Mercer

Surrey Pension Fund

Improving Alignment with the UN SDGs

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Sam Wreford & Steve Turner

welcome to brighter

Executive Summary

The key considerations for the Fund's index tracking equity portfolio are set out below. In this presentation we have outlined our recommendations as to how these can be achieved by using the LGIM Future World Index suite of funds across both developed and emerging market equities.

Cost	ESG	Climate Change	Performance
£300k+ p.a. fee saving	Improved ESG integration and UN SDG alignment	40% - 65% reduction in carbon footprint	No impact on expected return

If the Committee are in agreement to the proposals, the next step will be to liaise with LGIM regarding the transition of assets and other implementation considerations such as currency hedging

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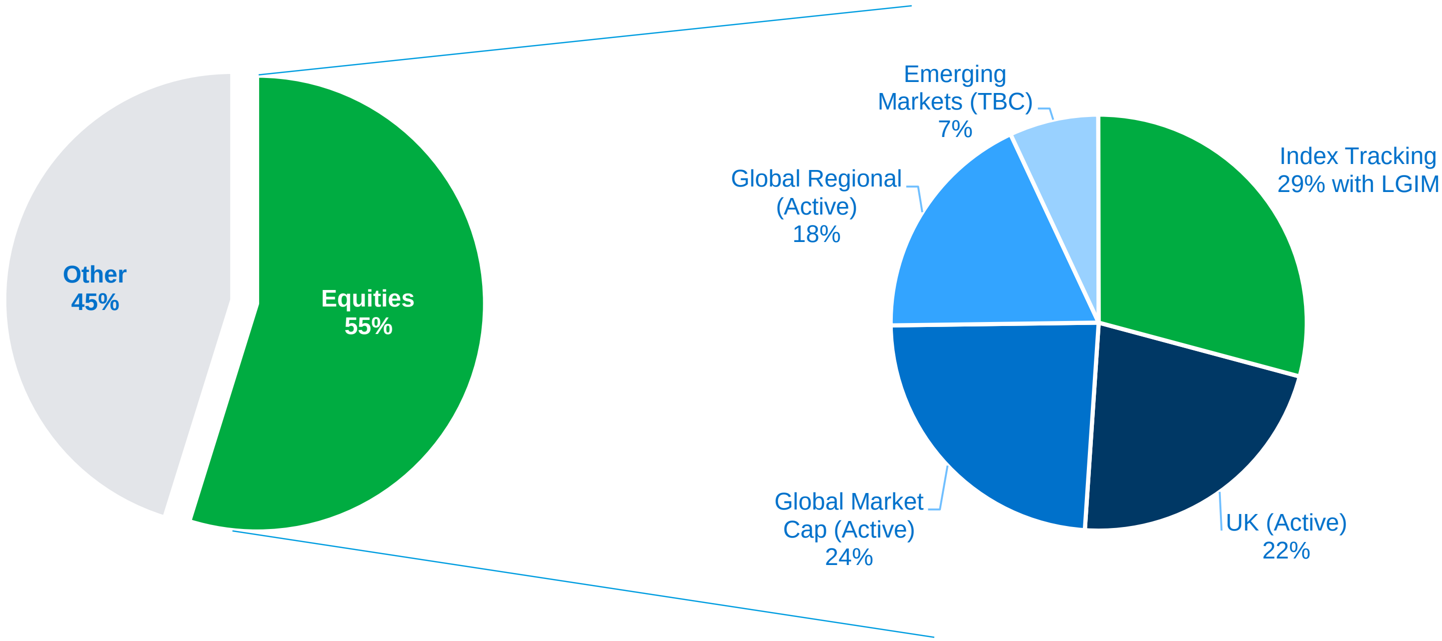
Current Portfolio Summary and Key Considerations

