Investment Strategy Statement

London Borough of Southwark Pension Fund

1. Introduction

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 require administering authorities to formulate and to publish a statement of their investment strategy (ISS), in accordance with guidance issued from time to time by the Secretary of State.

This ISS has been designed to be a living document and is an important governance tool for the London borough of Southwark Pension Fund (the Fund). This document sets out the investment strategy of the Fund, provides transparency in relation to how the Fund investments are managed, outlines the Fund’s approach to managing risk, how environmental, social and governance issues are taken into account and the approach with regard to pooling of investments. This document replaces the Fund’s Statement of Investment Principles.

This statement will be reviewed by the Pensions Advisory Panel annually, or more frequently should any significant change occur, with any resulting recommendations made to the Strategic Director of Finance and Governance.

Southwark Council is the administering authority for the Southwark Local Government Pension Fund and bears ultimate responsibility for the funding of member pensions. The management and strategic direction of the Fund, whilst separate from the council, will always take into consideration the council’s long term objectives.

In this regard the Fund’s investment principles are aligned with the council’s fairer future principles as defined in the Council Plan, in particular, the fairer future value of “spending money as if it were from our own pocket” and the “fit for the future” principles to ensure financial sustainability.


The Fund is fully committed to collaboration with other local authority partners and in 2015 invested, and is an active shareholder, in the London Collective Investment Vehicle (CIV). The London CIV is a collaborative venture between local authorities to deliver benefits of investment scale and efficiency to the participating Funds. The Fund will continue to support the development of the London CIV as an investment vehicle.
2. **Investment objectives and principles**

The Fund is an open, defined-benefit pension fund as part of the national Local Government Pension Scheme. The Scheme rules are determined at national level and cover many elements of the Fund, such as employee benefits and employee contributions. The nature of the Fund and scheme design means that payment of pensions will extend over the very long term.

In setting the investment strategy the Fund seeks to balance twin objectives: first, to achieve sufficient long-term returns for the Fund to be affordable and second, to keep the employers’ contribution rate as stable as possible.

The Fund will seek to operate a long term, sustainable strategy; one which does not rely upon the pursuit of short term returns or adherence to asset management trends, but utilises a well structured asset and fund manager investment allocation to target long term socially responsible investment performance. The Fund’s uncomplicated investment structure provides significant flexibility and adaptability if required.

To achieve the twin objectives, the Fund needs to invest in a diverse range of assets which provide higher returns relative to the growth of pension liabilities whilst taking account of the volatility inherent in investment markets. The principles set out below provide high level guidance on how the Fund seeks to meet these objectives and manage the associated risks.

**Governance**

- The Fund seeks at all times to adopt best practice governance standards within a structured framework, compliant with regulatory requirements and with expert independent advice taken throughout the decision making process.
- The Fund will operate with transparency and be accountable for decision making to stakeholders and scrutiny bodies.
- The Fund will ensure that officers and members of the Pensions Advisory Panel and Local Pension Board have the necessary skills, expertise and resources to ensure effective and evidence based decision making regarding the Fund’s investment strategy.

**Investment structure and risk management**

- The Fund is a long term investor and as such the Fund invests in a wide range of investment assets, which may be volatile or illiquid, such as equity or property, but that over the long term can generate a sufficient return to meet the Fund’s pension obligations.
- The Fund operates an evidenced and research based approach to investment; continually utilising research and guidance from investment professionals and peers, and seeking continual development in the understanding of investment.
The Fund recognises the importance of having the right asset allocation, but also the value of developing the right structure and appointing suitable investment managers. The Fund will take account of markets and the economic background in decision making, but will avoid making decisions on a purely short term basis.

The Fund will be comprehensive in the consideration of risks; the Fund will base assessments of risk on future pension liabilities and contributions, will consider financial and non-financial risks, diversify investment assets in an appropriate manner, but also recognise the limits of that diversification. As a long term investor the Fund understands that investment success depends significantly on the sustainable growth of the economy.

The Fund will seek the most efficient and cost-effective solutions to achieving the Fund’s objectives. This may involve active management and other services where additional costs are justified. Fees will always be considered in the context of overall performance and it is recognised that higher performance may be associated with higher fees.

The Fund is an active shareholder in the London CIV, with the Fund making regular contributions to the London CIV to assist in the development and expansion of the collaborative venture. Any future investments within the London CIV will be dependent upon the satisfactory completion of detailed due diligence and review to the same high standard that would be undertaken outside the investment pool.

Responsible investment and stewardship

- The Fund is a responsible investor; holding the belief that well governed companies that manage their business in a responsible and sustainable manner will generate better returns over the long term.

- The Fund is prepared to be innovative and demonstrate thought leadership in investment, within a framework of prudence and fiduciary duty.

- The Fund will actively exercise responsible stewardship of the assets held and act as a responsible voice in the broader investment community.

