

Responsible Investment Review

Active Pension Fund



We are the Environment Agency. It's our job to look after your environment and make it **a better place** - for you, and for future generations.

Your environment is the air you breathe, the water you drink and the ground you walk on. Working with business, Government and society as a whole, we are making your environment cleaner and healthier.

The Environment Agency. Out there, making your environment a better place.

**The Environment Agency Active Pension Fund is
registered with the Pension Schemes Registry
No. 10079069**

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Acknowledgements

Faith Ward, Investment Manager and Tony Westren, Business Information Planner (Environment Agency).
Our investment consultants Mark Mansley (SRI specialist, Rathbone Greenbank), Nick Sykes (Mercer) and Carolan Dobson (Independent Investment Advisor)
Our fund managers and supporting environmental research organisations, particularly Trucost and Innovest.

Foreword

At a time when both pensions and climate change have never had a higher profile, I am delighted to be able to present this report to you. I believe is the first of its kind for a public pension fund in the United Kingdom.

The purpose of our pension fund is to provide retirement benefits to our current and future fund members. We believe taking into account financially material environmental risks and opportunities is entirely consistent with our fiduciary duty to look after their best long term financial interests. We would be in breach of this duty were we to ignore the economic and financial affects of climate change on our investment strategy.

The aim of the report is to demonstrate to our fund members and other stakeholders that the Environment Agency's active pension fund is managed responsibly, with strategies and policies for the investment and management of the funds assets that are both financially robust and environmentally credible.

This report summarises and presents example of the work we have done or are engaged in our journey, so far, in the field of responsible investment, what we have learnt, and some of our plans for the future.

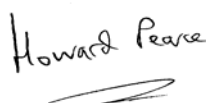
The initial journey was not an easy one, particularly in finding high quality fund managers who could see the importance of taking into account of financially material environmental risks and opportunities like climate change in their investment processes and decisions. However by thorough research and analysis of the investment manager market, and by working with other like minded pension funds, and via our involvement in collaborative initiatives, such as the United Nations Principles for Responsible Investment (UNPRI), Institutional Investors Group on Climate Change (IIGCC), and UK Sustainable Investment and Finance (UKSIF) we have made progress.

The incorporation of environmental, social and governance (ESG) issues asset management is becoming more mainstream and established in the pension fund and investment world as a activity to both reduce risk and generate higher financial returns. There is a growing body of opinion and some evidence that well governed companies produce better and more sustainable financial returns and better environmental performance than poorly governed companies. We also think investors, including pension fund managers and shareholders, can and should influence the board and directors to improve the management and financial and environmental performance of under-performing companies.

By shrewd investment we believe it should also be possible to get good financial returns from environmental technologies needed to adapt to and to mitigate climate change throughout the developed and developing world, and for future life in a lower carbon economy.

We believe these investment philosophies and our approach is making a real difference, to the way we invest for our fund members, and we are beginning to influence other pension funds, asset managers, the finance sector and business more widely.

None of the progress we have made would have been possible without the support of the Environment Agency's Pension Committee, the skills and dedication of my colleagues in the Environmental Finance and Pension Fund management team, the advice of our investment consultants and independent investment advisor; along with our fund managers and other service providers, who have helped to implement our investment strategy and environmental overlay strategy.



Howard Pearce
Head of Environmental Finance and Pension Fund Management
Environment Agency

Executive summary

The Environment Agency Active Pension Fund is the pension scheme of one of the world's leading environmental organisations. Over the last five years, we have embraced responsible investment (RI). We have done so because we are convinced that companies which address environmental risks and opportunities are more financially sustainable. In our opinion, these companies benefit not only the economy and their owners, but also the environment and society.

In short, we believe that responsible investment will bring us higher financial returns over the long run which is in the best interest of the fund members. We aim to explain how we changed our investment strategy – and how we influence other institutional investors, our own fund managers and the companies in which we invest.

Who is this report for?

First and foremost this report is for our members. We want you to understand the changes we are making and our plans for the future.

Also, our experience has been a very positive one. By sharing what we have learnt, we believe that we can help others develop their investment practices.

Our fund

The fund is a final salary scheme open to all Environment Agency employees. It is one of the largest fund in the Local Government Pension Scheme and one of the top 200 in the UK. At the end of 2008, our assets were worth £1.2 billion and we had nearly 21,000 members.

Nearly two-thirds of our assets are actively managed – that is to say our fund managers can decide whether or not to invest in a particular company or fund. This gives us real influence over corporate and investment companies attitudes.

Creating a new strategy

In 2003, our mainstream investments had been underperforming for some time. It was time to take a fresh look at how we did things.

We examined the effects of environmental, social and governance issues on company, fund and investment returns. We researched the availability and performance of 'green' investment funds.

Under the 1995 Pensions Act we had a legal duty to take account of environmental risks (for example from climate change) that could reduce our investment returns. We also agreed that we should look for opportunities to increase our financial returns by investing in financially robust green businesses.

The key elements of our approach

- An investment strategy that takes account of environmental, social and governance issues.
- Investing financially robust in green and clean technology funds and companies
- Employing fund managers who invest responsibly.
- Supporting initiatives that promote responsible investment.
- Working with like-minded organisations to bring about change.
- Campaigning for standardised reporting, especially for carbon disclosure

Investment strategy

After our Pensions Committee decides how to allocate our assets to different investment mandates we don't get involved in day-to-day investment decisions of our fund managers we appoint. So our Corporate Governance Policy and Environmental Overlay Strategy are very important. These provide a

clear strategic framework. They determine the types and balance of assets we hold. They set out criteria for investment. They directly affect our choice, expectations and evaluation of our fund managers, set out our performance benchmarks, and guidelines for monitoring and reporting.

Clean technologies

In 2003, we decided to specifically invest up to 5% of our assets in clean technologies. This would stimulate 'green' investment approaches and in the longer term we would benefit from increased returns. Going forward we will look at changing this allocation if and where financially rewarding opportunities exist.

Our fund managers

All our fund managers must take full account of environmental social and governance (ESG) issues. Depending on the types of assets they hold, this will be significant in their decision-making, their direct contacts with companies (engagement), and their voting at annual general meetings.

Through our fund managers, external service providers and directly ourselves undertake about 800 engagements a year on our behalf. They sell of shares in companies that do not meet our expectations and push for better disclosure on environmental issues.

We use our votes to support the development of policies and reporting on greenhouse gases, sustainability, waste and water use. In 2008/09 we directly voted on 80 environmental resolutions worldwide.

New tools and strategies

We have had to work with our fund managers to develop and use tools like environmental footprinting that can establish how ESG issues affect investment decisions.

Supporting Responsible Investment (RI) initiatives

We recognise the importance of supporting responsible investment initiatives. In June 2006 we signed up to the UN's Principles for Responsible Investment (UN PRI). These principles underpin our approach and this review shows how we put them into practice.

Working with others

We believe that we achieve more by working with investors and bodies that share our goals. These include the UK Social Investment Forum (UKSIF), Institutional Investors Group on Climate Change (IIGCC), the Carbon Disclosure Project (CDP) and Forrest Footprint Disclosure Project (FFDP).

We promote responsible investment at industry events, press for professional qualifications to cover RI issues, and publish our own research or joint research with other bodies.

Standardised reporting

If companies annual report and accounts covered environmental, social and governance issues in a standardised format, it would be much easier to make comparisons between companies. This is something we have been working hard to promote.

An award-winning fund

Change has not been quick or simple, but we are making progress. Since 2005, investment returns from fund managers that take sustainability and green issues into account has led us to allocate funds to new managers that also believe in the importance of environmental, social and governance issues to their investment decisions.

In 2008 we won four awards:

- Pensions and Investment UK Scheme Communications Awards 2008, Member Facing Function Award.

- Investments and Pensions Europe Fund Awards 2008. Socially Responsible Investment/Corporate Governance Award.
- IPE/Brooklyn Bridge/TBLI – Environmental Social Governance (ESG) Leaders Awards 2008 – Best investor in ESG award.
- Engaged Investor Trustee Awards 2008 – Best Scheme Governance (Public Sector).

The future

We aim to maintain momentum and continue to build on the progress we have already made. One area is improving the capture and assessment of information on environmental, social and governance (ESG) issues for our whole portfolio. This will enable us to assess risks and opportunities across the fund. The information will form a core component of our investment strategy review, which will be in 2009/10. We will also continue to promote carbon disclosure and contributing to green economy through further investments in clean technology.

This review is supported by our Annual Report and Accounts, research reports, voting disclosures, lists of our top_largest holdings and many other publications. Copies of these are available on our website at www.environment-agency.gov.uk/pensions.

Key elements in our approach to responsible investment

The table below provides an overview of our approach and key features of our strategy.

Investment strategy	Our investment strategy will seek to take account of the relationship between good environmental management and long-term sustainable business profitability.
RI/ESG issues addressed in investment policy	<ul style="list-style-type: none"> • materiality of RI/ESG issues • integration of RI/ESG issues • proxy voting • engagement • collaborative engagement.
Active membership in responsible investment initiatives	<ul style="list-style-type: none"> • United Nations Principles for Responsible Investment (UN PRI) • United Nations Environment Programme Finance Initiative (UNEP FI) • Carbon Disclosure Project (CDP) • The UK Sustainable Investment and Finance Association (UKSIF) • Institutional Investors Group on Climate Change (IIGCC) • Forestry Footprint Disclosure Project
Major publications – in collaboration with our fund managers	<ul style="list-style-type: none"> • <i>Unlisted Real Estate Funds – Environmental Review</i> (with Aviva Investors) 2009 • <i>Responsible Investment in Sustainable Private Equity</i> (with Robeco) 2007 • <i>Carbon Management and Carbon Offsetting in the FTSE All-Share</i> (with Standard Life and TruCost) 2007 • <i>Carbon Management and Carbon Neutrality in the FTSE All-Share</i> (with Standard Life and TruCost) 2006
Asset classes	<p>Global public equity: Managers investing in individual stocks look to see who comes top in their field using financial measures and environmental, social and governance (ESG) criteria. This is referred to in the industry as a 'best-in-class' approach.</p> <p>Global private equity: Our managers will only invest in companies that have pledged to act in a responsible manner. They can invest up to approximately 30% of their resources in environmental technology funds.</p> <p>Emerging markets equity: When we selected our manager, we looked closely at their track record and experience in dealing with ESG issues. We work closely with our manager, who is also a UN PRI signatory. Our manager employs an outside research provider to identify companies or funds with poor or leading sustainability practices.</p> <p>UK Property: Every year our managers carry out an environmental survey of all funds. Our portfolio includes Igloo Regeneration, regeneration property fund.</p> <p>Global bonds: Investors in corporate bonds are less used to considering ESG issues than is the case for equities. However our bond manager (Royal London) employs EIRIS, an ESG research company, to use best-in-class principles in investment decision-making.</p> <p>AVCs: We offer "ethical" funds through Standard Life.</p>
Voting	At a company's annual general meeting, shareholders have the opportunity to vote on resolutions put forward. Fund managers can choose to vote the Environment Agency's shares. They should also be in regular contact with senior executives at the companies in which our fund's assets are invested. This is as an important element of the investment process and good corporate governance. Fund managers should discuss environmental resolutions with the Environment Agency before voting.

Our approach

We believe that companies which manage environmental, risks, impacts and opportunities are more financially sustainable in the long term. In our opinion, these companies benefit not only the economy and their owners but also the environment and society.

We have worked hard to improve our investment practices, and are proud to report that we are making progress.

Context

It is essential that our responsible investment strategy accords with the legal framework in which the fund operates. The Environment Agency Active Pension Fund (EAPF) is part of the Local Government Pension Scheme (LGPS). The LGPS provides the legal framework for members' benefits and for our investments. For example, it places limits on certain types of investment. Our fund also complies with the Myners Principles, which were developed to strengthen institutional investment in the UK.

A summary of the LGPS investment restrictions and a checklist demonstrating our compliance with the Myners Principles are detailed in our Annual Report and Accounts, which is available on our internet site www.environment-agency.gov.uk/pensions.

