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RESPONSIBLE INVESTMENT AND ENGAGEMENT

LONDON BOROUGH OF ISLINGTON PENSION FUND (THE "FUND")

This paper has been prepared for the Pensions Sub-Committee ("PSC") of the Fund to provide an introduction to both the drivers for and approaches to Responsible Investment (RI). The paper also sets out guidance for some next steps that the PSC can take in terms of developing its approach to RI and engagement.

Mercer defines RI as the integration of environmental, social and corporate governance (ESG) factors into investment management processes and ownership practices in the belief that these factors can have material impact on financial performance (please see Appendix A for examples of ESG issues). RI is distinct from ethically driven investment, which is typically guided by moral values, ethical codes or religious beliefs.

There are five main approaches that fall under the broad category of RI. These approaches can be implemented on a stand-alone basis or in combination; indeed, most investors employing a comprehensive RI programme would have elements of most, if not all, of these approaches. We have set out below a brief summary of each of these approaches:

1. ESG integration — Ethically driven ✗ Financially driven ✓

At the forefront of recent developments in RI is an integrated approach to considering ESG factors as part of the investment process. Integration can be applied across all asset classes, although at present the asset class where ESG integration is most developed is listed equities. Investment managers adopting this approach actively take ESG issues and themes into account in their fundamental research, analysis and stock-selection decision-making processes.

Some investors utilise ESG indicators purely for risk management purposes, while for others they are fundamental to the idea generation and portfolio construction for added-value creation. Mercer rates over 5000 investment strategies on the extent to which ESG issues are integrated into the investment process. (For more detail on Mercer's ESG ratings approach, please see Appendix A).

2. Active ownership (engagement) — Ethically driven ✗ Financially driven ✓

Active ownership, also referred to as stewardship, is an investment approach whereby investors seek to use their influence as shareholders to change corporate behaviour, usually to bring them in line with best practice in a particular area and most commonly to improve standards of corporate governance through engagement.
Active ownership tools range from using voting rights and undertaking engagement activity through oral and written communication with companies on specific topics, to collaborative

engagement with other shareholders often to promote systemic change within a certain sector. These tools are increasingly being pursued in an effort to reduce risk and enhance long-term shareholder value. The UK Stewardship Code was introduced in 2010 to encourage on-going dialogue between investment managers and asset owners.

3. Screening (Positive or Negative)	Ethically driven ✓	Financially driven ✓

Positive screening is the inclusion or overweighting of public company stocks based on whether the company has a positive impact on society through their ESG policies (such as community investing, health, public transport and renewable energy). Negative screening is the exclusion or underweighting of companies that are involved in sectors with a perceived negative impact on society, such as gambling, alcohol, animal testing, armaments manufacturing and tobacco production, or companies with poor records of ESG performance.

4. Thematic investing	Ethically driven ×	Financially driven ✓

Investing in sustainability themes offers attractive opportunities to access the growth potential of companies providing solutions to the challenges of resource scarcity, demographic changes, and changes in the evolving policy response to a range of environmental and social issues. The vast majority of themed funds have a sustainability/environmental focus. These funds have grown significantly (both in terms of number of strategies and assets being managed) in recent years with the emergence of sustainability as a key social and investment trend that may drive long-term growth and returns.

5. Impact investing	Ethically driven ✓	Financially driven ✓*

The Global Impact Investing Network defines impact investments as “investments made into companies, organisations, and funds with the intention to generate measurable social and environmental impact alongside a financial return”. Impact investing strategies are typically private equity, private debt or other alternative strategies, although more recently some listed equity strategies have emerged. There is a wide variety of potential approaches, but a common type of fund uses investor capital to support small businesses in emerging or under-served markets and typically impact investing funds seek to invest in companies or organisations that are solutions-oriented in terms of addressing environmental or social issues. The key differentiator between impact investment strategies and ESG integration is an expectation of detailed measurement and reporting of positive impact alongside financial returns.

