

## ESG Policy - City and Council of Swansea Pension Fund

### Introduction

The Committee recognise that environmental, social and corporate governance ('ESG') issues can influence the Fund's long-term returns and reputation. Given this, the Committee aims to be aware of, and monitor, financially material ESG factors.

The day to day management of the Fund is delegated to professional investment managers. Regular meetings are held with the Fund's managers where they are expected to provide a summary of actions that they have taken, or are taking, to consider ESG factors on a day to day basis.

In line with investment regulations, and to guide them in the strategic management of the Fund's assets, the Committee has adopted an Investment Strategy Statement ('ISS').

The Committee commits to an ongoing development of its ESG policy to ensure it reflects latest industry developments and regulations. The Committee together with their investment consultant will review the ESG policy annually at the same time as reviewing their ISS.

The Committee has agreed a series of beliefs which have been incorporated into their ISS. These beliefs strengthen their position in regard to considering ESG factors and provide a framework for their engagement through their Fund managers.

In the appendix of this document we discuss the results of the Fund's 2017 "carbon foot-printing" exercise, which informed some of the considerations included within this policy.

## Statement of Responsible Investment

The Committee considers the Fund's approach to responsible investment in two key areas:

- 1 **Sustainable investment / ESG factors** – considering the financial impact of environmental, social and governance (“ESG”) factors on its investments.
- 2 **Effective Stewardship** – acting as responsible and active investors, through considered voting of shares, and engaging with investee company management as part of the investment process.

The following principles set out the Fund's approach:

- The Committee recognises that their duty is to act in the best financial interests of the Fund's beneficiaries. The Committee believes that ESG issues can have a material financial impact on the long term performance of its investments and consideration of such factors is a part of their fiduciary duty.
- The Committee has a number of ESG related beliefs which are integrated into the Fund's overall belief statement. The Committee recognises that successful engagement can protect and enhance the long-term value of the Fund's investments. This engagement can apply across a range of assets.
- The Committee endorses the principles embedded in the UK Stewardship Code.
- The Committee encourages engagement by their investment managers with investee companies on ESG factors to positively influence company behaviour and enhance the value of the holdings. In addition, the Fund expects its investment managers to work collaboratively with others if this will lead to greater influence and deliver improved outcomes for shareholders and more broadly.
- Investment managers are expected to take account of ESG factors as part of their investment analysis and decision-making process. Further, ESG issues will be an explicit factor in considering the appointment of any new investment manager, mandate and benchmark.
- Investment managers are expected to incorporate reporting on ESG factors into their regular reporting. This includes information on voting and engagement, in addition to details on how the investment managers assess and manage ESG factors in relation to their respective mandates. The Committee encourages their investment managers to develop their reporting and monitoring of ESG factors over time.
- The Committee believes that they will have greater influence on the future direction of companies if they remain invested. Overall engagement activities are viewed by the Committee as a key element of the broader approach to responsible investing. Remaining invested provides the Fund with a voice on how companies are generating their revenues and how they will change in the future. The Committee view divestment as being the ultimate sanction.
- The Committee intends to make use of collaboration with other funds to pursue their engagement policy. To help with this, the Fund is a member of the Local Authority Pension Fund Forum (“LAPFF”), one of the UK's leading collaborative shareholder engagement group.
- The Committee seeks greater transparency of the ESG relative aspects associated with their underlying investments. This includes the extent of the Fund's equity investments' carbon exposure and the Fund's exposure to stocks that may gain from a change in industry carbon policy.
- The Committee has made a commitment to reduce the Fund's listed equity portfolio's carbon exposure, as part of this, it has set a target of the Fund's equities being 50% lower when compared to the global stockmarket by 2022 (MSCI AC World index, measured in terms of carbon emissions per \$m invested).
- The Committee may consider portfolio ‘tilts’ in line with ESG or responsible investment objectives.
- Training and education is likely to form a key element in developing the Fund and its Committee position on ESG related matters.

### Voting policy

The Committee and the Officers work closely with the Fund's investment managers to support good corporate behaviour.

The managers are required to exercise their voting rights on behalf of the Fund when it is in the best interests of the Fund. Voting will be in accordance with the managers' corporate governance policies. The Committee also retains the right to instruct managers at any time to vote according to the Committee's wishes on a particular resolution (acknowledging that there may be limitations as to how this would work for pooled investments).

The Committee review their managers' voting guidelines on a regular basis (at least biannual) to determine their appropriateness for the Fund.

All managers are expected to report their voting records on a quarterly basis. The Committee is committed to disclose voting records to the Fund's membership on an annual basis through the Fund's website.

