Environment Agency
Pension Fund

Statement of investment principles

Introduction

The Environment Agency Active Pension Fund (the Fund or 'EAPF') is a funded, final salary (defined benefit) pension scheme with over 23,000 members and assets of £2.77bn as at 31 March 2016. Full details of the Environment Agency Pension Fund and our activities can be found on **www.eapf.org.uk**.

This Statement sets out the principles and basic framework that govern our process for investing the assets of the Environment Agency Active Pension Fund as required by the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. This Statement was made and approved by the Environment Agency Pension Fund Pensions Committee on 16 June 2015, after taking advice from its investment staff, investment consultants, independent investment adviser and consulting actuary.

We will refer to this Statement when making investment decisions to ensure they are consistent with these principles. As set out in the regulations, the Pensions Committee will review the Statement from time to time, but at least every three years following the triennial valuation of the Fund.

The Statement should be read and will be implemented in conjunction with the Fund's Governance Policy, Funding Strategy Statement, Responsible Investment Policy and Global Stewardship Statement. These provide and state our more detailed requirements and supplementary guidance on these specific topics for our external fund managers. It is also supplemented by the contents of our investment management agreements for each investment mandate. Details of the investment and performance objectives for each mandate are published in our annual report and financial statements.

Fund governance: Investment

Our Governance Policy sets out how the Fund is governed and the role of the Pension Committee; Pension Board; Investment Sub-Committee; and Environment Agency officers with respect to investment matters. The Environment Agency Board appoints the Pensions Committee and Pension Board, and delegates responsibility for compliance with legislation and best practice, overall strategic asset allocation, investment policy, budgets and the appointment of fund managers and investment advisers. The Environment Agency Board approves the annual report and Financial Statements of the Fund, which includes the policies under which the Fund is governed.

The Investment Sub-Committee normally consists of seven representatives of the Pensions Committee and receives advice from professional investment officers, specialist investment consultants, an independent investment adviser, the Fund's actuary, and other professional advisers as required.

The Investment Sub-Committee has received delegated responsibility to prepare and recommend the investment strategy to the Pensions Committee and, within the context of the agreed investment strategy, to decide on the structure of mandates and their specification, to appoint fund managers, to monitor the performance of fund managers, and to terminate or alter mandates.

We have delegated day-to-day management of the Funds asset's to a number of fund managers. They have full discretion to manage their portfolios subject to their investment management agreements with us and in compliance with the Fund's policies including this SIP. We do not seek to direct the managers on individual investment decisions.

We have appointed a performance measurer independent of the fund managers to calculate risk and return measures for each manager and the Fund overall. We have also appointed a global custodian who is responsible for the safe-keeping of the directly-held assets of the Fund and who works in close liaison with each fund manager.

The Fund's actuary is responsible for performing a formal valuation of the Fund every three years in order to assess the extent to which the assets cover accrued liabilities and to inform the development of an appropriate Funding Strategy Statement. The Funding Strategy takes account of, and informs the development of, our investment strategy and this SIP.

In all matters, our fiduciary obligations to Fund members are paramount, and neither the Fund's committees nor the Fund's officers would take any action which would be in conflict with these obligations. Similarly, fund managers are required to invest in the best interest of the Fund.

High Level Investment Principles

The EAPF is an open, defined-benefit pension fund with strong employer backing, positive cash-flows and pension obligations stretching to the end of this century. In setting our investment strategy we seek to balance twin objectives: first, to achieve sufficient long-term returns for the scheme to be affordable, second, to keep the contribution rate as stable as possible. To achieve this, the fund needs to invest in assets which differ in return characteristics from our pension liabilities. These investment principles provide high level guidance on how we seek to meet these objectives and manage the risks arising from the differences between assets and liabilities.

