Merton Pension Fund

Investment Strategy Statement

November 2020

Investment Strategy Statement

London Borough of Merton

Administering Authority for the London Borough of Merton Pension Fund

1. Statutory Requirement for an Investment Strategy Statement (ISS)

The Public Service Pensions Act 2013 (The Act) enables the Secretary of State to make regulations creating schemes of pensions for, amongst others, local government workers.

In England and Wales, such a scheme was created by the Local Government Pension Scheme Regulations 2013 (The Regulations). These Regulations were made by the Secretary of State exercising powers in the Superannuation Act 1972.

Under powers contained in The Act and The Regulations, the Secretary of State made the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016, which replace the 2009 Investment Regulations. These regulations came into force on 1st November 2016. Regulation 7(1) requires administering authorities to formulate an investment strategy statement (ISS) which must be in accordance with guidance issued by the Secretary of State.

The Investment Strategy Statement (ISS) is a document that replaces, and largely replicates, the Statement of Investment Principles under the proposed Investment Regulations. Administering Authorities will be required to prepare and maintain an ISS documenting how the investment strategy for the Fund is determined and implemented. The ISS will be required to cover a number of areas, specifically:

(a) A requirement to invest money in a wide variety of investments;
(b) The authority's assessment of the suitability of particular investments and types of investments;
(c) The authority's approach to risk, including the ways in which risks are to be measured and managed;
(d) The authority's approach to pooling investments, including the use of collective investment vehicles and shared services
(e) The authority's approach on how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and
(f) The authority's policy on the exercise of rights (including voting rights) attaching to investments.

The ISS must also set out the maximum percentage of the total value of all investments that it will invest in particular investments or classes of investments. This, in effect replaces Schedule 1 of the 2009 Regulations.

In maintaining the Statement, the Panel have obtained and considered advice from a suitably qualified individual, employed by their investment consultants, Mercer, whom they believe to have a degree of knowledge and experience that, is appropriate for the management of their investments.

The Panel will review the Statement at least every three years and as required with any material changes, which is more regularly than the Regulations require, but deemed appropriate.

The ISS should be read in conjunction with the following statutory documents:

- Funding Strategy Statement
- Governance Policy and Compliance Statement
- Communications Policy Statement
- The Pension Fund Annual Report and Accounts
- Actuarial Valuation

Background to the Fund

The Fund is part of the national Local Government Pension Scheme (LGPS). The LGPS was set up by the UK Government to provide retirement and death benefits for local government employees, and those employed in similar or related bodies, across the whole of the UK. The Administering Authority runs the London Borough of Merton Pension Fund, and has delegated responsibility for managing the Fund to the Pension Fund Advisory Panel (the Panel). The purpose of the Merton Fund is:

- To collect monies in respect of employee and employer contributions, transfer values and investment income.
- To accumulate and invest money received, and facilitate the management of this.
- To facilitate payment of Local Government Pension Scheme (LGPS) benefits, transfer values, costs, charges and expenses.

Primary Objective

The objectives of the Fund are as follows:

- To ensure that sufficient financial resources are available to meet all accrued Local Government Pension Scheme liabilities as they fall due.
- To ensure effective and efficient management of employer's liabilities.
- To allow the return from investments to be maximised within reasonable risk parameters.
- To enable employer contribution rates to be kept as nearly constant as possible, at reasonable cost to taxpayers, scheduled and admitted bodies.
- To ensure that the Panel's Sustainable Investment Beliefs issues are implemented.

These overall objectives are supplemented by the funding and investment objectives which are detailed in this document.

2. London Borough of Merton Pension Fund's Investment Strategy

The following sections details the Fund's investment strategy, which takes into account Regulation 7(2) (a), 7(2) (b) and 7(2) (c); listed below.

Investment of money in a wide variety of investments

Regulation 7(2) (a) requires that administering authorities invest in a diversified portfolio of assets to ensure that risk is appropriately managed and volatility of overall return is reduced. The guidance that accompanies the regulations does not prescribe the specific asset classes over which Fund monies must be invested.

Suitability of particular investments and types of investments

Regulation 7(2) (b) requires that in assessing the strategic allocation for the Fund, an administering authority assesses the suitability of particular investments and types of investments against the need to meet pension obligations as they fall due.

Objectives of the investment strategy

The Fund's investment objective is to achieve full financing of pension liabilities at least cost over time. The objective requires that the return on the investment of the assets of the Fund are maximised, but since investment performance can be variable, and its fluctuations affect actuarial results, the objective has to be tempered by seeking its achievement via reasonably stable performance and tolerable risks.

Within this, the fundamental objectives of the Fund's investment are:

- To maximise the return on the Fund's investments and achieve the investment return assumed in the Scheme's actuarial review.
- To achieve the required investment return through reasonably stable performance obtained at modest risk.
- To achieve the investment objective in compliance with Sustainable Investment Beliefs and the Panel's ESG policies, including consideration of climate change issues across the Fund in order to minimise financial risk and maximise long-term performance.

Since the investment return assumed in actuarial reviews is an assessment of returns over the long term, and in the short term returns may exceed or fall short of this, the Fund will consult its advisors to determine appropriate short-term targets that reflect and contribute to the longer-term objective.

The Fund's overall investment objective relates to its actuarial need, and whilst subsidiary, interim, performance objectives/targets based on market and peer group benchmarks may be used for performance evaluation, these do not represent the fundamental performance objective.

The Fund will establish practical, subsidiary, objectives for any sub-funds into which particular investment categories may be placed for practical purposes; having considered appropriate professional advice.

Funding strategy

In formulating the investment Strategy the Fund must first consider its funding strategy.

