ensuring that companies are well governed and well managed. We'll conduct a systematic review of our approach to climate change, to ensure that we align with best practices as set out by the Task Force on Climate-Related Financial Disclosures (TCFD) and the Institutional Investors Group on Climate Change's (IIGCC) Net Zero Investing Framework.

This is our first stewardship report, and it provides a context for and a description of our activities. We will continue to report on our stewardship efforts, and we invite and welcome feedback on our approach.

Principle 1

PURPOSE, STRATEGY AND CULTURE

Signatories' purpose, investment beliefs, strategy, and culture enable stewardship that creates long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.

OUR **PURPOSE**

Our purpose is to deliver a valued and sustainable retirement savings product for our existing and future members. For that reason, our primary objective is to ensure that there are sufficient funds available to meet all pension and lump sum liabilities as they fall due for payment. This means we need to generate sufficient long term returns to pay promised pensions and to make the scheme affordable to participating employers, now and in the future, while minimising the risk of having to increase contribution rates in the future.

In this report, we set out our assessment of how our purpose, strategy and culture meet the needs of our stakeholders.

Our investment beliefs

With liabilities extending decades into the future, it's in our interests to take our responsibilities as institutional asset owners seriously. To this end, our approach to responsible investment centres on effective stewardship of all assets, with a particular focus on good corporate governance to deliver sustainable value.

As required by LGPS legislation, we maintain a statement of investment principles (SIP) which articulates the investment principles which guide our strategies and decision-making. In terms of those beliefs, which enable stewardship and lead to sustainable benefits for the economy, the environment and society, we believe that:

- Responsible investment supports our purpose and that through robust stewardship and an effective approach to ESG risks, we should reduce the risk associated with the invested assets that LPF owns to pay pensions when they're due

- As a provider of responsible capital, LPF should be an agent for positive change, engaging with companies to help them maintain or adopt best business practices and sustainable business models

- In being transparent about the methods we use to foster responsible investment as an organisation and being accountable for our responsible investment strategy and approach

- Successful engagement adds value to our investment process; and that divestment has no effect on company finances in the long term and can produce perverse incentives in the short term

- As responsible owners we should engage with our investee companies and appointed managers, either directly or via collaborative partners. However, we also believe that this engagement must lead to action and where we feel progress is too slow, and the prospect of financial risk to us increases as a result, we're willing to withdraw our support and end our investment.

Finally, we believe that Climate Change is one of the defining issues of our time. We believe that asset owners are uniquely positioned to drive changes in governmental and corporate behaviour to bring about an acceleration in the sustainable energy transition and a decarbonisation of the global economy.


Protected raised bog area in rural Scotland

OUR STRATEGY

Introducing our Statement of Responsible Investment Principles

To reflect our belief in the importance of responsible investment, we published a Statement of Responsible Principles (SRIP). This describes our sustainable investing beliefs and commitments, and our strategy for integrating those with our investment activities.

Responsible investment remains a core part of the Statement of Investment Principles (SIP), which is required under LGPS legislation. However, in view of the growth in our responsible investment and stewardship activities across all asset classes, we released the first version of LPF's SRIP in June 2020 to inform members' and employers' more fully.

The SRIP explains how we incorporate ESG issues into investment analysis and decision-making processes, as well as how we seek appropriate disclosure on ESG issues from any entities in which we invest. We've also publicly confirmed our approach to climate change and the carbon transition, which we'll discuss later in this report.

The SRIP allows us to communicate with our stakeholders to explain our strategy in detail. It sets out how we implement responsible investment on an asset class by asset class basis, as well as detailing how we utilise all the tools at our disposal to achieve our stewardship aims.

Our SRIP will evolve over time to best reflect how we aim to act as responsible asset owners. While it's too soon to provide an update on the outcomes realised, we hope that it will encourage the start of an open conversation around collaboration that will lead to other funds implementing similar statements. To this end, we've confirmed that we're happy for our principles to form the basis for the wider adoption of such standards by other LGPS funds.

From oversight and monitoring, to affirming our position on climate change and the carbon transition, we'll provide examples of how we implement the SRIP throughout this report.

STRATEGY CASE STUDY: **TURNING OUR BELIEFS INTO OUTCOMES**

FORTUM

As part of climate action 100+, our internal team at LPF has been engaging with Finnish utility company Fortum to improve its carbon performance. While Fortum is a leader in European renewables, it does have plenty of carbon intensive generation, particularly in its Russian business. The company has also acquired a controlling stake in Uniper, one of Europe's largest fossil-fuel based generators, and is likely to merge the two businesses in 2022.

We've had a series of meetings with the CFO, CEO and chair of Fortum and delivered a statement (see page 50) at their 2020 virtual AGM. Our ongoing work with management is beginning to result in significant changes in policy. Following Uniper's 2035 net zero commitment announcement in early 2020, Fortum followed up with a similar announcement in December 2020. The company now aims to be carbon neutral in the European business by 2035 and has announced specific plans for the closure of 6GW of coal capacity by 2025, and a 50% reduction in carbon output by 2030 (as compared to 2019 levels). Further to this we've challenged company management on several occasions regarding corporate lobbying activities, and a policy review was announced by the company at their 2021 AGM.

Fortum still needs to undertake a a great deal of work, particularly around its plans for decarbonisation in the Russian business, but the company is taking many of the right steps. It's been a long-time supporter of carbon pricing, and its top management has entered an open and honest dialogue with the climate action 100+ engagement group.

LOTHIAN PENSION FUND

OUR CULTURE

Operating within the public sector means that we're subject to applicable public sector regulations and relevant public law duties. These require LPF to act fairly and transparently and brings us in-scope of the Freedom of Information regime. This promotes a strong degree of discipline and accountability across the organisation. We're always mindful of fulfilling our duties to stakeholders and serving their expectations regarding sustainable benefits for the economy, the environment and society.

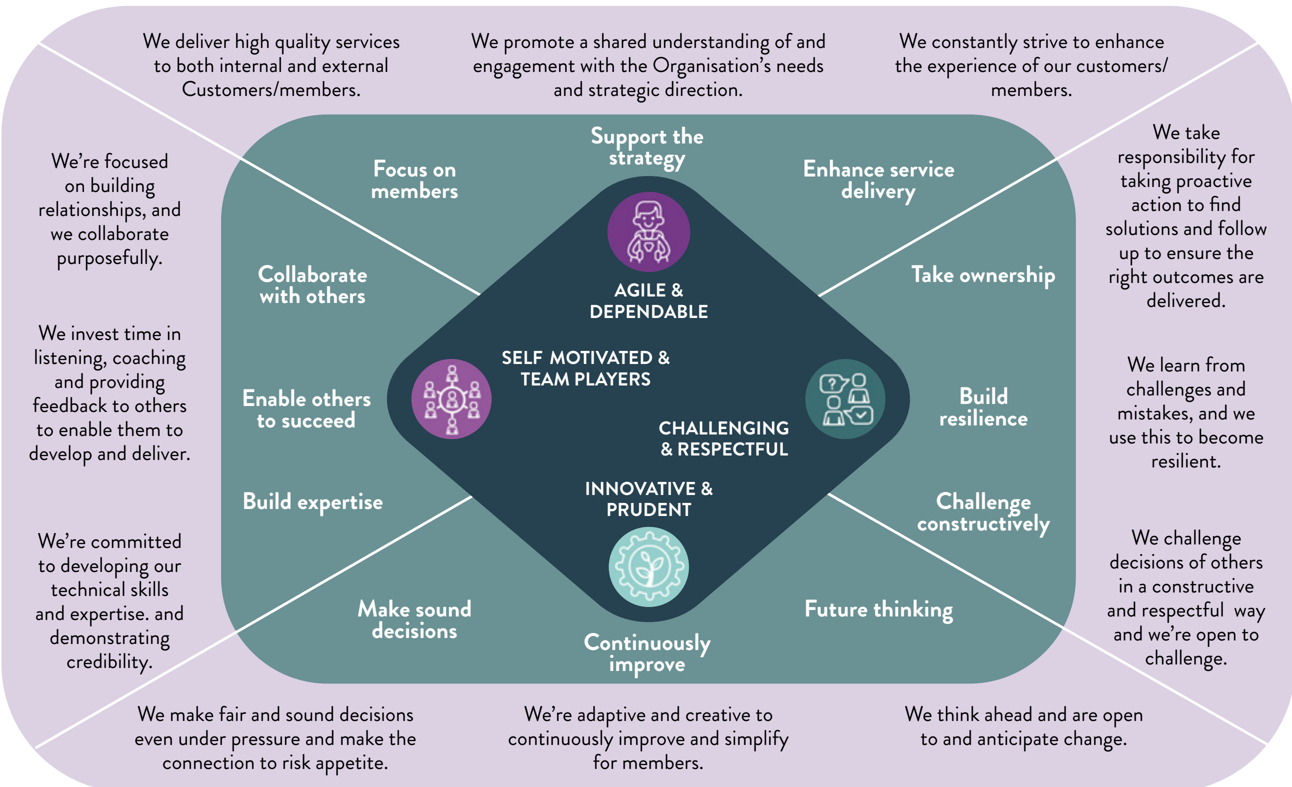
We manage over 85% of assets in-house, through internal equity, bonds and certain real asset portfolios. This aligns our investment decision-makers with our best interests.

As explained in relation to Principle 2 (Governance), operating an FCA-authorised vehicle within the group influences the culture throughout LPF. It allows LPF to build on the in-house investment expertise and promotes accountability and responsibility amongst individuals.

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. Whilst these accreditations aren't directly relevant to stewardship, they reflect LPF's high performance culture.

VALUES THAT SUPPORT OUR PURPOSE

We're passionate about enabling desirable and sustainable pensions, and our values are the enduring principles that inform, inspire and instruct the day-to-day behaviour of individuals working for LPF.



These values drive our active stance to stewardship and responsible investment and inform our approach to ESG. For example, our belief in the power of company engagement and the way in which we engage with companies and stakeholders, is relevant to our values of being 'Self Motivated and Team Players' and being 'Challenging and Respectful'.

Our value of being 'Innovative and Prudent' means that we focus on future thinking, which is critical in managing ESG risks today for positive outcomes for current and future beneficiaries.

Our combined values were also a key motivator in our decision to release our Statement of Responsible Investment Principles (explained below).

GENDER BALANCE

We recognise the importance of having a diverse, inclusive and respectful workplace. Specifically in relation to gender balance, we're working towards a goal of being fully gender balanced across the organisation by 2030.

- As of 31 March 2021, we have, in aggregate, 35% women in our top three leadership layers and across the whole company, 56% of our workforce are women
- Our mean gender pay gap is 29.3% (median: 0.36%)
- Our positive action approach to gender balance, which is benchmarked externally, is helping to ensure that our HR policies and processes are inclusive and accessible, from how we attract and recruit, to how we reward and engage our colleagues. We're confident this approach is the right one and through time, it will help us achieve a better balance of diversity throughout the organisation. During 2020, we recruited 16 colleagues and 69% of these were women.

In addition, we're proud to partner with **Future Asset,** an organisation in Scotland that enables girls in the senior phase of high school to explore how investment can change the world for the better, gain valuable, transferable skills and consider the benefits of possible future careers.

LOTHIAN PENSION FUND

Principle 2

GOVERNANCE, RESOURCES AND INCENTIVES

Signatories' governance, resources and incentives support stewardship.

A ROBUST GOVERNANCE FRAMEWORK

Relevant to stewardship, LPF has developed a focused and effective governance framework, tailored to the needs and activities of the organisation.

Pensions Committee

The City of Edinburgh Council (CEC) is the administering authority of LPF. Functions relating to pensions matters are delegated to CEC's Pensions Committee. The Pensions Committee oversees LPF's fund officers who carry out the operational activities of LPF. The members of the Pensions Committee act as 'quasi trustees' and meet four times a year. The Pensions Committee is made up of five elected councillor members and two non-councillor members who all have full voting rights. These roles are re-elected every three years.

The Pensions Committee is responsible for setting LPF's investment strategy. The implementation of the strategy, through more granular investment decisions, and monitoring of investments, is delegated to suitably qualified and experienced individuals employed by LPF, with sufficient time and other resources at their disposal. Reporting to the Pensions Committee focuses on the long-term objectives of LPF and how delegated decisions have contributed to these.

JISP

Investment strategy guidance is provided to the Pensions Committee by a Joint Investment Strategy Panel (JISP), working in collaboration with the Falkirk Council and Fife Council Pension Funds. The JISP meets quarterly and includes senior officers and external investment advisers. The external advisers bring significant experience in the investment industry and are used to both compliment the skills and experience of the internal investment team and to provide independent challenge. They provide trusted advice to the officers of the three administering authorities to enable them to fulfil their delegate powers effectively.

CLIMATE CHANGE GOVERNANCE

The Pensions Committee and the Pension Board (responsible for overseeing LPF's operation and ensuring that it's meeting its legal and administrative requirements) consider climate related issues as part of their annual review of LPF's approach to Stewardship. Climate-related risks and opportunities are an integral part of the overall investment process for LPF.

Climate-related risk management is reviewed as part of the regular monitoring process for all investment mandates and includes scrutiny of how ESG analysis is integrated into investment decision-making.

