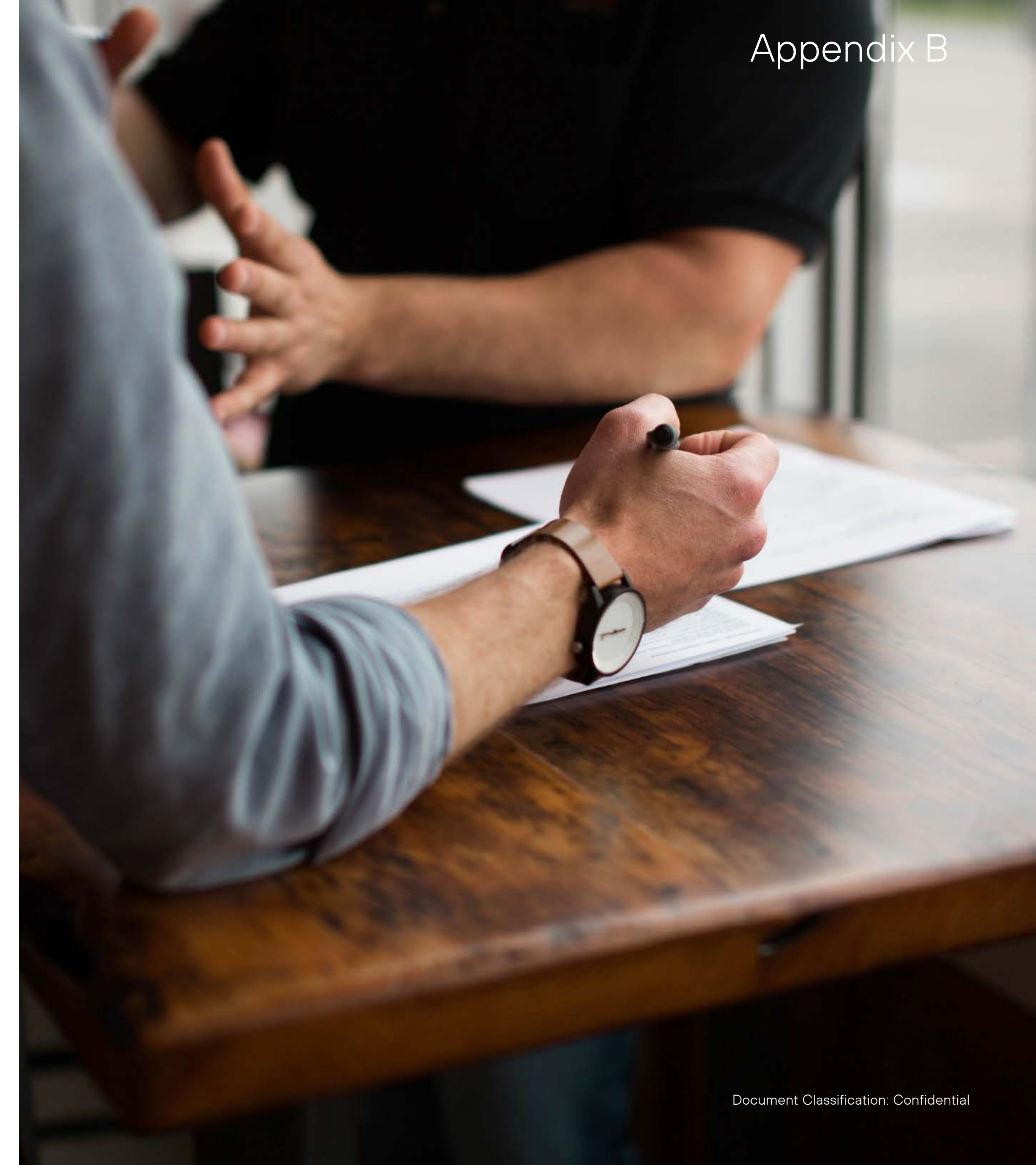
London Borough of Camden Pension Fund

Appendix B – Equity Portfolio Review

July 2020

Isio have agreed to the disclosure of this redacted report subject to the paragraphs below:

- *Isio's work was designed to meet the London Borough of Camden's requirements and the engagement activities were determined by them at the time our report was written. Our report was completed in July 2020 and we have not undertaken to update our report for events or circumstances arising after that date. In preparing our report, we have relied upon information made available from Hymans Robertson. We do not accept any responsibility as to the completeness or accuracy of such information. We draw your attention to the risk warning and limitations of modelling set out in the appendix..*
- *The report should not be used or relied on by any party other than our client for any purpose or in any context especially given the report is redacted to protect confidentiality requirements and commercial interests.*
- *In consenting to the disclosure of this report, Isio does not assume any responsibility to you in respect of its work for the London Borough of Camden, the report or any judgments, conclusions, opinions, findings or recommendations that Isio may have formed or made and, to the fullest extent permitted by law, Isio accepts no liability in respect of any such matters to any third parties. Should any third party choose to rely on the report, they will do so at their own risk.*



Executive summary

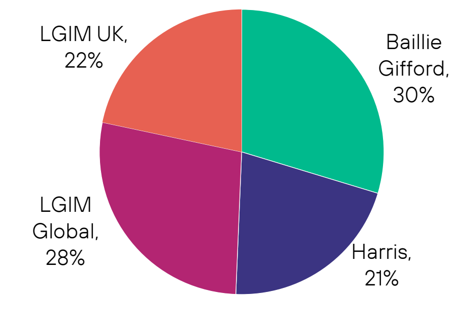
Addressee

- This report is addressed to the London Borough of Camden Council ("the Council") as Administering Authority of the London Borough of Camden Council Pension Fund ("the Fund"). The purpose of this report is to summarise a review of the Fund's equity allocation and outline Isio's views on proposed changes to this allocation.
- The Fund has a target strategic allocation to equities of 50% under the currently agreed investment strategy. As at 31 March 2020, the actual position was overweight at 60% of total assets,

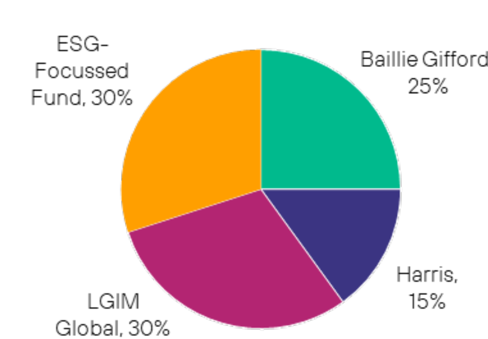
Summary of paper

- Within this report, we set out our views on the Fund's current equity allocation. We analyse its efficiency from a risk-adjusted return perspective and its alignment with the Fund's objectives and ESG beliefs.
- It is important to ensure the equity holdings are appropriately diversified and robust. We analyse the portfolio through a variety of lenses to assess whether there is a concentration of risk in a particular manager, management style, geographical region or sector.
- The analysis indicates that there is a bias towards the UK market and consequently to the financial and consumer services & goods sectors. Analysis of historical performance demonstrates scope to access equity returns more cheaply by allocating more to passive managers and there is now scope to align this allocation to your investment beliefs.
- Whilst the current equity managers do consider ESG when selecting underlying investments, we believe there is scope to enhance this.

Current equity portfolio manager split



Proposed equity portfolio manager split



- Based on our analysis, we recommend reducing the UK equity bias in favour of a more global approach, reducing the actively managed equity exposure and consider allocating to a passively managed approach with a sustainability focus.
- These changes will make a significant difference to the Fund's equity exposure and the sustainability of this. Reducing exposure to the UK index will reduce the exposure to the Oil & Gas sector in favour of technology. Introducing a passive fund with a specific sustainability focussed index will begin to provide a more sustainable equity allocation aligned with the Council's key investment beliefs. The move to passive will reduce costs versus active management.
- The report details a range of ESG-focussed options that the Council could consider. These could include a new fund from Baillie Gifford either focusing on aligning to the Paris Agreement or potentially the positive change impact fund and also a range of passive or rules based investment approaches that may be more cost effective than pure active management.

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Introduction

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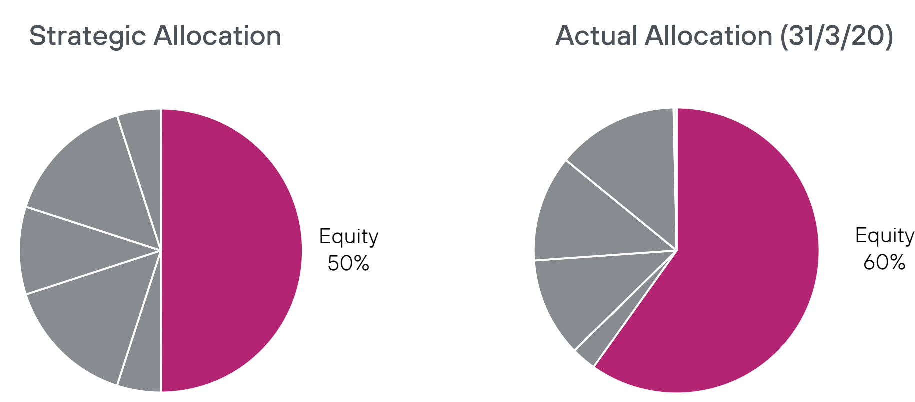
Introduction

Background

- The Fund has a target strategic allocation to equities of 50%. The actual position is currently overweight at c.60% of total assets. The Fund's investment strategy is currently being reviewed and we provide view on the overall allocation to equities in our "Investment Strategy Review" paper. The equity allocation forms a key part of the Fund's investment strategy and is we expect equites to remain a core part of the strategy.
- In this report, we focus on the underlying composition of the equity allocation. It is important to ensure the equity holdings are well diversified by region, sectors investment style and underlying holdings.
- Consideration of ESG factors is an increasingly important consideration in the overall risks inherent within the equity portfolio and underlying investee companies. It is important to ensure that these factors are given appropriate focus and consideration in the Fund's portfolio. This should be cognisant of the recently agreed Responsible Investment Policy.
- The Council has engaged Isio to undertake a review of the Fund's current equity allocation; to ensure its efficiency from a risk-adjusted return perspective, and to ensure the investments align with the Fund's objectives and Committee's ESG beliefs.



