Co-operative Pension Scheme (Pace)

Responsible Investment

6 April 2016 to 5 April 2017

The Pace Trustee is pleased to publish its annual report on responsible investment for the year to 5 April 2017. This explains what the Trustee and Pace's investment managers have been doing during the year to make sure we meet the requirements of our Responsible Investment Policy.

What has the Trustee been doing?

During the year the Trustee took some important steps regarding responsible investment.

We updated our Responsible Investment Policy

We worked with industry experts to complete a full review of our Responsible Investment Policy for Pace and have since applied the Policy to our investment strategy. Our updated Policy puts greater emphasis on asking for members' views on responsible investment and incorporating these with our own views to shape our investment strategy.

Our Responsible Investment Policy is on the Pace website at: https://pensions.coop.co.uk/documents/investment-documents.

We reviewed and updated our environmental, social and governance priorities

As the Trustee we recognise that environmental, social and governance factors can affect the financial performance of the companies and other assets that we invest in. These are called ESG factors, and we take these into account (along with a number of others) in our general approach to investment.

During the year we worked with the Co-op to develop three core responsible investment related areas of focus. The work carried out included asking Pace members for their views on a range of ESG related topics through an online survey. The priorities that emerged were:

- Corporate governance
- The environment and sustainable resource use
- Human rights.

In April 2017 we worked with MSCI, a leading provider of investment tools and research, to produce an exclusion list to help us avoid investing in assets that don't fit with our core beliefs. We developed this exclusion list so that it's practical to apply and doesn't constrain our investment managers in securing the investment returns needed to pay members' benefits. The investment exclusions we agreed include:

- Controversial weapons: companies involved in the manufacture or transfer of indiscriminate weapons, or the manufacture or transfer of armaments to oppressive regimes
- Human rights: government bonds issued by states which deny their citizens basic human rights

- The environment: companies involved in extractive industries which also have poor environmental standards

Our appointed investment managers comply with the Policy and have not made any purchases against the exclusions list.

We have also asked our investment managers to take account of ESG factors when they are implementing their investment mandates. As part of this, our investment managers engage directly with the companies they invest in, to understand and assess topics like board constitution, appropriate use of capital and directors' remuneration. When the Trustee appoints a new investment manager for Pace, we also consider the manager's approach to incorporating ESG factors into their investment strategy.

A summary of how our investment managers approach ESG factors is on pages 3 to 7.

We have assessed Pace Complete's investment exposure to climate change risk

Climate change has become an increasingly pertinent risk to the environment. It also poses a potential risk to the value of the Scheme's assets. During the year we worked with our investment advisor, Mercer, to better understand Pace's exposure to climate change risk.

This work looked at how investment returns might be affected by international efforts to limit global warming to two degrees celsius (the so called 2DC scenario). This included an assessment of risks arising from technology changes, resource availability, impacts of physical damage and policy changes.

The analysis showed that Pace Complete has a very low exposure to climate-related risks. This was mainly due to its low-risk investment strategy which had a small exposure to equity investments (these tend to have the highest climate-related risk). It also showed that the investment strategy we're currently implementing for Pace will further reduce its exposure to climate-related risks in the future.

The conclusion was that the impact of a 2DC scenario would result in only very marginal reduction in the expected returns on Pace Complete's assets over next ten years. This was a significantly lower level of impact than for most UK pension schemes.

Engagement of other forums

Pace publishes its statement of compliance with the Financial Reporting Council's UK Stewardship Code, which is updated annually. Six of the Scheme's nine portfolios (at 5 April 2017) have managers with a published statement of compliance with the Financial Reporting Council's UK Stewardship Code.

All of the Scheme's mandates are managed by signatories to the United Nations-backed Principles for Responsible Investment ("UNPRI"). Pace also joined the UK Sustainable Investment and Finance Association in 2016.

Appendix 1 contains a table summarising subscription to the UNPRI and compliance with the UK Stewardship Code for each of Pace's investment managers.

We monitor the voting behaviours of our investment managers

Following changes made to our investment strategy in December 2016, Pace has a limited exposure to equity which is passively managed by Legal & General Investment Management (LGIM). Nevertheless, we monitor proxy voting activity to understand how LGIM is using its voting rights on our behalf. The proxy voting activity of our investment managers on behalf of Pace is covered in more detail on page 8. This analysis shows:

- Voting activity undertaken on behalf of the Pace
- Governance standards at companies
- How Pace's investment managers use its voting rights

What have our investment managers been doing?

Our investment managers put a lot of work into investing responsibly and considering environmental, social and governance factors in their investment processes, and some go as far as extending this to how they run their business.