In making any future manager appointments, the Committee will assess the managers' voting policy as part of the due diligence process and will instruct the appointed manager accordingly. The Committee will also liaise closely with the Wales Pool Operator to ensure that they also adopt this approach.

### Engagement policy

The Committee believe that engagement is a positive activity and encourage the Fund's investment managers to engage where they believe that value can be added or risk can be reduced.

The Committee believes that all engagements should have well-defined objectives. The Fund's investment managers are to report on the objectives of any engagement activity, along with the consequent success or failure of any actions taken on, at least, an annual basis. The Committee will publish a summary of engagement activity undertaken by their managers on an annual basis. The Committee will also publish other collaborative activity carried out over the year e.g. as part of the membership with LAPFF.

The Committee supports engagement activity that seeks to achieve:

- Greater disclosure of information on the ESG related risks that could affect the value of an investment;
- Transparency of an investments' carbon exposure and how such companies are preparing for the transition to a low carbon economy.<sup>1</sup>

The Committee encourage their investment managers to actively participate in collaborative engagements with other investors where this is deemed to be in the best interests of the Fund. Managers are to report on their collaborations on an annual basis.

The Committees' investment consultant is required to provide input and analysis to assist the Committee in assessing the Fund's investment managers' performance from an ESG engagement perspective. This includes working closely with the Officers to develop the appropriate training arrangements.

The Committee liaise closely with the Wales Pool Operator to ensure that they also adopt the approaches set in this policy. The Fund's investment managers are encouraged to sign up to the appropriate industry initiatives, including the UK Stewardship Code, LGPS Cost Transparency and the Principles of Responsible Investment. The Fund is not currently signed up to the UK Stewardship Code or the PRI but is investigating the possibility.

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<sup>1</sup> As stated, the Committee has a desire to reduce the Fund's listed equity portfolio's carbon exposure and, as part of this, it has set a target of the Fund's equities being 50% lower when compared to the global stockmarket by 2022 (MSCI AC World index, measured in terms of carbon emissions per \$m invested). The Committee will aim to carry out a carbon foot-printing exercise of their equities at least on a triennial basis. The first of these reviews took place in 2017 (the results are discussed in the appendix to this paper).

## Appendix 1: Carbon exposure – 2017 review

*Paper issued by Hymans Robertson in March 2018*

### Background

#### Environmental Social and Governance (“ESG”)

The Committee has taken a number of steps to understand the impact of ESG issues on the Fund. In November 2017, Hymans Robertson delivered a detailed training session covering responsible investing, ESG and climate change. Hermes Equity Ownership Service also delivered a presentation highlighting examples of the positive change they had delivered through engaging with companies’ management and placing shareholder votes on their clients’ behalf. The Committee and Board considered their “investment beliefs” in the context of ESG matters and the results have recently been used to develop the ESG policy outlined in this paper

#### Carbon

As part of the Fund’s ESG focus, the Committee commissioned MSCI to undertake an analysis of the portfolio’s carbon exposure. MSCI has information on each global stocks’ carbon related exposure (or is in a position to make an assumption<sup>2</sup>). Using this information, MSCI is able to compare the carbon exposure of the Fund’s holdings with a range of reference benchmarks.

MSCI was provided with the individual holdings data from each of the Fund’s equity managers (ex-Aberdeen’s frontier markets mandate due to lack of comparable industry benchmark data) and with specific details on each of the mandates in terms of their benchmarks and allocations<sup>3</sup>. MSCI then compared the portfolio versus the broad global market capitalisation index (e.g. the MSCI ACWI as a proxy for the global stockmarket) and versus a low carbon version of the global index (this index has the same performance objective of the broad market capitalisation index, but has a general aim of being overweight to companies with low emissions relative to sales and low potential emissions).

In the remainder of this paper, we consider the results from this analysis and set out potential next steps for the Fund.

### Output of the analysis

#### Overview

The analysis focuses on the Fund’s equity exposure at 31 March 2017. This date was shown as it ties in with Fund’s year end.

The main objective was to get an understanding of the Fund’s carbon exposure. However, it also created an opportunity to consider the positions being taken by the Fund’s active managers, relative to their benchmark. The Fund’s passive manager’s exposure will be broadly in line with the underlying benchmark. However, the analysis gives the opportunity to compare the carbon exposure of the standard global benchmark versus its low carbon equivalent.

The analysis also includes some information regarding the Fund’s exposure to clean technology, which are expected to benefit from any move towards a more low carbon economy.

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<sup>2</sup> Further details on the assumptions made are included in MSCI’s reports.