- The Fund will collaborate with others whenever possible to share ideas and best practice, and to improve effectiveness and to reduce costs.
3. Investment strategy and the process for ensuring suitability of investments

The Fund’s asset strategy, along with an overview of the role each asset plays is set out in the table below:

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Target Allocation %</th>
<th>Investment Style</th>
<th>Maximum Allocation %</th>
<th>Role (s) within the strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>50.0</td>
<td>Passive 40.0</td>
<td>65.0</td>
<td>Expected long term growth in capital and income in excess of inflation over the long term.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Active 10.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Diversified Growth</td>
<td>10.0</td>
<td>Active 10.0</td>
<td>20.0</td>
<td>Primarily for diversification from equities. Equity like returns over time with a lower level of risk.</td>
</tr>
<tr>
<td>Absolute Return Fixed Income</td>
<td>10.0</td>
<td>Active 10.0</td>
<td>20.0</td>
<td>Diversified approach to fixed income investing which is not dependent on the direction of interest rates.</td>
</tr>
<tr>
<td>Index Linked Gilts</td>
<td>10.0</td>
<td>Passive 10.0</td>
<td>40.0</td>
<td>Low risk (relative to the liabilities) asset that provides inflation linked income and protection from falling interest rates.</td>
</tr>
<tr>
<td>Property</td>
<td>20.0</td>
<td>Direct 14.0</td>
<td>30.0</td>
<td>Provides diversification from equities and fixed income. Generates investment income and provides some inflation protection.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Pooled Fund 6.0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The above table sets out the Fund’s asset allocation strategy with a target allocation to each asset class. If the actual asset allocation as at a reporting quarter end moves outside a target range for a particular asset class, (plus or minus 5% of total investment assets) the Strategic Director of Finance and Governance will review the portfolio and prevailing market conditions to determine if a corrective rebalancing action is required. A breach of the target range will not necessitate a portfolio rebalance.

Under Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016, the Fund is required to set maximum investment limits pertaining to different asset classes so that actual allocation to those asset classes will not breach this maximum limit. The limits as applied to the Fund are set out in the above table.
Appendix A shows the Fund’s current investment manager appointments and mandates.

The Fund’s asset allocation is reviewed on an ongoing basis and undergoes a triennial strategy review as part of the actuarial valuation process. The triennial review looks at both qualitative and quantitative analysis, covering:

- The required level of return that will mean the Fund is able to meet its future benefit obligations as they fall due.
- The level of risk that the Fund can tolerate in absolute terms, and in relation to its funding level and deficit.
- An analysis of the order of magnitude of the various risks facing the Fund, so that the Fund can focus upon the most significant risks.
- The desire for diversification across asset class, region, sector, and type of security.
4. Risk measurement and management

The risks inherent within the portfolio are assessed both qualitatively and quantitatively as part of regular investment strategy reviews by the Strategy Director of Finance and Governance and the Pensions Advisory Panel. The Fund uses specialist external investment advisors under contract, to support these reviews and on an ongoing basis. The Fund highly values the use of specialist support in the management of performance and risk.

The Fund currently uses risk attribution analysis to determine the order of magnitude of the main investment risks the Fund is facing. The chart below shows the VaR (Value at Risk, essentially the estimated losses that would occur in a 1-in-20 event) facing the Fund, split into major risk categories.

As an additional illustration of risk, the table below, based on the 31 March 2016 Actuarial Valuation results and estimates, shows how a range of events could impact on the Fund:

<table>
<thead>
<tr>
<th>Event</th>
<th>Event movement</th>
<th>Impact on the Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fall in equity markets</td>
<td>25% fall in equities</td>
<td>£175m</td>
</tr>
<tr>
<td>Rise in inflation</td>
<td>1% increase in inflation</td>
<td>£286m</td>
</tr>
<tr>
<td>Fall in interest rates</td>
<td>1% fall in interest rates</td>
<td>£286m</td>
</tr>
<tr>
<td>Underperformance by the active managers</td>
<td>3% collective underperformance</td>
<td>£20m</td>
</tr>
</tbody>
</table>

VaR (£m)

![Graph showing VaR (£m) for different risk categories]

0 50 100 150 200 250 300 350
Inflation Longevity Equity Credit Alternatives Total

142 19 125 5 35 326

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The Fund’s overall investment strategy is designed to mitigate much of the underlying risk through the holding of a variety of different, diverse asset classes (e.g. long term directly held property investments).

**Equity risk**

The largest asset risk to the Fund is in relation to its equity holdings. Should equity markets deteriorate significantly this will have a large negative impact on the Fund’s assets. The Fund invests in equities in order to provide the necessary long term expected returns to help ensure that the Fund remains affordable. The Fund believes that the extra returns that are expected to be generated by equities compensate for the level of risk equities bring to the Fund. However, the Fund is aware of the need for diversification in growth assets, and the Fund’s strategy reflects this via allocations to absolute return investment mandates and property.

**Inflation**

CPI inflation will increase the value of pension benefits accrued by active and deferred members of the Fund as well as increasing the value of pensions in payment. The Fund has an allocation to index linked gilts for explicit inflation protection and other investment assets, such as property and equities, in the expectation that these will achieve returns in excess of inflation over time.

**Active manager risk**

Active investment managers are appointed to manage a portion of the Fund’s assets. This brings with it the risk of underperformance relative to the market but also brings the chance of additional returns and diversification. The additional risk is small relative to other risks. Extensive due diligence is undertaken before managers are selected and investment managers are also monitored regularly by Fund officers, the Pensions Advisory Panel, and by the Fund’s investment advisors.