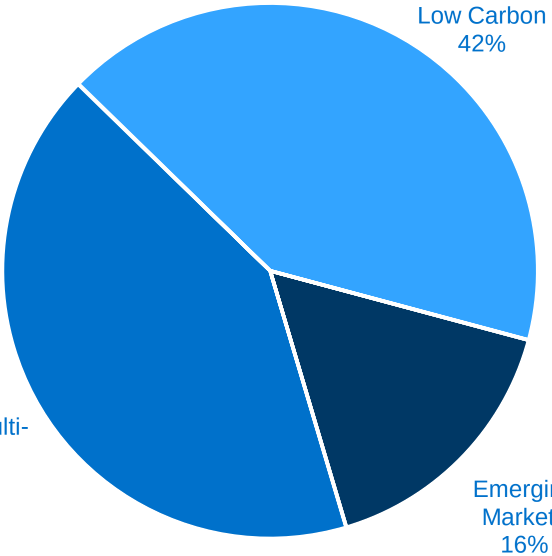
Equity Portfolio Summary

- The equity portfolio is in the process of being migrated to a new long term target, but timings are dependent on Border to Coast's launch of the Regional Equity fund.



The focus of today's discussion is on the index tracking portfolio managed by Legal & General Investment Management ("LGIM")

Current Target Index Tracking Portfolio



- The current index tracking portfolio makes use of three funds which have evolved over time. At a high level, the rationale for each fund is as follows:

  1. The Low Carbon Fund aims to reflect a lower carbon exposure than that of the broad market by overweighting companies with low carbon emissions (relative to sales) and those with low potential carbon emissions (per dollar of market capitalisation). The index is designed to achieve a relatively low (+/-0.3% p.a.) tracking error target while minimizing the carbon exposure.

  2. The RAFI Fundamental Index is a non-price-weighted index strategy that aims to deliver excess returns versus the market cap-weighted benchmark. The primary objective is to use fundamental measures of company size to sever the link between price and market capitalisation.

  3. The Emerging Market allocation has historically been used in order to gain exposure to developing countries such as China, which we would expect to outperform more developed markets over the long term. In general, we have a preference for actively managed emerging markets exposure, but suggest maintaining the passive allocation until further details of the Border to Coast regional equity fund are known (which could include Emerging Markets).

Considerations for the Index Tracking Portfolio

Cost

The Total Expense Ratio (“TER”) captures both the manager’s fee and any other underlying fund charges. For index-tracking strategies, cost is a key consideration.

ESG

Environmental, Social and Governance factors are key, as the Fund retains the implementation decisions for the index-tracking portfolio. The allocation therefore needs to remain in line with the Investment Strategy Statement (“ISS”), particularly in relation to the UN Sustainable Development Goals (“UN SDGs”).

Climate Change and Carbon Exposure

Climate Change is included within Environmental factors, but given it is a systemic risk, the Committee have historically given specific consideration to carbon exposure as reflected in the existing Low Carbon fund. Reducing such exposure within the equity portfolio is therefore a key consideration.

The Committee should also ensure that any changes to the structure of the equity portfolio can be completed without reducing long term expected returns and maintaining diversification