Scope of this Paper

- Analyse the current composition by regional allocation, manager, and fund management style, and identify any biases that may exist;
- Review overall historical performance relative to benchmark, identify drivers of the performance, and provide a view on how the funds are positioned to perform going forward;
- Provide a view on how the overall equity exposure composition could be evolved to better align with the Fund's objectives;
- Outline the sustainable equity approaches that are now available and that may be more aligned with the Committee's ESG beliefs;
- Provide information on potential ESG-focussed options available via the LCIV, or otherwise, for consideration in the Fund's equity allocation.

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Current Equity Allocation

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Allocation overview

Equity portfolio manager split as at 31 March 2020

Manager summary

Manager	Geography	Style	Objective	Description
Baillie Gifford	Global	Active Growth	Outperform the MCSI All Country World index by 2-3% p.a. gross of fees, over rolling 5 years	The Fund invests in an actively managed portfolio of stocks from around the world, focusing on companies which Baillie Gifford believe offer above average profit growth.
Harris	Global	Active Value	Outperform the MCSI All Country World index by 2-3% p.a. net of fees, over rolling 3-5 years	The Fund invests in an actively managed portfolio of stocks from around the world, focusing on 'cheap' companies that Harris believe are trading at a discount to the true intrinsic value of the business.
LGIM	Global	Passive	Track a composite global benchmark index[1]	Index tracking strategy aiming to replicate the performance of its benchmark.
LGIM	UK	Passive	Track FTSE All-Share index	Index tracking strategy aiming to replicate the performance of its benchmark.

Note: [1] Composite index includes UK Equity Index, North America Equity Index, Europe (ex UK) Equity index, Japan Equity index, Asia Pacific ex Japan Equity Index, Middle East/Africa equity index, World Emerging Markets Index.
Source: Investment Managers as at 31 March 2020.

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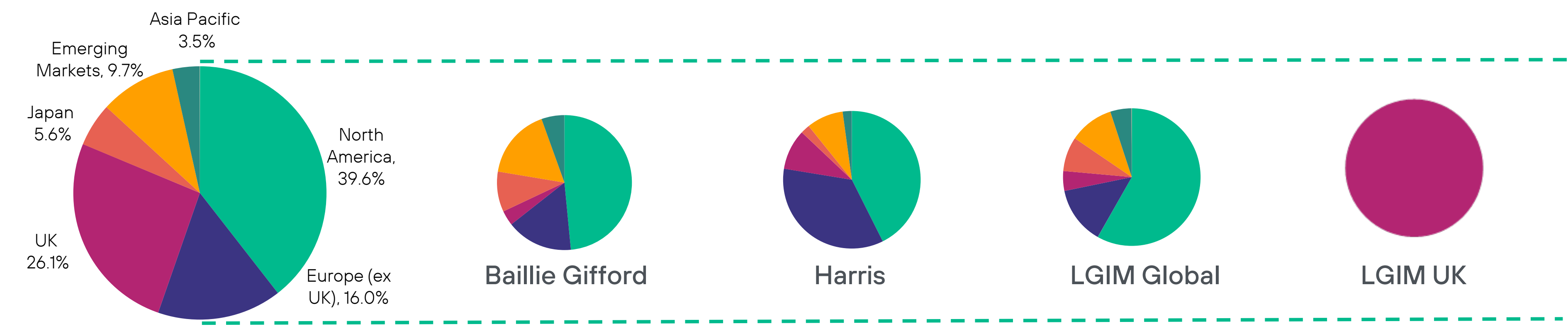
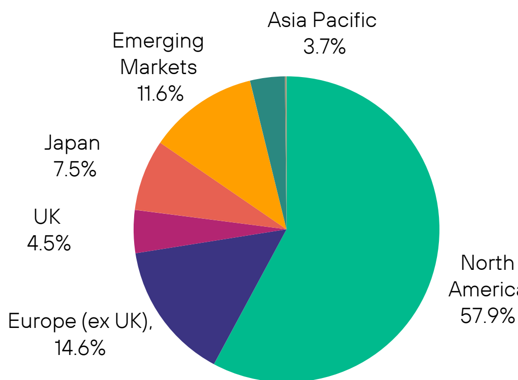
Regional breakdown





Global Equity Market Capitalisation

Analysis of Geographical Exposure

- The charts above show the regional exposures of each of the Fund's underlying equity mandates, along with the overall position of the Fund's consolidated equity portfolio. This can be compared to the world market capitalisation in the chart below.
- The existing equity portfolio has a significant bias towards UK equities (26.1%), with an overweight of c. 22% relative to the market capitalisation (4.5%). The bias arises primarily due to the allocation to the standalone LGIM UK equity mandate (22% of assets). This is also exacerbated at present by the active positioning of Harris – which is overweight to the UK. Whilst many large UK companies are global in nature, the UK (FTSE All-Share index) has significant concentration risk in certain industry sectors, e.g. financials make up c. 26% of the index. The UK also has significant concentration risk in specific stocks and sectors (e.g. oil majors such as Shell and BP), with the top 10 largest UK stocks constituting c.37% of the index.
- The Fund has a significant corresponding underweight towards North America. Around 25% of the North American equity index is comprised of technology stocks, so the underweight position to this region impacts the Fund's overall exposure to this sector.
- In recent years, the biases towards the UK and away from large tech stocks on the US has acted as a drag on performance.
- At a strategic level, we believe that the Council should consider reducing the overall bias towards the UK in favour of a more diversified global exposure. The simplest way to implement this would be to remove the allocation to the LGIM UK equity mandate and replace this with a more globally diversified passive equity allocation. By re-setting the strategic allocation to more closely align to that of the market capitalisation of the global equity index, any overweight or underweight positions that subsequently arise will be driven solely by the active managers' positioning, based upon their views and outlook.

Source: Investment Managers as at 31 March 2020,

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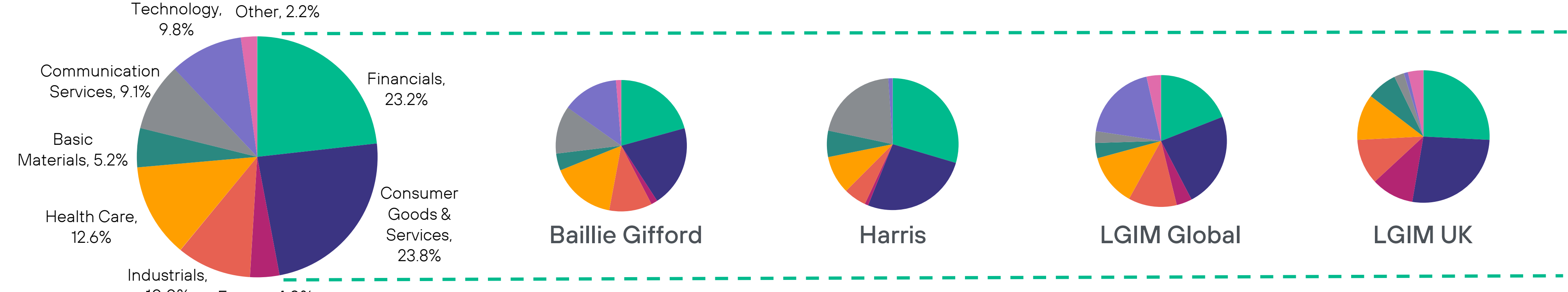
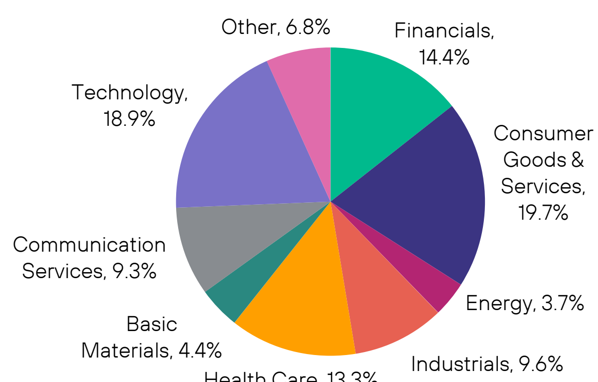
Sector breakdown



Fund's Equity Portfolio



Global Equity Market Capitalisation

Analysis of Sector Exposure

- The charts above show the sector exposure of each underlying equity mandate, along with the overall position of the Fund's consolidated equity portfolio. This can be compared to the world market capitalisation in the chart below.
- The equity portfolio has a significant bias towards financials (+9% vs market cap) and consumer goods and services (+4%). The Fund is also underweight in technology (-9%). This is largely a result of the overweight UK and underweight US exposure given these sectors are dominant in the UK/ US markets.
- Replacing the LGIM UK equity mandate in favour of a more global allocation would help to diversify the concentration in the financial and consumer goods & services sector.
- There may still be an overweight position in these sectors depending on the evolution of the active manager portfolios. These sectors are large components of the European market (to which Harris has historically held a large overweight position) and Emerging markets (to which Baillie Gifford has historically held an overweight position).
- Overall, we are broadly comfortable that there is sufficient diversification across a broad range of sectors, providing exposure to cyclical (GDP sensitive) and defensive industries. We believe there would be benefit in reducing the structural underweight to the technology sector. By re-setting the strategic allocation to more closely align to that of the market capitalisation of the global equity index, any overweight or underweight positions that subsequently arise will be driven solely by the active managers' positioning, based upon their views and outlook.