It has not been easy to find tools and techniques that take account of environmental, social and governance (ESG) issues while maintaining the financial robustness of a large public pension fund. Nor has it been straightforward to find funds or fund managers that can meet that challenge. However although the process has not been quick or simple, we have shown that this approach is possible and we continue to make progress.

How we have changed?

In 2002, two percent of our fund was in a low risk eco-enhanced UK passive equity portfolio. We had just begun to work with other funds to press for a change in attitudes to responsible investment. The EAPF was one of the founder members of the Institutional Investors Group for Climate Change.

In 2003, our investments had been underperforming for some time. We reviewed our investment strategy. We looked at emerging research and undertook our own research into our fiduciary duties and the effects of environmental and governance issues on investment returns.

Following this review, we revised our Corporate Governance Policy and developed our Environmental Overlay Strategy. This set out how we were going to implement responsible investment across the whole fund. Our strategy got timely support from the Freshfields report in 2005. Undertaken on behalf of the United Nation's Environment Programme Finance Initiative, this concluded:

'the links between ESG factors and financial performance are increasingly being recognised. On that basis, integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions'

We also examined many types of equity funds, public and private – including sustainability funds, environmental funds, low carbon funds, green energy funds, green technology funds, green property funds, and sustainable forestry funds. After evaluating the financial/environmental pros and cons of these funds through normal due diligence processes, we decided that we would invest up to 5% of our assets in 'clean technologies'. This would stimulate 'green' investment approaches and in the longer term we would benefit from increased returns.

Since 2005, the strength of our investment returns from sustainability orientated fund managers has led us to appoint to managers that can demonstrate that environmental, social and governance issues are an important part of their investment decision-making.

Purpose of this report

First and foremost this report is for our members. We want you to understand the changes we are making and our plans for the future. After all, your pension fund is one of the leading funds in the UK and further a field in the weight it gives to responsible investment (RI) and to environmental, social and governance (ESG) issues.

Secondly, our experience has been a very positive one. By sharing our experiences with other investors, we believe that we can promote responsible investment.

Thirdly we want to show the progress we have made. In June 2006 we signed up to the UN Principles for Responsible Investment (UN PRI), the first fund to do so from the Local Government Pension Scheme. The move restated our commitment to investing for sustainable financial returns. We feel that these principles underpin our investment and ESG philosophy. And this report shows how we are putting them into practice.

The report starts with an overview, including a financial overview and an outline of our investment strategy. The rest of the report is divided into six sections, mirroring the UN principles.

Some information is not in this report. For example, the Environment Agency is accredited to EMAS (the EU Eco-Management and Audit Scheme). We therefore report on our performance in key environmental areas in our Annual Report and Accounts. You will find this information at www.environment-agency.gov.uk/aboutus/publications. We have also not included full details of the fund governance. These are set out in our Governance Compliance Statement which is available on our website at www.environment-agency.gov.uk/pensions. Our latest annual return for the UNPRI is also available on the internet, which includes more statistical information.

What are RI and ESG?

The term responsible investment (RI) describes an investment process which actively considers environmental, social and corporate governance factors in investment decisions and ownership practices. Among investors, these factors are commonly shortened to ESG.

The increasing popularity of responsible investment stems from a growing recognition by investors that good ESG practices can benefit the financial performance of companies, particularly over the long term. This may be because investors who are aware of all these factors are better placed to manage risk – and thus to seize opportunities to increase financial returns.

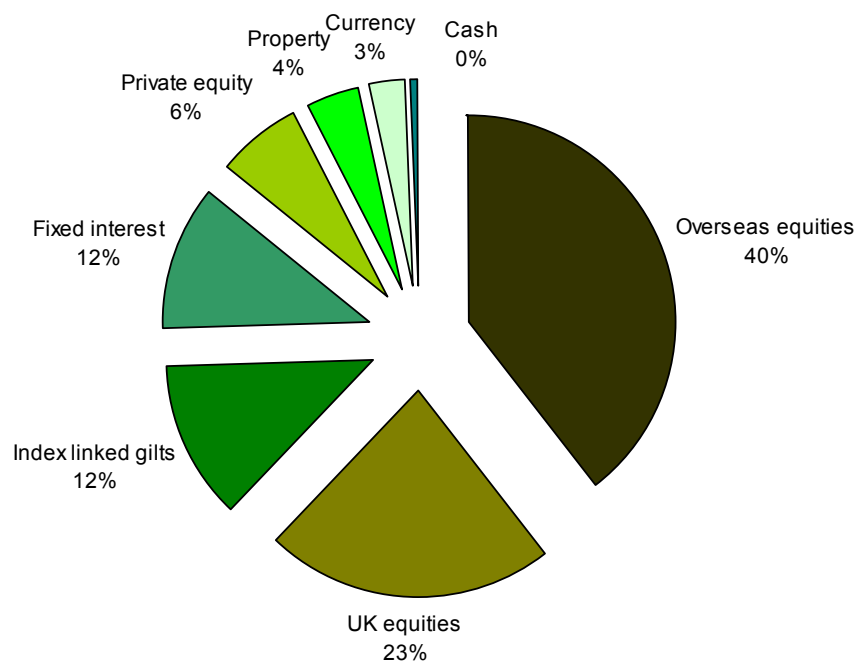
About the fund

The Environment Agency Active Pension Fund is part of the Local Government Pension Scheme. This provides the framework for management, investments and benefits. The scheme is a final salary scheme and is open to all Environment Agency employees.

Key fund facts

Fund as at 31 December 2008	
Assets under management	£1.2 billion
Defined benefit	100%
Number of fund members	20,466
Active members	11,556
Deferred members	5,170
Pensioners	3,740
Solvency funding level	86%
Website	www.environment-agency.gov.uk
Employing authority	The Environment Agency is the environmental regulator for England and Wales. We are responsible for controlling pollution and water management, and are dedicated to protecting and improving the environment so that future generations inherit a cleaner and healthier world.
Membership eligibility	All full and part-time employees, whether permanent or temporary, become active members of the fund – unless they have elected in writing not to join.

Fund by asset class, December 2008



Financial overview

The table below summarises the asset class, benchmark, target and rolling 3 year financial performance where available. Sarasin and Robeco are the managers with the strongest ESG theme in their investment process who have been with us for at least 3 years. Over this period they have also been our best performing managers, excluding our currency manager.

Manager	Asset class	Benchmark	Target	Rolling 3 year performance against benchmark
Passive management				
Legal & General	UK equities	FTSE All-Share	To match the benchmark	+0.1%
Legal & General	UK index-linked gilts	FTSE UK gilts indexed >5yrs	To match the benchmark	+0.1%
Legal & General	North American equities	FTSE World North America	To match the benchmark	+0.1%
Legal & General	European equities	FTSE World Europe ex UK	To match the benchmark	-0.4%
Legal & General	Japanese equities	FTSE World Japan	To match the benchmark	+0.1%
Legal & General	Asia Pacific equities	FTSE World Asia Pacific ex Japan	To match the benchmark	+0.3%
Active management				
Standard Life	UK equities	FTSE All-Share	To beat the benchmark by 2%pa	+0.1%
Sarasin & Partners	Global equities	MSCI all country world	To beat the benchmark by 2%pa	+4.2%
Aviva Investors	Property	IPD UK Monthly	To beat the benchmark by 1%pa	+0.5%
Robeco	Private equity	Absolute Return	IRR ¹ of 10% or 5% > MSCI world	+7.0%
IPM	Currency overlay	FTSE 100	To beat the benchmark by 6%pa	+16.5%
ECM	Corporate bonds	iBoxx sterling all non-gilt	To beat the benchmark by 1%pa	-10.1%
SWIP	Emerging market equities	MSCI emerging markets	To beat the benchmark by 3%pa	3yr data N/A
RLAM	Corporate bonds	iBoxx sterling all non-gilt	To beat the benchmark by 1%pa	3yr data N/A
RCM	Global equities	MSCI all country world	To beat the benchmark by 3%pa	3yr data N/A
Generation Investment Management LLP	Global equities	MSCI all country world	To beat the benchmark by 3%pa	3yr data N/A
Impax	Global equities	MSCI all country world	To beat the benchmark by 3%pa	3yr data N/A
Mandates terminated July 2008				
State Street UK	UK equities low-risk eco-enhanced	FTSE 350	To match the benchmark	-0.5%
Capital International	Global equities	MSCI all country world	To beat the benchmark by 3%pa	-1.3%
SSGA	Global equities	MSCI all country world	To beat the benchmark by 3%pa	-0.0%

Data based on 31st December 2008

State Street UK, SSGA and Capital International were replaced by RCM, Generation Investment Management LLP and Impax in July 2008.

¹ IRR – Internal Rate of Return.

Overview of our investment strategy

The investment strategy developed by our Pensions Committee aims to maximise the returns of the fund, within an acceptable level of risk. It is diversifying our investments throughout world markets, and protects the fund from currency fluctuations by using a passive currency-hedging overlay strategy.

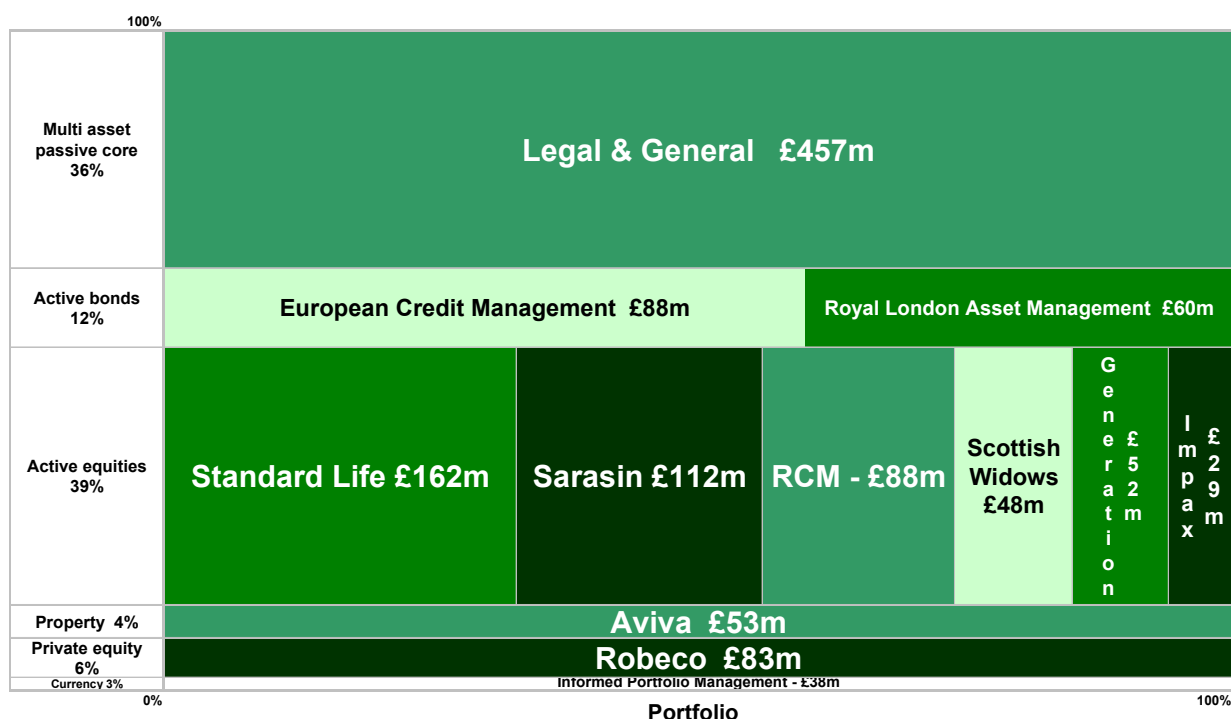
The Committee's strategy is to allocate assets as follows:

- 31.5% in UK equities
- 31.5% in global equities
- 13.5% in index-linked gilts
- 13.5% in corporate bonds
- 5% in property
- 5% in private equity.

The Committee believes that this diversification will reduce risk and improve potential returns.