Analysis of Current Equity Portfolio

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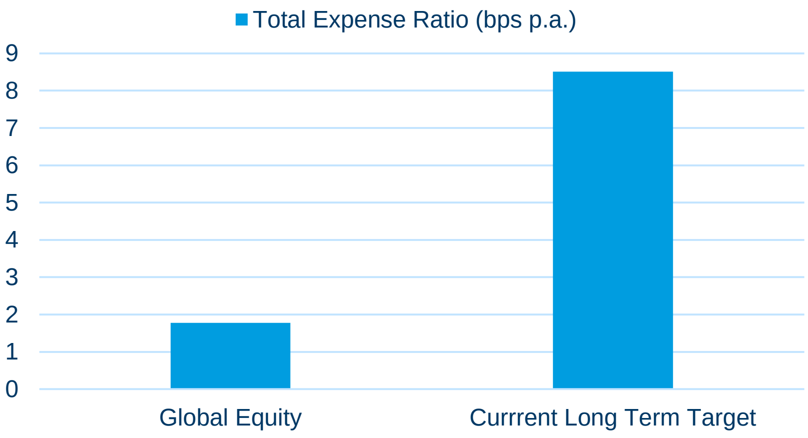
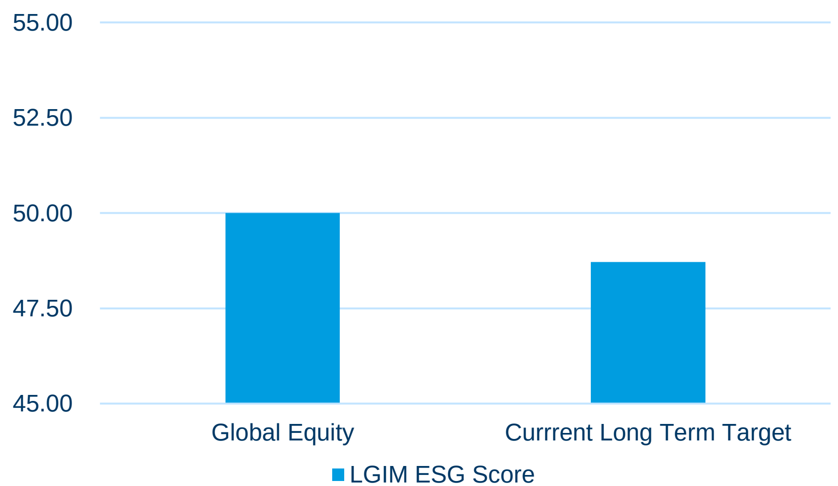
Current Equity Portfolio – Fees and ESG

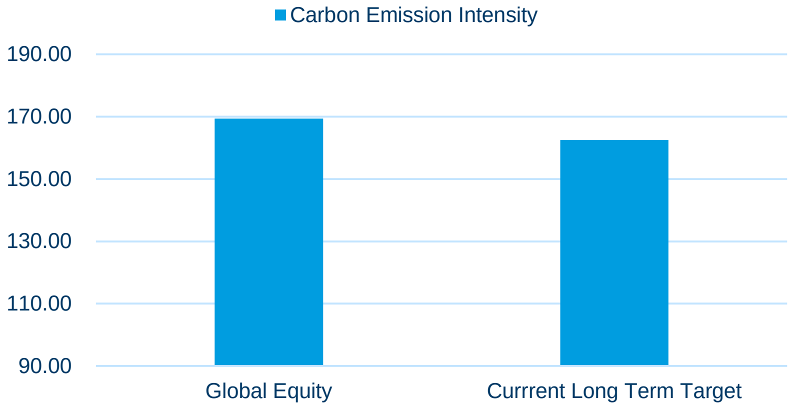


- The Fund's fees are very competitive compared to what we see for similar sized mandates elsewhere.
- However, the overall cost of the index tracking portfolio is higher than an allocation to the simple market cap index. This is to be expected, given that both the Low Carbon and RAFI strategies are more complex in their index construction.

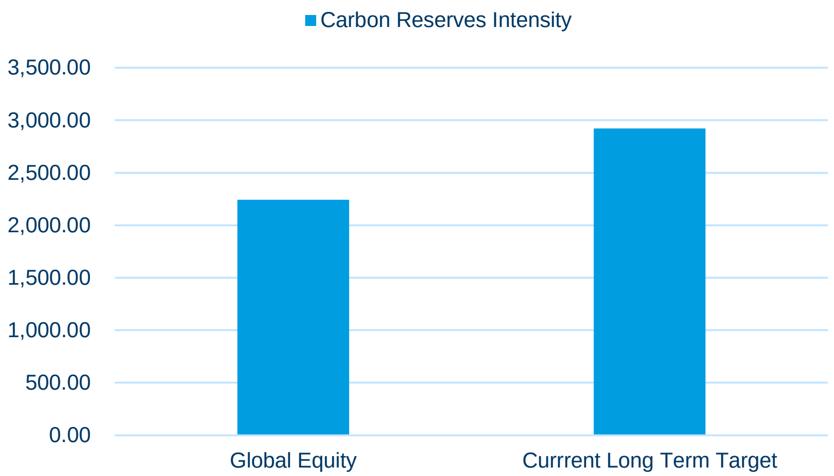
- LGIM apply a proprietary scoring approach to each company within their portfolios and for each of Environmental, Social and Governance factors. Although the Low Carbon Index is slightly higher than the broad index, both the RAFI and Emerging Markets funds have a lower ESG score.



