Capability Scotland Pension Scheme: Implementation Report

July 2021

isio.

Background and Implementation Statement

Background

The Department for Work and Pensions ('DWP') is increasing regulation to improve disclosure of financially material risks. This regulatory change recognises Environmental, Social and Governance (ESG) factors as financially material and schemes need to consider how these factors are managed as part of their fiduciary duty. The regulatory changes require that schemes detail their policies in their Statement of Investment Principles (SIP) and demonstrate adherence to these policies in an implementation report.

Statement of Investment Principles (SIP)

The Scheme has updated its SIP in response to the DWP regulation to cover:

- policies for managing financially material considerations including ESG factors and climate change
- policies on the stewardship of the investments

The SIP can be found online at the web address: https://www.capability.scot/assets/000/000/543/Capability_Scotland_-_September_2020_SIP_original.PDF.

The SIP in the above link was updated in September 2020, having previously been revised in September 2019 to reflect changing regulatory requirements. Changes to the SIP are detailed on the following pages.

Implementation Report

This first implementation statement covers the Scheme's reporting period from 1 April 2020 to 31 March 2021 (the "Scheme Year"). It sets out: (i) how, and the extent to which, in the opinion of the Trustees, the Trustees' policy on voting, stewardship and engagement has been followed during the Scheme Year and (ii) the voting behaviour by, or on behalf of, the Trustees during the Scheme Year, including the most significant votes cast and any use of a proxy voter during the Scheme Year.

This Implementation Report is to provide evidence that the Scheme continues to follow and act on the principles outlined in the SIP. This report details:

- actions the Trustees have taken to manage financially material risks and implement the key policies in its SIP
- the current policy and approach with regards to ESG and the actions taken with managers on managing ESG risks
- the extent to which the Trustees have followed policies on engagement, covering engagement actions with its fund managers and in turn the engagement activity of the fund managers with the companies they invest
- voting behaviour covering the Scheme Year for and on behalf of the Scheme including the most significant votes cast by the Scheme or on its behalf

Summary of key actions undertaken over the Scheme reporting year

- The Trustees reviewed the Scheme's Liability Driven Investment ('LDI') portfolio at the beginning of 2020 following advice from Isio, noting that the hedge was based on liability cashflows from the 2015 Actuarial Valuation. Following the review of the LDI portfolio, using the latest cashflow data provided by the Scheme Actuary from the 1 April 2018 Actuarial Valuation, The Trustees agreed to revise the target hedge ratio against interest rates and inflation from 65% to 80% (measured on a flat-gilts basis). This was successfully implemented over Q2 2020.

Implementation Statement

This report demonstrates that the Trustees of the Capability Scotland Pension Scheme have adhered to their investment principles and their policies for managing financially material considerations, including ESG factors and climate change.

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Position Director McGrigors Pension Trustees Limited

Date 22/09/2021

Managing risks and policy actions DB

Risk / Policy	Definition	Policy	Actions
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.	The Scheme increased its level of hedging to better protect the Scheme against interest rate and inflation risk. **The change to the hedging level was reflected in the SIP which was updated in September 2020.**
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).	The Trustees monitor the Scheme's liquidity position to reduce the impact of this risk via the annual report provided by the investment consultant. Ad hoc advice is also received from the Investment Consultant on a more regular basis, if cashflow requirements become significant.

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.	The Trustees reviewed the investment strategy in 2019 and implemented changes to reflect the revised strategy prior to the reporting period. **These changes to the asset allocation were reflected in the SIP update in September 2019.**
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.	The Trustees indirectly monitor this risk as part of annual performance reporting. After consideration, the Trustees did not believe there was any requirement for action to be taken in relation to this risk over the Scheme Year.
Environmental, Social and Governance	Exposure to Environmental, Social and Governance factors, including but not limited to climate change, which can impact the performance of the Scheme's investments.	Please see Appendix 3 of the Scheme's SIP for the policy relating to managing Environmental, Social and Governance considerations.	ESG actions undertaken: - The Scheme's ESG policy was reviewed by the Trustees as part of the SIP update in September 2019. The managers' ESG policies and approach

			were reviewed in Q1 2020. The Trustees are scheduled to receive training and to review their ESG policies over the next 12 months.
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.	The Trustees indirectly monitor this risk as part of annual performance reporting. After consideration, the Trustees did not believe there was any requirement for action to be taken in relation to this risk over the Scheme Year.
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.	There was no action taken in relation to this risk over the Scheme Year.