<sup>3</sup> To tie in with MSCI’s benchmark range a number of pragmatic compromises were made, including comparing the Aberdeen and JP Morgan portfolios versus the global index, rather than a global ex UK index and Schrodgers’ UK mandate versus a European benchmark. These compromises will impact the relative position of the results, but they should have no impact on the absolute results, not the key themes coming out the analysis. The date was based on the Fund’s holdings at 31 March 2017.

## Key carbon metrics

The key metrics can be defined as:

- **Carbon emissions** - the carbon emission (tonnes of CO<sub>2</sub>) per \$million invested. *Sum of ((\$investment in issuer/issuers' market cap) \* issuer's emissions) – results shown as per \$m invested*
- **Carbon intensity** – a measure of a portfolio's carbon efficiency and is defined as the total carbon emissions of the portfolio as a proportion of portfolio sales. This is a useful metric in allowing the comparison of emissions across companies of different sizes and industries. *Sum of issuers' carbon emissions/ Sum of issuers' \$m sales*
- **Weighted average carbon intensity** – the sum product of the constituent weights and carbon intensity. *Sum of portfolio weights\*carbon intensity*

Each of these metrics have merit. For the purpose of this paper, we define carbon emissions as the “carbon footprint”, but the other metrics could also have been defined in this way.

## Results

### Carbon focused

Overall, the results are encouraging. As shown in chart 1, the Fund's total equity holdings had a carbon footprint 9% lower than the MSCI ACWI and the weighted average carbon intensity is 16% lower. However, Chart 1, also highlights that the MSCI Low Carbon benchmark has an 80% smaller carbon footprint than the MSCI ACWI index highlighting that the choice of the underlying benchmark can have a significant impact on investors' carbon emissions.

Chart 1: Carbon emission metrics

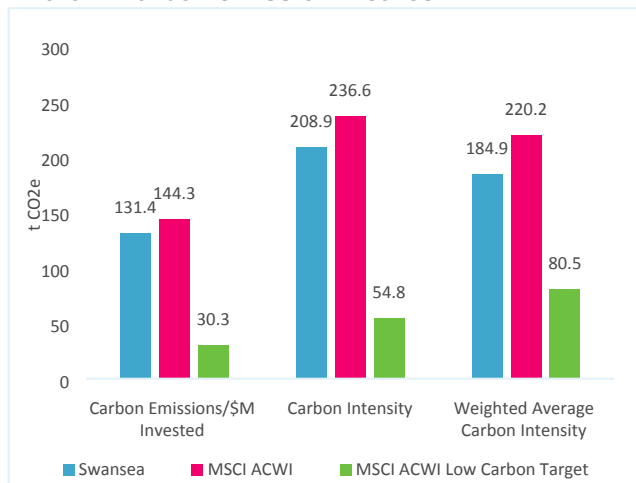


Chart 2: Weighted average intensity at manager level <sup>4</sup>

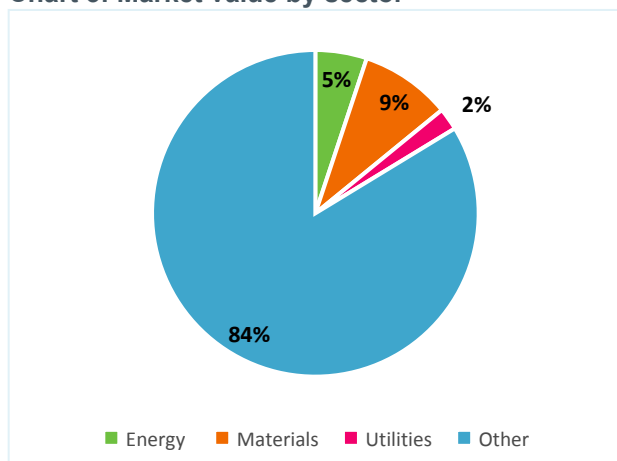
Details of each of the Fund's active managers' weighted average are shown in Chart 2. Each manager has delivered a portfolio with a lower position than their respective market capitalisation benchmark. Interestingly, although the Fund's two global managers (Aberdeen and JP Morgan) have similar weighted average exposure, there were notable differences in the carbon emissions (with JP Morgan notable higher due (c80% higher) to a number of their underlying Materials holdings, including Posco and Alco Corporation). Aberdeen's weighted average results were negatively impacted by the manager's Real Estate exposure (most notably Swire Pacific) and Materials exposure, including Praxair and Potash Corp.

