Appendix 1

Avon Pension Fund

Responsible Investment Report: Policy and Activities 2012/13

Introduction

The Fund recognises that transparency and disclosure of its Responsible Investing Policy and activities is an important element of being a responsible investor.

This report re-iterates the Fund's policy on Responsible Investment and reports on the activities undertaken during the year to meet and support the policy. For the purposes of this report, Responsible Investment (RI) and Environmental, Social and Governance (ESG) are used interchangeably and have the same meaning.

The report comprises the following sections:

Executive Summary

As a responsible investor, the Fund sought to manage RI risks through the following activity during the year:

- **Identified and strategically addressed RI risks by embedding analysis of the RI risks of asset classes in the review of the Fund's investment strategy**
- **Sought to ensure investment managers implemented RI / ESG policies or approach as per their stated policy:**
  - **Held managers to account and queried RI / ESG factors in investment process where appropriate**
  - **Reviewed whether engagement activity of managers was in line with their policies**
- **Analysed voting behaviour and actively sought explanations of voting behaviour from managers to evidence preferences and seek to influence**
- **Increased participation in collaboration and engagement activities of Local Authority Pension Fund Forum (LAPFF)**

Section 1 - Avon Pension Fund, Responsible Investment Policy

The Avon Pension Fund's (Fund's) Responsible Investment (RI) Policy is based on beliefs that express the Fund's duties as a responsible investor. These beliefs are:

- Responsible Investment issues can have a material impact on investment risk and return in the long run and therefore should be considered within the strategic investment policy
- Because Responsible Investment issues can impact underlying investments, investment managers should demonstrate a risk based approach to responsible investing issues within their investment decision-making process and where they engage with companies
- The Fund has a responsibility to carry out its stewardship duties effectively by using its influence as a long term investor to encourage responsible investment behaviour

The policy demonstrates how the Fund will implement these beliefs within the strategic and operational decision- making processes. It recognises that the Fund's strategic policy will develop over time and allows flexibility to manage RI issues within an evolving strategy. The policy also sets out how the Fund will monitor and disclose its activities in respect to RI issues.

<u>Policy</u>

- The Fund seeks to integrate a Responsible Investment approach across the entire investments portfolio, recognising the differing characteristics of asset classes This is evidenced by evaluating the following as part of the strategic investment review process:
    - The impact of RI issues on each asset class and the materiality of RI risks within each asset class or approach to investing
    - Whether an allocation of capital to specific environmental, social and governance (ESG) opportunities would generate value.
    - Whether RI/sustainability benchmarks for investments or alternative non-traditional financial analysis could provide a more informed understanding of the RI risks within the Fund
- The Fund believes that an inclusive approach whereby it can utilise all the tools at its disposal to manage rather than avoid RI risks can often be optimal. It recognises that approaches that exclude or positively select investments could be appropriate for particular mandates.
- The Fund requires its investment managers to provide a statement setting out the extent to which they take social, environmental and governance considerations into account in their investment processes. These statements form part of the Statement of Investment Principles.
- When appointing external investment managers, the Fund:
    - Includes in tenders an assessment of managers' process for evaluating responsible investment risks within their investment process and make use of this as an integral part of the selection process when relevant.

    - Considers whether appointing managers with specialist ESG research capability is appropriate for meeting the investment objective of the mandate.
    - Includes the adoption of UNPRI principles in the criteria for evaluating managers and, all other things being equal, it will prefer UNPRI signatories.

- The Fund actively monitors the decisions of its investment managers' regarding RI issues that have a material impact on the value of the Fund's assets.
- The Fund adopts the FRC Stewardship Code and seeks to comply with its principles for best practice when discharging its stewardship role.
- The Fund normally delegates voting and engagement to its investment managers and will monitor how investment managers vote in comparison to relevant Codes of Practice. Managers are required to vote at all company meetings where possible.
- The Fund recognises that collaboration with other investors is a powerful tool to influence corporate behaviour. The Fund takes an active role in the Local Authority Pension Fund Forum (LAPFF) to effectively exercise its influence through collaborative initiatives.
- The Fund supports the principles underlying the United Nations Principles for Responsible Investing (UNPRI). The Fund's Responsible Investment Policy seeks to improve compliance with these principles.
- The Fund encourages its external investment managers to become UNPRI signatories.
- The Fund recognises that transparency and disclosure of its Responsible Investing Policy and activities is an important element of being a responsible investor. Therefore the policy forms part of the Statement of Investment Principles and a Responsible Investing report will be published annually from 2013. This annual report will include the RI Policy, the Fund's compliance with the FRC Stewardship Code and UNPRI Principles and the voting report.
- This Policy should be reviewed as part of strategic reviews of the investment objectives and management of risk or as required in response to changing regulations or broader governance issues.