The Pensions Committee's approach to climate change risks informed its decision to adopt the SRIP in June 2020.

Fiduciary responsibilities

LPF's activities are guided by the legal principle of fiduciary duty. A legal opinion on the nature and extent of LPF's fiduciary responsibilities was obtained by the Scheme Advisory Board for the Scottish LGPS in 2016. LPF regularly reviews this analysis and monitors legal and regulatory developments as they relate to responsible investment.

Staff resourcing: LPFE and LPFI

To support the distinction between LPF's purpose and the functions and responsibilities of CEC (a local authority), in 2015 LPF set up:

- An employment services company to establish people and cultural controls appropriate to the specialist business LPF carries out (LPFE Limited) and
- An investment company that would enable the delivery of regulated investment services to other pension funds and institutional investors, whilst also more generally aligning LPF to higher FCA standards (LPFI Limited).

We've built out a staff structure to best resource our activities and allow us to exercise stewardship. Our current headcount is 79 and includes dedicated teams which support our communication with stakeholders, running good governance, stable ICT systems, effective HR management and delivery of legal services.

Even though LPF's activity isn't regulated in the same way as LPFI's services, LPF staff are asked to adopt a best practice approach and adhere to a higher standard of compliance in certain activities than what is strictly required by law. This level of compliance supports effective stewardship.

Furthermore, senior managers have a duty of responsibility to take reasonable care to avoid and/or stop a breach from occurring in the business area that they're responsible for, and such duty is formalised by regulation.

LPF staff may also be subject to annual assessments of whether they're fit and proper to carry out their role. This includes the portfolio managers who are responsible for investment management.

All LPF staff are subject to conduct rules which are intended to set the minimum standards of individual behaviour expected in a financial services firm.

The relevance and importance of responsible investment means it's incumbent on all LPF officers, in line with LPF's values and investment beliefs, to play a role in upholding LPF's approach to responsible investment. In 2021/22, LPF plans to review individual roles to ensure that responsible investment is owned, championed and implemented effectively within the governance structure, and amongst its staff.

Learning and development to support our responsible investment beliefs

Members of the Pensions Committee are required to undertake a minimum of 21 hours training per year. This supports them in fulfilling their role and managing the lobbying they may receive, as elected officers, on a wide range of issues (including aspects of LPF's investment activities). In addition, Hermes EOS, LPF's provider of voting and engagement services, is invited to present to, and interact with, the Pensions Committee at least annually.

During 2020/21, the Pensions Committee received training on climate change related risks and opportunities, and climate-specific reporting, including a carbon footprint of LPF's equity holdings, which is now updated annually.

As part of their continuing professional development, members of our investment team participated in the Alliance Bernstein's Climate Change Investment Academy with Columbia Climate School via a series of online lectures and discussions.

Responsible Investment Champions

LPF's Chief Executive Officer fulfils the role of "Impact Champion". In this role, he's exploring how to measure and assess impact from our investments while still providing a financial return that supports sustainable and secure pension benefits.

Our Chief Investment Officer is our "Governance Champion". This role makes him responsible for LPF's compliance with relevant regulations and its own policies and procedures, including LPF's responsible investment commitments.

We have appointed two portfolio managers as "Responsible Investment Leads" who are focused on integration and stewardship, including voting and engagement in the public and private markets. Their investment expertise and specialist knowledge across the asset classes in which we invest is essential to delivering effective stewardship. They work with our other internal portfolio managers to ensure material ESG risks are identified, monitored and managed throughout the investment process. They also support the oversight and monitoring of external managers, and champion LPF's responsible investment beliefs and stewardship activity in the wider investment industry.

Performance and reward

We recognise the importance of our people in achieving our responsible investment commitments and stewardship aims, and the need to develop, reward and support them in their roles, within their teams and as individuals.

In terms of staff performance, the role profile for each member of our investment team includes explicit reference to LPF's responsible investment and ESG aims. This makes each person involved in LPF's investment decision-making individually accountable for furthering LPF's responsible investment aims.

The annual performance review for portfolio managers and deputy portfolio managers looks at how they "ensure compliance with the Fund's policies and procedures, including its commitment to responsible investment, which involves company engagement and voting and integration of ESG analysis into investment decision-making."

LPF's remuneration scheme is deliberately structured to align staff with LPF's long-term aims and not to incentivise inappropriate risk-taking.

Our external engagement provider

Everything LPF does is about generating long term financial returns to pay pensions. This includes its engagement activity. Engagement focuses on company strategy covering many ESG issues, such as climate change, plastic usage, diversity and labour practices. LPF engages with companies because these issues create significant risks which, if not appropriately addressed, threaten investments with material and permanent capital impairment.

To adequately resource engagement activity, LPF contracts an external voting and engagement provider (currently EOS at Federated Hermes) to undertake much of LPF's voting and engagement. Our investment team interacts with EOS to contribute to the work plan and access the body of knowledge that resides with their engagement professionals. EOS represents owners of assets worth more than $1tn, which makes LPF much more influential than it would be engaging on its own. EOS is also able to undertake multi-year engagements, which LPF couldn't do alone.

EOS reports on voting and engagement activity across LPF's assets every quarter, as well as annually. Through this regular dialogue, we're able to ensure that our values remain aligned. EOS also engages with regulators, industry bodies and other standard setters to shape capital markets and the environment in which companies and investors can operate more sustainably.

We present voting and engagement case studies in relation to Principle 9 (Engagement) and Principle 12 (Exercising rights and responsibilities), later in this report.

Internal engagement resource

LPF has committed significant internal engagement resource as a participant member of CA100+. By participating actively in this group, LPF has influenced real change, including an acceleration of coal power plant closures across Europe and a change to the corporate lobbying practices of companies with significant carbon emissions.

These engagement actions assist the target companies to become better prepared for a net-zero world. In addition to direct engagement as part of CA100+, LPF encourages its managers to sign up to similar initiatives. In 2020, LPF was instrumental in the decision by the world's largest asset manager, BlackRock, to join the CA100+ initiative.

External managers

We expect our external managers to engage investee companies on our behalf on material issues including ESG factors. We receive quarterly updates from external fund managers on the number of engagements undertaken and the weight in a portfolio.

LOTHIAN PENSION FUND

Principle 3

MANAGING CONFLICTS OF INTEREST

Signatories manage conflicts of interest to put the best interests of clients and beneficiaries first.

Our commitment to managing conflicts of interest

In all its activities, LPF acts honestly, fairly and professionally. This approach is aligned to our values of being 'Agile and Dependent', and 'Innovative and Prudent'. As described in relation to Principle 2 (Governance), LPF has adopted the FCA standards across its operations, and this includes in relation to conflicts. This response focuses on LPF's own operations (distinct from any client services delivered by LPFI).

We're aware of the duties owed to our various stakeholders and the range of actual or potential conflicts of interest that may arise while carrying out investment activities. We recognise that effective management of conflicts of interest is fundamental to the effective stewardship of our assets. It also protects the best interests of LPF, our staff and our stakeholders.

Our Conflicts of Interest Policy sets out how we implement and maintain effective arrangements. The policy specifies the required standards and procedural controls for identifying, recording, monitoring and preventing conflicts of interest.

The LGPS

One of the most significant conflicts of interest is inherent to our structure, under which a local authority administers a multi-employer pension fund. As administering authority of LPF, CEC acts in a separate statutory capacity which is distinct from its role and responsibilities as a local authority. Pension fund assets are ringfenced from CEC's operating budget and LPF's operations are entirely funded by pension fund assets.

The objectives of the administering authority, and those of the pension fund, aren't always aligned. For example, CEC (as a local authority) may have an objective to promote jobs and prosperity within Edinburgh. This may conflict with our investment objective of delivering sustainable returns across a diversified range of assets, in line with our fiduciary duty and as reflected in our SIP.

The extent of delegation and separation between CEC and LPF within our governance structure supports the effective management of this conflict.

IDENTIFYING OTHER TYPES OF CONFLICTS

Other types of conflicts which may arise are where LPF:

- Is likely to make a financial gain, or avoid a financial loss, at the expense of a stakeholder
- Has an interest in the outcome of a service provided for the benefit of LPF or of a transaction carried out on behalf of LPF, which is distinct from LPF's interest in that outcome
- Has a financial or other incentive to favour the interest of one stakeholder or group of stakeholders over the interests of another stakeholder or group of stakeholders
- Receives or will receive from a third party an inducement in relation to a service provided to LPF, in the form of monies, goods or services other than the standard fee for that service (if any)

The following are non-exhaustive examples of "typical" conflicts of interest that could arise for LPF employees:

- Where a private interest of the employee, a family member or a personal contact influences a decision or recommendation the employee makes in the course of their employment
- Interests or involvement in a business outside LPF, without permission
- Accessing information at work which may assist in a private venture
- Receiving substantial gifts or hospitality to obtain preferable terms

OUR STRATEGY

At the organisation level, we use the following measures to support the overall management of actual and potential conflicts of interest:

- The members of our governing bodies (including the Pensions Committee and Pension Board and the corporate boards of LPFI and LPFE) are subject to a Code of Conduct or LPF policies and procedures which sets out considerations relevant to managing conflicts. Each member is asked to consider and declare any conflicts of interest at the beginning of any meeting
- The oversight exercised by our Senior Leadership Team supports the operation of independent functions with segregated duties. Management information and reporting procedures are used to deliver effective oversight
- Information barriers are in place to restrict access to records where necessary.

Within LPF, we use the following measures to support the overall management of actual and potential conflicts of interest by individuals:

- Restrictions and procedures relating to personal account dealing, restricted dealing / insider trading, gifts and hospitality and whistleblowing
- Maintaining a 'external bodies' register (which records details of any services provided to, or roles held with, organisations outside LPF)
- Maintaining a 'connected persons' register (which captures organisations that LPF may directly transact with, and which may have a material involvement, in the business of the pension funds)
- Providing employees with relevant training, at induction and periodically.

We're clear that it's incumbent on all our people to be alert to potential conflicts of interest and act accordingly. We provide compulsory 'Managing Conflicts of Interest' training for all colleagues. This was most recently completed in Q2 2021 and is part of our annual refresher training.

VOTING AND ENGAGEMENT

Voting and engagement can present potential conflicts of interests. It's of paramount importance that those we entrust to vote and engage on our behalf are transparent and robust in their approach to managing and mitigating potential conflicts. We entrust voting to EOS, our voting and engagement partner, and Baillie Gifford, which manages some of our equity assets. Both organisations have publicly available Stewardship Conflict of Interest Policies.

EOS also maintains a register of instances of conflicts as they arise and reviews its policy annually. The following are examples of EOS's approach to a range of real scenarios:

Votes in relation to a client's sponsoring company:

We recognised at an early stage that the AGM for a client's sponsoring company would be controversial. Our voting decisions in relation to this meeting were therefore assigned to a senior member of staff and the analysis was carried out early and comprehensively with oversight from an EOS director. After dialogue with the company, we took the view that the right decision was to recommend a vote against a board sponsored resolution at the AGM. We then communicated with the client to explain our decision.

Legal action in relation to the sponsoring company of a potential client:

A stewardship client was taking a leading role in a class action against a leading public company. We provided support in relation to this class action even though we were in discussions at the same time with the pension scheme sponsored by this company about it becoming a client.

Engagement at a company where the client's chair is a nonexecutive director:

We recognised the particular sensitivities for both the client and company when a significant client's chair also sat on the board of a public company which needed a highly active engagement. We were open and direct with the client and the company, flagging the issue but also making clear that the situation couldn't influence our work on behalf of all clients. This engagement included recommending voting against board sponsored resolutions at the company's AGM and asking directly for significant change to the board and to governance practice.

Principle 4

PROMOTING WELL-FUNCTIONING MARKETS

Signatories identify and respond to market-wide and systemic risks to promote a well-functioning financial system.

OUR APPROACH TO MARKET RISKS

As a long-term investor, sustainable, well-functioning markets are essential to our purpose of delivering a valued retirement savings product for our members. They will enable us to pay pensions and benefits when they fall due over the next several decades.

We need to ensure that the risks to our investments are effectively managed as we know that Environmental, Social and Governance (ESG) factors are fundamental considerations in driving the long-term value of our investment portfolio.

We're very aware that investment markets can go down as well as up and market conditions can change rapidly. Uncertainties that affect the behaviour of markets within the macroeconomic environment can affect the value of the assets held within a portfolio. We look at factors such as international political developments, market sentiment, economic conditions, circumstances where markets aren't allowed to freely move (due to government controls), changes in government policies, restrictions on foreign investment and currency repatriation, currency fluctuations and other developments in the laws and regulations of countries in which investment may be made.

Case study

One example of how we responded to a market risk is our work with the UK government to change the definition of inflation, explained below. This was relevant to protecting the value of our assets alongside the value of the pensions ultimately payable to our members.

INFLATION REFORM ENGAGEMENT

While engagement is often associated with companies, ESG issues come up at a government level too. As a long-term investor in government bonds, we continuously monitor and review monetary, fiscal and macroeconomic policy as they relate to governance. One such focus is in the measurement of inflation in the UK, and how it relates to the value of the index linked government bonds we invest in.

