Scottish Borders Council Pension Fund

Environmental, Social and Governance (“ESG”) Considerations - Overview

March 2018

What is ESG?

Company

Environmental

Resource Use
Emissions
Innovation

- Climate change
- Nuclear energy
- Energy wastage
- Water wastage
- Pollution
- Natural resources
- Deforestation
- Environmentally friendly
- Technologies
- Green buildings

Social

Workforce
Human Rights
Community

- Consumer protection
- Customer satisfaction
- Child minding services
- Diversity
- Employee satisfaction
- Employee rights
- Flexible working
- Health and safety policy
- Human rights policy
- Supplier protection

Governance

Management
Shareholders
CRS Strategy

- Anti-bribery
- Anti-corruption
- Anti-takeover devices
- Audit committee independence
- Board diversity
- Board member compensation
- CEO-Chairman separation
- Employee relations
- Shareholder rights
- Staggered board structure

Why consider ESG?

- It can have a significant financial impact:

Mark Carney, Governor of the Bank of England (2015 Lloyd's City Dinner):

"While a given physical manifestation of climate change – a flood or stream – may not directly affect a corporate bond's value, policy action to promote the transition towards a low-carbon economy could spark a fundamental assessment."

JP Morgan (email on 23 November 2017):

" Within our US Investment Grade portfolios, we sold bonds issued by a utility generation issuer that is a large owner of coal-fired generation. We were concerned with evolving environmental regulations, the carbon intensity of the assets and potential for stranded asset risk. The bonds were downgraded to the CC rating category and the Company faces a restructuring or bankruptcy. The company recently wrote down over USD 9 billion in asset value associated with the assets."

Source: "Stranded Assets: the transition to a low carbon economy, Emerging Risk Report 2017 Innovation Series, Lloyds.

How to incorporate ESG

What are the options?

Do Nothing, understand the risks

Incorporating ESG into investment strategy requires additional time and resource. **Financial**, **reputational** and **regulatory** risk from doing nothing.

Ensure managers have ESG policies in place

The first and most basic consideration is to ensure that appointed asset managers have suitable ESG and monitoring policies in place.

Appoint managers that integrate ESG centrally

Appointing asset managers that directly incorporate ESG in their investment strategies and recognise it as central to the decision making process.

Develop a bespoke ESG policy

Once an investor has customised their own ESG policy, they can take an active ownership approach to actively engage directly with companies to encourage change.

Do nothing is not an option

1. Do Nothing

- **Financial risk:** Evidence that incorporating ESG improves risk-adjusted returns i.e. Statman (2006) analysis of Responsible Investment indices within the S&P 500.
- **Reputational risk**: Investment by Church of England in controversial payday lender, Wonga (2013).
- **Regulation**: Requires ESG to be considered.

Ensure managers have ESG policies in place

2. Ensure managers have ESG policies in place

? **Financial risk:** Identifies managers' current approach and improves the understanding of the risks involved. Doesn't necessarily impact underlying portfolios.

✓ **Governance burden:** Marginal increase in governance to review and monitor managers' policies and approaches.

Appoint managers that integrate ESG centrally

3. Appoint managers that integrate ESG centrally

✓ **Financial risk:** Ensures risks arising from ESG considerations are managed in active portfolios. Passive portfolios will still simply track the index (consider which index to use).

? **Governance burden:** Increased governance time and cost to select and monitor managers' approach.