Approved by the Avon Pension Fund Committee on 22 June 2012.

Section 2 - Avon Pension Fund, Responsible Investing Activity in 2012/13

2.1Strategic Investment Review

The Fund undertook a review of the investment strategy which was finalised in March 2013. In determining the appropriate asset allocation the Fund analysed the characteristics of each asset class with regard to the RI risks to which each asset class is exposed, and evaluated the potential impact and materiality of RI risks on the asset class investment decision. The analysis then evaluated how such risks could be managed through various means such as investment approach or good governance practice.

In addition the review sought to identify opportunities arising from ESG factors and created an ‘other’ categorisation in the asset allocation ranges to allow for future opportunities to be incorporated in the asset allocation. This was in anticipation of future opportunities to (among other things) benefit from evolving opportunities to address or exploit ESG factors.

The following tables summarises the Committee’s evaluation of RI characteristics of the asset classes allocated to:

Asset Class	Can ESG Risks be Managed?	Notes
Growth Assets		
Equities	✓	ESG risks can be managed through shareholder voting rights and engagement with company management, either via investment managers or collaborative organisations. In addition active managers can take into account a company’s ESG policy in determining opportunities and risks for future share value.
Emerging market Equities	✓	There are sometimes issues around corruption and human rights at the government level and the regulatory and legal framework will often not be as developed or robust as for developed markets. In addition, in many markets, the limited rights of minority shareholders mean that investors have less ability to influence corporate behaviour. As a consequence, the potential risk of poor ESG practice amongst companies based in the emerging economies is higher than for multinational companies operating in these countries - multinational companies have to adhere to the standards of best practice in their home country.
DGF	Limited	There is less scope to reflect the Fund’s ESG policy through a DGF investment compared to equities.
Hedge Funds	Limited	There is little scope to reflect the Fund’s ESG policy in this area of investment due to the nature of the investments.
Illiquid Assets		
Property	✓	There has been an increase in the level of activity to make properties more environmentally sustainable as fund managers believe this can lead to superior returns over the longer term. New buildings are expected to have a strong focus on environmental sustainability.
Infrastructure	✓	An investment in infrastructure can support environmental and social projects, although whether a sufficient return is achievable for risks taken on needs to be carefully considered. The risks of disposal of assets that are no longer useful must be carefully considered, as must any environmental impact of building work, both of which could have financial implications for any investment.

Stabilising Assets		
Gilts	n/a	An allocation to gilts does not impact the Fund's ESG policy.
Index-linked Gilts	n/a	An allocation to index-linked gilts does not impact the Fund's ESG policy.
Corporate Bonds	Limited	There is limited relevance to ESG factors for corporate bond investment, although active managers are expected to have regard to possible risks in making their investment decision.
Absolute Return Bonds	n/a	An allocation to overseas bonds does not impact the Fund's ESG policy.
LDI	n/a	An allocation to LDI does not impact the Fund's ESG policy.
Cash	n/a	An allocation to Cash does not impact the Fund's ESG policy.

2.2 Investment Managers

Officers and the Investment Panel seek to monitor, understand and where appropriate challenge investment managers activity to gain assurance that policies and practices are being followed and also as a way of influencing managers to take such risks into account.

All managers provided a statement on how they take ESG factors into account in their investment decision making processes. These can be found in an appendix to the SIP.

At meetings between the Investment Panel and Investment Managers the following specific RI issues were raised by Panel members and Officers:

- Schroder Global Equity – As this is a relatively new mandate, discussed in detail how they identify RI risks and quantify the impact they could have on investment returns when constructing the portfolio.

- TT UK Equity – Asked to explain the most important factors they assess when voting on remuneration/board independence, their process for coming to a voting decision and whether it has changed (using voting history on Barclays voting as an example).

- Jupiter UK Equity - Discussed their approach to banking bonuses and BP spill and how they quantified the financial impact /risks. Also asked how they measure the impact of their engagement activities and how their engagement strategy has developed to effect change at investee companies (for example at what point does engagement cease to become effective and what further options are feasible to pursue).

Manager updates for 2012/13:

- No new Investment Manager appointments were made in 2012/13.
- SSgA gained UNPRI signatory status during the year.
- Invesco put an engagement overlay service in place to focus and prioritise engagement activity

2.3 Voting

Analysis of the proxy voting activity carried out by investment managers on the Fund's behalf was undertaken by Manifest Information Services. Their report is included in the Appendix and was reported to Committee. The key points were as follows:

- Managers are actively voting on the Fund's behalf.
- The extent to which voting disagrees with management (a measure of how 'active' a voting policy is) varies depending on the managers approach and the governance characteristics of the companies in the portfolio – for example Jupiter incorporate ESG factors into their selection criteria resulting in a relatively high governance standard amongst companies in their portfolio and therefore less reason to vote against management.
- The Fund's managers are marginally more active in expressing concerns through voting than the average shareholder.
- The most contentious and material issues were Board balance and remuneration.
- Focus for coming year should be remain on Remuneration policy and how this relates to corporate performance and objectives, and whether governance structures provide adequate independence to the decision making process and draw experience and knowledge from a diverse selection of individuals.

