The Capability Scotland Pension Scheme (the “Scheme”)

Statement of Investment Principles

Introduction

This SIP has been agreed by the Trustees of the Capability Scotland Pension Scheme (the “Scheme”). This statement sets out the principles governing the Trustees’ decisions to invest the assets of the Scheme.

The Scheme’s investment strategy is derived from the Trustees’ investment objectives. The objectives have been taken into account at all stages of planning, implementation and monitoring of the investment strategy.

This Statement has been prepared in compliance with the Pensions Act 1995, the Pensions Act 2004, and the Occupational Pension Schemes (Investment) Regulations 2005. Before preparing or subsequently revising this Statement, the Trustees consulted the sponsoring company and took appropriate written advice from their investment advisers, Isio Group Limited/Isio Services Limited (“Isio”). The Statement is reviewed at least every three years, and without delay after any significant change in the investment arrangements.

Governance

The Trustees of the Scheme make all major strategic decisions including, but not limited to, the Scheme’s asset allocation and the appointment and termination of investment managers.
When making such decisions, and when appropriate, the Trustees take proper written advice. The Trustees’ investment advisers are qualified by their ability in, and practical experience, of financial matters, and have the appropriate knowledge and experience. The investment advisers’ remuneration may be a fixed fee or based on time worked, as negotiated by the Trustees in the interests of obtaining best value for the Scheme.

Investment objective

The Trustees invest the assets of the Scheme with the aim of ensuring that all members’ accrued benefits can be paid. The Scheme’s funding target is specified in the Statement of Funding Principles, and the Scheme s funding position will be reviewed regularly to assess the position relative to the funding target and whether the investment policy remains appropriate to the Scheme’s circumstances.

The Scheme’s present investment objective is to achieve a return of around 2.6% per annum above the return on UK Government bonds (which are considered to move in a similar fashion to the calculated value of the Scheme’s liabilities).

Investment strategy

Following a review of the Scheme’s investment strategy during late 2018, the Trustees translated the Scheme’s objectives into a suitable strategic asset allocation benchmark for the Scheme (the “strategic benchmark”). The strategic benchmark is consistent with the Trustees’ views on the appropriate balance between seeking an enhanced long-term return on investments and an appropriate level of investment risk. Detail on the strategic benchmark is provided in Appendix 1.

The investment strategy takes due account of the maturity profile of the Scheme, together with the level of disclosed surplus or deficit (relative to the Technical Provisions valuation). The Trustees monitor Scheme performance relative to the agreed asset allocation benchmark. It is intended that the investment strategy will be reviewed at least every three years following actuarial valuations, and will normally be monitored annually. In monitoring performance and setting strategy, the Trustees seek written advice from a suitably qualified entity as required, currently Isio.

The Scheme employs a mix of both active and passive management. Detail on the investment management structure of the Scheme is provided in Appendix 1.

Investment Management Arrangements

The Trustees have invested in funds managed by BlackRock Investment Management ("BlackRock"), Insight Investment Funds Management ("Insight"), J.P. Morgan Asset Management ("J.P. Morgan"), Apollo Global Management ("Apollo") and Legal & General Investment Management ("LGIM"). The majority of assets are held on the Mobius Life investment platform with the exception of the Apollo and LGIM allocations, where the mandates are held directly with each investment manager.

All decisions about the day-to-day management of the assets have been delegated to the investment managers via a written agreement. The delegation includes decisions about:

- Selection, retention and realisation of investments including taking into account all financially material considerations in making these decisions;
- The exercise of rights (including voting rights) attaching to the investments;
- Undertaking engagement activities with investee companies and other stakeholders, where appropriate.

The Trustees take investment managers' policies into account when selecting and monitoring managers. The Trustees also take into account the performance targets the investment managers are evaluated on. The investment managers are expected to exercise powers of investment delegated to them, with a view to following the principles contained within this statement, so far as is reasonably practicable.

As the Scheme's assets are invested in pooled vehicles, the custody of the holdings is arranged by the investment manager.

The Trustees consider the different managers and asset classes described above, and the balance between them, to be suitable given the circumstances of the Scheme. This combination results in a diversified mix of assets, geographic spread and number of investments held.