Source: Investment Managers as at 31 March 2020,

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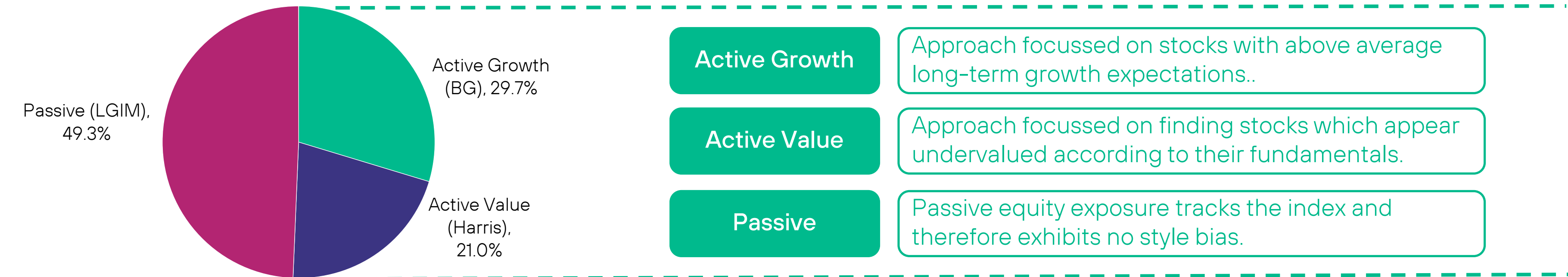
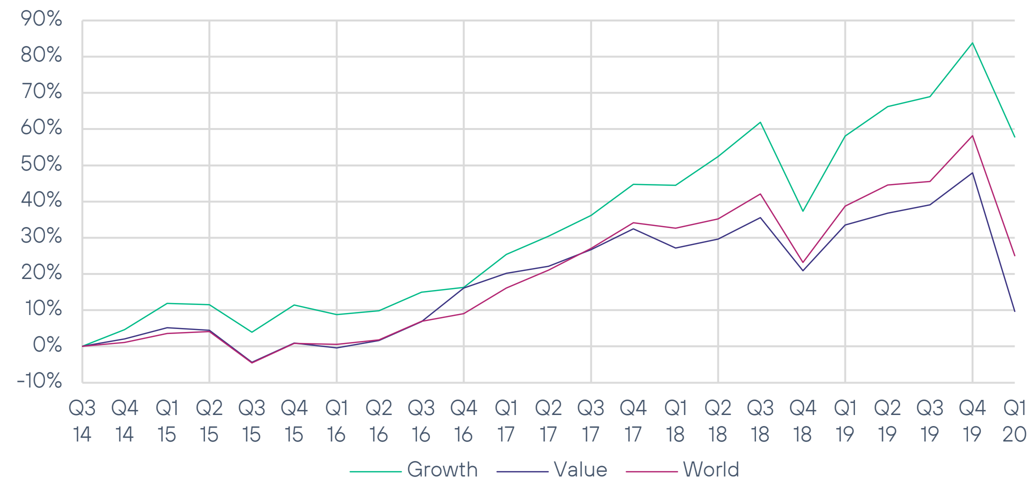
Style breakdown



Equity management styles – cumulative performance



Analysis of Style Exposure

- Passive investing is typically significantly cheaper to implement than active management. Both LGIM's global and UK passive equity mandates track their respective indices and therefore exhibit no style bias (other than the inherent characteristics of market cap indices). Given the construction of passive indices, where larger companies have larger allocations within the index, we note there is a bias to invest more in large-capitalisation companies inherent in this approach.
- The two active managers employ differing styles which historically have outperformed at different times and therefore provided a complimentary exposure. However in recent years, growth investing has consistently significantly outperformed value investing. Low global economic growth and prevailing low interest rates has meant that markets have placed a higher value on companies with high growth prospects, causing growth style companies and investing to outperform. Although the gap between growth and value stock valuations has never been as large as it is now (indicating that a trend reverse could be due), the current market environment of low interest rates and easy monetary policy looks set to continue for some time following the recent market shock caused by the Covid-19 pandemic. We believe that a much more normalised economic and interest environment will be required for markets to price stocks based on fundamental valuations, and for value investing to come back into favour, and begin to outperform growth,
- There is scope to access different factors, including value through cheap, rules based, passive investment approaches if desired.
- Ultimately, we believe there is limited evidence for active managers to consistently add value net of fees, There is widely available empirical evidence to support this view. For example. SPIVA reported that, for the 15-year period ended 31 March 2020, 83% of global equity fund managers underperformed their respective benchmark.[1]
- Given the Fund's desire to minimise investment costs, we believe that an increased allocation to more passively managed mandates should be considered.

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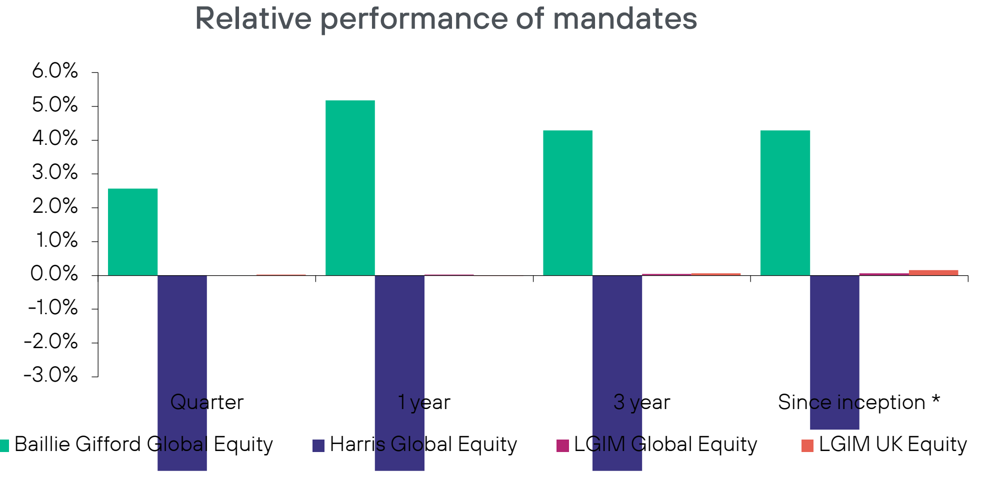
Sources: [1]https://www.ifa.com/articles/despite_brief_reprieve_2018_spiva_report_reveals_active_funds_fail_dent_indexing_lead_-_works/
Investment Managers as at 31 March2020 & eVestment.

Historical performance



Absolute performance (net of fees)

Mandate	Quarter			1 year (p.a.)			3 year (p.a.)			Since inception (p.a.)*		
	Fund	Bmk	Rel	Fund	Bmk	Rel	Fund	Bmk	Rel	Fund	Bmk	Rel
Baillie Gifford	(13.2%)	(15.8%)	2.6%	(1.3%)	(6.5%)	5.2%	6.7%	2.4%	4.3%	9.4%	5.1%	4.3%
Harris	(27%)	(16.0%)	(11.0%)	(16.9%)	(6.7%)	(10.1%)	(6.3%)	1.8%	(8.1%)	2.7%	7.3%	(4.6%)
LGIM Global	(15.9%)	(16.0%)	0.0%	(6.2%)	(6.3%)	0.0%	2.2%	2.2%	0.0%	10.8%	10.8%	0.1%
LGIM UK	(25.1%)	(25.1%)	0.0%	(18.5%)	(18.5%)	0.0%	(4.2%)	(4.2%)	0.1%	8.4%	8.2%	0.2%

Note: Figures may not sum to totals due to rounding
* Inception date of Baillie Gifford holdings is 11/04/2016, that of Harris Holdings is 13/05/2015, and that of the LGIM passive mandates is 17/03/2009.
Source: Investment Managers as at 31 March 2020,

Comments

- Following the global outbreak of COVID-19 and the subsequent sharp market sell-off, all equity managers posted negative absolute returns over Q1 2020. This also weighed on their one-year return figures, which had been positive at 2019 year-end.
- Gross of fees, both LGIM passive mandates have successfully tracked the benchmark indices over all periods.
- Baillie Gifford has consistently outperformed its benchmark across all time periods – this has been supported in recent years by the strong outperformance of growth stocks which has favoured Baillie Gifford's philosophy. Harris has suffered significant relative underperformance (as have all Value managers)
- Baillie Gifford's strong performance since inception has been driven by a focus on 'stalwart' growth stocks which are able to disrupt traditional sectors. Over the last quarter, they avoided steeper losses through both stock selection, and large holdings in Healthcare and Tech stocks; both of which benefited from COVID-19.
- Harris has suffered over the longer term primarily due to the fund's value style of investing, which has been out of favour in recent years. Harris do have the discretion to change the degree of their value tilt over time in order to generate returns. Poor stock selection within the mandate however has also hindered performance. In October 2019, we advised the Council to monitor Harris closely and take action if performance did not improve. For additional analysis on the performance of Harris's global equity fund versus other value managers, see appendix 1.
- We do however believe that the historical underperformance of Harris, alongside the historical outperformance of Baillie Gifford (essentially cancelling each other out since inception) supports consideration of reducing the actively manged allocation and allocating a higher proportion of the equity portfolio to a more passive approach.

