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PENSION FUND MANAGEMENT BOARD – 13TH NOVEMBER 2009

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) ISSUES

Purpose of the Report

1. To inform the Board of the policies of the Fund's equity managers in respect of corporate governance and socially responsible investment, and to ensure that the Board is satisfied that they are suitable for the Fund.

Background

2. Corporate Governance (CG) can be broadly defined as the system by which organisations are managed and controlled. Within the context of a pension fund, it generally relates to how the companies in which investments are held structure their Board so that it can make effective decisions that are in the best interests of not only shareholders but also other stakeholders such as suppliers, customers, employees, regulators and the community at large. Shareholders, whose aim is to maximise long-term value from the companies in which they invest, have a key role to play in the area of Corporate Governance.

3. Socially responsible investment (SRI) encompasses both environmental and social issues and is a term that is used to describe an investment policy that, from a Pension Fund's perspective, seeks to maximise long-term investment returns within an acceptable level of risk (a legal requirement under trust law) but also seeks to be socially aware. The *minimum* requirement of SRI is that the companies in which investments are made carry out activities that, as far as is practical, protect the environment and the rights of individuals. SRI is different to ethical investment, where investment decisions are made on the grounds of personal opinion – for example investing in alcohol-producing companies would be ethically unacceptable to some, but not to others.

4. There are overlaps within the areas of Corporate Governance and SRI, which is the main reason that these issues are best dealt with in a single policy (i.e. ESG). It is a number of years since the Board reviewed the policies of the Fund's equity managers and, following a request from two staff representatives, this report focuses on whether the Fund remains comfortable that the policies of the managers are acceptable.

Role of Shareholders

5. Shareholders are the owners of companies and the Board of Directors are employed by the shareholders to decide on strategic direction and to ensure that the company is run efficiently and effectively. Shareholders retain the right to replace the Board, or even individual directors, as long as rules are followed in respect of asking for a vote on the issue – this will invariably mean that there has to be significant shareholder dissatisfaction for this to occur.

6. At least annually, shareholders have the right to vote on resolutions put forward by the company – these resolutions are normally put forward by the Board, but shareholder resolutions can also be put forward. Voting at company meetings is an important asset to shareholders, but equally important is the ability to scrutinise the way that a company carries out its business and how it takes account of key risks. This more detailed scrutiny can only be carried out via direct meetings with management and only the very largest of Pension Funds have the resources or the expertise to be able to gain access to management and, by doing so, be able to ask the probing questions that are required. It is for precisely this reason that the vast majority of Pension Funds delegate the responsibility for ESG to their investment managers.

7. Investment managers invest in companies when they feel the share price will increase and when they feel that these increases in the share price will, in the long-term, be above the increase in the broader equity market. In order to make this assessment they need to have a detailed understanding of how a company operates, as well as a view on how the economic environment will affect the performance of the company. The risk to the future profitability of a company has to be an important part of the assessment of 'value', so it is in the interests of the manager (and, by default, their clients) that they take ESG very seriously.

8. There is a common perception that investors are short-term in their outlook and are, therefore, only interested in activities that will enhance the short term profitability (and share price) of a company. Whilst it is certainly true that the stock market often shows an extreme reaction to news and short-term profitability, and that some market participants are quite short-term in their outlook, there has never been any evidence within the Leicestershire portfolio that investment managers are trying to be 'traders' – holding periods for companies are generally very long (i.e. measured in years), although there are obviously occasions when a manager's view on a company changes and the holding period is shorter.

Shareholder Failings?

9. It is impractical to expect every major investor to have the resources and skills to be able to analyse the operations of a company to the extent that a judgement can be made on whether there is a more optimal business model for that company – this is precisely the reason that the majority of pension funds appoint external investment managers. It is, however, perfectly reasonable to expect these external managers to take account of every key risk and opportunity that a company may have – these risks and opportunities will be both financial and non-financial.

10. There has been significant concern that the financial crisis came about as a result of shareholders failing to carry out their Governance responsibilities properly, with the underlying belief that shareholders actually encouraged excess risk-taking in an attempt to maximise short-term share price rises. Attached as appendix A to this report is documentation sent by two staff representatives, the first page of which requests that three actions are taken by the Board. In requesting that a ‘do no harm’ clause in respect of causing systemic harm to the stability of the financial system, it is clear that there is a belief that institutional investors (which includes the Leicestershire Fund) are focused on short-term outcomes. This view is not accepted.

11. Some criticism of institutional investors is probably justified, and there are undoubtedly some managers who pay lip-service to ESG – they have policy statements that are perfectly adequate, but they allocate insufficient resources to be able to ensure that they fully understand what is happening within a company. It does, however, seem unlikely that institutional investors actively encouraged the amount of risk-taking within the financial services industry that it is now apparent existed. If investors had encouraged this risk-taking they would have been aware of (although would have undoubtedly underestimated) the systemic risk that existed and would have taken appropriate action to protect themselves against the risks.

12. A much more plausible criticism is that investors failed to ask sufficiently probing questions as to allow them to have a better understanding of where profits were coming from, which would then have given them a much better possibility of understanding the risks being taken. Given the opacity and complexity of some of the investment products it is clear that most of the financial services industry had no real understanding of the risks, so it is debatable whether institutional investors would have been able to form a reasonable assessment anyway. It is also worthwhile noting that Regulators, Central Bankers and Governments (all of whom have a much stronger ability to demand detailed information from companies than investors do) failed to take particularly meaningful action in respect of controlling the risks, which suggests the risks were very difficult to understand and quantify.