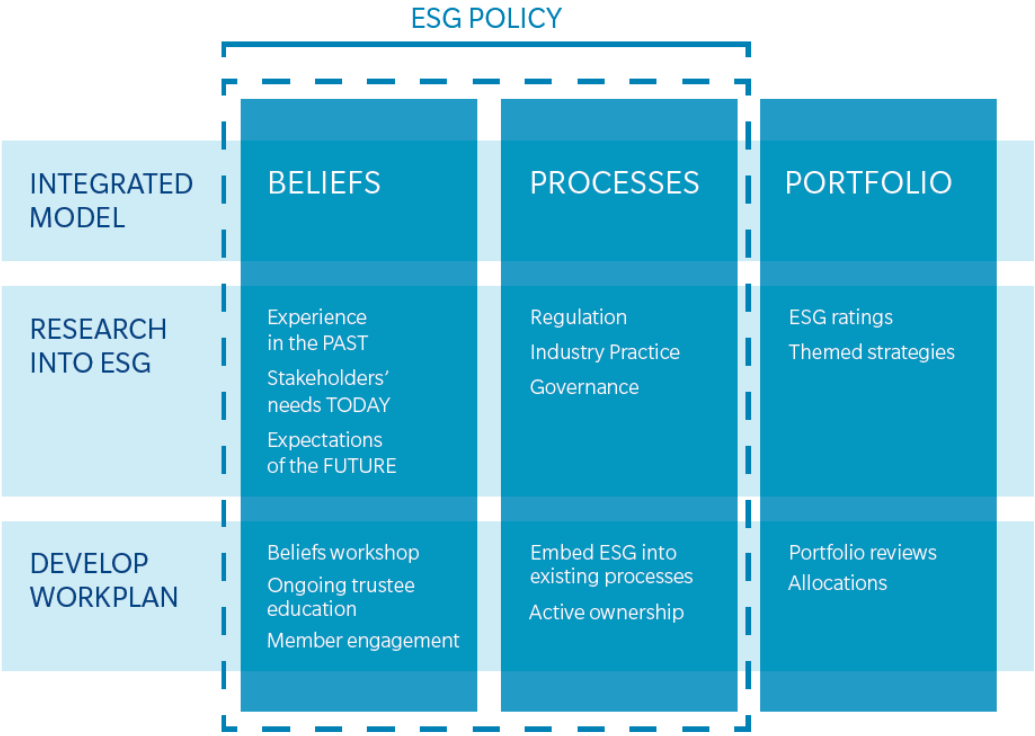
* Impact investment strategies vary between those that target market-level investment returns (and are therefore financially driven) and those that offer below market level returns, which are sometimes referred to as “impact-first” strategies. Those strategies that would be suitable for the Fund would fall into the former category.

Implementation and next steps

Responsible investment principles are applied most effectively when integrated into standard investment processes, providing an additional layer of insight and oversight. Mercer recommends that the PSC focuses on improving the level of ESG integration and active ownership

(engagement) within its existing investment manager structure as well as considering whether, longer-term, it should expand into thematic or impact investment strategies. In particular, the PSC could consider the ESG ratings and UK Stewardship Code compliance of its investment managers in more detail.

The framework below identifies where ESG and sustainability considerations sit within the typical 'Beliefs, Processes, Portfolio' investment approach.



We would be happy to work with the PSC to help integrate RI further into the Fund's investment strategy.

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Nick Sykes
August 2015

Appendix A: Examples of ESG issues

TABLE 1: ESG FACTORS

ENVIRONMENTAL FACTORS	SOCIAL FACTORS	GOVERNANCE FACTORS
Climate change strategy	Stakeholder relations	Board structure and diversity
Environmental policy	Working conditions	Independent board directors
Sustainability best practice	Supply chain management	Independent board leadership
Environmental management practices	Health and safety conditions	Separation of Chairman and CEO
Pollution management	Product safety measures	Executive compensation
Water supply management	Treatment of customers	Shareowner rights
Sustainable transport	Labour relations, including relationship with unions	Accounting quality
Waste management	Community impact assessment	Audit quality
Clean energy investments		Board skills

Appendix B: Mercer's ESG ratings

Mercer's ESG ratings process involves rating fund managers against their ability to outperform their benchmark whilst taking ESG factors into account. The ESG ratings are applied at the strategy level (rather than the manager level) and represent Mercer's view on the extent to which ESG and active ownership practices are integrated into the manager's investment process across different asset classes. Mercer assesses how ESG factors are incorporated into idea generation, portfolio construction, implementation and business management (see below table for further detail). The extent to which fund managers have formalised their approach varies considerably and, consequently, Mercer ESG ratings can vary greatly even within asset classes and styles. We believe investment decisions should not be taken on ESG ratings alone, but as part of the overall evaluation and selection process consistent with fiduciary duty.

Factors	Example considerations
Idea generation	Is there evidence of identifying ESG risks and opportunities at the portfolio level?
Portfolio construction	How effectively does the manager translate his/her ESG views into the active positions in the portfolio?
Implementation	Does ESG integration impact on the manager's portfolio turnover and investment horizon? Is there evidence of proxy voting and engagement activities?
Business Management	To what extent do the business leaders understand and accept the importance of ESG/RI and to what extent have they integrated these across the whole business?

