10 Years of Responsible Investment

10 YEARS

of responsible investment

In 2015, we are celebrating 10 years of being a responsible investor. Over the last decade, your pension fund has become a global leader in responsible investment and actively supports hundreds of other investors each year to adopt this way of working.

But, **what does being a responsible investor mean?** And **what difference has that made?**

Whilst in reality it has been hundreds of smaller changes, they add up to big impacts for which you should be immensely proud.

- **100%** of our assets are responsibly managed
- **£1bn** growth in fund assets over the last 5 years
- **£700** million pounds invested in clean technology and sustainable companies in 2015
- **44%** reduction in our fund's carbon footprint since 2008
- **31%** less carbon emitted per million pounds invested than the market average[1] for 2015
- **Top UK Pension fund** in addressing climate risk for second year[2] running
- **500+** company engagements each year, improving companies' performance on environmental, social and governance issues
- **3,000+** company AGMs each year where our votes have been cast

What does it mean to be a responsible investor?

Put simply, it describes a way of working, we;

- consider a wide range of issues e.g. environmental or social impacts and what financial impact they could have both in the short and long term
- look to work with and influence others
- act as good owners of the companies, assets and funds in which we invest
- operate in an open and transparent way

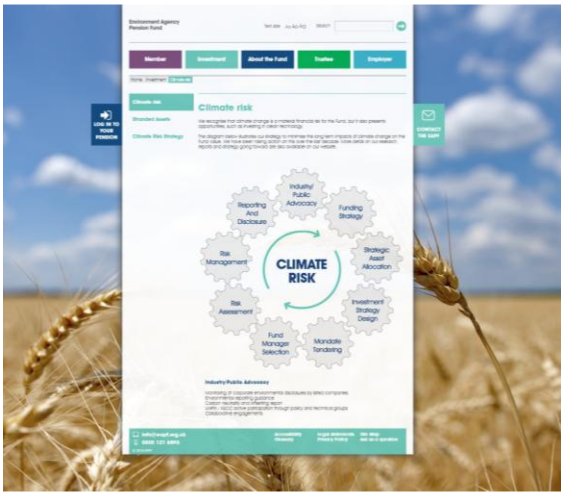
Whilst all this may seem like common sense, and we would agree, most pension funds and asset managers do not operate in this way. However, more and more are recognizing that this approach adds to the value of the fund, particularly in managing risk.

The Environment Agency Pension Fund (EAPF) is a defined benefit Local Government Pension Scheme with over 40,000 members and assets of £2.9 billion. It provides for the existing pensioners, deferred members and the future pensions of its members working for Environment Agency, Natural Resources Wales and Shared Services Connected Limited. In celebrating our 10 years of responsible investment, we wanted to share with our members and employers what we have achieved. We also wanted to use it as an opportunity to continue to influence other pension funds and the investment industry, to encourage more discussion and debate on key topics. Over the course of the year we are going to write nine more articles - 'Our 10-4-10'. Each article will look at different aspects of pension fund investment, for example, why do we think it is important that our mangers engage with companies and vote. Another article will explore why there is compelling case for all parts of the investment chain to think more long term.

1 2014/15 Carbon footprint of all active listed equity in EAPF against the MSCI All Country World Index

2 **Asset Owners Disclosure Project** (AODP) rankings. The AODP is an independent non-for-profit organisation whose objective is to protect members' retirement savings from the risks posed by climate change

We recognize that being **open and transparent,** is not only making information accessible physically but also trying to cut through the jargon. The 10-4-10 articles themselves form part of our commitment to be more transparent about the way the Fund is run and invested. These will be available on our website **www.eapf.org.uk** which already has an area dedicated to responsible investment, and which provides links to research, reports and evidence of delivery of our commitments. It is regularly updated so there is always something new to read.



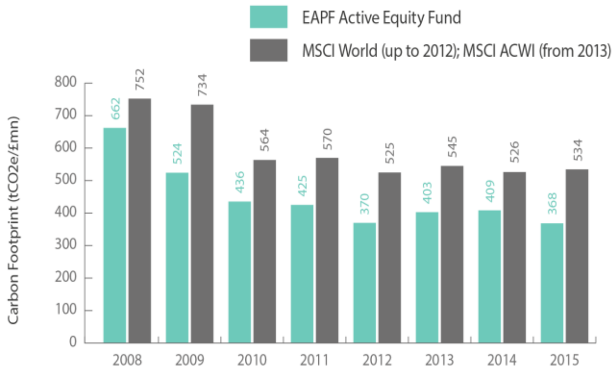
Managing climate risk is a top priority for the fund. We have been managing climate risk in the Fund since 2001 when we became a founder member of **Institutional Investor Group on Climate Change (www.iigcc.org.uk).**

Working with the group is a vital part of our work with others in managing climate risk. In 2014/15 we actively promoted the **Global Investor Statement on Climate Change**, which now has nearly 350 signatories representing $24trn of investments among global institutional investors.

