SURREY COUNTY COUNCIL

PENSION FUND BOARD

DATE: **31 MAY 2013**

LEAD OFFICER: **SHEILA LITTLE, CHIEF FINANCE OFFICER**

SUBJECT: **TOBACCO STOCK IN THE PENSION FUND**

SUMMARY OF ISSUE:

The recent transfer of public health responsibilities to local authorities with effect from 1 April 2013 has resulted in significant publicity regarding the holding of tobacco stocks by the same local authorities' pension funds. Questions have been raised as to whether this is compatible with the responsibilities held by administering authorities in relation to public health and the potential conflicts of interest that could result.

This report sets out the position with regard to the Pension Fund's fiduciary duties with regard to environmental, social and governance (ESG) considerations. The transfer of public health responsibilities alongside the County Council's responsibility to its pension fund has notably raised the profile of ethical investing.

RECOMMENDATIONS:

It is recommended that:

1. The Pension Fund Board consider the report and (after giving due consideration to the Board's overriding fiduciary duty) discuss the available options with a view to deciding on future ESG policies and, specifically, tobacco stocks, namely:

   a) Continue the current strategy with regard to ESG factors, allowing suitable delegation and discretion to the external fund managers, and receiving regular reports and updates from managers as to their approach.

   b) Examine and debate all other options available to the Pension Fund Board, including the prohibition of tobacco assets.

2. The Fund's Statement of Investment Principles be suitably updated to reflect the Pension Fund Board's decision.

REASON FOR RECOMMENDATIONS:

An agreed policy is now required as a result of the debate surrounding the dichotomy concerning the Authority's conflicting responsibilities with regard to pension fund investment, and public health and well-being.

DETAILS:

Background

1 Whilst ESG and ethical factors may be relevant in pension fund investment decision making, it could be argued that the Pension Fund Board should not dismiss the possibility of making certain investments on ethical grounds alone. Pension Fund Boards do have a fiduciary duty to consider the full range of lawful investment options available to them and decisions should be based on the expected investment performance of the asset.

Current Pension Fund Position with regard to Tobacco

2 By necessity, equity holdings held within the Pension Fund cover a wide range of companies, dealing in a wide spectrum of activities, all of which are lawful. The majority of LGPS funds have exposure to tobacco stocks. As at 31 March 2013, the Surrey Pension Fund held holdings in tobacco related companies which amounted to 0.5% of the total Fund, equating to just over £11.1m in equities and £1.5m in fixed income corporate bonds, totalling £12.6m.

3 The above figures relate to directly owned stocks held within segregated portfolios. The Pension Fund also has indirect exposure to approximately £4.8m within the LGIM passive pooled funds. A breakdown of the directly owned exposure as at 31 March 2013, 31 March 2012 and 31 March 2008 is set out in Table 1.

		Market Value £		
	Asset description	**31-Mar-13**	**31-Mar-12**	**31-Mar-08**
Equities	BRITISH AMERICAN TOBACCO ORD GBP0.25	3,154,266.64	2,407,832.64	4,687,200.00
	PHILIP MORRIS INTL COM STK NPV	715,466.59	1,248,745.60	545,640.31
	SWEDISH MATCH NPV	1,612,464.06	295,356.62	0
	ALTRIA GROUP INC COM	2,558,224.14	4,218,664.67	239,501.91
	JAPAN TOBACCO INC NPV	3,079,567.25	2,493,215.19	1,942,016.72
	GUDANG GARAM TBK IDR500	0.00	33,850.50	74,430.43
	REYNOLDS AMERICAN INC COM	0.00	0.00	1,164,830.81
	TOTAL	11,119,988.68	10,697,665.22	7,488,789.37
Bonds	BAT INTERNATIONAL FINANCE PLC	625,544.50	0.00	937,807.40
	IMPERIAL TOBACCO	820,546.30	1,616,870.85	0
	TOTAL	1,446,090.80	1,616,870.85	937,807.40
	GRAND TOTAL	12,566,079.48	12,314,536.07	8,426,596.77

Fiduciary Duty of the Pension Fund Board

4 Fiduciary duties set out the broad parameters within which trustees (and the council officers, fund managers and investment consultants appointed) must exercise the discretionary powers with regard to pension fund governance. These duties affect the exercising of discretion to make and manage investments, and require trustees and their agents to act prudently and for a proper purpose. In this context, members appointed to the Pension Fund Board are regarded as quasi trustees.

Proper Purpose

5 In the case of the pension fund, the proper purpose is ultimately to pay future pension promises to its members (active, deferred and pensioner) and therefore obtain sufficient returns with which to do so, as set out in the Fund's Statement of Investment Principles:

i) To be at or above a 100% funding level in order that it is able to meet its current and future liabilities.

ii) To seek investment returns that are consistently strong and outperform or match those available in the major investment markets and are comparable with other institutional investors.