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Environmental, Social and Governance ("ESG") Considerations

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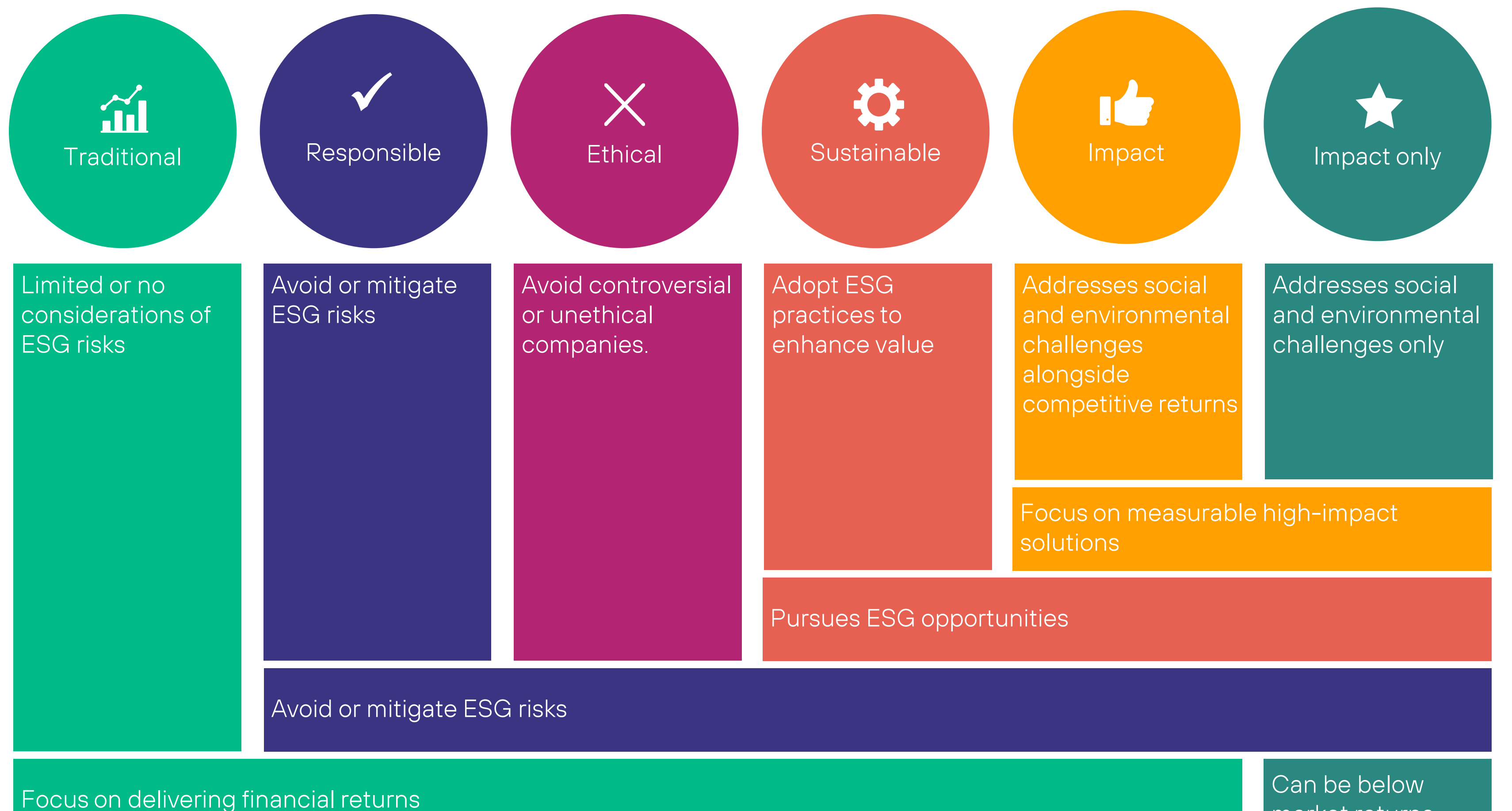
Responsible investment – spectrum of approaches



- The Council has agreed a Responsible Investment Policy that explains how the Fund will incorporate Environmental, Social & Governance ('ESG') factors into investment decision making and demonstrate a responsible approach to investment across the Fund's portfolio . The chart to the left illustrates a spectrum of approaches that can be implemented.
- We understand that the Council believes that a strong Responsible Investment approach will add value over the long-term and be mutually beneficial to wider society.
- The Council has identified a sub-section of United Nations Sustainable Development Goals which represent the strongest investment risks and opportunities for the Fund and its Pension Committee.[1] The Council expects all investment managers and advisors to prioritise these when making investment decisions on behalf of the Fund.
- The Council also expects Investment managers to ensure that they select investments that help transition to the net-zero carbon economy and to seek to avoid investing in stranded assets.

Note: [1] These include; Life below water (SDG 14), Life on land (SDG 15), Good Health and well-being (SDG 3), Clean Water and Sanitation (SDG 6), Affordable and clean energy (SDG 7), Sustainable cities (SDG 11), and Partnerships for goals (SDG 17).

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ESG in equity funds

What approaches are there?

- There are a range of approaches that sustainable equity funds employ. Two key aspects are engagement and exclusion:
  - **Engagement approach** – where the manager seeks to invest in companies which exhibit positive ESG traits and to engage with investee companies to ensure risks are managed and improvements made where appropriate.
  - **Exclusion approach** – the universe is screened for companies that exhibit negative ESG traits, and these are then removed from the investable universe.
- In practice, funds may adopt a combination of these approaches; for example, utilising an engagement approach, whilst excluding a small specific subset of investments, however returns will be driven by one approach or the other.
- Both approaches can be employed either on an active basis or a passive (index tracking) basis.

What do sustainable equity funds invest in?

- Managers who focus on engagement typically invest in companies that have a positive impact on:
  - **Environment** e.g. transition to a lower carbon economy,
  - **Social change**
  - **Governance**. displaying or encouraging strong corporate governance characteristics.
- Managers often employ some exclusions to a greater or lesser extent. These will typically consider:
  - **Fossil Fuel powered energy** e.g. oil & gas, coal
  - **Tobacco**, including suppliers and distributors
  - **Weapons**, controversial and civilian

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ESG considerations within current mandates

Baillie Gifford	
Baillie Gifford	• Baillie Gifford's investment philosophy is focussed on growth investing; they seek companies which will deliver significant long-term returns through achieving revenue and earnings growth which is higher than the market. The team believes that companies which adopt a thoughtful approach to stewardship are more likely to achieve long-term success and add significant value. Evaluating the quality of stewardship within a company is therefore an intrinsic part of the Fund's investment process. • Baillie Gifford have a Governance & Sustainability team, with every fund having an assigned Governance & Sustainability analyst to help monitor the companies in which the fund invests, and to engage with companies where appropriate. • Baillie Gifford's approach is well integrated into decision making. The approach predominantly focuses on governance and there is a risk that there is lesser focus on long term environmental factors. • Baillie Gifford do support the Task Force on Climate-related Disclosures ("TCFD"), although as they are not a public company, their support does not incur any requirements. Also of note, in a recent report compiled by ShareAction focusing on the approach to climate change by the asset management community, Baillie Gifford ranked 42 out of 75, with an overall rating of D (the highest being A). • Baillie Gifford has recently launched a 'Paris Aligned' version of the Global Alpha Fund which seeks to outperform with a carbon intensity below half that of the index and with a year on year decarbonisation target. This may be worth further exploration with Baillie Gifford given the Fund's objectives. In addition, Baillie Gifford offers a 'positive change' impact fund, which the Council might consider should they wish to go further in relation to the ESG focus of the Fund's portfolio. • *Please see Appendix C report for additional information.*

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ESG considerations within current mandates continued

Harris	• Harris's investment philosophy is focussed on value investing; they seek 'cheap' companies which they believe are trading at a discount to their intrinsic value. To determine this, they look to understand the business and the risks to which it is exposed, They are clear in saying this includes any material ESG risks. • Harris's analysis of ESG risks is integrated in their approach and has evolved over time. For instance they now routinely collect ESG ratings on stocks and have introduced more detailed carbon benchmarking of companies and portfolios. These ESG factors are now more embedded in the investment decision making process, during due diligence, valuation assessments and ongoing monitoring of their investments, than was previously the case. • **It is important to note that Harris may acquire companies with material ESG risks as long as these risks are being managed and are reflected in the price paid.** • Harris have not registered their support the for the TCFD • *Please see Appendix C report for additional information.*
LGIM passive mandates	• The objective of the LGIM passive equity mandates is simply to track the regional benchmark indices, therefore there is not scope for LGIM to employ an ESG approach when selecting underlying investments for these funds. • Given the large volume of assets held by LGIM however, they are able to, and frequently do, apply weight in ESG-related issues through the voting rights associated with these assets. Therefore although LGIM cannot express their ESG views within the passive mandates through allocation of capital, we recognise that they do frequently engage with ESG-related issues through voting.. We rate their engagement highly. • Also of note, in a recent report compiled by ShareAction focusing on the approach to climate change by the asset management community, LGIM ranked 3 out of 75, with an overall rating of A (the highest available). Legal & General PLC also support the TCFD • LGIM have a range of equity products available which are sustainable, and therefore utilise specific ESG objectives. • *Please see Appendix C report for additional information.*

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Proposed Direction of Travel

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Proposed direction of travel

Reduce UK bias	• The equity portfolio has a significant overweight to the UK relative to the broader market. In turn, this is driving overweight positions to the financial and consumer goods & services sectors. This exposure has been unhelpful for performance in recent years. • We believe that the Council should consider reducing the overall bias towards the UK, to favour a more diversified global exposure by replacing the existing passive UK equity Fund with a more global passive allocation. This could be into a sustainable approach which we consider in the following section.
Increase ESG focus	• We understand that the Council believes that a strong Responsible Investment approach will add value over the long-term and be mutually beneficial to wider society. The Fund's current equity mandates do consider ESG when selecting underlying investments, but do not employ an ESG-specific investment approach or overlay. • Given the suitable range of sustainable equity funds that are available (which we detail later in this report) there is scope for the Council to invest in mandates that more closely aligns with the Committee's ESG beliefs. • This can be achieved using the Baillie Gifford Paris Aligned fund and through a different approach to passive investing.
Reduce active management	• The Fund currently invests c.50% of the total equity portfolio in two active equity mandates, one of which has added value on a relative basis since inception and the other has detracted. • We believe that going forward the Council should consider reducing the allocation to active managers as we see limited evidence of ability to consistently add value net of fees. Baillie Gifford is one of the few exceptions to this. • Increasing the allocation to passively managed or smart beta equities, at the expense of actively managed equities, would result in a lower cost and lower governance equity portfolio.

