SINGLE-USE COMPANIES ARE OVER...

GREATER MANCHESTER / MERSEYSIDE / WEST YORKSHIRE

STEWARDSHIP REPORT Q3 2019

NorthernLGPS
The Collective Asset Pool for Greater Manchester Merseyside and West Yorkshire Pension Funds

RESPONSIBLE OWNERSHIP

RISE OF THE STAKEHOLDERS

The future of capitalism is back on the agenda, and investors have a leading role to play. If there were any doubt that Responsible Investment needs to become mainstream, events so far in 2019 must have put an end to it. Throughout the year so far we have seen numerous articles arguing for a reform of the economy to make it both more sustainable and more equitable.

Arguably some of the most significant developments have come from across the Atlantic, where the nature of the corporation, and in whose interests should be run, is being seriously debated for the first time in a generation. An important straw in the wind in August was the statement from the Business Roundtable, a lobby group comprised of many of America's corporate leaders, on the purpose of corporations.

The statement itself is only 300 words long, and in essence is a commitment by corporate leaders to take the interests of all stakeholders into account in the running of their business. Its significance is that it replaces the previous orientation of the Business Roundtable, which was that corporations should be run in the interests of shareholders, so-called 'shareholder primacy'.

The statement has not appeared in isolation: both Democrats like Elizabeth Warren and Bernie Sanders, and Republicans like Marco Rubio, have put forward proposals for reforming corporations. These too have suggested a move away from shareholder primacy, with a greater emphasis on the interests of employees and other stakeholders. There has also been significant criticism of the extent of share buybacks.

In the UK too there has been renewed interest in the idea of corporate purpose with numerous initiatives, like the Future of the Corporation programme at the British Academy. Once again, a broader conception of the role of business is being developed, that includes shareholder value creation, but is not solely defined by it.

For large investors like NLGPS these developments could appear threatening. There are some worrying signs from the US that some would like to use a greater emphasis on the importance of all stakeholders as an excuse to muzzle shareholders. If this is the case investors will need to push back.

However, overall these are changes that ought to support the development of real Responsible Investment. It would be naïve to argue that there are no instances where companies can generate returns for investors through activity that is socially or environmentally damaging. But these returns are not sustainable in both senses.

NLGPS will be paying out pensions for many decades to come, so we are inherently long-term in our orientation. We cannot treat our investments in companies like disposable waste. Therefore we have to take ESG factors seriously because of their influence on long-term value creation.

Looking more widely, our beneficiaries will retire into the world that is affected by the behaviour of companies, good or bad. If we can encourage better behaviour, whilst generating the returns necessary to pay pensions, that is a role we should undertake.

We know that expectations of inves-

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tors are growing. In the private sector, new rules come into force soon that place greater requirements on trustees to not just disclose their policy on Responsible Investment, but also how they enact it. Guidance from the Scheme Advisory Board for local authority funds will follow it. And the revised Stewardship Code will further codify investor responsibilities.

At the same time, investors are increasingly the subject of criticism from campaign groups and others. Some of this is focused on the investments that are held, some of it on how they are used(see 'Engaging for change' box). This scrutiny is only going to increase, and the transparency of the LGPS relative to private sector schemes means that local authority funds will attract particular attention.

The future of capitalism will be shaped by many forces and ideas, but in any future model of the company the role of investors, as providers of capital, will continue to be significant. We know that we have to play an active role.

Engaging for change

At NLGPS we put significant emphasis on the importance of engagement in our Responsible Investment strategy. Engagement has developed as the most common approach taken by investors over the past 20 years, in preference to screening or divestment. This is informed by the choice, first described by the economist Albert Hirschman, between 'exit' and 'voice' when faced by the problematic behaviour of an organisation. In the investment world exit means disposing of assets, whereas engagement is the use of voice.