**Liquidity risk**

The Fund recognises that there is liquidity risk in holding assets that are not readily marketable and realisable. Given the long term investment horizon and the potential for an illiquidity premium in investment returns, the degree of liquidity risk within the portfolio is considered as acceptable. The Fund has a large allocation to property but the majority of the Fund’s assets are realisable at short notice.

The table below sets out a summarised cash flow position of the Fund over the last five financial years.

<table>
<thead>
<tr>
<th></th>
<th>2011-12 £000</th>
<th>2012-13 £000</th>
<th>2013-14 £000</th>
<th>2014-15 £000</th>
<th>2015-16 £000</th>
<th>2016-17 £000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contributions and Transfers In</strong></td>
<td>55,650</td>
<td>49,364</td>
<td>51,288</td>
<td>54,569</td>
<td>61,181</td>
<td>55,789</td>
</tr>
<tr>
<td><strong>Benefits and Transfers Out</strong></td>
<td>-57,481</td>
<td>-50,956</td>
<td>-51,949</td>
<td>-51,801</td>
<td>-61,755</td>
<td>-60,269</td>
</tr>
<tr>
<td><strong>Investment Income</strong></td>
<td>17,249</td>
<td>14,104</td>
<td>12,345</td>
<td>12,903</td>
<td>12,717</td>
<td>14,324</td>
</tr>
<tr>
<td><strong>Net Position</strong></td>
<td>15,418</td>
<td>12,512</td>
<td>11,684</td>
<td>15,671</td>
<td>12,143</td>
<td>9,844</td>
</tr>
</tbody>
</table>
The Fund is currently cash flow positive; in that the sum of contributions received and investment income is greater than the benefits paid out to pensioners. During 2016-17 the Fund received £9.8m more in contributions and investment income than was paid out in benefits. As such the Fund is not currently exposed to unplanned and inefficient divestment of assets.

**Exchange rate risk**
This risk arises from investing in unhedged overseas (non GBP denominated) assets, with all pension benefits due to be paid in sterling. As a long term investor the Fund takes the view that currency volatility can be tolerated. The Fund’s portfolio is well diversified across asset classes, geography and investment managers.

**Demographic risks**
The Fund is subject to a range of demographic risks, but with particular importance to the investment strategy is the possibility of a maturing Fund membership profile. This would involve a change in the ratio between active members contributing into the Fund and pensioner members drawing pension benefits from the Fund. The more mature a pension fund, the more likely it is that disinvestments would need to be made to pay benefits. The Fund is not in that situation at present as income from contributions and investments is greater than benefit payments. However, this situation is monitored regularly and formally as part of the actuarial valuation and strategy review.

**Environmental, social and governance risks**
The Fund believes that environmental, social and governance (ESG) factors should be taken into account on an ongoing basis and are an integral part of the Fund’s objective to be a long term sustainable investor.

The Fund has committed to a long term process of cutting fossil fuel investments. More information on this policy is set out in section 6.

Fund engagement is crucial in relation to improving standards of corporate governance, which over the long term is expected to enhance investment returns. Details of the Fund’s approach are set out in sections 6 and 7 as well as the Fund’s initial approach for the implementation of a reduction in fossil fuel exposure as Appendix C.
5. Approach to asset pooling

The Fund is a shareholder of the London Collective Investment Vehicle (CIV). The London CIV was created in 2015 and is in the process of opening a range of sub-funds for potential investment. As part of any future changes to investment strategy, the Fund will look first to the availability of appropriate investment products within the London CIV.

The transition of any assets into the pool will follow the normal due diligence process with consideration of: transition costs, fees (direct and indirect), reporting arrangements, socially responsible investment requirements and, most importantly, expectations for future performance.

The Fund currently benefits from lower fees for passive investments arising from collective fee arrangements with the CIV, although these are not assets under management of the London CIV (value as at 30 September 2017 £848m, approximately 56% of the Fund).

The fund has a target allocation of 20% of the Fund to illiquid property assets and the cost of exiting these strategies early would have a significant negative financial impact on the Fund.

6. Environmental, social and corporate governance policy

The Fund is a long term investor that aims to deliver a truly sustainable pension fund; ensuring that it is affordable, delivers financially to meet the objectives of the Fund employers, and is invested responsibly.

The fiduciary duty of the Fund is to act in the best long term interests of Fund members. To do so properly requires the Fund to recognise that environmental, social and governance issues can impact on the Fund’s financial performance and that they should be taken into account in funding and investment strategies, and throughout the funding and investment decision making process.

The Fund recognises the growing financial risks associated with investment in traditional energy sources and is fully committed to the continued reduction in exposure to fossil fuel. The Fund commits to transferring over time any current investments in these traditional energy sources in a way that is both structured and affordable and also meets the Fund’s fiduciary duties.

Appendix C outlines the initial approach by which the Fund will achieve this divestment, how the risks and other considerations associated with such a commitment will be managed and how the divestment over time will be incorporated into the asset allocation strategy for the Fund.

The Fund will seek to incorporate ESG considerations at all stages in the investment process; from the overall asset allocation, to individual investment selections, and continued engagement and responsible stewardship of Fund assets.

The Fund will continue to explore new opportunities in sustainable energy and infrastructure. Where possible, these opportunities should be pursued through arrangements entered into
with the London CIV, although it is recognised at this time that there is no such plan for these facilities to be accessible through this route.

