Pace
pension
scheme

Co-operative Pension Scheme (Pace)

2020 UK Stewardship Code and **Responsible Investment report**

Foreword

The Pace Trustee is pleased to publish its annual report on responsible investment for the year to 5 April 2020. 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.

This year, our report also demonstrates how we have complied with the principles underlying the updated UK Stewardship Code, which came into force on 1 January 2020. The new code sets out a number of areas of good practice which the Financial Reporting Council (FRC), the UK's independent regulator responsible for promoting high quality corporate governance and reporting, believes institutional investors like Pace should aspire to. This report sits alongside our 'Implementation Report', which is published on the Scheme's website and is a statutory requirement setting out how we have complied with the policies in our Statement of Investment Principles.

This report has been prepared for the Trustee by the Co-op Pensions Department and reviewed and approved by the Pace Trustee.

Chris Martin, Chair, Pace Trustees Limited

About us

The Co-operative Pension Scheme (Pace) is a UK-registered occupational pension scheme with assets held on behalf of members by PACE Trustees Limited (the Trustee).

In 2018, Pace was separated into two legally separate sections. The Co-operative Bank is the only employer in the Bank Section; all other employers participating in Pace are in the Co-op Section.

Both the Co-op Section and the Bank Section contain historic defined benefit (DB) and defined contribution (DC) sections for members who are currently contributing.

As at 5 April 2020, there were over 77,000 members of Pace with DB benefits, including almost 37,000 members with pensions already in payment, and 40,000 members who are yet to retire; Pace's DB assets at that date were over £11bn.

The DB section of Pace (Pace DB) closed to future accrual in 2015. DB benefits were built up based on a member's salary and length of membership.

The DC section of Pace (Pace DC) was established in 2012, and since 2015, is the only section of Pace which has actively contributing members. As at 5 April 2020, there were over 69,000 members of Pace with DC benefits, all still contributing or yet to draw benefits (when members draw their benefits from Pace DC by taking cash, buying an annuity or transferring out, they leave the Scheme). The total value of members' pension pots in Pace DC was around £430m.

The average age of members of Pace DC is approximately 41, while the average age of members of Pace DB (both pensioner and non-pensioners) at the last actuarial valuation was higher at approximately 62; we therefore assume a longer time horizon when looking at investment strategy for Pace DC than for Pace DB.

How do we invest?

We've prepared a Statement of Investment Principles (SIP) (the document that governs the way the Scheme's assets are invested) for each of the Co-op and the Bank Sections of Pace, which are available on the Pace website.

In brief:

- Pace DB aims to pay benefits to members and their dependants as set out in the Trust Deed and Rules. These benefits are paid out of investments selected by the Pace Trustee.
- Pace DC allows its members to build their own retirement pots. Members choose how they want to invest their money from a selection of investment options offered by the Trustee.

We're committed to achieving these goals in a way that takes into account broader social and environmental concerns.

We would like our approach to responsible investment to reflect the views of Pace members as far as reasonably possible. We therefore welcome members' views on these issues. We also believe that our approach to responsible investment should be consistent with the values of our sponsors, and their members and colleagues, again as far as reasonably possible. Finally, we believe that our Responsible Investment Policy should reflect the extent to which environmental, social and corporate governance (ESG) issues might represent a risk to the Scheme.

Over time, we have worked with the Co-op and the Co-operative Bank to identify three broad issues which we feel reflect the views of these stakeholders. These issues are:

- Climate change and the protection of the environment;
- Labour conditions and equal pay; and
- Corporate governance.

This is set out in our Responsible Investment Policy, which is available on the Scheme's website.

New regulations have come into force this year which introduced new requirements for pension schemes setting out the policies they need to explicitly include in their SIP. In particular, the SIP needs to set out the Trustee's policies on how we take account of ESG considerations when setting investment strategy, and how we engage with the companies we invest in.

The remainder of this report sets out how we, and our asset managers, have aimed to be responsible asset owners over the year.

Over time, we have implemented a lower risk investment strategy for Pace DB. This means that we invest more in bonds and bond-like investments and less in shares ('equities') and other risky investments, aiming to reduce the volatility of Pace's funding position and improve security for members and employers.

As part of this journey, in early 2020 we entered into insurance policies with Aviva and Pension Insurance Corporation (PIC), two UK insurers, to match the pension payments due to some members of the Co-op Section of Pace DB. The value of these policies was around £2.4bn. In April 2020 we also entered into an insurance policy with a value of c£400m with PIC, to match the pension payments due to some members of the Bank Section of Pace DB. As we don't have control over how PIC or Aviva invest, we don't cover the insurance policies in this report.

Responsible Investment – what has the Trustee been doing this year?

1. We reviewed our Responsible Investment Policy

We review Pace's Responsible Investment Policy at least annually, with input from the Co-op and the Co-operative Bank, and last updated it in March 2020. The policy now explicitly calls out climate change as a particular financial risk to the Scheme, and also recognises the growing size and significance to members of Pace DC, and the need for the investment strategy of Pace DC to be invested in a sustainable and long-term way.

Climate change is a particular financial risk to the Scheme…

2. We continue to monitor our investment managers' approaches to incorporating environmental, social and governance (ESG) factors in their investment processes

We recognise that ESG factors can affect the financial performance of the companies and other assets we invest in. Our investment managers take account of ESG factors when they are implementing their mandates. As part of this, they engage directly with the companies they invest in to understand and assess topics like climate change, workers' rights, board constitution, and appropriate use of capital and directors' remuneration. When we appoint a new investment manager for Pace, we also consider the manager's approach to incorporating ESG factors and climate change issues into their investment strategy.

We consider ESG factors when appointing or evaluating managers…

We meet with each of our investment managers at least annually (at Trustee meetings or via our quarterly Manager Monitoring Investment Committee (MMIC) meetings), and ESG considerations and developments are a standing agenda item for each manager to provide an update on. Furthermore, our investment adviser assigns a rating to each manager according to the extent to which ESG issues and active ownership practices are integrated into their investment processes. The investment adviser's ESG-related ratings are reported to the Trustee and MMIC each quarter and are used as a factor in manager evaluation and selection.

3. We changed the default investment strategy for Pace DC to reflect our Responsible Investment Policy

Aligned with our review of Pace's Responsible Investment Policy, in 2018 we considered, alongside the Co-op and the Co-operative Bank, how to manage risks to members within Pace DC by reflecting ESG factors within the default investment strategy offered to members, given the long-term nature of members' investments.