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Alternative ESG-Focussed Equity Funds

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Sustainable equity funds

- The Fund can access a range of Sustainable equity portfolios through the incumbent fund managers and the LCIV arrangements.
- **Active management**: The LCIV offers two actively managed sustainable equity funds. Both are managed by RBC, who have a strong track record in this space. The actively managed funds are higher cost and more concentrated that the alternative rules based passive funds considered below. Given the experience of active management, desire to reduce cost and concerns around the LCIV governance, we believe that the passive options are likely to be better aligned with the Council's objectives.
- **Passive**: The Fund's incumbent passive manager (Legal & General), via the LCIV, can provide access to a range of passive (index-tracking) funds that are designed to exhibit positive ESG characteristics. We note that BlackRock and State Street also offer variants of these passive funds which may also be of interest to the Council (we summarise the BlackRock funds in Appendix 3). The funds are designed to be well diversified portfolios that track the wider market capitalisation index to varying degrees whilst targeting specific ESG characteristics. The funds can be split into three broad categories:
  - **Low carbon** – minimises exposure to carbon risk whilst tracking wider global index closely (+/- 0.3% p.a. tracking error);
  - **Positive ESG** – gains exposure to positive ESG factors whilst minimising carbon risk – aims to track wider index (+/- 0.5% p.a. tracking error);
  - **Multifactor** – Seeks to take specific factor exposures (e.g. Value, Size, Momentum) in conjunction with an ESG overlay (+/- 3% p.a. tracking error).
  - **Resource efficient** – Seeks to target companies that make efficient use of natural resources and to remove other biases, this deliver a strong ESG score as an output
- **Positive ESG**: Scoring the ESG characteristics of companies is a relatively new market development and there is currently some debate about the effectiveness of the scores. There is some evidence to suggest that using different providers' methodologies results in very different scoring of the same company. Nonetheless, these approaches will deliver lower carbon exposure and some alignment to the Fund's wider objectives.
- **Multifactor**: This provides exposure to a range of investment style factors together with an ESG focus – this introduces significant differences in performance relative to the index (and the track record of these approaches has been somewhat disappointing in practice). This might be attractive if the Council wished to replace Harris, but retain a Value tilt to balance the Baillie Gifford growth bias.
- **Resource efficient**: An approach that sits somewhere between active and passive investment management. It seeks to enhance returns by gaining exposure to companies that are more resource efficient, with the underlying portfolio selected systematically based on company disclosures on resource usage. Legal & General previously indicated that they would be willing to launch the Osmosis fund. We note that (if launched by LGIM) that management fees are likely to lie somewhere between passive and active management.

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Sustainable active funds (LCIV)

Fund summary – Actively managed & resource efficiency fund		
Manager	**RBC**	
Fund	**LCIV Sustainable Equity Fund**	**LCIV Sustainable Equity (Exclusion) Fund**
Regional focus	Global	Global
Engagement/exclusion	Engagement	Exclusion – Fossil fuels, tobacco, alcohol, weapons, gambling, adult entertainment
Management style	• Active management with focus on competitive businesses with growth prospects. ESG is integrated in investment approach to identify long-term risks to financial sustainability. • Portfolio has a positive ESG tilt and a lower carbon footprint than the MSCI World Index.	• Similar management style to LCIV Sustainable Equity Fund, in that the team employ an engagement strategy, however the sectors noted above will also be subject to exclusion. • The underlying portfolio is expected to differ to the LCIV Sustainable Equity Fund by c.5 stocks.
Benchmark	MSCI World	MSCI World
Objective	Outperform benchmark by 2% p.a. (net of fees)	Outperform benchmark by 2% p.a. (net of fees)
Number of stocks	30- 40	30-40
AuM	£398m	£219m
Fees	*Please see Appendix C for additional information*	*Please see Appendix C for additional information*

Note: All information as at 31 March 2020
Sources: LCIV & Osmosis

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Sustainable passive equity funds (LGIM)

Manager	LGIM			Osmosis
Fund	MSCI World Low Carbon Target Index	Future World Index Fund (Market Cap)	Future World Index Fund (Multi-factor)	MoRE World Resource Efficiency Smart Beta Fund
Regional focus	Global	Global	Global	Global
Engagement/exclusion	Engagement, with the exclusion of pure coal assets	Engagement with the exclusion of pure coal, weapons, climate impact (plus UN Global compact violaters for Market Cap)		Excludes firms that do not disclose sufficient data on energy, water and waste usage.
Management style	Passively managed	Passively managed	Passively managed	Uses a proprietary investment database tracking revenue vs resource usage by global firms, in order to generate a systematic, factor-based, investment process.
Tracked Index	MSCI World Low Carbon Target Index	Solactive GBS Dev. Mkts Large and Mid Cap Index	FTSE AW ex CW Climate Balanced Factor Index	MSCI World
ESG Objective[1]	Minimise Carbon exposure subject to a tracking error of 0.3%	Maximise average ESG score subject to a tracking error of 0.5%	Maximise average ESG score subject to a tracking error of 0.5%	Target maximum resource efficiency exposure whilst minimising tracking error to the benchmark
Carbon Intensity (t CO2e / $m invested)	53 (-72%)	171 (-13%)		Carbon intensity – c.60 (-c.70%) Water efficiency (cubic meter / min $) – c.300 (-c.70%) Waste efficiency (tonnes / min $) – c.5 (-c.65%)
Potential Carbon Emissions(t CO2e / $m invested)	21 (-99%)	1,493 (-47%)		N/A
Number of stocks	1,281	1,545	2,181	736
AuM	£3.8bn	£728m	£3.9bn	$418m
Fees (TBC)	*Please see Appendix C for additional information*	*Please see Appendix C for additional information*	*Please see Appendix C for additional information*	*Please see Appendix C for additional information*

Note: [1]The objective of a passive fund is to minimise tracking error, however in practice, various factors will cause scores to deviate slightly from those of the respective index. As such, we deem a tracking error of up to 0.5% acceptable.
Fees currently being paid for the LGIM Global equity mandate are 0.011% p.a. (AMC). This is calculated based on the fees of the underlying regional mandates, taken in proportion of the Fund's allocation to each.
All information as at 31 March 2020.

Source: LCIV, LGIM

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Proposal and Next Steps

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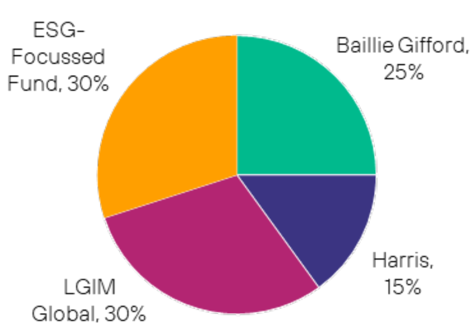
Proposed allocation

Proposed equity allocation



Key stats			
Mandate	Current allocation	Proposed allocation - Osmosis	Proposed allocation - LGIM FW
Total fees p.a.	0.23%,	0.26%,	0.20%,
No. of managers	3	4*	3
No. of mandates	4	4	4

Note: Expected returns, volatility and fees based on information as at 31 March 2020.
* Assumption that Osmosis is considered a standalone mandate and not via LGIM platform.
Sources: Investment managers & Isio calculations.

Proposal

- We recommend disinvesting from the LGIM UK equity mandate in favour of a more global approach. This will help address the bias to the UK, further aiding diversification within the portfolio across geographical regions and industry sectors.
- In order to manage overall costs, we propose that the passive UK equity mandate is transferred to a sustainable passive approach. Alongside this, we believe that reducing the exposure to Baillie Gifford and Harris is appealing to bring down total costs within the Fund. We therefore recommend trimming the total allocation to active managers (from 50% of the equity portfolio to 40%).
- Given Harris has underperformed the benchmark over the longer term (and also the wider value manager universe over the medium term), we propose they are given an agreed window to reverse this (maximum 1 year) and that they are closely monitored in the interim. We note that the Council may instead prefer to replace Harris immediately.
- The Council has a number of options with regards to selecting a sustainable fund. Given the objective to minimise investment costs where possible, we recommend utilising either the smart beta, or a passive fund.
- If a passive approach, with low fees and lower tracking error relative to the wider index is preferred, then we believe that the Legal & General's Future World Index Fund is aligned with this. This targets a lower carbon portfolio with an enhanced ESG score, whilst still tracking the wider index within a relatively tight tolerance. We expect this fund to more broadly replicate the wider market MSCI World index than the other alternatives, given that it invests in c.1,500 of the c.1,600 stocks that make-up the index.
- Should the Council prefer to focus on carbon reduction specifically, the LGIM MSCI World Low Carbon Target Index would provide a low-cost and low-governance passive solution.
- In our view, the Osmosis Resource Efficient smart beta fund is appealing if the Council prefer to retain a more active element to the strategy that seeks to deliver outperformance above the index. We note that accessing this proposition would require the product to be launched on the LGIM platform. We note that this approach will incur a higher cost than a passive fund.
- We note that there remains scope to allocate further to ESG-focussed funds. The recommendation made here is an initial step. As confidence in these new funds builds, and ESG equity propositions develop in terms of product offering and maturity, the Council could seek to make further allocations, e.g. the Baillie Gifford Paris aligned or positive change impact fund potentially using Harris as a source of capital if performance does not turn around.
- Any amendments to the equity allocation will incur implementation costs. These costs are uncertain until the incoming and outgoing funds, and value to be transferred are agreed. In any situation, we would look to reduce transition costs through in-specie asset transfers where possible.