Changes to the SIP

Policies added to the SIP	
Date updated: September 2020	
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 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 managers and how they define and monitor targeted portfolio turnover or turnover range.	The Trustees do not directly monitor turnover 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.

Implementing the current ESG policy and approach

ESG as a financially material risk

The SIP describes the Scheme's policy with regarding to ESG as a financially material risk. This page details how the Scheme's ESG policy is implemented, while the following page outlines Isio's assessment criteria as well as the ESG beliefs used in evaluating the Scheme's managers' ESG policies and procedures. The rest of this statement details our view of the managers, our actions for engagement and an evaluation of the stewardship activity.

The below table outlines the areas which the Scheme's investment managers are assessed on when evaluating their ESG policies and engagements. The Trustees intend to review the Scheme's ESG policies and engagements periodically to ensure they remain fit for purpose.

Implementing the Current ESG Policy

Areas for engagement	Method for monitoring and engagement	Circumstances for additional monitoring and engagement
Environmental, Social, Corporate Governance factors and the exercising of rights and engagement activity	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, the Trustees will use any ESG ratings information provided by their investment consultant to assess how the Scheme's investment managers take accounts of ESG issues; 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. Through the manager selection process, ESG considerations will form part of the evaluation criteria.	The manager has not acted in accordance with their policies and frameworks. The manager has received a 'red' ESG rating from the Investment Consultant, signifying that ESG considerations are below satisfactory.

ESG summary and engagement with the investment managers

Manager and Fund	ESG Summary	Actions identified	Engagement details
Apollo Total Return Fund	Apollo uses a team approach across the firm to address ESG issues, and ESG considerations are included in bottom up credit analysis for each potential investment for the Total Return Fund.	Apollo is looking to incorporate a formal scoring system for each individual investment. Apollo also currently provides firm-level reporting on ESG activities, and it was proposed that this should be extended to quarterly fund-specific client reporting.	Isio engaged with Apollo on the Trustees' behalf to review their ESG policies and set actions and priorities. Isio reports back to the Trustees with an update on Apollo's engagements annually. Apollo has now adopted an ESG scoring system from 1-5 and stated that investments would be escalated to the Investment Committee if necessary. Apollo are also now a UNPRI signatory. Apollo previously felt that the governance burden of signing up to the UNPRI was not worth the benefit.
BlackRock Dynamic Diversified Growth Fund	BlackRock has clear firm-wide sustainability goals and have a dedicated team to deal with developing and implementing ESG initiatives. They are actively driving change in ESG through their collaboration with various ESG groups. However, the lack of specific ESG aims and regular reporting for the Fund should be addressed. BlackRock	BlackRock should quantify key performance Indicators and show how portfolio companies are working towards their ESG objectives. Such metrics should be included in regular reporting. BlackRock should also develop measurable ESG objectives for DDG specifically. BlackRock could	Isio engaged with BlackRock on the Trustees' behalf to review their ESG policies and set actions and priorities. Isio reports back to the Trustees with an update on BlackRock's engagements annually.

	are good at communicating their views on ESG, but tangible evidence at Fund level is required.	detail engagements which are specific to the underlying investments of the Fund.	
JP Morgan Unconstrained Bond Fund	The Fund satisfies ESG requirements. ESG is integrated within the Fund's risk management process and investment approach. However, the lack of any ESG reporting needs to be addressed. Despite showing promise in the Fund's adoption of ESG into its processes and risk management, JPM as a company must consider their own impact on carbon emissions as well and their wider business practices.	JPM should finish developing their ESG reporting and ensure this is included in regular reporting. JPM could also consider creating a report that details their engagements with the issuers the Fund invests in. JPM should develop measurable ESG objectives for the Fund, beyond the current ESG policy, when analysing an issuer.	Isio engaged with JPM on the Trustees' behalf to review their ESG policies and set actions and priorities. Isio reports back to the Trustees with an update on JPM's engagements annually.
LGIM LPI Income Property Fund	LGIM have a strong and integrated ESG approach which follows a robust framework. At a firm level, LGIM have a strong history of active engagement and collaboration on ESG related topics. LGIM believe that sustainable investments are crucial to provide resilient, long-term investment returns.	LGIM should look to improve their reporting by logging their engagements and progress on ESG initiatives either annually or quarterly. It would be useful if LGIM provided more evidence of their progress to become net zero carbon across their real estate portfolios by 2050.	Isio engaged with LGIM on the Trustees' behalf to review their ESG policies and set actions and priorities. Isio reports back to the Trustees with an update on LGIM's engagements annually. LGIM have now developed a net zero carbon roadmap detailing milestones required to achieve net zero carbon across their real estate platform by 2050. LGIM have also engaged with a sustainability consultancy in order to establish an integrated reporting tool.
Insight Liability Driven Investment ("LDI")	Insight has shown they have sufficient resource and capability to assess the extent of ESG risks on counterparty exposure for LDI mandates. Insight recognise that their ESG framework can	Insight should consider developing internal diversity targets, focussed not just on gender but also race. They could also put greater emphasis on diversity and inclusion issues	Isio engaged with Insight on the Trustees' behalf to review their ESG policies and set actions and priorities. Isio reports back to the Trustees with an update on Insight's