The fund's fund managers implement this investment strategy. Each manager has complete control over the management of their portfolios, although they must always comply with statutory limits and our Statement of Investment Principles. Each manager is required to take due regard of our Active Fund Corporate Governance Policy and our Environmental Overlay Strategy. We explain these in the next section. At the end of this report are full copies of both the Environmental Overlay Strategy and our Corporate Governance Policy which are also available on our intranet site www.environment-agency.gov.uk/pensions

Asset allocation by manager (31 December 2008)



The colours used above are for illustrative purposes only and do not relate to ESG elements of the mandate.

Our Environment Overlay Strategy and Corporate Governance Policy

Background

A pension fund has to make sure that it can pay the pensions of its members. Our funding comes from contributions and investments. We like all funds to invest their resources wisely, in companies industries and sectors where they expect to get a good rate of return given the risk of the investment.

Historically our pension fund followed a traditional investment approach. At the time, this was widely thought to preclude taking proper account of environmental, social and governance (ESG) issues. This led to understandable criticism from the media and our employees. After all, we are one of the leading environmental organisations in the world. Why would we invest in companies with poor environmental track records?

In 2003, after a period of poor investment returns, we decided to review our investment strategy and manager structure. This gave us the opportunity to look again at how we did things. Our first step was to review the best available approaches to investment strategy. We also decided that we had a duty to avoid environmental risks (for example from climate change) that could reduce our investment returns. We also agreed that we should look for opportunities to increase our financial returns by investing in financially robust green businesses.

Our initial research on performance and risks answered the key concerns and questions of the Pensions Committee, and gave us the confidence to develop our strategies and to ensure we had the resource to implement it, including appointing a specialist SRI advisor as well as maintaining in-house expertise.

We needed to see how we were doing compared to other funds and fund managers. We compared the financial performance and the social and environmental characteristics of our fund and existing fund managers to those for other public, private, local government or NGO pension funds. This gave us a benchmark to chart both our progress and that of our peers.

We also carried out considerable research into the links between corporate environmental governance and financial performance. We also looked at the availability and performance of 'green' investment funds. These efforts all fed into the development of our new investment strategy and our Environmental Overlay Strategy.

Environmental Overlay Strategy

All our fund managers have to follow our Environmental Overlay Strategy and Corporate Governance Policy. We monitor and report on their progress every quarter. We work with our fund managers to develop tools and techniques and to raise awareness of how issues beyond the financial can affect investment decisions for different types of assets.

We invest in many different types of assets: equities, bonds, gilts, property and private equity. For each type, our approach requires us to consider different approaches, constraints, risks, opportunities and potential benefits. Note that the use of pooled and indexed products can be cost-effective, but it does reduce the range of governance tools open to us.

Our main influence comes from providing a clear strategic framework. This directly affects our strategic asset allocation, manager structure, manager selection, performance benchmarks, monitoring, and reporting. We don't get involved in the day-to-day investment decisions – this is the job of our fund managers.

In term of asset allocation the proportion of equities to bonds will influence the number of companies in which we can engage as an owner, rather than a holder of the company's debt which affords fewer rights and influence. In terms of management structure we favour segregated funds, in that we are the sole asset owner. Some of our equities are pooled, in that we do not own the underlying assets directly, but units in a fund with more than one asset owner. Where we invest in pooled equities, we

insist that the fund managers are able to vote on our behalf at company AGMs, which may be differently from the view of other members of the pooled asset group.

We expect our fund managers to look out for environmental issues that could reduce investment returns and to take the necessary steps to minimise our exposure to such risks. We therefore encourage them to use research on various environmental risks and/or use 'green' performance rating/ranking tools.

United Nation's Principles for Responsible Investment

In June 2006, we demonstrated our commitment to responsible investment by becoming a signatory to the United Nation's Principles for Responsible Investment (UN PRI). In signing up to these principles, investors make a public commitment to adopt and implement them. They do still of course have to make sure that their decisions are financially prudent. Signatories have to evaluate the effectiveness of the principles and help to improve them as time goes by. The aim is to improve long-term financial returns and to bring the objectives of institutional investors into closer alignment with the broader interests of society:

Principles of Responsible Investment

The Principles for Responsible Investment (PRI) were developed by an international group of institutional investors. Their development reflected the growing view among investment professionals that environmental, social and corporate governance (ESG) issues can affect the performance of investment portfolios. The process was coordinated by the [United Nations Environment Programme Finance Initiative \(UNEP FI\)](#) and the [UN Global Compact](#). The PRI reflect the core values of the group of large investors whose investment horizon is generally long, and whose portfolios are often highly diversified.

The Principles have three levels. The first provides the overall guiding framework, and states:

'As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:'

The second level outlines the six principles:

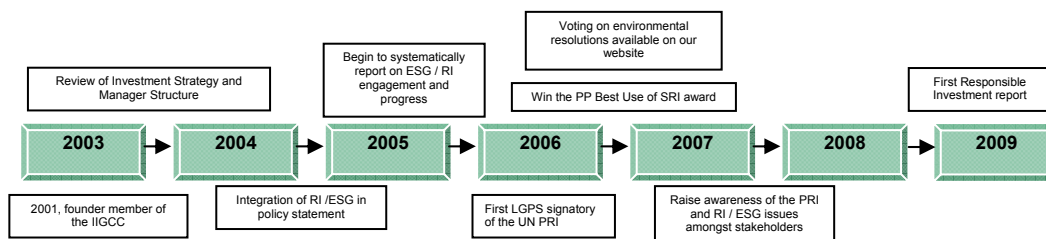
1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

The last level outlines a series of possible actions to consider when implementing each principle.

Source: UNPRI website: www.unpri.org

Principles in practice

The UN Principles for Responsible Investment have given us a framework to set out our progress towards being a responsible investor. Note that this is how the Environment Agency Active Pension Fund has done this – our framework is not prescriptive and doesn't define how other funds should approach change. Our implementation has also been gradual: the time-line below sets out some of the main milestones.



Principle 1: ESG issues in investment analysis and decision-making

We believe our main areas of influence are through our strategic asset allocation, investment portfolio structure, investment manager stock selection, performance targets, monitoring, and reporting – and not by getting involved in the day-to-day investment decisions, which is the role of its fund managers. We needed therefore to ensure our investment managers has the capability to consider and analyse ESG, subject to meeting other finance objectives. In implementing this process we used both investment and specialist SRI advisors as well as in-house expertise.

Manager selection

We select fund managers using the European Union procurement process. All our mandates have our own model investment management agreement. This sets out our investment, corporate governance and environmental policies, as well as our disclosure and reporting requirements. Under the UK Local Government Pension Scheme's (LGPS) investment regulations, we can terminate contracts if a manager's performance falls short of our requirements.

The most important factors in our assessment are:

1. past and potential for future out-performance (financial return against benchmark) and risks (these were assessed using a series of statistical methods)
2. quality of people and investment process
3. integration of sustainable, environmentally responsible investment and corporate governance
4. organisational structure of the investment manager e.g. independent or part of another company such as a bank
5. client reporting.
6. cost and value for money

As we narrow down our choice of potential managers, we look at each area in more depth. Focusing in on the fourth criteria, potential new managers have to provide us with detailed information on how they include a financially significant level of sustainability criteria in their investment decisions. Managers have to show how they:

- identify and select companies for investment
- undertake research on environmental, social and governance (ESG) issues
- encourage companies to improve their ESG performance
- use their votes at AGMs to influence corporate decisions
- report on their voting record and their direct engagement with companies

- identify specific themes – such as water availability and climate change – that can have an impact (negative or positive) on corporate performance
- identify companies with superior ESG performance that are more likely to contribute to sustainable development and financial returns.

We also invite the RI specialists of would-be managers to selection interviews. This gives us the opportunity to question them closely on their experience and success in dealing with ESG issues. In the 2008 selection process, we used our SRI advisor and specialist consultant to independently assess the ESG capabilities of each short-listed manager. This included how managers used their capabilities in practice during the investment process, company engagement and voting. We have published a report on the lessons learnt from our 2008 Global Equity Manager selection. This is available at www.environment-agency.gov.uk/pensions.

ESG issues in investment practices

Recognition in the UN PRI Progress Report 2007: ‘Assessing the capabilities of external managers on ESG issues’

‘The Agency integrates RI/ESG into its investment decision making processes through its investment manager selection and performance measurement process. Investment managers are evaluated on their ESG competencies and have to detail their RFP² response to address how financially material environmental risks and opportunities are integrated into the investment process. This includes stock selection, portfolio management, research, engagement, voting and performance reporting.

The Agency encourages managers to use research and performance rating/ranking tools on various environmental risks and regular review meetings address compliance with policy statements. Managers may be requested to explain and justify financially any investment decisions considered to be environmentally controversial. Managers are also required to provide an annual report on compliance with the Agency’s “green” policies.’

Industry best practice	Our current position
<ul style="list-style-type: none"> ■ Have a formal, public investment policy statement that refers to RI/ESG and <ul style="list-style-type: none"> - integrate this within the organisation’s broader investment policy or - expand upon it in a stand-alone document. 	√
<ul style="list-style-type: none"> ■ Guide the integration of RI/ESG issues into internal investment decision-making. Use a formal document or policy that covers listed equities and, in many cases, other asset classes such as property. 	√
<ul style="list-style-type: none"> ■ Have specialist staff whose job it is to analyse RI/ESG issues (even if this is not their full-time role). 	√
<ul style="list-style-type: none"> ■ Provide training for their organisation’s internal staff who manage non-ESG specialist investments – for example by giving briefings on the risks of climate change. 	√
<ul style="list-style-type: none"> ■ Assess the ESG capability of ESG specialists and internal investment managers. 	√
<ul style="list-style-type: none"> ■ Encourage investment professionals across the industry to train in issues related to RI and ESG – for example EAPF pushed for the inclusion of ESG materials within the programme for Chartered Financial Analysts. 	√

Describes what the top performing UN PRI signatories tend to do. Source: adapted by Mercer from the UN PRI report on Progress 2007

² RFP, Request For Proposal (pack of documents supporting tender application process)

Investment management agreements

We have our own model investment management agreement (IMA) used for all segregated funds. These make clear how managers should implement our Environmental Overlay Strategy and Corporate Governance Policy. The box below sets out extracts from our IMA.

Extracts from our Investment Management Agreement, 2008

On our policies

'The Manager shall observe the Client's Corporate Governance and Environmental Overlay Strategies and, in respect of investments in the United Kingdom, have due regard to the Combined Code and in respect of overseas investments have due regard to relevant recognised standards as agreed with the Client'

On the UN PRI

'The Client encourages the Manager to join the UN PRI and the EAI [Enhanced Analytics Initiative] and to disclose to the Client what proportion of the Manager's commissions are directed to members of the EAI'

On voting

'Prior to voting the Fund's shares the Manager (or its delegate) will discuss with the Client any resolutions containing sustainability and environmental issues at general meeting of companies whose shares are held within the Fund. The Manager shall report and justify to the Client any voting not in accordance with the Client's instructions.'

On reporting

'details of companies whose shares were held within the Fund during the relevant quarter with which the Manager has engaged (excluding routine post results meetings) and of the outcomes achieved'

'details of companies whose shares were held within the Fund during the relevant quarter with which the Manager has engaged on environmental issues including details of the issue, how it arose and the financial outcomes achieved'

Investment management process

All our fund managers must adhere to our Environmental Overlay Strategy. This sets out specific requirements for each type of asset. The box below summarises these requirements.

Public equity	For public equity, we have several mandates, each with a different investment strategy. Equity fund managers use specialist ESG research providers or in-house ESG research. Our assets are invested with managers which aim to select on a best-in-class companies using both financial and ESG criteria.
Bonds	Investors in corporate bonds are less used to considering ESG and RI issues than is the case of equities. However ECM have used data on environmental footprints from Trucost ³ to identify risks. Royal London employ EIRIS to use best-in-class principles in investment decision-making. More details are given below.
Private equity	We invest in a specialist, sustainable private equity fund-of-funds ⁴ . This includes a variety of funds in Europe and the US. There is a bias towards energy, water, waste, food and health sectors. Approximately 30% of the mandate is allocated to environmental technology funds. Our private equity fund managers will only invest in funds where the funds and the underlying companies have pledged to act in a responsible manner.
Property	We invest in a segregated property multi-manager service that is specifically designed for our requirements. Investments include 12 UK-based property funds, giving us a broad exposure to the UK property industry. The investment manager carried out environmental risk assessments across all 12 funds before investing. Our property portfolio also includes Igloo Regeneration, a sustainability and regeneration property fund which invests in disused brown-field sites. It works with the public sector to develop and provide well-designed, mixed-use, sustainable urban communities in the UK. Our property manager carries out a thorough annual survey of all our property fund managers. A summary of the findings from the 2008 review, our third annual environmental survey, is available on our website: go to www.environment-agency.gov.uk/pensions .