The responsible investment objectives of the Fund are promoted through membership of the Local Authority Pension Fund Forum (LAPFF). As a LAPFF member the Fund allies itself with 71 other shareholders with combined assets of over £175 billion to influence key areas of responsible investment interest.

The Fund’s key responsible investment principles are set out below:

- 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.
- Engagement through voting, meetings, and the LAPFF is a valuable tool to influence organisations in areas of responsible investment interest.
- Ensure that responsible investment is a core competency and skill to support decision making.
- Seek to innovate, demonstrate and promote responsible investment leadership and ESG best practice.
- Apply evidence based decision making in the implementation of responsible investment.
- Achieve improvements in ESG through effective partnerships with the London CIV and LAPFF.
- Share ideas and best practice to achieve wider and more valuable responsible investment outcomes.
- Be transparent and accountable in all Fund activities.
- Consider the costs of responsible investment decisions alongside fiduciary responsibilities.
- To continue with a structured, measured process of reducing and ultimately eliminating investments in fossil fuels.

7. Policy of the exercise of rights (including voting rights) attaching to investments

The Fund follows the principles of the UK Stewardship Code and exercises the voting rights attached to its investments wherever it is possible and cost effective to do so. The Fund intends to formally sign up to the UK Stewardship Code.

The aim is to promote and support good corporate governance principles and best practice. Voting rights should be exercised in accordance with the best financial interests of both the beneficiaries and contributors to the Fund. Environmental, social and ethical considerations may be taken into account when exercising votes where this acts in these parties’ best interests.

Fund managers have been instructed to vote in accordance with their house policies and practices, whilst also taking into account the Combined Code on Corporate Governance. Where practical, managers should vote in line with the council’s priority themes.
Fund managers report in advance of all voting rights they intend to exercise on behalf of the Fund. They provide details of their house view and on how they intend to vote. They ensure that this is consistent with the council’s key themes and also with the LAPFF principles. Fund managers’ views are compared with the voting recommendations of LAPFF. Where the fund managers' house views are not consistent with those of LAPFF, the fund manager is instructed by the Fund to vote in line with the recommendations of the LAPFF.

Fund managers provide a quarterly report on corporate governance activity. This lists all votes which have been exercised and all engagement with companies which has taken place. It allows for checks to be carried out in order to ensure all the Fund’s voting rights have been exercised in accordance with policy. Summary reports outlining voting and engagement activity are provided at quarterly Pensions Advisory Panel meetings.

**Myners Principles**

The Government introduced a code in October 2001 based on the results of HM Treasury’s review of institutional investment in the UK, carried out by Paul Myners. This code set out ten principles that were intended to improve the investment management of pension funds. These were updated in October 2008 and previously LGPS administering authorities were required to prepare, publish and maintain statements of compliance against a set of six principles within the Statement of Investment Principles. Although not specifically required by the Regulations the Fund sees the Myners Principles as a relevant governance tool and will continue to report on compliance.

The Fund is fully compliant with the six principles and Appendix B sets out the compliance statement.

**Advice Taken**

In creating this statement, the Fund has taken advice from its investment consultant. Also, in relation to each of the constituent parts, such as the asset allocation and risk mitigation, advice has been taken from its investment consultant, Mercer, and the scheme actuary, Aon Hewitt.
## Appendix A – Current investment managers and mandates.

<table>
<thead>
<tr>
<th>Manager</th>
<th>Mandate</th>
<th>Benchmark</th>
<th>Benchmark Weight (%)</th>
<th>Outperformance target (% p.a.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BlackRock</td>
<td>Balanced</td>
<td>In line with customised benchmarks using monthly mean fund weights</td>
<td>25.0</td>
<td>-</td>
</tr>
<tr>
<td>BlackRock</td>
<td>Dynamic Diversified Fund</td>
<td>LIBOR</td>
<td>10.0</td>
<td>+3.0% net of fees</td>
</tr>
<tr>
<td>BlackRock</td>
<td>Absolute Return Bonds</td>
<td>LIBOR</td>
<td>10.0</td>
<td>+4.0% net of fees</td>
</tr>
<tr>
<td>L&amp;G</td>
<td>Passive Global Equities and Bonds</td>
<td>FTSE All World</td>
<td>25.0</td>
<td>-</td>
</tr>
<tr>
<td>Newton</td>
<td>Global Equity</td>
<td>FTSE All World</td>
<td>10.0</td>
<td>+3.0% net of fees</td>
</tr>
<tr>
<td>TH Real Estate</td>
<td>Core Property</td>
<td>7.0% p.a. absolute return</td>
<td>14.0</td>
<td></td>
</tr>
<tr>
<td>Frogmore</td>
<td>Opportunistic Property</td>
<td>16.5% p.a. absolute return</td>
<td>1.5</td>
<td>-</td>
</tr>
<tr>
<td>Brockton</td>
<td>Opportunistic Property</td>
<td>15.0% p.a. absolute return</td>
<td>1.5</td>
<td>-</td>
</tr>
<tr>
<td>Invesco</td>
<td>PRS Property</td>
<td>8.5% p.a. absolute return</td>
<td>1.5</td>
<td>-</td>
</tr>
<tr>
<td>M&amp;G</td>
<td>PRS Property</td>
<td>8.0% p.a. absolute return</td>
<td>1.5</td>
<td>-</td>
</tr>
</tbody>
</table>
Appendix B

Myners Principles – Assessment of Compliance

1. Effective Decision-Making

Principle

Administering authorities should ensure that:

- Decisions are taken by persons or organisations with the skills, knowledge, advice and resources necessary to make them effectively and monitor their implementation; and

- Those persons or organisations have sufficient expertise to be able to evaluate and challenge the advice they receive and manage conflicts of interest.