Following this review, in June 2019 we changed the Pace Growth (Mixed) Fund, which forms a large part of the default investment strategy for Pace DC, from the Growth Mixed Fund to Legal & General's Future World Multi-Asset Fund, which we believe is more consistent with our Responsible Investment Policy.

We've changed Pace DC investments so they're more in line with our Responsible Investment Policy…

The Future World Fund 'tilts' investments towards companies that have higher governance standards, and aims to achieve positive social and environmental impacts, including companies which are less carbon-intensive or earn green revenue; it also excludes investment in coal mining and companies involved in the manufacture or distribution of controversial weapons.

Page 20 gives a deep dive into the Future World Multi-Asset Fund, and why we believe it is aligned with our objectives as a responsible investor.

4. We have continued to implement a list of excluded investments for Pace DB

We continued to work with MSCI, a leading provider of investment tools and research, to implement an exclusions list to help us avoid investing in assets (where possible) that do not fit with our core beliefs. We developed this exclusions list so that it is practical to apply and does not constrain our investment managers in securing the investment returns needed to pay members' benefits. The investment exclusions we agreed in April 2017 are:

- Extractive industries: excluding investment in companies involved in the oil, gas or mining industries which are also rated poorly by MSCI with respect to how their specific environmental risks are addressed;
- Controversial weapons: excluding investment in companies involved in the manufacture or distribution of land mines, cluster munitions, chemical weapons, blinding lasers or depleted uranium munitions; and
- Human rights: excluding investment in debt issued by countries which score poorly on a number of indicators of effective governance and provision of basic rights and services to their populations.

There are almost 500 companies we won't invest in because they don't meet our ESG standards…

Throughout the year, we worked with MSCI to keep the exclusion list up to date, to reflect their latest research updates. As at April 2020, the exclusions list covered:

- Corporate bonds issued by 483 companies in the extractive industries with poor environmental ratings (2019: 454 companies);
- Corporate bonds issued by five companies (2019: four companies) involved in the manufacture or distribution of controversial weapons; and
- Government bonds issued by 71 countries (2019: 67 countries) with poor human rights scores.

These exclusions are applied to Pace DB's assets, covering Corporate Bond and Liability Driven Investment mandates which made up over 78% of the Co-op Section's assets (excluding the insurance policies purchased earlier in the year) and over 96% of the Bank Section's assets as at 31 March 2020. This means that approximately £7.5bn of Pace's assets were screened using the exclusions list. We monitor the implementation of these exclusions, and over the year (as instructed), our bond managers have not made any purchases prohibited by the exclusions lists. A small amount of residual holdings (0.6% of Pace's total assets, excluding the insured assets) are in investments on the exclusions list. This shows a slight increase compared to 2019 (0.2%) as a result of the increase in the number of companies covered by the exclusions lists (and the transfer of other assets to PIC and Aviva).

We have discussed ways to reduce these small residual holding over time with our asset managers; market volatility in early 2020 as a result of the Covid-19 pandemic meant that it was an unattractive time to undertake transactions, and this will be revisited once markets have become less turbulent. A further update will be provided in next year's report.

How do we exercise 'stewardship'?

'Stewardship is the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society' – The 2020 UK Stewardship Code

We're committed to achieving our investment objectives in a way that takes into account broader social and environmental concerns, and by investing responsibly.

As the Trustee, we exercise our stewardship responsibilities in the best interests of all the members of Pace. We operate a Defined Contribution (DC) Committee which is responsible for the development and operation of Pace DC's investment policy, while the Trustee Board performs the same role for the Scheme's DB assets. Responsibility for the day-to-day management of assets is delegated to our appointed investment managers, and their approach to implementing responsible investment principles is monitored by the Manager Implementation and Monitoring Committee (MMIC). The duties of the MMIC and the DC Committee are to consider in detail performance monitoring, risk assessment, and operational and implementation matters. The Committees report back to the Trustee on key issues raised at the Committee in quarterly Trustee Board meetings or at ad hoc meetings when needed.

Following changes in late 2017 to reduce risk in our investment strategy, Pace DB no longer invests in company shares (either directly or through pooled funds). Nevertheless, we have acknowledged the importance of considering ESG factors (and specifically climate risk) in investment decision-making and reserve the right to use a more direct engagement approach with investment managers and investee companies. In such situations, we may:

- Work with investment managers and other institutions to engage with companies; and
- Contact investee companies directly or through our investment managers.

We encourage our appointed investment managers to commit to the Stewardship Code. Our managers have their own policies to demonstrate how they monitor and engage with the companies in which they invest, to protect and enhance value to clients. Seven of Pace's 11 investment managers (as at 5 April 2020) have published statements of compliance with the UK Stewardship Code, and links to their statements can be found in Appendix 2. In addition, all of Pace's mandates are managed by signatories to the United Nations-backed Principles for Responsible Investment (UNPRI) – see Appendix 1.

Managing conflicts of interest in relation to stewardship

We have a clear procedure for identifying and managing conflicts of interest which may arise from time to time. The Trustee Board meets at least quarterly, and in advance of each meeting, Trustee Directors are asked to consider if they have:

- Any material personal interest in the outcome of any discussions on the agenda;
- Any involvement in negotiating on funding or on any other matter on behalf of the Co-op or the Co-operative Bank;
- Any knowledge acquired from another role which would materially impact on decision-making, and which may not be shared with the Board; and
- Any difficulties in treating discussions as confidential.

Potential conflicts of interest are managed by obtaining appropriate legal advice where necessary, with full disclosure being made within minutes of meetings.

We believe it is important to be transparent so we inform our members how we invest in order to show the Scheme is exercising its responsibilities as an asset owner effectively. The following documents are updated at least annually and are publicly available on the Scheme's website:

- Pace's Statement of Investment Principles (SIP) for the Co-op and Bank Sections;
- Responsible Investment Policy (covering both DB and DC assets);
- The Scheme's annual report and accounts; and
- Our Annual Responsible Investment Report.

What have our investment managers been doing?

Our investment managers put a lot of work into investing responsibly and considering ESG factors in their investment processes, and some go as far as extending this to how they run their own businesses. The following sections cover in more detail the policies and approach to responsible investment taken by Pace's main investment managers for Pace DB – LGIM, RLAM, Insight Investment and BlackRock – where target holdings are at least 5% of total assets, and for Pace DC's assets.