³ Trucost and Eiris are specialist ESG research companies.

⁴ A fund-of-fund is a fund that invests in other funds rather than the underlying securities.

Monitoring

Once we have appointed our fund managers, we regularly evaluate their ability to deliver our Environmental Overlay Strategy. This includes looking at how they:

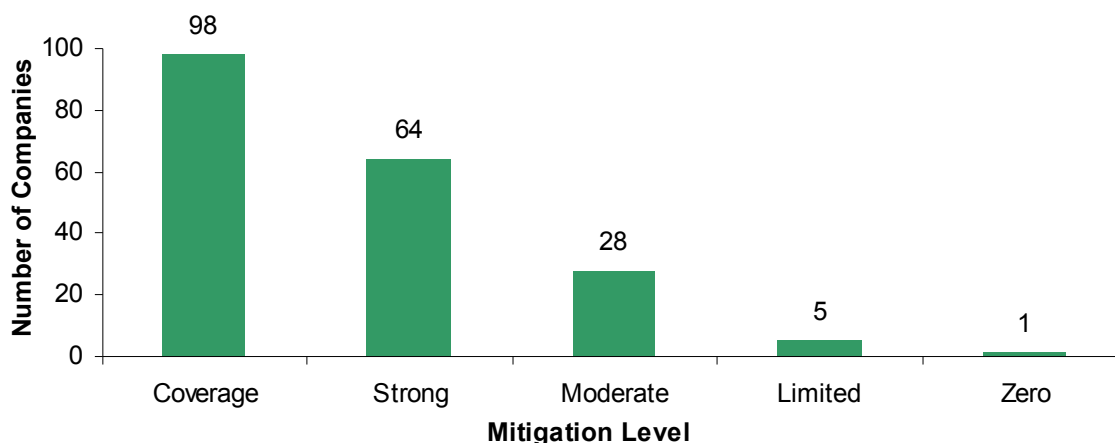
- take account of environmental issues in their investment decision-making
- work with the companies in which we invest (often referred to as 'engagement')
- vote at annual general meetings
- refer any environmental resolutions to us
- benchmark their performance against investment indices for financial performance, corporate governance and social responsibility.

With the exception of managers who deal with currency, all our managers have to report quarterly as follows:

- Our public equity managers must report on their investment performance and how they have influenced companies through voting and engagement. In particular, they must justify their voting decisions, for example a vote *against* a shareholder resolution⁵.
- Private equity managers are also required to report on their engagement with companies, including a comprehensive annual review, discussed later in this report.
- Fixed-income managers have to monitor environmental risks for their investments. They must also report on the ESG ratings of their bonds, wherever such information is available from their external ESG ratings provider. See the chart below.
- Property managers must report on current and emerging environmental issues concerning property.

The chart below shows the analysis of the portfolio provided in each quarterly report by our segregate corporate band manager Royal London Asset Management. The table show us the number of companies that have been assessed using the EIRIS methodology i.e. 98 and a further breakdown by the level of mitigation. EIRIS assesses the extent to which a company mitigates its environmental impact through the implementation and application of environmental management systems and reporting, as well as the degree to which the company can demonstrate its improvement on a number of environmental parameters.

Breakdown of the RLAM EAPF Portfolio by EIRIS scores - 31st March 2009



⁵ A shareholder resolution is a recommendation, by a shareholder or group of shareholders, which specifies a change in corporate policy or disclosure. A resolution is voted for or against by shareholders at a company's annual meeting. The shareholders who make the proposal are known as the filers, and must hold a minimum level of stock (shares).

Compliance Analyst

We also use Compliance Analyst, a web-based application provided by our global custodian Northern Trust, who hold all the records and process all the transactions for our fund. This tool enables us to monitor our fund managers' holdings across a range of ethical and socially responsible issues. Although we do not use negative screening, we do actively monitor the risks that these and other issues may present to our portfolio. We can then discuss these holdings with our managers. If appropriate this may lead to an engagement with companies. The investment manager will report back on the engagement at subsequently quarterly reviews.

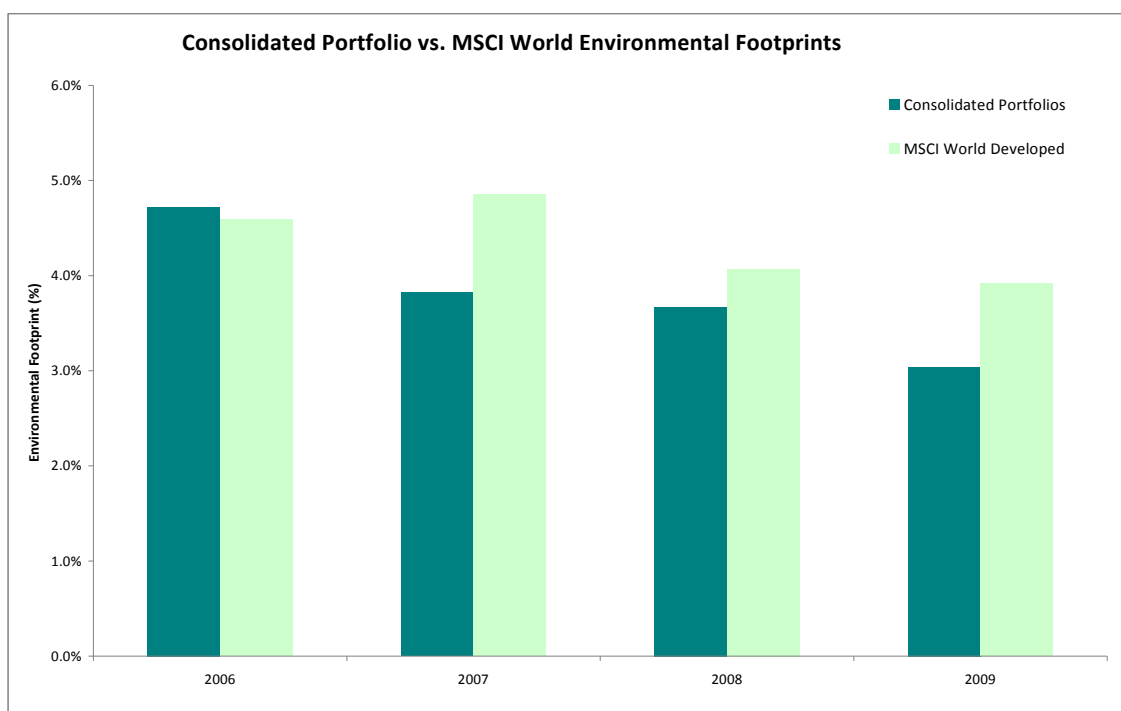
Environmental footprints

We wanted to understand the impact of climate change and other environment issues on our investments. We therefore carried out an assessment of our environmental footprint using a methodology developed by Trucost⁶. We looked at the footprint of each of our active equity funds against their respective benchmarks. Our aim is get a fresh perspective on risk, stock selection and sector exposures. The methodology looks at companies' environmental impacts, for example at the amount of raw materials, water and energy used and the waste and carbon emitted. Trucost looks at more than 700 factors when they assess a company's environmental impact.

Similarly, we have compared the environmental impact of our combined active equity holdings to the benchmark of the MSCI World Developed Countries Index. In 2008 we undertook additional analysis of carbon footprints for each active equity manager and the fund as a whole.

How it is calculated

The footprint for each equity manager, in relation to the EAPF, is compiled by allocating a proportion of the environmental impact of each company relative to the amount of stock that is held. Similarly, we have evaluated the environmental impact of our combined active equity holdings compared to the benchmark, the MSCI World Developed Countries Index. As illustrated by the figure below, we have systematically reduced our environmental footprint since the implementation of our new strategy.



⁶ www.trucost.com

Principle 2: ESG issues in ownership policies and practices

There is a considerable body of evidence that well-governed companies produce better and more sustainable returns. And investors such as pension fund managers and shareholders are well-placed to promote better governance. We can exercise considerable influence over company decision-makers (namely the Board of Directors and senior management) to improve their management and financial performance. This is generally referred to as 'active ownership'.

In June 2004, we therefore reviewed how our then fund managers were complying with our policy on corporate governance. We looked at how they engaged with companies they had invested in, and how they sought to influence their performance. We also examined their votes on our behalf at company AGMs, especially on environmental resolutions.

In light of this review, we decided to step up our active ownership practices for our actively managed fund. This decision was timely as it ensured our compliance with the Myners Principles. The Myners Principles set out best practice for investment decision-making. Pension fund trustees are recommended to adopt these principles on a voluntary 'comply or explain' basis. The principles have played an important role in encouraging active ownership in the UK.

We use two main tools to influence the environmental, social and governance (ESG) performance of the companies in which we invest:

- voting on shareholder resolutions
- engaging with companies in which we see potential for improvement.

Voting and shareholder resolutions

We allow our fund managers to decide when and how to vote. However we expect them to be in regular contact with senior executives at the companies in which we invest. Also, if the resolution deals with an environmental issue, we require managers to discuss the resolution with us before voting. In considering how to vote we our require our fund managers to subscribe to the principles of good corporate governance and to vote in accordance with these.

We have adopted the Corporate Governance Policy and voting guidelines of the Institutional Shareholders' Committee and the National Association of Pension Funds. We require our managers to follow the Combined Code for investments in the UK and relevant recognised standards for overseas investments.

We ask our managers to vote on our shares and our global custodian Northern Trust provides us with quarterly monitoring reports on their voting records. We focus our attention on the quality of corporate governance – and especially on corporate *environmental* governance – in the following regions (listed in order of significance):

1. United Kingdom
2. United States
3. European Union
4. Far East

Industry best practice	Our current position
They should:	
▪ apply their voting practices internationally where possible	√
▪ require reporting on voting activity – to ensure votes are executed according to policy direction. This may involve tracking voting instructions or requiring reports on voting	√
▪ develop comprehensive RI/ESG engagement capabilities in-house, outsource this to fund managers with substantial engagement capacity, or employ an unbundled engagement service	√
▪ establish engagement objectives and systematically evaluate progress .	√
▪ require fund managers to execute client-specific voting (as requested) and inform clients of opportunities to engage with companies on responsible investment issues.	√

Describes what the top performing UN PRI signatories tend to do. Source: adapted by Mercer from the UN PRI report on Progress 2007

We aim to vote on all environmental resolutions in the UK, Europe and North America and, where practical, world-wide. During 2008/09, we voted on 80 environmental resolutions, a few less than last year. The vast majority were in North America. However there were 23 environmental resolutions in Japan, all relating to nuclear power generation. This compared to 27 in 2007/8 and none in 2006/07. Apart from the dominance of resolutions relating to Japanese nuclear power, there were also many resolutions relating to climate change and greenhouse gas emissions. A breakdown of our voting over the last three years is shown below.