Our orientation is to use voice where possible and exit necessary. If an asset is likely to fall in value because of ESG factors, and there is little likelihood of voice making a difference, exit becomes more attractive. But by exiting the ability to exercise voice, and therefore the pressure for change, is lost. It also seems likely that whoever buys an asset that is sold will be less concerned about the ESG issues that led the seller to exit. And, of course, the asset does not cease to exist once it has been sold. Therefore the positive impact of exit is not obvious.

Whereas exit simply involves disposing of an asset, engagement encompasses a wide range of activity. In practice, engagement for NLGPS takes a number of forms. It includes meetings, calls and correspondence with companies in our portfolio. It includes the use of our shareholder voting rights, which we seek to retain as much control of as possible. It includes the filing and co-filing of shareholder resolutions. And it includes interacting with our asset managers over their activity. We expect our work in all these areas to expand in the future.

This is not a straightforward issue. Sometimes engagement can seem pointless to observers who are understandably frustrated by the pace of change. However our experience working both individually as funds and collectively through LAPFF is that engagement can and does make a difference to company behaviour. Therefore it remains our strong preference as an approach to delivering returns and bringing about change.

Public sector risk

ESG risks relating to work undertaken by companies for the public sector are something we are alert to. Local authority funds can be placed in a difficult position on occasion as contracting firms can be not only investments held by the funds, but also providers of services to authorities and admitted bodies within the LGPS.

During Q3 there was some media interest in the role of local authority funds as investors in companies involved in security in private prisons, with a particular emphasis on G4S, Serco and Sodexo. An article in Pensions Expert in July took an in-depth look at these issues, and included NLGPS members within its coverage.

In September our responsible investment adviser, PIRC, issued a report looking at the finances of companies in the outsourcing and servicing sector. Following the failures of firms like Carillion and Interserve, it is important that investors learn the right lessons and identify potential warning signs of future problems. When businesses of this scale fail employees lose their jobs and investors lose their money, and there can be significant knock-on effects to suppliers and service users.

Therefore stewardship in this sector has an important role to play. NLGPS has already undertaken some engagement in the outsourcing sector and we continue to monitor developments closely.

More widely there has been a renewed focus on the extent to which certain services should be provided directly by government through the public sector, rather than private sector provision. This goes beyond contracting and into fields such as energy supply. This in turn means that the potential risks also extend beyond public equity and into other asset classes, such as infrastructure.

These are not easy issues for public sector pension funds to tackle, given the multiple relationships we have with some companies. Therefore we think it's important that we acknowledge the unique risks that investors can face, and take steps to stay on top of them.

Northern and LAPFF

Northern LGPS is very committed to its membership of (LAPFF). In July the Forum held its AGM which reconstituted the executive committee. Northern LGPS is now represented on the executive by our chair, Councillor Ged Cooney. In addition both West Yorkshire Pension Fund and Greater Manchester Pension Fund are also represented on the LAPFF executive by Councillor Andrew Thornton, Rodney Barton and Tom Harrington. We look forward to continuing to play an active role in LAPFF in the future.

ENGAGEMENT

Major holdings

Engagement with the largest holdings across NLGPS continues to be one of the significant streams of our responsible engagement work. Where we are a significant shareholder we have met with a number of companies to discuss a variety of ESG issues.

As part of this process, in September we attended the AGM of N Brown Group. The company is head-quartered in Manchester and is an important local employer locally.

At the AGM we asked the board about its approach to board diversity and skills and employee engagement. The company has chosen to designate one of its non-executives, Richard Moross (pictured), as the director responsible for workforce engagement rather than appointing an employee to the board.

We were also very pleased to be able to speak directly to chair, senior independent director and finance director at the meeting. We expect to attend more AGMs as our Responsible Investment work expands.

During Q3 we also met with one of our major financial services sector holdings to discuss their approach to remuneration. These conversations can be challenging, as this is an industry where high pay, and potentially very generous variable remuneration, is commonplace. Whilst it is clear that differences remain, we felt reassured that the company had listened to our views, and understood the basis for them.

