Development of responsible investment policy

Introduction

This note is addressed to the Officers and Pensions Committee of the London Borough of Havering Pension Fund ("the Fund"). It sets out our thoughts on the evolution of the Fund's responsible investment policy in light of evolving market practice and the development of the committee's investment beliefs, including updated wording. This paper should not be released or otherwise disclosed to any third party without our prior written consent except as required by law or regulatory obligation. We accept no liability to any other party unless we have especially accepted such liability in writing.

Responsible Investment Principles: implication of investment beliefs for Fund policy

Earlier this year, the Committee undertook an exercise to frame its investment beliefs. These beliefs (reproduced as Appendix 1 of this note) cover various elements of the investment strategy and decision-making process. It is important to interpret these beliefs and consider how they affect the approach to responsible investment to be adopted by the Committee – not all beliefs are relevant in this context.

We set out below our interpretation of these beliefs in the form of a set of guiding principles along with the actions that the Committee could pursue. It is important to note that this represents a potential starting point for the Committee in the evolution of its approach to responsible investment for further discussion.

1. The Fund is a long-term investor – the strategies employed should recognise the importance of long-term decision making. Ensuring that assets deliver sustainable returns is more important than short-term profit seeking. In considering long-term risks, climate change is both a growing regulatory consideration and presents a long-term risk to financial outcomes and should be considered in decision making. We consider how the Committee could address this issue in the next section.
2. Index benchmarks dictate the manner in which passive assets are deployed and, in the case of market cap indices, includes an implicit assumption that all risks, including ESG risks, are priced. The Committee should regularly review the ongoing appropriateness of its index-tracking benchmarks to ensure that they remain appropriate for the Fund over the long-term. As the final step in the implementation of strategy, the forthcoming equity review should directly consider the appropriateness of the current benchmarks and the merit of alternative index benchmarks for the Fund.
3. Stewardship through the voting of shares and engagement with companies is a means of influencing the future direction of companies in order to preserve and potentially add value. Divestment simply transfers ownership of assets and, to some degree, does not automatically create change. Therefore, to the extent that stewardship does not achieve its objectives then divestment is the final step open to investors. Active management allows this step whereas passive investment strategies do not. Consideration could be given to the manner in which passive managers are mandated to allow such action – this can also be considered within the equity review.
4. Expanding the notion of stewardship, it is viewed that collaborative action is more likely to be effective than the Fund acting alone. To ensure that the Fund's voice is heard, the Committee should consider the issues it deems are more important to be vocal on, and to ensure that managers (including the London CIV) are held to account for related decisions. Recognising another of the Committee's beliefs, one such approach could be ensuring and vocalising the need for high standards of disclosure.

Climate risk considerations

There is a growing regulatory requirement for long-term investors to consider the extent to which climate change could impact on financial outcomes. For example, the PRA has required insurers and banks to take steps and, following the recent change to legislation for occupational pension schemes, the Pensions Regulator has set up a working party to consider guidance for pension schemes which will be published early in 2020. The Scheme Advisory Board is also expected to incorporate climate change considerations into its guidance for LGPS funds during 2020.

In its investment beliefs (set out in Appendix 1) the Committee recorded a belief that climate change and the expected transition to a low carbon economy represents a long-term financial risk to Fund outcomes. Whilst the Committee could wait for further guidance on this issue, we expect that the guidance will broadly follow the framework proposed by the Taskforce for Climate-related Financial Disclosures (TCFD). Accordingly, we believe the Committee should begin taking steps to consider this risk.

Following this framework, the Committee could consider actions including:

- Receiving training on climate risk to improve identification and assessment of climate-related risks across the investment portfolio
- Measuring exposure to and receiving reporting on climate risk considerations and using this to set targets;
- Escalating engagement with investee companies on climate-related topics.

In addressing climate risk, many pension funds have begun by focusing on their equity portfolios, seeking to understand (1) exposure to companies involved in the extraction and generation of power from fossil fuels and (2) exposure to companies with high levels of carbon emissions. Whilst carbon risk is not climate risk, this would be a sensible first step for the Committee and can be considered within the forthcoming equity review.

Next steps

Taking the Committee's investment beliefs and building on developing market practice, we believe that the Committee can take steps to better state its approach to responsible investment and more directly embed the consideration of responsible investment issues into investment processes. Drawing on the points above, we have drafted additional wording for the Committee's policy statement which we set out in Appendix 2. Committee is asked to consider this draft wording.