<sup>4</sup> In chart 2, Schroder's results are shown against the MSCI Europe and MSCI Europe Low Carbon

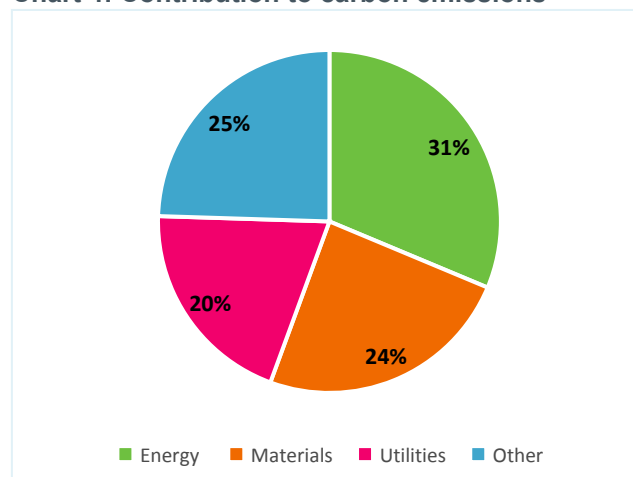
Schroder's carbon footprint is lower than the benchmark index, albeit the holdings in Royal Dutch Shell and Carnival were notable contributors to the mandate's carbon intensity.

Considering the analysis at a sector level, the Fund's exposure to the materials, energy and utilities sectors contribute to the majority of the Fund's carbon footprint. Together, these sectors contribute to 75% of the Fund's carbon emissions despite only comprising 16% of the Fund's equity portfolio. This is illustrated in Charts 3 and 4 below.

**Chart 3: Market value by sector**



**Chart 4: Contribution to carbon emissions**



In such exercises, the energy, materials and utilities sectors are typically those with the highest carbon intensity although a company is not "bad" simply because it happens to operate within a carbon intensive sector. It is important to recognise that some sub-sectors will have very low carbon intensity. For example the utilities sector includes both water companies (low carbon intensity) and electricity companies (high carbon intensity).

### Scope 1 and Scope 2

Carbon emissions are typically shown in three main "scopes"

- Scope 1: Direct "emissions from sources owned or controlled by the organisation"
- Scope 2: Indirect "emissions from the consumption of purchased electricity, steam or other energy generated upstream"
- Scope 3: Other indirect e.g. employee commuting.

To date, the majority of the industry focus is on Scopes 1 and 2 (as was the results of MSCI's analysis). The Fund's exposure is c 80% from Scope 1, which is slightly less than the MSCI ACWI, which is 84%. Only 58% of the MSCI ACWI Low carbon index comes from Scope 1. This notable change in the benchmark splits between scopes 1 and 2 reflects some of the main sector differences between the two benchmarks.

### Carbon risk management relative to industry

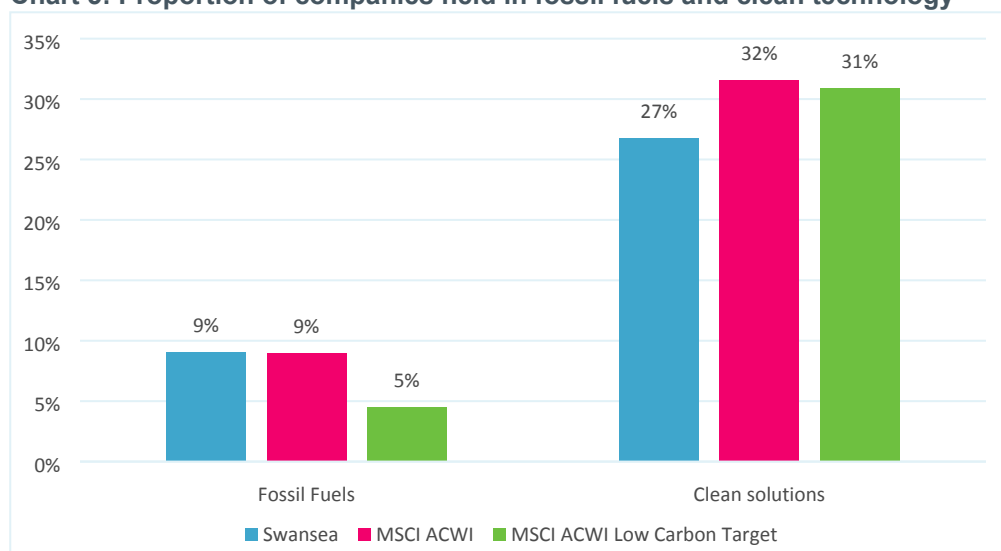
MSCI also included their views on companies' position relative to their industry in dealing with managing carbon risk (MSCI rates companies as Leaders, Average or Laggards). In terms of the top ten contributors to each active managers' weighted carbon intensity:

- Two of Aberdeen's Materials holdings (Maple Leaf and Tenaris) are viewed as being a laggards. We recommend that you follow up on these holdings with the manager.
- None of JP Morgan's or Schroders were viewed as laggards.