Develop a bespoke ESG policy

4. Develop a bespoke ESG policy

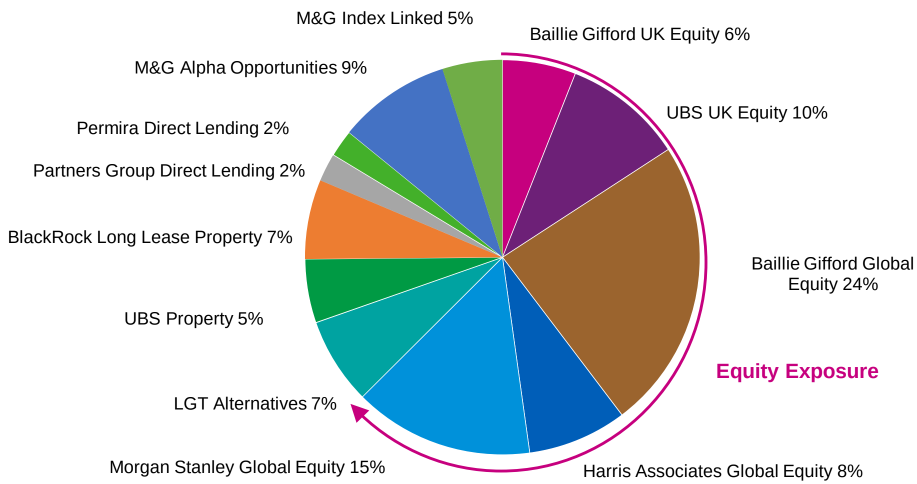
✓ **Financial risk:** Tailored approach to meet Fund's specific requirements & views of pensions committee. Comprehensive tracking of compliance with approach, voting etc.

× **Governance burden:** Requires significant investment of time to develop a comprehensive approach across the entire investment portfolio.

Your Investment Strategy and ESG

Your strategy

Fund Value (31 December 2017): £699.0m



- The Fund's equity exposure is c. 63% of invested assets.
- A good starting point for ESG considerations.
- All of the global equity portfolios are actively managed.
- The UBS equity portfolio is passive and will track the agreed index.

Potential approaches

Active management:

- Utilising an investment manager which specifically accounts for ESG-related factors within the investment process. Managers include either qualitative or quantitative ESG criteria as key parts of the rating process for each stock. They may still invest having considered the risks. Also engage proactively to influence investee companies.

Passive management:

- There are a range of different global market indices that could be employed to create a diversified equity portfolio that can be accessed very cost effectively, e.g. indices based on lower carbon stocks, those that have high ESG scores, those that utilise resources efficiently etc.

Positive bias:

- Invest in sustainability-themed investments addressing social and environmental change (low carbon, energy efficiency etc.)

Negative Screening:

- Remove/reduce exposure to specific risk factors or sectors.

Your equity managers and ESG

Approach to ESG			
Equity Manager	**UNPRI**	**UK Stewardship Code**	**Additional Comments**
Baillie Gifford	✓ Signatory to the UNPRI since 2007	✓ Agrees and complies with the UK Stewardship Code	▪ Integral to their investment process. ▪ Have their own dedicated Corporate Governance team of 10 individuals, which is responsible for developing and coordinating their ESG-related research in conjunction with the investment teams. ▪ Have their own Global Corporate Governance Principles and Guidelines.
UBS	✓ Signatory to the UNPRI since 2009	✓ Agrees and complies with the UK Stewardship Code	▪ Passive approach means ability to integrate ESG factors in decisions is limited ▪ Has its own Sustainable and Impact investing team, which works closely with teams across the business to integrate ESG into their investment processes. ▪ Established an ESG committee in January 2010, which meets quarterly.
Harris Associates	✗ Not currently a signatory, however, Harris are looking into the opportunity to become a signatory.	✓ Agrees and supports the UK Stewardship Code	▪ Complies with the Japan Stewardship Code ▪ Member of the Asian Corporate Governance Association ▪ No UK or UN body affiliations
Morgan Stanley	✓ Signatory to the UNPRI since 2013	✓ Agrees and complies with the UK Stewardship Code	▪ Takes approach to ESG seriously. ▪ A founding member and participant of the U.S Partnership for Renewable Energy Finance ▪ Signatory of the Carbon Disclosure Project ▪ Board member of International Emissions Trading Association ▪ Member of the Capital Markets for Climate Initiatives UK advisory panel

What are others doing?