Current Equity Portfolio – Climate Risks



- The significant reduction in both Carbon Intensity and Carbon Reserves that the Low Carbon fund currently contributes to the portfolio is offset by the fact that both the Multi-Factor (RAFI) fund and Emerging Markets allocation have higher carbon exposure that the broad market index.



- In order to remain comfortable with both allocations, the Committee would need to be sure that the funds add value to the portfolio in terms of return expectation and/or risk reduction through diversification.
- If not, there are alternatives strategies that could be considered.

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Current Equity Portfolio – Return and Diversification

	FTSE All World	RAFI Multi-Factor Developed Index GBP	MSCI World Low Carbon Target Index GBP	FTSE World Emerging Markets
1 Yr Return	39.5%	38.6%	38.5%	40.5%
3 Yr Return (p.a.)	13.1%	10.4%	13.7%	7.4%

- It is important to note that the Low Carbon Target Index fund does not have an explicit target to outperform the broad index. It specifically aims to track the broad market within a +/-0.3% p.a. tracking error, whilst minimising the carbon footprint.
- The emerging markets exposure would be expected to outperform the broad market over the long term, but it is normal to expect higher volatility over shorter time periods.
- The RAFI allocation was originally introduced prior to the investments with Border to Coast and was specifically intended to provide a more diverse exposure to various risk factors than a pure market cap weighted passive fund. At that point, the active management was concentrated in four managers. Given that the Global Alpha and UK Alpha funds at Border to Coast have been constructed using a number of managers that provide complementary investment styles, we believe that the diversification that the RAFI allocation provided previously has reduced in magnitude.
    - Performance has lagged the broad market during the Covid crisis in particular, as large, growth oriented companies have typically outperformed more established names due in part to the acceleration of various themes, particularly in the technology sector. If the value style was to perform well then the new structure may well underperform the current portfolio. However, it is important to bear in mind that the Border to Coast portfolios do have material exposure to value and it is more difficult to achieve such exposure without negatively impacting the carbon footprint.

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Proposed Equity Portfolio - Objectives

Cost
The Committee should look to invest in strategies that minimise cost, whilst not compromising on investment returns or risk management.

ESG
A focus on broader ESG issues, with an eye on the UN SDGs is required in order to remain / enhance alignment with the ISS.

Climate Change and Carbon Exposure
Where possible within the confines of the agreed investment strategy, opportunities should be taken to lower the carbon footprint of the index tracking equity portfolio.

Expected Return
Any changes will need to be consistent with the assumptions in the Actuarial Valuation, and in particular should not reduce the level of expected return.

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LGIM Future World Index

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Proposed Equity Portfolio – LGIM Future World

- The LGIM Future World Index funds apply an ESG tilt which aims to increase exposure to companies that are better positioned from an ESG perspective, and reduce exposure to companies with poor ESG practices.
- This is achieved by scoring each company on each of the 28 indicators on the next slide. These indicators are grouped into the seven themes under the four pillars and weighted based on the views by LGIM's Corporate Governance team on the relative importance of each theme. The scores for each pillar are then weighted and used to calculate an overall ESG score for a company, ranging from 0 – 100.
- LGIM has partnered with Solactive in designing the index. A key advantage for LGIM to use Solactive was that they pay a fixed fee, and no licensing fee, compared to other third party index providers where fees are based on asset levels (including RAFI). The index is constructed using a 'power' tilt approach, where each company's weight is tilted according to its ESG score and its initial index weight. Constraints are applied to limit the increase of any individual security's weight, and on the maximum and minimum sector differences versus the initial index, in order to ensure that diversification is maintained.
- Overall, we believe LGIM's approach to self-indexation is insightful and the intention to clearly link these ratings to their voting and engagement program can create an effective stewardship tool. In our view, LGIM continues to lead amongst passive managers on the work it has done around its active stewardship program, as reflected in the fact that they have Mercer's highest ESG rating (ESGp1).
- *Note: the pace of development of equity indices targeting broad ESG and Climate Change related risks has been repaid in recent periods, which is likely to continue. As such, market developments in this area should be periodically monitored to assess broad fit with the Fund's overall investment objectives.*

