AA Pension Scheme

# Engagement Policy Implementation Statement 2022

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## AA Pension Scheme (the "Scheme")

This Engagement Policy Implementation Statement ("EPIS") has been prepared by the Trustee and covers the AA Pension Scheme year 1 April 2021 to 31 March 2022.

### Introduction

On 6 June 2019, the Government published the Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019 (the "Regulations"). The Regulations require that the Trustee produces an annual statement which outlines the following:

- Explain how and the extent to which the Trustee has followed its engagement policy which is set out in the Statement of Investment Principles ("SIP").

- Describe the voting behaviour by or on behalf of the Trustee (including the most significant votes cast) during the Scheme year and state any use of third party provider of proxy voting services.

### Executive summary

Based on the activity over the year by the Trustee and its investment managers, the Trustee believes that the stewardship policy has been implemented effectively. The Trustee notes that its delegated managers, Aon Investments Limited ("AIL") and Kempen Capital Management ("Kempen"), along with its investment managers outside of the delegated arrangements were able to disclose adequate evidence of voting and engagement activity.

The Trustee expects improvements in disclosures over time in line with the increasing expectations on asset managers and their significant influence to generate positive outcomes for the Scheme through considered voting and engagement.

### Scheme stewardship policy

This statement has been prepared in line with the Trustees' stewardship policy as set out in the SIP effective March 2022. The relevant extracts from the SIP in relation to 'Stewardship – Voting and Engagement' are 6.2-6.7.

The SIP can be found on the Scheme website here https://aapensions.com/document-library/financial-information and is included as an Appendix to the accounts.

Through this report, the Trustee reviews how the actions of its investment managers (and sub-investment managers within its delegated arrangements) have aligned with its expectations and principles set out in the SIP. The Trustee will set out where it expects more information or engagement to be undertaken by its managers.

### Scheme stewardship activity over the year

#### Training

Over the year, the Trustee had responsible investment training sessions with their investment advisor, which provided the Trustee with updates on the evolving regulatory requirements and the importance of stewardship activity and appropriate consideration of Environment Social and Governance ("ESG") factors in investment decision making. In addition, the Trustee has received ongoing training on the Task Force on Climate-Related Financial Disclosures (TCFD) requirements.

#### Ongoing Monitoring

Investment monitoring takes place on a quarterly basis with monitoring reports being provided to the Trustee by Aon as well as the Scheme's two delegated managers AIL and Kempen. The reports include ESG ratings and highlight any areas of concern, or where action is required.

The Trustee's investment adviser, Aon Solutions UK Limited ("Aon")'s, ESG rating system is for buy rated investment strategies and is designed to assess whether investment managers integrate responsible investment and more specifically ESG considerations into their investment decision making process. The Aon ESG ratings are based on a variety of qualitative factors, starting with a proprietary due diligence questionnaire, which is completed by the fund manager. Aon's researchers also conduct a review of the managers' responsible investment related policies and procedures, including a review of their responsible investment policy (if they have one), active ownership, proxy voting and/or stewardship policies. After a thorough review of the available materials, data and policies, as well as conversation with the fund manager, the lead researcher will award an ESG rating, which is subject to peer review using an agreed reference framework. Ratings will be updated to reflect any changes in a fund's level of ESG integration or broader responsible investment developments.

**TCFD**

The Scheme is currently progressing towards meeting the requirements as set out as part of TCFD. The TCFD establishes a set of eleven clear, comparable and consistent recommended disclosures about the risks and opportunities presented by climate change. The increased transparency encouraged through the TCFD recommendations is intended to lead to decision-useful information and therefore better informed decision-making on climate-related financial risks. Aligning the Scheme to the TCFD can be a long process and requires careful planning. Aon are currently working with the Trustee ahead of the first publication of the report before 31 October 2023.

## Engagement activity – Delegated manager (AIL)

The Trustee has delegated a portion of the Scheme's assets to AIL. AIL manages the Scheme's assets in a range of funds which can include multi-asset, multi-manager and specialist third party liability matching funds. AIL selects the underlying investment managers on behalf of the Trustee.

The Trustee has reviewed AIL's latest Annual Stewardship Report and believes it shows that AIL is using its resources to effectively influence positive outcomes in the funds in which it invests.

