DRAFT LETTER TO All MANAGERS

Dear

Responsible Investing and Social Impact (RISI)

Background

For many years now, the Clwyd Pension Fund (CPF) has had a formal sustainability policy, which was put in place well before there was any formal requirement for such. It has recently updated this to the reflect the modifications in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 and the statutory guidance issued by the MHCLG.

Again the CPF's policy revision took the Regulation requirements much further than was necessary, strengthening considerably the focus on social and impact investing and the measurement of outcomes. This enhanced focus was reflected throughout the changed policy document, but particularly in a new appendix, specifically relating to "Non-financial Factors and Social Investing".

It was felt that, having established this new policy document, the CPF needed to try to assess both the performance of managers against this in terms of outcomes and impact, and the performance of the CPF itself in terms of investment decisions and its allocation to RISI-qualifying funds, with an initial focus on private equity and real assets (PE/RA), a 22% allocation within the CPF. Whilst the CPF has for some time invested directly in environmental and social impact funds within PE/RA, it was also clear that many other funds and investments contained exposure to sectors and specific underlying assets that were likely to be RISI-compliant.

This latter objective of trying to measure the CPF's degree of RISI compliance, even just within PE/RA, effectively meant trying to at least assess each of the CPF's managers and funds in this respect – a daunting task as the CPF has almost 50 such managers, around 160 relevant funds and countless underlying assets.

The CPF was also aware that at least one public sector body, the Environment Agency Pension Fund (EAPF), had already set a target weighting for environmental, social and governance (ESG) investing within its portfolio.

Approach

The CPF's objective is to place a far greater emphasis on the outcome and impact of investment decisions rather than just the decision-making process itself, whilst accepting that there is clear linkage there. Certainly broader ESG aims and processes in terms of governance and the screening of investments by managers remain very important for the CPF as part of its sustainability policy, since these can ensure positive outcomes or at least avoid potentially negative ones. As a result, these will remain on the in-house team's agenda for discussion with managers at all update meeting. However, for the future, there will also be an increased focus on the outcomes of those investment decision and the measurement of their impact. As noted above, this exercise and this letter focus specifically on this latter objective.

A considerable amount of research was carried out during 2017 trying to determine how this objective might be approached. The CPF was already aware that there was a growing interest in and focus on responsible investing, green issues and social impact. A number of national and global groupings were already trying to establish definitions around these, agreed criteria for inclusion and possible measurement methodologies. These were used as a basis for the development of the CPF's approach. The exercise itself was carried out on a phased basis over several months and started with setting of some broad guidelines. As part of this process, the CPF followed the progress being made through the Impact Management Project facilitated by one its dedicated social impact managers, Bridges Fund management (BFM).

Broad Guidelines

In trying to establish a RISI assessment process, it was agreed at an early stage that –

- Any such process had to be simple, relatively easy to implement and at minimum cost.
- Initially at least the exercise should concern just private equity and real asset (PE/RA).
- In assessing compliance, the focus should be on direct RISI elements, not wider ESG considerations.
- Detailed criteria would need to be set for the CPF and its managers to determine RISI compliance.
- Any RISI-compliance target must reflect the asset types being considered and the criteria set.
- If limited to PE/RA, this target should be a % of both the 22% PE/RA weighting and the total fund.
- The degree of RISI compliance would henceforth be a factor in due diligence on prospective investments.

Definition and Criteria

Here the aim was to specify criteria that identify funds or investments for inclusion in RISI quantification and, in doing this, reference was made to a number of Sustainable Development Goals (SDGs). These include good health and wellbeing (SDG 3), quality education (SDG 4), sustainable cities and communities (SDG 11) and responsible consumption and production (SDG 12). Some components of these, such as clean energy and the elimination of waste, are straightforward, whilst others, such as job creation and the provision of services can be less clear. In these latter areas, the criterion of deprivation or under-served areas would be a key factor. In addition, it is also important to take account of the investee business itself in terms of the proposal's likely longevity and potential for growth in relevant RISI areas.

It was ultimately decided to adopt the three broad categories as a basis for this approach – sustainable communities and living, health and well-being and education and skills. These broad criteria are set out below with the main areas for inclusion listed. It should be noted that the deprivation and investee business issues overarch all three main areas.

