



# RESPONSIBLE INVESTMENT FRAMEWORK

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## 1) INTRODUCTION

This framework defines the commitment of LGPS Central Investment Pool ('the Pool') to responsible investment (RI). Its purpose is to detail the approach that the Pool aims to follow in integrating environmental, social and governance (ESG) issues in its investments. This framework has been adopted by the Section 101 Committees of the Pool's participating funds.

### 1.1 Beliefs and Guiding Principles

The Pool's RI beliefs and guiding principles underpin its RI approach and are described below.

#### *ESG Integration*

The Pool believes that effective management of financially material ESG risks should support the Pool's requirement to protect returns over the long term. With regard to climate change risks, the Pool recognises that the scale of the potential impacts is such that a proactive and precautionary approach is needed in order to address them.

The Pool considers RI to be relevant to investment performance across asset classes.

The Pool recognises the need to operate at a market-wide level to promote improvements that will help it to deliver sustainable long-term growth.

It is supportive of the UK Stewardship Code and will, on commencing operation, be a Tier 1 signatory to the Code.

#### *Engagement Versus Exclusion*

Investee companies with robust governance structures should be better positioned to handle the effects of shocks and stresses of future events. There is risk but also opportunity in holding companies that have weak governance of financially material ESG issues. Thus, the Pool has a policy of risk monitoring and engagement in order to positively influence company behaviour and enhance shareholder value, influence that would be lost through a divestment approach. The Pool extends this principle of 'engagement for positive change' to the due diligence, appointment and monitoring of external fund managers who are at an early stage of developing its RI approach.

The Pool believes that it will improve its effectiveness by acting collectively with other like-minded investors because it increases the likelihood that it will be heard by the company, fund manager or other relevant stakeholder compared with acting alone.

#### *Fees and Incentives*

Managing fees and costs matter in low-return environments. Fee arrangements with external fund managers – as well as the remuneration policies of investee companies – should be aligned with the participating funds' long-term interests. The Pool recognises that it is part of its fiduciary duty to ensure that there is appropriate alignment.

#### *An Evolving and Flexible Approach*

The Pool recognises that it, along with the entire investment chain, is on a journey with respect to RI. This framework will remain flexible and will evolve over time to reflect evolving market developments.

### 1.2 Oversight and Application

Section 101 Committees of participating funds will review this policy at a minimum annually, or whenever they or the Pool proposes revised RI policies and procedure. The Head of RI is responsible for policy implementation.

### 1.3 Content

The RI framework is divided into two distinct sections:

- What the Pool expects of itself, companies and fund managers with respect to RI (Section 2).
- How the RI beliefs and guiding principles are implemented in practice (Section 3).

Definitions are also provided in Section 4.

## 2) RI EXPECTATIONS

### 2.1 Pool

#### 2.1.1 General

The Pool aims to:

- 1) Be aware of and monitor financially material ESG issues in the context of investment and manager selection. Depending on the asset class and nature of the proposed mandate or vehicle, the Pool will monitor:
  - ESG issues in relation to internally managed investments;
  - the extent to which the external managers incorporate ESG issues into their investment processes; and
  - hold external managers to account for improvement in their ESG performance over a reasonable timeframe.

- 2) Make full use of its ownership rights, including voting and engagement activities. Either directly, collaboratively or through specialist service providers:
  - hold constructive dialogue with listed companies;
  - encourage the disclosure by companies of ESG issues; and
  - participate in the development of public policy on ESG issues.
- 3) Disclose and maintain a policy for identifying and managing conflicts of interest with the aim of taking all reasonable steps to put the interests of participating funds' beneficiaries first.
- 4) Keep our stakeholders aware of our RI activities through:
  - making its RI policy documents public, eg, voting policies, RI policy;
  - providing a summary of the Pool's RI activities for publication in participating funds' annual reports;
  - publishing aggregate voting and company engagement statistics on a quarterly basis

### 2.1.2 Climate Change

The Pool aims to:

- encourage improvement in the level of disclosure by companies of material climate change impacts through collaborative initiatives;
- support – and where applicable co-file – reasonable shareholder proposals to disclose/justify a company's approach to climate change risk;
- review its fund managers to understand their approach to incorporating climate change considerations and encourage improvements in identifying and assessing the potential impact of climate change;
- contribute to public policy with regard to climate change as it relates to investment considerations;
- increase awareness of climate change as it applies to investment decision making through participation in relevant industry forums and collaborative initiatives; and
- keep up to date on the latest research and thinking on the financial materiality and interconnectedness of climate change within and across asset classes.