The Fund's funding strategy seeks to achieve (via employee and employer contributions and investment income) two objectives, and these are detailed in the Funding Strategy Statement:

- A funding level of 100%, as assessed by the Fund's appointed actuary, triennially, in accordance with the LGPS regulations.
- As stable an employer contribution rate as is practical.

In the opinion of the Fund actuary, the current funding strategy is consistent with the investment strategy of the Fund. The asset outperformance assumption contained in the discount rate is within a range that would be considered acceptable for funding purposes; it is also considered to be consistent with the requirement to take a "prudent longer-term view" of the funding of liabilities as required by the UK Government.

However, in the short term – such as the three yearly assessments at formal valuations – there is the scope for considerable volatility and there is a material chance that in the short-term and even medium term, asset returns will fall short of this target.

Setting the investment strategy

The suitability of the Investment Strategy is determined by its ability to invest in assets to target a minimum rate of return consistent with the annual growth in liabilities assumed in the actuarial valuation as at 31 March 2019 (the discount rate to value the liabilities was 4.8%), with the weighting between constituent asset classes determined to reduce the expected volatility of the funding level going forward.

The Panel has determined its investment strategy after considering the Fund's liability profile and requirements of the Statutory Funding Objective, their own appetite for risk, the views of the Employers on investment strategy, the Employers' appetite for risk and it's Sustainable Investment Beliefs. The Panel have also received written advice from their Investment Consultant – Mercer.

Against these strategic targets, the Panel regularly reviews its Investment Strategy and in doing so considers the risk/return characteristics of each asset class and sub-asset class in this assessment. The Merton Pension Fund considers the mix of asset classes by scenario modelling and forming an overall portfolio and considers the correlation in volatility and return of each, including key impacts risk such as climate change.

The basis of the Panel's strategy is to divide the Fund's assets between a "growth" portfolio, comprising assets such as equities, diversified growth funds (DGFs), alternatives and property, and a "stabilising" portfolio, comprising assets such as bonds. The growth/stabilising allocation is set with regard to the overall expected return objective of the Fund's assets, which is determined by the funding objective and current funding level, as well as the risk tolerance.

The Panel recognise the benefits of diversification across asset classes, as well as within them, in reducing the risk that results from investing in any one particular market. Where they consider it advisable to do so, the Panel have appointed investment managers and more recently the London CIV

to select and manage the allocations across asset classes, in particular where it would not be practical (or appropriate) for the Panel to commit the resources necessary to make these decisions themselves.

In assessing the suitability of investments required to form the overall portfolio the Merton Fund considers a number of characteristics of each asset class, and sub asset class. These characteristics include potential return, risk/volatility of returns, liquidity and ESG characteristics. In setting and reviewing an overall investment strategy for the Merton Fund the starting point is always the Actuary's assessment of the liabilities of the Fund. This assessment will include cash flow requirements and an assessment of the required return to ensure the long term solvency of the Fund, and it is essential that the investment strategy is compatible with this.

Investment decisions

The Panel distinguish between three types of investment decision: strategic, tactical and stock-level.

Strategic investment decisions

These decisions are long-term in nature and are driven by an understanding of the objectives, needs and liabilities of the Fund.

The Panel takes all such decisions themselves. They do so after receiving written advice from their officers and investment adviser. Examples of such decisions and of tasks relating to the implementation of these decisions include the following:

- Setting investment objectives
- Determining the split between the growth and the stabilising portfolios
- Determining the allocation to asset classes within the growth and stabilising portfolios
- Determining the Plan benchmark
- Reviewing the investment objectives and strategic asset allocation
- Consider Sustainable Investment Beliefs in order to minimise financial risk and maximise long-term opportunities across all asset classes.

Tactical investment decision

These decisions are short-term and based on expectations of near-term market movements. Such decisions may involve deviating temporarily from the strategic asset allocation and may require the timing of entry into, or exit from, an investment market or asset class.

These decisions are the responsibility of the Officers and the London CIV. However, where such decisions are made within a pooled fund; they are the responsibility of the investment manager of the fund.

Stock selection decisions

All such decisions are the responsibility of the Fund's investment managers with which the Fund invests.

Permitted assets

The Panel are permitted to invest across a wide range of asset classes, including, but not limited to, the following:

- UK and overseas equities
- UK and overseas government bonds, fixed and index-linked
- UK and overseas corporate bonds
- Multi-asset credit (MAC)
- Convertible bonds
- Property
- Infrastructure
- Private equity
- Social impact funds
- Private credit
- High yield bonds
- Diversified growth funds
- Derivatives (for risk management purposes)
- Cash

The Fund currently invests in mainly pooled portfolios. In addition the Fund will normally hold a proportion of its monies in short-term bank deposits and money market funds to meet operational requirements.

Balance between different types of investments

The Regulations require the administering authority to have regard for the diversification of the Fund's investments.

The Fund will, at all times, invest across a diversified portfolio of investments to reduce investment risk. In addition to diversifying by assets, the Fund will invest across a number of managers and via different approaches and styles to investing.

The Fund may invest via pooled and segregated portfolios based on the appropriateness for each portfolio. The Fund can invest across a combination of passive, active and absolute return investment approaches based on return potential, cost and flexibility of implementation.

Asset Allocation and Long Term Expected Return on Investment

The Panel is responsible for setting the strategic asset allocation for the Fund which in turn must be consistent with the investment return assumed in the funding strategy.

The investment strategy reflects the medium to long term nature of the liabilities but must also provide flexibility to manage short term volatility in markets. In addition, the investment strategy must take account of possible changes to cash flows as the membership profile of the Fund or the benefits structure changes.

