HYMANS ROBERTSON

Appendix D

Leicestershire County Council Pension Fund

Climate strategy – engagement and divestment

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1 Introduction

Addressee and purpose

This paper is addressed to the Local Pension Committee of Leicestershire County Council Pension Fund ("the Fund"). The purpose of this paper is to provide recommendations on the role of engagement and divestment in delivering the Fund's climate strategy.

This paper should not be used for any other purpose. It should not be released or otherwise disclosed to any third party except as required by law or with our prior written consent, in which case it should be released in its entirety. We accept no liability to any other party unless we have accepted such liability in writing. We provide comment from an investment but not a legal or tax perspective.

Background and scope

Climate change poses significant risks to long-term investors but also an important source of investment opportunities. The Fund is developing a strategy for dealing with the impact of climate change on the Fund's primary purpose which remains to fund the pension benefits of its members. Contributing to the wider response to climate change is not considered to be an objective in its own right. The Fund is keen to ensure that its climate strategy is suitably ambitious, deliverable and aligned with current best practice, and has requested input on several topics relating to the development of the strategy. This paper covers:

- Importance of stewardship in delivering the Fund's climate strategy;
- Role of engagement and divestment and the pros and cons of each;
- Characteristics of effective engagement;
- Circumstances in which divestment and exclusion are appropriate;
- Areas for future development.

The Fund has adopted the Net Zero Investment Framework ("NZIF") to guide the development and implementation of its Climate Strategy. We believe this is a robust framework and our recommendations are aligned with it.

Summary of recommendations

Long-term asset owners can play a significant role in decarbonising modern economies though the capital allocation decisions they make and the stewardship of the companies they finance. The role is increasingly being reflected in regulations and best practice, and recognised to be one of the fiduciary obligations of asset managers. It is also reflected in the Fund's commitment to Responsible Investment ("RI") and in its investment beliefs.

Both engagement and divestment are proven and necessary elements of an effective approach to stewardship; they should not be seen as mutually exclusive.

Engagement has the potential to add value to portfolio companies and promote real world change. It is the recommended approach for long-term asset owners providing the circumstances are conducive to engagement. Divestment is a necessary alternative and forms a key part of an escalation strategy when engagement proves to be ineffective. Exclusion policies can pre-empt the need for divestment and can be effective if applied sparingly.

The majority of engagement activity and divestment decisions are delegated by the Fund to its investment managers include LGPS Central ("LGPSC"). The Fund retains responsibility for setting investment strategy and policies, which will continue to have a significant impact on stewardship activity and outcomes. Changes to investment strategy (strategic asset allocation) can, for example, lead to partial or full divestment from entire

asset classes. Policies on engagement and divestment/exclusion can also materially influence actions taken, so the Fund should clearly state its expectations of investment managers in these areas.

The effectiveness of the Fund's stewardship programme depends on four key elements: agreeing engagement themes/priorities, setting and monitoring engagement objectives, appropriate delegation and a clear approach to escalation including divestment.

It also depends on the availability of consistent and accurate climate risk reporting across the vast majority of the asset classes in which the Fund invests.

In view of these findings, we recommend the Fund:

- Incorporates both engagement and divestment/exclusion as necessary elements of its stewardship programme, not as mutually exclusive alternatives;
- Defines the limits of engagement and an escalation strategy incorporating divestment and seeks to agree these with its investment managers wherever possible;
- Notes that divestment/exclusion can be implemented at several levels; by the Fund reducing or eliminating its allocation to a specific asset class or manager, and by the Fund's investment managers divesting individual portfolio companies;
- Confirms that the four stewardship themes/priorities recently agreed with LGPSC, of which climate change is considered the most important, remain relevant and focuses on them when engaging with all its investment managers including LGPSC;
- Aims over time to increase the frequency and depth of its oversight of stewardship activities undertaken by LGPSC and its other investment managers;;
- Develops a carefully targeted exclusion policy which is aligned with the Fund's investment beliefs and, wherever possible, seeks to ensure LGPSC and its other investment managers comply with it;
- Works with LGPSC to expand the scope of its climate risk reporting and to advocate for the introduction of mandatory corporate emissions disclosure standards across all sectors of the economy.

We look forward to discussing these recommendations with the LPC.

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For and on behalf of Hymans Robertson LLP, May 2022.

2 Stewardship

As the focus on sustainability / ESG issues has grown, there has been an increased emphasis on the importance of effective stewardship as a mechanism to deliver enhanced returns and tangible real-world outcomes. Stewardship is defined by the Financial Reporting Council ('FRC') as "the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society".