State of Compliance

The Fund is currently fully compliant with this principle:

- The Pensions Advisory Panel is supported by suitably qualified officers and external advisors. All members of the Panel are offered training on appropriate topics.

2. Clear Objectives

Principle

An overall investment objective(s) should be set out for the fund that takes account of the scheme’s liabilities, the potential impact on local tax payers, the strength of the covenant for non-local authority employers and the attitude to risk of both the administering authority and scheme employers and these should be clearly communicated to advisors and investment managers.

State of Compliance

The Fund is currently fully compliant with this principle:

- The Fund’s objectives are set out in the Investment Strategy Statement and the Funding Strategy Statement. The objective, benchmark and risk parameters are clearly stated in the Investment Management Agreements with each investment manager.

- Covenants of all scheme employers are reviewed on an ongoing basis.
3. Risk and Liabilities

Principle

- In setting and reviewing their investment strategy, administering authorities should take account of the form and structure of liabilities.
- These include the implications for local tax payers, the strength of the covenant for participating employers, the risk of their default and longevity risk.

State of Compliance

The Fund is currently fully compliant with this principle:

- The asset allocation strategy is reviewed every 3 years. Mercer Ltd is commissioned to carry out an asset liability study which models the risk/reward characteristics of different investment strategies.
- The study follows the triennial actuarial valuation and the form and structure of liabilities are fully taken into account.

4. Performance Assessment

Principle

- Arrangements should be in place for the formal measurement of performance of the investments, investment managers and advisors.
- Administering authorities should also periodically make a formal assessment of their own effectiveness as a decision making body and report on this to scheme members.

State of Compliance

The Fund is currently fully compliant with this principle:

- The Pensions Advisory Panel monitors the performance of the investment managers and the suitability of the investment strategy on a regular basis.
- Performance measurement is provided by JP Morgan and Mercer Ltd.
- Assessment of the effectiveness of the administering authority is reflected through the effectiveness of the decision making in the investment returns achieved. Further, with the establishment of the Local Pensions Board, scrutiny of the Pensions Advisory Panel is now being undertaken.
- A procurement exercise was carried out in 2014 which resulted in the appointment of Mercer Ltd as the fund’s investment advisors. They were appointed through the
National LGPS Frameworks and as such are subject to ongoing review at the framework level. Feedback is provided to the framework on an annual basis.

5. Responsible Ownership

Principle

Administering authorities should:

- Adopt, or ensure their investment managers adopt, the Institutional Shareholders’ Committee Statement of Principles on the responsibilities of shareholders and agents.

- Include a statement of their policy on responsible ownership in the statement of investment principles.

- Report periodically to scheme members on the discharge of such responsibilities.

State of Compliance

The Fund is currently **fully compliant** with this principle:

- The Fund has adopted the investment managers’ policies on activism and each has adopted the Institutional Shareholders’ Committee Statement of Principles. All investment managers adopt a policy of engagement with companies.

- The Fund’s policy on responsible ownership is set out in its Investment Strategy Statement.

- Investment managers report on the exercise of voting rights and this is monitored by officers and the Pensions Advisory Panel to ensure consistency with the Fund’s policy.

- The pension fund is a member of the LAPFF, the UK’s leading collaborative shareholder engagement group.

- Responsible ownership is periodically reported to the Pensions Advisory Panel and states how active fund managers are discharging these responsibilities.

- A section on responsible ownership is included in the Pension Fund Annual Report and a member survey has been completed. These ensure that members are both provided with the relevant information and are able to input their views into the responsible ownership process going forward.
6. Transparency and Reporting

Principle

Administering authorities should:

- Act in a transparent manner, communicating with stakeholders on issues relating to their management of investment, its governance and risks, including performance against stated objectives.

- Provide regular communication to scheme members in the form they consider most appropriate.

State of Compliance

The Fund is currently fully compliant with this principle:

- Documents relating to the Pension Fund are published on the council’s website.

- The annual report sets out the arrangements during the year for the management of investment, governance and risks and other relevant information.

- Members can also request information directly from the council.

- The Pension Advisory Panel minutes are published on the council’s website.
Appendix C

Moving Toward a Reduced Fossil Fuel Exposure
Introduction

The London Borough of Southwark Pension Fund is an open, defined-benefit pension fund as part of the national Local Government Pension Scheme. The nature of the Fund and scheme design means that payment of pensions will extend over the very long term.

In setting the investment strategy, the Fund seeks to operate a long term, sustainable strategy; one which does not rely upon the pursuit of short term returns but utilises a well structured asset and fund manager investment allocation to target long term socially responsible, sustainable investment performance. The Fund’s uncomplicated investment structure provides significant flexibility and adaptability if required.

To achieve the twin objectives, the Fund needs to invest in a diverse range of assets, which provide higher returns relative to the growth of pension liabilities whilst taking account of the volatility inherent in investment markets.

