September 2018

Divest Derbyshire's Response to
Derbyshire Pension Fund's revised Investment Strategy Statement

This is a response to the Derbyshire Pension Fund's revised Investment Strategy Statement on behalf of **Divest Derbyshire**. Divest Derbyshire is a coalition of 20 non-profit organisations across Derbyshire (see list at end), whose many members include Derbyshire Pension Fund members as well as Derbyshire council tax-payers. We welcome the opportunity to comment on the revised Investment Strategy Statement. While we are also pleased to note that the Pension Fund's Responsible Investment principles in the Strategy now include a reference to climate change and climate risks to investment, we have the following concerns:

Divestment rather than engagement is more compatible with fiduciary duties

We are disappointed that the Fund continues to rely on its failed strategy of engagement with fossil fuel firms. The statement on page 11 that "*a strategy of engagement with companies to influence behaviour and enhance value, rather than negative screening to exclude stocks from the portfolio on ESG/ethical grounds is more compatible with the administering authority's fiduciary duties and supports responsible investment*" is somewhat disingenuous. This continues to ignore the fact that the risks from fossil fuel holdings are not only ESG concerns but significant financial and fiduciary concerns. Pension trustees are legally required to take into account factors which are financially material to risks or returns when making investment decisions, regardless of whether or not those factors might sometimes be considered to be ESG.

A recent inquiry by the Parliamentary Environmental Audit committee noted that fiduciary duty is often misinterpreted as a duty to maximise short-term returns rather than consideration of factors which may be material over the long term and that this could be particularly problematic when it came to the management of long term pension funds. [1]

The UK Sustainable Investment and Finance Association (UKSIF) says that:
'*Fiduciary duty means acting in the best interests of beneficiaries, who will have, given the nature of pensions, long-term investment horizons. The integration of financially material environmental, social and governance (ESG) issues into investment decisions and robust stewardship policies can help reduce investment risk and enhance returns, yet misconceptions remain around the legality of consideration of these factors*.'[2]

Our group has made the point repeatedly that we are not just calling for divestment from fossil fuels on ethical grounds (important as these are given that climate change is the single biggest threat to the planet). There is significant and growing evidence which point to the fact that divestment is a proper financial response to current market conditions. This is driven largely by the strong likelihood that future returns from fossil fuel investments will not replicate past performance.

Fossil fuel stocks, once prime blue-chip contributors to institutional funds, are now increasingly speculative. Revenues are volatile, growth opportunities are limited, and the outlook is decidedly negative.[3]

Earlier this year New York City announced a goal to divest its $5 billion fossil fuel interests from its pension within five years, one of the most significant divestment efforts in the world to date. Their Chief Resilience Officer stated that this decision was part of their fiduciary duty to pensioners

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[1] https://publications.parliament.uk/pa/cm201719/cmselect/cmenvaud/1063/106305.htm
[2] Evidence to the Environmental Audit Select Committee, reference above.
[3] IEEFA (2018) The Financial Case for Fossil Fuel Divestment.

because fossil fuel investments "*have continued to underperform relative to the market and the outlook for them is poor*."[4]
Other Local Authority Pension Funds and large pension funds worldwide have all divested from fossil fuels in line with their fiduciary duties. These Pension Funds have found alternative investments of equal or better value.

It has been argued by many, including the Chair of the UK's Investment Association[5] that divestment from fossil fuels is not only compatible with, but is compelled by fiduciary duty. The Law Commission has also argued that environmental, social and governance factors can in some cases be considered material risks and as such are financial factors. '[6] The Government has recently published guidance which reassures trustees "*that they can (and indeed should) take account of financially material risks, whether these stem from investee firms' traditional financial reporting, or from broader risks covered in non-financial reporting or elsewhere*."[7]

In line with this we recommend adding the following sentence (in red) to the existing statement:

"A strategy of engagement with companies to influence behaviour and enhance value, rather than negative screening to exclude stocks from the portfolio on ESG/ethical grounds, is more compatible with the administering authority's fiduciary duties and supports responsible investment. However the administering authority will seek to exclude stocks from the portfolio where there is evidence that these are associated with long term financial risks, as well as ESG concerns, in line with fiduciary duties."