Officers monitored voting activity and undertook further analysis of the managers' voting activity on remuneration at various times during the year.

The Fund is a member of the LAPFF who issue voting alerts (see section below for summary of full LAPFF activity) to help focus member voting on issues at widely held stocks. This year, alerts included Cookson and Barclays on executive pay, ConocoPhillips regarding greenhouse gas emissions targets, and News Corp and BskyB regarding director elections. Full list of alerts in 2012 were as follows:

Barclays (April 2012)
ConocoPhillips (April 2012)
Flir Systems (April 2012)
RBS Group (May 2012)
HSBC Holdings (May 2012)
Intesa Sanpaolo (May 2012)
ExxonMobil (May 2012)
Cookson Group (May 2012)
Société Générale (May 2012)
News Corporation (Sept 2012)

The Fund communicated these alerts to the relevant managers and received explanations where the recommendation was not followed.
Officers identified that although managers make use of proxy advisory research services, they do not outsource the voting decision to such agencies.

2.4 Engagement and Collaboration

Engagement and collaboration activity is undertaken on the Fund's behalf by the Fund's external investment managers and by LAPFF.

Managers Activity

The extent to which managers undertake engagement with companies (if at all) depends largely upon their investment approach. The Panel and Officers focus on gaining assurance that managers are undertaking engagement activity in line with their policy and tested this at meetings through specific questioning on voting and engagement.

During the year, engagement by managers was enhanced by Invesco implementing an engagement overlay over their portfolio. Jupiter maintained their comprehensive engagement activity, along with programmes undertaken by BlackRock and SSgA. TT and Genesis do not have specific RI engagement programmes but as active investors who put a lot of value in quality of management, they are meeting management continually and where RI issues are impacting performance these will be raised with management as part of the investment process.

The Fund encourages managers to actively participate in industry collaborative bodies where appropriate.

LAPFF Activity

The Fund has increased its participation in LAPFF (an organisation that promotes the investment interests of local authority pension funds, and seeks to maximise their influence as shareholders whilst promoting social responsibility and corporate governance at the companies in which they invest). Committee members and Officers attended three of the four LAPFF business meetings in 2012/13. Activity and achievements are reported quarterly to Committee via the LAPFF quarterly engagement report. Highlights this year include:

- Shareholder resolutions were filed at News Corporation and Société Générale on the issues of appointing an independent Chair and establishing a two-tier board structure (respectively).
- Reached more than 650 companies through collaborative investor initiatives on issues such as climate change, water management, forests and biodiversity, hydraulic fracturing, and environmental risks.
- Engaged with 15 companies on governance issues that comprised the annual Global Focus List. Goldman Sachs agreed to increase its dividend following concerns raised by LAPFF regarding the distribution of profits. Heineken and Afren agreed to revise their remuneration practices after concerns were raised by LAPFF.
- Met with companies in the transport sector to discuss climate change risks. Companies included Rolls-Royce, Renault, Fiat, Daimler, Stobart, easyJet and International Consolidated Airlines Group.
- Continued LAPFF's long-standing engagement with BP to discuss health and safety, and with Shell to discuss environmental management in Nigeria.

- Issues related to labour rights were addressed in meetings and correspondence with several companies, including Lonmin, National Express, Deutsche Telekom and Carnival.
- LAPFF also discussed sustainable supply chain management with Kingfisher, Reckitt Benckiser and Marks & Spencer.
- Met with the UK banks to discuss international financial reporting standards and raise concerns regarding the over-valuation of assets and the under-statement of liabilities.

Section 3: Avon Pension Fund, Statement of Compliance with Stewardship Code

This is an updated draft following small amendments made to the Code in 2012. The changes to the Code with relevance to the Fund were as follows, with references to changes made in the Fund's revised draft statement in brackets:

- Principle 1
  – Guidance advised clarifying the scope of application of the Code within the investment portfolio (have stated it applies mainly to the Fund's equity portfolio)

- Principle 5
  – Guidance advised that to aid collaboration the Fund should include a contact for Stewardship issues (contact inserted)

- Principle 6
  - Guidance increased emphasis that investors should publicly disclose voting records (inserted explanation as to why undertake and publish aggregate voting data)
  - Guidance advised improved disclosure on use of proxy voting advisers (inserted confirmation that the Fund does not use proxy advisory services itself)
  - Guidance advised that Investors should disclose approach to stock lending and recalling lent stock (comments inserted explaining position on stock lending)

- Principle 7
  – Guidance advised that Funds should ask asset managers whether assurance on their voting and engagement activity has been covered as part of internal control report – (added comment that this is included as part of the Funds annual review of managers' internal control reports)

The revised draft statement for approval is as follows:

AVON PENSION FUND

Statement of Compliance with FRC Stewardship Code

Principle 1 – Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.

