

Pensions Committee

13 December 2017

Report title	Responsible Investment Activities	
Originating service	Pensions	
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Recommendation for decision:

The Committee is recommended to:

1. Approve the de-selection of Hanwha Corporation from the Fund's internal passive equity portfolio

Recommendations for noting:

The Committee is asked to note:

1. The Fund's voting and LAPFF's engagement activity for the three months ending 30 September 2017, including Appendix 1.
2. The issues discussed by LAPFF are set in the Quarterly Engagement Report which is available on their website:
<http://www.lapfforum.org/publications/qrtly-engagement-reports/>
3. The update provided on the recent engagement activities with Hanwha Corporation.
4. Other activity undertaken to ensure the Fund continues to develop and support its approach to Responsible Investment.
5. The Fund's responses to recent articles in the press relating to investments in fossil fuels producers and tax risk.

1.0 Purpose

- 1.1 To update the Pensions Committee on the work undertaken by the investment team regarding their responsible investment activities since the last Pensions Committee meeting in September.

2.0 Background

- 2.1 The Fund has a longstanding policy of supporting good corporate governance in the companies in which it invests. The Fund will also challenge companies who do not meet either the standards set by their peers or reasonable expectations as measured by best practice. The Fund's approach is part of its overall investment management arrangements and its active responsible investment policy. There are three main areas of responsible investment that we focus on: **engagement through partnerships, voting globally** and **shareholder litigation**.

3.0 Responsible Investment Activities

Engagement through Partnerships

- 3.1 The Fund's strategy is to engage with its investee companies and other key stakeholders through partnerships and on its own. The Fund aims to protect and increase shareholder value by engaging on a range of financially material ESG investment factors. A significant part of the Fund's engagement program is implemented through partnerships including the Principles for Responsible Investment (PRI), the Local Authority Pension Fund Forum (LAPFF), Institutional Investors Group on Climate Change (IIGCC) and the UK Pension Fund Roundtable.
- 3.2 Through LAPFF, the Fund engaged with 20 companies during the quarter. Most engagements concerned remuneration general governance issues, climate change and employment standards. Six engagements led to a small, moderate or substantial improvement or a change in process. Most engagements were conducted by meetings by writing letters to the company Chair. LAPFF continues to engage Sports Direct on the subjects of employment standards, board composition and governance. A summary of LAPFF's engagement activities for the quarter are provided alongside the voting activity report in Appendix 1. The issues are set out in the Quarterly Engagement Report which is available on LAPFF's website:
<http://www.lapfforum.org/publications/qrtly-engagement-reports/>
- 3.3 Through the United Nations' Principles for Responsible Investment (PRI), the Fund is currently a support investor to four engagement topics, each of which concerns a number of holdings. As previously reported the Fund is a participant in engagement concerning cyber security risk management in a joint effort with approximately 50 other global institutional investors. WMPF has recently decided to join an engagement on climate change risk which will be based upon the framework created by the Transition Pathway Initiative (TPI), of which the Fund is a founding member. This engagement will also be channelled through the PRI.

- 3.4 As part of a LAPFF engagement, the Fund's RI Officer attended the AGM of Ashtead Group Plc to ask a question about executive remuneration. The company had engaged shareholders during the year and subsequently improved the remuneration policy by aligning the performance share plan with business objectives (in particular the leverage target, which incentivises capital discipline over the long term). The RI officer asked the board to reflect on the UK government's recent response to the consultation on its green paper on corporate governance reform, which contained a number of proposals designed to further align executive pay with shareholder interests. The company responded positively to the question, welcoming the government's recommendations and committing to comply with the disclosure recommendations. WMPF will keep the situation under observation. The board also provided detail and explanation on the CEO's pension contribution and the decision to pay UK employees the real living wage.
- 3.5 The Fund has signed a supporting letter from the Workforce Disclosure Initiative (WDI) to 75 target companies. WDI encourages companies to disclose business-relevant data concerning human capital management in a standardised and useable way. The first round of engagement has completed and WDI are expected to launch their report in January 2018.