- We are long term investors: we invest in productive assets that contribute to economic activity, such as equities, bonds and real assets, and thereby aim to earn a sustainable and sufficient return on our investments.
- We are responsible investors: we believe that we will overall generate better returns by investing in companies and assets that contribute to the long term sustainable success of society.
- We adopt best practice fund governance with appropriate prioritisation, decision making at the right level, and internal accountability.
- We make our decisions based on extensive expertise: trained and insightful committee members; experienced and professional officers; and high quality, knowledgeable advisers.
- We take an evidence and research based approach to investment: continually learning and reappraising from academic research, investment professionals, and our peers, and seek continual development in our understanding of investment.
- We are prepared to be innovative and demonstrate thought leadership in investment, within the requirement of prudence and our fiduciary duty.
- We will make our investments work as hard as possible to meet our objectives: we recognise the importance of getting the right asset allocation, but also the value of getting the right structure and managers within asset classes. While we take account of market and economic levels in our decision making, we avoid making decisions on a purely short term basis.
- We will be comprehensive in our consideration of risk, and efficient in where we take risk: we will base our assessment of risk on our liabilities and contributions; consider financial and non-financial risk as appropriate; diversify risk as much as possible, but also recognise the limits of that diversification – as long term investors we accept that our investment success depends substantially on the sustainable growth of the economy.
- We will exercise responsible stewardship of the assets we hold, and act as a responsible voice in the broader investment community.

- We will seek the most cost-effective solutions to achieving our objectives and implementing these principles: we recognise the impact of costs on the Fund, but we are prepared to pay for active management and other services when we believe that the costs incurred are likely to be justified by the benefits.
- We believe in the importance of being transparent and accountable, to ensure correct decisions are taken and to minimise risk. This applies both in our own operations, those we work with, and our investments
- We will collaborate with others whenever possible, to share ideas and best practice; to improve effectiveness and to minimise costs.

Responsible Investment

We are long term investors who aim to deliver a truly sustainable Pension Fund; ensuring that it is affordable; delivers financially to meet the objectives of our scheme employers; and is invested responsibly.

Our fiduciary duty is to act in the best long-term interests of our members. To do so properly requires us to recognise that environmental, social and governance issues can adversely impact on the Fund's financial performance and that they should be taken into account in our funding and investment strategies, and throughout the funding and investment decision-making process. Full details are contained in our responsible investment policy, and other associated policies, notably our Policy to Address the Impacts of Climate Change. Managers are expected to comply with these policies when complying with this Statement of Investment Principles.

A summary of the key Responsible Investment principles;

- Apply long-term thinking to deliver long-term sustainable returns.
- Seek sustainable returns from well-governed and sustainable assets.
- Apply a robust approach to effective stewardship.
- Responsible Investment is core in our skills, knowledge and advice.
- Seek to innovate, demonstrate and promote RI leadership and ESG best practice.
- Apply evidence-based decision-making in the implementation of RI.
- Achieve improvements in ESG through effective partnerships that have robust oversight.
- Share ideas and best practice to achieve wider and more valuable RI and ESG outcomes.
- Be transparent and accountable in all we do and in those in which we invest.

We believe the application of these principles will enable the delivery of our commitments as a signatory to the United Nations Principles of Responsible Investment (UNPRI) and the UK Stewardship Code and facilitate the implementation of the Kay Principles.

We became the first Local Government Pension Scheme (LGPS) signatory of the UNPRI in July 2006. The UNPRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact. The principles reflect the view that ESG issues can affect the performance of investment portfolios and therefore must be given appropriate consideration by investors if they are to fulfil their fiduciary duty. The UN Global Compact asks companies to embrace, support and enact, within their sphere of influence, a set of core values in the areas of human rights, labour standards, the environment and anti-corruption. We complete the annual report on progress in implementing the principles and publish on our website.

We also comply with the UK Stewardship Code and other global codes. Our Stewardship Compliance Statement is available on our website. We also require all our managers to comply and apply best practice standards of global stewardship.

Investment objectives

Our investment return objective is to achieve 100% funding on an ongoing basis by 2031, with a reasonable probability of reaching 90% funded by 2022 and our risk objective is to limit the likelihood of a fall in the funding level below 80% at the 2016 and subsequent actuarial valuations. These objectives are currently being reviewed as part of the Triennial Valuation process. The aim of these objectives is to achieve a return on our assets which:

- achieves sufficient long-term returns for the benefits to be affordable to employers, while keeping the contribution rate as stable as possible;
- is sufficient to meet Funding Strategy Statement objectives arising from triennial actuarial valuations of the Fund;
- contributes towards achieving and maintaining a future funding level of 100%;
- in overall terms, seeks to outperform a fund-specific benchmark;
- is set at a level which does not force the Fund to take unnecessary risks.