	be developed even further and we believe this is a positive sign that they are continually improving their approach for considering ESG.	when assessing companies and counterparties. Insight should look to add counterparty ESG scores to their client reporting.	engagements annually..
Insight Liquidity Plus Fund	Whilst Insight has a clear business level ESG policy, there are currently no formal ESG objectives or engagements targets for the cash fund itself.	It was proposed by Isio that Insight should consider demonstrating how ESG risks are monitored.	Isio engaged with Insight on the Trustees' behalf to review their ESG policies and set actions and priorities. Isio reports back to the Trustees with an update on Insight's engagements annually.

The Trustees are satisfied with Isio's engagement on their behalf, and are also comfortable that the managers' performance and responses are in line with expectations, given the policies outlined in the Scheme's SIP.

Engagement

As the Scheme invests via fund managers the managers provided details on their engagement actions including a summary of the engagements by category for the Scheme Year.

Fund name	Engagement summary	Commentary
Apollo Total Return Fund	Total Engagements: 31 Environmental: 8 Social: 5 Governance: 5 Human Capital: 3 ESG: 3 All: 7	Apollo has a clear due diligence and engagement framework. The team continually engage with portfolio companies through discussion with management, and these engagements have been a key driver for the production for formal company ESG reports and Key Performance Indicators. As bond investors, Apollo's voting rights are limited, making it more difficult to engage with portfolio companies in comparison to equity investors. Examples of significant engagements include: **Clearway Energy -** Apollo met with the firm's CEO and CFO to discuss the efficiency of the company's existing renewable wind farms, as well as the acquisition of new renewable wind and solar powered projects. Following this engagement, the company intend to invest at least $300m in renewable energy projects during 2020. **Gannett Co. Inc. -** At the Board meeting Apollo discussed the overall health of the organization as well as diversity and inclusion. The Company has established a Diversity Advisory Council and Employee Resources Groups to increase representation particularly among the leadership team. Following this engagement with Apollo, the company has now set a goal of >50% of the workforce consisting of underrepresented groups by 2025 and increasing diversity at the director level and above.

BlackRock Dynamic Diversified Growth Fund	Total Engagements: 938 Environmental: 584 Social: 411 Governance: 822	BlackRock engage with their companies through their Investment Stewardship team in order to provide feedback and inform their voting decisions. These engagements largely relate to the Fund's equity positions only, which comprised c.30% of the overall portfolio as at 31 March 2020. Examples of significant engagements include: **Chevron Corporation -** BlackRock has a long and constructive history of engagement with Chevron. BlackRock has discussed a range of topics, including corporate governance, climate reporting, greenhouse gas (GHG) and methane emissions reductions, human capital management, and risk oversight processes, among other topics. While Chevron has not made the commitments of some of its European peers towards emissions reductions or business model shifts towards lower carbon alternatives, the company has been consistently open to evolving its reporting processes in response to feedback from investors. Chevron now provides reporting aligned with the Task Force on Climate-related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board (SASB). **Woodside Petroleum Ltd. –** BlackRock regularly monitors Woodside's governance practices and risk profile as part of its responsibility to shareholders. In recent engagements with the company's board, BlackRock had extensive discussions on a range of material issues including the company's approach to the Task Force on Climate-related Financial Disclosures (TCFD), board composition and diversity, broad refreshment and supply chain-related issues.
JP Morgan Unconstrained Bond Fund	Total Engagements: 8 Environmental: 4 Governance: 6	JPM engages with their underlying portfolio projects on a range of ESG issues, mainly related to corporate governance within portfolio companies. Examples of significant ESG activities within portfolio projects include: **Bank of America** – JPM engaged with Bank of America on board dynamics, diversity and inclusion, and sustainable financing efforts. JPM noted the positive stance the company is taking with regard to disclosure of D&I-related data. The company agreed there is a lot of work to do regarding 2050 targets laid out in the European Green deal. The company itself has achieved carbon