The investment strategy reflects the differing return and risk profiles of each asset class. However, long term risk and return expectations are not consistently generated over all time frames and, for all

asset classes, there can be periods of under- or out-performance compared to the long term expectations.

Current Strategic Benchmark

After the results of the 2019 Actuarial valuation were received, the Fund reviewed its overall asset allocation, with advice received from the Fund's Investment Consultant, Mercer. The results of this review were presented to the Panel in September 2020 and resulted in a revised Strategic Allocation which is shown in the table below. The revised strategy improves the potential return of the Fund's assets to a level higher than the Actuary's discount rate, and reduces the overall risk, when compared to the previous strategy.

The Fund's strategy, as set out below, does not assume any outperformance from the investment managers. The Minimum and Maximum range allowed acts as the Fund's own limit on its investment strategy, and ensures compliance with the guidance which requires this. The expected risks and returns stated in this table are as at the time of the 2020 strategic review.

Asset Class	Strategic Allocation	Range Allowed	Expected Return p.a.	Expected Risk (Volatility) p.a.
Growth Assets				
Developed Market Equity	30.0	15-40	4.9%	18.7%
Emerging Market Equity	10.0	0-20	7.8%	30.1%
Diversified Growth	8.0	0-15	4.3%	10.5%
Property	5.0	0-10	3.3%	14.5%
Infrastructure	11.5	0-20	4.6%	15.4%
Social Impact	5.0	0-10	7.4%	26.7%
Private Credit	6.5	0-10	3.8%	9.3%
Stabilising Assets (Cashflow Driven Investment Portfolio)				
Multi-Asset Credit	9.0	0-15	4.7%	8.2%
Cashflow Driven Investment	15.0	0-25	1.7%	3.4%
Risk Management Framework			0.0%	8.8%

Notes:

- Expected return and risk figures reflect the mean and standard deviation respectively of the 10-year return forecasts from Mercer's Asset Model as at the time of modelling (30 April 2020).
- Decarbonisation objective of the fund is considered across all asset classes, resulting in no-named allocation to low carbon assets at this level of taxonomy.

The inclusion of a diversified range of assets in the strategy is expected to reduce the overall volatility of returns without significantly altering the Fund's expected long term return. This was the case when modelling the revised investment strategy in 2020.

3. Approach to risk, including the ways in which risks are to be measured and managed

Regulation 7(2) (c) requires that funds describe their approach to risk within their investment portfolio, including summarising the key risks and detailing the approach to mitigate the risk (where possible or appropriate). It also requires that funds ensure that the approach is complicit with that in their Funding Strategy Statement.

Approach to risk

The Fund recognises that there are a number of risks that need to be factored into the Investment Strategy, and the expected estimates of volatility are reflected in the table above. The financial, demographic and regulatory risks are addressed in the Funding Strategy Statement, and so are not repeated here. This statement looks to address the financial risks for the Fund, in particular the risk of the performance of the Fund's assets not achieving the actuary's expected rate of return. The following paragraphs explain Merton's approach to addressing this risk.

Investing heavily in higher risk assets (e.g. equities) would be expected to increase the long term returns achievable from the assets, and thus to reduce the contributions required to Fund the liabilities over time. However, this type of strategy would be expected to lead to volatile short to medium term results, both in absolute terms and, particularly, relative to the Fund's liabilities.

Equally, whilst investing in lower risk assets (e.g., bonds) would be expected to reduce risk within the Fund (in terms of the volatility of returns, the Funding level and contribution rates), this may not be desirable as it would lead to a lower expected return and hence higher contribution rates over the long term.

In considering the Fund's investment strategy, one must therefore bear in mind this balance between risk and return. In practice, the investment strategy objective will be to achieve the highest possible return whilst minimising downside risk, within agreed parameters.

Investment, by its very nature, is a risk based activity where the returns achieved will reflect differing levels of risk. There are a number of investment risks to consider within an investment fund, a number of these are considered below:

Solvency risk and mismatching risk

- These are measured through a qualitative and quantitative assessment of the expected development of the assets relative to the liabilities.
- These are managed by setting a Fund-specific strategic asset allocation with an appropriate level of risk.

Manager risk including the London CIV

- This is assessed as the expected deviation of the prospective risk and return, as set out in the managers' objectives, relative to the investment policy.
- It is measured by monitoring the actual deviation of returns relative to the objective and factors supporting the managers' investment process, and by monitoring and replacing any managers where concerns exist over their continued ability to deliver the investment mandate.

- The aim of the investment strategy and management structure is to manage the appropriate level of risk for the return target which reflects the funding strategy. The Fund's external investment managers are required to invest in line with the investment guidelines set by the Fund. Independent custodians safe keep the assets on behalf of the Fund.

Liquidity risk

- This is monitored according to the level of cash flows required by the Fund over a specified period.
- It is managed by holding an appropriate amount of readily realisable investments. The Fund's assets are invested in pooled funds which are readily realisable. As a result the investments in less liquid asset classes such as property, hedge funds, private equity and infrastructure are limited.

Political risk

- This is measured by the level of concentration in any one market leading to the risk of adverse influence on investment values arising from political intervention.
- The Fund manages this by regular reviews of the investments and through investing in funds which give a wide degree of diversification.

Legislative risk

- This is the risk that legislative changes will require action from the Panel so as to comply with any such changes in legislation.
- The Panel acknowledge that this risk is unavoidable but will seek to address any required changes so as to comply with changes in legislation.