AIL has carried out a considerable amount of engagement activity over the year. AIL held a number of ESG focused meetings with the underlying managers across its strategies. At these meetings, AIL discussed ESG integration, and voting and engagement activities undertaken by the investment managers. This allowed AIL to form an opinion on managers' strengths and areas for improvement. AIL provided feedback to the managers following these meetings with the goal of improving the standard of ESG integration across its portfolios. AIL continues to execute its ESG integration approach and engage with managers.

Aon also actively engages with investment managers and this is used to support AIL in its delegated services. Aon's Engagement Programme is a cross-asset class initiative that brings together Aon's manager research team and Responsible Investment specialists to promote manager engagement with the needs of Aon's clients in mind.

In Q3 2021, Aon and AIL were confirmed as signatories to the UK Stewardship Code. With one-third of applicants failing to reach signatory status, this achievement confirms the strength and relevance of stewardship activity undertaken by Aon and AIL.

## Voting and Engagement Activity – Underlying AIL Investment Managers

Over the period, the Scheme was invested in a number of equity, fixed income and alternative funds through its investment with AIL. This section provides an overview of the voting (where applicable) and engagement activities of some of the most material underlying managers.

## Voting and Engagement activity – Equity and Multi Asset (AIL)

Over the year, the Scheme was invested in the following equity funds, through the delegated arrangement with AIL.

- AIL Global Active Equity Strategy
- AIL Emerging Markets Wealth Strategy
- AIL Global Impact Strategy
- AIL Global Multi-Factor Equity Strategy

In this section there is a summary of voting information and examples of significant voting activity for each of the Scheme's relevant managers. The investment managers provided examples of 'significant' votes participated in over the period. Each manager has its own criteria for determining whether a vote is significant. Examples of what might be considered a significant vote are:

- a vote where a significant proportion of the votes (e.g. more than 15%) went against the management's proposal
- where the investment manager voted against a management recommendation or against the recommendation of a third-party provider of proxy voting
- a vote that is connected to wider engagement with the company involved
- a vote that demonstrates clear and considered rationale

The Trustee considers a significant vote as one which the voting manager deems to be significant.

**AIL Global Active Equity Strategy**

Within the active global equity strategy (which consist of 5 managers; Harris, Arrowstreet, GQG, Ardevora and Sands Capital), all managers voted in over 96% of resolutions over the year to 31 March 2022. No more than 2.5% of votes were abstained by any manager during the period in question.

The following example (GQG Partners Global Equity Fund) demonstrate voting and engagement activity carried out by one of the sub-investment managers within the strategy over the year.

In April 2021, GQG voted against the management proposal to approve the climate transition plan for the commodity training and mining company, Glencore Plc. GQG voted against the proposal because the transition plan did not contain any near-term targets for reducing the company's greenhouse gas emissions. Also, there were no clear commitments for how the company plans to transition away from relying on thermal coal, which represents 10-15% of the company's earnings in the medium term. The company had not set science-based targets as approved by the Science Based Targets Initiative.

GQG engages with companies on ESG issues where it thinks the engagement would be useful and productive. GQG engages with individual companies on specific ESG risks such as enhanced disclosure, board structure and diversity, labour management, or remuneration issues. GQG also carries out thematic engagements where it engages with several companies held in the same portfolio on a specific ESG issue. Examples of its thematic engagement activities are diversity and inclusion in executive management and enhanced ESG disclosures. GQG also takes part in collaborative engagement initiatives. GQG believes that a collaborative approach, with combined assets under management, can be more influential in effecting change.

Further information can be found here: https://gqgpartners.com/sites/default/files/ESGpolicy.pdf

The manager was able to provide evidence of the engagement policy being implemented in practice.

**AIL Emerging Markets Wealth Strategy**

Within the emerging markets wealth strategy (which consists of 5 managers; Oaktree, TT International, Coronation, GQG and Sands Capital), all managers voted in over 98% of resolutions over the year to 31 March 2022. No more than 5.1% of votes were abstained by any manager during the period in question.

The following example (Oaktree Emerging Markets Equity Fund) demonstrates voting and engagement activity carried out by one of the sub-investment managers within the strategy over the year.

