Report

meeting	**PENSIONS INVESTMENT SUB COMMITTEE**	
date	**14 March 2008**	agenda item number

REPORT OF THE STRATEGIC DIRECTOR OF RESOURCES

LONG TERM RESPONSIBLE INVESTMENT

1. Purpose

1.1 To report developments in the area of long term responsible investing and to seek views on the Fund’s approach to environmental, social and governance (ESG) issues in investment decision making.

2. Background

2.1 The Fund’s Statement of Investment Principles (SIP) contains a separate statement relating to socially responsible investment (SRI). This initially derived from the study carried out by the Fund in the mid 1990s and the contents have not changed substantially since.

2.2 The principles and policies adopted can be split into two broad groups. The first relates to the conclusion from the study that it is possible to improve the returns to a pension fund if environmental issues are taken into account. In line with this, part of the Fund was invested in an environmental portfolio in order to compare returns and ensure genuine outperformance before applying this approach to the whole fund. Unfortunately the returns from the portfolio were disappointing.

2.3 The second group relates to engagement with companies in which the Fund invests, Examples of this are actively voting stock, investment in activist funds and membership of groups such as the Local Authority Pension Fund Forum (LAPFF). These aim to ensure best practice in corporate governance and are indicative of long term responsible investing.

3. Recent Developments

3.1 In recent years, the profile of responsible investment has increased as it becomes more mainstream. The range of issues considered now includes factors such as employment practices, labour standards and the environment, as well as the governance arrangements in place to deal with these factors. There has been a gradual change in the consideration of these issues from looking mainly at the ethical implications to a focus on how they might impact on financial returns.

3.2 This is an important move, as there has always been some uncertainty over whether trustees of a pension fund can have regard to extra-financial factors in making investment decisions. The traditional viewpoint stems from the case of Cowan v Scargill which established that, generally, trustees should put aside their own views and make investment decisions in the best financial interests of the beneficiaries, present and future.

3.3 It has been argued from this that extra-financial factors cannot be considered in investment decisions. However, if it is believed that those factors will have an impact on the investment return, then it is difficult to see how a decision in the best interests of beneficiaries can exclude them. It is important, therefore, to take a view on how far ESG factors can influence investment returns.

4. Guidance

4.1 If it is accepted that ESG issues should be considered, there is a range of guidance that has been developed to assist trustees.

4.2 LAPFF exists to help local authority pension funds maximise their influence as shareholders in promoting high standards of corporate social responsibility and corporate governance amongst the companies in which they invest. To this end, LAPFF has produced a number of trustee guides to assist funds in assessing and engaging with companies on various issues such as work force standards and corporate governance.

4.3 LAPFF has also worked with the UK Social Investment Forum (UKSIF) and CIPFA Pensions Panel to produce a self assessment template on ESG issues for local government pension funds. The template is intended as a tool to take trustees through the key issues, initially as an information aid and then leading to discussion, development and implementation of policies and plans. The UKSIF discussion paper identified Nottinghamshire as being in the top 10% of local government schemes in the country.

4.4 A major development has been the United Nations principles for responsible investment (PRI), launched in 2006. These are intended to provide a framework to assist investors in considering ESG issues. The following is extracted from the principles:

> "As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society."

4.5 The principles are intended to be voluntary and aspirational but, by signing, an organisation is committing to adopt and implement them. Organisations can sign in one of three categories (asset owners, investment managers or professional service partners) and there are currently over 300 signatories with assets under management in excess of USD10 trillion. LAPFF has recently signed as a professional service partner and a number of local authority pension funds have signed in their own right.

5. The Fund's Approach

5.1 Many of the current policies adopted by the Fund show the existing long term commitment to responsible investing. These include:

- holding investments in its own name
- exercising ownership rights through voting shares
- not engaging in stock lending
- instructing votes in line with best practice in corporate governance
- engaging with underperforming companies via investment managers and LAPFF

5.2 However, the SRI statement in the SIP has remained unchanged for some time and would benefit from updating. The main focus of recent initiatives is that ESG issues will have an increasing impact on financial performance and so companies that address these issues effectively will generate superior returns. It is suggested, therefore, that the Sub-Committee considers to what extent they agree with this and whether changes need to be made to the SIP to incorporate these views.

6. Statutory and Policy Implications

6.1 This report has been compiled after consideration of implications in respect of finance, equal opportunities, personnel, crime and disorder, human rights and those using the relevant service. Where such implications are material, they have been described in the text of the report.

7. Recommendations

7.1 That the Sub-Committee considers its views on ESG issues to feed into a revised statement on responsible investment.

A L DEAKIN
DIRECTOR OF RESOURCES

Background Papers Available for Inspection
None