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Next steps

Next Steps

- The Council should consider the analysis and views outlined in this paper.
- In particular, the Council should consider whether to:
  - Reduce the UK equity and sector biases in the portfolio;
  - Introduce an sustainable approach for an element of the Fund's passive equity exposure;
  - Whether the preference is to focus specifically on carbon risk, or on broader ESG risks.
  - Whether the Baillie Gifford Paris aligned or positive change impact fund should be explored further.
- We look forward to discussing this report with the Council in due course.

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Appendices

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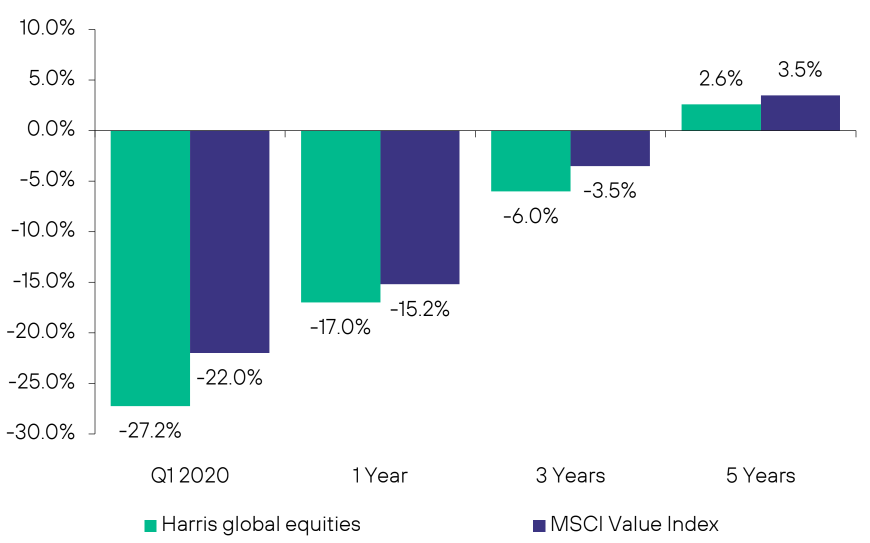
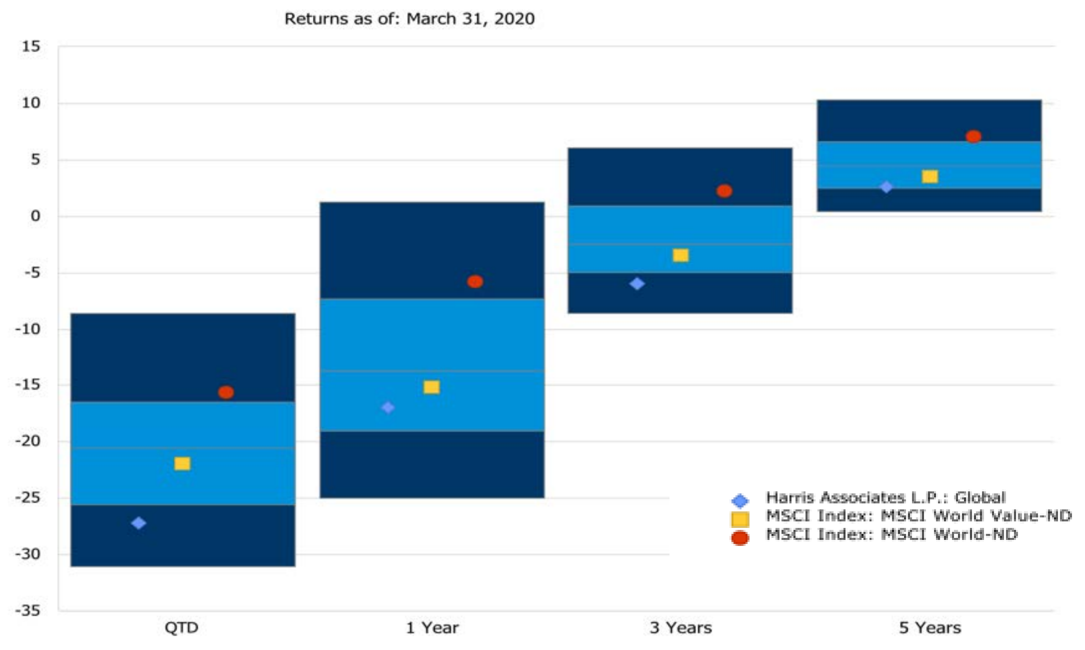
A1: Harris global equity fund performance

- The below charts demonstrate the performance of the Harris global equity fund in the context of the value management style of investing.
- The chart on the left shows returns of the Harris fund, versus those of the MSCI Value Index.
- The chart on the right shows the performance of Harris versus the universe of active value equity managers.
- Both charts highlight that Harris has underperformed the value index and the median value peer over all periods shown.
- We cannot therefore attribute all of Harris' poor performance to the style being out of favour.

Performance of Harris global equity fund vs MSCI value index



Performance of Harris global equity fund vs value manager peer group



Source: Harris & eVestment

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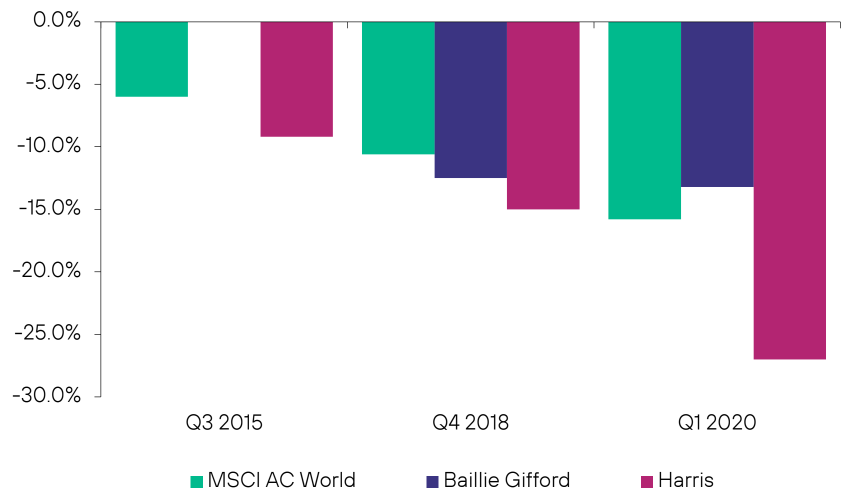
A2: Current active equity – stress market performance

Performance in worst 3 equity quarters since the active funds' inception



Performance in worst 3 equity quarters since the active funds' inception			
Quarter ending	September 2015	December 2018	January 2020
MSCI AC World	(6.0%)	(10.6%)	(15.8%)
Baillie Gifford[1]	n/a	(12.5%)	(13.2%)
Baillie Gifford Relative	n/a	(1.9%)	2.6%
Harris	(9.2%)	(15.0%)	(27%)
Harris Relative	(3.2%)	(4.4%)	(11.2%)

Note: [1] Baillie Gifford fund inception date was April 2016. Analysis is high level and for illustrative purposes only (due to short time period and limited performance data).
Source; Investment Managers

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A3: ESG equity funds– additonal passive funds (BlackRock)

Fund summary – Passively managed ESG Equity funds			
Manager	**BlackRock**		
Fund	**ACS World Low Carbon Equity Tracker Fund**	**ACS World ESG Equity Tracker Fund**	**ACS World Multifactor ESG Equity Tracker Fund**
Regional focus	Global	Global	Global
Engagement/exclusion	Both: Exclusion – High carbon emissions	Both: Exclusion – Thermal coal, tobacco, weapons, UN Global compact violaters	
Management style	Passively managed	Passively managed	Passively managed
Tracked Index	MSCI World Low Carbon Target	MSCI World ESG Focus Low Carbon Screened	MSCI World Select Multiple Factor ESG Low Carbon Target
ESG Objective	Minimise Carbon exposure subject to a tracking error of 0.3%	Maximise exposure to higher ESG scores subject to a tracking error of 0.5%	20% improvement in ESG scores than MSCI World Index
Number of stocks	1,303	477	405
AuM	£1.7bn	£746m	£200m
Fees (TBC)	*Please see Appendix C for additional information*	*Please see Appendix C for additional information*	*Please see Appendix C for additional information*

Note: All information as at 31 March 2020
Source: LCIV, LGIM & BlackRock

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A4: ESG equity funds – additional comparison and views