In February 2022, Oaktree supported a management proposal from food company, Muyuan Foods, on its 2022 restricted stock incentive plan for. Oaktree supported the proposal because it believed the incentive plan to be of wide benefit to most employees and based on fair key performance indicator targets. The company also disclosed a detailed forecast of its expected future costs from issuing share-based compensation for the years 2022 to 2024. Oaktree noted that the forecast looked fair and good.

The outcome of the vote was in support of the proposal. Oaktree considered this vote significant because it was a significant step towards increasing alignment between the management and minority shareholders.

Through its strong relationships with companies, Oaktree believes it can play a constructive role in helping them improve their practices. Oaktree states that it engages with every company in its portfolio as well as many others in its investment universe.

Oaktree has an ESG escalation committee to enhance its decision-making process when a significant ESG-related event occurs at a company. Following such an event, the research analyst covering the stock refers the issue to the committee including details of the potential ESG implications. The issue will be reviewed by the escalation committee which determines the action to take on the stock.

Oaktree has a research database where it stores details of its engagements. This allows teams to follow developments and showcase engagements where it acts as a delegated or a stakeholder to improve corporate responsiveness.

The manager was able to provide evidence of the engagement policy being implemented in practice.

**AIL Global Impact Strategy**

Within the active global impact strategy (which consists of 3 managers; Nordea, Mirova and Baillie Gifford), the managers voted in over 95% of eligible resolutions over the year to 31 March 2022, with the exception of Baillie Gifford falling below that mark. AIL will provide feedback to Baillie Gifford that a higher level of voting frequency is expected.

The following example (Baillie Gifford Positive Change Fund) demonstrates voting and engagement activity carried out by one of the sub-investment managers within the strategy over the year.

In August 2021, Baillie Gifford voted against a proposal from the management of medical device company, Abiomed, regarding an executive compensation package. Baillie Gifford opposed the proposal due to concerns about one-off equity awards granted during the year. Ahead of voting, Baillie Gifford had a call with the company to discuss the proposal in more detail. Following discussions with the company and internally, Baillie Gifford decided to oppose the resolution and Baillie Gifford communicated its decision to the company. The resolutions passed. Baillie Gifford continues to engage with the company on compensation and other ESG issues.

Baillie Gifford engages through regular meetings with portfolio companies to monitor performance. Baillie Gifford states that its strategy is to steer change through active engagement rather than immediate disinvestment. This may take the form of approaching the company with concerns, meetings with management, or voting against management. Baillie Gifford may decide to disinvest or reduce holdings in a company if it continually falls short in its ESG practices and goals.

Baillie Gifford usually addresses specific governance and sustainability concerns by engaging directly with a company. Its research informs the topics on which it engages. When appropriate, Baillie Gifford engages collaboratively with other shareholders through a range of industry organisations and initiatives.

Further information can be found here: https://www.bailliegifford.com/en/uk/about-us/literature-library/corporate-governance/our-stewardship-approach-esg-principles-and-guidelines-2022/

<u>Engagement Example</u>

In September 2021, Baillie Gifford engaged with the Chief Financial Officer of Nibe, a manufacturing company specialising in sustainable energy systems like heat pumps. The aim of the engagement was for Baillie Gifford to understand more about Nibe's ESG impact reporting practices and to encourage improved disclosure of the carbon emissions avoided from the use of its products.

Nibe confirmed that its emissions calculations were still in progress, made more complicated by the decentralised systems used in its products. Nibe also said that is not ready to set Science-Based Targets but it is actively considering them. Baillie Gifford also discussed the proactive role Nibe is playing in the promotion of heat pumps as a climate solution. Baillie Gifford will continue to monitor the company's progress and engage accordingly.

**AIL Global Multi-Factor Equity Strategy**

The Scheme invests in the AIL global multi factor equity strategy, which primarily invests in the LGIM Multi Factor Fund. Over the year to 31 March 2022, LGIM voted on 99.8% of all resolutions in the Multi-Factor Fund (LGIM are the passive manager investing in the underlying factor index) and abstained from 0.2% of resolutions.

LGIM uses proxy voting adviser ISS to execute votes electronically and for research. LGIM also receives research Institutional Voting Information Service ("IVIS"). This augments LGIM's own research and proprietary ESG assessment tools. LGIM does not outsource any part of the voting decisions to ISS. LGIM has a custom voting policy in place with ISS. This seeks to uphold what LGIM considers to be best practice standards companies should observe. LGIM can override any voting decisions based on the voting policy if appropriate. For example, if engagements with the company have provided additional information.