Market risk

- This is the risk the fair value of future cash flows of a financial instrument will fluctuate because of changes in market prices.
- The Fund seeks to manage this risk through the strategic policy which ensures diversification of investments across a range of asset classes and markets that have low correlations with each other and across a selection of managers.
- As most of the portfolio is exposed to market risk, the main risk to the Fund is a fall in market prices. Although market movements cannot be completely avoided, and indeed there are periods when all assets become more highly correlated, the impact can be mitigated through diversifying across asset classes and approaches to investing.
- Market risk comprises of the following three types of risk:

Currency risk

- This is the risk that occurs when the price of one currency moves relative to another (reference) currency. In this context, the Fund may be invested in overseas stocks or assets, which are either directly or indirectly linked to a currency other than Sterling. There is a risk that the price of that overseas currency will move in such a way that devalues that currency relative to Sterling, thus negatively impacting the overall investment return.

Interest rate risk

- This is the risk that an investment's value will change due to a change in the level of interest rates. This affects debt instruments more directly than growth instruments.

- The Panel acknowledge that the interest rate risk related to individual debt instruments is managed by the underlying investment managers through a combination of strategies, such as diversification, duration and yield curve management.

Inflation risk

- This is the risk that the value of the Fund's liabilities which are inextricably linked to Consumer Price Index (CPI) inflation, increase at greater rate than the assets.
- The Panel acknowledge that inflation risk relating to the Fund's liabilities is managed by the underlying investment managers through a combination of strategies, such as diversification, investing in assets that move in line with inflation, such as Infrastructure and Index Linked Gilts.

Counterparty and collateral adequacy risk

- Within the Risk Management Framework, investments in leveraged derivative-based instruments are exposed to counterparty and collateral adequacy risks.
- Counterparty risk relates to the risk that a counterparty is unable to honour its commitment at the maturity of a derivative contract, whilst collateral adequacy is the risk that underlying conditions negatively impact the Fund's investments to the extent that additional assets are needed to support the use of derivatives.
- Both of these risks are managed by the Fund's Risk Management Framework manager, in conjunction with monitoring by the Fund's Officers and Investment Consultant.

Environmental, Social and Governance ("ESG") risk

- The Panel recognises that ESG risks, including climate change, can have a financially material impact on the return of Fund's assets.
- Governance risk is assessed by reviewing the Fund's investment managers' policies regarding corporate governance.
- ESG risks are furthermore, barring decision taken by the Panel on strategic allocation and manager selection, managed by delegating the exercise of voting rights to the managers, who exercise this right in accordance with their published "Corporate Governance", "Stewardship", "Voting and Engagement" policies. Summaries of these policies are provided to the Panel from time to time and analysed by the Panel to ensure that policies are aligned with the Fund's beliefs and do not create financial or reputational risks.
- Climate change in particular will present material risk to the Fund, for example due to the materialisation of the transition risks and physical asset damages caused by more severe global warming scenarios.
- The approach to managing ESG related risks are further elaborated in Section 5.

Proper advice

In assessing the Fund's strategy, including an assessment of the implicit risks, and setting the maximum limits the London Borough of Merton has taken proper advice from Mercer (the Fund's Investment Consultant), with input from the Fund's Officers and Barnett Waddingham (the Fund's actuaries).

4. Approach to pooling

Regulation 7(2) (d) requires that all authorities commit to a suitable pool to achieve benefits of scale. It also requires that administering authorities confirm the chosen investment pool meets Government's investment reform criteria, or to the extent that it does not, that Government is content for it to continue.

Pool Characteristics

The Merton Fund has formally agreed to join the London Collective Investment Vehicle (CIV) as part of the Government's pooling agenda. The London CIV has been operational for some time and is in the process of opening a range of sub-funds covering liquid asset classes, with less liquid asset classes to follow.

(a) The Fund will transition liquid assets into the London CIV when there are suitable investment strategies that meet the asset allocation and investment strategy available on the London CIV platform.

(b) The Fund is monitoring developments and the opening of investment strategy fund openings on the London CIV platform with a view to transitioning liquid assets across to the London CIV as soon as there are suitable sub-funds to meet the Fund's investment strategy requirements.

The Fund holds assets in life funds. If in the future should it hold life funds within its strategy it intends to retain these outside of the London CIV in accordance with government guidance on the retention of life funds outside pools for the time being. The Fund agrees for the London CIV to monitor the passive funds as part of the broader pool.

The Fund holds some illiquid assets and these will remain outside of the London CIV pool. The cost of exiting these strategies early would have a negative financial impact on the Fund. These will be held as legacy assets until such time as they mature and proceeds re-invest through the pool assuming it has appropriate strategies available or until the Fund changes asset allocation and makes a decision to dis-invest.

The Merton Fund intends to invest most of its assets through the London CIV, however it is recognised that this will take a number of years before this can be fully implemented. The London CIV has a road-map for assets to move into the pool, and the Merton Fund intends to transition assets in line with this plan. The transition plan is shown below:

Indicative Sub-Funds Available on London CIV	2015	2016	2017	2018	2019	2020	2021	2022	2033
Global Equities (Active)	1	3	6	6	6	6	6	6	6
Global Equities (Passive)		4	5	4	3	3	3	3	3
UK Equities (Active)			2	2	2	2	2	2	2
UK Equities (Passive)		2	2	1	1	1	1	1	1
Multi Asset / DGFs		4	4	4	4	4	4	4	4
Fixed Interest & income/cashflow generating		1	3	4	5	5	5	5	5
Property				2	3	4	4	4	4
Alternative products				2	2	4	5	5	5
Private Equity					2	3	3	3	3
Real Assets				2	2	3	3	4	4
Infrastructure			1	2	2	3	4	5	6
Total Sub-Funds open	**1**	**14**	**23**	**29**	**32**	**38**	**40**	**42**	**43**

5. Responsible Investment Policy

Regulation 7(2)(e) requires administering authorities to demonstrate that it considers any factors that are financially material to the performance of the Fund's investments, including social, environmental and corporate governance factors, and over the long term, dependent on the time horizon over which their liabilities arise.