The UK differs to many countries in its use of the Retail Price Index (RPI), as opposed to the Consumer Price Index (CPI), to measure inflation. The RPI tends to increase at a faster rate, impacting those that depend on it to index prices such as pensioners, pension funds, businesses and other investors.

The difference between the two indices, known as the "wedge", has been intensely debated over the last decade. The RPI is widely understood to be statistically flawed, and its continued use has created uncertainty around when and how to rectify the situation as fairly as possible.

Last year the government determined to align the RPI with CPI-H (CPI including owner occupiers' housing costs). The way in which the alignment is made affects the value of index-linked government bonds and the smooth functioning of the market for these securities and has significant long term implications for the modelling of pension fund liabilities.

We were pleased to take part in the consultation that the government jointly ran with the UK Statistics Authority on how best to make the transition.

In response to the questions asked of participants in the consultation, we set out our view on how the proposed change and possible timelines for implementing it could impact pension funds such as our own. In particular, we highlighted the significance of the timing of doing the reform by either 2025 or 2030 and in doing so, how that would help reduce uncertainty about the future measurement of inflation. Our view is there should be no uncertainty in the measurement to ensure that index linked government bond markets remain liquid and orderly in the long term.

By engaging with the UK Treasury and Statistics Authority, we sought to influence positive change in financial markets with minimal disruption to their effective functioning. Where possible, we use our knowledge and experience to assist policymakers on ESG issues (in this instance a governance issue) of national importance.

Ross Crawford
Portfolio Manager
Lothian Pension Fund

UNDERSTANDING MARKET AND SYSTEMIC RISKS

Given the potential impact on our investment returns, we closely monitor market-wide and systemic risks. We collect information from many sources.

External advisers

- LPF uses the independent investment advisers appointed to the JISP to gain insights on market trends and conditions
- LPF's external managers include market commentary within their periodic investment reports, which LPF reviews in details
- LPF's actuary may comment on general investment issues as part of the valuation work they do for LPF.

Suppliers of information

- EOS supports us in identifying systemic and emerging risks as well as mitigating these risks through engagement. Our Internal Equities team work closely with EOS in our collective approach to engagement, reflecting the areas of stakeholders' interest and concern. LPF undertakes to utilise our voting rights, including those exercised through proxy, to engage with the management of companies in whom we invest to promote appropriate standards of corporate governance that safeguard shareholder interests and respect stakeholder interests
- The organisations which support LPF's portfolio monitoring for shareholder litigation share insights on market-wide issues relevant to risk.

Reviews

- LPF monitors its counterparties and suppliers to ensure they remain creditworthy and suitably authorised to provide services
- Our investment team monitors the creation of debt within the financial system to identify systemic and non-systemic vulnerabilities.

Collaboration

- Collaborative initiatives are a valuable source of intelligence on emerging risks and ways to mitigate these risks. We have a long track record of collaborating with other investors, asset owners and organisations. Most recently, in January 2021 we joined the Institutional Investor Group on Climate Change (IIGCC) where we'll take part in a number of workstreams that will enable our portfolio managers to further our influence on responsibility and sustainability within the finance industry, as we look to make positive real-world impacts alongside generating positive investment returns. More information on our collaborative activities is provided in Principle 10 (Collaboration).

HOLDING COMPANIES TO ACCOUNT

In addition to our engagement activities supported by EOS, we recognise shareholder action as another way that we, as an institutional investor, can promote good corporate governance and therefore contribute to well-functioning markets.

Where it's economical to do so, our fiduciary duty may require us to take action to recover funds lost through investments in companies as the result of corporate mismanagement, but we wish to highlight how this can also reduce some systemic risk where corporate reforms can be secured alongside financial recovery. This may be important where there's a void in the role of industry regulators, (due to constrained resources for example) or where changes in political administration can impact the willingness of regulators to take enforcement actions.

We use third party providers to support our portfolio monitoring, to collect information and legal analysis necessary to make informed decisions about the best options for asset recovery and the wider benefits of participating in potential claims. We have an internal policy to guide our actions, and this considers the significance of a company's wrongdoing, and the wider context of our stakeholder expectations.

Confidentiality restrictions limit how much detail we can provide about specific actions, but LPF is currently involved in a number of actions across multiple jurisdictions and has previously taken 'lead plaintiff' status for US-based actions.

OUR APPROACH TO CLIMATE CHANGE RISK

As stated in Principle 1, in relation to our investment beliefs, we believe that Climate Change is one of the defining issues of our time. We believe that asset owners are uniquely positioned to drive changes in governmental and corporate behaviour to bring about an acceleration in the sustainable energy transition and a decarbonisation of the global economy. We recognise the critical importance of limiting climate-related emissions and the role those financial institutions can play in helping to achieve that goal, and how this will in turn, contribute to a well-functioning financial system.

Our calls for more ambitious NDCs in the UK's net zero target were answered

COP26 will include the first five-year review of progress made since the signing of the Paris Agreement in 2015. The key to success in these progress reports is the continuous evolutions to countries' Nationally Defined Contributions (NDCs). These NDCs set out what individual countries plan to do to play their part in decarbonising economies.

At the beginning of December 2020, we joined 77 other businesses and investors in calling for more ambitious NDCs in line with the UK's 2050 net zero target. Ten days later, the UK published a new set of NDCs, setting an aggressive 68% reduction in economy wide greenhouse gas emissions by 2030 (vs. 1990 levels).

MEASURING CLIMATE RISK IN OUR PORTFOLIOS

We believe that accurate measurement of emissions is an important element in assessing the climate risk of an investment portfolio. Supported by a research budget specifically allocated to data services targeting ESG and climate-related risks and opportunities, we published our first annual carbon footprint for listed equities in 2018. This measured the weighted average carbon intensity of the total portfolio.

The UK Government recently announced that emissions reporting will be mandatory for occupational pensions schemes by 2025 under the TCFD framework. Although this doesn't currently apply to the LGPS, LPF has undertaken to meet the reporting requirements by 2023. This is a priority for us, but we acknowledge the challenges in areas such as infrastructure investment, where we're dependent on the level of information provided by external managers, some of whom are not currently subject to TCFD reporting.

NAVIGATING COVID-19

As a commercial property portfolio owner, we sought to support the financial stability of our tenants in furtherance of a broader aim of promoting well-functioning markets, as described below.

The impact of C-19 on commercial property and the actions we've taken:

- 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
- During the pandemic, tenants, particularly those in the retail and hospitality sectors, experienced difficulties with short term cashflows and struggled to pay rents
- As a UK balanced property portfolio owner, LPF received numerous requests for rent holidays, deferments, and other concessions to assist occupiers through this difficult period
- On a practical level the property team engaged directly with tenants to review individual requests. Where appropriate, we sought to reach agreements that would support vulnerable tenants' businesses and maximise tenant retention beyond the crisis and, where possible, extend contracted income through the removal of break options or lease term extensions.

OUR RECOVERY STRATEGY

We put plans in place for each of the portfolio's 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.

There will be occupiers whose businesses ultimately 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, we believe that we've mitigated short term void risks. This will protect the rental income returns for the future and strengthen tenant relationships to add value over the longer term.

Principle 5

REVIEW AND ASSURANCE

Signatories review their policies, assure their processes and assess the effectiveness of their activities.

We have a range of internal and external review and assurance processes which support good stewardship. We run our review and assurance in conjunction with other underlying business and compliance processes, such as external manager monitoring programmes, which includes responsible investment governance and stewardship, to assess and ensure responsible investment policies are being implemented (see Principle 8).

REVIEW

We take a formal approach to reviewing our policies and their effectiveness. In relation to responsible investment, examples of such reviews are provided below.

We created our SRIP as a direct result of review and assurance.

During a review of our SIP in 2019, we concluded that it didn't fully describe our approach and commitment to integrating responsible investment in all areas of our investment process. As a result, we decided to provide a supplement to our SIP – our SRIP, described in relation to Principle 1.

Annual review

Our SRIP is reviewed annually. Potential improvements to our responsible investment approach are suggested by LPF staff and proposed for inclusion in the SRIP. Our JISP advisers appraise any changes and recommend a final version which is then reviewed by the Pensions Committee. The SRIP becomes official policy when it's approved by the Pensions Committee. The training standards described earlier in this report support the ability of our various governing bodies to provide a meaningful review of our policies. In addition, their fiduciary duty requires them to take proper advice to discharge their function. This means they may need to consider using suitably qualified advisers before revising policies and procedures.

Assessment

All PRI signatories agree to allowing PRI to undertake a comprehensive annual assessment of their approach to responsible investment. As part of this process, LPF is able to do a gap analysis on areas of best practice highlighted by PRI alongside our evolving responsible investment experience. This process of gap analysis is supported by our internal assurance of the PRI. Examples of findings from our gap analysis in 2019 and its implementation in 2020, include:

- **Strategy and Governance**

  The 2019 transparency report indicated that we could make improvements to the availability of responsible investment policy or guidance documents. This (combined with the motivations described in Principle 1 and the DWP's consultation on occupational pension schemes producing Implementation Statements) led to the development of the SRIP in 2020 and the creation of our responsible investment E-Zine, ***Engage.***

- **Listed Equity – Individual engagement**

  We were rated B in this area in 2019 which indicated room for review and improvement. This led to us applying greater focus on our internal processes such as identifying and prioritising engagement activities, setting objectives for engagement activities and monitoring/reviewing engagement activities. It was also one of the motivating factors behind our decision to join Climate Action 100+.

- **Listed Equity – Proxy Voting**

  The securities lending process was noted as an area where we improved in 2019 versus 2018. We were motivated by this year-on-year improvement and saw an opportunity for further development. The implementation of our new stock recall software in 2020 was a direct output of our gap analysis of the 2019 assessment.

  A summary of PRI's latest evaluation is shown below. It highlights that our processes and approach to Responsible Investment are rated at or above the median of asset owner signatories across all categories measured.

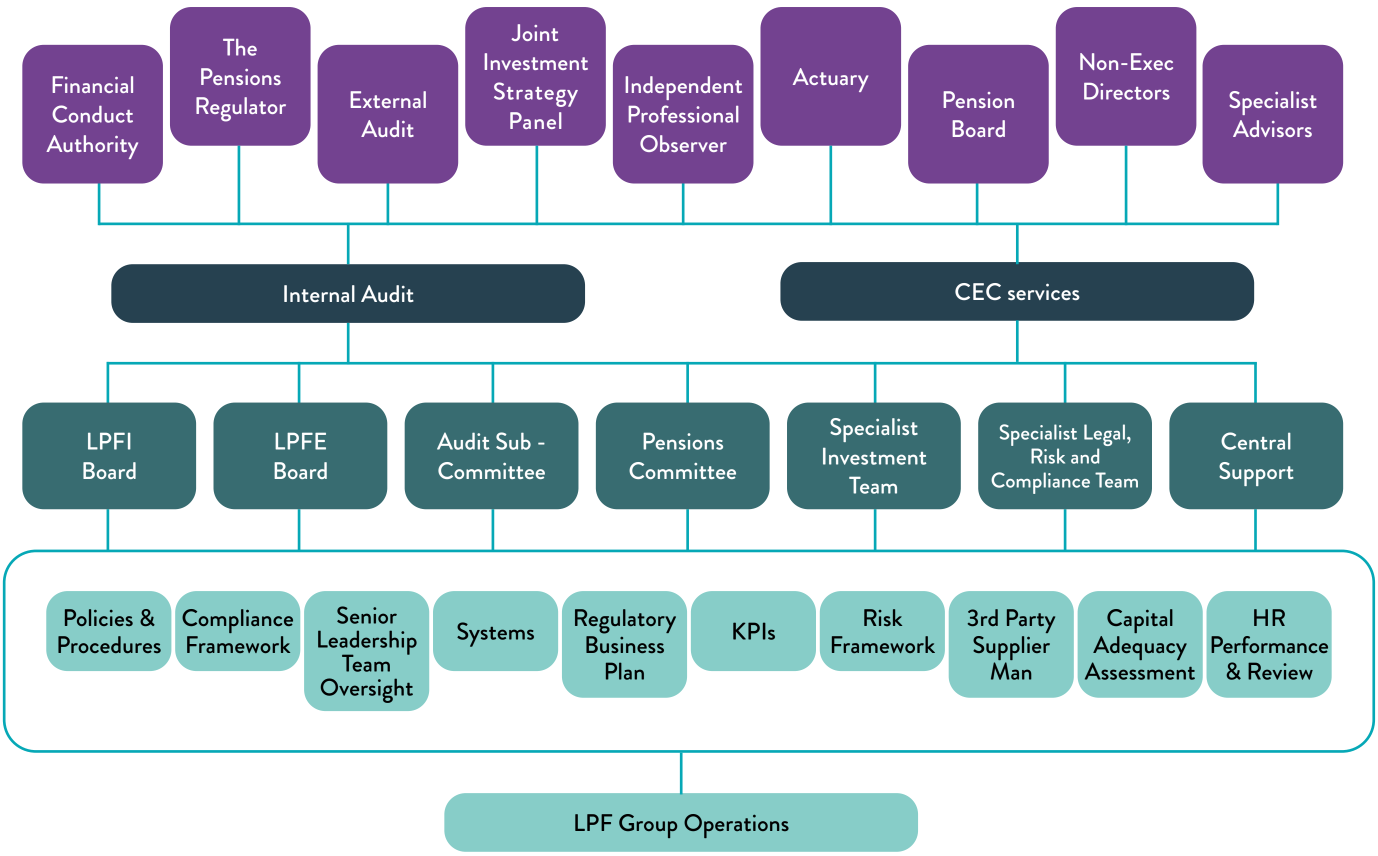
SUMMARY SCORECARD

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

OUR ASSURANCE MAPPING PROCESS

We manage review and assurance as part of an "assurance stack" and we review its effectiveness and efficiency regularly to continuously improve.