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LGIM Future World – Scoring Indicators

Indicators	Theme	Pillar
Emissions intensity score (Sector) Reserves intensity score Climate revenues	Environmental	Environmental
Females on board (%) Women in workforce (%) Women in management (%) Female executives (%)	Social: Diversity	Social
Bribery and corruption policy-raw Freedom of association Discrimination policy-raw score Scope of social supplier Employee incidents-raw score Business ethics incidents-raw Social supply chain incidents	Social: Human Capital	Social
Float percent Equal voting rights	Investor Rights	Governance
CEO-chairman separation Independent board members Average board tenure	Board Diversity	Governance
Non-audit to audit fees ratio Audit committee expertise Income statement auditor	Audit Flags	Governance
ESG reporting standard Verification of ESG reporting CDP participation Tax disclosure Director disclosure Remuneration disclosure	Disclosure	Transparency

LGIM Future World – Portfolio Management

Enforce	*Enhance*		*Engage*
1. Create universe	**2. Apply ESG score**	**3. Construct index**	**4. Engage**
LGIM Protection list	**LGIM corporate governance team**	**Bespoke index design with Solactive**	**Active ownership & climate impact pledge**

1. Create universe – LGIM Protection list

- **Pure coal miners**
- **Manufacturers of controversial weapons**
- **Companies in perennial breach of the UN Global Compact**

2. Apply ESG score – LGIM corporate governance team

4 independent raw data providers

28 ESG data points across**:**

Environment - focused on climate change

Social - focused on diversity, human capital and ethics

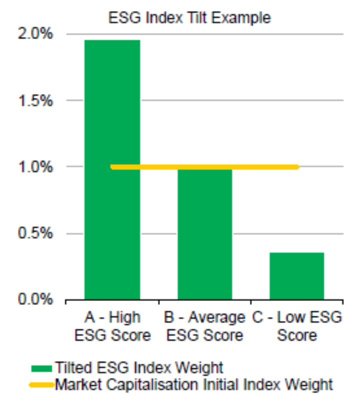
Governance - focused on shareholder rights and good governance

Transparency - Quality of company disclosures

C13,000 companies scored internally

3. Construct index – Bespoke index design with Solactive

Using overall ESG score, **tilt** company capital allocation within index



4. Engage – Active ownership & climate impact pledge

Active ownership

Key differentiator for LGIM, engage and influence through stewardship. Escalate appropriately when required

LGIM Climate Impact Pledge

- to **encourage** strong governance and sustainable strategies
- to **divest** from those who fail to meet minimum standards

Source: LGIM

Engagement with consequences – LGIM can divest

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Linking the strategy to the SDGs

- These linkages are subjective based on Mercer views. The Future World Index fund series is not specifically designed with the UN SDG's in mind, but provides better overall alignment relative to the current position, in our view.

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Females on board (%)
Women in workforce (%)
Women in management (%)
Female executives (%)
Equal voting rights

Emissions intensity score (Sector)
Reserves intensity score
Climate revenues

ESG reporting standard
Verification of ESG reporting

Bribery and corruption policy-raw
Freedom of association
Discrimination policy-raw score
Scope of social supplier
Employee incidents-raw score
Business ethics incidents-raw
Social supply chain incidents
Independent board members
CEO-chairman separation

Provides broader exposure to the UN SDGs than the pure Low Carbon portfolio and RAFI