We've also tried to highlight specific examples of how these managers engage with the companies we invest in on our behalf.

We also engage with our other asset managers routinely on their exercise of stewardship of the companies they invest in, or the properties they own on behalf of the Scheme and their interaction with tenants; in some instances, for example asset-backed securities, this is less directly applicable as they invest in instruments such as Collateralised Loan Obligations (CLOs) which themselves invest in tranches of underlying debt rather than individual businesses. In these cases, we would expect our asset managers to meet with the underlying managers of the vehicles they invest in, and the companies involved in servicing those investments.

Pace DB

Investment Grade Credit Mandates

Mandate managers: Legal & General Investment Management; Royal London Investment Management; and Insight Investment Management.
Allocation: c32% of the Co-op Section and c33% of the Bank Section assets as at March 2020.
Objectives of mandates: Pace invests in corporate bonds through 'Buy & Maintain' approaches, which seek to hold bonds to maturity where possible, avoiding defaults through strong stock selection and limited trading, while building diversified portfolios.
Voting rights: No, but managers are expected to provide updates on their engagement with the companies in which they invest on our behalf.

Legal & General Investment Management (LGIM)

LGIM believes that by bringing together the sector expertise from across its active investment and stewardship teams, it can influence and change company and market behaviours to achieve positive societal impacts.

It does this through:

- Company engagement;
- Using its voting rights;
- Integrating environmental, social and governance factors into portfolio management;
- Addressing systemic risks and opportunities;
- Influencing governments, regulators and policy makers; and
- Collaborating with other investors and stakeholders.

LGIM is committed to addressing ESG issues by developing and carrying out corporate governance and responsible investment activities, including Active Ownership, Advocacy, ESG Integration and Product Development. LGIM prioritises company engagement over exclusion, believing that this can effect change through collaborative efforts with companies in a more positive way. LGIM believes that combining this method with engagement and voting and targeted exclusions can be a very powerful tool to assess ESG issues.

Over the year, LGIM continued to enhance how it uses ESG information in credit research, and how analysts form an assessment of an issuer's ESG profile. It believes that incorporating a qualitative element is essential to capture the ESG risks embedded within each company. This has been done through its proprietary ESG tools, which cover areas such as:

- Workers' rights and fair remuneration;
- Climate change / the environment; and
- Controversial weapons.

Specifically, for Pace's Buy & Maintain credit portfolios, LGIM uses a bespoke investment framework to help it with its investment process, with the below objectives in mind:

- Encouraging companies to improve their behaviour and the quality of their ESG disclosures – this enables LGIM to raise the standards of entire markets, and helps generate sustainable, long-term returns;
- Assessing a company's ESG risks – LGIM sees unmanaged ESG factors of companies as posing potential risks and opportunities, which can have a material adverse impact on the performance of investments;
- Identifying the winners of the future – the companies to which investors will allocate ever-larger amounts of capital.

To achieve their objectives, ESG factors are integrated into the investment process using top-down and bottom-up approaches. Once LGIM has identified a long-term driver of returns, its next step is to identify the companies which are best placed to benefit or lose out from it within the value chain. This is supported by its fundamental bottom-up research, which includes ESG assessment and company engagement. This helps LGIM to understand key drivers impacting that business.

In addition, LGIM's Corporate Governance and Index teams have developed a rules-based and transparent methodology by which to score companies against ESG metrics. This LGIM ESG Score is used universally across LGIM's business, including for its Future World funds.

ESG scores are assigned to companies based on the following themes:

- Environmental – assessing the exposure of companies to climate change and the shift to a low-carbon economy; comprising carbon emissions, the level of carbon reserves and green revenues;
- Social – comprising of diversity (representation of women in company boards, executive, management and workforce); and human capital (policies to ensure companies have the right culture and treat workers fairly);
- Governance – a range of criteria that indicate 'best practice' in terms of investor rights, board diversity and high-quality audits;
- Disclosure – assessing the quality of company disclosures. These indicators give LGIM insight into the quality of the ESG disclosure and the level of disclosure in relation to ESG-related data points.

The ESG scores (created for over 13,000 companies) are published which enables companies to know exactly where they are doing well and where they need to improve. LGIM believe this can incentivise companies to improve their scores and raise their ESG standards and best practice.

As well as ESG scores, over the year LGIM also introduced an 'Active ESG View' which incorporates additional inputs and assessments in order to reflect a fuller picture of the ESG risks and opportunities embedded within each company. LGIM believes this helps with their analysis when picking investments to mitigate ESG risks and increases the probability of better long-term outcomes.

LGIM also considers climate risk factors, mainly through the integration of ESG factors in the credit quality assessment as described above. Earlier this year, in partnership with Baringa Partners, a management consultancy, LGIM concluded a review of the global energy system and the opportunities for decarbonisation. It created a bespoke investor-focused climate toolkit ('Destination') to facilitate construction of fully independent energy scenarios. The framework uses in excess of 10 million data variables to model the energy system by making choices in the lowest cost and most efficient way and now helps LGIM to make decisions and develop dynamic pathways for the energy system.

The new toolkit allows LGIM to measure and manage carbon exposure, as well as identifying underlying climate risks across the capital structure.

In addition to its ESG policy, LGIM has implemented a separate policy for controversial weapons to exclude those companies involved in the manufacture and production of cluster munitions, antipersonnel landmines, and biological and chemical weapons. LGIM also has a separate policy on Climate Change (see box).

LGIM's policy and engagement on climate change

LGIM is committed to addressing the issue of climate change and has a specific climate change policy. It engages with companies that it invests in to ensure their strategies are aligned with global climate goals. It has done so through its Climate Impact Pledge, through which it assesses over 80 of the world's largest companies across six different key industries, engaging with them to improve their strategies to address the climate emergency.

LGIM's assessment takes into account a range of indicators, from governance structures to business strategy, targets and lobbying activities, to ensure it can gain a well-rounded view of companies' exposure to climate risks and opportunities.