It is not possible to control the absolute return on investments but over the long-term the Fund believes its investment strategy should result in a high probability of achieving the objectives of its Funding Strategy Statement. In the short-term, returns are measured against a Fund-specific benchmark and the Actuary prepares quarterly intra-valuation updates on the Fund's funding level. Further details on the expected returns from investments and how they interact with the Actuary's formal triennial valuation of the Fund's assets and liabilities are included in the Funding Strategy Statement.

Each active manager has an outperformance target, and taking these together with other actions we have set ourselves the target that, as a whole, the Fund should outperform its strategic benchmark by 1% per annum, averaged over several years, (or £20-£30m in cash terms). Over the long term this will lead to significantly lower contributions than would otherwise occur.

In addition the Fund seeks to use its influence as a large institutional investor to support and develop best practice in responsible investment, through best practice in responsible investment and good global stewardship.

Types of investment to be held

The Fund may invest in any category of investment permitted by LGPS regulations. In selecting categories of investments to invest in, the Fund will have regard to return potential, financial risk, liquidity, management costs and any potential environmental, social and governance risks and opportunities. In accordance with our principles above, we seek to invest in areas contributing to long term economic activity rather than assets where returns are based on speculation or short-term trading.

Assets currently held include equities (both listed and unlisted), index-linked gilts, corporate and other bonds, private debt and real assets including property, infrastructure, forestry and agriculture assets.

Asset allocation

The strategic asset allocation of the Fund uses different types of assets to achieve diversification. It is set after considering the results of an asset and liability modelling exercise. In setting the strategic asset allocation we seek a long-term rate of return sufficient to meet our investment objectives, which has been determined as a return of +3.25% over the expected return on gilts. We also consider the challenges presented by volatile market conditions, changes to the benefit structure of the LGPS, the demographics of the fund, possible transfers out, and potential changes to the investment regulations; all of which potentially impact on the most suitable investments and the appropriate allocation to them.

At the highest level, the asset allocation splits the investment portfolio into three – equities, bonds and diversifying growth assets. Equities and bonds are traditional asset classes. “Diversifying growth assets” covers a range of assets that we consider to offer reasonably attractive returns without many of the risks associated with equities. They include real assets (property, infrastructure and forestry/agriculture), “growth fixed income” and “illiquid credit/private debt”.

We have adopted a flexible approach to asset allocation using three levels. The first level provides a broad framework, indentifying key asset classes and setting allocation ranges to these areas. The second level is to define our medium-term strategic asset allocation target, which indicates the allocation we are moving towards. The final level is the current Fund benchmark, reviewed at least each year, which reflects the practical limitations on where and the pace at which we can invest (e.g. due to the time taken to invest in illiquid assets) and provides a fair comparator for performance measurement purposes,

The framework is intended to provide a degree of high level risk control, ensuring asset allocation remains broadly appropriate and diverse, while being flexible enough to enable the Fund to respond to changes in funding levels, market conditions and other factors. We have updated the framework this year, to provide for increased potential to reduce investment risk in the Fund when appropriate. The asset allocation framework is reviewed at least annually by the Pensions Committee. The actual asset allocation may vary outside the target ranges because of movements in markets and the availability of suitable investment opportunities.

Within this Framework the medium-term target asset allocation is set, with the input of the Fund’s advisers, after considering current funding level, the return requirements and acceptable risk of the Fund, as well as market conditions and valuations. The medium term target is typically expected to be achieved in around 3 years. The Investment Sub-Committee then sets the current benchmark. This reflects the medium-term target asset allocation but allows for the fact that our investments in illiquid assets may take some time to achieve, and therefore sets current allocations to these assets at realistic levels. The underweight exposure (against the medium-term target) to diversifying growth assets is then reallocated to bonds and equity on a pro-rata basis.

