



**Local Authority
Pension Fund
Forum**

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**Building personal accounts:
designing an investment approach.**

**A discussion paper to support consultation
May 2009**

***Response by the
Local Authority Pension Fund Forum, LAPFF***

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Background

The Local Authority Pension Fund Forum, LAPFF was set up in 1991, as a voluntary association of 49 local authority pension funds based in the UK. LAPFF exists 'to promote the long term investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest.' The Forum's members currently have combined assets of over £75 billion.

The Forum has taken the opportunity below to provide our view on those issues which we consider relevant to our activities and hence have restricted our response to chapters six and seven.

Chapter six Achieving high-quality corporate governance

6.1 To what extent can the personal accounts scheme deliver high-quality corporate governance at low cost?

LAPFF believes that it is possible to deliver high-quality corporate governance at a relatively low cost. As discussed in the consultation document this can take various forms but at a minimum responsible (i.e. considered, principled and pragmatic) voting across all markets is achievable. The choice of custodian is a factor here, as is the set of voting guidelines the trustee corporation wishing to create and follow. In addition, if the use of a proxy voting platform/advisor is used, choosing the appropriate one is also important.

Corporate engagement will usually incur more cost and requires more skilled resources on an on-going basis, if performed totally internally. However, most firms that engage with companies usually create an annual 'company focus list' which will target certain laggards of unacceptable corporate governance. This makes the activity much more manageable and focussed. Again, certain possibilities of outsourcing do exist.

LAPFF suggests that the scheme carefully assesses the capabilities of fund managers to manage opportunities and risks associated with ESG factors (environmental, social and corporate governance) and that such factors are incorporated into the investment process. The scheme's expectations ought to be included in the tender process for investment mandates and provided for explicitly within any investment management agreement, IMA. Fund managers should also report formally to the trustees on a regular basis on their activity and application of ESG factors. With voting and engagement, when outsourcing is utilised, a degree of internal expertise is still required.

6.2 How will this evolve over time as the scheme's assets under management grow?

As assets, grow so will influence, both at the investee company level and with service providers. As such, economies of scale should exist. It will also mean that the coverage of activity can be expanded to include the more challenging markets, eg emerging markets. From the outset, there should be at least one dedicated internal resource to ensuring fund manager effectiveness, monitoring ESG guidelines, participating in industry forums/collaborative actions and acting as a central point of contact for all ESG issues.

6.3 How do we achieve high-quality corporate governance where assets are managed passively?

There is some perception that passive managers can reasonably opt out of promoting good corporate governance of investee companies as they cannot sell their holding as a last resort. However, as passive index managers, they have a responsibility to preserve and grow capital and thus mitigate the risk of a decrease in shareholder value. As such, it is in their client's interest to encourage good corporate governance. Passive managers often hold a relatively high percentage of holdings in individual companies and as such can have a significant impact on voting outcomes. The size of holding can also provide more scope of influence with the company during engagement. A consideration is that some passive managers may not offer pro-rata voting within their passive/pooled structures.

LAPFF recently commissioned RImetrics to perform an audit of passive manager capabilities and approach to corporate governance. LAPFF followed this up with further engagement and communication with the relevant passive managers. Currently, there is a wide variation of capabilities across the passive manager options. However, we see no reason why they could not all improve in this area, especially in voting globally as a minimum and we continue to push for improvement. We have also had discussions with PRI signatories and FairPensions to further pursue this and they have both pledged support.

6.4 What approach should the trustee corporation take to the voting of shares, both overseas and in the UK?

We see no reason why voting should be restricted to a domestic market. International investing is and will continue to be an important investment strategy for most pension schemes. Standards of corporate governance vary across markets and so voting and engagement are an essential part of gaining

improvement. The reasons for voting domestically are certainly valid for non-UK investments.

Stock lending is an acceptable practice that generates revenue. However, there is an impact on voting. Many investors can work with this conflict and many follow the ICGN Stock Lending Code. Essentially, stock recall for 'important' voting items is possible, acceptable and usually a straight forward process, however there are some complications in markets such as the US which operates a record date system.

Chapter seven

Responsible investment and its role within the personal accounts scheme

7.1 How can the personal accounts scheme engage in responsible investment in a cost-effective way?

It is increasingly recognised that collaboration between institutional investors is (where possible) the best approach to engagement with investee companies (e.g. Chapter 5 in the Walker Review). In addition to providing a more unified voice in discussions with company management, it is also a very cost effective approach and one that the LAPFF has adopted with considerable success since its inception.

PADA may find it useful to use a benchmark such as the UN Principles for Responsible Investment (PRI) as a guide in its approach to responsible investment and corporate governance. The PRI also provides for a in which to share best practices and participate in collaborative engagement activities at low cost.

As mentioned previously, there does not necessarily have to be a high cost associated with responsible investment. Moreover, the economies of scale that PADA will generate should allow it to secure favourable terms with any service provider, including for voting, engagement and other advisory service around responsible investment.

The piece that is outside of this is ethical investing. The ethical stance on a topic can vary considerably from one person to the next and so is difficult to standardise within a single fund. Maybe once assets and capabilities grow over time, separate ethical based fund options could be made available.

7.2 Should responsible investment be a matter for the default fund alone, or for all fund choices, as far as it is practical and relevant?

Many investors are now using the term responsible investing to incorporate non-financial factors such as environmental, social and governance, ESG factors. It is widely believed that companies should consider all of the above as each can affect long term shareholder value. For example, companies that utilise cost effective off-shore production plants need to consider environmental and social factors as they can affect their share price – breaching child labour guidelines or polluting local water supply will of course affect the way the company is reviewed by customers and the public at large and so impacts reputation, sales, profit and share price. At another level, we encourage companies to consider sustainability factors with regards to their everyday business. LAPFF would consider the taking of all the ESG factors into account as fundamental to long term investment.

LAPFF would expect the default fund to incorporate environmental, social, governance and sustainability factors into its broad corporate governance position and leave any specific ‘ethical’ restrictions to a separate fund.

7.3 How should the trustee corporation interpret its fiduciary duty in relation to responsible investment while maintaining a commitment to low charges?

As mentioned previously, responsible investing does not have to be high cost. Both responsibly considered voting and engagement should be fundamental to the trustee corporation’s approach to responsible investing. Fiduciary duty is relevant in reducing risk and improving performance for the scheme’s beneficiaries and as such responsible investing applies.

Further, PADA should review the emerging legal arguments around considering ESG issues within investment mandates and whether this is consistent with a trustee’s fiduciary duty e.g. such as those set out in the July 2009 UNEP-Fi report on “Fiduciary Responsibility” (available at: <http://www.unepfi.org/>).

7.4 If responsible investment is pursued, will the members be best served by building in-house capability or outsourcing?

A mixture of both is probably the optimum way to proceed. LAPFF can certainly share their experience in relation to this as it is how we operate currently. In fact, LAPFF is currently reviewing its research and engagement arrangements which we hope to be completed by the end of 2009/early 2010. In addition, we believe that RImetrics are also currently conducting an independent review of all the proxy advisory service providers covering voting, research and engagement. As mentioned previously, we would suggest that at least one dedicated internal resource is in place from the start of the scheme. This resource will set up

systems and processes, develop a strategy, ensure that ESG considerations are factored into tender documents and IMAs etc. And would be able to direct PADA's involvement in collaborative engagement initiatives and (if appropriate) contribute to the ongoing debate around active ownership/responsible investment and any other industry developments.

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