As an example of how LGIM engage with and assess companies, for the electric utilities sector it states that it expects companies to outline their plans to decarbonise energy generation, including detail of their expenditure and research on cleantech, and the setting of clear targets for emissions of carbon dioxide, methane and other pollutants. In 2019 LGIM reinstated Dominion Energy as an investment candidate, having excluded them under its Climate Impact Pledge in 2018. This is because, since its engagement with them in 2018, the company had made several improvements, including publishing its first climate change report, improving carbon disclosure via the Carbon Disclosure Project, publicly supporting the Paris Agreement and adopting voluntary targets to halve methane emissions in the next decade.

LGIM aims to actively engage with companies, and it believes its direct engagement helps it to identify ESG risks and opportunities. Ongoing dialogue with companies is a fundamental aspect of LGIM's approach to responsible investment. The outcomes from these engagements with companies are also fed back into LGIM's ESG tools.

LGIM sets clear objectives and timelines when it first engages with companies where issues have been identified, and these are reviewed throughout the engagement process to allow their management to oversee the progress of engagement activities.

To effectively tackle ESG issues that impact the value of their clients' assets, LGIM applies a multi-layered escalation strategy. Where the initial engagement does not lead to an appropriate outcome, LGIM may choose to adopt a stronger stance by using different escalation tools – for example, through voting against individual directors' reappointments (where LGIM has investments elsewhere within their business that do have voting rights), direct engagement with regulators or through applying pressure by means of public statements and press releases.

LGIM monitors investee companies over the long term and the progress on engagement activity is regularly reviewed by its dedicated team using company disclosures, independent research providers, their investment teams and the media.

Examples of LGIM's engagement with issuers in Pace's Buy & Maintain credit portfolio

1. BP – climate change
LGIM has been engaging with BP in relation to their strategy and role in the energy transition to a low-carbon economy on a regular basis. For example, LGIM's investment stewardship team asked BP to demonstrate how its strategy is consistent with a Paris-aligned emissions trajectory, and to set operational emissions reduction targets aligned with a well-below 2C pathway. LGIM also focused its dialogue with BP on long-term oil price assumptions, credible targets to decarbonise the portfolio, and commitment to achieve these targets.

BP has subsequently made a number of announcements in August 2020 which underline its shift towards low-carbon energy, at the expense of shrinking long term investment in fossil fuels. This includes targeting a reduction in emissions from operations of 30-35% and a 15% reduction in carbon intensity of products by 2030, and materially increasing their investment in renewable energy.

2. McKesson – US opioid epidemic
LGIM has undertaken analysis (based on the legal, regulatory, financial and ESG risks to the pharmaceutical and healthcare sectors) to investigate the implications of the crisis of the opioid epidemic in the US , which has led to tens of thousands of deaths annually in recent years. In 2019, as public interest continued to build, a number of companies (including McKesson) faced litigation over their alleged role in the crisis.

LGIM's analysis assigned a 'weak' ESG score for McKesson as it viewed the management of McKesson lacked elements of responsibility and of safety risk assessment, and that this could have longer-term financial implications for the business. As a result, LGIM sold its McKesson positions from the Buy & Maintain portfolios in October 2019.

Royal London Asset Management (RLAM)

RLAM is committed to being a responsible investor. It believes that seeking to integrate material ESG information into its decision-making is in the best long-term interests of its clients and can help to deliver better returns.

RLAM believes that corporate bond investing demands a bespoke fixed income and ESG approach, and as a result developed an approach that is intended to be both credible and realistic, with an emphasis on redressing bondholders' traditionally weak control. RLAM invests in businesses that provide a 'net benefit to society' and believes that it is a leader on ESG issues while generating financial returns for investors like Pace.

RLAM aims to generate sustainable, risk-adjusted returns that reflect a wider understanding of what will drive economic performance in the future. As part of that commitment, RLAM seeks to identify and understand ESG risks and opportunities as part of its investment process. To achieve this, it engages with companies and industry regulators to understand the issues and to promote best practice.

For credit portfolios, RLAM's ESG analysis focuses on factors which might mitigate or exacerbate the potential for downside loss or risk of default. This includes specific considerations of where debt sits in the capital structure, the duration of the position, and any security associated with the bonds. RLAM has a dedicated responsible investment team to identify and evaluate ESG issues that might impact a sector, along with detailed investigations of the ESG profile of specific issuers and bonds, which feed into their credit analysis and the credit team's bond evaluation.

RLAM considers a company's treatment of their staff is a key social factor when assessing a company's wider exposure to ESG risks. At a minimum, RLAM would look for a company to have a publicly available modern slavery statement, and more generally would consider any evidence of workers' rights being violated in their ESG analysis. In addition, as part of their ESG analysis, RLAM reviews the gender pay gap reporting regime of UK-based issuers, as well as issuers' broader workforce diversity.

RLAM also confirmed it reflects Pace's exclusions list when choosing securities to invest in, and will continue to work with Pace to ensure ESG is incorporated in its investment process for Pace's mandate.

RLAM's policy and engagement on climate change and the environment

RLAM is committed to addressing the issue of climate change and has a specific climate change approach report.

RLAM doesn't explicitly exclude companies involved in fossil fuel production above and beyond Pace's exclusion list, but notes that its credit research process and ESG analysis tends to lead to them having low exposure to companies which extract fossil fuels. For utilities with exposure to coal-based power production, RLAM regularly engages with companies on their approach to the energy transition, including their timelines and targets for decarbonising their generation portfolios.

In addition, RLAM does not have any exposure to companies with involvement in palm oil production or rubber production.

RLAM focuses on engaging with investee companies by having a long-term investment outlook and closely monitoring companies where it considers it will be able to have the greatest influence. RLAM also focuses on areas where existing research is not well established, focusing on companies with a particular reliance on debt capital markets, privately held issuers and those where its lending is secured against underlying assets. In particular, RLAM continues to target engagement around decarbonisation of portfolios across its utility holdings, the climate resilience of its water holdings and the strategic response to energy efficiency regulation that its Commercial Mortgage Backed Securities (CMBS) investments and other real estate issuers are taking. RLAM believes that engaging with these issuers is particularly important because they have a greater reliance on debt markets than other companies (who may be more reliant on equity for capital and so less inclined to engage with bondholders).

RLAM takes an active approach to stewardship by engaging with issuers in their fixed income portfolios. RLAM regularly monitors its investee companies using its own research and also through regular engagement meetings with management and non-executive directors to discuss issues relating to strategy and governance. Through dialogue with investees' management teams, RLAM aims to satisfy itself with the effectiveness and efficiency of the board of investees, and to ensure that it is aware of, and are appropriately managing, all material risk factors, including environmental and social risks.