Investment Manager Monitoring and Engagement

The Trustees monitor and engage with the Scheme's investment managers and other stakeholders on a variety of issues. Below is a summary of the areas covered and how the Trustees seek to engage on these matters with investment managers.

Areas for engagement	**Method for monitoring and engagement**	**Circumstances for additional monitoring and engagement**
Performance, Strategy and Risk	• The Trustees receive an annual performance report which details information on the underlying investments' performance, strategy and overall risks, which are considered at the relevant Trustees meeting.	• There are significant changes made to the investment strategy. • The risk levels within the assets managed by the investment managers have increased to a level above and beyond the Trustees' expectations. • Underperformance vs the performance objective over the period that this objective applies.

Environmental, Social, Corporate Governance factors and the exercising of rights	• See Appendix 3	• See Appendix 3

Through the engagement described above, the Trustees will work with the investment managers to improve their alignment with the above policies. Where sufficient improvement is not observed, the Trustees will review the relevant investment manager's appointment and will consider terminating the arrangement.

The Trustees are satisfied that the mandates awarded mean that sufficient assets will be realisable to provide cash to meet payments by the Scheme.

Employer-related investments

The Trustees policy is not to hold any employer-related investments as defined in the Pensions Act 1995 and the Occupational Pension Schemes (Investment) Regulations 2005, except where the Scheme invests in pooled vehicles that may hold employer-related investments, in which case the total exposure to employer-related investments will not exceed 5% of the Scheme's value.

Direct investments

Direct investments, as distinguished by the Pensions Act 1995, are products purchased without delegation to a fund manager through a written contract. When selecting and reviewing any direct investments, the Trustees will obtain appropriate written advice from their investment advisers.

Ian Gordon

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Reason: I am approving this document

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Appendix 1

Strategic asset allocation split by fund manager

Fund Manager	%	Fund	Manager Benchmark/Target
LGIM	10.0	LPI Income Property Fund	RPI + 2.5% p.a. (net)*
Apollo	26.5	Apollo Total Return Fund	LIBOR + 5.3% p.a. (net)
J.P. Morgan (accessed via the Mobius Life platform)	30.0	JP Morgan Unconstrained Bond Fund	LIBOR + 2.6% p.a. (net)
BlackRock (accessed via the Mobius Life platform)	12.5	Dynamic Diversified Growth Fund	LIBOR +3% p.a. (net)
Insight (accessed via the Mobius Life platform)	21.0	A range of Liability Driven Investment ("LDI") funds	The allocation is managed on a passive basis, whereby the objective is to match, rather than exceed the performance of the nominated liability-based benchmark.
Total	**100.0**		

Totals may not sum due to rounding.

* This is not an explicit Fund target but it has been deemed an appropriate benchmark for the Scheme to measure performance, given the Fund's investment objective and strategy.

Asset split by asset class

Asset Class	Strategic Benchmark (%)	Expected Return[1] (%)
Diversified Growth	12.5	Gilts + 3.5%
Semi-Liquid Credit	26.5	Gilts + 3.7%
Diversified Credit	30.0	Gilts + 2.6%
Long Lease Property	10.0	Gilts + 2.5%
LDI	21.0	Gilts
Total	**100.0**	**Gilts + 2.6%**

Totals may not sum due to rounding.

1 Expected return assumptions are based on Isio's central (best estimate) assumptions as at 30 June 2020.

Appendix 2 – Risks, Financially Material Considerations and Non-Financial matters

A non-exhaustive list of risks and financially material considerations that the Trustees have considered and sought to manage is shown below. The Trustees consider these factors will be financially material for the Scheme over the length of time during which the benefits provided by the Scheme for members require to be funded to a level which would allow the benefits to be bought out with an insurer.