One theme we have identified from engagement with some companies in the financial services sector is the role of international comparisons, in respect of both performance and pay. One European financial institution told us that it felt inappropriate for its peer group to include large American firms. However, it also argued that American-style pay was necessary, and that US investors felt its executives were underpaid.

Just Transition

The need for a Just Transition to a low-carbon economy continues to be an important aspect of our climate-related work. This is an area where things are moving rapidly. A new guide on Investing In A Just Transition being launched at an event in early November, something NLGPS is closely involved with.

NLGPS has participated in a number of initiatives on this topic as part of its involvement in LAPFF including some company engagement. We have also agreed to participate in a wider collaborative company engagement on this topic in January. It's fair to say that this is relatively new territory for both companies and investors, and the meaning of a Just Transition is not necessarily well understood yet. It is clear that the changes that individual companies may need to make in their operations can be quite significant.

It is also clear that engagement by investors with companies will only be one element of the transition. Public policy will have a very important role to play in terms of regional investment, regulation, support for workers and communities affected by changes in employment and so on.

Stakeholder engagement is also important, and our RI advisers have been talking to unions about the employment-related aspects of a Just Transition. PIRC participated in a discussion with union representatives from around the globe in at the Committee on Workers' Capital meeting in Paris in September.

To bring these various threads together we intend to hold a Just Transition event in the North in early 2020. Our aim to bring together representatives of employees, local businesses, investors and politicians to discuss how we could all work together more effectively.

ENGAGEMENT

Going global

Another aspect of our work that we expect to become increasingly important is international engagement, especially through collaboration. Along with many other local authority funds, and other pension schemes, a substantial proportion of the equity holdings across the NLGPS funds are now overseas. Across the LGPS there has been a gradual process of shifting away from domestic equities.

Holdings in overseas companies are generally smaller than in UK companies, meaning that collaboration is important. We have building links with investors outside the UK through various initiatives during 2019, including through support for shareholder resolutions at a number of companies around the world. We will have more to say about this aspect of our work in Q4.

Employee representation resolutions

Board-level employee representation continues to attract attention as an idea, both at individual companies and in public policy discussions. In Q3 a resolution seeking employee representation was proposed at the annual meeting of Fedex in the US. NLGPS voted in favour, but the resolution was not supported by most shareholders. The Fedex propoal followed a similar resolution that we supported at the Alphabet AGM in Q2. Another resolution on the same topic will go to the Microsoft AGM in December. In line with our policy on this issue, we expect to support the resolution.

Although so far these resolutions are failing to attract strong shareholder support the emergence of this topic as an engagement issue in both the US and the UK during 2019 may be significant. Taken alongside developments such as the Business Roundtable statement they show that ideas about new models of governance are becoming practical proposals.

Looking to public policy, once again there is interest in employee representation in both the US and the UK (and, of course, it's quite common in other European countries). Given the focus on workforce engagement in the revised UK Corporate Governance Code, we have continued to seek views from companies on how employee views can be given expression in the boardroom.

One early conclusion from these discussions is that companies, and individual directors, that have already experienced have employee representation on boards are more relaxed about the idea than those that have not.