<u>Sustainable Communities and Living</u>

- Any clean energy investments (wind, solar, wave, hydro etc.) and any infrastructure and technological development around these areas;
- Treatment of waste, landfill avoidance, clean water production, recycling of material and energy;
- Energy and waste saving through real estate developments and construction;
- Cleaner transport developments;
- Responsible consumption and production;
- Any infrastructure and technological developments related to the above.

<u>Health & Well-being</u>

- The provision of residential and day care health services;
- Initiatives to address aging population, chronic illness and obesity issues;
- Community health support projects (transport, pharmacies etc.)
- Projects to support healthy living;
- Any health infrastructure and technological developments related to the above.

<u>Education & Skills</u>

- The provision of nursery, before-school, after-school and day care services for children;
- The provision of apprenticeships, adult training and further education;
- Projects addressing numeracy/literacy;
- Other projects aimed at addressing skill shortages and job creation;
- Any infrastructure and technological developments related to the above.

Application and Measurement

With the criteria set, consideration moved to the determination of a workable methodology so that these could be applied and a RISI measurement determined. The agreed outcomes from these considerations are set out below.

- Measurement should be at value, not cost, as this best defines the active element within the CPF portfolios.
- For simplicity and consistency, application should be at individual fund level to create a percentage RISI weighting, rather than trying to value RISI for all individual investments on an ongoing level.
- Whilst this percentage basis would only deliver an "approximation", the alternative of valuing every individual holding within a fund with existing resources was impossible, and the outcomes would only be available well in arrears, after the receipt of detailed valuations from every fund.
- This exercise would be carried out initially for all the CPF's heritage holdings and later for new funds or commitments as part of due diligence and once they joined the portfolio.
- On existing investments, each fund would be assessed using current data to determine those investments meeting the RISI criteria to produce a percentage RISI figure for that fund. This would then be applied to the current and all future valuations to produce quarterly RISI valuation levels.
- New Investments would be assessed in terms of their RISI weighting at the time of commitment based upon the information from the manager concerned and the due diligence carried out.
- For all funds, RISI impact or outcome statistics would also be sought from managers, and adjustments could be made to fund percentages going forward, on the basis of later data or where clear and significant changes from the intended strategy were identified.

Exercise

The initial exercise on PE/RA was carried out in late 2017 to test the above approach and to deliver draft results for consideration. In structuring this work, the following important points were noted.

- Some areas such as infrastructure and timber/agriculture were likely to be more RISI significant than others, although there were specific funds within PE and property with strong RISI credentials.
- In terms of value, a good number of funds were closed or had minimal value and would therefore be less significant in terms of the overall RISI percentage.
- Evidence of RISI would be firmer in funds closer to full investment than newer ones, where prior fund or pipeline evidence would need to be used.
- A relatively small number of the CPF's PE/RA holdings would probably deliver the bulk of the RISI percentage (20/80 rule?), so the emphasis needed to be on these.
- Portfolios down to investee company would not always be known, particularly on fund of funds.
- Even where a fund's portfolio was fully known, there would still be subjective considerations about RISI compliance or degree of compliance.
- So, whatever the fund, the evidence was unlikely to be absolute and RISI assessments, of necessity, would usually be subjective approximations to some extent.
- A very conservative approach should be taken in determining these initial RISI percentages.
- The key factor was not the absolute overall figure determined, but rather the determination of an established measurement process and a base level to see how RISI figures moved over time.
- With this in mind, 31 March 2017 portfolios and valuations were deemed a reasonable starting point to establish an early base position for the first exercise.
- Whilst this would exclude a number of the infrastructure commitments made in-year, it would allow an early comparative view to be considered at 31 March 2018.

Results

The exercise itself produced two key documents as follows, with the outputs from these spreadsheets and the exercise summarised in the table below.

- RISI Portfolio Analysis – A narrative document listing every PE/RA fund individually, giving details of RISI involvement, where accessible, and a suggested RISI weighting.
- RISI Percentage Analysis – A spreadsheet listing every PE/RA fund individually, showing commitment size (£), value at 31 March 2017, RISI percentage to be applied from the above document, the resulting RISI value, plus overall RISI weights on the basis of the PE/RA portfolio valuation and the total CPF valuation at 31 March 2017.