In terms of voting rights, although RLAM does not have voting rights at a company's annual general meeting as a bondholder, its focus on lending where it has security or protective covenants does give it a significant degree of pre-emptive control, which means RLAM is engaged in a much higher level of bondholder voting (and direct agenda) than is typical for most corporate bond investments.

Examples of RLAM's engagement with issuers in Pace's Buy & Maintain credit portfolio

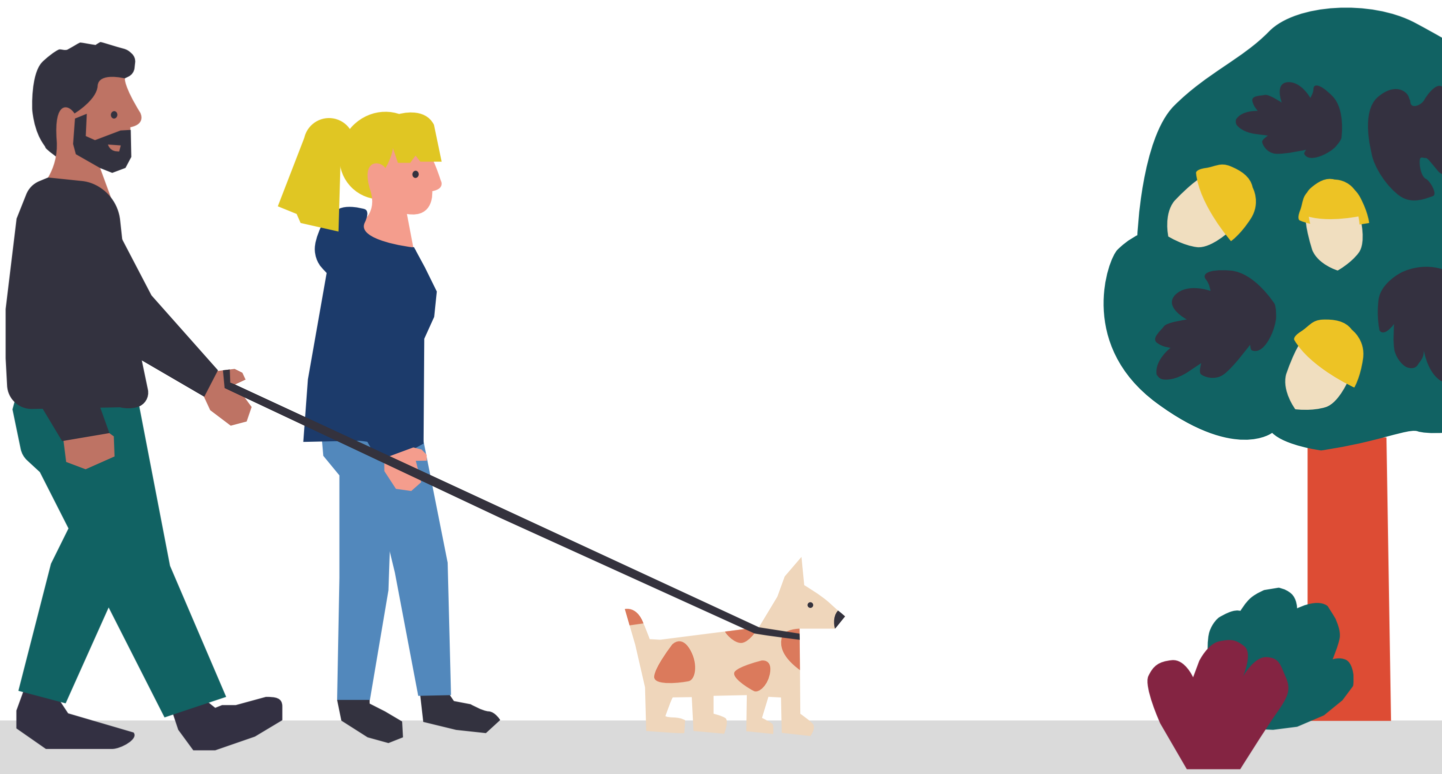
Gas Networks
According to provisional government figures, 2018 was the first year in which the UK's households emitted more CO2 into the atmosphere each year than its power stations – much of this from burning gas. In October and November 2019, RLAM engaged with the industry regulator, Ofgem, and companies which transport this gas in local areas including SGN, Wales & West, Cadent and Northern Gas Networks (all of which are held by Pace), to understand what future the sector might have in a world of net zero carbon emissions.

RLAM's analysis and discussions with each firm found that no single scenario offered a perfect solution (with the financial costs of different methods of energy transition expected to be large).

RLAM has therefore been selectively reducing its exposure to long-term gas networks in recent months (including for Pace) where there are more attractive risk-adjusted returns available.

British Land – working with equity analysts
RLAM's Responsible Investment team will consistently vote at the annual general meetings of all UK listed companies where they hold a position. Given that many of these listed companies issue debt held within RLAM's credit portfolios, its corporate governance team often shares updates with its credit research teams when carrying out analysis of management incentives if it finds credit-specific metrics (or the lack of these).

For example, RLAM noticed that British Land was focusing management incentives away from development profits towards metrics designed to ensure the resilience of the company's balance sheet and its day-to-day liquidity. As this is a property company where the Pace portfolios hold bonds issued by a subsidiary and by the parent company, its responsible investment team flagged this to its credit research team.



Insight Investment Management

Insight is committed to addressing stewardship and engagement and believes doing so can drive change and support effective investment. Over the year, Insight has made some collaborative engagements with professional bodies, including:

- Climate Action 100+: supporting engagement with issuers such as Enel and BHP as part of the monitoring of their climate-reduction strategies;
- International Capital Market Association (ICMA): Insight was appointed to the Advisory Council for the Green and Social Bond Principles, to advise and share their feedback on how to strengthen and grow the impact bond market through guiding the development of impact bond guidelines;
- Institutional Investors Group on Climate Change (IIGCC): this body introduced a new collaborative group focusing on building portfolios that are aligned with a two-degree Paris Agreement-aligned world, which Insight participated in.

Insight is also committed to fulfilling the reporting and transparency requirements of the updated 2020 UK Stewardship Code.