The Merton Pension Fund's Pensions Panel ("Panel") has a fiduciary duty to act in the best interest of its members. To do this effectively the Panel recognises the importance of managing Environmental, Social and Corporate Governance ("ESG") issues, including climate change, that are financially material to the Fund, both in terms of opportunities and risks. What is more, there is a growing urgency with respect to long-term sustainability issues, particularly climate change. Therefore, it is imperative that ESG considerations and active ownership are integrated throughout investment processes and that they are taken into account as part of funding and investment strategy setting.

The Fund has made significant progress over the last 24 months in evolving its policies on Responsible Investment and climate change. We are continuing to focus on this as a key area for the Fund and aspire to be at the forefront of responsible investment practice. As part of this, the Panel has revisited its beliefs, updated its policies and processes, and is committed to increasing its allocation to sustainable and low carbon assets. The Panel recognises that ESG and stewardship are rapidly developing topics and will continue to develop its understanding, approaches, and ambition in these areas.

Sustainable Investment beliefs

The Panel holds the following Responsible Investment beliefs.

Responsible and sustainable investors	We believe that in the long term we will generate better financial returns and advantage to members**, as well as the broad society by investing in companies and assets that demonstrate they contribute to the long-term sustainable success of the global economy and society. Also known as ESG issues, these issues should therefore be considered throughout the Fund's investment process.**
Long time horizon	We are investors with a long time horizon. This requires us to consider long-term sustainability issues, both in terms of opportunities and risks, as relevant to the Fund and its investment strategy.
Stewardship	Good stewardship and governance enhances long-term portfolio performance and guards the Fund's reputation and is therefore in the best interests of its members. Robust voting and engagement forms an integral part of the Fund's beliefs and it expects its asset managers to hold stewardship in as high regard.

Climate change as a systemic and an investment risk	Climate change presents a systemic and material risk to the ecological, societal and financial stability of every economy and country on the planet, and therefore will impact our beneficiaries, employers and our investment portfolio.
The Paris Agreement and zero carbon	Investing to support the Paris Agreement goals that keep a global temperature rise this century to well below 2°C relative to pre-industrial levels, is entirely consistent with securing long-term financial returns and is aligned with the best long-term interests of our beneficiaries, employers and our portfolio holdings. In alignment with the Paris Agreement the Fund has set itself a zero carbon 2050 target and is decarbonising its portfolio accordingly.
Social Impact	To the extent possible, the Fund avoids investments in regions, countries and companies that have embargoes or sanctions in relation to poor human rights records and/or links with terrorist organisations.

Duties towards Stakeholders

The Panel believes it has ethical and social responsibilities to three key stakeholder groups: Members, Residents and Society. The following sections outline its responsibilities with respect to each stakeholder group.

Duties to Members

- The Panel's primary, statutory responsibility for the Fund is fiduciary; that is, to ensure that the Fund's investments produce the required return to meet members' benefits, within the confines of the target risk budget.
- Given the Panel believes that good stewardship can enhance long-term portfolio performance, and is therefore in the best interests of its members that the Fund follows the best practice in stewardship (voting and engagement).
- Given the Panel believes that ESG metrics are considered important factors for the sustainability of investment returns over the long term ESG is therefore a primary consideration in fulling Fund's duties to its members.

Duties to Residents

- The Panel believes it has a duty towards the residents of the London Borough of Merton.

Duties to Society

- The Panel believes it also has a duty towards the wider society in which it plays a part as an institutional investor. As such, the Fund takes into account material ESG considerations as they positive contribute to the wellbeing and prosperity of the Society.

The Fund aims to communicate using its website, newsletters, policy documents, Annual Report and proposed Annual General Meeting to engage directly with all stakeholders.

Financially material ESG considerations

The Panel believes that consideration of ESG metrics can enhance long-term and short term portfolio performance. The Fund expects its fund managers to consider and integrate material ESG factors within their investment analysis and decision making to aid the selection, retention and realisation of investments.

The Fund expects its external investment managers (and specifically the London CIV through which the Fund will increasingly invest) to undertake appropriate monitoring of all investments with regard to its policies and practices on all issues, including ESG and climate change, which could present a material financial risk to the performance of the Fund. The Funds expects its managers to report to the Fund and proactively engage the Fund in conversation about ESG risk and opportunities.

Non-Financial ESG Considerations

The pursuit of a financial return is the predominant concern for the Fund to ensure the payment of all pensioners as they fall due. The Fund is aware it may also take non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the Fund and where they have good reason to think stakeholders would support the decision.

When formulating and developing any policy on non-financial ESG factors, the Panel will take proper advice from either its Investment Consultant or other appropriate expertise in this area and ensure the Local Pension Board and other stakeholder views are considered through the use of specific Board reports and consultations. Any policies once developed would be available on the Fund's website.

Social impact investments

According to statutory guidance published by MHCLG in July 2017 in preparing and maintaining their Investment Strategy Statement (ISS) administering authorities should explain their approach to social investments.

The Government Impact Investment Implementation Taskforce Final Report "Growing culture of social impact investing in the UK, 2019[1]" addresses the issue of 'social impact investments'; meaning those that deliver a social impact as well as a financial return. Furthermore, the Government considers that social investments are encouraged and appropriate for investors such as LGPS funds even if some part of the financial return is forgone in order to generate the social impact, where the administering authorities have good reason to think scheme members share the concern for social impact, and there is no risk of significant financial detriment to the fund.