### Thermal coal, oil and gas reserves

MSCI also considered the proportion of the portfolio which is made up by companies that own thermal coal, oil and gas reserves, three areas that are thought to be most at risk of being “stranded” assets. Chart 5 (left hand side) below shows that the Fund’s portfolio is 0.2% overweight, relative to the MSCI ACWI, in companies that own Fossil Fuel Reserves. The key contributors to this are the Fund’s holdings in Shell, BP, Lukoil and Rosneft (JP Morgan are notable investors in the latter two stocks).

**Chart 5: Proportion of companies held in fossil fuels and clean technology**



### Clean technology

In terms of focusing on stocks that may benefit from a change in industry carbon policy, chart 5 (right hand side) also analyses companies involved in “clean technology” solutions based on their sales in the following categories: Alternative Energy, Energy Efficiency, Green Building, Pollution Prevention, and Sustainable Water. Relative to the global index, the Fund has less exposure to stocks that generate revenue from these categories (of the Fund’s 27% exposure, the majority is in stocks with 0-20% of their revenue is from these categories).

### Summary and next steps

The information from MSCI acts as a useful guide to the Fund's carbon exposure. There are a number of potential next steps for the Committee to consider, which should be considered alongside the Fund's engagement policy and investment beliefs, in particular:

### Agree objectives

By carrying out this process, the Committee has achieved one of its objectives of understanding the Fund's carbon exposure (this puts the Fund ahead of any many other funds in doing such an exercise, a recent Greenwich Associates survey suggested that just 5% of UK pension funds had considered such an exercise).

Based on previous discussions, we understand that there is a desire to reduce the Fund's carbon exposure, albeit no specific targets have been discussed, or specifics e.g. emissions, carbon intensity or fossil fuel exposure.

**Details of the specific measures can be considered in more detail over the course of 2018, what is key is that if a target is introduced a consistent method is adopted to allow the Fund's progress to be considered over time.**

### Reference index

We propose that the MSCI AC World index is used as the reference index. This is a commonly used index to represent "global stockmarkets" and is commonly used as a benchmark for global equity portfolios.

### Target levels

If we focus on carbon emissions, the analysis discussed in this paper indicates that Fund already has c9% less carbon intensity than the index. The extent of your desire to put a target in place (exposure relative to the reference index), and if so, the size of this target should be subject to further discussion with you. However, we anticipate it being in the region of 20%-50% (amount to be defined following discussions with you) of the reference index achieved over an appropriate timescale (e.g. 5 years).

### Review Fund benchmarks

The impact of benchmark choice is most notable for the Fund's passive mandates, where the manager's objective is to replicate the underlying index. MSCI's analysis shows the significant difference in the MSCI ACWI and the MSCI Low Carbon benchmarks. There are now a range of low carbon/ESG benchmarks that the Fund could consider. We recommend further training takes place on these during 2018, with the potential that a proportion (potentially all) of the Fund's passive assets are benchmarked against such a benchmark.

### Challenge active managers

The results have flagged the Fund's exposure to specific higher carbon stocks. The Fund's managers should be asked to explain their rationale for holding such stocks, most notably

- Aberdeen: Challenge on engagement with Maple Leaf and Tenaris and understand how firm takes carbon risks into account for Swire Pacific.
- JP Morgan: Challenge on stock selection in energy and materials. How are carbon risks being priced into stock selection decisions.

### Feed into pooling

Post pooling the Pool's operator will be responsible for appointing the underlying active managers. The Committee should seek details as to their process for assessing manager's ESG capabilities and willingness to provide carbon reporting.



### **Repeat exercise**

It is important that you assess what progress is made relative to any objectives. However, there needs to be a balance between frequency of analysis, and cost of doing the analysis. We believe every two years should be broadly sufficient, albeit you may wish to receive more frequent updates from your active managers.

### **Consider broader assessment**

Carbon is just one ESG element. There is scope to consider broadening this review to include other ESG related aspects e.g. human rights, labour rights, governance. This would work in a similar way to the process for carbon monitoring i.e. the Fund's underlying holdings compared to a broader universe using a providers underlying scoring.

Where possible this assessment should also be broadened out to the Fund's other asset classes i.e. not just equities.

We look forward to discussing his paper with you in March.

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For and on behalf of Hymans Robertson LLP

### **General Risk Warning**

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.