Update on Cluster Munitions Engagement

- 3.6 WMPF has previously enjoyed engagement successes in relation to cluster munitions production at companies including Lockheed Martin, Singapore Technologies, Textron and Alliant Techsystems. During the quarter in review and for the past year, WMPF continued to work with LAPFF on allegations of cluster munitions production at Hanwha Corporation. This investment represents a small position in one of the Fund's internally managed passive equity portfolios, less than 0.01% of the Fund's total value. In the UK, the Cluster Munitions (Prohibitions) Act 2010 prohibits inter alia the production, retail, transfer and stock piling of cluster munitions. South Korea has not signed the Oslo Convention on cluster munitions and it is not illegal to manufacture and sell cluster munitions in South Korea. It is not illegal for a UK investor to invest in Hanwha Corporation.
- 3.7 The Fund's policy regarding ethical investment concerns is to engage for positive change. In line with this policy, the Committee's view has been that achieving positive change at Hanwha Corporation – i.e. the company's cessation of the manufacture of cluster munitions – is preferable to a scenario in which the Fund divests its shareholding but the company continues to manufacture cluster munitions. In the days leading up to the September Pensions Committee, LAPFF received a response from Hanwha, which appeared to open the door for dialogue on the topic. However, shortly after the Pensions Committee meeting, LAPFF received a second letter that suggested that engagement is unlikely to succeed at this time. It should be noted that, were the Fund to divest from Hanwha Corporation, the company would continue to produce cluster munitions. This consideration continues to motivate the Fund's preference for engagement for positive change where ethical concerns have been raised.

- 3.8 According to the regulations and statutory guidance within which the Fund operates, investment decisions may only be made for non-financial reasons (i.e. for ethical reasons) where two conditions are satisfied: (a) that there is no significant financial detriment and (b) where scheme members are likely to agree with the ethical position adopted. With regards to condition (a), the Fund has run an adjusted shadow portfolio in recent months which excludes Hanwha Corporation. This has shown, for the sample period in question, that the tracking error associated with the portfolio excluding Hanwha is not material. The committee should be aware that the conclusion regarding tracking error in this adjusted portfolio exercise is limited in scope to the exclusion of one particular stock at one particular time, and that the extrapolation of this conclusion to other stocks in other time periods is not valid. Beyond tracking error, the committee should be aware that both the sale of shares in Hanwha Corporation and the purchase of shares in another company will incur transaction costs. The level of transaction costs could be mitigated by executing the de-selection of Hanwha Corporation as part of a portfolio rebalance or reconstruction. Regarding condition (b) the Law Commission has stated that the presence of an international convention – in this case the Oslo Convention on cluster munitions – to which the UK is a signatory, is sufficient for pension fund trustees to assume that scheme members' views will align with the ethical view expressed.
- 3.9 The committee is recommended to approve the de-selection of Hanwha Corporation within the Fund's internal passive equity portfolio. In order to mitigate transaction costs, this would be executed as part of the next portfolio rebalance or reconstruction, which is expected in the coming months. The reasons for this recommendation are: that engagement is unlikely to succeed at this time; that the de-selection of this particular stock at this particular time is not expected to cause significant financial detriment; that there is likely to be portfolio reconstruction in the near term which represents a rare opportunity to execute the de-selection; that scheme members have expressed ethical concerns regarding Hanwha Corporation and that one of the company's product lines is the subject of an international convention. If the committee approves the de-selection of Hanwha Corporation, the factors mentioned above will be monitored over time to ensure the decision remains the correct one, both from a financial and an ethical point of view.

Fossil Fuels Divestment Campaigns

- 3.10 Gofossilfree, a fossil fuel divestment campaign organised by several NGOs (350.org, Community Reinvest, Platform London and Friends of the Earth), was active in the weeks preceding the Pensions Committee meeting. The campaign, which was organised nationally, encouraged local citizens to write to the trustees of their local council pension fund, requesting divestment from companies that produce fossil fuels. The campaign group estimated, for 168 UK funds, the proportion of the fund invested in companies that produce fossil fuels. WMPF was found to have the 149th greatest exposure – i.e. relatively little exposure compared with the other funds in the sample. A number of local councillors across the West Midlands, including members of the Pensions Committee, were written to by local citizens who requested fossil fuel divestment for ethical and financial reasons.

- 3.11 The Chair of the Pensions Committee has issued a response on behalf of WMPF, and this response has been distributed to the relevant elected members. The response explains the reasons for the Fund's climate change strategy and provides examples of the Fund's successful active ownership programme and climate advocacy work. In summary, the Fund is aware of the physical and financial risks posed by climate change, but does not think that a divestment approach is the best strategy to deal with these risks. The Fund's view is that a strategy of engagement with companies, rather than negative screening to exclude stocks from the portfolio, is more compatible with its fiduciary duty and more supportive of responsible investment.

Tax Risk

- 3.12 In response to various articles in the press following the release of the so-called Paradise Papers, the Fund released the following statement:

"The Local Government Pension Scheme is a statutory benefit scheme. The pension benefits that scheme members build up during their employment are set out in legislation.