LPF GROUP ASSURANCE STRUCTURE



We maintain an assurance overview and mapping document which is designed to ensure that we meet our objectives, are adequately resourced, manage to high professional standards, meet legislative requirements, and deliver high levels of customer satisfaction.

The LPF group's assurance map is categorised in accordance with the **'four lines of defence'** model, as illustrated below.

GROUP LINES OF DEFENCE OVERVIEW

Senior Management / Risk Oversight
SLT, Risk Committee

Governing Body
Pension Board, Pension Committee, Audit Sub-Committee

1st line of defence

Business units
Pensions Admin, Finance, ICT, Investment, Legal, People & Comms. Owns and manages risks day-to-day.

2nd line of defence

Compliance & Risk
Combined function*. Monitors first line controls, provides advice and support; ensures risks are managed by first line.

3rd line of defence

Internal Assurance
Internal Audit, independent assurance on effectiveness of 1st & 2nd line: provides recommendations.

4th line of defence

External Assurance
External Audit & other external assurance providers. Outside the organisation. Provides additional assurance to stakeholders.

*** in addition to LPF's internal Compliance & Risk function, the 2nd line includes Compliance Monitoring services provided by external consultant, BDO**

LPF's Risk and Compliance function is accountable for maintaining an assessment of the assurance framework and, in conjunction with the SLT, ensuring that the framework continues to align with recent developments and LPF's risk appetite. They also ensure awareness and oversight of the assurance map, distillation of its principles throughout LPF's operations and culture and seek to address any perceived gaps or over-extensions.

LPF operates a separate Audit Sub-Committee to review and scrutinise matters, such as internal audit, the financial accounts and regulatory compliance in greater detail. The Audit Sub-Committee meets three times a year and reports to the Pensions Committee.

The assurance overview produced by LPF's Risk and Compliance function is considered by the Audit Sub Committee and the Pensions Committee annually, as part of its Systems and Controls update. It's also tabled once a year to the boards of LPFI and LPFE.

LOTHIAN PENSION FUND

TRANSPARENCY AND REPORTING

LPF welcomes external scrutiny of its activities to support its assurance and review processes. In line with the expectations of a public sector organisation, many of our policies and procedures are available on our website. We also publish our PRI transparency report annually on our website and we publish our PRI assessment results on our website and in our annual report.

We recognise the importance of external reporting, which facilitates independent assessment of our practices. Internally, LPF commits senior resources to supporting the quality of such reporting. For example, related to responsible investment:

- Our Responsible Investment Leads have day-to-day ownership of our reporting commitments such as the PRI and the FRC Stewardship Code
- Our Risk and Compliance and Communications teams ensure accuracy, regulatory compliance, clarity of message and public communication of reporting, as necessary
- Our Senior Leadership Team, specifically our CEO and CIO, are chief sponsors and have ultimate sign off.

Other reports related to responsible investment include the report on our approach to climate-related risks and opportunities. We will submit in accordance with the TCFD recommendations, and this inaugural annual UK Stewardship Code Report.

As reflected in our governance structure, we have multiple layers of regulation and oversight. We prepare extensive internal reporting across all aspects of the organisation. Together, this reporting brings strong discipline in ensuring we review our policies, assure our processes and assess the effectiveness of our activities.

During 2020, LPF had no examples where investments were made outside of the stated stewardship and investment policies, by either the internal investment team or our external managers. Further information on external manager monitoring is available in Principle 8.

Principle 6

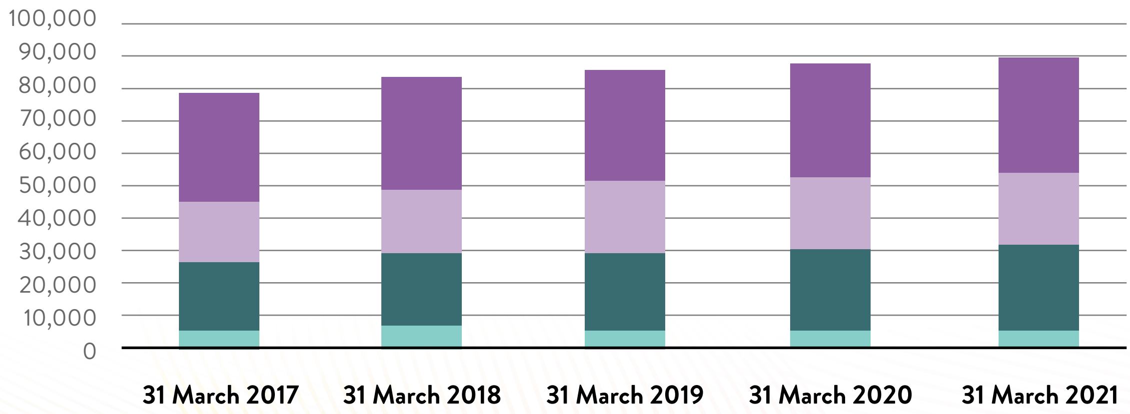
CLIENT AND BENEFICIARY NEEDS

Signatories take account of client and beneficiary needs and communicate the activities and outcomes of their stewardship and investment to them.

As mentioned earlier in this report, we refer to our stakeholders, rather than clients. LPF's stakeholders are the people and entities with an interest in the assets and activities of LPF. That includes the members of the pension scheme (existing and future), their dependants and beneficiaries, as well as the participating employers who contribute to the assets of the fund, and our governing bodies.

OUR MEMBERSHIP

The table and bar chart below shows a breakdown of the membership of our defined benefit scheme.



Active	33,526	34,528	34,569	35,655	35,863
Deferred	18,381	19,437	20,280	21,406	21,644
Pensioners	23,595	24,430	25,299	26,668	27,704
Dependants	4,202	4,195	4,169	4,172	4,152
Total	**79,704**	**82,590**	**84,317**	**87,921**	**89,363**

AN OVERVIEW OF OUR INVESTMENT APPROACH

The table below shows the investment strategy designed to fund over 90% of the liabilities. The remainder of the assets are held in lower risk strategies more suited to their employer liabilities and these are shown in the SIP and the annual report.

Policy Group	Minimum	Strategy	Maximum
Equities	50%	60%	70%
Real Assets	10%	20%	30%
Non-Gilt Debt	0%	10%	20%
LDI / Gilts	0%	10%	20%
Cash	0%	0%	15%
TOTAL		**100%**	

The strategic allocation of our assets is defined by the target weights (in parenthesis) to the following policy groups:

- **Equities (60%)** are aligned with our long-term goals to deliver returns above inflation to support pension payments
- **Real Assets (20%)** are typically investments in long-lived, tangible and essential assets, including property, infrastructure and timberlands
- **Non-Gilt Debt (10%)** instruments are issued by a range of borrowers to finance their activities in various sectors of the economy, providing interest income, capital repayment and sometimes inflation protection for owners
- **Gilts (10%)** are debt instruments issued by the UK Government, which can be utilised to provide a close match to the Funds' liabilities
- **Cash (0%)** provides instant or short-term liquidity and isn't regarded as a long-term strategic asset as its returns have historically been low compared with other assets.

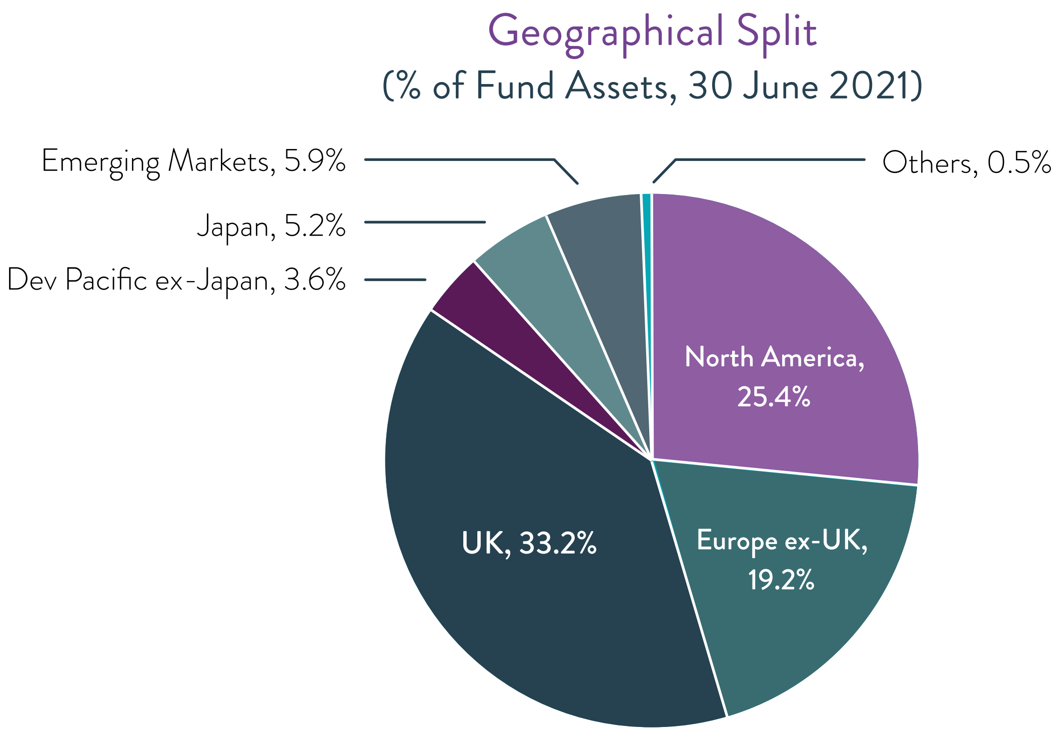
Implementation of our investment strategy is achieved using both internal and external managers. We assess all our investments with a view to meeting a required level of financial return in the context of achieving an appropriate level of risk diversification. ESG issues are an integral part of that assessment. The benefit of having portfolio managers as our in-house responsible investment leads is that we're able to integrate our stewardship and our investment decisions across the fund, according to asset type. How ESG issues are incorporated into investment analysis and decision-making processes varies according to the asset category (but not geography) and whether the mandate is internally or externally managed. The following table explains our approach by asset category and mandate.

Internal Equity investment	Our portfolio managers analyse ESG data as part of the stock selection process and, on an ongoing basis, monitor ESG developments at underlying investee companies. Data and rating changes from independent providers trigger stock reviews. We won't provide new financing to companies or projects that are incompatible with the aims of the Paris Agreement, and we engage with existing portfolio companies to ensure climate risk is accounted for. Our internal managers invest directly in listed markets and private market funds, and they monitor public and private markets with the benefit of having integrated ESG analysis into investment decision-making for many years. Our internal managers are ideally looking for investments where ESG-related improvements are in evidence with long term benefits likely to accrue to shareholders. For example, our internal managers assess and monitor the capital spending on green energy, noting that much of it is undertaken by the incumbent energy providers (the diversification of carbon-extractive companies and carbon burning utilities). Through our engagement activity, we encourage positive outcomes for asset owners through good capital allocation decisions.
Internal Sovereign Bond investment	Our investment managers analyse ESG reports and respond to government and market consultations (as referenced in Principle 5), either directly or with our collaborative partners.
External Managers	During the appointment process, we assess the approach of managers to incorporate ESG issues into their investment analysis and decision-making processes. We monitor the managers' implementation of the approach on a quarterly basis alongside all other investment matters, with ESG a standing agenda item. We engage regularly and review the PRI transparency reports of external managers, where available. Managers are encouraged to join PRI as signatories where they're not already members.
Equity	Our ambition is to appoint managers who won't provide new financing to companies or projects that are incompatible with the aims of the Paris Agreement.
Corporate Debt	We also assess how they incorporate ESG in their active ownership. Our ambition is to appoint managers who won't provide new financing to companies or projects that are incompatible with the aims of the Paris Agreement because of the investment risks we believe it presents. We engage regularly to discuss and review holdings.
Internal Direct Property investment:	During the selection process, we assess the environmental efficiency and sustainability credentials of properties, including climate change impacts. In conjunction with an appointed property manager, we ensure that ESG initiatives to mitigate risk and maximise opportunities are implemented at every stage of the ownership cycle. ESG improvement targets and performance will be incorporated into strategy through asset management plans for owned assets and all new investment acquisition appraisals. As part of our monitoring and review of direct property assets we engage directly with tenants, building long-term relationships with them.
External Real Asset management (infrastructure, property and timber) managers:	During the appointment process, we assess the approach of managers to incorporating ESG issues into their investment analysis and decision-making processes. We monitor the managers' implementation of the approach on a quarterly basis alongside all other investment matters, and review PRI transparency and GRESB reports of external managers, where available. Where appropriate, we seek improvement to both the management and implementation of that approach. Managers are encouraged to join PRI as signatories where they're not already members.

