Dear Liz,

Thanks for the opportunity to comment on the updated ISS. The LPB welcomes the changes and improvements made to the ISS and we concur with the assessment of its compliance with the LGPS regulations and statutory ISS guidance. Well done on this.

The LPB does have three queries about the APF ISS and associated investment policies such as the responsible investment policy (RIP) which is regularly referenced as a key supporting document to the ISS.

Ethical investing

Some elected Council Members and local MPs ask questions on this topic to at least one LPB member. What is the APF strategic policy on ethical investing (i.e. non-financial factors)? and specifically do any APF fund managers exclude from APF investment portfolios any companies on an ethical basis? (i.e. not on financially material ESG grounds but for other non-financial reasons). The ISS statutory guidance says the administering authority can consider such factors if there is good reason to think that scheme members would share the concern; and the decision should not involve a risk of significant financial detriment to the fund, it could do so.

Avon response:

The APF policy is not to exclude purely on moral grounds at the strategic level. Appointed managers can elect to do so but the Fund still expects them to target the return and risk profile of the mainstream index benchmark. For example, in the UK Equity SRI mandate managed by Jupiter, the manager elects not to invest in gambling alcohol and tobacco companies based on non – financial criteria (as well as oil and mining companies). However their performance benchmark is the FTSE All Share index (with an outperformance target of 2% over rolling 3 year periods). As a consequence their performance has been more volatile than a manager with the same performance target than one that has no exclusions. At times this can be significantly negative or positive on a relative basis, highlighting how important it is to consider risk, not just returns, when evaluating at a strategic level. In the volatile markets of 2007-2012 the 3 year relative performance fell from +5% in 2007, to -3.3% in 2009, to -7.6% in 2010 before recovering to +2% in 2012.

Managers seek to construct portfolios with the optimal risk and return profile and this is more challenging when exclusions are applied. For example, the Low Carbon index, which has a significantly lower carbon exposure that the mainstream MSCI Global equity index, has a higher than index exposure to other sectors such as tobacco in order to optimise the level of risk. In the Jupiter portfolio, because there are such significant exclusions versus the index, they have to manage the portfolio to a higher level of risk. The Fund has to take this into account when strategically allocating the risk budget.

At the strategic level the Fund has considered excluding tobacco and fossil fuels previously. As a result in 2017 the Fund agreed to reduce the carbon exposure. Market solutions make this a reasonable approach from risk/return and cost perspectives. Tobacco is more of an issue within the UK market given the size of the sector within the index (around 5% at each review in 2011 and 2017). When reviewed the analysis demonstrated there would have been a significant financial impact over most long time periods if excluded. In addition a solution excluding tobacco was more costly to implement.

What is the APF position of the adoption of the United Nations supported Tobacco Free Finance Pledge https://globenewswire.com/news-release/2018/09/26/1576316/0/en/Global-leaders-launch-Tobacco-Free-Finance-Pledge.html ? Would the APF consider becoming a signatory to this ? Some leading pension funds and some other LGPS funds have decided for fiduciary reasons not invest in tobacco companies - with no discernible impact on these funds funding level - because of the very large volume of other alternative industry sectors/companies asset managers can invest in.

Avon:

We would need to research the Tobacco free pledge.

The Fund's position is that it will only sign up to collaborations if they directly relate to the fund as an investor, are aligned with our strategic policy/asset allocations, the Fund can influence and participate as an investor and that it is actually possible to meet all disclosure requirements etc. The focus is mainly on LGPS collaboration and disclosure standards by companies, our disclosure and reporting and analysis to support strategic decisions rather than supporting more general lobbying or campaigning initiatives. The Fund considers ethical investment issues from a strategic risk perspective and should not be viewed as a vehicle for advancing individual causes.

<u>Sustainable Investing</u>

The 2016 RI policy makes reference to introducing an allocation to sustainably-themed assets (and renewable infrastructure) as part of this 2018 ISS review - has such a new allocation been made and how ? or is going to be made, when and how ?