The Trustees adopt an integrated risk management approach. The three key risks associated within this framework and how they are managed are stated below:

Risks	**Definition**	**Policy**
Investment	• The risk that the Scheme's position deteriorates due to the assets underperforming.	• Selecting an investment objective that is achievable and is consistent with the Scheme's funding basis and the sponsoring company's covenant strength. • Investing in a diversified portfolio of assets.
Funding	• The extent to which there are insufficient Fund assets available to cover ongoing and future liability cash flows.	• Funding risk is considered as part of the investment strategy review and the actuarial valuation. • The Trustees will agree an appropriate basis in conjunction with the investment strategy to ensure an appropriate journey plan is agreed to manage funding risk over time.
Covenant	• The risk that the sponsoring company becomes unable to continue providing the required financial support to the Scheme.	• When developing the Scheme's investment and funding objectives, the Trustees take account of the strength of the covenant ensuring the level of risk the Scheme is exposed to is at an appropriate level for the covenant to support.

The Scheme is exposed to a number of underlying risks relating to the Scheme's investment strategy, these are summarised below:

Risk	**Definition**	**Policy**
Interest rates and inflation	• The risk of mismatch between the value of the Scheme assets and present value of liabilities from changes in interest rates and inflation expectations.	• To hedge 80% of movements in interest rates and inflation on a flat gilts basis.
Liquidity	• Difficulties in raising sufficient cash when required without adversely impacting the fair market value of the investment.	• To maintain a sufficient allocation to liquid assets so that there is a prudent buffer to pay members benefits as they fall due (including transfer values).
Market	• Experiencing losses due to factors that affect the overall performance of the financial markets.	• To remain appropriately diversified and hedge away any unrewarded risks, where practicable.

Credit	• Default on payments due as part of a financial security contract.	• To diversify this risk by investing in a range of credit markets across different geographies and sectors.
Environmental, Social and Governance	• See Appendix 3	• See Appendix 3
Currency	• The potential for adverse currency movements to have an impact on the Scheme's investments.	• The Scheme's current diversified growth and credit mandates hedge all currency risk back to Sterling.
Non-financial	• The views of Scheme members and beneficiaries in relation to ethical considerations, social and environmental impact, or present and future quality of life of the members and beneficiaries of the Scheme in the selection, retention and realisation of investments.	• Non-financial matters are not taken into account in the selection, retention or realisation of investments. • This policy will be reviewed at least annually.

Appendix 3 – Environmental, Social and Governance Considerations

The Trustees' investment of Scheme assets through pooled funds has the practical result that the Trustees cannot themselves directly influence the ESG policies and practices of the companies in which the pooled funds invest. However, the Trustees do take into account ESG factors (including climate change risks) in relation to the selection, retention and realisation of investments.

The Trustees take those factors into account in the selection, retention and realisation of investments as follows:

- Selection of investments: assess the investment managers' ESG integration credentials and capabilities, including stewardship, as part of the manager selection process as well as through other regular reporting channels.

- Retention of investments: Developing a robust monitoring process in order to monitor ESG considerations on an ongoing basis by regularly seeking information on the responsible investing policies and practices of the investment managers.

- Realisation of investments: The Trustees will take ESG considerations into account regarding decisions on realisation of investments.

The Trustees will also take those factors into account as part of its investment process to determine a strategic asset allocation, and consider them as part of ongoing reviews of the Scheme's investments.
The Trustees will continue to monitor and assess ESG factors, and risks and opportunities arising from them, as follows:

- The Trustees will obtain regular training on ESG considerations in order to understand fully how ESG factors including climate change could impact the Scheme and its investments;

- As part of ongoing monitoring of the Scheme's investment managers, the Trustees will use any ESG ratings information available within the pensions industry or provided by their investment consultant, to assess how the Scheme's investment managers take account of ESG issues; and

- Through their investment consultant the Trustees will request that all of the Scheme's investment managers provide information about their ESG policies, and details of how they integrate ESG into their investment processes on an annual basis.

Stewardship

The Trustees' policy on the exercise of rights attaching to investments, including voting rights, and in undertaking engagement activities in respect of the investments is that these rights should be exercised by the investment managers on the Trustees' behalf. In doing so, the Trustees expect that the investment managers will use their influence as major institutional investors to exercise the Trustees' rights and duties as shareholders, including where appropriate engaging with underlying issuers of debt or equity to promote good corporate governance, accountability and to understand how those companies take account of ESG issues in their businesses. The investment managers are also expected to use their influence to engage with the wider investment manager community. The Scheme does not hold any direct debt or equity investments, and so engages solely through the pooled investment managers.