Comparison and views – Proposed ESG equity funds

Manager	LGIM		BlackRock		Osmosis
Fund	MSCI World Low Carbon Target Fund	Future World Index Fund (Market Cap)	ACS World Low Carbon Equity Tracker Fund	ACS World ESG Equity Tracker Fund	Osmosis MoRE World Resource Efficiency Fund
Pros	▪ Current manager ▪ Sits alongside LCIV ▪ Large, established fund ▪ Low target tracking error - 0.3% p.a. ▪ Non-exclusion approach with a focus on low carbon producing companies – this has bene a key issue for the Council ▪ Similar stock coverage compared to wider index ▪ Attractive TER	▪ Current manager ▪ Sits alongside LCIV ▪ Addresses wider environmental, social and governance factors as well as fossil fuel/carbon emissions ▪ Low target tracking error - 0.7% p.a. ▪ Similar number of stocks compared to wider index ▪ Most attractive TER	▪ Manager on LCIV platform but not an LCIV proposition ▪ Large, established fund ▪ Low target tracking error - 0.3% p.a. ▪ Non-exclusion approach with a focus on low carbon producing companies – this has bene a key issue for the Council ▪ Similar number of stocks compared to wider index ▪ Attractive TER	▪ Manager on LCIV platform but not LCIV proposition ▪ Addresses wider environmental, social and governance factors ▪ Low target tracking error - 0.5% p.a. ▪ Attractive TER	▪ "Smart beta" approach follows a more active management style than alternatives ▪ Approach simple and intuitive ▪ Back testing performance results are positive. ▪ Potential for LGIM to launch an institutionally wrapped version of the proposition
Cons	▪ Narrow focus on minimising carbon ▪ Ignores wider social and governance issues	▪ Some sector exclusions but not expected to be key driver of portfolio construction ▪ AuM lower than alternatives	▪ New manager but within LCIV umbrella ▪ Narrow focus on minimising carbon ▪ Ignores wider social and governance issues	▪ New manager but within LCIV umbrella ▪ AuM lower than alternatives ▪ Significantly lower number of stocks than the benchmark (and equivalent LGIM portfolio) reduces diversification	▪ Third party manager – access would rely on LGIM launching the fund on the LCIV platform ▪ Smallest fund AuM, however has blue chip client base ▪ Fees higher than other passive alternatives but lower than active.
Isio View	*Please see Appendix C comment 1 for additional information.*	*Please see Appendix C comment 2 for additional information.*	*Please see Appendix C comment 3 for additional information.*	*Please see Appendix C comment 4 for additional information.*	*Please see Appendix C comment 5 for additional information.*

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A5: Sustainable equity funds – performance comparison at 31/03/20

Comparison and views – Proposed ESG equity funds					
Manager	LGIM		BlackRock		Osmosis
Fund	MSCI World Low Carbon Target Fund	Future World Index Fund (Market Cap)	ACS World Low Carbon Equity Tracker Fund	ACS World ESG Equity Tracker Fund	Osmosis MoRE World Resource Efficiency Fund
1 Year Performance (% p.a.)	4.6%	n/a	(2.6%)	n/a	(8.8%)
1 Year Realised Tracking Error (% p.a.)	(0.1%)	n/a	0.4%	n/a	1.6%
Since Inception* Annualised Performance (% p.a.)	8.8%	(18.5%)	1.7%	(9.4%)	1.6%
Since Inception* Realised Tracking Error (% p.a.)	(0.1%)	N/A – expected to be 0.5% p.a. or less	0.4%	0.3%	0.9%

Note: Performance and tracking error sourced from the investment managers and are net of fees. Performance since inception provide the longest period available and included back tested returns for LGIM and BlackRock Funds. All information as at 31 March 2020

*Since inception for each of the funds is: MSCI World Low Carbon Target Fund - August 2015, Future World Index fund – Feb 2020, ACS World Low Carbon Equity Tracker Fund – Dec 2017, ACS World ESG Equity Tracker Fund – July 2019, Osmosis MoRE World Resource Efficiency Fund - May 2017

Sources: LCIV, LGIM, BlackRock & Osmosis

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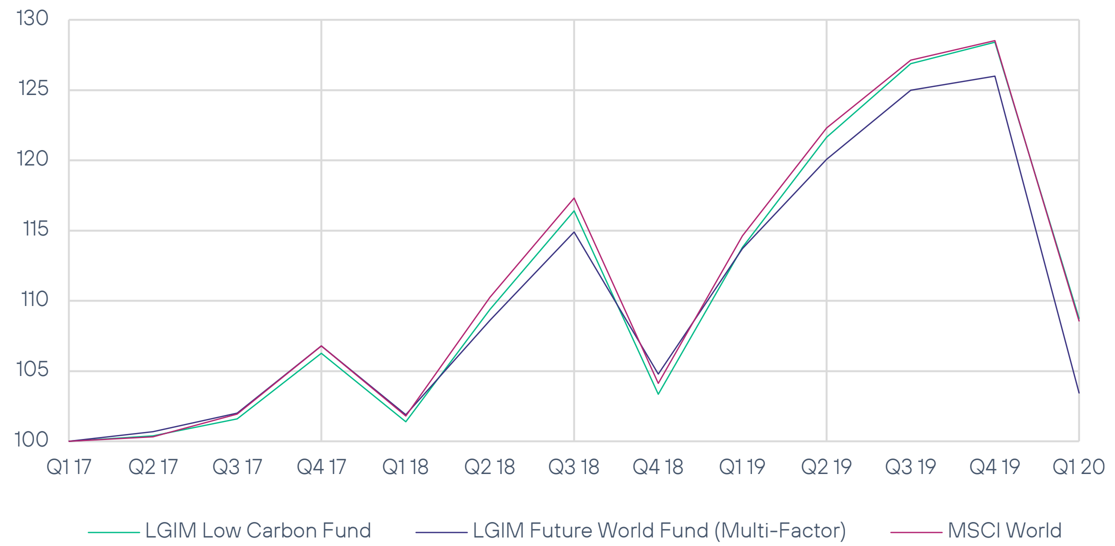
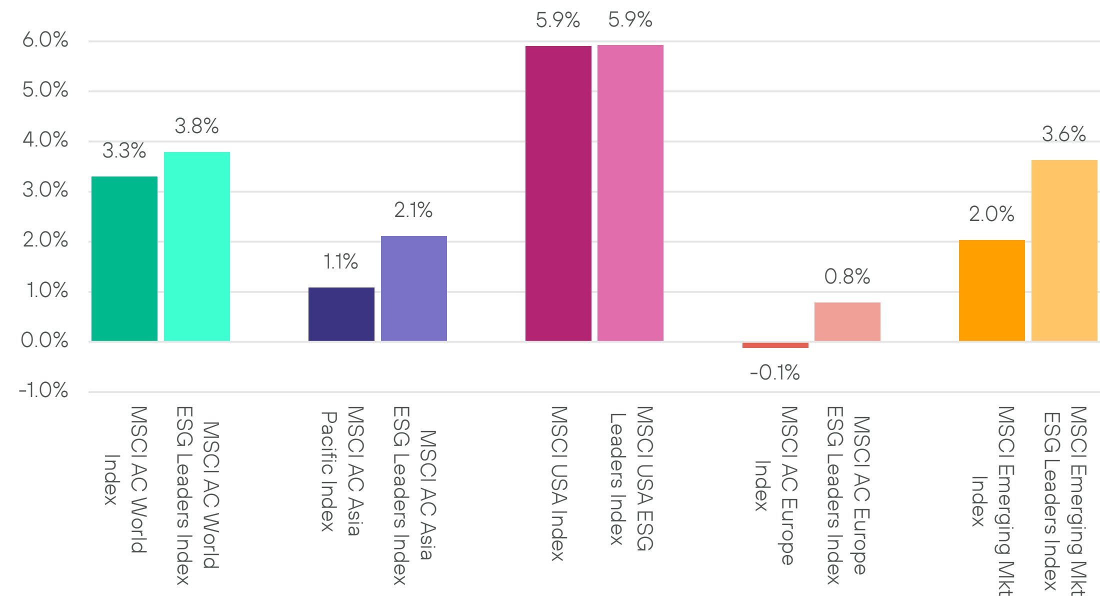
A6: ESG equity funds – performance vs wider market

- The below charts help to illustrate that opting to invest in a sustainable equity fund does not equate to sacrificing returns.
- The chart on the left shows the performance of two of the LGIM sustainable equity funds proposed within the report, versus the broader MSCI world index. The chart shows returns since inception of the LGIM Future World Index Fund (Multi-factor) in Q1 2017. The LGIM Future World Index Fund (Market Cap) has been omitted given the fund's inception date of Q1 2020.
- The chart on the right shows the performance of various regional equity markets, versus their equivalent ESG-focussed index.
- It can be seen in both charts that there is no meaningful difference in performance (i.e. a small tracking error) between the funds and indices which have sustainable objectives, and those which do not.

Sustainable fund performance vs broader market



5-yr performance of regional indices vs their sustainable equivalent – to 31/03/20



Source: LGIM, Isio

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A7: ESG manager summaries - Assessment criteria

Assessment Criteria

We have used a 'Traffic Light' system throughout this report to capture the fund manager's ESG capabilities against each criteria. The criteria are summarised below:

1. Approach/framework – There is a clear approach/framework for integrating ESG factors.
2. Risk Management – ESG factors are integrated holistically in the manager's risk management framework.
3. Voting & Engagement – There is evidence of exercising voting rights (where applicable) and ongoing engagement with companies on ESG issues to help initiate change.
4. Reporting & Monitoring – The manager provides meaningful and regular reporting on ESG issues, including voting and engagement activities.
5. Collaboration – There is evidence of engagement with other stakeholders and market participants to encourage best practice on various issues such as board structure, remuneration, sustainability, risk management and debtholder rights.

Manager Reviews vs Criteria

We have begun by assessing the mandate against the criteria described above. This is based on the information provided to us by the investment manager. We have provided our view on the mandates using the 'Traffic Light' system as illustrated below. Detailed information for each one can be found in the appendix.