Depending on the asset class, there are various stewardship tools, available to asset owners, including:

- Engaging directly with current or potential portfolio companies, across all asset classes
- Voting at shareholder meetings
- Filing shareholder resolutions/proposals
- Fulfilling direct roles on portfolio company boards and committees
- Litigating against companies or management
- Engaging with policy makers and standard setters
- Engaging with the media to promote stewardship goals.

Additional mechanisms available to asset owners when considering their approach to ESG issues include exclusions and divestment. Exclusions indicate that the asset owner does not want to allocate investment to certain companies/ industries when making investments. Divestment indicates an asset owner is already invested in a company/ industry and is actively considering selling down in part or in full.

The Fund's investment beliefs acknowledge the importance of stewardship in managing the response to climate change and indicate a preference for engagement over divestment. These beliefs are shared by LGPSC, the Fund's primary investment manager.

Importance of effective stewardship

A range of financial, regulatory and sustainability motivations are driving asset owners and investment managers to undertake stewardship, including*:*

- Improving risk-return
- Regulation
- Fiduciary duty
- Universal ownership
- Improving real-world outcomes

Improving risk-return

ESG analysis seeks to quantify risks that aren't captured by traditional financial metrics. There is a growing body of academic and industry evidence that identifying and addressing ESG issues through continued engagement contributes to improved risk-adjusted returns (PRI, 2021).

Regulation

There has been a growing push from financial regulators and policy makers for asset owners to take active roles in overseeing and influencing investee companies, including through stewardship codes and a raft of new proposals and regulations. Stewardship codes have been designed to enhance the quality of engagement, with the UK Stewardship Code placing clear requirements with regards to how investors' stewardship practices should address ESG issues. These codes, policies, and regulations, some voluntary and some mandatory, show the growing importance on asset owners to take responsibility of the stewardship of their assts.

Fiduciary Duty

As a key tool in addressing sustainability risks and maximising overall long-term value, stewardship is widely considered part of an investor's fiduciary duty. It is important to consider the outcome achieved and the process followed to assess whether these duties have been met and the expectation is for investors to use engagement and other stewardship tools in order to manage risks and maximise returns.

Universal Ownership

Given the reliance of societies and economies on common assets / 'public goods', such as a stable climate, functioning ecosystems and equitable societies, investment returns and broader client and beneficiary interests are dependent on them. Investors with well-diversified, multi-asset, global portfolios can be seen as 'universal owners' and their obligations to be effective stewards including contributing to the continued functioning of economies. Universal owners should therefore be concerned not only with the returns of the assets they own but also overall economic performance and should look to engage on systemic issues, supporting broader sustainability outcomes and well-functioning financial markets. This is particularly relevant to the Fund given its belief in the benefits of being a long-term investors, which depend on a well-functioning and sustainable economy.

Real- World Outcomes

Finally, regulators, beneficiaries and society are increasingly expecting asset owners to consider the real-world outcomes of their capital allocation decisions. By exerting influence, through engagement and/ or other stewardship actions, investors can drive real world change. While divestment can be an important mechanism in approaching ESG issues, divestment alone reduces an asset owners influence over the entity and may therefore do little to improve issues in the real world.

The role of stewardship in the response to climate change

Climate change is increasingly acknowledged to be one of the most significant risks to asset owners, but it is also becoming clear that the actions countries need to take to decarbonise their economies represent an enormous investment opportunity. Pension funds, with their clear fiduciary responsibility to ensure members benefits are paid, are increasingly expected to take climate-related risks and opportunities into account in developing and implementing their investment strategies.

Conducting stewardship activities within investment portfolios is one the most direct levers that investors can use to achieve real-world decarbonisation. There is a significant focus from a UK regulatory perspective on the use of engagement to advance companies' transition towards net-zero and the UK's climate goals given that these goals cannot be achieved through divestment alone. Effective stewardship is also considered to be best practice for institutional investors and is a key element of the NZIF.

Divestment can be seen as a capital allocation decision and, if the transition of investment portfolios is completed by capital allocation alone, it will do little to support real-world decarbonisation directly. Facilitating the transition to net-zero in the real economy will require investors to actively support decarbonisation efforts through effective stewardship and engagement.