As a long term investor, with significant investment assets and pension liabilities the Fund must be comprehensive in the consideration and mitigation of risks that the portfolio faces. The Fund will base assessments of risk on future pension liabilities and contributions, will consider financial and non-financial risks, diversify investment assets in an appropriate manner, but also recognise the limits of that diversification.

A developing risk to the Fund is from investment exposure to fossil fuels. Extraction and combustion of fossil fuels generate significant carbon dioxide (CO₂) output. There is a growing scientific consensus¹ that continued CO₂ production will have a detrimental impact upon the earth’s climate.

The Fund, through its diversified portfolio of investments, is exposed to organisations where a portion of the market value is derived from current or future extraction and production of fossil fuels. Global and local regulatory restrictions on fossil fuel extraction and usage, in addition to changing consumer trends, may degrade the viability of fossil fuel extraction and usage. The value of investments in companies that derive much of their revenue or value from these resources would be at risk.

On 13 December 2016, after due consideration of the long term risk to the Fund; the Fund announced that investments in fossil fuel companies would be cut over the long term. This commitment was incorporated into the Investment Strategy Statement for the Fund published in March 2017. Southwark is one of the first LGPS Funds to make such a commitment and places the Fund at the forefront of sustainable fossil fuel aware investment.

The Fund recognises the growing financial risks associated with investment in traditional energy sources and is fully committed to the continued reduction in exposure to fossil fuel over time. The Fund commits to transferring over time any current investments in these traditional energy sources in a way that is both structured and affordable and also meets the Fund’s fiduciary duties.

This document outlines how the Fund will approach this divestment, how the risks and other considerations associated with such a commitment will be managed and how the divestment over time will be incorporated into the asset allocation strategy for the Fund.
Fossil Fuel Divestment Principles:

The overall approach of the Fund to incorporating wider environmental social and governance issues (ESG) is set out in more detail within the Investment Strategy Statement. This applies throughout the investment process from the initial investment to ongoing engagement and responsible stewardship of Fund assets.

This document will specifically address the Fund’s principles for the divestment over time of fossil fuel investments: The four key principles for the document for divestment are set out below:

- Fossil fuel risk will be incorporated into the overall asset allocation strategy
- The commitment to reduction in fossil fuel investment is more than a long term risk mitigation strategy.
- Divestment is not risk free.
- Engagement and CIV

Principle 1: Incorporation into asset allocation strategy

The primary purpose of the Fund is to meet the pension benefits for the members of the Fund. Every three years the Fund undergoes an actuarial valuation, which estimates the value of pensions due to be paid to members. The result of which allows the Fund to review the asset and investment strategy in order to establish the most appropriate mix of assets to best achieve the required level of net of fees investment return on an appropriate risk adjusted basis, whilst ensuring diversity of assets, sufficient liquidity and appropriate governance of the investments.

The Fund will seek to fully integrate fossil fuel risk into the investment strategy review process, from overarching asset allocation to individual investment choices. All investments will be considered through the lens of fossil fuel risk, but that any investment cannot be separated from the overall investment objectives for the Fund and must be subject to a full business case in consideration of the overall portfolio as well as fees and transition costs.

Principle 2: More than a long-term risk mitigation strategy

The Fund has a fiduciary duty to all the employers within the Fund and for the scheme members and as such must manage the investments assets effectively with an investment time horizon in line with the liabilities for the Fund and have due regard to the investment risk inherent within the portfolio.

The Fund recognises the risk that fossil fuel investment places upon the Fund for future investment and as such, this document largely involves the desire to mitigate risk.

However, purely focussing upon those investments that are negatively exposed to the decline in profitability and viability of fossil fuel extraction and usage excludes an key consideration for the Fund; identifying those investments that are positioned to gain from such a transition.

The Fund therefore will proactively seek to identify suitable investments that fit within the overall asset allocation strategy and will be the beneficiaries from a low carbon regulatory and investment environment. The Fund will target both a downside risk mitigation strategy and a desire to invest in positive ‘green’ focussed assets.
Principle 3: Divestment is not risk free – Potential for negative implications

The Fund has sought to operate an uncomplicated and stable investment structure, resisting short term investment decision making. This approach has proved successful for the Fund with strong investment performance over the previous long term. The implementation of a fossil fuel risk mitigation commitment has the potential to complicate investment decision making.

It is therefore imperative that, as set out in Principle 2, the Fund must seek to incorporate fossil fuel implications into the overarching investment strategy rather than seeking to separately implement fossil fuel risk mitigation approaches.

The Fund has long held a large portion of equity investments as passive (investments that are held in the same proportion as that of the market as a whole) with a current target allocation of 40%. This approach acknowledges the challenges and typically higher costs involved in seeking to predict future investment winners and losers. The inclusion of a fossil fuel risk mitigation strategy within this leads to a risk that in the short term the Fund may be negatively exposed to overall market returns if fossil fuel based investments outperform the wider market. Global usage of fossil fuels is still predicted to comprise a significant portion of global energy usage in years to come and as such the Fund must be cognisant of the potential investment returns forgone should fossil fuel usage decline at a rate slower than the market has priced in.