		neutrality and is rolling out a series of sustainable financing products. **Telefonica –** JPM met with the company to obtain an update on their ESG program, including various issues such as their human capital management, Covid-19, governance and Board issues, sustainability strategy and executive remuneration. JPM felt the company presented their ESG efforts well, however this did not seem to translate into their overall strategy. JPM wanted to understand why the share price continued to fall despite the longevity of Telefonica's ESG strategy. JPM see this as an area that they will need to continue to engage with the management and Board on. The company have taken steps forward in areas such as gender diversity, where they now have 30% female representation at Board level.
LGIM LPI Income Property Fund	LGIM currently do not provide details of their engagement activities at a Fund level, however, this is something they are looking to implement going forwards. Isio remains in contact with LGIM surrounding the firm's engagement reporting.	Due to the nature of most of the leases within the LPI Fund, LGIM can only engage with the tenants of the assets which are held in the Fund. They maintain dialogue with all occupiers, and as part of this, positive ESG-related behaviours are encouraged.
Insight LDI	Total engagements: 16 Environmental: 1 Social: 3 Governance: 14	Insight has engaged with a number of industry participants on long term strategic issues in relation to LDI, including: - RPI reform and leading the UK's national conversation on RPI, working with the DWP, UK Government and various other institutions - The LIBOR transition - Working with derivative counterparty banks on the integration of ESG factors into the assessment of credit risk The team regularly engages with regulators, governments and other industry participants to address long term structural issues, aiming to stay ahead of regulatory changes and adopt best practice.
Insight Liquidity Plus Fund	Insight currently do not collect engagement data for their Cash Fund, which is limited to the extent in which they may assess underlying counterparty exposure.	Whilst Insight have a clear business level ESG policy, there are currently no formal ESG objectives or engagements targets for the Cash Fund itself.

Voting (for equity/multi asset funds only)

As the Scheme invests via fund managers the managers provided details on their voting actions including a summary of the activity covering the Scheme Year. The managers also provided examples of any significant votes.

In line with the policies outlined in the Scheme's SIP, the Trustees have delegated to the fund managers the exercise of voting rights over the Scheme Year. The Trustees have not explicitly utilised any proxy voting services over the Scheme Year. Only one of the Scheme's investment managers, BlackRock, holds equity exposure; therefore the others have not been included in this section.

Fund name	Voting summary	Examples of significant votes	Commentary
BlackRock Dynamic Diversified Growth Fund	Voteable Proposals: 12,398 Proposals Voted: 11,980 Votes With Management: 11,175 Votes Against Management: 703 Abstain Votes: 105	**Daimler AG -** BlackRock voted against three resolutions in July 2020, including the ratification of Supervisory Board members' actions in the 2019 financial year, the election of a member to the Supervisory Board and on an amendment of Article 16 of the Articles of Incorporation. Despite the Boards' recommendation that shareholders vote for all resolutions, BlackRock voted against given their concerns about progress on climate-related risk reporting, the external mandates held by the proposed Supervisory Board member, and the reduction in shareholder rights from the proposed article amendment. **Facebook Class A Inc -** BlackRock voted against the proposal to elect a Director to the Board as he also serves on the Audit Committee and is therefore not considered independent. Blackrock also voted for a shareholder proposal to approve a recapitalization plan for all stock to have one vote per share. BlackRock voted for this proposal as they generally support one share one vote capital structures.	BlackRock use Institutional Shareholder Services (ISS) electronic platform to execute vote instructions. BlackRock categorise their voting actions into two groups: holdings directors accountable and supporting shareholder proposals. Where BlackRock have concerns around the lack of effective governance on an issue, they usually vote against the re-election of the directors responsible to express this concern.

The Procter & Gamble Company - BlackRock voted for a proposal which requests a report assessing if and how P&G could increase the scale, pace, and rigour of its efforts to eliminate deforestation and the degradation of intact forests in its supply chains. BlackRock also voted against the shareholder proposal requesting the publication of a report assessing the company's diversity and inclusion efforts. Due to P&G's longstanding initiatives and robust disclosures, BlackRock place P&G at the forefront of DEI efforts in the market. As a result, they determined that the requested report would be redundant and therefore did not support it.

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