In June 2021, LGIM applied it's voting policy to vote against a resolution to elect the Chief Executive Officer ("CEO") of retailer Target Corporation to the role of Chair of the company's board as well. It is LGIM's policy to advocate for the separation of CEO and board chair roles. LGIM believes these two roles to be substantially different, requiring distinct skills and experiences due to risk management and oversight. Further, LGIM expects a CEO or non-executive director not to hold too many board positions to ensure they can undertake their duties effectively. 93.7% of shareholders voted in favour of the resolution. LGIM considered this vote to be significant because it is an example of how it applied and escalated its voting policy on the topic of combined board chair and CEO role. LGIM will continue to engage with investee companies, publicly advocate their position on this issue and monitor company and market-level progress.

LGIM has a six-step approach to its investment stewardship engagement activities, broadly these are:

1. Identify the most material ESG issues,
2. Formulate the engagement strategy,
3. Enhancing the power of engagement,
4. Public policy and collaborative engagement,
5. Voting, and
6. Reporting to stakeholders on activity.

LGIM monitors several ESG subjects and conducts engagement on various issues. It's top five engagement topics are climate change, remuneration, diversity, board composition and strategy. LGIM's engagement activities are driven by ESG professionals and their assessment of the requirements in these areas seeks to achieve the best outcome for all their clients.

More information can be found on LGIM's engagement policy https://www.lgim.com/landg-assets/lgim/_document-library/capabilities/lgim-engagement-policy.pdf.

At the time of writing, LGIM had not provided engagement examples for the fund. The Trustee's delegated manager, AIL, has engaged with LGIM regarding its lack of fund level engagement reporting and expects improved reporting to be showcased in the next year's EPIS. The example provided below is at a firm level, i.e. it is not specific to the fund the Scheme is invested in.

The manager was able to provide evidence of the engagement policy being implemented in practice.

## Engagement activity – AIL Fixed Income

Over the period, the Trustee primarily invested in fixed income strategies through the bespoke AIL portfolios. Whilst voting rights are not applicable to non-equity mandates, the Trustee recognises that debt investors have significant capacity for engagement with issuers of debt. Debt financing is continuous, and so debt issuers have a vested interest to make sure that investors are happy with the issuer's strategic direction and policies. Whilst upside potential may be limited in comparison to equities, downside risk mitigation and credit quality are critical parts of the investment decision-making process. The Trustee also believes engagements from fixed income managers are key to reducing ESG risks within the Scheme's portfolio, such as the ability to contribute to the transition towards a low carbon economy.

Over the year, Scheme was invested in the following fixed income funds through the delegated arrangement with AIL:

- AIL Multi-Asset Credit Strategy (now Sustainable MAC Strategy)

- AIL Active Fixed Income Strategy
- AIL Low Risk Bonds Strategy

AIL have confirmed that all applicable appointed managers in this asset class have demonstrated responsible investment policies and practices consistent with the Trustee policy and will promote continued transparency and improvements in transparency over time. An example being the Aegon European Asset Backed Securities (“ABS”) Fund held within the AIL Fixed Income portfolio.

Aegon believes that actively engaging with companies to improve their ESG performance and corporate behaviour is generally more effective than excluding companies from investment. Engagements are conducted by its investment managers, research analysts and its Responsible Investment team.

When engaging with portfolio companies, Aegon considers the UK and Dutch Stewardship Codes and the Principles for Responsible Investment (“PRI”). Aegon also participates in collaborative engagement initiatives such as the UK Investor Forum and the Institutional Investors Group on Climate Change.

Aegon engages with ABS issuers regularly through ESG questionnaires that are specific for consumer loan ABS. It has meetings to discuss the questionnaire answers, the companies’ ESG goals and any areas for improvement.

In 2021 Aegon engaged with Brignole, an ABS issuer. Aegon wanted to better understand the consumer loans issued by the company, so it could assess if the loans had any environmental impact. Further, Aegon suggested that the company increase borrowing for an environmental purpose by offering borrowers a discount.