Available Research

6 Various pieces of research have also been conducted with regard to ESG issues. The law firm, Freshfields Bruckhaus Deringer, commissioned by the United Nations Environment Programme Finance Initiative (UNEPFI) produced what is considered to a significant work regarding the incorporation of ESG issues into investment risk analyses. The Freshfields report suggests that pension fund trustees will fulfil their fiduciary duties, provided they treat the purpose of the investment power (which for pension funds will ordinarily be to seek a financial return for the beneficiaries) as the primary purpose and, while allowing for the influence of other relevant considerations, do not allow it to be overridden by any other purpose.

7 This means that the consideration of secondary considerations, such as ESG issues, could legitimately form part of any investment decision as long as they do not override the primary consideration of making a financial return. Importantly, the assessment of any individual investment should properly include its fit into the investment portfolio as well as its expected return. Considerations such as risk versus return and correlation to the rest of the portfolio are essential, and it is part of the trustee's role to seek returns across the entire portfolio across a variety of different economic possibilities, rather than on inclusion or exclusion on an investment by investment basis.

Statutory Regulation

8 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (SI 2009/3093) govern matters in relation to ESG within Statements of Investment Principles (SIP). In particular, Regulation 11 requires an administering authority to formulate a policy for the investment of its fund money, with a view to the advisability of investing fund money in a wide variety of investments; and to the suitability of particular investments and types of investments.

9 Regulation 12(1) states that an administering authority must, after consultation with such persons as it considers appropriate, prepare, maintain and publish a written statement of the principles governing its decisions about the investment of fund money. Regulation 12(2) requires SIPs to include the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.

10 In issuing these regulations, the Government did not seek to impose requirements regarding ethical investment, only to state their policy. There is currently no regulatory requirement to take into account ESG considerations. The Surrey Pension Fund sets out its position via its SIP and the extent to which the Surrey Pension Fund currently takes ESG considerations into account is set out in Part 10 of the SIP.

Surrey Pension Fund's Current Approach

11 The last Surrey Pension Fund Statement of Investment Principles (SIP) was approved by the Investment Advisory Group on 10 September 2012. The latest redrafted SIP (with further expansion on the proposed approach with regard to ESG issues) is due for review and approval at the Pension Fund Board meeting of 31 May 2013. The revised SIP states in paragraph 10:

> ***Stewardship and Responsible Investment***
> *The Council wishes to have an active influence on issues of environmental or ethical concern with companies in which the Pension Fund is a shareholder. It will seek to codify its approach with Fund Managers and will use the services of specialist agencies as necessary to identify issues of concern. The Council requires the Fund Managers to take into account the implications of substantial "extra-financial" considerations, e.g., environmental, social or reputational issues that could bring a particular investment decision into the public arena. Whilst the Fund has no specific policy on investing or divesting in stock with regard to ESG issues, in comparing potential investment decisions, and where differences in predicted returns are deemed immaterial, external fund managers could deploy ESG considerations in deciding upon selection.*

12 The SIP now makes clear that such ethical considerations should be delegated to the Fund's external fund managers. The Fund encourages its managers to view and consider ESG factors where it is thought that long-term performance may be enhanced by such consideration and, under current arrangements, such consideration and resultant stock choices will be the responsibility of the external managers employed to select investment on the Pension Fund's behalf.

13 The requirement for the Fund's SIP to include reference to ESG considerations, if any, acknowledges that such considerations should be naturally part of an informed investment policy. Fund managers will always need to consider these "extra-financial" matters in the context of the overriding fiduciary duty of the Pension Fund Board and the benchmark performance targets set for those fund managers. In comparing potential investment decisions, and where differences in predicted returns are deemed immaterial, fund managers could deploy ESG considerations in deciding upon stock selection and the Pension Fund's SIP sets out this parameter.

14 The Fund is also an active member of the Local Authority Pension Fund Forum (LAPFF), thus demonstrating a commitment to sustainable investment and the promotion of high standards of corporate governance and responsibility.

Separation of Specific Responsibilities

15 The County Council is the administering authority for the pension fund and its responsibility arising from such a role is one of the many statutory responsibilities attributable to it. Responsibility for public health has recently been added to the responsibilities list. All of the Council's responsibilities are distinctly separate from those relating to the County Council as administering authority for the Pension Fund.

16 An appropriate separation of functions within the County Council's responsibilities is considered sufficient to address any potential conflict of interest. The separation of responsibilities is achieved by the distinct nature and governance arrangements relating to individual committees of the County Council. The bodies that oversee investment (the Pension Fund Board) and public health (Health and Wellbeing Board) are separate committees of the Authority. It is not the Cabinet that oversees these responsibilities.

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17 Whatever the organisational structure, the Council must ensure that there continues to be appropriate separation of functions between pension fund investment decision making and public health policy making. Mention should also be made that four external employers represented on the Pension Fund Committee have no public health responsibilities.

18 The investment of pension funds in tobacco companies (undertaken at the discretion of the Fund's independent external investment managers) would never implicate tobacco industry involvement in public health policy making by the County Council. The nature of the mandates with the Fund's investment managers does not provide for such investment services to provide a route for any influence, direct or otherwise, on Council public health policy, either from the fund managers themselves or the companies in which they invest.

19 The Pension Fund holds expectations of its fund managers to hold companies to account on the highest standards of behaviour and reputational risk management which may damage long term performance, and for those issues to be part of their stock selection criteria.