3 Engagement and divestment

Engagement

Engagement is one of the many stewardship tools available to investors and typically involves meetings, calls or email communication between the investor and engagement target in which specific ESG issues are discussed, and clear expectations and objectives are set. Voting and proposing shareholder resolutions are further forms of engagement.

Engagement can take place with multiple stakeholders, for example, asset owners are able to engage directly with investment managers, portfolio companies and policy makers to improve ESG practices, sustainability outcomes or public disclosure. Engagement typically takes the form of meetings, calls, emails or letters between the investor and the engagement target during which issues are discussed and investors make clear their expectations.

Engagement can be carried out individually, collaboratively or with an engagement service provider.

Individual Engagement

Individual engagement sees an investor engaging directly with current or potential portfolio companies. Asset owners can also engage directly with their investment managers to ensure their RI beliefs and priorities are aligned.

Collective Engagement

Collective engagement involves a group of stakeholders engaging portfolio companies together. This could be achieved through a formal investor network or other membership organisation, for example Climate Change 100+ (in which the Funds pooling company, LGPS Central, is an active participant). Collaborative engagement allows investors to share resources to pursue collective goals and enhances their leverage and impact as a collective voice. Collaborative engagement can also be a helpful escalation strategy where individual engagement with a portfolio company or investment manager has been unproductive.

Engagement Service Provider

Investors are also able to appoint third party engagement service providers to conduct engagement on their behalf. LGPS Central, for example, use EOS (a division of Federated Hermes) as its global engagement and voting service partner.

Given different ownership structures, the stewardship and engagement tools available to asset owners will differ by asset class, for example:

	Stewardship & Engagement Tools
Listed Equity	Direct and/or collaborative corporate engagement Voting Proposing shareholder resolutions Divestment Applying exclusions/ screens
Fixed Income	Direct engagement with issuers

	Debt origination & reissuance: avoid new debt issues, underweight, or divest
Private Markets (Equity & Debt)	For equity investors, given their controlling interest: directly influence companies' systems and processes Debt investors are exerting increasing influence through the use of ESG covenants, margin ratchets and other provisions in loan agreement. In both cases, the incentive to engage is greater than in public markets because it is relatively harder to divest.

Regardless of the asset class and stewardship tools available, asset owners should have the same fundamental perspective on engagement.

This is especially true in the case of passive strategies where divestment is not an option. While passive strategies are often chosen to limit the costs of managing assets, there is still a fiduciary duty to be an effective steward regardless of the additional cost implications of engagement.

Divestment

Divestment is the process of selling in part, or in full, an investment and can be achieved by asset owners in multiple ways, including:

a) Reducing or eliminating the strategic allocation to a specific asset class, for example high emissions asset classes;

b) Reducing or eliminating the allocation to a specific investment manager, for example if they fail to integrate ESG factors effectively;

c) Delegating decisions to divest individual portfolio companies to investment managers.

Divestment may be informed by asset owners' investment beliefs and should be justified on financial grounds, on the basis of potential for significant financial risk, and/ or where there is an expectation of improved financial return.

Engagement vs Divestment

Debate in responsible investment is often on engagement vs. divestment, however both should form part of an effective stewardship strategy. For example, divestment could be used as an escalation strategy following unsuccessful engagement with the portfolio company. It is also possible for an investor to choose to both partially divest, and therefore reduce exposure, and continue to engage the company. Rather than being a binary choice, in practice a range of factors can guide nuanced approaches on a spectrum from total to partial or no divestment alongside no engagement, to significant engagement and escalation approaches.

When considering the appropriate approach to address ESG issues, thought should be given to the advantages and disadvantages of each.

Proponents of divestment argue that it is a moral imperative, that it promotes societal and political change, and that investment in a company with a high ESG risk is a financial risk. An advantage of divestment is that it is an immediate action to address this risk and sends a loud and clear message to the market. For example, in the

case of fossil fuel companies, it is argued that the stigmatisation caused from divestment offsets the political and financial power of the company which helps to achieve change in public discourse and then creates the conditions needed for political change (Quigley, Bugden and Odgers, 2021).

Research by academics at the University of Augsburg found a causal relationship between divestment and the decarbonisation of divested companies (Rohleder, Wilkens and Zink, 2021). The paper found several means through which companies delivered emissions reductions post divestment, including:

1. Decommissioning carbon intense assets;
2. Selling assets such that the production of emissions is simply passed to a third party and emissions continue;
3. Other process changes that improve the carbon efficiency of processes.