Analysis of voting issues	2006/07	2007/08	2008/09
Greenhouse gases and climate change	8	17	25
Sustainability report	11	16	10
Chemicals cost/ manufacturing/ products/disposal	6	4	1
Energy/fuel efficiency	3	7	7
Security of the site where nuclear/chemical substances are stored relating to antiterrorism	3	26	16
Timber procurement	4	2	2
Drilling in sensitive areas	4	1	0
Waste and recycling	2	1	1
GMOs (genetically modified organisms)	4	5	2
Environmental impact of operations	5	6	7
Environmental/ social issues linked to executive pay	2	1	0
Other	2	7	9
Total	54	93	80

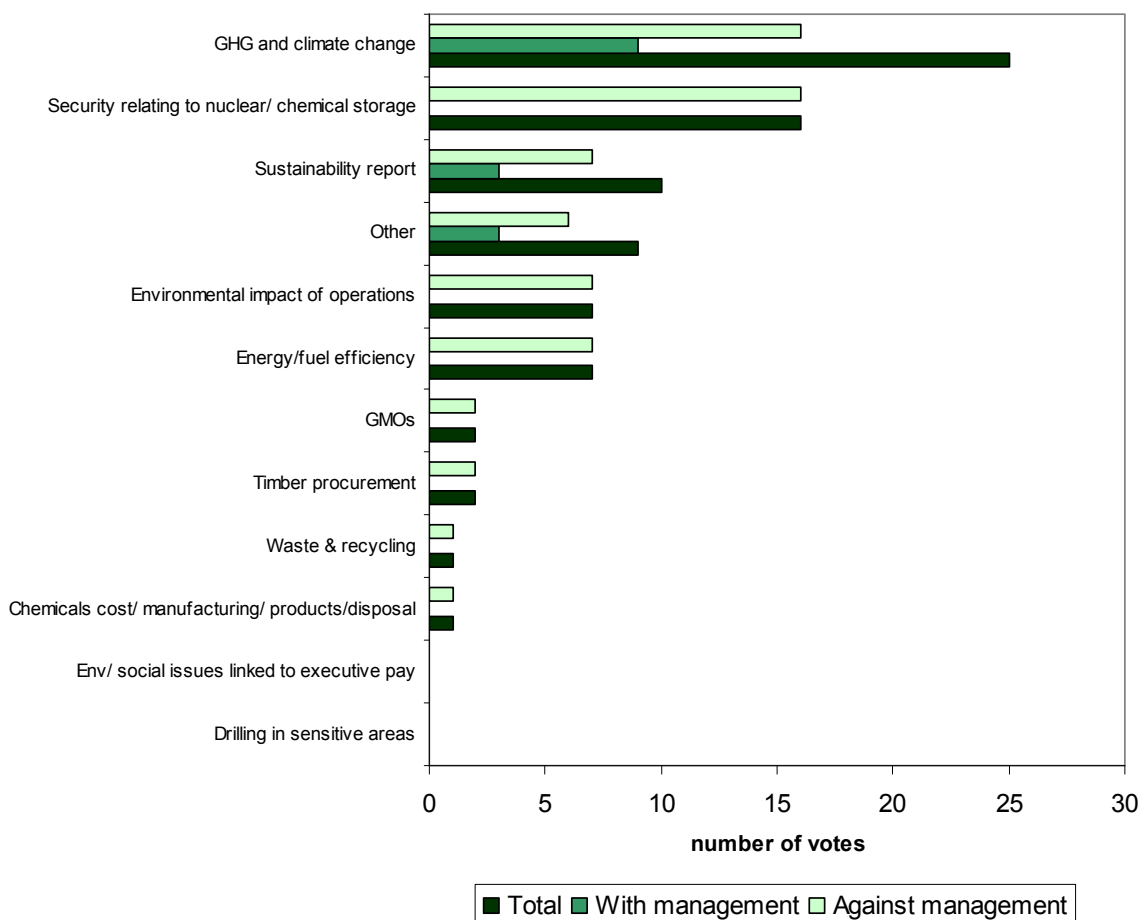
Please note some of the nuclear resolutions would be covered below under site security others under waste.

Examples of our voting decisions

Company (date of meeting)	Resolution	Our vote	Reason
Exxon Mobil Corp (30/05/07)	Report on emission reduction goals	For	The adoption of greenhouse gas (GHG) emission goals would be beneficial for both the company and its shareholders. It would provide insight into the company's ability to maintain its leadership position in the market by ensuring continued compliance with developing legislation for GHG emissions.
Dow Chemical (15/05/09)	Report on environmental remediation in Midland Area	For	We agree with the production of this report as it will be of benefit to shareholders and the environment
RR Donnelley & Sons (28/5/09)	Report on Sustainable Forestry	For	The phasing out of the purchase of non FSC certified paper would protect the company's reputation, we would therefore recommend the production of this report to enhance shareholder value.

The box below illustrates our voting record for the twelve months to 31 March 2009. The figures are broken down by issue and voting stance. They show that we use our votes to support the development of policies and reporting on greenhouse gas emissions, sustainability, waste and water use. Our voting record on shareholder-led environmental resolutions is available on our website at www.environment-agency.gov.uk/pensions

Breakdown of the votes cast on environmental shareholder resolutions by the EAPF 1 April 2008 - 31 March 2009



Royal Dutch Shell, annual general meeting in 2006

The most significant environmental resolution in the EU in recent years was at the 2006 AGM of Royal Dutch Shell. The resolution was organised by Ecumenical Council for Corporate Responsibility and was co-signed by 130 shareholders, including the Rowntree Foundation in the UK and some large US pension funds. The resolution called for Shell to improve its governance and performance, particularly in local community relations and environmental risk and impact assessment. In the vote, 17% of shareholders did not support Shell Management (6% for, 11% abstentions). By UK standards this was significant. We were one of a number of institutional investors who supported the resolution.

Engagement

It is the job of our fund managers to work with the companies in which we invest. They are also responsible for identifying issues for this engagement. However, we are in regular contact with our managers in order to make sure that their engagements are in line with our policies. We use an extensive network of resources, including prosecution data and company environmental news, to identify issues to raise with our managers.

In 2004 and again in 2007, working with Trucost⁷, we asked 580-UK listed companies about their environmental disclosures in their company annual report and accounts. This exercise will be repeated in 2010.

Our managers and external service providers undertake about 800 engagements a year on our behalf. While our own engagement activity focuses on environmental issues, around two thirds of our managers' and external providers' engagement activity focuses on business strategy and corporate governance. They also address issues such as activities in conflict zones, benefits and compensation, bribery and corruption, distribution of fair trade products, HIV/Aids, health and safety, human rights, labour issues, nanotechnology and new technology.

How do we know that working with companies get results?

We realise that we need to know whether or not working with companies is making a difference. We also need to see the results in practice. Does our work have a clear link to improved company performance or better environmental targets?

We realise that this is a great challenge: more work is needed in this area. One of our biggest problems has been the need for extensive data collection. This relies on the transparency of our fund managers, which has sometimes proved difficult. This relies on our fund managers providing us with sufficient information in a meaningful and comparable form. This has sometimes proved difficult.

We are able to draw on a number of different tools to judge the success of our engagements. These include:

- identifying whether governance and or environmental practices have changed.
- obtaining a written commitment from a company to improve in a particular area.
- seeing gradual improvements over time as the result of working with other organisations on a particular issue.
- looking at the performance of the share price.

We have used the above techniques on a case-by-case basis, usually to examine an individual company or sector. We are currently developing ways of evaluating engagement activity at a manager and portfolio level.

⁷ Trucost is an environmental research company

Case study: Example of engagement leading to disinvestment

Global equity – Sarasin LLP

Companies should be clear that we take the concerns our fund managers very seriously. We will sell our shares if necessary. In the two cases below, our manager Sarasin decided to sell all our holdings.

Severn Trent

Our shares were sold following a number of pollution incidents and a Serious Fraud Office investigation which found evidence of serious financial misrepresentation.

Canadian National Railway

Canadian National Railway has persistent poor financial and environmental performance and is not open about poor safety incidents. Sarasin sold our shares and has invested instead in rival competitor Canadian Pacific Railway. This maintains our exposure to this market sector.

Case study: Examples of engagements leading to improved performance

Emerging Markets – SWIP

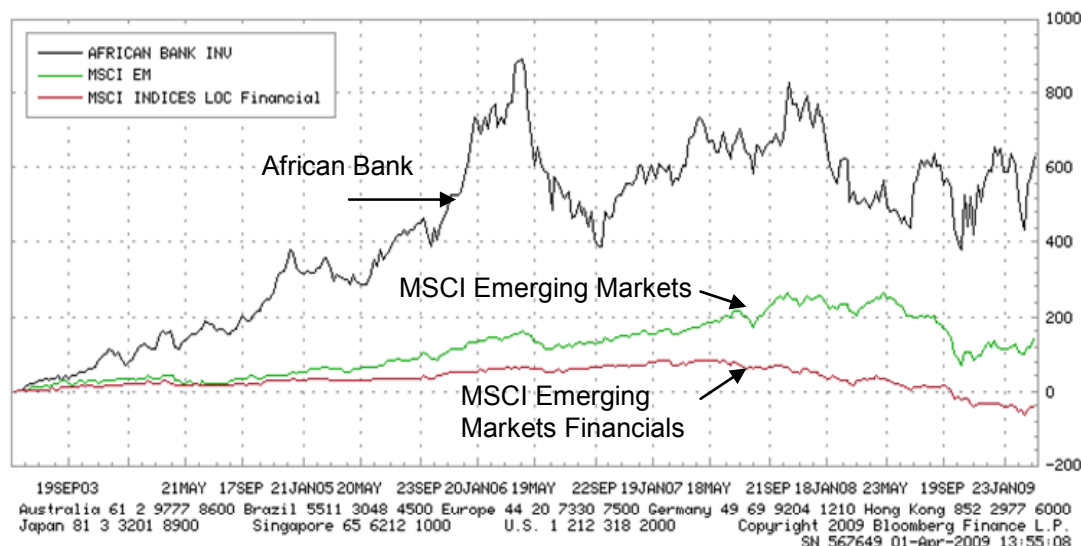
African Bank

SWIP have been major shareholders in African Bank, South Africa's leading micro-lender, since early 2003 and have developed a very healthy working relationship with management. Micro-lending is an industry that is prone to exploitation by unscrupulous lenders. SWIP's discussions with African Bank have always stressed the need for the business to be highly transparent in the provision of affordable, responsible and convenient credit. Also, given the company's funding base SWIP have encouraged management's prudent balance sheet policies. These should ensure the stability of funding for future growth - a particularly relevant issue given today's rapidly changing credit environment. SWIP consider African Bank as a leader their industry in sustainability reporting and empowerment policies. These are two very important factors in the current South African political economy.

Comparative returns for African Bank versus its benchmark and emerging market financial peer group

Securities	Range	Cncy	Prc	Appr	Period	Total Ret	Difference	304 Wk. Annual Eq
1 ABL SJ Equity	5/30/03 - 3/27/09	GBP	306.40 %		Weekly	633.45 %	491.60 %	40.74 %
2 MXEF Index		GBP	114.87 %			141.86 %		16.36 %
3 MSGLFNCL Index			-42.46 %			-42.46 %*	-184.32 %	-9.04 %

(* = No dividends or coupons)



Source: adapted from a case study provided by SWIP (chart Bloomberg)

Principle 3: Disclosure of ESG issues by entities in which we invest

It would be very helpful if companies reported on environmental, social and governance (ESG) issues in a standardised format. This would make it much easier to make comparisons within and across sectors. It could also make it possible to include ESG data within regular financial reports. This is something we have been working hard to promote, especially among the companies in which we invest. We have also supported other initiatives for better reporting on ESG issues. Examples include the Carbon Disclosure Project and a Global Framework for Climate Risk Disclosure⁸. In addition, we ask UK listed companies to report on their use of the Defra's environmental Key Performance Indicators (KPIs). For more information www.defra.gov.uk/environment/business/index.htm.

We also encourage better reporting by providing companies with regular feedback. In 2006 and 2007, we commissioned reports from Trucost on the impacts of FTSE All-Share companies on climate change and established how they are managing their risks from climate change.

Case study: Carbon disclosure working with Standard Life and Trucost

Carbon Management and Carbon Offsetting in the FTSE All-Share 2007

Carbon Management and Carbon Neutrality in the FTSE All-Share 2006

In 2006, we commissioned Trucost to research the role and relative efficacy of carbon neutrality⁹ compared to other carbon management strategies. We also asked them to establish its relevance to different business sectors. The resulting report, published in July 2006, found that 16 companies from 14 different sub-sectors were aiming for carbon neutrality or a low-carbon strategy out of the companies within the FTSE All-Share at the time.