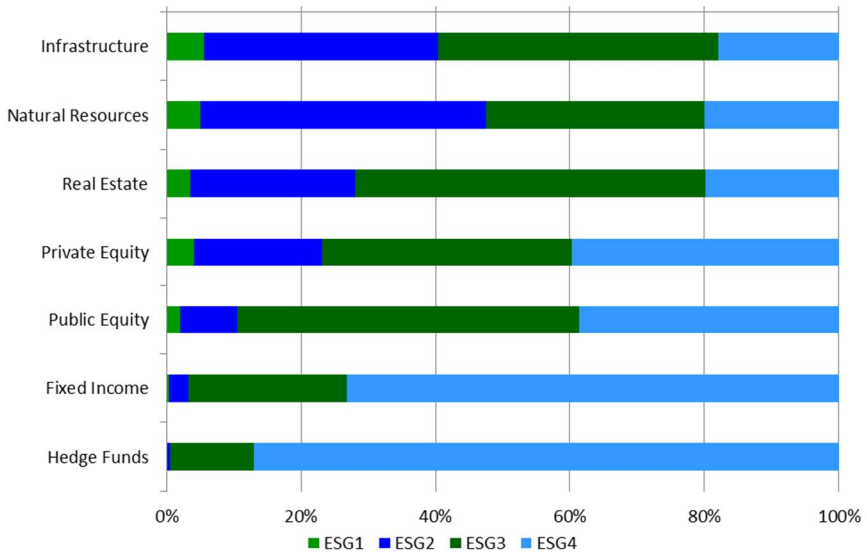
The ratings are presented as 'zones of capabilities' along a 4 point scale as follows:

Rating	Description
ESG1	The highest ESG rating is assigned to strategies that Mercer believes to be leaders in integrating ESG and active ownership into their core processes, and that provide clear evidence that ESG overall, or a particular ESG theme, is core to idea generation and portfolio construction.
ESG2	The second highest rating is assigned to strategies that, in Mercer's view, include ESG factors as part of decision making, with a strong level of commitment made at the firm-wide level and some indication that data and research are being taken into account by the managers in their valuations and investment processes.
ESG3	The penultimate rating is assigned to strategies for which, in Mercer's view, the manager has made some progress with respect to ESG integration and/or active ownership, but for which there is little evidence that ESG factors are taken into consideration in valuations and investment processes.
ESG4	The lowest ESG rating is assigned to strategies for which, in Mercer's view, little has been done to integrate ESG and active ownership into their core processes.
N	Strategy not rated by Mercer.

Figure 2 below shows the distribution of ESG ratings, across a number of different asset classes, as at the end of August 2014. Approximately 10% of those strategies with an ESG rating

(~6,000) have received our highest ratings - ESG1 or ESG2. While this is currently a relatively small percentage, we note that industry standards continue to evolve towards a greater formalisation of ESG integration. ESG1-rated strategies are often structured so that ESG issues drive the idea generation process. Examples of these types of strategies include sustainability themed funds focused on sustainable development (through ideas such as clean energy or water efficiency), and therefore ESG1-rated strategies tend to be less diversified and more volatile than "core" or other strategies. ESG2-rated strategies include some Socially Responsible Investment (SRI) funds but also a growing number of mainstream, diversified investment strategies across different regions and asset classes.

ESG ratings distribution across asset classes – Mercer Universe as of August 2014 (n=5,970)



ESG ratings for passively managed equity strategies

In 2014, Mercer adapted the ESG ratings framework for passively managed equity strategies, introducing our ESG-Passive "ESGp" ratings. The ESGp ratings scale is designed to assess passive equity managers' commitment to voting, engagement, and industry collaboration on ESG issues. This is reflected in the ESGp four factor framework, which is detailed in the table below.

Factors	Example considerations
Voting and engagement process	Quality of engagement – is the focus only on corporate governance issues or does the team have a process in place for environment and social engagements?
Resources and implementation	Effectiveness of engagement outcomes – is this being measured? If so, how?
ESG integration and internal initiatives	What additional work is the team undertaking regarding ESG data analysis to enhance the active ownership process?
Industry collaboration / firm-wide activities	Does the team work with other institutional investors in collaborative initiatives and engage with regulators and policymakers?

ESGp ratings are also assigned using an ESGp1 to ESGp4 scale (see below) but are not directly equivalent to Mercer's ESG rating scale for active equity strategies, as passive equity strategies do not consider Idea Generation or Portfolio Construction.

Rating	Description
ESGp1	Leaders in voting and engagement across ESG topics, with active ownership activities and ESG initiatives undertaken consistently at a global level.
ESGp2	Strong approach to voting and engagement across ESG topics, and initiatives at a regional level, with progress made at a global level.
ESGp3	Focus tends to be on voting and engagement on governance topics only, more regionally focused with less evidence of other internal ESG initiatives.
ESGp4	Little or no initiatives taken on developing a voting and engagement capability, with little progress made on other ESG initiatives.
N	Strategy not rated by Mercer.

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