Legal & General Investment Management ("LGIM")

LGIM is one of the world's biggest passive investment managers and carries a lot of weight with investee companies, and when voting at AGMs. It aims to engage on key themes and governance issues with companies, governments and regulators in an attempt to protect and improve the value of clients' assets. It looks at how well the invested companies incorporate ESG factors into their ideas and engages with them directly to improve performance. Two examples are set out below:

<u>Board Independence</u>

During 2016, LGIM engaged with a multinational bank to check they had appropriate plans for selecting a new chairman after its then chairman announced his intention to resign. It was felt that the bank had a history of promoting the role of chairman internally but in this case LGIM called for the appointment of an independent, external chairman. The bank held various meetings during the year with its directors and LGIM on this issue and later confirmed the new chairman would be an external appointment, the then Chief Executive Officer ("CEO") at an external insurance company.

<u>Palm Oil</u>

Palm oil is one of the highest drivers of agricultural-linked deforestation. As a result of this, it is a key contributor to rising atmospheric CO2 levels and climate change. LGIM is a member of the PRI working group on sustainable palm oil and actively engaged with five of the largest palm oil companies across Indonesia and Malaysia, and with the Indonesian government. In time, they saw an increased commitment from the companies to protect high carbon reserve and conservation areas, as well as to engage with smaller farmers. The Indonesian government has also ceased providing new concessions and is strengthening the certification process for sustainably sourced palm oil.

<u>Climate Change</u>

LGIM engaged with one of the world's largest oil companies on its failure to acknowledge and support the Paris Agreement. It was also concerned with the potential for assets to become stranded, where the company would not be able to produce expected revenue due to limits placed on it by increasing regulation targeted at combatting global warming. Meetings were held with the company directly, but more recently with other investors to increase the influence applied. Following engagement, the company issued a statement welcoming the Paris Agreement, and LGIM has committed to continue working with it and other investors on the issue of stranded assets.

<u>Executive Pay</u>

LGIM thinks executive remuneration should be fair and reflect the long-term shareholder value brought to shareholders. It also has a record of raising concerns with companies around pay equality between boards and employees.

It recently had concerns on the proposed increase in a UK based multinational's remuneration package for its executives, which would see its CEO's 'Long Term Incentive Plan' increasing from 350% of salary to 450% of salary, on top of an annual bonus of 200% of salary. Following LGIM's engagement, the company subsequently announced a suspension to the plan to increase executive pay and won't be reviewing it again until 2018.

Cantillon Capital Management

Cantillon incorporates ESG issues in its investment analysis and decision-making processes by doing the following:

- Having good working relationships with company management
- Raising concerns with companies on ethical issues
- Investigating situations where companies are suspected of operating questionably

Dangerous Products

During the year, Cantillon met with the management of a company which, it had emerged, sold a product in South Korea that contained toxic chemicals which had resulted in serious illnesses and death. Cantillon worked with the company to understand whether its internal controls were at fault and what the impact could be on the company. Following engagement, the company has actively worked with victims and the government, and provided compensation for the harm caused. Cantillon became satisfied that its internal controls were sufficiently strong and kept its investment in the company.

Insider Trading

Another event arose this year when the CEO of one of the companies in which Cantillon invested was investigated for alleged insider trading. Cantillon contacted the company to better understand the allegations and possible outcomes. It subsequently decided to sell its shares in the company as it became more aware of how dependent the business was on the CEO and of the risks a change in leadership would bring.

Marathon Asset Management

Marathon's main objective is protecting investor value and it believes that ESG factors can affect this in the companies it invests in. Marathon buys shares in companies to hold and become an active investor it, and because of the long-term nature of its investment style (with an average holding period of eight years), it must be sure that ESG deficiencies do not restrict a company's growth prospects.

During the year Marathon put more focus on corporate governance by carrying out detailed analysis on company management.

Matthews International Capital Management

Matthews includes ESG factors in its research process and thinks about both the 'survivability' and sustainability of business models and the governance structures of companies, particularly for Pace's portfolio. The quality of company management and governance are looked at by Matthews, including management's integrity, corporate governance culture, alignment with minority shareholders, business strategy, and ability to adapt to change and to handle risk appropriately.

Meetings with company management are an essential part of Matthews' investment process, as they believe engaging with companies to understand them better is relevant to successful long-term investments.

Matthews recognises issues like changing demographics, rising incomes, and wealth creation across Asia and that a greater focus is being placed on social and environmental issues, including a clean environment, food safety, gender-inclusive employment markets, equitable incomes and distribution of wealth, and access to health care.

Royal London Asset Management ("RLAM")

RLAM has been a signatory to the United Nations-backed Principles for Responsible Investment (UN PRI) since 2008, are involved in fixed income steering groups and have served on the PRI tax advisory committee. RLAM also complies with the UK Stewardship Code and it is an active member of the UK Sustainable Investment and Finance Association and other fora.