	Commit Cost £000	**Value £000**	**RISI Value £000**	**RISI % Of PE/RA %**	**RISI % Of CPF %**
Private Equity					
FOF	174,930	80,270	8,742	2.6	0.5
Direct	237,370	66,183	18,553	5.5	1.1
Free	80,600	17,247	236	0.1	0.0
	492,900	**163,700**	**27,531**	**8.2**	**1.6**
Real Assets					
Infrastructure	93,300	31,468	24,998	7.5	1.5
Property Open Ended	28,167	39,765	398	0.1	0.0
Property Closed Ended	142,500	73,563	16,249	4.8	1.0
Timber Agriculture	27,500	28,013	28,013	8.3	1.7
	291,467	**172,803**	**69,657**	**20.7**	**4.2**
	784,367	**336,509**	**97,188**	**28.9**	**5.8**

Conclusions

As can be seen, the application of this analysis suggests that, overall, about 29% of the PE/RA portfolio on a value basis is deemed RISI-compliant as at 31 March 2017 and that this equates to around 6% at total CPF fund level[1]. This appears to be very much within the range expected prior to the undertaking of the exercise. At a more detailed level, the bulk of the RISI weighting did prove to have come from a limited number investments, as shown below -

- PE FOF – Of the 2.6% (% of PE/RA), almost 80% came from two environmental funds.
- PE Direct – Whilst more broadly spread, of the 5.5%, 70% is accounted for by five funds.
- RA Infrastructure – Again this was spread, but two funds accounted for over 50% of the 7.5%.
- RA Closed-Ended – Over 95% of the 4.8% is accounted for by three relevant funds.
- RA Timber/Agriculture – All exposure was deemed RISI on the grounds of decarbonisation, the reversal of de-forestation impacts and the global food shortage.

[1] £1.67 billion at 31 March 2017

Actions

On the basis of the exercise, it was agreed –

- To set the following long-term RISI targets for the CPF –
  - % of PE/RA assets – 50%
  - % of total Fund – 10%
- To share these overall results with the CPF's PE/RA managers and to ask for feedback on the approach and process adopted.
- To share with PE/RA individual managers the exercise results on their vehicles and to seek their views on these, particularly the RISI percentages determined.
- To seek from managers information on the degree and type of RISI impact analysis carried out on their fund commitments post-investment.
- To raise and discuss all the above issues with managers at the regular update meetings held with them.

It is accepted that the RISI results achieved represent very much an educated approximation, but they do provide a base against which progress towards greater RISI compliance can be measured. However, hopefully with your help and cooperation, both the approach and process can be refined and the results achieved updated to reflect input from you.

This is seen as a key initiative by the CPF and any feedback on the on the approach, process, exercise and the results achieved would be very much appreciated.

The exercise results on your vehicles are shown on the attached pro forma. I should be grateful if you would complete the pro forma indicating your own estimated figure for RISI compliance, together with some justification for this and any other comments on the CPF's approach and process.

I look forward to hearing from you.

Kind Regards

RISI RETURN

MANAGER – HARBOURVEST

CPF Assessment (%)

Fund	Details	%
A	These are broadly based FOF but with little information on underlying assets, it is difficult to quantify RI exposure. Assumed 2%.	2
B		
C		
D	Invests in cleantech funds and other generalist funds with strong cleantech elements.	70
E	Broadly based FOF but with little information on underlying assets, it is difficult to assess RI exposure. Assumed 2%.	2

Manager Assessment

Fund	Details	%
A		
B		
C		
D		
E		

Comments on Approach & Process

RISI RETURN

MANAGER – HARBOURVEST

Assessment Breakdown over SDGs

Fund	Details	%
A	SDG – Sustainable Communities & Living	
	SDG – Health & Well-being	
	SDG – Education & Skills	
	SDG - Other	
B	SDG – Sustainable Communities & Living	
	SDG – Health & Well-being	
	SDG – Education & Skills	
	SDG - Other	
C	SDG – Sustainable Communities & Living	
	SDG – Health & Well-being	
	SDG – Education & Skills	
	SDG - Other	
D	SDG – Sustainable Communities & Living	
	SDG – Health & Well-being	
	SDG – Education & Skills	
	SDG - Other	
E	SDG – Sustainable Communities & Living	
	SDG – Health & Well-being	
	SDG – Education & Skills	
	SDG - Other	