The Trustees will monitor and engage with the investment managers about relevant matters (including business performance, strategy, capital structure, management of actual or potential conflicts of interest, risks, social and environmental impact and corporate governance matters), through the Scheme's investment consultant. The Scheme's investment consultant conducts regular meetings with each of the investment managers to discuss these matters. The Scheme's investment consultant then liaises with the Trustees on an annual basis to convey the outcome of their engagements.

Investment managers will be asked to provide details of their stewardship policy and engagement activities on at least an annual basis. The Trustees will, with input from their investment consultant, monitor and review the information provided by the investment managers. Where possible and appropriate, the Trustees will, through the Scheme's investment consultant, engage with their investment managers for more information and ask them to confirm that their policies comply with the principles set out in the Financial Reporting Council's UK Stewardship Code.

Appendix 4 - Policy on Investment Manager Arrangements

The Trustees have the following policies in relation to the investment management arrangements for the Scheme:

How the investment managers are incentivised to align their investment strategy and decisions with the Trustees' policies.	• As the Scheme is invested in pooled funds, there is not scope for these funds to tailor their strategy and decisions in line with the Trustees' policies. However, the Trustees invest in a portfolio of pooled funds that are aligned to the strategic objective.
How the investment managers are incentivised to make decisions based on assessments of medium to long-term financial and non-financial performance of an issuer of debt or equity and to engage with them to improve performance in the medium to long-term.	• The Trustees review the investment managers' performance relative to medium and long-term objectives as documented in the investment management agreements. If the Trustees have concerns over the performance of an investment manager, they liaise with the Investment Consultant in the first instance in order to come to a more informed view. Thereafter, if necessary, the Trustees may then meet with the investment manager in order to form a final opinion of how to proceed with the mandate. • The Trustees monitor the investment managers' engagement and voting activity on an annual basis as part of their ESG monitoring process. • The Trustees do not incentivise the investment managers to make decisions based on non-financial performance.
How the method (and time horizon) of the evaluation of investment managers' performance and the remuneration for their services are in line with the Trustees policies.	• The Trustees review the performance of all of the Scheme's investments on a net of cost basis to ensure a true measurement of performance versus investment objectives. • The Trustees evaluate the performance of each investment manager relative to their respective performance objective or benchmark and within the context of the prevailing market environment. Where relevant, the manager's performance in relation to realised risk or downside protection also forms part of the Trustees' assessment of performance. The Trustees also consider the each investment manager's client service quality, including quality of reporting and climate-related disclosure, when making an overall assessment. • The Trustees evaluate performance over the time period stated in the investment managers' performance objective, which is typically 3 to 5 years. In the event of what is deemed to be underperformance from an investment manager, the Trustees would liaise with the Investment Consultant in the first instance to better understand the potential rational for the performance. Thereafter, if necessary, the Trustees may then meet with the investment manager in order to form a final opinion of how to proceed with the mandate. • Investment manager fees are reviewed annually to make sure the correct amounts have been charged and that they remain competitive.
The method for monitoring portfolio turnover costs incurred by investment	• The Trustees do not directly monitor turnover

managers and how they define and monitor targeted portfolio turnover or turnover range.	costs. However, the investment managers are incentivised to minimise costs as they are measured on a net of cost basis. • The Trustees recognize that portfolio turnover and associated transaction costs are a necessary part of investment management and that the impact of portfolio turnover costs is reflected in performance figures provided by the investment managers. • The Trustees do not believe in setting a portfolio turnover target – being the frequency with which the assets are expected to be bought/sold – because each investment manager's style differs in terms of level of frequent active management, and therefore turnover, involved. The Trustees believe monitoring transaction costs should be monitored indirectly as one aspect of a holistic approach to overall manager performance assessment.
The duration of the Scheme's arrangements with the investment managers	• The duration of the arrangements is considered in the context of the type of fund the Scheme invests in. - For closed ended funds or funds with a lock-in period the Trustees ensure the timeframe of the investment or lock-in is in line with the Trustees' objectives and Scheme's liquidity requirements. - For open ended funds, the duration is flexible and the Trustees will from time-to-time consider the appropriateness of these investments and whether they should continue to be held.