It has a dedicated Governance Team with three full-time analysts and publishes its voting records online, along with information about its engagement with companies. It commits to being a responsible investor and promoting responsible investment with other stakeholders, to bring sustainable returns that will also help economic performance in the future. As part of this, RLAM:

- Engage with companies and industry regulators to understand the issues that are most important to their business
- Track engagements and report on the outcomes in quarterly public reports
- Initiates or joins collective engagements with other investors where it thinks it will be more effective than engaging alone
- Provide investors with a quarterly reporting through its web-site

Executive Pay

During the reporting year, RLAM voted against a remuneration report at BP which proposed to measure its directors' performance by only assessing whether the company beat its peers during the year, and not necessarily on the company's own growth.

Climate Change

RLAM supported Anglo American and Glencore, who proposed producing an annual report on climate change, and welcome more disclosure by boards to fully prepare companies for future scenarios in a carbon constrained world.

Comgest

Over the year, Comgest's investment and ESG teams engaged with the invested companies on subjects such as:

- ESG information disclosure
- Ownership and share capital structures
- Corporate culture, innovation
- Board and committee structure, succession planning, top management changes
- Remuneration schemes of top executives, KPIs for short/long-term incentives, related party transactions
- Environmental risk mitigation, greenhouse gas emissions, environmental impacts of companies' projects
- Human capital management, health and safety
- Responsible marketing

Comgest participated in 23 industry initiatives and events during the period.

LaSalle Investment Management

LaSalle think that factoring sustainability, the environmental, social, economic and corporate governance issues throughout the lifecycle of an asset can improve investment returns. By managing an asset in the right way, it can lower operating costs, increase occupancy and reduce voids, as well as reduce risks such as flooding and obsolescence, all of which will have a positive impact on the asset's performance.

It feels that sustainable buildings not only have a lower environmental impact, but they attract tenants who are looking to occupy healthy spaces. Pace had 13 assets within the fund that were included within LaSalle's Sustainability Management Programme, which records data on energy, waste and water and uses specialist consultants to help reduce consumption.

LaSalle has sustainable refurbishment and development standards which set out targets and minimum standards in 12 areas, including energy, water, waste, biodiversity and wellbeing. This impacts Pace's portfolio where refurbishment is taking place; the upgrade of the asset will improve the Energy Performance Certificate from the current E-G ratings to the target building rating of C.

LaSalle sits on the board of the Better Buildings Partnership in the UK and on the European Association for Investors in Non-Listed Real Estate Vehicles' (INREV) Sustainability Committee. It also submits and tracks landlord consumption globally to the Greenprint Foundation. According to the Ethisphere Institute, LaSalle's parent company, JLL, was recognised in 2017 as one of the "World's Most Ethical Companies" for the tenth consecutive year.

Mercer Implemented Consulting

The Mercer Alternatives portfolio does not invest directly in companies, however Mercer has a documented Sustainable Investment Policy in which it outlines its views that:

- ESG risks and opportunities can have an impact on long-term risk and return

- Active ownership, through voting and engagement, provides investors with opportunities to improve long-term shareholder value

- Investing for the long term can add value

Mercer has a dedicated global Responsible Investment team, has advised investors on aspects of ESG integration since 2004 and consulted during the UN PRI's development in 2006.

TwentyFour Asset Management

TwentyFour Asset Management ("24AM") focus their investment process on the governance of the fixed income strategy in which they invest, but has recently begun to integrate social and environmental elements of ESG in each area of their business and investment process, including Asset-Backed Securities.

24AM believe that the poor governance of a company is the root cause of an unsuccessful business and ultimately would affect the value of the bond. They carry out careful due diligence and ESG checks on all companies in which they invest. Any that do not pass their check would not be invested in. They also assess the sustainability of a company as they believe sustainability is an important factor in a successful business, particularly where the ability to refinance transactions on an ongoing basis is an important consideration.

One of 24AM's founding partners, Rob Ford, is a key adviser and consultant to a number of regulatory, policymaker and governmental bodies on structuring and regulation of the ABS industry, including the three major bodies from the European Union (the European Parliament, Commission and Council) and a number of other national authorities in Europe and the UK.

PGIM

PGIM values environmental considerations when considering an investment. It adopts a 'Sustainability Strategy Statement' to guide its actions to make both its investments and business 'greener' and more sustainable. It seeks to reduce or avoid the harmful effects of actions on natural resources, and to take steps to improve the efficiency of their assets.

PGIM does not look to acquire assets where it suspects there would be a damaging effect on either the environment or a local community, however it recognises property can be a controversial subject because people tend to have different opinions to development plans. For example, assets which are going through refurbishment or under development will always be controversial to a portion of a local community, while equally the underutilisation of land and old derelict buildings can be just as detrimental.

Insight Investment Management

Insight thinks that engagement with investee companies can be more limited for fixed income investors than for equity investors. However, through a combination of ESG risk screening, applying ESG risk score and financial analysis, Insight is able to bring together an assessment of the financial risks related with a company's performance, including ESG considerations, as part of its investment process.