To date the Fund has not made any social impact investments but aims to invest c.5% of total Fund assets in such investments over the next 3-5 years.

[1] https://www.gov.uk/government/publications/growing-a-culture-of-social-impact-investing-in-the-uk

Climate Change Risks and Opportunities – investment objective settings:

Long term commitment:

The Panel recognises the commitments made by countries, regions, organisations and local authorities such as the London Borough of Merton in relation to climate change. Merton Council declared climate emergency in 2019 and set a carbon reduction target to make Merton carbon neutral by 2050. Consistent with this, the Fund commits to actively decarbonise its investments so that its investment portfolio reaches net zero carbon by 2050.

The Fund sets the base year of portfolio carbon measurement to 2018, where applicable[2], and sets itself first two intermediary target setting horizon[3], as follows:

- Short term 2018-2022
- Medium term 2023-2027

Our short term climate change commitments:

For the **short term 2018-2022** the Fund sets the following decarbonisation targets and commitments:

1) To monitor and guide decarbonisation and allocations to sustainable opportunities, the Fund will adopt TCFD supplemental guidance for asset owners.

2) Reducing exposure to carbon intensive companies as measured by Weighted Average Carbon Intensity[4], an indicator of current climate-related risks, to begin with in the equity allocation by **40%** compared to the base year of 2018

3) Reducing potential emissions as measured by a fossil fuel reserve[5], an indicator of emissions that could be generated if fossil fuel reserves owned by the companies in the Fund were burned, in the public equity allocation compared to the base year of 2018 by **50%**.

4) Investing at least **7%** of Fund's portfolio in sustainable opportunities[6] .

5) In alignment with TCFD recommendations the Fund will form a view on decarbonisation of all assets classes beyond public equities and will develop mechanisms to evaluate progress.

6) Given the fast developing climate investment landscape both in terms of opportunities and methodologies in measuring and monitoring progress the Fund expects to continuously review the appropriateness of the targets and the now set measures with view of making them more informative, comprehensive and ambitious. The Fund will set new targets for the "Medium term 2023-2027" by the end of this target setting period.

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[2] The Fund begin to track the Weighted Average Carbon Intensity performance of its public equity investments in 2018

[3] Immediate Term & Medium Term periods also align with the 3rd and 4th nationally legislated carbon budget periods (respectively) under the UK Climate Change Act (2008)

[4] Weighted Average Carbon Intensity (tons CO2e / $M sales). Calculated based on Scope 1 and 2 emissions. Will facilitate comparison with non-equity assets. FSB Taskforce for Climate-related Disclosures (TCFD) recommended metric for asset owners indicating portfolios exposure to carbon-intensive companies.

[5] Potential Emissions (MtCO2). The total potential carbon emissions of the coal, oil, gas and unconventional oil & gas reserves owned by a company.

[6] Current definition: equity investment that has focus on sustainability as a way to generate investment ideas. Does not include low carbon strategies focussed on carbon risk reduction.

6. Policy on exercising voting rights

Regulation 7(2) (f) requires administering authorities to explain their policy on exercising rights (including voting rights) attaching to investments. The guidance refers to the Financial Reporting Council's UK Stewardship Code and requires that funds explain, where appropriate their policy on stewardship with reference to the Stewardship Code.

The Fund recognises the importance of its role as stewards of capital and the need to ensure the highest standards of governance and promoting corporate responsibility in the underlying companies in which its investments reside. The Fund recognises that ultimately this protects the financial interests of the Fund and its ultimate beneficiaries. The Fund has a commitment to actively exercising the ownership rights attached to its investments reflecting the Fund's conviction that responsible asset owners should maintain oversight of the companies in which it ultimately invests recognising that the companies' activities impact upon not only their customers and clients, but more widely upon their employees and other stakeholders and also wider society.

Stewardship policy

Stewardship (voting and engagement) is delegated to LCIV and the investment manager on a discretionary basis, subject to the investment manager being guided by the UK Corporate Governance Code appended to the Stock Exchange Listing Rules and to be signatories of the UK Stewardship Code. In addition the Fund is a member of the Local Authority Pension Fund Forum, a collaborative body which exists to serve the investment interests of local authority pension funds.

In the case of pooled investments, the fund manager will act within the terms of the relevant pooled fund agreement. Where required, voting on high profile or contentious issues should be explained to the Panel by investment managers at meetings of the full Panel. This will serve to strengthen the Fund's compliance with the UK Stewardship Code with regard to monitoring and disclosure of voting activity. The Fund also expect to on periodic basis learn how investment managers in positive and productive manner engagement investee companies on the Fund's behalf.

The Panel will review stewardship issues in respect of pooled funds and consider and take action as appropriate. For operational purposes, investment managers will work within their own internal operational and policy guidelines, which are to be explained to and agreed with the Panel.

The Fund's investments through the London CIV are covered by their Stewardship related policies which has been agreed by the Pensions Sectoral Joint Panel. When it comes voting, it is delegated to the external managers and monitored on a quarterly basis. The CIV will arrange for managers to vote in accordance with voting alerts issued by the Local Authority Pension Fund Forum as far as practically possible to do so and will hold managers to account where they have not voted in accordance with the LAPFF directions.

The Panel may (should it consider it appropriate to act independently of investment managers) appoint a corporate governance, proxy voting, and/or engagement manager(s) to provide voting and engagement services to it.