LOTHIAN PENSION FUND

OUR GEOGRAPHICAL EXPOSURE

The pie charts below show an estimated breakdown of the investments of the total fund by geography and asset class at end June 2021.



OUR OPERATING PLAN

LPF has helped more than 75,000 local government workers and their families experience a financially secure retirement. We're open to new members and contributions which means that we can expect to be paying pension benefits to our current members for the next 100 years. We expect to be here to provide for the beneficiaries of the youngest members of our Fund today so, in 2020, we formalised an Operating Plan that sets out how we'll achieve the sustainability that such multi-generational obligations require, year on year.

Our CEO holds focus group sessions with members to understand the relevance of LPF in their lives and how they wish to see us develop. The SLT also engaged with other stakeholders in a listening exercise to understand their expectations. The Pension Board is formed of representatives from trade unions that represent LPF members and scheme employer representatives. The role of this board in our assurance structure means that we have good degree of stakeholder engagement from these groups. Based on the focus group discussions, listening exercise and with input from bodies such as the Pension Board, we built our plan.

The plan centres around six broadly defined strategic goals, each with more detailed objectives and accompanying targets and measures to allow us to monitor our progress and identify where interventions may be required. This forms the basis of the work ahead of us across our organisation, including our approach to stewardship and responsible investment. The intention is that good stewardship and responsible investment flows through all aspects of our planning process, with particular and explicit attention within our six operating plan goals. We've set targets for activities and behaviours supporting these goals, such as **"Demonstrating positive outcomes achieved as an owner of assets"** and **"Be part of a sustainable scheme now and work to safeguard its future"**.

LOTHIAN PENSION FUND

OPERATING PLAN GOALS

Provide secure and affordable benefits for our members

- Deliver sufficient investment returns over the long term to meet funding targets
- Work with employers to deliver investment strategies appropriate for their finances
- Operate an effective system of controls and governance to safeguard our assets
- Maintain accurate data to ensure our benefits obligations are accurately costed

Reduce complexity

- Eliminate complexity and unnecessary friction in internal processes across the Fund
- Make it easy for members to deal with us
- Operate with clear information accessible across multiple channels
- Work with our employers to reduce administrative strain in supporting their employees

Manage our risks

- Cultivate a risk-aware culture with clear accountability and ownership of risks
- Develop technology and operational resilience to protect data and service continuity
- Maintain multi-layer assurance arrangements to proactively identify and resolve threats
- Demonstrate to our stakeholders that our appetite for risk is appropriateemployees

Create a place where people do great work

- Grow a high-performing and inclusive workforce
- Empower a broad range of talents to meet organisation priorities
- Cultivate leadership competencies and develop succession plans across the team
- Create an employer brand and culture that inspires our connected communities

Influence the LGPS of the future

- Be part of a sustainable scheme now and work to safeguard its future
- Deliver reliable and impartial advice to policy-makers on a reactive and proactive basis
- Demonstrate the power of collaboration through success of investment partnerships

Be responsible

- Continue to integrate ESG into our investment processes
- Demonstrate good stewardship of assets owned
- Seek to have a positive impact on the economy and society
- Give our people capacity and encouragement to contribute to our communities

We presented a new Operating Plan for 2021-22, including responsible investment goals to our Pensions Committee on behalf of our members and employers. We refer to this Plan in more detail, and its focus on sustainability, later in this Principle and throughout this report.

COMMUNICATION

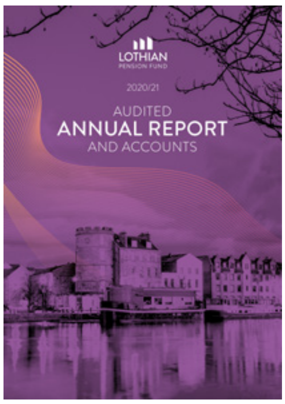
We believe that transparency in terms of investments, communication, access to information and cross-industry collaboration are key components in protecting our stakeholders' interests and ensuring we continuously improve.

At LPF, we support our stakeholders on both a proactive and a reactive basis. Considerable time and effort is spent on proactive engagement designed to support our stakeholders. It means that we can provide clear, carefully constructed responses to frequently asked questions demonstrating understanding of the issues and provide insights into the work that we do and the work that's done on our behalf by third parties and collaborative partners.

Specifically on the subject of proactive responsible investment communications, we've created a library of publicly available resources on our website, including:

- The **ENGAGE** responsible investment newsletter, launched Spring 2020
- The **Annual Report and Accounts** (which includes Taskforce for Climate-related Financial Disclosures or TCFD compliant reporting)
- The **SRIP,** launched Summer 2020
- The SIP
- Voting data
- Engagement case studies
- Internal equity approach to responsible investment

We encourage members to read, listen and understand these resources to be well informed about the nature of investing and LPF's approach to responsible investing.



LPF is both responsive to, and proactive in, its approach to media engagement and external communications. Our Responsible Investment Leads take an active role in contributing to media articles, thought leadership and speaking events.

This included involvement in the following:

- Appearing on a PLSA Local Authority Conference panel on Natural Capital
- Recording an Asset TV Interview on responsible asset ownership
- Chairing the Scottish Asset Owners RI Roundtable
- Appeared on an ESG Roundtable with Lynchpin Advisory
- Delivering a GAIN (Girls Are Investors Network) Investment Case Study Workshop
- Chairing a Talk About Black co-event with the UK asset owner community which directly let to the founding of the Asset Owner Diversity Charter
- Recording podcasts for 50Faces and Ethical Compass
- Collaborating on creating the syllabus for the UK CFA Climate and Investing certificate
- Featured roundtable speaker at the Mallowstreet ESG Indaba
- Appearing on a World Pension Summit 2020 panel
- Appearing on a Friends of the Earth Edinburgh panel discussion

We also undertake reactive engagement in three broad categories:

- Freedom of information requests
- General and stewardship enquiries
- Indirect general enquiries through Councillors/MSPs/MPs

ENQUIRIES

Both the direct and indirect general enquiries typically follow a similar format. They're enquiries either generated by a website form or downloaded from a website, suggesting that it should be directed to a local political representative. Often these enquiries are from individuals unrelated to the pension fund.

In these instances, we support busy councillors by providing standardised responses. This ensures consistent responses, speed, and greater efficiency and time savings for councillors, committee members and officers alike, as well as upholding the levels of service our stakeholders expect.

We make a pledge to our members that, when they contact us, we'll:

- Deal with the query promptly, efficiently, fairly and in an easy-to-understand way
- Communicate our service standards
- Reply as quickly as possible with information if we can't answer the query on the spot
- Treat all queries with respect
- Treat our members as individuals

LOTHIAN PENSION FUND

Principle 7

STEWARDSHIP, INVESTMENT AND ESG INTEGRATION

Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities.

The purpose of our pension fund is to pay pensions to members as they fall due over a multi-decade timeframe. As an early signatory to the PRI, we've incorporated environmental, social and governance issues into our investment decision-making since 2008. We see stewardship as an essential and integral part of our investment process.

- Our stewardship activities inform us about how companies are performing on specific ESG issues, about how proactively these issues are being managed, and about companies' wider approach to strategy and risk management
- Our stewardship activities often encourage better disclosures to support our investment research and decision-making on ESG issues
- Our investment process identifies risks and opportunities both at a stock and sector level, providing us with a prioritised list of issues to focus on in our engagement
- Our dialogue with companies often generates wider insights about trends, drivers, best practices, and relative company performance, informing ESG analysis.

"There is no such thing as a risk-free investment. ESG issues are central drivers of investment risk and return. Our job is to be aware of the relevant risks, to ensure that we're being paid for the risks we're taking, and to manage and mitigate these risks."

Gillian de Candole
Portfolio Manager and Responsible Investment Lead

As discussed in Principle 2, our stewardship efforts are purposely managed and led by our investment team, so that they're embedded in the investment process systematically. We don't treat this as a separate activity. We encourage company management teams to improve their practices and give them time to do so. This support is not open-ended or unquestioning; if we feel progress is too slow, and the prospect of financial risk to us is increasing, we'll withdraw our support and reduce or exit an investment.

We integrate stewardship and ESG issues into our investment analysis and decision-making process.

> *"Getting the right balance of ESG issue management, engagement and investment value in the stewardship of our assets is critical to delivering on our promises to our stakeholders."*
>
> **David Hickey**
> Portfolio Manager and Responsible Investment Lead

PRIORITY ESG ISSUES

We've identified 12 financially material ESG issues or themes that represent our engagement priorities for 2020-22 and guide our voting and engagement activity both internally and through our external engagement provider, EOS (for more information, see Principle 9). We believe they're important issues that will impact shareholder value and so deserve focus in any investment analysis.

- Climate change
- Pollution, waste and circular economy
- Natural resources
- Human and labour rights
- Human capital management
- Conduct, culture and ethics
- Board effectiveness
- Executive remuneration
- Shareholder protection and rights
- Business purpose and strategy
- Risk management
- Corporate reporting

OUR TOP PRIORITY
CLIMATE CHANGE

Governments and regulators are grappling with a hugely complex, global systemic risk.

We address climate change risks in two ways – through our investment selection process and through our engagement activities. As part of the stock selection process for the fundamentally managed portfolios, any material climate-related risks and opportunities (such as carbon pricing and the low carbon transition) are individually assessed by the managers before acquisition and monitored once they're portfolio holdings. Both the fundamental and quantitively managed equity funds utilise engagement with managers to improve practices.

In our day-to-day meetings with company management, we routinely discuss how they'll align their businesses with the aims of the Paris Agreement. We encourage our external managers to do likewise and report on their engagement activity. We believe that accurate measurement and disclosure of emissions and clarity of strategic direction are key to accurately assessing the climate risk and return potential of company shares. Encouraging better disclosure is now a standard part of our dialogue with companies. Data quality remains variable depending on geography and publicly listed companies are generally more transparent than private companies.

We align our collaborative efforts to achieve shared outcomes, such as better reporting

Carbon intensity numbers are currently treated as outputs of the investment process rather than targeted inputs into the investment process. This is because these numbers are fundamentally easy to "game". For investors, reported portfolio carbon intensity metrics could easily be lowered simply by selling the most carbon intensive stocks and replacing those investments with lower emission stocks. This may be optically attractive, but companies will continue to emit carbon in the same manner whether our, or any other, fund sells or retains the shares.

Strengthening corporate reporting on climate change has therefore been a key focus of our engagement efforts. We worked with the Transition Pathway Initiative and Climate Action 100+ to encourage better, more meaningful corporate carbon reporting.

Earlier in this report we refer to our TCFD commitment to assess the carbon intensity of all our assets by the end of 2022. While we believe that all roads lead to net zero, we need good data to build a clear roadmap of risks, opportunities and implications, so that we can make informed decisions that are in the long-term interests of our stakeholders.

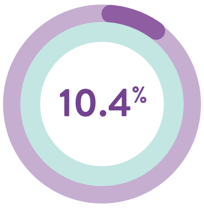
While we assess and manage climate-related risks and opportunities for all our assets, our approach differs by asset class. Below we describe how we assess climate-related risk within our infrastructure investments.

We recognise the contribution that some specific sectors and industrial activities make to climate change. While there is a tendency to label companies in carbon-intensive industries as 'bad' and those in low-carbon and alternative energy businesses as 'good', investment is more nuanced than this.

We have a policy of engagement rather than blanket divestment. This 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 we commissioned suggests that divestment at best is ineffective, and at worst provides a clear disincentive for management to change.

SPOTLIGHT ON
RESPONSIBLE INVESTMENT IN INFRASTRUCTURE

Our infrastructure investments have the potential to generate attractive risk-adjusted returns, with cash flows often linked to inflation.



Infrastructure investments represented 10.4% of the value of Lothian Pension Fund assets at 31 March 2021, comprising one of the largest and most diversified allocations among UK LGPS funds. Of the total infrastructure investment of £892 million (31 March 2020: £962 million), the majority is invested in the UK.

Integrating ESG in infrastructure investment

In addition to being a PRI signatory, we also subscribe to GRESB (Global Real Estate Sustainability Benchmark) to further enhance our analysis of ESG issues. We use the PRI and GRESB annual surveys of managers' ESG policies and activities to support our engagement with our managers, which drives improvements and implementation of best practice by our managers.

At 31 March 2021, 92% of the infrastructure portfolio value was invested in assets/funds which were also signatories of the PRI and 27% of funds participated in the 2020 GRESB Infrastructure Assessment. Most of our infrastructure funds also publish an internal ESG policy, outlining the consideration given to ESG issues within the decision-making and ongoing investment monitoring process, and this has become a standard consideration for manager selection.

Within the GRESB Infrastructure Assessments, participating funds and assets report annually to GRESB on their internal controls and policies. GRESB validates the submitted data and assesses the fund or asset with reference to a series of performance indicators, including the sustainability of its investment strategy, stakeholder relations and level of gender/diversity reporting. The aggregate scores determine a total fund or asset score which can be used to benchmark performance against its peer group.