Previous Framework %	Asset Class	Framework Range %	Medium term Target Allocation
45-60	**Equities**	**40-60**	**50**
40-55 5-12	Public Global Equities of which emerging markets	35-55 5-12	45
0-6	Private equity / specialist opportunities	0-6	5
15-25	**Diversifying Growth assets**	**15-30**	**22**
9-14 3-6 0-4 0-4	Real assets property infrastructure farmland and timberland	9-20 3-10 0-10 0-4	12 5 5 2
0-8	Illiquid Credit / Private Debt	0-8	5
0-6	Growth Fixed Income	0-6	5
25-35	**Fixed income assets**	**25-40**	**28**
5-20 13-25	Index-Linked gilts Corporate bonds	5-20 13-30	7.5 20
<3	Cash	<3	0.5

The asset allocation results in a significant weight being given to equities, which we consider appropriate given the long-term nature of our liability profile and our investment objectives, but this is spread across a range of managers with different approaches and styles (see below). As our funding level permits we are also gradually reducing the allocation to equities to reduce our overall investment risks, although we expect to retain a significant equity allocation.

Allocations to certain areas (real assets; illiquid credit/private debt; private equity/specialist opportunities) are illiquid and the actual level of investment will depend on the rate of drawdown once investments are identified, any changes in value and the pace at which capital is returned. They may therefore vary significantly from target levels. In particular, should the above ranges be exceeded as a result of market movements, while new investments will not be made, there will be no immediate requirement to reduce exposure through forced sales.

We regularly review the balance between exposure to growth assets (equities and diversifying growth assets) and lower risk assets (fixed income and cash), and if they vary by more than a certain amount from the target asset allocation, rebalance the portfolio back to the target asset allocation. The Fund's strategic benchmark and manager performance targets and their achievement are publicly disclosed within the Fund's Annual Report and Financial Statements.

Managers and Mandates

Within each asset class the Fund seeks to have a well-diversified portfolio. This is achieved by ensuring each investment manager holds an appropriate spread of investments and within certain asset classes, working with a range of managers to ensure a diversity of styles and expertise.

We have a specialist fund manager structure with managers appointed with a mandate to manage assets in a specific area. This enables us to access managers with particular expertise and skills. Each mandate has a detailed specification, including a mandate-specific benchmark, performance target and risk controls. They are required to comply with the investment provisions and limits prescribed in relevant regulations (currently the LGPS Investment Regulations 2009).

Subject to these statutory constraints and compliance with both this Statement of Investment Principles and associated policies, and the terms of their Investment Management Agreements, which includes the requirement to maintain a diversified portfolio, all the managers have full discretion over the choice of individual investments.

The Fund's preference is for segregated portfolios in which the Fund is the direct beneficial owner of the underlying investments, but the Fund also uses collective investments (pooled) funds when we consider them to be appropriate, based on considerations including speed of implementation, costs, flexibility, ease of administration and impact on voting and active ownership.

The Fund uses a combination of passive (indexed), and active approaches to investment management, based on consideration of availability, cost, flexibility and return potential. Passive approaches aim to deliver the return of the underlying market index and consequently contain a very large number of holdings. They are used for gilts, equities and corporate bonds, in both pooled and segregated approaches. We consider the case for integrating responsible investment within our passive investments, particularly where suitable indices exist. Within global equities, a significant allocation has also been made to "smart beta": to both a fund based on an alternative index using a fundamental value approach to construction, and to mandates managed using quantitative low volatility approaches. These aim to provide improved risk/return characteristics over conventional passive approaches. We have also introduced a buy-and-maintain approach, in corporate bonds, which has a quasi-passive approach to investing but does not seek to follow a benchmark index. This is useful particularly where benchmarks are deficient from the Fund's perspective.

The remainder of the Fund is managed on an active basis, using investment managers to select the investments they consider to have the best return potential, with an average outperformance target of +1.5% p.a. This portion of the Fund is spread across UK equities, global equities, corporate bonds, and other fixed income assets, property/real assets, and private equity and debt. The decision to appoint active managers is only made after careful consideration of the likely costs, the likelihood that the manager will be able to add value after fees, the impact on risk, and the ability of the manager to implement the responsible investment strategy. Once appointed, managers are carefully scrutinised for value for money, and any reasonable opportunities to reduce costs will be pursued.

In keeping with our investment principles, we focus on developing successful long term partnerships with our managers. We have developed a detailed approach to investing long term, including establishing "covenants" with our managers to outline what is expected of each other. In assessing managers we focus on long-term performance potential including aspects such as idea generation and team stability, rather than short term performance. Where managers are underperforming we seek to work with them to address any issues and improve performance.