The Avon Pension Fund takes its responsibilities as a shareholder seriously. It seeks to adhere to the Stewardship Code, and encourages its appointed asset managers to do so too.

In practice the Fund's policy is to apply the Code both through its arrangements with its asset managers and through membership of the Local Authority Pension Fund Forum. The Fund focuses on applying this code to its equity portfolios.

The Fund's policy in this area is set out in its Statement of Investment Principles (SIP).

Each of the Fund's investment managers has an explicit corporate governance policy explaining how and when they will intervene in a company and how they measure the effectiveness of their strategy. Nine managers have published a statement of commitment to the Stewardship Code. In the case of the remaining four, three are hedge fund managers who are not long term holders of stock, and one is a property manager where the opportunity for stewardship activity is limited.

The Fund's voting policy requires its UK equity managers to vote at all company meetings and the managers are expected to uphold the principles of the UK Corporate Governance Code (formerly the Combined Code). The overseas equity managers are required to vote at all overseas company meetings where practical.

Principle 2 - Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed.

The Fund encourages the asset managers it employs to have effective policies addressing potential conflicts of interest.

In respect of conflicts of interest within the Fund, pension committee and investment panel members are required to make declarations of interest prior to committee and panel meetings.

Principle 3 - Institutional investors should monitor their investee companies.

Day-to-day responsibility for managing the Fund's equity holdings is delegated to external asset managers, and the Fund expects them to monitor companies, intervene where necessary, and report back regularly on activity undertaken. Reports from the active equity managers on voting and engagement activity are received by the pensions committee on a quarterly basis.

In addition the Fund receives an 'Alerts service' from Local Authority Pension Fund Forum which highlights corporate governance issues of concern at investee companies. These alerts are shared with the relevant asset managers.

Principle 4 - Institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities.

As highlighted above, responsibility for day-to-day interaction with companies is delegated to the Fund's asset managers, including the escalation of engagement when necessary. Their guidelines for such activities are expected to be disclosed in their own statement of adherence to the Stewardship Code.

However on occasion, the Fund may itself choose to escalate activity, principally through engagement activity coordinated by the Local Authority Pension Fund Forum.

Principle 5 - Institutional investors should be willing to act collectively with other investors where appropriate.

The Fund seeks to work collaboratively with other institutional shareholders in order to maximise the influence that it can have on individual companies. The Fund achieves this through membership of the Local Authority Pension Fund Forum, which engages with companies over environmental, social and governance issues on behalf of its members.

The Fund's contact with regard to Stewardship activities is Liz Woodyard, Investments Manager.

Principle 6 - Institutional investors should have a clear policy on voting and disclosure of voting activity.

In respect of shareholder voting, the Fund exercises all votes attaching to its UK equity holdings, and seeks to vote where practical in overseas markets. Responsibility for the exercise of voting rights has been delegated to the Fund's appointed asset managers. This includes consideration of company explanations of compliance with the Corporate Governance Code. Regular reports are received from asset managers on how votes have been cast.

Aggregate voting records of managers are reported to the Committee at the quarterly meeting. Detailed monitoring analysis of managers voting activity is undertaken and reported on an annual basis in a Review of Proxy Voting report that is publically available. Whilst not practical to publish each individual vote on every stock held, the Fund undertakes aggregate analysis to make the information disclosed more meaningful by identifying governance themes across the portfolio.

The Fund itself does not use proxy advisory services but employs Manifest Information Services to provide a summary report of voting taken on the Fund's behalf and benchmark the voting activity against their view of best practice – this analysis forms the basis for the annual report on voting activity.

The Fund permits holdings in its segregated portfolios to be lent out to market participants. The Fund retains the right to recall loaned stock or block stock from being loaned from its segregated portfolios should the Fund wish to not lend the stock for any reason. The stock lending policy on pooled funds is determined by the individual investment managers.

Principle 7 - Institutional investors should report periodically on their stewardship and voting activities.

The Fund reports on stewardship and voting activity in its annual report. The Fund also annually reviews and updates it's SIP, which sets out the Fund's approach to responsible investing and assess compliance with governance best practice. The activity undertaken by LAPFF is reported to the Committee on a quarterly basis.

As part of its annual review of the Internal Control Reports of its managers, the Fund has identified the voting process as an area it would expect to be tested within the controls environment.

Avon Pension Fund
For approval, June 2013

Appendix: Avon Pension Fund, Review of Proxy Voting 2012/13

(This document is included as Appendix 2 to the covering report).