20 However, aside from the very logical approaches expressed above, and looking at the situation purely from a layman's point of view, regardless of the very distinct separation of responsibilities, the very fact that the County Council has public health responsibilities and at the same time invests in tobacco stocks represents a situation that appears self-contradictory. The reality is that the Council has distinctive duties in relation to these two different responsibilities, although the Statement of Investment Principles does provide a mechanism of seeking in some way to reconcile these issues.

Investment Regulations

21 There is currently no statutory regulation regarding prohibition upon the Pension Fund investing in tobacco companies. Members of the Pension Fund Board are required to act in accordance with their overall fiduciary duty. The investment policy of the Fund must be guided by the primary purpose of the Fund in that investments should be made for the beneficiaries and not made for other purposes. It could be deduced from this that investment powers should not be used to make moral statements at the expense of the beneficiaries.

22 Ultimately, the Pension Fund has a duty to consider the full range of investment options available, and securing an appropriate financial return is a prime concern of the Fund in order to meet future pension commitments. However, ESG factors may be relevant as an additional consideration in order to provide distinction to investments with similar financial characteristics.

Current Options

23 After giving due consideration to the overriding fiduciary duty, the Pension Fund Board should either:

i) Continue the current strategy with regard to ESG factors, allowing suitable delegation and discretion to the external fund managers, and receiving regular reports and updates from managers as to their approach; or

ii) Examine and debate all other options available to the Pension Fund Board, including the prohibition of tobacco assets.

Implications of Prohibiting Further Investment in Tobacco Assets

24 The Pension Fund's SIP would need a suitable redraft setting out this policy change.

25 Fund manager benchmarks would need to be amended to reflect the prohibition of such stocks. Market benchmarks without tobacco assets do not currently exist, thereby making it very difficult to measure fund manager performance and hold the managers to account on benchmarked performance.

26 How far should the policy extend? If tobacco stocks are prohibited, then it could be argued that the Fund should prohibit the shares of the supermarket chains that sell tobacco, as well as the haulage companies that transport the goods to the supermarkets, and the consultants and investment banks that provide corporate and financial advice to the tobacco companies.

27 The policy sets a precedent for future engagement by pressure groups with particular grievances against specific companies, the most prominent examples being alcoholic drinks manufacturers, gambling and casinos, and arms manufacturers. By setting this initial precedent, it could be regarded as the starting point for future lobbyists to gain a foothold.

28 The counter-argument to the above point is the evidence of the dangers associated with tobacco as opposed to, say, enjoying alcohol and gambling in a responsible manner.

29 There is the risk of limiting the Fund to future out-performance if specific stocks are prohibited. For example, tobacco has comfortably out-performed the entire range of stock categories over the last 25 years as well as the first quarter of 2013. It should be stated that if tobacco stocks become unattractive as a result of various future concerns having a financial impact on the financial framework of the companies, then the fund managers would divest from those companies in any case.

CONSULTATION:

30 The Chairmen elect of the Pension Fund Board has been consulted on the proposed debate and has offered full support.

RISK MANAGEMENT AND IMPLICATIONS:

31 The prime risk of divesting from prohibited stocks is the possibility of limiting the Fund to future out-performance if those stocks out-perform the market.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

32 The cost of any proposed action will be borne from existing budgets.

CHIEF FINANCE OFFICER COMMENTARY

33 The Chief Finance Officer is satisfied that all material, financial and business issues and possibility of risks have been considered and addressed with all available options presented to the Board, along with the associated implications attached to each. The officer's view is that the overriding duty of the Pension Fund Board is to maximise investment returns, and that the fiduciary duty to all stakeholders with regard to the financing of future pension flows remains paramount.

LEGAL IMPLICATIONS – MONITORING OFFICER

34 As stated throughout the report, the Council, as the quasi trustee of the Pension Fund, has a fiduciary duty to ensure that it acts in the best interests of the beneficiaries and also that it acts impartially. For a local authority pension scheme, ultimately, this will mean for the benefit of local council tax payers and the paramount concern in this will be their financial benefit. Ethical issues are relevant considerations that can be taken into account, and the Statement of Investment Principles enables this to be included in practice. The Council's duties as a public health authority would also be regarded as a relevant consideration. However, given the fiduciary duty, it would not be lawful to have a completely blanket policy excluding certain investments unless it can be demonstrated that, following proper consideration, this would not compromise the investment performance of the fund. A policy that takes account of the ethical considerations in investment decisions whilst regarding financial benefit as the paramount concern would be in line with the Council's fiduciary duty.

EQUALITIES AND DIVERSITY

35 The implementation of a policy regarding stock prohibition on selective stocks will not require an equality analysis, as the initiative is not a major policy, project or function being created or changed.

OTHER IMPLICATIONS

36 There are no potential implications for council priorities and policy areas.

WHAT HAPPENS NEXT

37 The following next steps are planned:

- Pension Fund Board to decide on policy.

Contact Officer:
Phil Triggs, Strategic Finance Manager (Pension Fund and Treasury)

Consulted:
Pension Fund Board Chairman

Annexes:
None

Sources/background papers:
None