Insight works to support a stable and resilient social, environmental and economic system and efficient, well-managed financial markets. It believes in integrating ESG issues into its investment processes, together with active engagement with issuers and other stakeholders to support better investment decisions. Insight believes that this in turn will help to achieve its clients' targeted investment outcomes.

Insight's Responsible Investment Policy focuses on six beliefs, broadly aligned with Pace's own policies:

- Putting responsibility at the heart of how it does business;
- Integrating material ESG factors into its investment process;
- Acting as effective stewards of companies and other entities;
- Supporting efforts that seek to improve the operation, resilience and stability of financial markets;
- Collaborating with others on ESG issues; and
- Exercising transparency and disclosing its activities.

Insight used a number of external ESG research sources to support its ESG analysis, and over the year Insight has strengthened its ESG analysis as it identified that the data providers disagree on certain ESG risks and there are gaps in available information. This has led Insight to develop a proprietary model that aligns with its approach to corporate fixed income.

This proprietary model covers 99% of investment grade corporate bond indices. The framework considers 29 key ESG issues, including carbon emissions, water management, raw material and controversial sourcing, human capital and corruption.

These focuses are applied in the credit evaluation of all assets at Insight and are components of its checklist to better quantify long-term risks. As well as applying Pace's exclusion list, Insight's own ESG framework overlaps with Pace's Responsible Investment Policy in a number of areas:

- Insight has a policy to not have any exposure to companies involved in the manufacture or distribution of incendiary/illegal arms or weapons.
- When building long-term Buy & Maintain portfolios (like Pace's mandate), Insight focuses on secure, sustainable investments and would not therefore typically invest significant amounts in companies in the extractive sectors.
- Insight closely monitors risks from the extractive, utilities and energy sectors as it believes they are most vulnerable to a transition to a low-carbon economy and have a big impact on climate change.
- Insight expects companies to uphold minimum standards on labour and health and safety. It will engage with companies that fail to meet these minimum standards on a case-by-case basis. New issues such as equal pay are becoming more relevant for how Insight evaluates corporate culture and over time it expects to use this data as part of its issuer due diligence.
- Insight believes corporate governance is a critical component of issuer risk. Insight evaluates corporate governance for every company that it invests in and will engage on governance risk wherever it considers this to be material.

Insight's policy and engagement on climate change

Insight believes climate change presents a systemic investment risk. Its engagement policy for climate change is to advocate for action at a policy level. Insight believes that all issuers within its investment universe are susceptible to the consequences of climate change through potential impacts on supply chains, regulatory uncertainty and resource scarcity.

Insight considers a global legislative framework endorsed by policymakers to be the most effective mechanism to mitigate climate change and create investment certainty. To achieve this, Insight joins annual investor campaigns to push for a global climate agreement. Through its membership of Institutional Investors Group on Climate Change (IIGCC), Insight signs the global investor statement on climate change and advocates for action in a collaborative process.

Insight has also introduced a climate risk index for corporate debt which ranks approximately 1,800 issuers according to how they manage climate change-related risks and is aligned with the framework developed by the Task Force on Climate-related Financial Disclosures. Insight believes this climate risk index can indicate how fixed-income corporate credit issuers manage their climate change-related risks and opportunities, and how they are positioning themselves for the transition to a low-carbon economy.

Insight uses this as part of its credit analysis process, and its aim is for it to provide full coverage across the holdings in its Buy & Maintain credit strategies (including Pace). At present, the majority of Pace's bonds managed by Insight are covered by the index.

Insight takes an active approach to voting and stewardship. For its fixed-income portfolio where it does not have voting rights, Insight aims to engage with all companies prior to investing to review performance, strategy, risk management and ESG issues. Over 2019, Insight conducted 1,151 engagements, of which 82% incorporated discussions of ESG issues (up from 54% of 1,311 engagements in 2018).

Insight focuses on the areas where companies have received low scores in its 'landmine' checklist. The issues Insight engages on include the oversight and effectiveness of boards of directors, environmental performance, health and safety events, accounting deficiencies and strategic changes. If Insight identifies issues and is unhappy with management's responses to its engagement on these issues, it would reduce or completely sell these holdings.

Examples of Insight's engagement with issuers in Pace's Buy & Maintain credit portfolio

In late 2019, Insight sold a holding in a large car manufacturing company (which was in the Buy & Maintain bond mandates) where its engagement and decision-making was driven by ESG considerations and the expected impact of these risks on potential future financial outcomes.

Insight's research team carried out an analysis and determined that it has a worst-in-class ESG rating (5 on the 'Social' score) with poor disclosure and unsatisfactory engagement. Insight was particularly concerned about the company's product safety and quality as well as the carbon footprint of their products. Insight also viewed their operating and financial disclosures as weak and that company's cash flow statement confusing.

Insight was also concerned about this company's increasingly reliance on warranty sales; when questioned, the company said there would be increased focus on improving quality through a centralised core engineering team. However, the recall numbers in 2019 worsened instead of improving.

These are the areas that caused concerns, which led Insight to sell the holdings in this company.

Insight has confirmed it reflects Pace's exclusion list when choosing securities to invest in, and will continue to work with Pace to ensure ESG is incorporated in its investment process for Pace's mandate.

Liability Driven Investment Mandate

Mandate manager: BlackRock Investment Management (BlackRock).
Allocation: c47% of Co-op Section assets / c63% of Bank Section assets as of March 2020.
Objectives of mandates: BlackRock's objective is to match its overall benchmark which is based on Pace's liabilities using a gilt-based measure.
Voting rights: Not relevant.

Our holdings with BlackRock are in a UK government bond-based 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 its exclusions list to the portfolio, as there is limited flexibility for BlackRock to also invest in some corporate or overseas bonds. In particular, we also note that we apply an exclusions list preventing investment in government bonds issued by countries that score poorly on human rights issues.

We recognise that investing in government bonds, and therefore having exposure to a country's wider economic growth and stability, does not come without a carbon footprint. We plan on working with BlackRock over 2021 to understand how this can be quantified.