Above satisfactory

Satisfies requirement

Below satisfactory

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A7: Isio Investment Advisory – ESG manager review framework

Above satisfactory– The manager is well resourced and displays strong knowledge on key ESG issues. There is significant evidence of support from the business to build and maintain ESG capabilities. The manager incorporates ESG factors as a source of investment return and as a tool to mitigate risk at the portfolio management level. This is supported by evidence of how ESG factors are applied and measured. The manager acts as an active owner by taking responsibility of voting and engagement with companies. The manager collaborates with other market participants to encourage best practice on various ESG related issues. The manager provides detailed ESG related reporting to clients.

Satisfies requirements – The manager has good knowledge of ESG issues and collaborates with market participants to encourage best practice in the wider market. There is evidence of support from the business to build and maintain ESG capability, but evidence of how ESG factors are applied at the portfolio management level may be limited. The manager takes responsibility for voting and engagement and provides high level reporting to clients.

Below satisfactory – The manager displays limited knowledge of ESG issues at the business and portfolio management level. The manager is unable to provide evidence of voting and engagement. The manager relies heavily on voluntary codes, such as the UNPRI, to reflect their ESG capabilities.

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A7: Legal & General ("LGIM") – Passive equity

Criteria	Risk Management	Investment Approach/Framework	Voting & Engagement	Reporting	Collaboration
Isio IA View	*Please see Appendix C for additional information.*	*Please see Appendix C for additional information.*	*Please see Appendix C for additional information.*	*Please see Appendix C for additional information.*	*Please see Appendix C for additional information.*
Please see Appendix C for additional information. *Please see Appendix C for additional information.*	– LGIM have developed ESG Scores and an ESG Active View, which are tools used for qualitative and quantitative assessment of ESG risks and opportunities. – We note there is no opportunity to incorporate ESG risk assessment into these funds, given their passive nature. – LGIM has a 'Future World' fund range, covering a range of asset classes. These funds are largely passively managed, tracking FTSE indices which are tilted towards firms with 'positive' ESG scores.	– LGIM have made a commitment to integrating ESG issues as part of their investment processes. They believe it can help to mitigate risk and has the potential to improve financial outcomes. – LGIM have an independent Corporate Governance and Responsible Investment team, who take an active role in understanding and assessing the impact of ESG factors for the wider business. – Though we note there is no scope to incorporate ESG into the investment approach, given the manager's role in tracking benchmark indices.	– LGIM believe in active ownership, aiming to engage with companies to create positive change. LGIM provide an annual report covering the areas that they have engaged with companies on. For instance, in 2017 LGIM covered four areas: climate change, diversity and income, governance and culture, and "raising our voice". – LGIM actively exercise voting rights and publish a report detailing the decisions that they have voted for or against. LGIM use third party data provided by ISS, who carry out voting research and analysis, to help determine how they should exercise their voting rights on various key issues.	– LGIM provide an annual firm-level report covering the key areas where they engaged with companies. – LGIM produce a quarterly ESG Impact report which discusses the ESG landscape, case studies, key developments and outlook. Contained within the quarterly report is a Global Engagement Summary. This quantifies data including; number of companies engaged with, total engagements over the quarter and engagement meetings attending. – We note that LGIM currently do not provide bespoke fund-specific ESG reporting covering information such as ESG ratings exposure relative to benchmark, carbon emissions etc.	– LGIM and Solactive have collaborated to release the Solactive L&G ESG Index family, targeted at investors who wish to integrate ESG into their investment strategy. – LGIM take an active approach to stewardship by using their scale as a global investment manager to influence and change company and market behaviours. In doing so, LGIM aim to achieve positive societal impacts, in the belief that it will create more sustainable long-term value. – LGIM have been a UNPRI signatory since 2010.

Above satisfactory

Satisfies requirements

Below satisfactory

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A7: Baillie Gifford – Global Alpha Fund

Criteria	Risk Management	Investment Approach/Framework	Voting & Engagement	Reporting	Collaboration
Isio IA View	*Please see Appendix C for additional information.*	*Please see Appendix C for additional information.*	*Please see Appendix C for additional information.*	*Please see Appendix C for additional information.*	*Please see Appendix C for additional information.*
Please see Appendix C for additional information. *Please see Appendix C for additional information.*	– Baillie Gifford are looking to invest for the long term. As such they believe well managed companies that take a consistent and holistic approach to managing ESG risks are less volatile stocks than those that don't manage ESG risks. – For Baillie Gifford, the value added in the portfolio should be seen in well performing portfolios that aren't subject to catastrophic ESG events or regular run-ins with the regulators or other stakeholder groups, but rather higher, less volatile returns over the long term.	– Baillie Gifford have a dedicated Governance & Sustainability team and every strategy has a governance & sustainability analyst assigned – Baillie Gifford view a positive and proactive approach to ESG as a competitive advantage for companies in which they look to invest in. Given the Fund is a bottom-up stock picker, ESG is well integrated within the investment process. – Baillie Gifford focus on governance and sustainability and factor in additional considerations such as a company's performance in environmental and social issues.	– Voting decisions are made by the Governance & Sustainability team in collaboration with the investment managers. Baillie Gifford has a Proxy Voting Policy available on its website. – Baillie Gifford engages with companies they hold on behalf of their clients. In 2018 they had 235 engagements with 182 companies. – The primary reasons for ESG engagement include: fact find, monitor progress, exert influence and support the management team.	– Baillie Gilford publicly issues an annual report on Governance & Sustainability. This highlights the firm's main ESG principles and progress in these areas. – Baillie Gifford publicly discloses a summary of all voting and engagement activities on their website on a quarterly basis.	– Baillie Gifford participates in the promotion of ESG issues through membership of various organisations. – Baillie Gifford collaborates with other investor groups on a case by case basis, where there is underlying benefit to their clients. For instance, they are a Partner for Mercer's "Investing in a Time of Climate Change" working group. – Baillie Gifford arrange forums between regulators, consultants and asset owners to encourage discussion on ESG matters.

Above satisfactory

Satisfies requirements

Below satisfactory

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A8: Case for active management

Positives	Considerations
• **Flexibility** - a broader range of markets and strategies are available under active management compared to a passive approach. • **More targeted mandate** - specific targets and outcomes can be set and achieved under active management. • **Potential for excess return** - there is potential for outperformance relative to a traditional passive approach. • **Potential for better risk management** - active managers are more able to react quickly to changes than passive managers and are expected to be more effective in volatile markets and during market downturns. • **Reduces market capitalisation bias** – market capitalisation bias (found in traditional passive management) can be addressed in some active mandates but can be replaced with other biases.	• **Dependence on provider** – there is a dependence on the chosen active manager's skill and it is difficult to find an active manager who will outperform across all market environments. To gain confidence requires detailed due diligence. • **Governance** – the governance requirements to effectively monitor active mandates is higher than passive. • **Market timing** – a chosen active management style can underperform for long periods if not rewarded by the broad markets. • **Increased complexity** – there are a variety of approaches available in the market. These approaches are typically more complex than traditional passive approaches. • **Cost** – active mangers typically charge higher management fees and have higher overall costs than traditional passive or smart beta approaches. • **Regret risk** - Given their active risk, there is potential for underperformance of the benchmark. This could lead to regret of appointing a particular active manager.

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A9: Case for passive management

Positives	Considerations
• Low cost – traditional, market capitalization-focused, passive equity management has low investment management fees and total expenses. The Fund also benefits from the discounted fee negotiated by LCIV. • Simple – a passively managed approach is less complex than an active or smart beta approach. • Diversified – passive equity mandates replicate the indices they track. As such the underlying portfolios are typically diversified across the large number of individual companies in the respective index. Other approaches can lead to more concentrated portfolios. • Low regret risk - few active managers consistently outperform across market cycles. Investing passively minimises the chance of regret during a period of underperformance or appointment of an active manager who subsequently underperforms. • Low governance – passive managers do not seek to take active positions, leading to less stringent monitoring requirements.	• Bias – passive equity approaches follow a traditional broad index, where larger companies carry higher weightings, resulting in a "large cap" bias. • Potential for regional/sector concentration – passive investments may be concentrated in the dominant areas of the particular index that is being tracked e.g. North America for global equities, or the financial sector for UK equities. • Blunt – passive investment can be seen as a blunt investment management tool with no scope for outperformance over index return or ability to position defensively. • Tracking difference – after charges are taken into account, most trackers may not follow an index perfectly. However, past performance of index-tracking funds suggests that this is not expected to be material.

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A10: Case for a multifactor approach

Positives	Considerations
• **Potential for excess return -** there is potential for outperformance relative to a traditional passive approach. • **Focus on one or more individual factors –** a smart beta approach can focus on an area of interest, whether that is value, momentum or ESG related factors such as reduced fossil fuel usage. This has the potential to improve diversification and reduce risk relative to a purely passive approach. • **Reduces market capitalisation bias –** this bias (found in traditional passive management) is addressed but can be replaced with other biases. • **Academic backing –** strategies are often thoroughly researched and founded by sound academic and economic principles.	• **Limited track record –** there is limited live performance track record, with many funds relying on simulated back testing. • **Dependence on provider –** consistency of investment process, factor definitions and robustness of approach depends on the specific provider selected. To gain confidence requires detailed due diligence. • **Unintended exposures –** some approaches lead to unintended exposures. For example the RAFI 3000 index carries a significant overweight to large oil companies. • **Market timing –** single factor strategies can underperform for long periods. Smart beta funds have limited ability to rotate exposures or change positioning unlike actively managed funds. • **Increased complexity –** there are a variety of approaches available in the market. These approaches are typically more complex than traditional passive approaches.

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