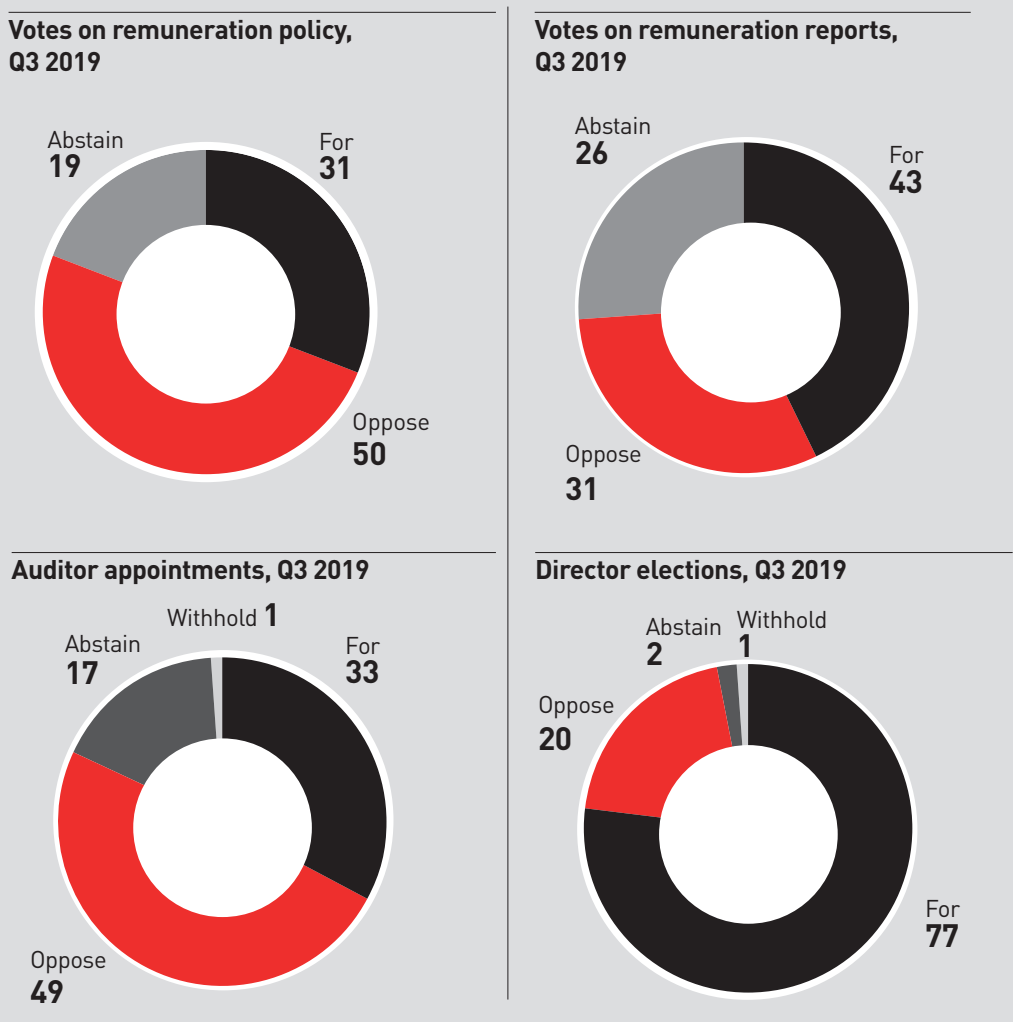
House-builders project

Work on our thematic project on the house-building sector continued during the quarter, as we moved into the company engagement stage of the project. Our approach to this project has been to have constructive dialogue with companies in the sector, to better understand the risks and opportunities facing investors. We met with two of the three companies that are part of our focus list in Q3.

During these engagements we have sought information on company practices on a range of ESG issues. For example, a significant focus has been on environmental risk. This is partly about company disclosures, particularly of Scope 3 emissions, but also about the extent to which they consider flood risk and other physical impacts arising from climate change. We have also sought more information about employment practices, such as the use of subcontracting.

We are currently in the process of drawing together conclusions from our initial engagements in the sector and will be reporting on our findings soon.

Q3 VOTING & ENGAGEMENT REVIEW



Q3 saw a number of cases where companies were hit by multiple high oppose votes across different types of resolution.

The entire NLGPS voting record, disclosing all votes on all resolutions at all companies, is available online in a searchable database.

Although most company meetings take place during the first half of the year, the second quarter in particular, Q3 still saw some interesting results. Overall, NLGPS funds voted at 318 meetings during the third quarter. In its role as responsible investment adviser to NLGPS, PIRC engaged with 122 companies around issues relating to meetings during the quarter, in addition to engagement activity that was not meeting-related. Our full voting record is available online in a searchable database at https://northernlgps.org/node/49

Director elections

Director elections are the most numerous resolutions we vote on each quarter. During Q3, NLGPS voted on the election of 12724 directors. In total, 77% of directors were supported, with 20% opposed. In the remainder of cases NLGPS abstained, or withheld support.