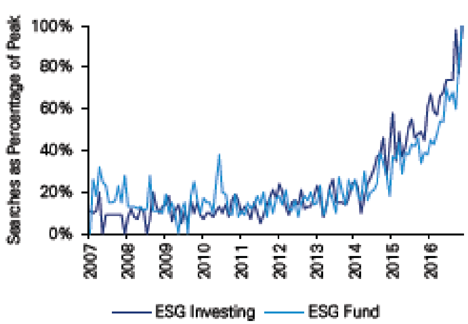
Recent Regulatory changes

- **2017/18** - UK's LGPS system transformed with new requirements to address ESG and Stewardship activity including "clearly address issues of responsible investment"
- **2018** – Expectation that the UK Government will change regulation relating to the fiduciary duties faced by corporate pension schemes allowing them to more easily disinvest from oil, coal and gas companies due to environmental concerns

Industry Trends

- General shift of census from "nice to have" to "must have"
- Asset management industry responding with expansion of product universe.
- Increasing evidence base to support thesis that companies with strong ESG characteristics/ efficient resource usage have outperformed
- Shift of focus on low carbon/stranded assets

Google Searches for ESG Terms



Source: Google trends

Some anecdotes…

- Norway's $1 trillion wealth fund is looking to drop all oil and gas companies from its benchmark index. These holdings currently represent c. 6 percent of total assets, or $37 billion.
- At the One Planet Summit on 12 December 2017, AXA announced it is both dropping investments, and ending insurance for controversial US oil pipelines, as well as quadrupling its disinvestment from coal businesses.
- New York City is looking to disinvest $5bn of its pension fund's holdings, from fossil fuel companies over the next 5 years.
- We have observed some LGPS funds in England & Wales making allocations to Low Carbon indices to reduce exposure to these risks.

UN PRI signatories and Assets Under Management

Source:UNPRI

Transition to a Low Carbon Economy

Carbon emissions - 3 key sectors

Exhibit 1: Current and Future Carbon Emissions

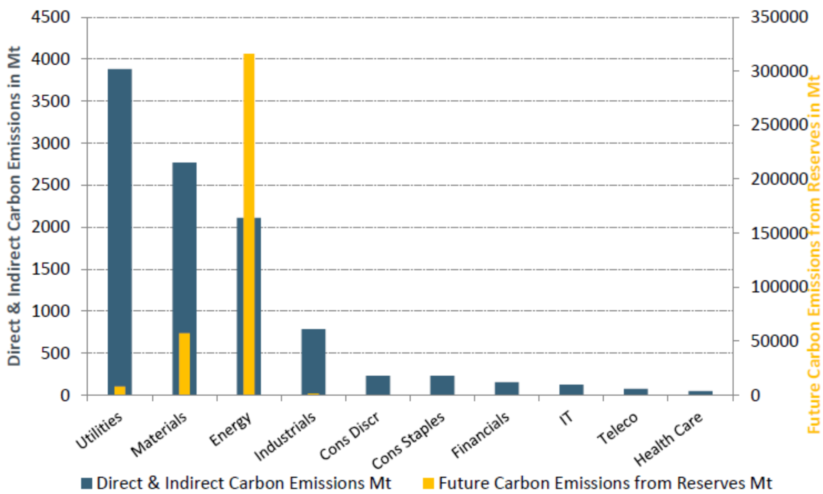
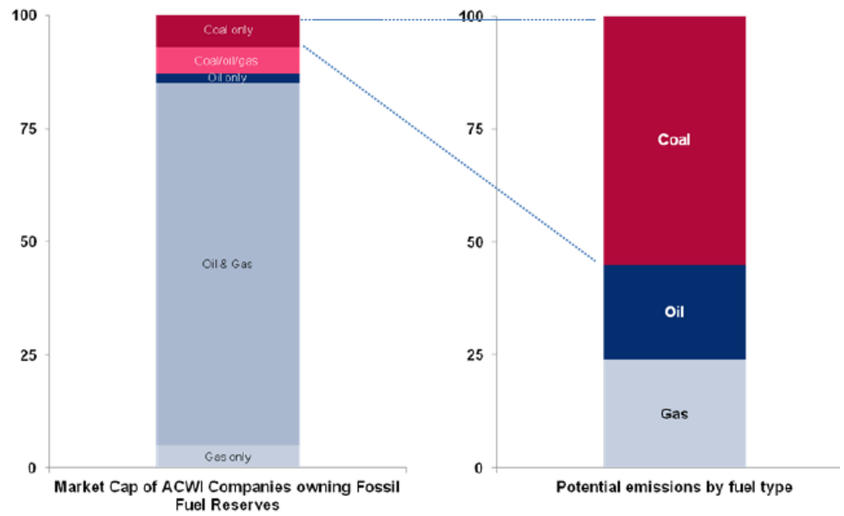