13. There were a number of warning signs that investors were fully aware of (house price bubbles and excess consumer credit, for example), and were able to take a view on. It would, however, have been almost impossible to predict the economic meltdown that ultimately occurred and this is precisely why so many investors remained committed to equities as a core asset class – with hindsight, selling equities at their peak and waiting for the market to fall would have been a ‘no-brainer’. Had they been actively encouraging excess risk-taking by companies, institutional investors would certainly have been better prepared for the market sell-off.

14. Countries, companies and individuals were happy to share in the economic growth that came, in part, from increases in asset values and consumer expenditure. There was little suggestion from anybody at that stage that investors should be 'reining in' the activities of companies and forcing them to take less risky approaches. Institutional investors are certainly not exempt from blame in respect of the ultimate outcome, but they should not be made to feel that the outcome would have been radically different if they had been stronger in their ESG approach – there were many other parties who could have had a much bigger impact if they had taken the actions that, with hindsight, were sensible.

ESG Approaches of Equity Managers

15. The Pension Fund Management Board last considered the corporate governance/ socially responsibility policies of the Fund's investment managers a number of years ago, although these subjects are considered as part of the assessment of any newly appointed managers. It is appropriate that the policies are reviewed again, in order that the Board can satisfy itself that the approaches taken by the managers remain acceptable.

16. Appendices B – E of this report are the policies of the investment managers whose portfolios include equities (excluding UBSGAM and Goldman Sachs, who only manage small residual emerging market portfolios). The policies of Capital International, Legal & General and Standard Life are quite long and detailed but cover all of the areas that would be expected – these managers are large and have the resources to be able to carry out their ESG monitoring adequately. The summary policy by Ruffer is much less detailed and reflects not only their relatively small size, but also their overall approach to portfolio construction and risk. Their corporate governance approach was understood before they were appointed and may seem a little vague, but risk awareness is central to their idiosyncratic management style and it is probably true to say that Ruffer thinks more about systemic risk and worst-case scenario outcomes that any other manager that the Fund employs. The lack of a more detailed policy was not, therefore, considered to be a reason for not appointing Ruffer.

17. Overall, I believe the policies and actions of the Fund's investment managers are sufficient to be effective. If the Board agree with this, the Statement of Investment Principles remains valid and does not require amendment.

18. The Fund's investment managers include details of all significant ESG issues within their quarterly reports, so the Board are kept informed of how they have dealt with each case. This satisfies the requirement within the Statement of Investment Principle that managers regularly report on SRI/Corporate Governance.

Request from Staff Representatives

19. As stated previously in this report, two of the staff representatives have asked that three actions are taken (shown as A, B and C in Appendix A(i)). Comments on this request are shown below:

Request A

This report covers the review of the Statement of Investment Principles. There is undoubtedly an issue in respect of the Board having sufficient time to adequately scrutinise the performance of the investment managers the area of ESG, but this can only be addressed by a new governance structure for the Fund. It is expected that a report on different governance structure options will be produced for the January 2010 strategy meeting, and if changes are agreed this will allow the Board more time to consider matters relating to manager performance in ESG.

Request B

This requests relates to the items 1 and 2 from the attachment to the TUC letter, which is Appendix A(ii). Item 1 seems unnecessary, given that it is highly unlikely that any manager would knowingly make investment decisions that might cause systemic harm to the financial system. The United Nations Principles of Responsible Investment (item 2 within the TUC list) are 6 very broad principles that relate to acting as a responsible investor, but they all imply that the Fund itself will ensure that certain actions are taken. Given my previously stated view that the only practical method of carrying out effective ESG is via our investment managers, it is far more sensible for the Fund to encourage its managers to sign up to the principles than it is to sign up to them ourselves. The six principles that comprise the United Nations Principles of Responsible Investment are summarised on Appendix F.

Legal & General feel unable to sign up to the Principles as the first of the principles requires confirmation that environmental, social and governance (ESG) issues will be incorporated into investment analysis and decision making – as a mainly passive manager they are forced to buy every stock within an index and investment analysis and decision making are not really required by them. The UN PRI refuses to relax the principles for index houses, and hence L & G can not sign up, but they do support the Association of British Insurers' guidelines on ESG and expect all companies to follow them.

Capital International has not yet signed up, and have been cautious about adopting others' language to describe its own processes. They do, however, believe that their ESG stance is broadly consistent with the UN PRI and are in high level discussions which might lead to them signing up to the principles.

Standard Life have already signed up to the principles.

Request C

SRI policies are already taken into account when appointing an investment manager. Calling for improvements requires a far more active monitoring role, and a far clearer definition of what is and isn't required by the Fund in this area, than the Board currently has. This may be resolved by a new governance structure for the Fund that frees up the required time at Board meetings.

Recommendations

20. The Board is ASKED TO CONFIRM the investment managers' policies in respect of ESG and that the Statement of Investment Principles requires no change.

Equal Opportunities Implications

None specific

Background Papers

None.

Circulation under the Local Issues Alert Procedure

None.

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