## 2.2 Companies

The Pool expects UK companies to adhere to the UK Corporate Governance Code<sup>1</sup> on a comply or explain basis. Further, the Pool has bespoke UK corporate governance guidelines which aim to deal with issues that are either not covered by the Code, require greater emphasis or are specifically left open for shareholders to resolve with company boards.

The Pool expects companies outside the UK to adhere to international voting principles, recognising local application and development.

### *Environmental and Social Risks*

The Pool expects companies to manage and disclose its environmental and social risks to the extent required for an understanding of the development, position and performance of the company.

In alignment with the Association of British Insurers' position, there are aspects of environmental and social reporting on which the Pool places particular value given their relevance across all sectors, its holistic approach to risk management, and the view that owners should not micro-manage companies. This is narrative reporting which:

- sets ESG risks in the context of the whole range of risks and opportunities facing the company;
- contains a forward looking perspective; and
- describes the actions of the board in mitigating these risks.

In terms of the specific environmental and social issues to focus upon, the Pool takes a case-by-case sector-based approach.

## 2.3 Fund Managers

### 2.3.1 Due Diligence

The Pool collects the following information from each manager before they are appointed where applicable to the asset class:

- Copy of their ESG, active ownership policies or equivalent which articulates how ESG factors (stemming from research, active ownership activities or other sources) are integrated into their investment process
- Case studies or examples of where ESG issues have influenced an investment decision
- Information on the process for integrating any third party ESG data (for example, MSCI) into their company financial models, investment strategies and portfolio construction
- RI reporting format

<sup>1</sup><https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf>

- Whether they are a signatory of the UN-backed Principles for Responsible Investment (PRI) and Stewardship Code, copy of their PRI public report and annual assessment scores if applicable.

### 2.3.2 Appointment

The Pool assesses the ESG capability of a fund manager as a factor within each of the people, process and performance categories. In its decision to appoint a fund manager, the Pool takes a balanced consideration of all relevant factors including ESG. However, the Pool will pay particular attention to adherence to relevant soft regulatory codes<sup>2</sup>, notably the UK Stewardship Code, depending on the market in which it invests.

In practice, this means the Pool is willing to hire a fund manager at an early stage of developing its RI approach so long as there is a demonstrable RI commitment and a willingness to improve in their approach over time. In alignment with our guiding principles on 'engagement versus exclusion', the Pool believes that there is added value in working with them to improve their approach.

### 2.3.3 Monitoring and Reporting

Each external fund manager is expected to report<sup>3</sup> at agreed intervals to the Pool on how their RI activities are contributing to improved long-term risk-adjusted returns. Examples of information that can be provided in aid of this objective include but are not limited to the following:

- The evolution of how the manager integrates the consideration of ESG issues into its investment and active ownership activities.
- How investment and active ownership functions are combined to protect and/or enhance shareholder value
- How the manager exercised the Pool's voting rights.
- Any outcomes arising from the manager's engagement with companies and their effectiveness.

## 3) RI IMPLEMENTATION

The Pool's active ownership approach can be divided into three distinct areas: **voting globally**, **engagement through partnerships** and **shareholder litigation**. This section briefly outlines the Pool's processes for each.

### 3.1 Voting Globally

Where practical<sup>4</sup>, the Pool aims to vote in every single market in which it invests. In the interests of sending a consistent signal to investee companies, the Pool has decided to use a third party provider for analysis of governance issues and executing its proxy voting rights across all markets in which it invests. At the present time, the Pool believes that the advantage of a consistent signal outweighs the inherent disadvantages to disconnecting the voting function from the investment and engagement decisions of external fund managers. However, given market developments in this area, the Pool will re-evaluate this position on a yearly basis.