We also recommend that the Committee:

- Directly consider ESG and climate risk considerations as part of its forthcoming equity strategy review, and
- Agree to more direct scrutiny of its equity investment managers on their stewardship and, where appropriate, challenge managers on the action they have taken.

We look forward to discussing this note with Committee.

Prepared by:-

Simon Jones, Partner & Head of Responsible Investment
Callum Stewart, Investment Consultant

For and on behalf of Hymans Robertson LLP

November 2019

Appendix 1: Investment beliefs

1 Clear and well-defined objectives are essential to reflect the Funds long-term strategic direction of travel and to help build a plan for achieving these objectives.

2 The Fund and its liabilities are long-term in nature and the Committee supports long term investing as a means of enhancing returns, reducing transaction costs, encouraging improved governance and delivering stable contribution rates.

3 Strategic asset allocation is a key determinant of risk and return, and thus is typically more important than manager or stock selection.

4 Diversification between asset classes and regions is expected to provide greater stability to investment returns whilst diversification over many different managers needs to be balanced against the Committee's governance budget.

5 Returns net of fees and costs are more important than the absolute level of fees although investment managers' fees should be transparent and reviewed regularly.

6 Active management can add value although the performance of active managers should be measured over a sufficiently long investment horizon.

7 Benchmarks matter, particularly where they dictate the manner in which assets are invested.

8 Environmental, Social and Governance factors can pose financially material risks and it is incumbent on investment managers, where they have the discretion to do so, to ensure that such risks are reflected in decision making

9 Effective stewardship through informed voting and engagement can positively influence corporate behaviours although success is most likely to be achieved through greater collaboration

10 Climate change and the expected transition to a low carbon economy represents a long term financial risk to Fund outcomes and should be considered as part of the Committee's fiduciary duty.

11 Decision making can be improved through the greater disclosure of information and the Fund should both support and demonstrate high standards of disclosure.

12 Excluding assets from portfolios for non-financial reasons is unlikely to be appropriate in the majority of circumstances.

Appendix 2: Proposed update to responsible investment policy wording (draft with changes tracked)

~~How social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments~~

Approach to responsible investment including climate change considerations

It is recognised that a range of factors, including Environmental, Social and Governance (ESG) factors, can influence the return from investments. The Fund will therefore invest on the basis of financial risk and return having considered a full range of factors contributing to the financial risk including ESG factors to the extent these directly or indirectly impact on financial risk and return. In making investment decisions, the Fund seeks and receives proper advice from internal officers and external advisers with the requisite knowledge and skills.

The Fund recognises that climate change is a systemic risk with the potential to directly impact economic, financial and social systems. Wherever possible, the Fund will directly consider the potential impact of climate risks on investment decision making within its investment portfolios.

The Fund requires its investment managers to integrate all material financial factors, including corporate governance, environmental, social, climate and ethical considerations, into the decision-making process for all fund investments. ~~It~~Within passive mandates where the choice of index dictates the assets held by the investment manager and the manager has minimal freedom to take account of factors that may be deemed to be financially material, the Fund will review the index benchmarks employed for the Scheme on at least a triennial basis.

The Fund expects its managers to follow good practice and use their influence as major institutional investors and long-term stewards of capital to promote good practice in the investee companies and markets to which the Fund is exposed. As a minimum, the Fund expects its managers (including the London CIV) to be signatories of the UN supported Principles for Responsible Investment and, where appropriate, the FRC UK Stewardship Code. The Fund will periodically review its managers' reporting against these standards, as well as other relevant industry standards, and will challenge its managers to improve their practices where the Fund deems it appropriate to do so.

The Fund expects its external investment managers (and specifically the London CIV through which the Fund will increasingly invest) to undertake appropriate monitoring of ~~current~~underlying investments with regard to ~~their~~the policies and practices on all issues which could present a material financial risk to the long-term performance of the ~~fund~~Fund such as corporate governance and environmental factors. The Fund ~~expects~~will engage with its ~~fund~~ managers to ~~integrate material ESG factors within its investment analysis and decision making.~~ understand what actions have been taken during regular review meetings.

Whilst the Fund expects that manager appointments in respect of new investments will be made through the London CIV, where the Fund makes its own appointments, responsible investment considerations will form a component of the manager selection decisions. The Fund will also encourage the London CIV to adopt best practice standards in the evaluation and monitoring of managers employed for investment.