Schedule 1 of the LGPS (Management and Investment of Funds) Regulations 2009 imposes limits on certain categories of investments. There is a provision in Section 15 for a fund to change these limits to higher limits set out in column 2 of the Schedule, if certain conditions are met. We have considered the increased amount of risk associated with the higher limits and do not believe that it is material and so have decided to adopt them.

Risk

We take the management of risk in our investments very seriously. We maintain a detailed risk register of all the investment-related risks that could affect the Fund, and use this to monitor their severity and the implementation of mitigating actions.

To achieve the required returns the Fund needs to invest in assets involving a degree of risk and so although we seek to manage our investment risk we cannot eliminate it. The most fundamental risk is that the Fund's assets produce lower long-term returns than those assumed by the Fund's actuary, leading to a significant deterioration in the Fund's funding position.

This risk of deteriorating Fund asset values cannot be entirely avoided (for instance if all major investment markets were to decline in unison) but it can be mitigated by ensuring that the assets of the Fund are invested across a number of different asset classes and markets. Diversifying assets across different asset classes is widely recognised as being an effective way of mitigating the risk of reductions in the value of the Fund's assets.

Different types of investment have different risk characteristics and return potential. For example, historically the returns from equities have been higher than from bonds but they are more risky (volatile), particularly in the short term. In setting the investment strategy we consider the expected risks and returns from various asset classes and the correlation between these returns to develop a strategy with an adequate expected return with an acceptable level of risk. Detailed modelling analyses the expected results of different strategies (in terms of funding levels and contributions) over a range of possible long term market outcomes to determine the preferred strategy. This strategy is then reflected in the Fund's strategic asset allocation.

A separate investment risk is the risk of underperforming the Fund's strategic benchmark. This relative risk is less significant than the strategic risk above, but we still seek to manage it. It can arise either because asset allocation has deviated from the strategic benchmark allocation or because our fund managers are underperforming. We monitor the actual asset allocation continually and take action if required. Individual managers may, particularly over the short term (a year or less), underperform their benchmark but over the long term we expect them to add value. For the Fund as a whole, the range of different managers reduces the risk of significant underperformance.

The Fund also believes that other financially material risks including, but not limited to, corporate governance, climate change, pollution, and other environmental issues, need to be considered and controlled. Our Responsible Investment policy details our approach to these issues. Our active Fund managers are required to consider these sources of risk (and opportunity) when evaluating investments on our behalf, and they are also considered in our investment strategy and asset allocation

Climate change is a key financially material environmental risk for the Fund, and as such we have developed a comprehensive and robust strategy to minimise the long term impacts on the Fund value. Our website has a dedicated area focusing on climate risk, outlining the plans and actions undertaken by the Fund.

The Fund is aware of the nature of its liabilities, and considers how closely its different assets match its liabilities. We have considered the case for liability-driven investments, including explicit liability hedging, but do not consider it appropriate at this time given current market levels, but will continue to keep it under review. We have preferred to focus on assets which have some liability-like characteristics, for example offering some inflation linkage, such as real assets.

The Fund reviews the potential for active hedging of any aspects of risks (e.g. currency risk). At present the Fund does not hedge the currency risk in its equity exposure, as it is not considered effective in reducing overall risk. However, any currency risk in overseas fixed interest exposure would normally be hedged. We continue to monitor the case for hedging such risks.

There are also a variety of other risks to be considered, for example operational risks of loss arising from default by brokers, banks or custodians. Here, the Fund is careful only to deal with reputable service providers to minimise counterparty risks.

Liquidity and the realisation of investments

The majority of the Fund's investments will be made in bonds and stocks that are listed on recognised Stock Exchanges and may be realised quickly if required. Our corporate bond holdings are generally reasonably liquid, but may be harder to realise in certain market conditions. However, given the strong positive cash inflows of the Fund, and the long term nature of the Fund, we are satisfied that a significantly greater proportion of the Fund is held in liquid assets than is likely to be needed to meet any expected or unexpected demands for cash.