Within that total sit some interesting individual stories. For example, at US drugs maker **McKesson Corporation** four directors received votes against of over 10%, with one of these receiving a vote against of over 15%. We did not support the two directors attracting the highest opposition, because of concerns over time commitments and the company's sustainability policies and practice.

In Ireland low-cost carrier **Ryanair** saw a string of votes against board members, with four receiving oppose votes over 20%, including chair David Bonderman and senior independent Kyran McLaughlin. We opposed all four directors, due to concerns over board independence.

In the UK, we backed the re-election of **Findel** finance director Stuart Caldwell who received a vote of almost 42% against. However, it is clear that this level of opposition – the highest for any director of a UK company in Q3 – was driven by major shareholder **Sports Direct**. In contrast, we opposed the election of a number of directors at Sports Direct, including chief executive Mike Ashley, over governance concerns such as the failure to appoint an auditor.

We also backed incumbent board directors at travel company **FirstGroup**, which was under pressure from activist shareholders seeking a change in strategy.

We opposed the re-election of Adrian Li, Tony Pidgley and Glyn Barker at **Berkeley Group Holdings**. In the case of Adrian Li, the vote against his re-election was 46% and, including abstentions, a majority of shareholders did not support him. Surprisingly, in response the company said it was "pleased with the support for [his] re-election".

Executive pay

Overall, NLGPS opposed companies on advisory votes on remuneration in 31% of cases, abstained in a further 18% and supported in 26%. Oppose votes on remuneration policies stood at 50%, compared to 19% abstain and 31% for.

Notably several companies that received high votes against directors also received high votes against executive pay. **McKesson Corporation** lost the advisory vote on compensation for its executives. We had opposed because of concerns about both the structure and potential excessiveness of the policy.

Berkeley Group Holdings received a 43% vote against its remuneration policy, with oppose votes and abstentions totalling more than votes for. It also received a 42.5% vote against the resolution seeking to amend the LTIP, again with significant abstentions. We opposed both resolutions.

At **Ryanair** the company received both a 50.5% vote against on the advisory resolution seeking approval for the remuneration report, and a 21% vote on the binding resolution to approve the 2019 LTIP. We abstained on the first resolution and opposed the second. The company does not appear to have disclosed full AGM voting results, including

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abstentions. However it seems likely that the remuneration report failed to receive the support of a majority of shareholders voting.

Other companies receiving over 20% votes against their remuneration reports or policies here we opposed or abstained on during the quarter include **Sophos Group**, **BCA Marketplace**, **Homeserve**, **Mediclinic**, **Dixons Carphone**, **Telecom Plus**, **Aveva Group** and **FirstGroup.**

Auditors

During Q3 we voted against 49% of auditor appointments, typically in response to high levels of non-audit work being under-taken or long tenure, and support 33%. We abstained or withheld support in the remainder of cases.

Dual-listed Investec received an almost 20% vote against the appointment of KMPG and 16.5% vote against the appointment of Ernst & Young as joint auditors at its AGM in August. We voted against both due to concerns about long tenure and the company's failure to respond to previous votes against.

There was a 9% vote against the appointment of KPMG as auditor at Oxford Instruments. We opposed due to long tenure.

We were unable to vote on the election of the auditor at Sports Direct, as the resolution was withdrawn ahead of the AGM.

Shareholder resolutions

We supported a number of shareholder resolutions at US companies during the quarter. In addition to the resolution seeking an employee representative on the board at **Fedex**, we also supported a resolution for greater disclosure around political spending. The received a vote for of 26%.

We supported a similar resolution at **McKesson** which received a vote for of 45%.

At **Microchip Technology Inc** we supported a resolution a resolution calling for a report on human rights risks in its operations and supply chain.