Proposed Changes

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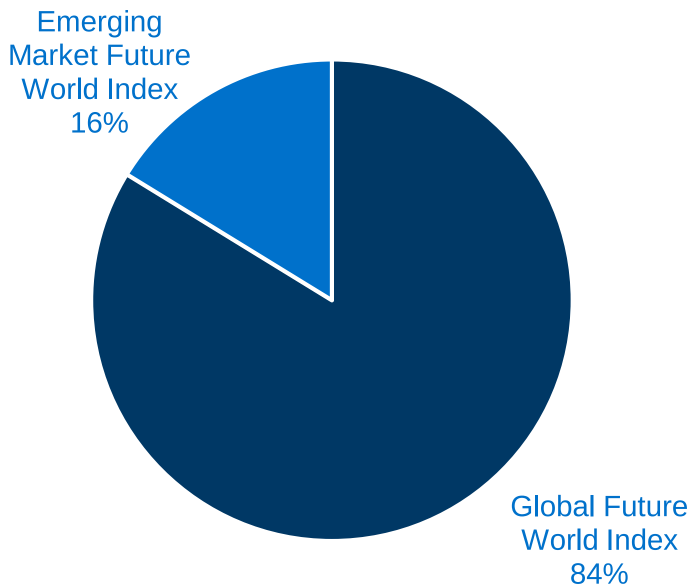
Proposed Index Tracking Equity Portfolio



- On balance, we are happy to support the termination of the RAFI Multi Factor Index fund for two key reasons:

    1. The broader and more diverse active equity portfolio managed by Border to Coast since the initial investment.

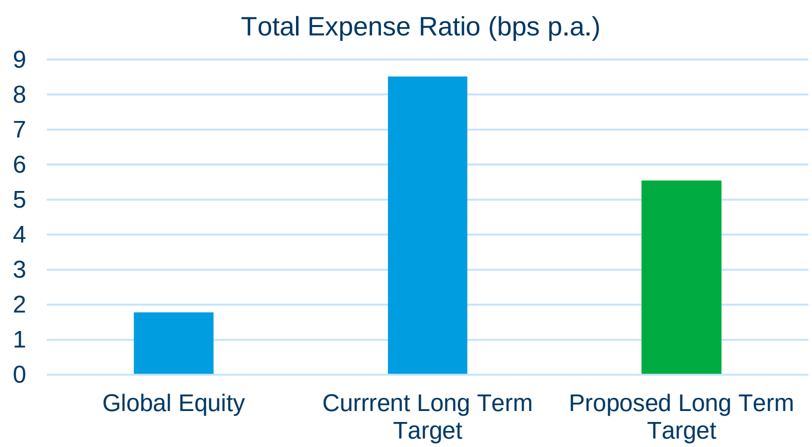
    2. The relatively high costs of the strategy, given the second layer of fees to RAFI.

- In addition, we believe that the Future World Index suite of funds (both emerging market and developed) provides exposure to a broader range of ESG factors which are more aligned with the UN SDGs than the Low Carbon Index fund (and RAFI).

- This, in combination with a very competitive TER of less than 5 bps p.a. means that we view the Future World Index suite is a stronger fit for the Fund's objectives, whilst saving c. £300k p.a. in cost.

- It is important to be aware that the transaction costs of making the changes is estimated to be c. £600k (5.5 bps). This is much lower than would be expected for a full sale and repurchase as LGIM will be able to complete the majority of the transfer in specie.