Defined Contribution Section

Mandate manager: Legal & General Investment Management			
Pace Fund	**Proportion of Pace DC Assets (Co-op Section)**	**Proportion of Pace DC Assets (Bank Section)**	**Fund objective**
Growth (Mixed)	90.7%	92.9%	Long-term investment growth, using a diversified set of asset classes, while reflecting significant environmental, social and corporate governance (ESG) issues into the fund's investment strategy.
Cash	8.3%	5.4%	Provide capital protection, with growth at short-term interest rates.
Growth (Shares)	0.5%	1.3%	Capture UK (30%) and overseas (70%) equity market returns.
Growth (Ethical Shares)	0.4%	0.3%	Track the total return of the FTSE4Good Global Equity Index.
Pre-retirement	0.1%	0.1%	Reflect diversified investment underlying a typical traditional annuity product.
Pre-retirement (inflation-linked)	0.0%	0.0%	Reflect diversified investment underlying a typical inflation-linked annuity product.

* LGIM is a signatory to the UNPRI as well as having published a statement of compliance with the Financial Reporting Council's UK Stewardship Code.

Pace DC is administered by Legal & General Assurance Society Ltd, and members have the option to invest in a range of funds, which are shown above, together with the proportion of members' assets invested in each fund as at 5th April 2020.

As we highlighted earlier, in June 2019 we changed the Pace Growth (Mixed) Fund, which forms a large part of the default investment strategy for Pace DC, to use Legal & General's Future World Multi-Asset Fund which we believe is more consistent with our Responsible Investment Policy. The fund invests in a range of assets which may include equities, bonds, cash and listed infrastructure, private equity and global real estate companies, aiming to provide long-term investment growth while also reflecting significant ESG issues into the fund's investment strategy.

The box on the next page sets out more detail on how the Future World Fund range works.

What does the Future World Multi-Asset Fund do?

LGIM believes that well-managed companies are more likely to deliver sustainable long-term returns. Therefore, assessing companies on their management of ESG issues is an important element of risk management. As part of the assessment, LGIM created a Future World Protection list, which was developed specifically for the Future World fund range.

Companies that fail to meet minimum standards of globally accepted business practices are incorporated into the list, which in turn incentivises companies to operate more sustainably. Across the LGIM Future World funds, securities issued by companies that are on the Future World Protection list will not be held or any existing exposure to them will be significantly reduced. The Future World Protection List includes companies which meet any of the following criteria:

- Involvement in the manufacture and production of controversial weapons;
- Perennial violators of the United Nations Global Compact, an initiative to encourage businesses worldwide to adopt sustainable and socially responsible policies; and
- Pure coal miners – companies solely involved in the extraction of coal.

In terms of selecting individual shares or corporate bonds to invest in, LGIM assigns ESG scores to each company it could invest in, considering factors such as carbon emissions, green revenue, board diversity and supply chain policies to score each potential investment. These scores are then used to 'tilt' the fund to invest more in companies with higher scores, which are therefore more likely to have sustainable business models and income, and away from companies with lower scores. These scores include metrics on companies' performance on both social and environmental themes which have a link with some of their sustainable development goals. The metrics include:

- Greenhouse gas emissions intensity;
- Fossil fuel reserves intensity;
- Green revenues – the proportion of a company's revenues coming from climate/ environmental solutions;
- Women on the board, at executive level, in management and in the wider workforce;
- Discrimination policies; and
- Social supply chain policies.

As well as tilting investments, the Future World Multi-Asset Fund incorporates LGIM's Climate Impact Pledge. This is LGIM's commitment to engage with the largest companies across six sectors identified as key to meeting the 1.5°C target set in the Paris Agreement: oil and gas, mining, electric utilities, autos, food retail and financials. As part of the pledge, LGIM has committed to vote against the chairs of the boards in companies that have shown persistent inaction to address climate risk, and to disinvest entirely where LGIM has the ability to do such (such as the Future World funds). Detailed case studies of their company engagement activity on climate change can be found in their Active Ownership report.

In 2018, LGIM publicly divested its Future World funds from eight companies for their persistent inaction to address climate risk. LGIM has subsequently engaged with all eight companies and, as a result of positive outcomes, two were reinstated. When the annual rankings were updated in 2019, five new companies were also added to the disinvestment list, including Exxon Mobil who did not meet LGIM's minimum requirements on emissions reporting and emission targets.

The Trustee believes the Future World Multi-Asset Fund is therefore a good 'fit' for the criteria set out in our Responsible Investment Policy.

LGIM publishes a number of metrics to quantify the impact of the 'tilts' within the fund (and the exclusion of certain companies, as detailed above). This has had a quantifiable impact on the companies which the fund invests in, in particular on climate change-related factors:

- The 'carbon emissions intensity' (which measures the relationship between carbon emissions of a company and its sales) is 49% lower for the Future World Multi-Asset Fund than the market as a whole (i.e. a similar fund without the 'tilts'); and
- The carbon reserves of the companies LGIM invests in are almost 60% lower than for a fund without these 'tilts'. Based on LGIM's analysis, this means investing in the Future World Multi-Asset Fund reduced exposure to fossil fuel reserves by the equivalent of over 2,400,000 barrels of oil compared to an unadjusted index tracking approach. This is based on the £390m Pace DC members had invested in the Future World Multi-Asset Fund (via the Pace Growth (Mixed) Fund) at 5 April 2020.

LGIM's exercise of voting rights

Pace DC offers options for investment to members which include exposure to shares (either through equity funds or the multi-asset fund). The Trustee does not directly exercise voting rights as these investments are through pooled funds with many other investors. Voting rights are exercised by L&G using ISS's ProxyExchange electronic voting platform, although voting decisions are retained by L&G and strategic decisions are made by LGIM's Corporate Governance Team in accordance with their governance policies for each region.

LGIM sees voting as a key way to make its voice heard and hold companies accountable. Last year, LGIM voted on over 115,000 proposals during almost 12,000 company meetings.

LGIM regularly reviews its voting policies, and recent updates include:

- Voting against all combined CEO/Chairs in all markets (excluding Japan), beginning in 2020; and
- Voting against Japanese companies that do not have at least one female director on the board, beginning in 2020.

LGIM has also introduced a custom voting policy which covers most developed markets in Europe and other parts of the world (although UK shares are covered by a separate policy), but it shows LGIM's commitment in enhancing its voting policy. This new policy requires companies:

- To have a higher level of independence and diversity on the board and set a low level of external board positions;
- To provide more in-depth disclosures regarding executive compensation and the employment of performance criteria for full long-term incentive plans; and
- To increase the representation of female board members in North America (LGIM will expect at least 25% of board membership of the largest 100 companies in the S&P/TSX to be female in 2020). Where this is not the case, LGIM will be voting against the Chair of the Nomination Committee.