Avon:

The indicative strategic allocation to sustainable equities is 5% (c. 13% of the allocation to equities). The UK SRI equity mandate managed currently by Jupiter is anticipated to transition into Brunel's Sustainable Global Equity portfolio. It is currently a smaller portfolio so not a priority for the pool.

Jupiter also manages a Global sustainable pooled equity fund which we have seeded with £10m. This uses UN SDGs to identify companies etc. which will also transition into the sustainable portfolio.

What is the APF strategy in respect of the adoption and usage for investment purposes of the United Nations Sustainable Development Goals (UN SDGs) ? Would the APF consider adopting them and reporting the APF contribution to their achievement as an increasing number of leading pension funds and asset managers are now doing ? or might BPP undertake this?

Avon:

The Fund has not adopted these. Brunel are intending to report against these goals in the future.

<u>Responsible Investing</u>

What is the APF position on the adoption of the United Nations Global Compact (UNGC) in respect of companies that its current fund managers ? and BPP ? Would APF consider becoming a signatory of the UNGC ? Is the APF content to permit its current asset managers or BPP to invest in listed or unlisted companies if they are violating any part of the UNGC ?

Avon:

The Fund is not a signatory. Brunel is a signatory and members of a number of other global initiatives and we rely on their affiliations in the main as they have the resources to actively contribute and participate.

What is the APF position on its own adoption of the United Nations Principles of Responsible Investment (UNPRI)? Would APF consider becoming a signatory to the PRI ? so the APF investment strategy is in line with BPP policy.

Avon:

This is one area the Fund could consider once more assets have moved to Brunel and Brunel is in a position to support the Fund in its disclosure and evidence of compliance. This is a good example of it is not a box ticking exercise as signatories have to demonstrate ongoing compliance to a proscribed standard.

The LPB recognises the Administering Authority may consider it rather late in the current ISS review process to make important new strategic policy decisions. If there is not time at its next meeting it is suggested that they are considered for potential inclusion of the next update of the APF ISS and or APF RI policy or the RIP annual report, or perhaps in future be implemented and reported on via asset managers appointed by BPP.

Avon:

It is the Boards responsibility to review the ISS for compliance purposes. The Fund reviews its ESG strategy periodically and if there is an issue that the Board feels the Committee should consider in a future ESG review then it can make that suggestion. In doing so the Board should present its case. However it should be remembered that the Fund considers ethical issues in terms of the materiality of the risk they represent to the fund in achieving strategic objectives.

General

The ISS document is a 'much better read' than the last version. But as a key public document for the APF it would benefits from some thorough professional proof-reading to ensure the same tense and person is used throughout. Acronyms are nearly all spelled out, (LGIM may be the only exception?) which is good, but a number of cross-references should be made and a few other (foot)notes/explanations added for reasons of clarity and explanation for its users :

* para 2 .1 bullet 4 introduces the 'employer covenant' but does not explain it or its significance;
* the fiduciary duty of APF to its members is only introduced at 5.1 and not explained until 7.1 and the wording could be strengthened;
* in para 6.3 (i), 'repurchase agreements' are described, but 'swaps' are not but should be;

Avon:
There will be a final proof read ahead of publication.
We will add explanation/footnote on employer covenant and swaps.
We will add in fiduciary duty into introduction.

Investment returns

Ref paras 4.2 and 4.3: the actuary's best estimate (at 2016) of average expected return' is CPI + 3.5%. APF then prudently used CPI +2.2% as the assumption to get to 100% funding. In 2017, the best estimate return reduced to 2.9%. This implies that the assets are estimated to perform less well is this correct ? However, the return needed to get to 100% funding goes down to 2.1% despite the estimate that assets will perform less well? This is confusing and needs explaining.

Avon:
This paragraph will be reworded and footnote added for explanation.