## Engagement activity – AIL Alternatives

AIL have engaged with some of the appointed hedge funds where voting and stewardship are more applicable. From the information received, AIL see evidence that sub-investment managers acknowledge the importance of climate change and take steps to integrate these issues into investment decisions. By 31 March 2022 the allocation to hedge funds within the AIL delegated portfolio was less than 1%. This was an active decision from the Trustees to reduce the exposure to hedge funds.

## Engagement activity – Delegated manager (Kempen)

The Trustee has delegated a portion of the Scheme's assets to Kempen. As part of Kempen delegated portfolio, the Schemes investments are managed by external managers who each have their own ESG (& engagement policies) and are responsible for implementing this across the assets they invest in (or companies they engage with at a firm level). Kempen actively monitors and engages with external managers, which includes ESG, which is embedded within its investment philosophy. Should an external manager approach conflict with Kempen's own investment beliefs, Kempen will engage with them in order to address the concerns.

Voting at shareholder meetings of investee companies is a key tool of stewardship and active ownership. Throughout 2021 Kempen voted at 437 distinct company meetings, with 14% of our votes cast against management. Kempen uses of ISS as a voting platform and votes are based on Kempen's custom voting policy.

Kempen produces a stewardship dashboard which highlights key numbers with respect to Kempen's exclusion & avoidance practices, ESG integration, and active ownership (voting and engagement) activities over 2021.

Over the year, 43 companies were on the exclusion list due to their involvement with controversial weapons. Kempen also avoids 105 tobacco companies and 30 companies were avoided due to their involvement in significant controversies.

<u>Engagement</u>

As a delegated manager Kempen notes that its role in the investment value chain is to help Trustee fulfil its stewardship obligations towards members. Kempen believes the consideration of material ESG risks and opportunities is part of the delegated duty of institutional investors and helps the clients embed considerations of sustainability into their investment approach. Kempen differentiates between the following sections within its ESG approach:

- **Engagement for awareness.** By aiming to raise awareness about a certain issue or to get more information on a particular company.
- **Engagement for change.** By having concrete objectives with specific timelines set in advance, specifying what it would like to achieve. Progress of these engagements is measured via an internal milestone framework.
- **Public policy and collaborative engagements.** By aiming to improve the overall landscape of (financial) markets and general level of ESG performance in particular sectors, markets and geographies.

Kempen undertakes a thorough ESG scoring due diligence of external managers, which covers the governance of ESG issues, relevant policies, implementation and disclosure. Kempen is increasingly seeking evidence from external managers on their ESG compliance and proactively engages with them. Kempen also screens the holdings and funds in the external portfolio and discusses possible controversial investments with the fund managers. If external managers are not willing to comply with Kempen's minimum environmental standards, it may choose to divest.

As an example, Kempen has on occasions removed or withheld investments with underlying managers on ESG grounds, such as:

- Divested assets from M&G's Corporate Bond Fund in stages, noting that the manager reversed its conflicting policy before Kempen fully divested;
- Withheld assets from Insight until Kempen's concerns on tobacco exposure in the manager's buy-and-maintain portfolios were addressed;
- Challenged LGIM on their existing approach to corporate bonds and worked collaboratively to develop an alternative net zero aligned strategy to move assets into.

Further details of how Kempen engages with external managers can be found in its Stewardship and Engagement policy here:

https://www.kempen.com/-/media/Asset-Management/ESG/Polocies/December-2021-Kempen-Stewardship-Policy.pdf

Engagement example

An example of where Kempen believed its concerns were not adequately addressed was Fujitec (escalator developer and manufacturer). Kempen has had exposure to the company since 2014 and own approximately 3.5% of the shares outstanding. Kempen voted against the directors because of insufficient progress on engagement topics to improve on corporate governance and capital allocation. Kempen also went public with its concerns in an open letter to Fujitec Board of Directors over a disappointing mid-term plan and inadequate corporate governance at the company. Fujitec's underperformance versus peers and the structural undervaluation of the company's stock led Kempen to provide numerous suggestions to improve shareholder communications, capital efficiency, corporate governance and the geographical footprint. This led to a positive response on Kempen's recommendations. Further detail can be found here: Kempen Capital Management issues open letter to Fujitec's Board of Directors | Kempen

## Engagement activity – Alternative non-delegated assets

The Scheme invests in a number of alternative strategies (property, infrastructure, private debt, private equity, hedge funds) both within and outside of the delegated mandates.