Furthermore when it comes to climate change action, the Fund expects its investment managers to be active climate stewards of the Fund's capital. This includes participating in joint collaborative engagement action with other institutional investors to advance low carbon transition. The Fund also

expects investment manager proxy voting activities to unequivocally support low carbon transition. The Fund will monitor its managers voting and engagement activities.

UK Stewardship Code

In late 2019, the Financial Reporting Council ("FRC") published its revised 2020 UK Stewardship Code ("2020 Code"). The latest Code defines stewardship as *"the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society."*

The Code sets out a number of areas of good practice to which the FRC believes institutional investors should aspire to. FCA-regulated asset management firms required to disclose the nature of their commitment to the Code or where they do not commit to the Code, their alternative investment strategy. The Ministry of Housing, Communities & Local Government recommends that administering authorities in the Local Government Pensions should become signatories to the Code.

The London Borough of Merton as administering authority for the Merton Pension Fund is not currently a signatory to the 2020 UK Stewardship Code. However, the Fund attempts to follow the principles, and plans to become a signatory in the future.

The Fund expects its external investment managers to be signatories of the UK Stewardship Code and reach Tier One level of compliance or to be seeking to achieve a Tier One status within a reasonable timeframe. Where this is not feasible the Fund expects a detailed explanation as to why it will not be able to achieve this level.

The Fund through its participation in the London CIV will work closely with other LGPS Funds in London to enhance the level of engagement both with external managers and the underlying companies in which invests. The London CIV's draft Stewardship Code Statement of Compliance is attached at Appendix 2.

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Appendix

LONDON CIV

UK STEWARDSHIP CODE STATEMENT OF COMPLIANCE & ENGAGEMENT POLICY

UK STEWARDSHIP CODE STATEMENT OF COMPLIANCE & ENGAGEMENT POLICY

London LGPS CIV Limited ("London CIV") was formed as a voluntary collaborative venture by the London Local Authorities in 2014 to invest the assets of London Local Government Pension Scheme ("LGPS"). "London CIV" and its London Local Authority investors who are its shareholders recognise the importance of being long term stewards of capital, have a range of arrangements for stakeholder engagement in place, and support the UK Stewardship Code, which it recognises as best practice.

The London CIV is authorised and regulated by the Financial Conduct Authority as an Alternative Investment Fund Manager ("AIFM") with permission to manage authorised and unauthorised Alternative Investment Funds. The London CIV in the management of its investments has appointed a number of external investment managers. We therefore see our role as setting the tone for the effective delivery of stewardship and shareholder engagement on our behalf and on behalf of our investing Funds. We are clear that we retain responsibility for this being done properly and fully in the interests of our own shareholders.

This Policy sets out the London CIV's Engagement Policy for the purposes of Shareholders Rights Directive II ("SRD II"), and how it implements the original seven principles of the Stewardship Code ("the Code"). A revised statement in respect of the twelve principles of the revised Stewardship Code will be issued when approved. For these purposes, London CIV is acting in the capacity of an asset owner rather than an asset manager, representing the interests of the London Local Authority LGPS Funds.

Given the similarity between the Principles of the Code and the disclosures required by SRD II, we determined that this single disclosure is sufficient to demonstrate our compliance with both.

Stewardship Code Principle 1
Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.

SRD II Engagement Policy
How we integrate shareholder engagement in our investment strategy

The London CIV on behalf of its London Local Authority Shareholders recognises its position as an investor on their behalf with ultimate responsibility to members and beneficiaries and recognises that shareholder engagement and effective stewardship can help protect and enhance the long-term value of its investments to the ultimate benefit of all stakeholders in the LGPS.

As we do not invest directly in companies, we hold our fund managers accountable for the delivery of stewardship on our behalf in terms of day-to-day implementation of its stewardship activity. We require the appointed fund management teams to be responsible for holding to account the management and boards of companies in which they invest. The London CIV believes that this approach is compatible with its

shareholder engagement and stewardship responsibilities as it is the most effective and efficient manner in which it can promote and carry out stewardship activities in respect of its investments, and ensure the widest reach of these activities given the CIV's investment arrangements.

A key related area where stewardship is integrated into the wider process is in the selection and monitoring of external investment managers. When considering the appointment of external investment managers the consideration of Environmental Social and Governance ("ESG") integration and stewardship activity of each investment manager is part of the selection process.

The London CIV expects its equity investment managers to have in place an Engagement Policy and adhere to the principles within the UK Stewardship Code. This position is communicated to the Fund's investment managers and forms the basis of the approach to monitoring the investment managers as outlined in this document.

The London CIV expects the investment managers' Engagement Policy to apply to all equity investments, including overseas equity holdings, as required by SRD II. Whilst the Stewardship Code is primarily directed at UK equity investments only, the London CIV encourages its investment managers to apply the principles of the Code to overseas equity holdings where possible.

The primary mechanisms for the application of effective stewardship for the London CIV are exercise of voting rights and engagement with investee companies. The London CIV expects its external equity investment managers that invest directly in companies, to pursue both these mechanisms. We receive quarterly reporting from managers which includes their stewardship and voting activities where appropriate. We seek consistently to ensure that these stewardship activities are carried out actively and effectively in the furtherance of good long-term investment returns.

We expect all of the London CIV's equity managers to publicly disclose their Engagement Policy and their Stewardship Code Statements on how they will discharge their stewardship responsibilities. We expect managers that invest in companies directly to discharge their responsibilities by:

- having extensive dialogue with the company's management throughout the year on a range of topics such as governance, financial performance and strategy; and
- voting, either directly or via the services of voting agencies.