Current Equity Portfolio – Fees and ESG



35% reduction in TER

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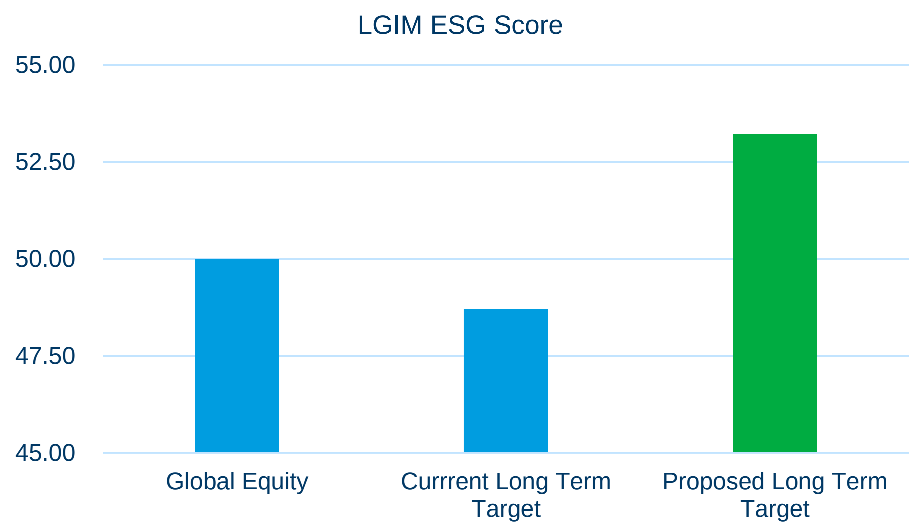
Meaningful improvement in ESG score



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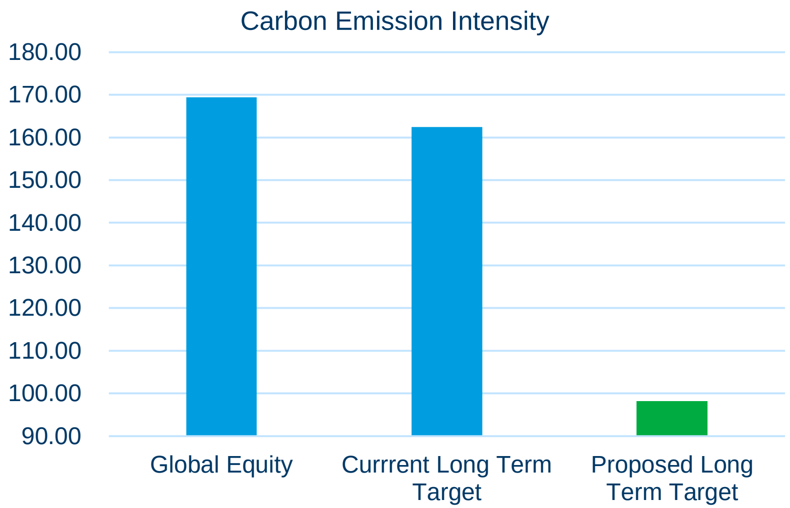
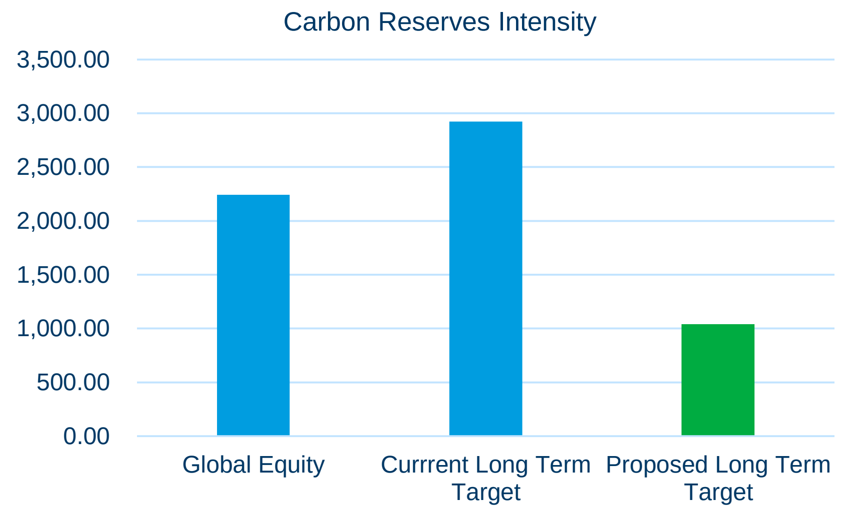
Current Equity Portfolio – Climate Risks



40% reduction in emissions intensity

65% reduction in carbon reserves intensity



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Summary and Next Steps

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