All the private equity managers are either PRI signatories or adopt guidelines from the PRI and the Trustee is comfortable that all managers continue to consider financially material ESG factors in their due diligence processes and make reasonable efforts to encourage their portfolio companies to consider relevant ESG-related principles and to support their implementation.

The Trustee recognises that the investment processes and often illiquid nature of the alternative investments may mean that stewardship is potentially less applicable or may have a less tangible financial benefit than with other asset classes. Nonetheless, the Trustee expects that all its managers should open a dialogue to engage with issuers/companies they invest in should they identify concerns that may be financially material.

Opportunities for engagement may be more limited in liquid alternative investments given their investment process and the nature of the investments. In particular, the Trustee acknowledges voting activity from the hedge fund managers may be limited due to the potentially short-term/opportunistic nature of the underlying investments. The Trustee notes that, where applicable, AIL will still periodically ask the responsible investment related questions and engage with hedge fund managers where appropriate.

## Appendix

## Voting Statistics for the year ending 31 March 2022

The table below summarises voting statistics for the most material equity funds within the AA portfolio.

| | **Number of resolutions eligible to vote on over the period** | **% of resolutions voted on for which the fund was eligible** | **Of the resolutions on which the fund voted on, % that were voted against management** | **Of the resolutions on which the fund voted, % that were abstained** |
|---|---|---|---|---|
| **AIL Active Global Equity Strategy** | | | | |
| Arrowstreet – Global Developed Equity Fund | 6,625 | 96.2 | 8.4 | 0.8 |
| GQG – Global Equity Fund | 682 | 99.3 | 9.5 | 2.5 |
| Ardevora – Global Long-Only Equity Fund | 2,950 | 100.0 | 8.2 | 0.2 |
| **AIL Emerging Markets Equity Strategy** | | | | |
| Oaktree – Emerging Markets Equity Fund | 1,085 | 100.0 | 8.1 | 2.6 |
| TT International – Emerging Markets Unconstrained Strategy | 1,029 | 98.1 | 9.1 | 5.1 |
| GQG – Emerging Markets Fund | 867 | 100.0 | 7.8 | 3.8 |
| **AIL Global Multi-Factor Equity Strategy** | | | | |
| LGIM – Multi Factor Equity Fund | 11,660 | 99.8 | 19.1 | 0.2 |
| **AIL Global Impact Strategy** | | | | |
| Baillie Gifford – Positive Change Fund | 333 | 93.7 | 2.6 | 0.3 |
| Nordea – Global Climate and Environmental Strategy | 711 | 98.3 | 14.0 | 0.0 |
| Mirova - Global Sustainable Equity Fund | 719 | 100.0 | 44.4* | 0.0 |

Source: Managers.

*Of the 44.4% of the resolutions that Mirova voted against, 0.012% did not pass (4 resolutions that were voted against did not pass). The themes that caused Mirova to vote against management include concerns with the remuneration scheme (lack of corporate social responsibility (CSR) criteria, existence of stock options, concerns with the fair distribution of value) and board composition concerns – such as lack of employee representative, insufficient female representation, lack of board committee dedicated to the oversight of CSR.

| | Number of resolutions eligible to vote on over the period | % of resolutions voted on for which the fund was eligible | Of the resolutions on which the fund voted on, % that were voted against management | Of the resolutions on which the fund voted, % that were abstained |
|---|---|---|---|---|
| **Kempen Delegated portfolio** | | | | |
| SSGA – World TPI Climate Transition Index Equity Fund | 4,409 | 99.3 | 9.9 | 0.7 |
| Impax – BNP Paribas (Funds) SMaRT Food Fund I | 619 | 99.8 | 5.7 | 1.0 |
| LGIM – Diversified Fund | 90,252 | 98.8 | 20.5 | 0.8 |
| JPMorgan Asset Management (Asia Pacific) Limited - JFAM A/C 631259/631080 | 2,169 | 100.0 | 9.0 | 0.0 |
| Northern Trust Company – NT EM ESG Leaders Equity Index Fund* | 2,734 | 99.0 | 11.0 | 1.0 |

Source: Managers.
*The statistics are shown for the reporting period over 1 January 2022 to 31 March 2022.