Funds and assets across all infrastructure sub-sectors can participate in the GRESB Infrastructure assessments, but Transport and Renewable Power assets currently have the greatest participation rate within our portfolio.

We've taken a position on environmental and social factors

We recognise the role infrastructure investment can make to address part of the current environmental challenges related to climate change. Approximately 15% of the infrastructure portfolio is invested in renewable energy. During the year, the fund allocated c.£69 million to investments in UK social infrastructure, transport and utilities. New opportunities continue to be appraised.

LOTHIAN PENSION FUND

STEWARDSHIP AND INVESTMENT IN ACTION

Case study 1

Stewardship enables profit and purpose to go hand in hand

We've invested in Kering, the luxury goods company behind brands such as Gucci, Yves Saint Laurent, Balenciaga, Alexander McQueen for many years, meeting annually with the CEO.

While the company has grown spectacularly in recent years (it has averaged a growth rate of over 10% per year) and maintained high margins (over 30%), we've been concerned that its "social license to operate" might be at risk if it fails to prioritise sustainability. Amidst a heightening awareness amongst consumers of sustainability in fashion and buying habits, we met with Kering's CEO just before lockdown in March 2020 for reassurance that ESG issues continued to be well-managed.

The company openly communicated its belief 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. It believes that sustainability should be "open source" and it's happy to share best practices with its competitors.

Our engagement reaffirmed our confidence in the core investment case, and also reassured us that the company was aware of, and effectively managing, sustainability-related risks.

Since our meeting in March 2020, the company has appointed three new directors with diverse backgrounds to the Board to continue to set the standard amongst fashion brands.

LOTHIAN PENSION FUND

Case study 2

Harnessing a successful investment through ongoing stewardship, for positive change.

We've owned Persimmon shares for almost eight years and have met with the management many times. While our investment has been very successful, in 2020 we became concerned that there were some potential ESG clouds gathering. These included concerns about:

- Succession planning, and the importance of maintaining a strong, stable management team as the company navigated the challenges presented by the COVID-19 pandemic
- Incentives, in particular our disappointment at the company's decision to move the long-term incentive plan from a ten-year horizon to a three-year horizon
- Diversity, in particular the lack of diversity within the senior leadership team and within the Board (although a new company-wide Diversity Panel has been established to address this issue)
- Climate change and the environment, including the timeline to zero carbon, and the implications of no longer being allowed to install gas boilers in new homes from 2025. We also discussed Persimmon's initiatives in this area, including its new brickworks facility. The bricks aren't made of clay, don't use kilns and producing them actually absorbs CO2.

As a result of this engagement we saw significant improvements, notably in relation to diversity (a school-based education initiative, although this will take time to bear fruit) and environmental management (with the increasing use of timber frames, the use of more modern methods of construction and ongoing research surrounding the use of ground/air-source heaters). The environmental improvements culminated in Persimmon improving its Home Builders Federation star-rating which is evidence of positive change.

LOTHIAN PENSION FUND

Principle 8

MONITORING MANAGERS AND SERVICE PROVIDERS

Signatories monitor and hold to account managers and/or service providers.

OUR USE OF MANAGERS AND SERVICE PROVIDERS (INCLUDING SELECTION)

As explained below, we acknowledge the need to apply rigorous monitoring and accountability to our internal and external service providers. The FCA standards adopted across the organisation require us to manage providers to reduce the risk of operational disruption and harm to stakeholders. This involves applying appropriate systems and controls to manage the risks associated with a provider.

This response focuses on the monitoring of our providers, but also relevant is the process we apply to their selection and appointment. Through this process, we can set clear expectations about our monitoring needs. A good example of this was our 2020-21 tendering exercise for our voting and engagement provider. The public sector procurement requirements to which we're subject set a rigorous and transparent process to secure competitive tension amongst providers. Aside from the best value this delivers for our stakeholders, our tender questionnaire also allowed us to scrutinise specific criteria on ESG matters (diversity and inclusion and climate change) we considered important to the service.

Prospective tenderers were asked about their approaches to assessing listed companies on these issues, as well as their own corporate approaches to these areas, including policies and public commitments made by their organisations.

The following table is an extract from the tender questionnaire which demonstrates the weighted criteria. We now continue to monitor to the successful tenderer, EOS at Federated Hermes, on their performance against the selection criteria and as part of a quarterly review cycle.

Extract from voting and engagement partner re-tender questionnaire 2020/2021

Part A	STAGE TWO - AWARD CRITERIA	WEIGHTING	Part A	STAGE TWO - AWARD CRITERIA	WEIGHTING
1	Corporate Commitment	5%		SERVICE FIT	
2	Diversity & Inclusion	4%	9	Client Service	12.5%
3	Engagement Process - Overview	11%	10	Reporting	12.5%
4	Voting Process - Overview	10%	11	Responsible Stewardship - Engagement	12.5%
5	Process - Risk Management	8%	12	Responsible Stewardship - Voting	12.5%
6	Collaboration	5%			
7	Climate Chnage Risk	5%			
8	Value Add Opportunities	2%			

SUPPLIER MANAGEMENT FRAMEWORK

Supported by our internal legal team, we operate a framework to set out how each supplier and their services are managed. We seek to secure the following as contractual protections in our supplier engagement terms, to allow us to exercise effective oversight:

- Clear performance and quality standards applicable to specified services, and measurement of these using 'key performance indicators' where appropriate
- Regular review meetings
- Documented escalation procedures applicable where standards are not met, with specified supplier personnel dedicated to our client relationship
- Continuous improvement initiatives to improve the efficiency and effectiveness of custodian services.

Key suppliers relevant to our stewardship of assets include our JISP advisers, our global custodian, the provider of our order management system software, and the providers of data and research services, including ESG information.

Also relevant is EOS. EOS provides regular updates of its engagement activity and its voting activity, which we publish to our website. We also monitor its effectiveness at its annual client advisory board, which is an effective means of prioritising engagement activity. We undertake regular update meetings with the client team at EOS, as well as the senior executive team with whom we have an excellent working relationship. This allows us both to review current practices and performance and provide meaningful input into engagement priorities and approach.

INTERNAL MANAGER MONITORING

Portfolios managed by the in-house investment team are monitored at different levels and at different intervals. Daily reconciliations of assets between custodial and front office systems confirm that portfolios are being managed within the relevant constraints. Systems are coded to prevent managers from breaching those parameters and to alert the Compliance function of potential or actual breaches, which could occur. The Chief Investment Officer attends monthly meetings of investment groups, which are arranged by policy group, providing oversight and scrutiny of portfolio construction and transactions. The Chief Executive Officer and the Chief Investment Officer review all mandates and reports on a quarterly basis.

All quarterly reports include detail on portfolio risk and return, portfolio construction, transactional activity, ESG analysis and engagements. The external independent advisers on the JISP review all reports every quarter and meets with each of the portfolio managers annually to provide assurance that the mandates are being managed in-line with expectations.

The benefit of managing a substantial proportion of assets internally is that we always have full transparency and that our internal managers are fully cognisant and aligned with our policies.

OVERVIEW OF EXTERNAL MANAGER MONITORING

We monitor all our external managers to ensure they continuously maintain their own responsible investment and stewardship commitments.

EQUITIES AND DEBT

- During the appointment process, we assess the approach of managers to incorporating ESG issues into their investment analysis and decision-making processes and in their active ownership
- We monitor the managers' implementation of the approach, in addition to their performance against the mandate and related investment matters (with any subsequent amendments) on a quarterly basis. MiFID 2 was intended to enhance investor protections and it specifies some of the content which our managers must include in their quarterly reports, but we agree the extent of additional content we require to be included in such reports upon appointment. In addition to the quarterly reports that managers provide, we issue a quarterly questionnaire to address other material points, including ESG issues, systematically
- Members of our internal investment team also meet with external managers quarterly to understand any changes that might affect the management of the mandates. Both the Chief Executive Officer and the Chief Investment Officer review all external mandates with the internal investment team after these meetings.

PRIVATE FUND MANAGERS

- To monitor our diversified portfolio of private market funds, the largest portion being infrastructure assets, we review the manager's quarterly updates of activity, performance and portfolio construction to demonstrate adherence to the fund's agreed strategy. Monitoring includes performance, risk, ESG issues and portfolio construction relative to diversification constraints
- Our portfolio managers are in regular contact with our fund managers, attending annual investor meetings and reviewing the periodic reporting and updates received. In some cases, an LPF representative sits on the LP advisory boards of the funds to review matters like conflicts of interest or which require LP consent. This can provide greater transparency and a forum for challenge.

GENERAL

- Where available, we review the PRI transparency or GRESB reports
- The submission of internal reports for senior oversight is as described in relation to Principle 7, with any issues and escalation actions discussed at the quarterly JISP meetings.

We don't always expect external fund managers to be the "finished article". In some instances, we'll consider selecting fund managers with less-developed approaches to responsible investment if we can be assured that there's a present and demonstrable road map towards improvement and development. One example where this may be the case is in relation to infrastructure and real estate investments, where ESG and responsible investment is perhaps not as established as in other asset classes. We believe we can add value in working with managers at this level if we're confident in the investment case and their overall philosophy.

LOTHIAN PENSION FUND

HOLDING MANAGERS TO ACCOUNT ON CLIMATE

Following the announcement of our ambition not to fund companies whose business models aren't aligned with the goals of the Paris agreement, we began engaging with our managers on steps that they could take to align their practices with our aims and objectives. This is a complex area and work is currently ongoing with all our external managers. It's early days, and we'll be transparent on the outcome of these engagements.

Manager monitoring evolves as expectations evolve

The monitoring (and selection) processes for external managers incorporate ESG assessments, which continue to be refined as the industry evolves. Our policies and expectations change over time, and this is no more evident than in the climate-related commitments that we have made in our SRIP. Our approach is to work with managers requesting change where required and we have found a willingness to evolve alongside us: through reporting on ESG analysis and engagements, followed by discussions to gain a better understanding to ensure we are aligned. Where we are not aligned, we would ultimately terminate the mandate. We have not had to do that over the last year. We monitor private market funds in a similar way, engaging to promote higher standards.

We're beginning to monitor our managers' diversity performance

One area where expectations have evolved and we want to address, relates to the severe lack of diversity within the fund management industry. This is an ESG issue that we as asset owners and responsible investors feel strongly about both in terms of our values; our role as a manager of managers. It also links to our commitments to promoting well-functioning markets, with a better investment industry. This is why we established the Asset Owners Diversity Charter and why charter signatories will increase the pressure on fund management firms to share information about diversity, so that industry progress can be benchmarked. It's why we're asking other asset owners to join us in making this part of our collective fund manager monitoring process.

> *"We believe it's reasonable for our members to expect the money in the scheme to be run by a cross section of investment managers that reflect the diversity in the pension scheme."*
>
> **David Hickey**
> Portfolio Manager and Responsible Investment Lead

Principle 9

ENGAGEMENT

Signatories engage with issuers to maintain or enhance the value of assets.

As discussed in Principle 7, we believe that a proactive combination of collaboration, engagement and voting supports our mission to pay pensions over the long term. We believe that successful engagement adds value to the investment process by promoting best practice governance and by highlighting and promoting best practice in dealing with environmental, climate change and social issues.

Also discussed in Principle 7 are the 12 key ESG issues or themes which we focus on in our engagement and in our investment research. We've chosen these because of their actual or potential financial significance to our portfolios.

Where material risks remain following engagement activity, we retain the ability to divest. We discuss divestment in more detail below.

Our view on divestment from companies involved in the extraction of fossil fuels

LPF is often challenged about its approach to responsible investment, including requests to promote a policy of divesting from companies involved in the extraction of fossil fuels. We don't disinvest from or 'blacklist' companies for purely non-financial reasons. We do, however, believe that environmental, social and governance issues can affect the financial performance of the companies in which we invest. We take these issues seriously and integrate them into our decision-making processes.

We have a policy of engagement with companies and policymakers rather than a policy of exclusion or divestment. By engaging with the companies in which we own shares, we strive to improve the sustainability of corporate strategy to the benefit of shareholders, and to the benefit of wider society. We believe that a policy of disinvestment potentially passes shares to less responsible or less active share owners, who are less likely to hold management to account. In our view, this achieves nothing in terms of real-world sustainability.

We recognise the outsized impact that some specific sectors and industrial activities have on climate change by virtue of the magnitude of their greenhouse gas emissions. While many prefer to label companies in carbon-intensive industries as 'bad' and those in low-carbon and alternative energy businesses as 'good', history shows that firms need to reinvent themselves to survive. We therefore strive to influence and support positive changes by corporate leaders to achieve sustainability for their firms and for society.

Consequently, we have 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.

OUR APPROACH TO ENGAGEMENT

We commit significant resources to engagement activity, which we divide into four distinct elements as shown in the table, below.