Responsible investing

RI is approached under the heading of the ESG policy, but paras 7.4 is poorly drafted and needs some clarification. For example Para 7.6 states that APF 'believes that engagement and responsible stewardship will influence corporate behaviour more effectively than disinvestment'. Evidence to support this assertion/belief is not provided but should be. The sections on 'exercise of rights' (8.1 and 8.20) are weak and need strengthening. Perhaps the APF compliance with the FRC UK Stewardship Code could be an Appendix and/or a hyper signpost provided?

Avon:
Para 7.4 is taken from the RI policy and lists the RI principles agreed by the Fund. The ISS needs to state our policy, 7.6 explains the Fund's reasoning; we do not have to evidence all detail of each issue in the ISS.
The section on voting rights sets out our voting policy and how it is currently implemented so it cannot be strengthened. The FRC Code (and other documents) is hyperlinked in appendix 2.

Future reviews of the ISS

You also ask if the LPB wishes to be consulted again on future reviews of the ISS. The answer is affirmative because

1) The LPB has a statutory role under LGPS Reg 7 (2) concerning how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention, and realisation of investments.

In formulating and maintaining their policy on social, environmental and corporate governance factors, an administering authority
- must take proper advice
- should explain the extent to which the views of their ***Local Pension Board*** *and other interested parties who they consider may have an interest will be taken into account when making an investment decision based on non-financial factors*
- must explain the extent to which non-financial factors will be taken into account in the selection, retention and realisation of investments
- should explain their approach to social investments.

The Law Commission defines "non-financial factors" as factors which might influence investment decisions motivated by other (non-financial) concerns, such as improving members' quality of life (now or future) or showing disapproval of certain industries. In general, non-financial factors may only be taken into account if two tests are met if good reason to think that scheme members would share the concern; and the decision should not involve a risk of significant financial detriment to the fund.

Under LGPS regulation 7 the LPB has a duty to scrutinise the ISS of the APF in respect of the extent to which financially material ESG and non-financial ESG issues are taken account in the selection, non-selection, retention of investments. For example in relation to fossil fuel businesses (whose products cause climate change and a range of socio-economic impacts), companies who manufacture/distribute munitions or who manufacture/distribute/promote pornography or tobacco based products, or actively use child labour or who do not disclose their compliance with UN Ruggie principles. These are ESG issues where the legal position, case law, asset management industry, and pension funds member opinions (on their pensions being derived from investing in such companies) are rapidly evolving and historical positions have changed or are changing. In so far as it can APF has a responsibility to consider member views on these issues it would be desirable for APF to adopt best LGPS practice in such areas.

2) The Government has signalled its intention to review/update primary or secondary legislation (2005 Occupational Pension Scheme (Investment) Regulations and 2016 Disclosure Regulations) or statutory guidance to formalise a requirement for asset managers and pension funds to integrate financially material ethical & ESG issues (like climate change) into their decision making. The LGPS Scheme Advisory Board has proposed that the MHCLG should update aspects of the LGPS 2016 Investment Regulations and the ISS statutory guidance, and or the TPR may issue an updated or new Code for UK pension funds during 2019 or 2020. The LPB would have a legal duty to help ensure the APF is in compliance with any changed or new statutory requirements.

3) The LPB also has a remit under Reg 8 of the LGPS regulations which means it needs to understand the on-going evolution of the APF ISS, so that if its advice was ever sought under LGPS regulation 8 by the Secretary of State or Scheme Advisory Board, the LPB could so from an well informed position.

We must stress the LPB would never wish to delay the process for reviewing or updating the ISS in future so early consultation with the LPB would be beneficial.

Avon:

In terms of future consultation there seems to be little merit in reviewing what will almost always certainly be a compliant document particularly as the evolving Brunel situation will mean a continuing number of amendments as portfolios are transitioned. It would be more helpful if this could be done informally and by exception.

Considering the questions arising, it seems more pertinent to ask how the Board could engage when the Fund next considers its ESG strategy – and in which case the Board may benefit from some structured training.

We look forward to discussing the ISS with you and hearing your response to the points above.

Best regards,
Howard Pearce, Independent Chair
Local Pension Board, Avon Pension Fund