There is ongoing engagement with London CIV's shareholder investors throughout the year both in respect of fund launches and as owners of London CIV through the company's corporate governance arrangements.

Stewardship Code Principle 2
Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed.

SRD II Engagement Policy
How we manage actual and potential conflicts of interests in relation to the London CIV's engagement.

Day-to-day implementation of the Fund's stewardship activity has been delegated to external investment managers. The London CIV expects its investment managers to document their approach to stewardship, which should include how they manage any conflicts of interest that arise to ensure that the interests of the London CIV's Investors are prioritised. The London CIV will review annually the conflicts of interest policy of its managers and how any conflicts have been managed during the year.

The London CIV has policies in place to manage conflicts of interest that may arise for the Board and its officers when making decisions on its behalf. The Conflicts of Interest policy is reviewed by the London CIV board on a regular basis. A Conflicts of Interest Register is maintained.

Shareholders of the London CIV attending General Meetings are required to declare any conflicts of interest at the start of any meeting and equivalent arrangements apply in respect of the Shareholder Panel.

Stewardship Code Principle 3
Institutional investors should monitor their investee companies.

SRD II Engagement Policy
How we monitor investee companies on relevant matters, including: (a) strategy; (b) financial and non-financial performance and risk; (c) capital structure; and (d) social and environmental impact and corporate governance.

We recognise that active and ongoing monitoring of companies is the foundation of good stewardship, reminding companies in which we invest that they have obligations to their shareholders to deliver returns over the appropriate long-term investment timeframe and, consistent with this, to manage any related environmental and social risks responsibly.

The London CIV requires its external investment managers to monitor investee companies. Issues to be monitored are likely to vary, however typically these might include a company's corporate strategy, financial performance, risk (including those from environmental and social factors), capital structure, leadership team and corporate governance. The London CIV encourages its investment managers to satisfy themselves that investee companies have in place engagement policies and adhere to the spirit of the UK Corporate Governance Code.

The London CIV reviews investment managers in this area as part of their regular meetings. For equity investment managers this includes consideration of:

- who has overall responsibility for ESG risk analysis and integration;
- resources and experience of the team;
- at what stages of the process ESG risks are considered;
- exposures to environmental, social or governance risk within the portfolio; and
- the investment manager's willingness to become an insider and, if so, whether the manager has a policy setting out the mechanisms through which this is done.

Stewardship Code Principle 4
Institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities.

SRD II Engagement Policy
How we conduct dialogue and communicate with relevant stakeholders of investee companies.

The London CIV recognises that constructive engagement with company management can help protect and enhance shareholder value. Typically, the London CIV expects its investment managers to intervene with investee companies when they view that there are material risks or issues that are not currently being adequately addressed.

The London CIV reviews investment managers in this area as part of their regular meeting. For equity investment managers that invest directly in companies, this includes consideration of:

- whether voting activity has led to any changes in company practice;
- whether the investment manager's Engagement Policy specifies when and how they will communicate with investee companies and escalate engagement activities;
- overall engagement statistics (volume and areas of focus);
- example of most intensive engagement activity discussed as part of the manager's annual review meeting; and
- the estimated performance impact of engagement on the strategy in question.

Given the range of fund managers and Fund investments, the London CIV carries out its monitoring at the manager level to identify:

- trends to ensure progress is being made in stewardship activities;
- specific managers where progress or the rate of progress is not adequate; and
- appropriate specific actions necessary.

Stewardship Code Principle 5
Institutional investors should be willing to act collectively with other investors where appropriate.

SRD II Engagement Policy
How we cooperate with other shareholders.

As day-to-day management of the Fund's assets has been delegated to external investment managers, the London CIV expects its investment managers to get involved in collective engagement where this is an efficient means to protect and enhance long-term shareholder value.

In addition, the London CIV will work collectively with other investors including other LGPS Asset pools and the Local Authority Pension Fund Forum (LAPFF) to enhance the impact of their engagement activities.

Stewardship Code Principle 6
Institutional investors should have a clear policy on voting and disclosure of voting activity.

SRD II Engagement Policy
How we exercise voting rights and other rights attached to shares.

The London CIV has delegated its voting rights to the Fund's investment managers and requires them to vote, except where it is impractical to do so. The London CIV also monitors the voting alerts of the LAPFF and where these are issued, requires the investment managers to take account of these alerts as far as practical to do so. Where the investment manager does not vote in line with the LAPFF voting alerts, the London CIV will require detailed justification for non-compliance.

The London CIV reviews and monitors the voting policies and activities of its investment managers, this includes consideration of:

- the manager's voting policy and, what areas are covered;
- the level of voting activity;
- whether the investment manager typically informs companies of their rationale when voting against or abstaining (and whether this is typically in advance of the vote or not);
- if securities lending takes place within a pooled fund for the strategy, whether the stock is recalled for all key votes for all stocks held in the portfolio; and
- whether a third party proxy voting service provider is used and, if so, how.

Stewardship Code Principle 7
Institutional investors should report periodically on their stewardship and voting activities.

The London CIV encourages transparency from its investment managers and expects its managers to report publicly on their voting in an appropriate manner. In addition the London CIV receives reviews and monitors quarterly the voting and stewardship engagement activities of its investment managers.

The London CIV reports quarterly to its investors and will include information on voting and engagement activities from investment managers where appropriate including updates as required on updated stewardship and voting policies of managers. The London CIV also requires its managers to provide it with annual assurances on internal controls and compliance through recognised framework such as the AAF01/06 or equivalent.

The London CIV will incorporate a voting and engagement report in its annual report and accounts and will also place a copy of the report separately on the website.

This disclosure will be reviewed at least annually and updated as necessary.