Exhibit 3: Fossil Fuel Reserves Held by ACWI Constituents



- 3 sectors account for majority of carbon emissions & reserves
- It is not clear how long it will take for risks to impact asset prices
- Important to consider both shorter term potential performance against longer term risk

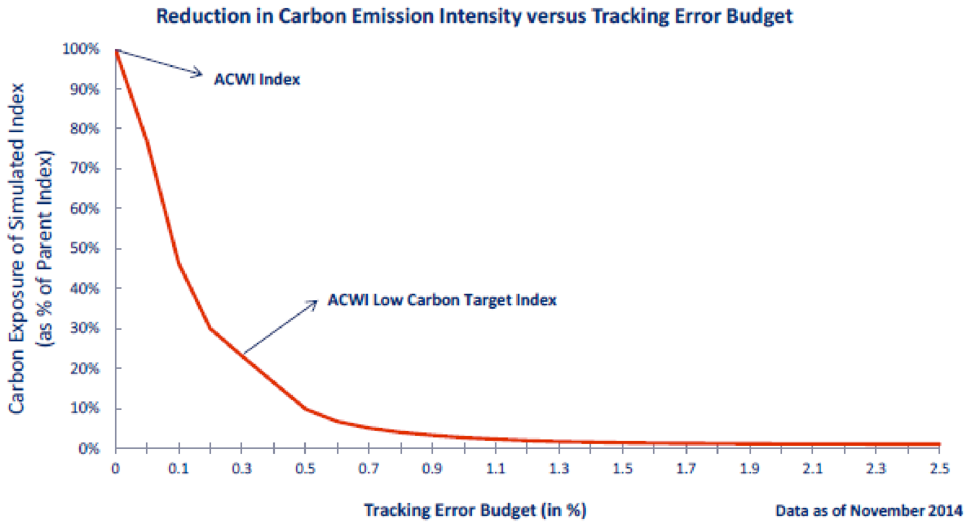
Source: MSCI ESG research as of January & February 2015

Some example indices

Exhibit 10: Comparison of Global Low Carbon and Global Fossil Fuels Exclusions Indexes

	MSCI Global Fossil Fuels Exclusion Index	MSCI Global Low Carbon Target Index	MSCI Global Low Carbon Leaders Index
Approach used in index design	Selection	Re-Weighting	Selection + Re-Weighting
Short term risk	Not considered	Uses optimization to reduce tracking error to parent index	Uses optimization to reduce tracking error to parent index
Long term thesis	Exposure reduction based solely on selecting companies with low fossil fuel reserves	Uses optimization to reduce exposure to companies most vulnerable to stranded assets (i.e., exposed to current and future emissions) while retaining complete opportunity set	Exposure reduction based on selecting companies with low current carbon emission and low fossil fuel reserves

Exhibit 7: Increasing Tracking Error Budget Yields Diminishing Results



Source: MSCI

Points for Discussion

Points for discussion

Potential Next Steps

- Review of investment manager ESG policies
  - Undertake a more detailed review of each manager's approach and capabilities on ESG to document the approach employed when selecting stocks, engaging with investee companies and voting.

- Review and update of ongoing monitoring
  - Review the current ESG reporting from each manager to determine whether there are any gaps and consider how this can be improved or altered to best fit the Council's requirements

- Annual review of underlying managers
  - To review each managers approach over the year and highlight any changes and trends.

- Specific financial risk
  - Is the Committee concerned about any risk in particular?
  - Should there be further exploration of different passive indices (e.g. low carbon, resource efficiency, ESG scoring)?

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