While both (1) and (3) would be positive real-world outcomes, (2) would simply result in the transfer of ownership of emission, with little progress in decarbonisation of the economy.

The research is also clear that a comparison of the effectiveness of divestment against other shareholder actions such as engagement, has not been completed and therefore divestment cannot be seen as a 'better' tool until further research has been undertaken.

A disadvantage of divestment is that it is purely a shift in ownership and has the potential to be counterproductive to the extent that assets pass to an owner that "cares less" about environment or social outcomes. From the perspective of the corporate, they could face an owner which exerts lower levels of scrutiny and challenge, and which demands less accountability from management than a more actively engaged owner. For asset owners, divestment deprives them of the opportunity to exert continued influence and a share of any value that is created.

Proponents of engagement argue that it encourages a more sustainable future as asset owners use their influence as stewards of capital to motivate real-world change through constructive, open dialogue.

However, there are drawbacks to engagement. For example, in order to engage effectively, significant resources are required which might not be practical or realistic. Factors that would influence the cost and resource intensity of engagement include the scope and depth of engagement activity; size, seniority and expertise of the engagement team and whether engagement is conducted collectively (in which cases cost and resource demand is shared) or independently. The most effective engagements are when an investor has devoted time and human capital to understanding a company. A recent survey of 70 leading asset owners, asset managers and listed companies found that "engagements are only helpful conversations when investors are knowledgeable about the companies they invest with. Ill-informed investors are seen as an obstacle to successful engagement" (Eccles et al., 2021).

In the context of decarbonisation, a common argument against engagement is that it will not lead to change on the scale and in the timeframe needed to enact real-world change (Quigley, Burden and Odgers, 2021).

Asset owners should give due consideration to the best method in which to effectively shape sustainability outcomes. Key factors when considering whether to engage or divest are summarised below.

Table 1: Key factors favouring engagement and divestment

Factors favouring engagement	Factors favouring divestment
Investor is seeking real-world impact	Investor is seeking value-alignment

Issue is systemic and non-diversifiable	Few opportunities to transition to a more sustainable business model
Investors have or can improve their leverage by working collaboratively	Investors have low leverage, e.g. a controlled company, lack of legal recourse
Persistent influence is possible and likely to be productive	Companies are not receptive to ongoing engagement
Alternative escalation measures remain open to investors	Other escalation measures have already been exhausted
Fiduciary constraints on use of divestment	

*Source: UN Principles of Responsible Investment

4 Effective engagement

Important aspects of effective engagement include prioritising which ESG issues to focus on, how stewardship objectives are set and monitored, delegation of engagement activities and the approach to escalation.

This starts with by establishing a Stewardship Policy, which should be reviewed and updated regularly. The Fund has developed a Climate Stewardship Plan which addresses the approach to mitigating climate-related risks within the fund by identifying both portfolio companies and portfolio managers for engagement.

When engaging directly with investment managers, this time is most effectively spent using, and building on, existing disclosures and on the understanding of the manager's investment process. There has been an explosion of public disclosure from managers in relation to their approach to sustainable finance and associated implementation activities spurred by both more rigorous regulatory requirements and increased expectations from clients. By using information in the public domain, relevant datasets and engaging advisors if needed, asset owners can focus on asking more critical questions that matter to their fund and beneficiaries to glean information that may not be as easily determined from their outward disclosures alone.

A key aim of effective stewardship is to gain insight into the investment managers processes and create opportunities to hold them to account where responses are not satisfactory. Questions should be informed by existing disclosures, existing knowledge of the manager, and priority ESG themes identified for the fund.

For example, understanding and challenging the investment managers' approach to tackling climate-related risks and opportunities is required by fiduciary duties to preserve long term value for beneficiaries.

Engagement themes / priorities

To be effective in enacting real-world outcomes, pension funds should determine their ESG Beliefs, including which ESG issues they deem as priorities. Pension funds should identify themes that are financially material in order to build a holistic view of the ESG risks and opportunities.

Once ESG priorities have been set, resources can be more efficiently aligned to support these priorities. Communicating these priorities to investment managers will enable greater alignment and focus and, in a similar vein, communication of these priorities to investee companies/ issuers will enable them to understand key risk areas that they should be focussing on.

LGPS Central, has set the following Stewardship Themes over the current three-year period (2020 – 2023):

1) Climate Change
2) Plastic
3) Fair tax payment and tax transparency
4) Human rights.