In order for WMPF to deliver the benefits to our members, we are required to invest the contributions we receive seeking returns from those investments to help meet the cost of providing pension benefits today and in the future.

WMPF seeks return opportunities and protects the assets by having a diversified investment portfolio across a number of asset classes and global markets. Managing investment risk and delivering enhanced returns ensures the contributions of our employers are used effectively and to mitigate the need for higher contributions in the future.

When delivering its investment strategy, the Fund assesses a wide range of investment opportunities taking into account the returns available and the level of risk, working with independent advisers to assess the best opportunities for investment within a responsible investment framework.

As a multi jurisdiction investor the Fund can be subject to double taxation from foreign and domestic countries which can have a detrimental impact on the investment returns the Fund receives. This is because tax can fall due both in the country where the investment takes place and in the UK where the Fund is based.

The Fund believes everyone should pay tax where it falls due and supports through LAPFF the Fair Tax Mark certification scheme which seeks to encourage and recognise organisations that pay the right amount of corporation tax at the right time in the right place."

Voting Globally

- 3.13 The Fund currently has its own bespoke UK voting policy which our voting provider, Pensions and Investments Research Consultants Ltd (PIRC), executes on the Fund's behalf. The Fund follows the voting advice of PIRC for European, US, Japanese and Pacific region company meetings.

- 3.14 The voting activity for the quarter across markets and issues can be found in Appendix 1. During the period the Fund voted at a total of 229 company meetings – 90 UK, 29 European, 32 North American, 12 Japanese, 43 Asia (excluding Japan), 15 Australasian/South African and 8 in the rest of the world. During this period there were 27 meetings where the Fund supported all the resolutions put forward by companies. Approximately 30% of the resolutions were not supported by the Fund. The largest number of resolutions that were opposed concerned the re-election of directors (usually voting against non-independent non-executive directors where the Fund or its advisors do not see sufficient independent oversight on a company board) and remuneration.
- 3.15 The “voting season” – a three-month window in which most investee companies hold their AGMs – began in April. Following this period, the Fund has decided to join forces with other responsible owners in writing joint letters to companies explaining the rationale for votes against management and setting expectations for the next 12 months. The Fund will seek meetings with companies where concerns are particularly acute. Four companies have been initially identified for joint letter writing. It is expected that this number will grow as the Fund identifies companies to which it will write directly.

Shareholder Litigation

- 3.16 As mentioned above, the pursuit of litigation against investee companies forms part of the Fund’s Responsible Investment Framework. The Fund partakes in shareholder litigation activities where it thinks monies can be recouped on behalf of the fund’s members and where there is no risk of cost or penalty to the Fund. Litigation is not considered unless the costs and benefits are known.
- 3.17 The Fund’s shareholder litigation programme has continued in the manner reported previously.

Other Activities

- 3.18 A pilot programme of monitoring the Fund’s private equity managers’ (General Partners) approaches to responsible investment has begun. The programme is complementary to the existing due diligence processes already in place. The Fund’s RI Officer is part of a working group coordinated by the UN Principles for Responsible Investment, whose objective is to define best-practice standards for this kind of monitoring. It is likely WMPF will adopt these standards when they are finalised. At the time of writing, five out of a sample of ten GPs had been monitored.
- 3.19 The Fund’s RI Officer spoke at the PLSA’s Manchester conference in October. The panel discussed the value of investment stewardship, explaining how engagement and voting add value within WMPF’s investment process.
- 3.20 West Midlands Pension Fund received “highly commended” for Best Approach to ESG at the LAPF Investment Awards.

4. Financial implications

- 4.1 The promotion of good corporate governance amongst companies in which the Fund invests is complementary to the Fund's objective of maximising financial returns, as it is widely believed that good corporate governance improves shareholder value in the long term.
- 4.2 The committee should note that the de-selection of Hanwha Corporation, if executed, will involve transaction costs and an increase in the portfolio's tracking error. The tracking error is not believed to be significant at this point in time.

5.0 Legal implications

- 6.1 This report contains no direct legal implications.

7.0 Equalities implications

- 7.1 This report contains no equal opportunities implications.

8.0 Environmental implications

- 8.1 Environmental implications are addressed through the Fund's corporate governance policy.

9.0 Human resources implications

- 9.1 This report contains no direct human resources implications.

10.0 Corporate landlord implications

- 10.1 This report contains no direct corporate landlord implications.

11.0 Schedule of background papers

- 11.1 LAPFF Quarterly Engagement Report July to September 2017:
<http://www.lapfforum.org/publications/qrtly-engagement-reports/>

12.0 Schedule of Appendices

- 12.1 Appendix 1 (Voting and Engagement Activity)