There are likely to be additional management expenses within equity investment mandates that have some element of fossil fuel exclusion. As such the Fund must be confident that the additional risk from holding a portion of the Fund that is exposed to fossil fuels must be considered to be greater than the additional burden of higher management fees and any associated costs of transitioning assets from one mandate to another. It is therefore important for the Fund to collaborate with other local authority partners to work to reduce the costs for such reduced fossil fuel investments.

The measurement and assessment of which investments are most exposed to fossil fuels is not straightforward. Some companies may hold fossil fuel reserves or operations which are more damaging to the environment as a result of greater CO2 output but that might be paradoxically less exposed to changing regulatory environment due to lower extraction costs. Companies not directly involved in the production or extraction of fossil fuel may derive significant portions of their revenue from fossil fuel companies. The Fund must ensure that any assessment of exposure to fossil fuels risk is sophisticated and investments are not distorted by inaccurate data.

Principle 4: Engagement and Local Authority partnerships – LCIV

There is growing appreciation of the growing risks and opportunities that Pension Funds face from the transition away from traditional fossil fuel usage, including among Local Government Pension Funds. It is important that the Fund works with other Local Authority partners to share knowledge and best practice as well as utilising collective assets to push for the most effective and efficient implementation of reduced fossil fuel strategies.

The Fund will work with local authority partners, such as the London Borough of Hackney, as well as the LCIV, the pooled investment vehicle of which the Fund is a shareholder and active supporter, in the application of this commitment. The Fund will also seek to be an active voice in the investment community for the advancement of investment outside of fossil fuels.
## Portfolio Assessment

The existing asset allocation for the portfolio is differently exposed to fossil fuels. The below table sets out the current asset allocation and high level fossil fuel exposure characteristics for each asset class.

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Target Allocation %</th>
<th>Investment Style %</th>
<th>Exposure to Fossil Fuels</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>50.0</td>
<td>Passive 40.0</td>
<td>Medium – Direct</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Investments are held in companies in the same proportion that they appear within major global indexes. As such exposure to fossil fuels match that of the particular equity market, with some having a greater exposure arising from the companies that comprise each index.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Active 10.0</td>
<td>Medium – Direct</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Individual stock selection is delegated to an external manager dependent upon specific stock and other criteria, so fossil fuel exposure will vary according to manager views.</td>
</tr>
<tr>
<td>Diversified Growth (Multi Asset)</td>
<td>10.0</td>
<td>Active 10.0</td>
<td>Medium – Direct &amp; Indirect</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>This Fund will be exposed to fossil fuels to varying degrees based upon the specific asset allocation within the Fund.</td>
</tr>
<tr>
<td>Absolute Return Fixed Income</td>
<td>10.0</td>
<td>Active 10.0</td>
<td>Medium – Direct</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Diverse selection of corporate bonds, which will include companies that have revenue or assets derived from fossil fuels.</td>
</tr>
<tr>
<td>Index Linked Gilts</td>
<td>10.0</td>
<td>Passive 10.0</td>
<td>Low- Indirect</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>The index linked gilts are only UK government bonds and are therefore only as exposed to fossil fuels as the wider UK economy.</td>
</tr>
<tr>
<td>Property</td>
<td>20.0</td>
<td>Direct 14.0</td>
<td>Low - Indirect</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Directly owned property within the UK market, manager has a focus is upon energy and water efficiency.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Pooled Fund 6.0</td>
<td>Low – Indirect</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Newly constructed or recently renovated properties to comply with highest standards of water and other energy usage.</td>
</tr>
</tbody>
</table>
Moving Towards a Reduced Fossil Fuel Exposure – December 2017

The previous table is a very high level indication of the typical exposure for asset classes. In recent years the availability and sophistication of carbon and fossil fuel data has increased dramatically, allowing investors to calculate the carbon footprint of the Fund both in absolute terms and relative to a typical asset class benchmark.

This assessment is most commonly applied to listed equities as significant numbers of listed companies publically report their estimated greenhouse gas emissions using the greenhouse gas protocol standard template for measurement. This allows for greater consistency in comparison between companies and sectors and allows an investor to better understand which elements of the portfolio are the most exposed to fossil fuel risk.

A key element for this document is to not just focus upon the risk to the Fund from fossil fuels but also to invest in assets that are best positioned to benefit from a low fossil fuel environment. Two companies involved in electricity generation may have a very similar current carbon output; but one has focussed capital spend and research on renewable energy and other ‘green’ activities. As part of a portfolio assessment, a data provider can analyse the extent to which income for the portfolio is derived from low fossil fuel sources.

This assessment is easier to perform for listed equities, due to the wider availability of company specific data, but can be extended to analyse other assets classes within the portfolio. The Fund has commissioned a full assessment of the greenhouse gas exposure within the fund on a current output and potential output basis. The results of which will allow the Fund to monitor progress in the reduction of exposure as well as to set meaningful targets for this reduction.
**Timeline:**

The Fund’s implementation period for fossil fuel reduction is split into three main time horizons, encompassing short medium and long-term objectives.