Climate risk page of EAPF website

Reducing our fund's footprint

We have reduced our carbon footprint by 44% since 2008[3]. The chart to the right illustrates the combined carbon footprint of all our active equities. We publish our environmental and carbon footprints for active equities[4] and corporate bonds on our website and in our annual report and financial statements. Publishing our carbon footprint fulfills our commitment to the **Montréal Carbon Pledge**, where investors commit to measure and publicly disclose the carbon footprint of their investment portfolios on an annual basis.



The United Nations Environment Programme has now asked us to join the **Portfolio Decarbonization Coalition**, which is a small group of investors who are seen as climate leaders, with the objective of finding solutions to decarbonizing the economy.

"Some of the biggest – and potentially transformational – announcements at my Climate Summit came from the private sector. A coalition of institutional investors has committed to decarbonise $100 billion in institutional equity investments"

Ban Ki-Moon, Secretary General of the United Nations

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[3] 44% reduction in the carbon footprint of our combined active equities

[4] Actively managed equities are where a manager specifically selects stocks or securities to achieve goal

Looking after the best long term interests of our members

When someone acts as a fiduciary, it means they take responsibility for someone else's affairs, very often these are financial, and that places a duty on that 'person' to act in their best interests. As we manage your pension, we have a fiduciary duty. We define our fiduciary duty as to;

... act in the best long-term interest of our members and to do so, requires us to recognise that environmental, social and governance (ESG) issues can adversely impact on the Fund's financial performance and should be taken into account in the funding and investment strategies and throughout the funding and investment decision making process.

There has been much debate about how to define this duty with respect to pension funds and their intermediaries (consultants and asset managers). The Law Commission, which recommends reform of the law for England and Wales, produced a report last summer that has clarified that in their view **"When investing in equities over the long-term, the risks will include risks to the long-term sustainability of a company's performance. These may arise from a wide range of factors, including poor governance or environmental degradation, or the risks to a company's reputation arising from the way it treats its customers …. Where poor business ethics raise questions about a company's long-term sustainability, we would classify them as a financial factor which is relevant to risk."**[5]

We hope to remove any impediment to investors wishing to consider such issues. We will continue to raise awareness of how considering such risks and opportunities adds to the long term financial performance. Working with the industry, using our influence to get more investors thinking about environmental, social and governance risks, is a core part of role as a responsible investor.

Responsible versus ethical investment

Considering how environmental, social and governance factors may pose a financial risk to a company or a pension fund is core to Responsible Investment. As described in our introduction, being responsible investors to us is integrating this thinking in everything we do, considering how these factors might affect the fund now and also over medium to long term. Ethical investment is when a set of 'views' or 'values' is used to select or eliminate companies in which to invest. Industries often eliminated are ones involved in gambling, alcohol or tobacco. The Law Commission uses the example of tobacco to distinguish the use of financial (responsible investment) and non-financial factors (ethical investment) in considering exclusion (see box). There is considerable overlap in the analysis and tools used to implement both styles of investment.

Financial and Non-financial factors

"Withdrawing from tobacco because the risk of litigation makes it a bad long-term investment is based on a financial factor. Withdrawing from tobacco because it is wrong to be associated with a product which kills people is based on a non-financial factor."

Law Commission, 2014

(Pension Trustees' Duties when setting an investment strategy. Paragraph 1.24: Guidance from the Law Commission or A.24 Fiduciary Duties of Investment Intermediaries of the Executive Summary).

The Environment Agency Pension Fund has chosen to be a Responsible Investor. We adopt the same principles as our employers in taking a risk based approach focused on delivering outcomes. Remaining as an investor, albeit at a lower level than an average fund in some sectors, we can continue to influence the strategy and behavior of the companies in which we invest by holding

[5] Law Commission Fiduciary Duties of Investment Intermediaries, Summary A1.6-1.7

them to account. Conversely, we actively allocate to companies contributing to a more sustainable future (currently 25% of fund which is a market leading level of investment).