LGIM continues to develop and follow its own policies rather than adopt those of third parties, as it believes that by using its own policies it can better align with its own engagement activity and have a global consideration (as some third party policies may be focused on a particular country).

LGIM votes consistently in line with its policies across all pooled funds; the table below summarises how it voted across all global equity holdings in 2019 (i.e. including shares held within the Future World Multi-Asset Fund as well as Pace DC's self-select equity funds). Full details of LGIM's voting record can be found in its Active Ownership report.

Proposal category	Total votes for	Total votes against	Abstentions	Total
General				
Anti-takeover related	536	25	0	561
Capitalisation	4,871	626	0	5,497
Director-related	22,060	4,055	259	26,374
Non-salary compensation	2,665	1,439	0	4,104
Reorganisations and mergers	1,448	280	0	1,728
Routine/Business	10,224	914	0	11,146
Shareholder-related				
Compensation	45	39	0	84
Governance	14	138	0	152
Directors' issues	184	578	2	764
General economic issues	1	1	0	2
Health issues	65	32	0	97
Other/misc.	23	82	0	105
Routine/Business	59	181	0	240
Human Rights	4	13	0	17
Social proposal	12	17	0	29
Total resolutions	42,211	8420	269	50,900
No. of AGMs	3,303			
No. of EGMs	797			
No. of companies voted on	3,686			
No. of companies where voted against management or abstained on at least one resolution	2,599			
% of companies with at least one vote against	71%			

Source: LGIM 2019 Active Ownership report.

Appendix 1

The following table summarises each of Pace DB'S investment managers' compliance with the UK Stewardship Code for the 6 April 2019 - 5 April 2020 period, and whether they are a signatory to the UNPRI:

Investment manager	Mandate	Management style	Signatory to the UN PRI	UK Stewardship Code Compliance	DB Co-op Section assets (31 March 2020)	DB Bank Section assets (31 March 2020)
LGIM	Corporate Bonds	Buy & Maintain	Yes	Yes	8.6%	11.2%
RLAM	Corporate Bonds	Buy & Maintain	Yes	Yes	9.4%	11.1%
Insight	Corporate Bonds	Buy & Maintain	Yes	Yes	13.5%	10.9%
24AM	Asset Backed Securities	Active	Yes	Yes[1]	4.0%	3.1%
PGIM	Alternative Inflation-Linked	Active	Yes	No[2]	4.2%	-
BlackRock	Liability Driven Investment	Active	Yes	Yes	46.8%	63.1%
Insight	Illiquid Credit	Active	Yes	Yes	4.6%	-
ICG	Illiquid Credit	Active	Yes	No[1]	4.1%	-
M&G	Illiquid Credit	Active	Yes	Yes	3.3%	-
LaSalle	UK Property	Active	Yes	No[2]	0.4% (in the process of being disinvested)	-
Mercer	Alternative Growth	Active	Yes	Yes	1.0% (in the process of being disinvested)	0.8% (in the process of being disinvested)

[1]ICG generally supports the objectives that underline the Code but as they do not invest in shares of listed companies in the UK, the provisions are not deemed to be sufficiently relevant.

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

Appendix 2

Our managers' statements of compliance with the UK Stewardship Code

BlackRock Investment Management:
https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-statementoncompliance-uk-stewardshipcode.pdf

Insight Investment:
https://www.insightinvestment.com/globalassets/documents/responsible-investment/stewardship-code/stewardship-code.pdf

Legal & General Investment Management:
https://www.lgim.com/landg-assets/lgim/_document-library/capabilities/uk-stewardship-code.pdf

M&G Investments:
https://global.mandg.com/~/media/Files/M/MandG-Plc/documents/responsible-investing/stewardship/MG-investments-and-the-stewardship-code-Jan%2020.pdf

Mercer Ltd:
https://investment-solutions.mercer.com/content/dam/mercer-subdomains/delegated-solutions/CorporatePolicies/uk-stewardship-code-statement-of-commitment.pdf

Royal London Asset Management:
https://www.royallondon.com/globalassets/docs/shared/investment/69348-stewardship-and-ri-report-2020.pdf

Twenty Four Asset Management:
https://twentyfouram.com/uk-stewardship-code/

Appendix 3
UK Stewardship Code 2020

The UK Stewardship Code sets out the FRC's expectations for best practice reporting on asset owners' exercise of stewardship. The code contains a set of 12 key principles, and asset owners are expected to report on activity undertaken in line with these principles as well as outcomes (and in some cases, providing context to allow readers to understand and assess the approach taken).

To help readers, we have signposted where we have covered the 12 principles in this report below.

Principles	Document reference
Purpose and Governance	
1 Purpose, strategy and culture	'How do we invest?' (page 3)
2 Governance, resources and incentives	'How do we exercise stewardship?' (page 6)
3 Conflicts of interest	'Managing conflicts of interest in relation to stewardship' (page 6)
4 Promoting well-functioning markets	Our Statement of Investment Principles covers our policies on market-wide risks such as changes in interest rates and currency rates, as well as our approach to climate risk and other systemic risks.
5 Review and assurance	'Foreword' (page 2); 'How do we invest?' (page 3) and 'Responsible Investment – what has the Trustee been doing this year?' (page 4)
Investment approach	
6 Clients and beneficiary needs	'About us' (page 2) and 'How do we invest?' (page 3)
7 Stewardship, investment and ESG integration	'Responsible Investment – what has the Trustee been doing this year?' (page 4) 'How do we exercise stewardship?' (page 6) 'What have our investment managers been doing?' (page 7)
8 Monitoring managers and service providers	'What have our investment managers been doing?' (page 7) Appendices 1 and 2
Engagement	
9 Engagement	'How do we exercise stewardship?' (page 6) 'What have our investment managers been doing?' (page 7)
10 Collaboration	'What have our investment managers been doing?' (page 7)
11 Escalation	'How do we exercise stewardship?' (page 6) 'What have our investment managers been doing?' (page 7)
Exercising rights and responsibilities	
12 Exercising rights and responsibilities	'What have our investment managers been doing?' (page 7) – in particular, 'LGIM's exercise of voting rights' (pages 21-22).