Our intention was to promote a discussion by investors on these key issues. We felt, rightly, that this would improve awareness, understanding and disclosure of carbon management strategies by FTSE-listed businesses. And indeed, there was both action and heated commentary on these topics in the following year. In December 2006 the House of Commons' Environmental Audit Committee launched an inquiry into the voluntary carbon offset market

In January 2007, Defra began consulting on a voluntary Code of Best Practice for carbon offsetting. Throughout the year media and consumer organisations were vocal in examining the credibility and reliability of carbon offsetting. The Advertising Standards Authority also expressed concerns. In light of these events, we asked Trucost to follow up on their research. Defra subsequently developed a Quality Assurance Scheme for Carbon Offsetting, which is now managed by the Department for Energy and Climate Change further information is available at www.defra.gov.uk/environment/climatechange/uk/carbonoffset/index.htm

In 2007 we looked at the latest developments in the use of carbon offsetting and carbon neutrality by FTSE companies and published an updated report. Both reports are available on our internet site www.environment-agency.gov.uk/pensions.

⁸ The Global Framework for Climate Risk Disclosure is a statement of investors' expectations about the information that they need to analyze climate risk and opportunities. The Framework aims to encourage standardized climate risk disclosure.

⁹ 'Carbon neutrality' involves an organisation investing in schemes that reduce levels of CO₂ in the atmosphere. When the CO₂ emissions reduced by such investments equal the CO₂ emissions generated by the operations of the organisation, the net CO₂ emissions generated are zero or 'carbon neutral'.

We are not looking to get involved in day-to-day investment decisions – this is the role of our fund managers. Instead, we encourage our fund managers to use ESG research in investment decisions and ask them to explain these decisions. We believe that the best way to identify companies for investment is to look for those whose ESG performance is better than that of their sector peers – a best-in-class approach. But it also important to engage with companies that have a poor ESG performance. This is more effective than simply ruling these companies out, and may bring broader long-term benefits.

Case study:

Engagement and disclosure in emerging markets – Scottish Widows Investment Partnership (SWIP)

Gazprom

Gazprom is Russia's largest gas producer. SWIP have met regularly with their management over the last decade and have repeatedly raised the issue of the company's poor environmental reporting. We believed this was lagging substantially behind the best practice of Gazprom's global peers. Any environmental information that was disclosed was of limited value. Very often it was in Russian with no English version available. By continuing to work with management on this issue, we have seen a marked improvement in disclosure: the company produced its first Environmental Report in 2005, setting out its Environmental Management System, Control Procedures and Environmental Strategy. SWIP regarded disclosure as a necessary first step in our efforts to assess a company's environmental performance. However, more was needed. SWIP's ongoing discussions with Gazprom now focus on the operational impact of their environmental policies – namely how the company plans to maintain the balance between the ongoing development of its substantial gas reserves and the minimisation of environmental damage.

Source: based on Scottish Widows, engagement data to EAPF

Principle 4: Promoting responsible investment within the investment industry

We have not always found it easy to promote responsible investment with some investment firms. However we are now making some headway. We have encouraged our service providers and peer organisations to become signatories to the UN's Principles for Responsible Investment (UN PRI). Our publications and presentations have shown others that our investment decisions can take proper account of responsible investment and environmental, social and governance (ESG) issues. Our approach to responsible investment is driven by our view that it will lead to higher financial returns.

Since we became signatories of the Principles for Responsible Investment in 2006, we have encouraged our fund managers and service providers to adopt the principles themselves. By January 2009, all managers of our active segregated funds had signed up to the UN PRI. We are now pushing for all our other managers to become signatories too.

Manager	Signed up to the UN PRI?
Standard Life	Yes
Sarasin	Yes
RCM	Yes
Generation Investment Management LLP	Yes
Scottish Widows Investment Partnership	Yes
Impax Asset Management	Yes
Royal London Asset Management	Yes
Aviva Investors (formerly Morley Fund Management)	Yes
Robeco	Yes
European Credit Management	No
Legal & General (passive, index funds) ¹⁰	No
Informed Portfolio Management (currency)	Not applicable
Service Providers	
Trucost	Yes
Innovest	Yes
Mercer	Yes
Hymans	Yes
Northern Trust	No, but considering
Rathbone Greenbank	No, but considering

Case study: Promote UN PRI within investment industry

In most cases, asset owners who have signed up to the UN PRI rely on their external asset managers to implement the principles. Although many asset managers have signed up to the principles, a large number have yet to do so.

In September 2008, we joined forces with the Universities Superannuation Scheme (USS) to improve this situation. We believe that acting with other organisations gives more weight to our campaign for change. Together we aim to encourage those asset managers who haven't signed up to the UN PRI to take account of ESG issues in their investment analysis, decision-making and general practices. In January 2009, we sent a joint letter to:

Barclays Global Investors	SSGA	Capital	Legal & General
Fidelity	Northern Trust	Citigroup	Merrill Lynch
UBS	Credit Suisse		

¹⁰ The name and amount of stocks held by a passive index manager is determined by the index selected by asset owner. The manager therefore is not undertaking any 'stock picking' activity, which is the main reason given by the managers for not being able to implement the PRI guidelines. Work is underway to make the principles more accessible to passive index managers.

Investing responsibly

We look regularly at our investments to see whether we could do better (or worse) by moving more resources into 'green' or socially responsible investment (SRI) funds. Financial performance remains a key factor for investment.

All our managers take account of environmental issues – how much depends on their specific mandate and the area in which they operate. However, since 2005, we have gradually increased the amounts we invest in funds that look more actively at environmental risks and opportunities. The chart below shows clearly just how much has been achieved in the last four years.

The **dark green** section represents the proportion of the fund where ESG issues are a core element of the investment process. In March 2009 this represented about 18% of our active fund. It covers:

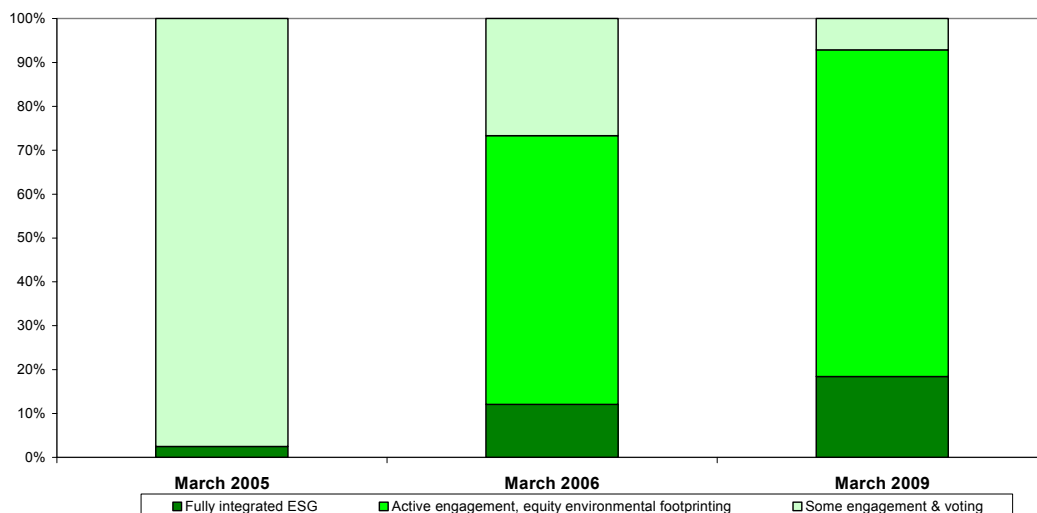
- our mandate for sustainability equity
- our environmental pure play investments, which means at least 50% of the revenues of the company are derived from clean technologies.
- our equity investments where ESG issues are a core indicator
- our private equity investments in clean technology
- our investment in Igloo Regeneration Fund, a specialist sustainable property partnership.

The **mid-green** section shows the proportion of the fund where investments held by equity managers which have active engagement activities and vote. They use either an in-house team or an external provider. For example, Hermes Equity Ownership Service undertakes all the engagement and voting activity for our passive equities held by Legal & General. This section also includes other asset classes where we engage with the company or carry out an ESG assessment as part of the investment process for example the use of EIRiS environmental scores by RLAM in the selection of bonds. This section also includes the other property funds and mainstream private equity the process includes an annual ESG survey.

The **light green** (■) section indicates the proportion of the fund where the managers vote and undertake more limited engagement or environmental research.

How green is our fund?

Allocation to ESG driven investments
(excludes cash & currency)



Industry best practice principles 3 to 6	Our current position
■ Supports shareholder resolutions that promote ESG disclosure	√
■ Offers employees a pension fund that is a signatory to the UN PRI	√
■ Asks service providers to sign up to the UN PRI	√
■ Revisits relationships with service providers when RI/ESG capabilities are inadequate	√
■ Engages in dialogue, or lobbies, on government policy or industry regulations related to RI/ESG issues	√
■ Supports the development of tools for benchmarking the integration of RI/ESG issues (for example, enabling sector-based comparisons)	√
■ Initiates collaborative engagements and seeks support from other investors, including through the Clearinghouse, the forum for UN PRI signatories (see page 32)	√
■ Discloses annual voting records, with an analysis of key votes	√
■ Systematically reports on RI/ESG engagement activities, results and progress	√ ¹¹
■ Raises awareness of the UN PRI and RI/ESG issues among pensions and investment industry.	√
■ Contributes to the improved integration of RI/ESG issues by fund managers (including engagement and voting practices) and communicates on RI/ESG issues with asset owners.	√
■ Evaluates the impact of their RI/ESG efforts on: <ul style="list-style-type: none"> - corporate behaviour or performance - portfolio performance or risk - the consideration of RI/ESG issues by service providers. 	√

Describes what the top performing UN PRI signatories tend to do. Source: adapted by Mercer from the UN PRI report on Progress

¹¹ internal use only, summary information in the Annual report and Accounts

Private equity

Private equity is not normally seen as a natural asset class for a fund with demanding ESG requirements. However this is exactly what we have through Robeco, which manages our fund of funds. The funds that it manages have two elements: 30% allocation to clean technology and 70% allocation to traditional private equity.

Robeco, undertakes an annual survey of the underlying funds in which we invest against a wide range of governance, social and environmental criteria. It is a pre-requisite of investment that the funds adhere to the Responsible Entrepreneurship Guidelines developed for the Robeco Sustainable Private Equity (RSPE) program by Robeco and its parent company, Dutch bank Rabobank.

In 2008, the ESG requirements were considerably higher and more specific than in 2007. Despite this a number of funds realised substantial ESG improvements and the average ESG score in 2008 (64.1%) was slightly higher than in 2007 (63.9%). In general, the investment managers reported in greater detail than in 2007 and provided 178 examples of specific ESG improvements in the portfolio companies.

We want to promote responsible investment in this area. In 2007, we worked with Robeco to published a report Responsible Investment in Sustainable Private Equity – A Case Study , which is available on our website. The report details how we approached the issue of appointing a private equity manager within the context of our responsible investment strategy.

Case study: Extract from the Responsible Investment in Sustainable Private Equity

The rationale for responsible investment in sustainable private equity

Although there is no one single path to sustainability, technological advances in areas such as nanotechnology, biotechnology, energy technology, material technology, and information and communication technology all point to the possibility to meet the needs of a growing world population in a satisfactory way without sacrificing natural or social capital. The vast majority of fast growing companies with exciting new sustainable technologies are too small to be listed on stock changes. Therefore, the only way to invest in these companies that can offer highly attractive investment returns and at the same time contribute to sustainability is through investing in private equity.

Sustainability is gaining momentum in the private equity industry. This can be seen by the increasing number of dedicated sustainable private equity funds coming to the market. At present, over 200 dedicated sustainable private equity funds exist, of which more than 50 were successful in raising enough money and can be considered of institutional quality.

Dedicated sustainable private equity funds typically focus on new forms of energy, new food, agriculture and nutrition technologies and new ways of utilising resources, including water. Looking at the market for new energy technologies for example, there is a strong demand for innovative energy technology solutions in the fields of renewable energy (biomass, solar, wind and hydro) and decentralised generation systems (such as fuel cells and micro-turbines). Also, the potential for private equity investments in the water sector is very large, given that the demand for water will continue to increase in the coming years, both in quantitative and qualitative terms. This is for example caused by the increasing number of industry sectors that require ultra-pure water, such as the semiconductor industry and the pharmaceutical industry. As a result, consumer demand is driving new water treatment, desalination, recycle and reuse initiatives and innovations.