While the bulk of their engagement effort is centred on these themes, LGPS Central also regularly cover other key ESG issues such as fair remuneration and board compensation. Identifying and publicly disclosing these engagement priorities fosters open communication and dialogue between the pool and engagement targets. We recommend the LPC confirms that the four stewardship themes/priorities recently agreed with LGPSC, of which climate change is considered the most important, remain relevant and focuses on them when engaging with all its investment managers including LGPSC.

Monitoring engagement activity

Once ESG priorities have been set, an engagement strategy should be formulated with clear objectives over stated timeframes and consideration given in advance of any escalation which may be required should key requests not be met. The Fund's Climate Stewardship Plan meets these requirements in respect of climate change.

The progress of this engagement strategy should be monitored, and the Fund should request regular reporting from all its investment managers on their engagement activity, which should cover:

- Context - summary of key ESG themes and how these have been responded to over the year (through engagement and/or voting activity)
- Action - update on progress of engagement objectives against stated timeframes
- Outcome - detailed case studies of company engagement activity and impact
- Details of collaborative engagement activity (if any) and partner organisations

The Fund receives a quarterly Stewardship Update from LGPS Central who engage directly with companies on ESG themes. Their stewardship efforts are supplemented by a global engagement and voting service provider, EOS at Federated Hermes. The Fund should request similar updates from its other investment managers in their quarterly reporting.

The LPC meets with one investment manager per quarter to review investment performance and stewardship activity amongst other factors. We recommend the Fund works over time to increase the frequency and depth of these oversight arrangements.

Escalation strategy

Exercise of stewardship through voting and engagement should be escalated over time, if required, usually in the case of unsatisfactory engagement with companies/ investment managers and their failure to achieve the objectives of the engagement.

There are certain circumstances where engagement alone is likely to prove ineffective, eg where:

- There are limited opportunities for the company to transition to a more sustainable business model;
- The company is unwilling to provide appropriate transparency, or to engage in constructive and open dialogue;
- The company persistently fails to set appropriate objectives, aligned with a relevant decarbonisation parthway, and/or fails to deliver those objectives;
- The investor is primarily seeking value alignment, ie.not wishing to profit from industries or business practices that violate ethical beliefs).

In these instances, asset owners should have defined escalation strategies. Examples of escalation activities may include filing shareholder resolutions, using voting power, collaborative engagement, litigation and publicly disclosing engagement.

Divestment may also follow unsuccessful engagement. This can be viewed as a means of risk management, in the case that an investment is misaligned with the stated investment goals of the fund. This lever can be employed for investments which are seriously misaligned, for example carbon-intensive fossil fuel activities such as thermal coal and unconventional oil and gas. Divestment in this instance is a powerful escalation strategy,

following extensive engagement, as it communicates a loss of trust in the capabilities of management to execute a low-carbon business strategy.

5 Exclusions

Exclusions are becoming increasingly commonplace in fund design and generally being applied where there is limited ability for the asset owner/ manager to have any meaningful impact through stewardship (eg. a company whose only business is in mining thermal coal). The application of exclusions should be given careful consideration and there should be a clear rationale for their adoption.

Exclusions/ screening within an investment strategy may be informed by the asset owners' investment beliefs and offer an effective starting point to avoid companies which most obviously breach these values. As with divestment, exclusions should be justified on financial grounds, on the basis of potential for significant financial risk, and/or where there is an expectation of improved financial returns.

Exclusion and screening use a set of predetermined criteria to determine which companies, sectors or activities are eligible or ineligible to be included in an investment portfolio. These criteria might be based on an investor's preferences, values and ethics.

Exclusions can be applied in various ways, including:

a) Negative screening:

- Excluding certain sectors or companies for poor ESG performance relative to industry peers or based on specific ESG criteria (eg. poor business practises)
- Avoidance of activities on moral/ ethical grounds (eg. Tobacco, alcohol, gambling, adult entertainment, controversial weapons, fossil fuels)
- Revenue based thresholds (eg. companies which derive >50% revenue from fossil fuels)

b) Norms-based screening:

- Excluding companies against minimum standards of business practises based on international norms and frameworks (eg. Excluding UN Global Compact violators)

We believe the use of exclusions should be minimised. Long exclusion lists, particularly those covering all companies in many sectors, are likely to reduce the level of portfolio diversification and thereby increase the volatility of returns.

We recommend the Fund develops a carefully targeted exclusion policy which is aligned with the Fund's investment beliefs and, wherever possible, seeks to ensure LGPSC and its other investment managers comply with it.

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