Action is needed sooner rather than later
The draft Investment Strategy states: *"It is recognized that risks and opportunities related to climate change could be experienced across the whole of the Fund's investment portfolio and that the current understanding of the potential risks posed by climate change and the development of consistent climate related disclosures are still at an early stage." [our emphasis]*

This statement indicates that the Pension Fund does not have all the information it needs to reach a decision. Given that the potential impact on the value of certain investments is so large the prudent thing to therefore do would be to reduce exposure to the most clearly risky companies. Fiduciary duty requires making a decision based on the information you have now and adjusting it as new information comes to light, not waiting for perfect information. We support a more pro-active strategy and recommend that the Fund Investment Committee talk to trustees and fund managers from the Environment Agency, Southwark, Waltham Forest etc to obtain a better understanding of the significance of climate risks from fossil fuels and alternative investment opportunities.

Consistency with Derbyshire Climate Change Charter.
Derbyshire County Council have a Climate Change Charter 2014-2019[8] whose aims include the following: "*To provide a Derbyshire wide ambition and a course of action to tackle climate change based on six priority areas*" including by: *"Identifying and developing specific actions to be taken to reduce the risks associated with negative climate change impacts and build a countrywide resilience to these impacts*." and: "*Help organisations, business and communities to understand their impact on*

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[4] https://www.greenbiz.com/article/why-new-york-city-divesting-fossil-fuels
[5] https://www.divestinvest.org/events/press-conference-divest-invest-reaches-5-2-trillion/
[6] Law Commission, Pension Funds and Social Investment Summary (June 2017)
[7] https://www.gov.uk/government/consultations/pension-trustees-clarifying-and-strengthening-investment-duties
[8] https://www.derbyshire.gov.uk/site-elements/documents/pdf/environment/climate-change/climate-change-charter.pdf

climate change and their contribution towards reducing that impact." The Charter also states the ambition to investigate opportunities to support renewable energy technologies and the low carbon sector.

It is difficult to see how continued investment in fossil fuels by Council's own Pension Fund is consistent with this charter. The charter makes frequent reference to the ambition for local communities to work towards low carbon living and working but this is undermined by the damage done by continued investment in fossil fuels. Derbyshire County Council should lead by example and divest their pension fund from fossil fuels.

Thank you.
Divest Derbyshire campaign.
28 September 2018

Divest Derbyshire campaign is supported by the following organisations (in alphabetical order): Amber Valley Against Fracking; Calow Against Gas Extraction (CAGE); Chesterfield and District Trades Union Council; Chesterfield Climate Alliance; Clay Cross Against Fracking; Coal Aston and Dronfield Against Fracking; Derby Climate Coalition; Eckington Against Fracking; Glossopdale Transition Initiative; Melbourne Area Transition; Sustainable Edale; Sustainable Hayfield; Transition Belper; Transition Buxton; Transition Chesterfield; Transition Hope Valley; Transition Matlock; Transition New Mills. Transition Wirksworth; University of Derby Students' Union.

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Extract from Derbyshire Pension Fund Draft Investment Strategy Statement, Sep 2018
https://www.derbyshire.gov.uk/site-elements/documents/pdf/council/have-your-say/consultation-search/consultation-search-index/draft-investment-strategy-statement-sept-18.pdf

Responsible Investment

Responsible investment is an approach to investment that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long term returns.2

The Committee believes that responsible investment covers both incorporating ESG factors into the investment process and Fund stewardship and governance through considered voting and engagement with investee companies.

Effective management of financially material ESG risks should support the requirement to protect investment returns over the long term. The Fund's investment team seek to understand relevant ESG factors alongside conventional financial considerations within the investment process, and the Fund's external investment managers are expected to do the same. Non-financial factors may be considered to the extent that they are not detrimental to the investment return.

The Committee recognizes its responsibility to act in the best interest of the Fund's employers and scheme members, whilst seeking to protect local tax payers and employers from unsustainable pension costs.

A strategy of engagement with companies to influence behaviour and enhance value, rather than negative screening to exclude stocks from the portfolio on ESG/ethical grounds, is more compatible with the administering authority's fiduciary duties and supports responsible investment.

It is recognized that risks and opportunities related to climate change could be experienced across the whole of the Fund's investment portfolio and that the current understanding of the potential risks posed by climate change and the development of consistent climate related disclosures are still at an early stage. It also recognised that it will take time for companies to adapt to changing regulatory and market positions. The incorporation of ESG factors into the investment process and Fund stewardship and governance activities will seek to manage the risks associated with climate change.