Source: Responsible Investment in Sustainable Private Equity - A Case Study, 2007 Robeco and EAPF

Property

We wanted to assess the environmental best practices of UK and European property funds. To do this, Aviva Investors and the EAPF commissioned a survey, with the aid of Innovest (a specialist provider of extra-financial research). The survey looked at all funds in the IPD Pooled Property Funds Indices, and at other selected UK and European funds which invest in property for pension funds and other investors.

This annual survey, now in its third year, finds out what such funds know about corporate social responsibility and the environmental, social and governance issues affecting property investment. We look particularly at environmental issues. Aviva Investors believe this to be a vital survey, as it is only by accurately and consistently monitoring funds' performances that we can:

- see developments over time
- benchmark funds against their peers
- draw up new environmental key performance indicators and targets that are effective and ambitious.

Case Study: Engagement with property funds – working with Aviva Investors

There was a low response rate to our 2008 survey, which reflects the amount of work to be done to green the property sector. Of the 81 funds that were asked to fill out the survey questionnaire, only 22 (27%) provided full responses.

Overall performance

Of the funds which replied in full, the overall environmental performance scores ranged from 78% to 22%. The average score was 44%. This huge range shows that property funds are far from having a standard approach to green issues. Note that the two top-scoring funds are very different: one is a large balanced fund and the other a far smaller specialist fund. Despite their differences, both demonstrate a positive, open attitude towards environmental issues. This shows that the environment can play an important role in all types of funds, regardless of size or specialisation.

Summary of findings

- There is a greater awareness of environmental issues than in 2007, but this has not yet resulted in significant action. For the funds included in the survey, it would seem that environmental factors are not yet a fundamental consideration in the investment process.
- Funds believe that there is a link between environmental performance and value, but they are unable to quantify this at present.
- Few funds disclose, monitor or report environmental performance to investors.
- There are a few 'green champions' setting the benchmark for the industry.
- The questions on portfolio development and management produced particularly weak scores. However, with the introduction of Energy Performance Certificates (EPCs) and Display Energy Certificates (DECs), we hope this will steadily improve.

www.environment-agency.gov.uk/pensions

Principle 5: Working together

We believe that we achieve more by working with other investors and bodies that share our goals. These include the UK Social Investment Forum (UKSIF), Institutional Investors Group on Climate Change (IIGCC), and the Carbon Disclosure Project (CDP).

The purpose of these working relationships varies. For example, through our work with the Local Authority Pension Fund Forum (LAPFF), we aim to encourage FTSE 100 companies to report on their environmental performance.

As part of signing up to the UN's Principles of Responsible Investment (UN PRI) we make good use of their forum, the Clearinghouse. Here signatories can share information about how they are working with the companies in which they invest. The first forum of its kind in the world, the Clearinghouse aims to bring together like-minded investors and give greater weight to their voices and interventions.

As discussed already, we have worked closely with our fund managers to publish research on responsible investment. This has included two reports on corporate carbon management, where we are pushing for better disclosure. For more details, see 'Disclosure of ESG issues by entities in which we invest' page 25.

Since 2005, we have actively supported pension and investment industry events across Europe including the Triple Bottom Line Investors, Clean Investors, Local Government Conference, Asset Allocation Summit, UK Investment summit to name but a few. At these events we have given presentations on responsible investment (RI) and promoted initiatives such as the UN PRI, IIGCC and the CDP. We also encourage other funds to consider environmental, social and governance issues (ESG) in their investment decision-making through, describing what we have done with our own fund.

In 2007, we advocated RI/ESG issues be covered in professional training programmes, such as those for Chartered Financial Analysts (CFAs). We have also published guides and information on environmental accounting in the UK with Envirowise *Reduce your costs with environmental management accounting* and with the United Nations Expert Working Group on Environment Accounting - *Clean and Competitive: Environmental Management Accounting for Business and Environmental management accounting: An introduction for government decision-making*. Links to these documents are on our website at www.environment-agency.gov.uk/pensions.

Case study: Aviva Investors (previously known as Morley Fund Management)

Adding your voice to others can be a powerful tool

In 2007, the Environment Agency Pension Fund was part of a coalition of twenty large investors – together we hold approximately US\$2.13 trillion in assets. We wrote jointly to the chief executives of 103 companies. All of these companies had signed up to the UN's Global Compact, the world's largest voluntary social responsibility initiative. These companies were based in 29 different countries, which underlines the importance of global investors working together in this way.

We joined together with 37 other signatories of the UN PRI. Together we managed assets worth US\$3 trillion. The group sent a jointly signed letter to selected chief executives of listed Global Compact signatories. In some cases, this letter welcomed particularly good practice. In others we wrote to challenge them to meet the Compact's universal principles and regain full participant status. This action supported Principles 2, 3 and 5 of the PRI. (See page 14)

This letter achieved clear results. At the 2008 PRI Conference in Seoul, Aviva Investors (then Morley Fund Management) reported that around 20% of the companies contacted subsequently submitted a 'Communication on Progress' (COP). By mid-January 2009, this figure had reached 33%. These companies are now listed as active members by the Global Compact.

Information based on PRI clearinghouse posting by Aviva Investors, 2009. For more information on the UN's Global Compact, please go to www.unglobalcompact.org

Work on environmental accounting and working with the main accounting bodies for the UK is undertaken in conjunction with our Environmental Finance team, within the Environment Agency. The focus is to develop tools and techniques to promote and monitor corporate disclosure of environmental risks. The rationale being that as investors we need accurate, comparable information on all risk facing a business, including ESG risks. The role of accountants, including the management accountants, financial accountants and company secretaries is critical in this process.

Case study: Trucost

Environmental disclosures: The second major review of Environmental Reporting in the Annual Report & Accounts of the FTSE All-Share for the year ending 31 March 2007. The first review took place in 2004.

Together with our research partner Trucost, we set out to evaluate the environmental disclosures made by all companies in the FTSE All-Share, excluding investment trusts.

We found there had been some improvement in qualitative reporting since 2004. About 98% of FTSE All-Share companies mentioned the word environment in their annual reports and accounts. This is an improvement from 89% in 2004. Also 35% made their environmental disclosures in the audited sections of their annual report and accounts – compared to just 10% in 2004. However, there is still concern at the relatively low levels of quantitative disclosures on environmental risks (and opportunities) that are financially material to shareholders and potential investors.

42% of companies did disclose quantitative environmental data – a 15% increase since 2004. However, given the financial implications of climate change, it was surprising that only 29% of companies reported quantified figures on energy use or other topics related to climate change. The study also found that only 15% of companies reported on one of the key environmental performance indicators recommended by UK government.

The UK government has made it clear that environmental reporting is important, and that it views this as a permanent fixture in corporate reporting. In January 2006 voluntary guidelines and key performance indicators (KPIs) were published which provide a framework for reporting on significant environmental issues. Companies must include these in their annual reports and accounts. As of October 2007, under the Companies Act 2006, directors also have a duty to take account of the impact of a company's operations on the environment.

We are undertaking the third review of environmental disclosures and are aiming to publish the report in the Autumn of 2010.

We are shortly to publish a report with the Institute of Chartered Accountants for England and Wales (ICAEW). This aims to help accountants and auditors in the generation and auditing of non-financial data in organisational annual report and accounts. The report details the main questions, and answers, accountants and auditors might have with respect to dealing with ESG issues in the annual report and accounts. For example which Financial Reporting Standard sets out the appropriate method for disclosure of a given environment issue.

Copies of this report will be available on our website at www.environment-agency.gov.uk/environmentalfinance

Principle 6: Progress and reporting

This report is our first attempt to draw together the many initiatives and actions we have undertaken in implementing responsible investment.

We have already published details of our responsible investment strategy and our notable achievements. These are in our Annual Report and Accounts and in *Fundfare*, our member newsletter.

We make as much use as we can of the internet, as we believe this makes it much easier for people to find out what we are doing. Our website address is www.environment-agency.gov.uk/pensions. Our website includes:

- our Annual Report and Accounts
- *Fundfare*
- our investment strategy implementation review
- research reports on responsible investment
- our voting on environmental resolutions, updated every June and October
- details of our largest holdings
- a review of our selection process for a global equity manager
- links to the research undertaken by our Environmental Finance team
- links to collaborative research we have taken part in.

Pension awards

We believe that our new strategies are making a real difference to the way we invest, and that we are beginning to influence the wider investment industry. We're delighted at the wide recognition we are receiving for our work include environmental issues in the investment process.

In 2008 we won four awards:

- Pensions and Investment UK Scheme Communications Awards 2008, Member Facing Function Award.
- Investments and Pensions Europe Fund Awards 2008. Socially Responsible Investment/Corporate Governance Award – Winner.
- IPE/Brooklyn Bridge/TBLI Environmental Social Governance (ESG) Leaders Awards 2008 – Best investor in ESG award – Winner.
- Engaged Investor Trustee Awards 2008 – Best Scheme Governance (Public Sector).

In a special report, Ethical Corporation magazine recognised Howard Pearce, Head of the Environment Agency Pension Fund, as one of top ten Ethical Leaders of 2008. This praise was for his work in integrating ESG issues into investment practices and processes.

What next

We aim to maintain momentum and continue to build on the progress we have already made.

One area is improving the capture and assessment of information on environmental, social and governance (ESG) issues for our whole portfolio. This will enable us to assess risks and opportunities across the fund. The information will form a core component of our investment strategy review, which will begin in 2009/10.

We will also continue to promote carbon disclosure in company annual reports and contributing to green economy through our fund's investments in clean technology.

Carbon reporting and disclosure

We have already made some progress in this area. Our *Carbon Management & Carbon Neutrality* reports for companies in the FTSE All-Share highlighted the need for credible carbon management programmes. We looked in particular at how companies are using offsetting mechanisms to achieve carbon neutrality.

The Companies Act 2007 has introduced new environmental reporting requirements and the Climate Change Act 2008 has set up a framework for companies to report their emissions, in order to increase the consistency and comparability of reported figures. Coupled with increased stakeholder pressure, this means that most companies are now discussing the issue of climate change at board level. International efforts to regulate and reduce greenhouse gas emissions have led more and more companies to make public commitments to reduce the emissions that they are responsible for. Many are moving towards being lower carbon users, by investing in schemes that reduce levels of greenhouse gases emitted into the atmosphere elsewhere.

We intend to focus our engagement activity on one of our most enduring themes – the standardisation of environmental and carbon accounting and reporting. This is fundamental as it will allow for performance comparison of private and listed companies.

Continue to examine opportunities in green investments

We can see long-term benefits in supporting clean technologies and environmental services sector. We believe that due global green stimulus packages that the size of these sectors will grow, and with it our investment returns. We will therefore continue to examine various types of private equity funds: including sustainability funds, environmental funds, low carbon funds, green energy funds, green technology funds, green property funds, and sustainable forestry funds.

In all cases we continue to research and evaluate the financial benefits of these and environmental funds through our financial and environmental due diligence processes. Financial performance will always be the key factor for investment.

Further information

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Annex 1

Details of selected organisations and initiatives, with links for more information and definitions of the terminology used in this report.

Carbon Disclosure Project (CDP)	www.cdproject.net/
UNPRI	www.unpri.org/
Defra - Department for Environment, Food and Rural Affairs	www.defra.gov.uk/
EMAS - The EU Eco-Management and Audit Scheme	www.iema.net/ems/emas
Enhanced Analytics Initiative (EAI)	http://www.enhancedanalytics.com/portal/ep/home.do
Institutional Investors Group on Climate Change (IIGCC)	www.iigcc.org
Ecumenical Council for Corporate Responsibility (ECCR)	www.eecr.org
Local Authority Pension Fund Forum (LAPFF)	www.lapfforum.org
Institutional Shareholders' Committee	http://www.institutionalshareholderscommittee.org.uk/
Freshfield's Report	www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf
Local Government Pension Scheme (LGPS)	www.lgps.org.uk
Pensions regulator - Myners Principles	www.thepensionsregulator.gov.uk/igg/background.aspx
National Association of Pension Funds – Corporate Governance	www.napf.co.uk/Policy/Governance.cfm
UK Sustainable Investment and Finance (UKSIF)	www.uksif.org/
UN Environment Programme Finance Initiative (UNEP FI)	www.unepfi.org/
UN Global Compact	www.unglobalcompact.org/
UN's Principles for Responsible Investment (UN PRI)	www.unpri.org

Annex 2 Corporate governance strategy

Introduction

We believe there is a considerable body of evidence that well governed companies produce better and more sustainable returns than poorly governed companies. We also think investors, including pension fund managers and shareholders, could influence the Board/Directors of under-performing companies to improve the management and financial performance of those companies.