Reference to the Pool's voting policies is provided in Section 2.2 under 'Company Expectations'.

#### *Securities Lending Programme*

The Pool has an active securities lending programme. To ensure that the Pool is able to vote all its shares at important meetings, the Pool has worked with service providers to establish procedures to restrict lending for certain stocks and recall shares in advance of shareholder votes. The Pool monitors the meetings and proportion of the securities on loan, and will restrict and/or recall lent stock in select circumstances.

### 3.2 Engagement Through Partnerships

The Pool uses various engagement platforms to maximise its influence as an active owner in collaboration with other like-minded investors. The Pool's primary engagement partnerships are highlighted below.

#### *Local Authority Pension Fund Forum*

The Pool is a member of the Local Authority Pension Fund Forum (LAPFF). LAPFF is the UK's leading collaborative shareholder engagement group encompassing local authority pension funds from across the country with combined assets of over £160 billion. The Pool is an active participant in LAPFF's engagement programs. Membership of LAPFF provides the Pool with:

- independent research and advice on the ESG risks of companies to inform further stakeholder engagement;
- advice on the governance practices of companies;

<sup>2</sup>For example, UK and Japanese Stewardship Codes

<sup>3</sup>Refers to either formal written reporting and to informal verbal communications, which can be regular and/or ad-hoc in frequency.

<sup>4</sup>Issues such as power of attorney or share blocking in certain markets may prevent the Pool's ability to do so

- a forum to engage with companies to improve governance practices; and
- proxy voting advice on proxy voting for annual general meetings.

#### *Industry Engagement*

In collaboration with other like-minded investors, notably other LGPS investment pools, the Pool may engage with public policy makers, regulators, trade bodies, indexes and other players in the financial markets to achieve the aim of promoting sustainable growth. The Pool considers these initiatives on a case-by-case basis.

### 3.3 Shareholder Litigation

The Pool frequently hold securities that are the subject of individual and class action securities litigation. There are a number of litigation options available when a company has violated securities laws that result in losses to participating funds.

For US-based claims, the options would be to:

- remain in the class action and file proof of claim;
- participate as a lead plaintiff in a class action; or
- opt out and file a private action.

For non-US based claims, the options would be to join an existing group action or file a group action as a lead plaintiff.

The Pool takes a case-by-case approach in determining whether or not to join a class action but considers factors such as:

- advantages and disadvantages of the Pool becoming actively involved;
- relative size of the Pool's potential losses compared to other organisations;
- likelihood of success; and
- whether the Pool is fully indemnified against costs, expenses, counterclaims and any other losses.

- 3.4 Where external service providers are used for voting, engagement and shareholder litigation, the Head of RI will be responsible for ensuring that the quality of service provision is kept under regular review, reporting concerns internally and following up with the supplier. This includes verifying that engagement and voting are undertaken in line with LGPS Central's agreed RI Framework.

## 4) DEFINITIONS

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### **Responsible Investment**

The integration of environmental, social and corporate governance (ESG) considerations into investment management processes and active ownership practices in the belief that these factors can have an impact on financial performance. The Pool also supports the PRI's definition of responsible investment which can be found here:

<http://www.unpri.org/introducing-responsible-investment>

### **ESG**

Environmental, social and governance factors which may impact on company performance and therefore investment returns. Examples include resource management and pollution prevention, climate change impacts, labour management, product integrity, executive compensation, board independence and audit function.

### **Governance**

The process and principles by which a company or organisation undertakes its business. For the Pool, governance includes how it undertakes both its operational and investment responsibilities on behalf of its members.

### **Active Ownership**

Refers to the responsibility of the Pool to participate, where appropriate, in the governance decision-making of companies in which it invests by way of voting and by engagement with company management, either directly or via its fund managers. It also recognizes the relevance of engaging with regulatory bodies and other market players to support policies that promote long-term sustainable growth.