Effective monitoring and identification of ~~these~~ESG issues can enable engagement with boards and management of investee companies to seek resolution of potential problems at an early stage. Where collaboration is likely to be the most effective mechanism for encouraging issues to be addressed, the Fund expects its investment managers to participate in joint action with other institutional investors as permitted by relevant legal and regulatory codes. Where appropriate, the Fund will work with the London CIV to promote collective engagement on behalf of all investors.

The Fund monitors the activity of its investment managers on an ongoing basis and will review the approach taken annually.

Consideration of non-financial factors and social investments

At the present time the Committee does not take into account non-financial factors when selecting, retaining, or realising its investments. The Committee will review its approach to non-financial factors periodically, taking into account relevant legislation and the Law Commission's guidance on when such factors may be considered. Additionally, the Committee monitors legislative and other developments with regards to this subject and will review its approach in the event of material changes.

The Committee understands the Fund is not currently able to exclude investments in order to pursue boycotts, divestment and sanctions against foreign nations and UK defence industries, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government.

The Fund does not at the time of preparing this statement hold any assets which it deems to be explicit social investments; however, this ISS places no specific restrictions on the Fund in respect of such investments beyond those of suitability within the Investment Strategy as a whole and compatibility with the Committee's fiduciary duties. In considering any such investment in the future, the Committee will have regard to the Guidance issued by the Secretary of State and to the Law Commission's guidance on financial and non-financial factors.

Stewardship of assets

~~The Fund in preparing and reviewing its Investment Strategy Statement will consult with interested stakeholders including, but not limited to Fund employers, investment managers, Local Pension Board, advisers to the Fund.~~

~~**The exercise of rights (including voting rights) attaching to investments**~~

The Fund recognises the importance of its role as stewards of capital and the need to ensure the highest standards of governance and promoting corporate responsibility in the underlying companies in which its investments reside. The Fund recognises that ultimately this protects the financial interests of the Fund and its ultimate beneficiaries. The Fund has a commitment to actively exercising the ownership rights attached to its investments reflecting the Fund's conviction that responsible asset owners should maintain oversight of the companies in which it ultimately invests recognising that the companies' activities impact upon not only their customers and clients, but more widely upon their employees and other stakeholders and also wider society.

~~The Fund's investments~~The Fund recognises that its equity assets are invested in pooled vehicles, it remains subject to the voting policies of the managers of these vehicles:

- Investments through the London CIV are covered by the voting policy of the CIV which has been agreed by the Pensions Sectoral Joint Committee. Voting is delegated to the external managers and monitored on a quarterly basis. The CIV will arrange for managers to vote in accordance with voting alerts issued by the Local Authority Pension Fund Forum as far as practically possible to do so and will hold managers to account where they have not voted in accordance with the LAPFF directions.
- In respect of ~~the Fund's~~Fund investments outside the London CIV, the Committee has delegated the exercise of voting rights to the investment managers on the basis that voting power will be exercised by them with the objective of preserving and enhancing long term shareholder value. ~~Accordingly, the~~

The Fund's managers have produced written guidelines of their process and practice in this regard. The managers are strongly encouraged to vote in line with their guidelines in respect of all resolutions at annual and extraordinary general meetings of companies under Regulation 7(2)(f). The Committee monitor the voting decisions made by all its investment managers and receive reporting from their advisers to support this on an annual basis.

~~The Fund will~~The Committee will request its investment manager provide details of any change in policy on an annual basis. The Committee will review these changes and, where necessary, will challenge managers to explain the reasoning for any change.

The Committee reviews voting activity by its investment manager on an annual basis and may also periodically review managers' voting patterns. The Committee will challenge its managers to explain voting decisions on certain issues, particularly with regard to climate risk disclosure. The Fund will also incorporate a report of voting activity as part of its Pension Fund Annual report which is published on the Council website.

At the time of production of the ISS the Fund has not issued a separate Statement of Compliance with the Stewardship Code, but fully endorses the principles embedded in the ~~seven Principles of the~~ Stewardship Code.

In addition, the Fund expects its investment managers to work collaboratively with others if this will lead to greater influence and deliver improved outcomes for shareholders and more broadly.

The Fund through its participation in the London CIV will work closely with other LGPS Funds in London to promote best practice by the CIV and enhance the level of engagement both with external managers and the underlying companies in which invests.

Consultations and review of policy

The Fund in preparing and reviewing its Investment Strategy Statement will consult with interested stakeholders including, but not limited to Fund employers, investment managers, Local Pension Board, advisers to the Fund.

The Committee will review this policy annually, or earlier if there is a material change in circumstances e.g. new regulations or legislation.

Appendix 3: Proposed update to responsible investment policy wording (draft clean version)

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