Our strategy and approach is driven by our fiduciary duty to deliver financial returns on our investments. We do not undertake negative screening. We invest in index funds holding shares in most companies, in most stock markets. We therefore distinguish ourselves to be a responsible investor, by being an active owner.

The Environment Agency Pension Fund believes in shareholder activism and being an active owner directly, through our managers and dedicated governance overlay providers. The funds subscribes to the Myners' principles of best practice in investment management.

We focus our attention on the quality of corporate governance (and especially corporate environmental governance) of UK, US, EU, Far East stocks in that order, linked to the relative size of our holdings

We delegate much of the day to day corporate governance activities to our managers and overlay service provider. The capability and performance of our manager in this area is a key component of our selection and retention criteria. Once appointed, we monitor activity and success of our managers and overlay service provider on a quarterly basis.

Engagement

We focus our engagement efforts on corporate environmental governance, Corporate Social Responsibility "CSR", and sustainability issues and their associated resolutions at company meetings and other engagement opportunities.

We work in partnership with other like minded investors, fund managers, bodies, and service providers with similar objectives, to influence the business and investment world on these and other issues.

We delegate the large volume of non-environmental corporate research, engagement, and voting to our fund managers or a third party/parties and monitor, assess and externally report on this activity.

In partnership with our fund managers we set out engagement priorities, including collaborative engagements, for the forthcoming year.

Voting

We aim to vote the Fund's shares in all markets were practicable. Our fund managers vote at their discretion and must confirm that they subscribe to the principles of good corporate governance and, when exercising their vote, take this into account.

We have adopted the Institutional Shareholders' Committee and the National Association of Pension Fund Corporate Governance Policy and Voting Guidelines. In respect of investments in the United Kingdom, we require our managers to have due regard to the Combined Code and in respect of overseas investments have due regard to relevant recognised standards.

Regular contact, at senior executive level, with companies, in which the Fund's assets are invested, is an important element of both the investment process and good corporate governance and we require our managers to report, quarterly, on their engagement and the outcomes achieved.

Our fund managers refer "environmental" resolutions to us for advice on voting policy on these areas. We also published our voting record for all environmental resolutions.

All managers are presently requested to vote the Fund's shares and quarterly monitoring reports are provided by our global custodian Northern Trust.

Monitoring

We monitor our fund manager's adoption of our corporate governance policies and requested they comply with it and inform us of any future environmental resolutions.

We also meet with our global custodian Northern Trust and their contractor the Institutional Shareholder Service (ISS), through whom our fund managers vote our shares at company AGM's. We also have electronic access to their VOTEX system, through which we can monitor fund managers voting actions.

Disclosure

We believe disclosure underpins good corporate and environmental governance.

We promote the Agency's Active Pension Fund approach and voting actions on environmental corporate governance, sustainability, CSR, and environmental issues.

Working in partnerships

The Environment Agency liaises with bodies with similar activism goals including the UK Sustainable Investment and Finance Association (UKSIF), Institutional Investors Group on Climate Change (IIGCC), and Carbon Disclosure Project (CDP).

The Environment Agency continues to work with the Local Authority Pension Fund Forum (LAPFF) to encourage FTSE 100 companies to report on their environmental performance. We will also publish reports on the environmental disclosure of FTSE all-share companies.

The Environment Agency monitors the California Public Employees Retirement System (CALPERS) which is the largest pension fund in the world and the French Pensions Reserve (FRR) who are also implementing environmental investment strategies.

We expect all our fund managers and engagement and voting overlay service to follow our strategies and policies subject to any Environment Agency specific instructions which should be followed in full, failure to do so could be a breach of the Investment Management Agreement.

Approved by the Pensions Committee on 23 June 2009 and will be reviewed in 2009/10 as part of an investment strategy review.

Annex 3 – Environmental overlay strategy

Vision

The Environment Agency (“the Agency” / “We”) will seek to ensure that its future strategy and policies for the investment and management of pension fund assets are financially robust and environmentally credible, and where feasible, through their implementation, will seek to contribute to creating a “greener” business world.

Aim

To be one of the leading public sector pension funds in respect of the implementation of financially robust and environmentally responsible investment policies.

Legal compliance

We will seek to comply fully with the regulatory requirement(1) to include in the statement of investment principles (SIP) details of our policies on social, ethical, environmental (SEE) issues in respect of the selection, retention, realisation of investments and exercise of voting rights.

We will regularly update and develop new policies in light of any future changes to company law, pensions law, and codes of best practice in respect of corporate governance and environmental management.

Fiduciary duty

We will fulfil and comply with our fiduciary duty to maximise risk-adjusted investment returns in the best long term interests of pension fund members. As a result of which we affirm that we will assess and take account of existing and future financial risks (e.g. climate change and cost of pollution clean ups and opportunities from environmental issues on clean ups), and financial opportunities from the exploitation of green technology and services.

Capability

We will seek to ensure our pension fund management team possesses high-quality knowledge, skills, and experience in respect of financially and environmentally responsible investment, and has access to external research, expertise, and training to maintain and develop this capability.

Statement of investment principles

When preparing and maintaining the SIP, we will be mindful of our overall corporate strategy (e.g. “greening” business) and corporate environmental governance policies (e.g. encouraging company environmental reporting and disclosure of environmental risks and performance). A revised SIP will be developed with the benefit of research into best practice in respect of

1. The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998; and
2. environmental issues from other pension funds, and will be reviewed and published annually by the Pensions Committee.

Investment strategy

Our investment strategy will seek to take account of the relationship between good environmental management and long-term sustainable business profitability.

We will seek to overlay this environmental strategy across our investment portfolio. We recognise that when the strategy is applied to investments in equities, bonds, gilts, property and private equity, this will involve considering different approaches, constraints, risks, opportunities and potential benefits.

Our main influence will be through our strategic asset allocation, manager structure, manager selection, performance benchmarks, monitoring, and reporting – and not by getting involved in the day-to-day investment decisions, which is the role of our fund managers.

We will encourage our fund managers to use research on various environmental risk and/or “green” performance rating/ranking tools to identify and avoid financial risks attributable to environmental issues, such as climate change, that could impact negatively on investment returns.

We will, through monitoring their performance, ask our fund managers to explain and justify financially any investment decisions, for example on stock selection, which in our view are environmentally controversial. We will favour investing on a positive “best in class” selection basis, and encourage the use of engagement rather than negative screening.

Asset allocation

We will periodically review our asset allocation strategy between different investments. We will investigate and evaluate financially the risks/opportunities and performance/potential returns from investing more assets in various types of “green”/SRI funds, taking into account their financial performance relative to other funds.

Based on financial returns we have incrementally increased our allocation to funds and/or fund managers that integrate sustainable responsible investment into their investment decision making. The details of our investments, the benchmarks and targets are all disclosed in our Pension Fund Annual Report.

We will also examine various types of private equity funds including sustainability funds, environmental funds, low carbon funds, green energy funds, green technology funds, green property funds, and sustainable forestry funds. After researching and evaluating the financial/environmental pros and cons of these funds through normal due diligence processes, we will invest a proportion of our assets in these fund types in order both to stimulate such “green” investment styles and to share the returns.

Fund manager selection

When selecting the Fund’s investment advisers and appointing external fund managers, we will use our standard procurement process. This includes environmental assessment tools and criteria, as well as financial performance criteria and value for money.

The environmental criteria include the relative quality, integration and impact of environmental research; the information used in external managers’ investment management and performance reporting processes; and the amount of resource that external managers have available for this work.

We are committed to responsible investment and are striving for all our fund managers and investment service providers to be cosignatories of the United Nations Principles for Responsible Investment.

Investment management agreements

We engage managers using our own model investment management agreement. This has been drafted to meet industry standards of best practice, and will ensure the use of consistent terms and conditions, fund valuation methods, manager fee calculation and payment mechanisms in respect of the various investment mandates. It also includes our corporate governance/environmental policies and disclosure and reporting requirements. External fund managers agree to comply with such requirements as a condition of their appointment.

Performance benchmarks

We will measure our fund managers’ investment performance using either industry standard indices/benchmarks or “customised” versions to track/monitor performance targets. Where appropriate we may separately monitor other indices, such as FTSE4Good Index, Dow Jones SD Index or Domino Social Index. We may also use specially constructed versions of these indices to assess our own and various other investment styles. Some assets (such as property and private equity) will need their own “specialised” benchmarks.

Investment management processes

We will inform our asset managers (and those who provide their company research information) about our own environmental data, be it publicly available or obtainable from us, which is potentially financially significant (e.g. on climate change). Such information could relate to environmental risks (e.g. our operator performance risk assessment scores), emissions (e.g. our Pollution Inventory) and performance (e.g. our Spotlight publication). Our aim is to help inform, but not interfere with, independent investment management processes. We affirm that the purpose of all such information exchange with managers is to help deliver sustainable high financial returns on our investments.

Shareholder activism, engagement and voting

We will aim to comply with the Myners activism principle and to become more engaged as an active investor, especially with companies whose environmental behaviour and performance are currently impacting negatively on short or long-term investment returns – or could do so in the future. We will normally do this through partnership and alliances with other pension fund groups (e.g. UKSIF, IIGCC, LAPFF) to increase the impact of our policies. However, we reserve the right to act independently where necessary.

We will encourage our asset managers (or an engagement or voting overlay service provider) to actively engage with the top management of those companies they invest in. This is to help improve the companies' performance in both financial and environmental terms. We will also encourage voting on key resolutions concerned with corporate governance and environmental issues.

We will provide our asset managers (or an engagement and voting overlay service provider) with details of our corporate governance, environmental policies and preferred voting stances, for example, in respect of companies that do not report on their green house gas emissions and environmental performance in their annual reports and accounts.

Performance monitoring and reporting

We will assess the compliance of both the investment processes and the decisions of external fund managers with our SIP policy statements and IMA requirements. This will be part of regular review meetings to discuss quarterly fund management performance and company engagement and voting reports.

We will receive an annual report on fund managers' compliance with the SIP's "green" policies. We will also report on our own environmentally related activities. These reports will be summarised in the Pension Fund Annual Report.

Performance benchmarking and assessment

We will periodically benchmark the environmental investment performance of our fund managers, and also this environmental investment strategy, against other public sector and private pension funds. We will take action as required to improve both their relative performance and this strategy.

Research and development

Resources permitting, we will undertake some SRI research in-house and/or support joint studies with other pension funds and organisations that have interests in environmental or sustainable investment. We will do this to inform our own policies.

Collaboration

We will join and/or collaborate with other organisations with environmental goals. Such organisations include the UNPRI, UK Social Investment Forum (UKSIF), Carbon Disclosure Project (CDP), Local Authority Pension Fund Forum (LAPFF) campaign on environmental reporting, and Institutional Investors Group on Climate Change (IIGCC).

Communication and disclosure

We will communicate our approach to sustainable environmentally responsible pension fund management, and report on the “green” performance of our pension fund.

We will do this on our intranet (Easinet), our web site pages (www.environment-agency.gov.uk) and in publications such as the Pension Fund Annual Report and Fundfare, a members’ booklet. Users of this information will include staff, pensioners, and other pension funds and policy makers in Government.

Continuous improvement

We will ensure our Pensions Committee is regularly advised and updated on external developments and on our own performance in this area. We will keep our policies and approach under continual review so as to improve their efficacy.

Approved by the Pensions Committee on 23 June 2009 and will be reviewed in 2009/10 as part of an investment strategy review.

Notes

Would you like to find out more about us, or about your environment?

Then call us on

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email

enquiries@environment-agency.gov.uk

or visit our website

www.environment-agency.gov.uk

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floodline 0845 988 1188

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