The Fund approach is to be very active and work with others to achieve change. A great example of this was in early 2015 we co-filed (alongside 150 other investors) a special resolution at the **2015 AGMs of BP and Shell** respectively to improve the transparency of those companies with respect to how they are managing climate related risk. By asking BP and Shell to do this, through their routine annual reporting, it will provide all shareholders equally (including many individuals), with the information to assess the effectiveness with which these companies are managing this risk and protecting shareholder value. We were delighted that the management of BP and Shell both supported the resolutions, recommending that all their shareholders support it. BP's AGM was held on 14 April and the resolution was passed with 98.28% and Shell's on 19 May with 98.91% of votes in favour. Our approach is to engage with companies to improve performance that benefits us as shareholders and wider society.

Working with others

Working with others increases the effectiveness of the Fund's engagement activities.

In January 2015, the Environment Agency Pension Fund, together with 15 other institutional investors published a guide to **Responsible Investment Reporting in Public Equity**. The report has been very well received, has been used by funds globally and with the help of one of our managers it will shortly be translated into Japanese.

Considering all the issues

We integrate management of Environmental Social and Governance (ESG) issues throughout the investment and funding strategy; this includes asset allocation, mandate design, risk management, fund manager appointment and monitoring, collaborative engagement and transparent reporting. Thinking about these issues at a strategic level is critical. We are participating in a groundbreaking study looking at how investors can **integrate climate risk in strategic asset allocation** being led by Mercer, our investment consultants.

Sustainable investment

We set ourselves the target of 25% of our investments in clean technology and other sustainable opportunities – far more than any other pension fund worldwide. This was achieved in 2015.

Investments include;

- Property opportunities targeting energy efficiency, urban regeneration and sustainability
- Venture capital funding the next generation of technologies that provide new solutions –such as electric vehicles and LED lighting
- Long term sustainable infrastructure, such as renewable energy and energy efficiency
- Listed companies demonstrating best practice in sustainability, improving efficiency and reducing social and environmental impacts

All the assets of the pension fund are selected by external fund managers. This means that it is our external fund managers who make the detailed decisions in which companies we invest in. This is important in avoiding conflicts of interest for our employers, but also gives us the flexibility to select the best managers for each set of assets. The skills needed to decide environmental and other issues vary from one asset class to another. We place a high importance, and indeed time and energy, in selecting good quality managers who deliver financially and can manage the wide variety of risks that come with making investments. The list below is extracted from the **NAPF Responsible Investment Guide 2013** and details some of the types of ESG risk our managers consider when selecting companies in which to invest.

Examples of Responsible Investment factors

Governance risk	Material social risks	Material environmental risks
• Board independence	• Human rights	• Climate change
• Succession planning	• Employment	• Natural resources
• Board diversity	• Health and safety	• Energy use
• Auditors	• Supply chain	• Water

Extracted from NAPF Responsible Investment Guide 2013

Acting as good owners

As investors we own a portion of the companies we invest in. We can use our rights as owners to encourage companies to act more responsibly and improve their practices. Acting collectively with other asset owners increases the effectiveness of the engagement. For our index tracking funds[6], where we own small amounts of a large number of companies, we employ as specialist provider, Hermes Equity Ownership Services, who bring together 30 clients to represent £134bn of assets. We work with Hermes' other clients to set the engagement priorities and undertake to meet senior executives of over 400 companies per year. Hermes also undertake policy engagement work, for example supporting the development of the Japanese Corporate Governance code. Each quarter we publish a report on our website on the engagement and voting activity undertaken by Hermes.

All our active managers are required to adhere to our Responsible Investment Policy which sets out expectations with regard to implementation of their mandate. It is important that voting at a company AGM is part of the equity investment process, so we choose to delegate that to our managers, but with robust monitoring and oversight. We provide specific guidance on environmental issues and our voting on these resolutions is published on our website.

Awards

We won two awards in November 2014, one for the work we are doing integrating Environmental, Social and Governance and the other for Climate Related Risk Management. Both were awarded by Investment Pensions Europe (IPE) which recognises good practice and excellence across European Pension Funds. We also won Portfolio Institutionals' Best implementation of responsible investment award in May 2014. These awards cited specifically that the achievement of having 25 per cent of the Fund in clean technology and sustainably-themed investments, which is market leading.

Looking forward

We look forward to sharing the other nine articles during the year and hope they provide you with insight into your fund, issues impacting the investment industry and where we see our priorities going forward. We would welcome your feedback on this article and throughout the year to help us shape our agenda for the next decade as a responsible investor.

Please contact us at eapf@environment-agency.gov.uk

[6] An index fund (also index tracker) is an investment fund that aims to replicate the movements of an index of a specific financial market, or a set of rules of ownership that are held constant, regardless of market conditions. The advantage is they are highly diversified with low management costs