During the year, Insight's analysts engaged on ESG issues with more than 150 companies across a range of issues and geographies, including with UK investment grade issuers operating in politically sensitive, oligopolistic industries.

Insight was awarded an 'A' rating by the PRI for integration of its ESG approach in fixed income. It updated its responsible investment policy to turn its focus away from the basics of responsible investment, towards its broader aspirations as a business.

BlackRock

BlackRock's is a liability hedging portfolio, so responsible investment considerations do not directly impact on investment decisions for its mandate, and as such it does not form part of its investment process – Pace does however apply the exclusions listed on pages 1 and 2 to the portfolio.

Defined Contribution ("DC") Section – Legal & General

Pace's DC section is administered by Legal & General Assurance Society Ltd. and members have the option to invest in a range of funds, which are shown below. LGIM manage the underlying assets of these funds and are a signatory to the UNPRI as well as having published a statement of compliance with the Financial Reporting Council's UK Stewardship Code. As mentioned above, LGIM have carried out significant work in promoting high standards of corporate governance and action on climate change, which have been key themes in its engagement with investee companies.

Pace Fund	Proportion of DC Section Assets	Fund Objective
Growth (Mixed)	94.6%	Long-term investment growth, using a diversified set of asset classes.
Cash	4.5%	Provide capital protection, with growth at short-term interest rates.
Growth (Shares)	0.4%	Capture UK (30%) and overseas (70%) equity market returns.
Pre-retirement	0.3%	Reflect diversified investment underlying a typical traditional annuity product.
Growth (Ethical Shares)	0.2%	Track the total return of the FTSE4Good Global Equity Index.
Pre-retirement (Inflation-Linked)	0.0%	Reflect diversified investment underlying a typical inflation-linked annuity product.

Appendix 1

The Scheme's overall voting record of equities across the year in the table below:

	Votes cast	Voting policy-with	Voting policy-against	Abstention
Legal & General Investment Management (LGIM)	44,426	39,409	4,942	75
Cantillon Capital Management*	791	705	42	44
Marathon Asset Management*	3,107	3,048	59	0
Comgest Asset Management*	332	267	65	0
Matthews Asia*	571	504	67	0
Royal London Asset Management*	2,117	2,016	66	35

*Following changes to the investment strategy made in 2016, Pace terminated all equity managers with the exception of LGIM. Data is as for the year to 9 Dec 2016 for Cantillon, Marathon, Comgest and Matthews, and to 16 December 2016 for RLAM.

The proxy voting activities carried out by investment managers over the period covered issues such as:

- Board balance and remuneration
- Committee independence
- Health, the environmental, climate change, facility safety and renewable energy
- Social proposals, such as the gender pay gap and anti-discrimination

Appendix 2

The following table summarises subscription to the UNPRI and compliance with the UK Stewardship Code for each of the investment managers of Pace's defined benefit ("DB") section in the 6 April 2016 - 5 April 2017 period:

Investment Manager	Mandate	Management Style	Signatory to the UN PRI	UK Stewardship Code Compliance	DB Section Assets Held[1]
LGIM	Global Equity	Passive	Yes	Yes	7.7%
LaSalle[3]	UK Property	Active	Yes	No[3]	2.1%
Mercer	Alternative Growth	Active	Yes	Yes	4.6%
Insight	Buy and Maintain Credit	Buy & Maintain	Yes	Yes	4.5%
RLAM	Buy and Maintain Credit	Buy & Maintain	Yes	Yes	9.3%
24AM[2]	Asset Backed Securities	Active	Yes	No[2]	3.2%
PGIM Real Estate[3]	Alternative Inflation Linked	Active	Yes	No[3]	0.1%
BlackRock	Liability Driven	Active	Yes	Yes	57.3%
LGIM	Buy and Maintain Credit	Active	Yes	Yes	Awaiting Funding
Cantillon[4]	Global Equity	Active	Yes	Yes	0%
Marathon[4]	European Equity	Active	No	Yes	0%
Matthews[2&4]	Asia Pacific Equity	Active	Yes	No[2]	0%
RLAM[4]	UK Equity	Active	Yes	Yes	0%
Comgest[4]	Emerging Markets	Active	Yes	Yes	0%
LGIM	Corporate Bonds	Passive	Yes	Yes	0%

[1]Source: BNY Mellon investment reporting – 5 April 2017. 11.1% of assets were managed by BlackRock's Transition Management team at the time.

[2] 24AM and Matthews generally support the objectives that underline the Code but have not yet determined whether to publish a statement regarding compliance.

[3]LaSalle and PGIM Real Estate manage investments in real estate, and not UK listed securities to which the UK Stewardship Code applies.

[4]These mandates were terminated in December 2016 following changes to Pace's investment strategy.