The materially illiquid assets within the Fund are those held in private equities, real assets and private debt. These are normally held through pooled funds. As a long term investor, we regard it as entirely appropriate to hold such illiquid assets. In particular as we expect such funds to benefit from an enhanced return "illiquidity premium" to compensate for the long term nature of these investments. Furthermore, all funds we invest in will have a long term strategy for the realisation of their investments, through sales, repayments or income. We do not expect to exceed a 25% allocation to illiquid assets in aggregate at present.

Stewardship and the exercise of our rights as owners

Our fund managers can generally vote all the Fund's shares at their discretion. However, in our investment management agreements, we reserve the right to do this ourselves or via a specialist service provider, if we wish to do so. Before appointment, our fund managers have to confirm that they subscribe to the principles of good corporate governance and, when voting at company AGMs, take them into account. In respect of investments in the United Kingdom, this requires its managers to have due regard to the UK Corporate Governance Code and, in respect of overseas investments, have due regard to relevant recognised standards. We also require our managers to apply the highest standards of global stewardship.

When specific environmental resolutions are proposed at company AGMs, our fund managers are required, wherever possible, to refer such resolutions to the EAPF, who will direct the investment manager how to vote the Fund's shares on that resolution. The Fund's policy is to be generally supportive of resolutions calling for greater disclosures of a company's environmental performance or for improvements in environmental practice. Each resolution is considered on its own validity and merits, and due regard is paid to any possible adverse effect on investment performance that our voting may have. Further information is provided in our Voting Policy, available at **www.eapf.org.uk.**

Collaboration

The Fund actively engages in collaboration with other pension funds, investors, asset managers, advisers, industry bodies and associated organisations to share best practice, improve efficiencies, promote product development and save money. To deliver our Responsible Investment policies we work closely with organisations including the UN Principles for Responsible Investment, IIGCC (institutional Investors Group on Climate Change), UKSIF (UK Sustainable Investment and Finance Association), and the CDP (Carbon Disclosure Project). We also share our understanding and experience through speaking at investment industry events and publishing articles on-line. We are working closely with other LGPS funds in response to the Government's initiative calling on LGPS funds to pool assets to reduce costs, maintain or improve performance and consider infrastructure more fully.

Stock lending

The Fund does not directly engage in stock lending, although some pooled funds in which the Fund invests may have a different policy.

Statement of compliance with the Myners Principles

We fully comply with Lord Myners' six principles codifying a model of best practice in pension fund governance, investment decision-making and disclosure. Evidence is contained within the documents referenced in our Annual Report and Financial Statements and on our internet site **www.eapf.org.uk.**

Approved by the Pensions Committee on 16 June 2016.

Annex: Regulatory context

This statement has been made under the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (“The LGPS Investment Regs”) Section 12 that requires that the Environment Agency must (after consultation with such persons as it considers appropriate) prepare, maintain and publish a written statement of the principles governing its decisions about the investment of Fund money. The statement must also state the extent to which the administering authority complies with guidance given by the Secretary of State, and the associated guidance issued by CIPFA in December 2009, entitled Investment Decision-making and Disclosure in the Local Government Pension Scheme: A Guide to the Application of the Myners Principles. This can be found in the section ‘Compliance with Myners Principles’ at the end of this document.
This statement is required to cover the Fund’s policy on:

Disclosure requirement	Relevant Section
The types of investment to be held.	Types of investment
The balance between different types of investment.	Asset Allocation Mandates and Managers Risk
Risk, including the ways in which risks are to be measured and managed.	Risk
The expected return on investments.	Investment Objectives
The realisation of investments.	Liquidity and the realisation of investments.
The extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.	Responsible Investment
The exercise of the rights (including voting rights) attaching to investments, if there is any such policy.	Stewardship and the exercise of our rights as owners
Stock lending.	Stock lending.
Statement of compliance with the six Myners Principles.	Statement of compliance with the six Myners Principles.

The Environment Agency is also required by Local Government Pension Scheme (Administration) Regulations 2008 section 35 and Local Government Pension Scheme (Administration) Regulations 1997 section 76A to publish a separate Funding Strategy Statement for the Active Fund. This sets out the assumptions used by our Actuary in determining the funding level, and sets out a fund-specific strategy for the Fund which is reflected in the investment strategy adopted by the Environment Agency for the Active Fund.