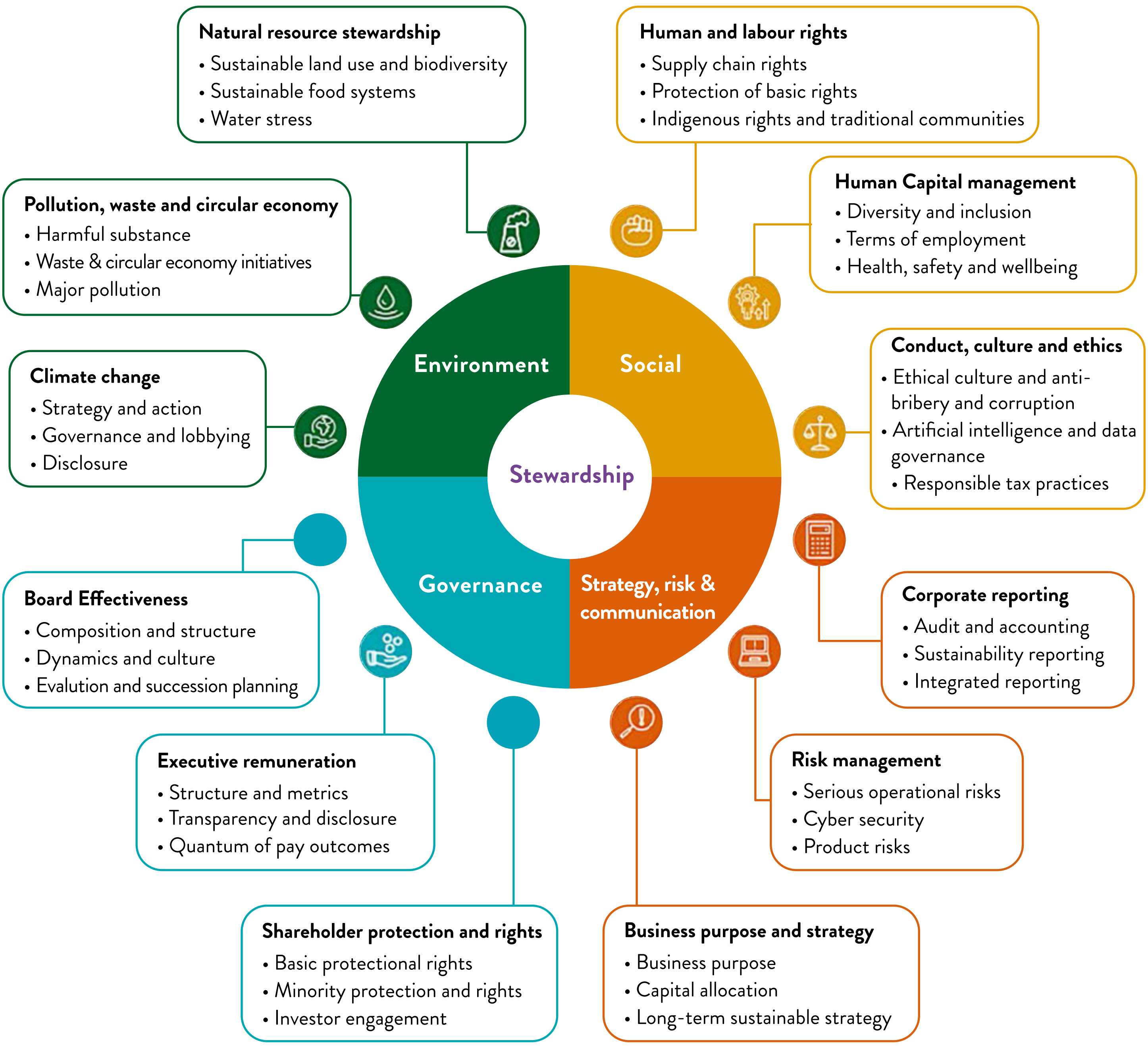
We use a variety of engagement approaches, including written correspondence, face-face meetings, voting and public communications. Our preference is for direct engagement as it allows us to set out our expectations and to fully explain our interests and motivations. Irrespective of the engagement approach, the goal is always to achieve good financial outcomes for our stakeholders and to encourage positive corporate behaviour.

Direct Engagement with companies and issuers	In situations where we have significant holdings or where companies have financially significant ESG issues, we'll look to engage directly with these companies to understand their approach. In Principle 7 we present two examples – Kering Group and Persimmon – where we engaged with companies on financially material ESG issues, and described the outcomes that were achieved In Principle 7, we also describe our direct engagement in the range of asset classes that we manage and in Principle 12 we discuss how we vote our shareholdings.
Indirect engagement with companies and issuers through our investment managers	We encourage our external investment managers to engage with the companies and other entities in which they invest. As we discuss in Principle 7, we assess external managers' approach to engagement and stewardship as part of the manager selection process. We then review each managers' approach on a quarterly basis alongside all other investment matters, and we also review the PRI transparency reports of these external managers, where available. We regularly challenge our managers on their approach, to understand the goals and effectiveness of their engagement activities. We routinely ask our managers to sign up to the same efforts that we sign up to. This includes PRI (as required in PRI Principle 4), and Climate Action 100+. Our structure (all segregated accounts) means we realistically control all our engagement and voting.
Collaborative engagement with other investors	We recognise that delivering systemic change in the way companies operate can't be achieved by a single investor acting alone. We therefore collaborate with other investors on a range of ESG issues. We provide more detail in Principle 10. In Principle 1 we provide the specific example of our engagement with Fortum, which we've led on behalf of the Climate Action 100+ initiative. This engagement is a hybrid between our direct and collaborative engagement approaches.
Indirect engagement with companies through an engagement service provider	We recognise that engagement can bring important benefits to our investment portfolio and the wider market. We also recognise that we, our investment managers, and the collaborations that we support, cannot cover every ESG issue at every company, with the detail and care that's needed to ensure that engagement is effective in driving improvements in company practice and performance. Working with EOS provides us with a breadth and depth of coverage. In 2020, EOS engaged with 252 companies on 1,109 environmental, social, governance, strategy, risk and communication issues and objectives. We present some data and examples of the EOS engagement below, including the outcomes that have resulted from this engagement.

We have an agreed engagement plan with EOS

Each year, we consult with EOS to develop an engagement plan that aligns our priority issues and supports the wider goal of driving higher standards of corporate behaviour. In 2020, we agreed that EOS would focus its 2020-2022 engagement on the 12 main priority themes set out in Principle 7 and illustrated below. We agreed that we would support EOS's public policy engagement (explained later in this section), as we recognise that many ESG and sustainability issues require policy interventions.

ENGAGEMENT THEMES



2020: AN OVERVIEW

An overview of the engagement EOS conducted on our behalf in 2020 is presented in Figure 1, with Figure 2 showing the geographic coverage of this engagement.

Figure 1.

We engaged with 252 companies over the last year.

- Environmental **26.3%**
- Social and Ethical **18.6%**
- Governance **36.2%**
- Strategy, Risk and Communication **18.8%**

Figure 2.

We engaged with 20 companies over the last year.

- Environmental **34.7%**
- Social and Ethical **19.4%**
- Governance **33.7%**
- Strategy, Risk & Comms **12.2%**

We engaged with 13 companies over the last year.

- Environmental **18.5%**
- Social and Ethical **18.5%**
- Governance **35.2%**
- Strategy, Risk & Comms **27.8%**

We engaged with 61 companies over the last year.

- Environmental **23.8%**
- Social and Ethical **16.9%**
- Governance **39.5%**
- Strategy, Risk & Comms **19.9%**

We engaged with 97 companies over the last year.

- Environmental **27.7%**
- Social and Ethical **18.6%**
- Governance **35.2%**
- Strategy, Risk & Comms **18.6%**

We engaged with 59 companies over the last year.

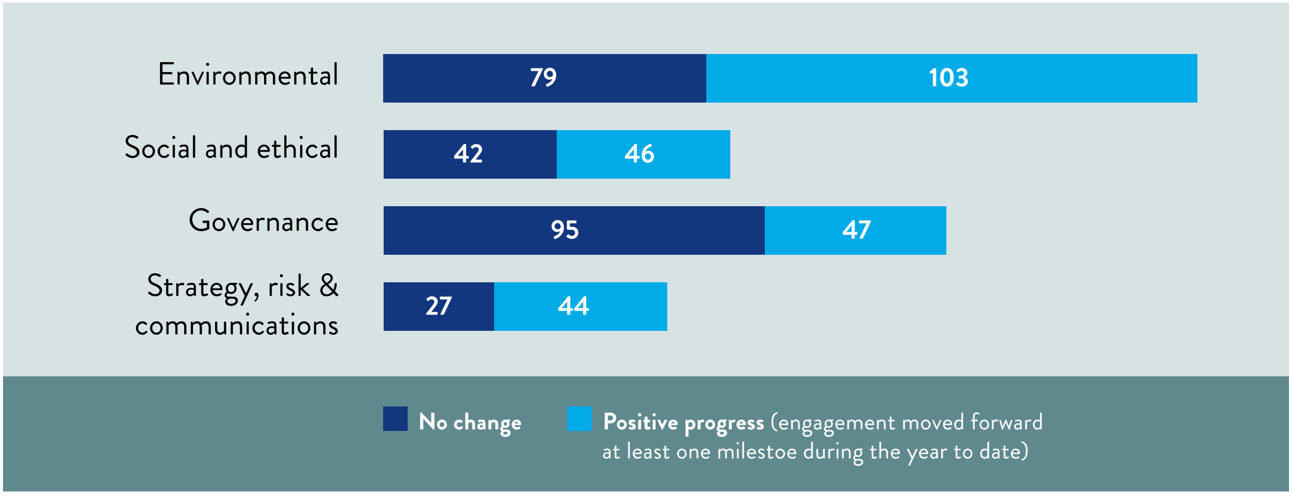
- Environmental **24.2%**
- Social and Ethical **20.3%**
- Governance **36.4%**
- Strategy, Risk & Comms **19.1%**

We engaged with 2 companies over the last year.

- Environmental **100%**

EOS also provide data on the progress (or success) of the engagement conducted on our behalf. Its data, shown in the figure below, suggests that significant progress was made in 2020, with over 200 examples of companies moving forward by at least one milestone, where the milestones are defined as follows:

MILESTONE 1	Concern raised with the company at the appropriate level
MILESTONE 2	The company acknowledges the issue as a serious investor concern
MILESTONE 3	Development of a credible strategy/stretching targets set to address the concern
MILESTONE 4	Implementation of a strategy or measures to address the concern.



EOS'S ENGAGEMENT WITH POLICYMAKERS

EOS engages with policymakers for a more sustainable financial system. This is achieved through engagements and meetings with government officials, financial regulators, stock exchanges, industry associations, and other key parties. It also participates in public consultations. In 2020 EOS made 52 public policy consultation responses or proactive equivalent such as a letter. As mentioned, LPF supports EOS's public policy engagement, as we recognise that many ESG and sustainability issues require policy interventions.

EOS participates in sign-on letters on ESG policy topics which it supports, typically as one of a few collaborative industry bodies and initiatives around the world, in which it is an active participant.

Principle 10

COLLABORATION

Signatories, where necessary, participate in collaborative engagement to influence issuers.

LPF is committed to working collaboratively to increase the reach, efficiency and effectiveness of RI. We work with a host of like-minded partner funds, service providers and related organisations striving to attain best practice in the industry and to improve industry standards. A list of our collaborative partners and their roles is publicly available on our website.

We work with others towards common goals

There are limits to the influence that we can 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 and we take a very active role in several of the Responsible Investment initiatives below.

COLLABORATION IN FURTHERANCE OF THE PRINCIPLES FOR RESPONSIBLE INVESTMENT (PRI)

We've been a signatory of the UN-backed PRI since 2008 and align our practices and processes to their six principles and definition of Responsible Investment. Our SRIP formally acknowledges the role and integration of the PRI's six principles within our investment process. PRI's Principle 5 is relevant: "We will work together to enhance our effectiveness in implementing the Principles." The collaborative activities below evidence our continuing commitment.

CA100+ is an international collaborative initiative by institutional investors representing over $55 trillion 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.

We've committed significant internal engagement resource to CA100+ by becoming a participant member of CA100+ in 2020. By participating actively in this group, our officers have influenced real change, including an accelerated timetable of coal power plant closures across Europe and a change to the corporate lobbying practices of companies with significant carbon emissions. Such engagement actions assist the target companies in becoming better prepared for a net-zero world. In addition to direct engagement as part of CA100+, we encourage our managers to sign up to similar initiatives. In 2020, our efforts to persuade the world's largest asset manager, BlackRock, to join the CA100+ initiative came to fruition.

IIGCC is a network of over 300 European investors representing over €37tn in assets. We joined the IIGCC in 2020 to further the work we do alongside other like-minded asset owners. The workstreams at IIGCC include: the Policy Programme; the Corporate Programme; the Investor Practices Programme; and the Paris Aligned Investor Initiative. The 'Net Zero Technology Accelerator' working group is chaired by one of our Responsible Investment leads and we're currently assessing the organisation's recent investor guide on the 'Net Zero Investor Framework' and its suitability for implementation.

TPI is a global initiative led by asset owners and supported by asset managers. It assesses companies' preparation for the transition to a low-carbon economy, supporting efforts to address climate change. In our SRIP, we've committed to benchmarking holdings against TPI's assessment as a measure of financial risk.

CPD runs a global environmental disclosure system, supporting thousands of companies, cities, states, and regions to measure and manage their risks and opportunities on climate change, water security and deforestation. The data collated performs a vital role in the measurement of environmental risk and allows us to reflect the carbon risk more accurately in portfolios. By contributing to the data which is collected from multiple sources, LPF improves the breadth and accuracy of the disclosures produced which can in turn, be used to influence issuers.