Membership of the Local Authority Pension Fund Forum (LAPFF) helps Derbyshire Pension Fund to engage with companies to understand relevant issues and to promote best practice. LAPFF was set up in 1991 and is a voluntary association of 77 Local Authority pension funds based in the UK with combined assets of over £230bn. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote high standards of corporate governance and corporate responsibility amongst the companies in which they invest.

Collective pressure from investors via organisations such as the LAPFF has helped to encourage listed companies to enhance their corporate governance and to improve their environmental and social impacts. The Fund attaches great importance to the exercise of voting rights and currently casts votes in respect of its directly held equity investments in the United Kingdom and North America.

The Committee has appointed Institutional Shareholder Services, a third party voting agency to provide voting services for its directly held UK equity investments. Voting is carried out in line recommendations from Institutional Shareholder Services, whose voting principles cover four key tenets on accountability, stewardship, independence and transparency. The Fund also periodically receives voting alerts from the LAPFF on certain resolutions. If the voting alert from the LAPFF conflicts with the voting service recommendation, due consideration is given to all the arguments before the vote is cast. A report to review the Fund's voting activity is taken to the Committee on a quarterly basis.

The Fund has appointed Wellington Management (Wellington) in a discretionary capacity to manage its directly held North American investments, including voting in line with local practice. Wellington have policies and procedures to ensure that they collect and analyse all relevant information for each meeting, applying their proxy voting guidelines accurately and executing votes in a timely manner.

The Fund is a Tier 1 signatory to the Financial Reporting Council's UK Stewardship Code (the Fund's statement of compliance with the Code can be found on Derbyshire County Council's website: https://www.derbyshire.gov.uk/site-elements/documents/pdf/working-forus/pensions/investments/investment-strategy/financial-reporting-council-stewardship-code-statement2017.pdf).

The Code aims to enhance the quality of engagement management between investors and companies to help improve long-term risk-adjusted returns to shareholders. The Fund expects its external investment managers to support the UK Stewardship Code. Following the launch of the LGPS Central Pool, an increasing portion of the Fund's investments will be transitioned into products managed by LGPS Central Limited. The Company has developed a Responsible Investment & Engagement Framework (the Framework) incorporating the Responsible Investment beliefs of the Pension Funds within the LGPS Central Pool which will be applied to both internally and externally managed investment mandates. The Framework contains the following beliefs:

• Long-termism: A long-term approach to investment will deliver better returns and the long-term nature of LGPS liabilities allows for a long-term investment horizon.
• Responsible Investment: Responsible Investment is supportive of risk adjusted returns over the long-term, across all asset classes. Responsible investment should be integrated into the investment process of the Company and its investment managers.
• Diversification, risk management and stewardship: Diversification across investments with low correlation improves the risk return profile. A strategy of engagement, rather than exclusion, is more compatible with fiduciary duty and more supportive of responsible investment, because the opportunity to influence companies through stewardship is waived in a divestment approach. Even well diversified portfolios face systematic risk. Systematic risk can be mitigated over the long-term through widespread stewardship and industry participation.
• Corporate governance and cognitive diversity: Investee companies and asset managers with robust governance structures should be better positioned to handle the effects of shocks and stresses of future events. There is clear evidence showing that decision-making and performance are improved when company boards and investment teams are composed of cognitively diverse individuals.
• Fees and remuneration: The management fees of investment managers and the remuneration policies of investee companies are of significance for the Company's clients, particularly in a low-return environment. Fees and remuneration should be aligned with the long-term interests of our clients, and value for money is more important than the simple minimisation of costs.
• Risk and opportunity: Risk premia exist for certain investments; taking advantage of these can help to improve returns. There is risk, but also opportunity in holding companies that have weak governance of financially material ESG issues. Opportunities can be captured so long as they are aligned to the Company's objectives and strategy, and so long as there is a sufficient evidence base upon which to make an investment decision.

• Climate change: Financial markets could be materially impacted by climate change and by the response of climate policy-makers. Responsible investors should proactively manage this risk factor through stewardship activities, using partnerships of like-minded investors where feasible.