- The short term: one-four years (2017-2021)
- The medium term: four-ten years (2021–2027)
- The long term: beyond ten years (2027+)

Given the difficulty in predicting the global investment and technological environment in addition to Fund specific liability and investment requirements, longer term periods will likely be subject to significant variability and uncertainty.
Short Term – From 2017 to 2021

Triennial Actuarial Valuation and Investment Strategy Review

- The Fund published the most recent actuarial valuation in March 2017, the results of which is the foundation for the current asset strategy review, ongoing as at October 2017. The asset allocation review aims to ensure that the current investment allocation is appropriate to meet the required investment return to fund future pensions within a suitable risk profile. Where investment underperformance is identified or risk profile changes, either across an asset class or manager specific, any subsequent reallocation will be considered with regard to overall fossil fuel exposure.

Local Authority Collaboration and Pooling

- It is important that the Fund works together with other likeminded local authority partners, e.g. London Borough of Hackney, in order to develop suitable fossil fuel reduction opportunities. Collaboration will also seek to mitigate some of the fee and transition cost implications of changing investment allocation.
- The Fund will engage with the LCIV through representation by officers and members on key LCIV governance panels to push for the availability of reduced fossil fuel investment mandates within the LCIV.

Fund Managers

- Continue work with Blackrock to agree the transition of c£150m, or c10% of the whole fund, to a specific low carbon equity index. This index re-weights investment exposure to those companies with low carbon emissions and low future carbon emissions, whilst minimising divergence from overall market returns. This is estimated to reduce carbon emissions by 70% from existing equity assets.
- The Fund will continue dialogue with Newton Investment Management to ensure that fossil fuel risk is considered as part of stock decision making and that those with significant CO₂ output be treated with caution.
- The Fund will use this period to investigate the implications and opportunities in different low carbon equity investments as well as the possibility to deploy capital in long-term investments in sustainable technology and alternative energy sources.
General

- The Fund has commissioned a carbon footprint assessment for the portfolio to analyse the overall exposure across each asset classes to identify the most effective methods to reduce the risk from fossil fuels. This analysis will also establish the proportion of the Fund, which is positively exposed to low carbon or ‘green’ revenue. Quantifying exposure will allow the Fund to develop meaningful targets for the reduction in fossil fuel exposure over the long term, whilst also identifying the areas of greatest risk within the portfolio. The results for the equity investments within the fund is scheduled to be reported at the March 2018 meeting of the Pensions Advisory Panel.
- The Fund will continue to support the work of the Local Authority Pension Fund Forum (LAPFF) as representing 90 local authority pension funds in their engagement with companies to promote best practice climate aware business activities.
- Any changes to investment allocations will need to be communicated with key advisors, such as the Fund actuary, as well as the Fund’s external auditors.
Medium Term – From 2021 to 2027

Triennial Actuarial Valuation and Investment Strategy Review

- The medium term will incorporate the results of the triennial valuation in 2022 and 2025 and will constitute key points for major review of assets and investments to ensure that these are best placed to meet the payment of benefits to members of the scheme. Fossil fuel risks and opportunities incorporated in the consideration for any amendments to the asset allocation strategy.
- The carbon footprint and risk analysis will be re-calculated at each triennial asset allocation review and incorporated into the overall portfolio risk assessment.

Local Authority Collaboration and Pooling

- The Fund is committed to working with the LCIV and will seek to comply with the government requirements for pooled investments. Over the course of this period the proportion of assets under the control of the LCIV will increase significantly, which may limit the availability of reduced fossil fuel investment mandates. Therefore, the Fund will continue to seek to exert influence over the strategic direction of the available investments within the LCIV, alongside other local authority partners, to ensure that these are appropriate for the sustainable strategy that the Fund wishes to implement. The opportunity for reduced fossil fuel or sustainable investment in multi asset mandates will likely develop as part of continued engagement between the Fund and other likeminded members of the LCIV.

Fund Managers

- Continued engagement with fund managers to ensure that fossil fuel risks and opportunities are consistently and appropriately taken into consideration throughout the decision making process.

General

- The Fund will continue a policy of engaging with companies through membership of the LAPFF and the LCIV to encourage companies to adopt the highest of standards with regard to fossil fuels and energy efficiency.
- The Fund will be able to measure progress made against targets for the proportion of investments exposed to low carbon or green revenues and the overall carbon exposure of the Fund. In the event that elements of the portfolio should be changed then subject to business case and appropriate due diligence, any change in portfolio must be considered in light of the overall investment strategy with regard to fossil fuels.
**Long Term: 2027 onwards**

**Triennial Actuarial Valuation and Investment Strategy Review**

- The Fund will continue to assess the overall investment strategy as required to meet the pension benefits for members based upon the calculations within the triennial actuarial valuations. As and when asset and manager allocations require amending, the risk of fossil fuel exposure will be incorporated into any due diligence regarding risk and reward decision making.

**Local Authority Collaboration and Pooling**

- In the long term, the vast majority of assets will be invested through the LCIV so ensuring the availability of suitable opportunities within the LCIV will be key for the continued reduction in fossil fuel investments as well as positioning the Fund to benefit from clean technology and low carbon industries. This will allow the Fund to invest across a variety of disparate asset classes without compromising the ambition to be a long-term sustainable investor.

**Fund Managers**

- The majority of this engagement will be exercised through the LCIV pooled investment vehicle.

**General**

- The Fund will fully incorporated fossil fuel risk, through regular and sophisticated monitoring and portfolio analysis into the investment decision making process. Carbon reduction targets as part of the overall portfolio will play a key role in the increasing percentage of investment assets within sustainable or low carbon income sources.