GRESB is an investor-led, sustainability benchmarking provider for real assets, covering real estate and infrastructure assets. It's a key driver of transparency regarding energy consumption data, particularly for standing real estate. We support this collaborative initiative as an investor member.

We've been clients of EOS since 2008 and they manage most of our voting and engagement activity. Our Internal Equities team work closely with EOS in our collective approach to engagement, reflecting the areas of stakeholder interest and concern. Through working collaboratively with EOS, and alongside EOS's international client base, we're able to have a stronger voice when engaging with our investee companies. We provide more detail in our text on Principle 9.

LAPFF is a collaborative shareholder engagement group, comprising over 80 UK local authority pension funds and six of the LGPS pension fund pools in England and Wales. A member of LPF's Pensions Committee is on the executive board of LAPFF, representing LAPFF and its member funds in high level engagement with company management.

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

UK Pension Fund RI Roundtable

The UK Pension Fund RI Roundtable is a longstanding collaborative endeavour, first convened by the Environment Agency Pension Fund, which brings together UK Asset Owners from the public and private sector, alongside charitable bodies and endowments, to work together to establish best practice in RI. LPF is an active participant.

Scottish Asset Owners Responsible Investment Roundtable

LPF founded this group, which brings together asset owners from the public and private sector in Scotland to raise awareness of responsible investment issues, so that a broader range of funds are able to establish best practice in RI.

Working with high school girls throughout Scotland to promote careers in investment management, Future Asset strives to open up the industry to poorly represented pools of talent. The investment industry has a well-known gender diversity problem, and LPF's investment professionals support Future Asset events acting as presenters and mentors for the girls, as well as providing work experience as a Future Asset partner.

Diversity Project Scotland

The Diversity Project is "a cross-company initiative championing a more inclusive culture within the Savings and Investment profession". LPF has long championed diversity in our investee companies, and this is a natural extension of that effort to improve diversity within our own ranks. Both investment and human resources colleagues are participating in this project.

Asset Owner Diversity Charter

THE ASSET OWNERS' DIVERSITY CHARTER

In mid-2021, we were delighted to be part of a group of UK asset owners inviting others to sign a new Diversity Charter to tackle a lack of diversity across the fund management industry.

The Charter has been devised by some of the largest pension schemes in the UK, forming a group called the Asset Owner Diversity Working Group, Co-chaired by LPF's Responsible Investment Lead, David Hickey and Helen Price from Brunel Pension Partnership. Representatives from Nest, RPMI Railpen, West Midlands Pension Fund and London CIV also participate.

The Diversity Charter offers a toolkit for analysing how asset managers are performing on diversity and inclusion, and where they can improve.

By signing up to the Asset Owner Diversity Charter, signatories are committing to take account of diversity and inclusion records from fund managers when choosing new partners. Diversity questions will form part of the overall assessment scores for each bidder. Fund managers will have to disclose information and demonstrate how they're tackling diversity and inclusion within their workforce.

Signatories also commit to including diversity as part of ongoing manager monitoring, and a questionnaire will be provided to managers annually for completion.

Other signatories outside of the initial steering group have already declared their support and have signed the Diversity Charter, and now represent £1.08 trillion of AUM.

We led an asset owner collaboration

We've had great success working with BlackRock, the world's largest asset manager. Alongside collaborative colleagues, 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 AUM to the goals of CA100+. The work of small but committed asset owners, representing the views and interests of their stakeholders, has changed policy at BlackRock.

Principle 11

ESCALATION

Signatories, where necessary, escalate stewardship activities to influence issuers.

We aim to engage proactively and constructively in public and private markets, with companies directly or via external managers. As we illustrate in this report, our stewardship activities include:

- Direct engagement with investee companies and issuers
- Collaborative engagement with companies, including leading the Climate Action 100+ engagement with Fortum
- Abstaining or voting against management (including against specific directors and against the annual report and accounts)
- Using the media and other forums to challenge companies
- Using the insights from engagement to inform our investment research and decision-making.

Given the range of assets in which we invest, we don't have a universal escalation policy. Instead, we tailor our approach to the investment type and the scale of the issues identified. We prefer to engage through dialogue for improvement, but we will escalate our concerns if necessary improvements are not forthcoming.

Escalating concerns with companies in which we invest

We expect companies to advise us when there are material changes and issues which impact long term shareholders. Our initial position is to support the board and management to improve their corporate strategy to the benefit of shareholders.

When appropriate and where we have concerns, we'll begin a dialogue and put forward proposals for the board's consideration. Should our concerns not be adequately addressed, we may consider a range of escalation options as part of an escalation process illustrated below:

Escalating ESG concerns with external managers

We also set clear expectations of stewardship in our mandates with external investment managers. We challenge them if we feel that they're not delivering on the stewardship commitments they've made to us. If we're concerned about an investment manager's performance (which we'll capture in our monitoring reports), and if the investment manager has not improved following feedback from us, we have a range of escalation options available to us, as outlined in below.

Typical escalation options:

- Notifying the external manager about their placement on a watch list
- Engaging the external manager's board or investment committee
- Reducing our exposure to the external manager until any non-conformances have been rectified
- Terninating the contract with the external manager (or not reappointing them) if failings persist over a period of time

Escalating concerns through our engagement and voting provider

As we discuss in Principles 9 and 12, Hermes EOS provides us with an engagement service which involves engaging with the publicly listed companies in our portfolios and providing us with voting recommendations for these holdings. Generally, EOS' preference is to engage with companies. This would only be escalated into voting against management in situations where engagement is proving to be ineffective. We strongly support this approach and see shareholder votes against management as a strategy to be deployed sparingly in situations where dialogue is ineffective. We generally support EOS' voting recommendations, but we scrutinise all recommendations and do, on occasion, vote in a different way (e.g. if we think it's premature to escalate or if we think that it's time to escalate and EOS has not recommended it).

Escalating concerns in private markets

While the options available to us in terms of escalation in close ended investment funds are more limited, we do make it clear that concerns or a lack of transparency will feed into the assessment of subsequent investment opportunities presented by that manager.

EXAMPLES OF RECENT ESCALATION ACTIVITY

During 2020 we employed multiple escalation approaches.

- On one occasion, we requested that our engagement partner, EOS at Federated Hermes, begin new engagements on our behalf on emerging issues in portfolio companies
- On multiple occasions, we escalated specific engagements to more senior levels of accountability in companies from Investor Relations Officers to C-level management to the Chair and independent board members
- As part of CA100+, we prepared to co-file resolutions with two companies. This complex and time-consuming process occurred over the close of 2020 and the beginning of 2021. One co-filing targeted the lack of transition planning at an oil company, where we were due to co-file alongside US pension giant Calpers. Legal challenge by the underlying company forced us to cease this approach. The second co-filing targeted corporate lobbying practices at a European utility firm, where we were due to co-file with Swedish Public Pension fund AP7. On the day of filing, the company in question agreed to a complete review of their corporate lobbying processes, leading to our decision to drop the resolution we were due to file. The company is making excellent progress on their new corporate lobbying approach
- During 2020, there were no stock sale decisions made as a result of engagement failures
- Divestment remains a key tool available to our managers in the event that the risk exposure from any individual investment (including ESG matters) is assessed to be too high.

Principle 12

EXERCISING RIGHTS AND RESPONSIBILITIES

Signatories actively exercise their rights and responsibilities

We believe that responsible investment involves exercising our shareholder voting rights, and that such voting is an integral part of our engagement with companies. We vote on all resolutions tabled at the General Meetings of our investee companies or LPF consent matters within funds we've invested in.

Voting, in combination with engagement, can reinforce the message we send to company management about how they're running their businesses. While much focus tends to be on controversial votes and votes against management, we think it's equally important to signal our support for management in situations where management is doing a good job of navigating risks, challenges and complexities. As can be seen from our voting data below, we recognise that, in most cases, boards are managing these issues effectively and we continue to support them in their endeavours.

We subscribe to a specialist third party service (EOS) to provide engagement (see Principle 9) and to provide proxy voting recommendations to us. Generally, we follow EOS's voting policy (available here) and voting recommendations which is informed by their engagement with companies. However, when there's a controversial vote (e.g. a recommendation to vote against management) or when there's an issue that we're concerned about (e.g. a governance risk identified through our investment research), we'll speak with EOS about the resolution, to understand the context and their reasons for the recommendation being made.

We maintain our autonomy to override voting instructions.

In recognition of the value of active engagement, our external voting provider works with our internal and external fund managers to co-ordinate and execute voting instructions. We require them to provide portfolio managers with notice of voting instructions and allow them to override any EOS recommendation.

There are some instances where we have chosen not to follow EOS's recommendations. For example, in 2020 we voted against proposed changes to Fortum's articles of association where the EOS recommendation was to vote in support of the changes.

We report on our voting activities, including the number of votes cast, the votes for and against management and controversial votes. We report this information alongside information on our engagement activities because we believe that the two activities work together, not as discrete, stand-alone activities.

We're prepared to file or co-file shareholder resolutions on important issues at our investee companies. For example, in 2020, as part of the CA100+ collaborative engagement, we prepared to file or co-file shareholder resolutions at two companies. Further details of these two resolutions can be found in Principle 11.

DATA AND STATISTICS: HERMES EOS ADVISED FUNDS

We publish information on our voting activities and its relationship to engagement on our website: **https://www.lpf.org.uk/downloads/file/112/hermes-eos-annual-report-2020.**

Company-by-company data is available on request. Our stakeholders have signalled that publication of this data on our website was hard to consume (with details on specific companies lost amongst the scale of disclosure), so we no longer routinely publish all this data.

In 2020, we voted on all equity holdings in the fund. This meant that we voted on 8,196 resolutions at 568 meetings. At 295 of those meetings, we opposed one or more resolutions, and at seven meetings, we abstained.

The issues on which we abstained or voted against management (in-line with EOS recommendations) are presented below.

We recommended voting against or abstaining on 886 resolutions over the last year.

- Board structure **32.8%**
- Remuneration **32.8%**
- Shareholder resolution **17.3%**
- Capital structure and dividends **7.1%**
- Amend articles **1.8%**
- Audit and accounts **4.1%**
- Poison pill/Anti-takeover device **0.2%**
- Other **3.8%**

REFLECTIONS ON THE 2020 VOTING SEASON

2020 was an exceptional year. Covid-19 caused huge disruption to companies globally. Many businesses suffered dramatic losses and needed to make drastic cuts to their workforces and the payments (dividends) that they made to their investors. We recognised that we needed to balance our longer-term engagement agenda with understanding and supporting the efforts that companies were making to manage through the pandemic. Given the importance of a stable board for effective crisis management, in a number of cases we decided to vote in favour of chairs or committee chairs, despite having concerns about poor gender diversity or board or committee independence.

While climate change-related votes (e.g. at Shell, Exxon, Woodside Petroleum and Santos) dominated the press coverage, most of our voting and AGM attention was focused on two more traditional areas: board composition and diversity, and executive remuneration. We offer some reflections on the issue of gender diversity in UK boardrooms below.

GENDER DIVERSITY IN THE UK

In the UK, the Hampton-Alexander Review established 2020 targets for 33% female representation on boards and in leadership roles.

In 2020, we opposed 35 proposals because of concerns about the lack of diversity at board level and below.

We continued to support EOS's efforts to target laggard FTSE 100 companies with all-male executive committees. One such company is Rolls-Royce. We would normally have recommended against the re-election of the chair in such circumstances but, given the upheaval at the company due to the pandemic, we agreed with EOS that 2020 wasn't the best year to carry out such a change. We also received assurances from the company that diversity was a strategic priority for the business. While we supported management, we've agreed with EOS that it will continue to push for more ambitious targets and rapid change.

Executive remuneration is always a contentious issue and, against the backdrop of the coronavirus, decisions on how to reward executives were thrown into sharp relief. We believe that CEOs and boards should lead by example, particularly in situations where companies made use of government support, made workforce pay cuts or job losses or where the company was otherwise distressed. We looked for appropriate reductions to salaries and incentive pay and for boards to use their judgement to ensure executives weren't being unduly insulated from the impacts of the crisis where others weren't. We opposed pay proposals where we didn't believe appropriate adjustments had already been made.

SECURITIES LENDING

Our securities lending programme uses our existing asset base to generate an additional source of income. The programme is managed in accordance with our responsible investment policies. During 2020 we updated our policy for securities lending. We now automatically recall all securities on loan for voting purposes. This means that we'll always vote on all our holdings for our entire holding in every company, which adds significant weight to the influence we exercise as shareholders.

SHAREHOLDER ACTION

We describe our approach to shareholder action in relation to Principle 4. We consider this to be another way that we exercise our responsibilities as asset owners. Taking action to recover assets lost through investments in companies as the result of corporate mismanagement or wrongdoing is an aspect of our duty to stakeholders.

LOTHIAN
PENSION FUND

PO Box 24158,
Edinburgh, EH3 1GY

Phone: **0131 529 4638**
Email: **pensions@lpf.org.uk**
Web: **www.lpf.org.uk**