USS

*For members, for the future.*

**The Universities Superannuation Scheme (USS)**

# Stewardship Report 2021

This document is issued by Universities Superannuation Scheme Limited (in its capacity as the sole corporate trustee of the Universities Superannuation Scheme) / USS Investment Management Limited.

This document may make reference to specific entities and other constructs within the USS Group. Set out below is a summary of what we mean:

- Universities Superannuation Scheme (the Scheme) – a trust-based workplace pension scheme governed by a trust deed and rules.
- Universities Superannuation Scheme Limited (the Trustee) – the trustee of the Scheme. The trustee makes sure the Scheme, which is set up for the benefit of our members and their dependants, is run in line with the trust deed and rules and legal duties.
- USS Investment Management Limited (USSIM) – a subsidiary of the Trustee. It looks after the investment and management of the Scheme's assets.

However, for simplicity and to aid readability, this document may also make use of terms such as Universities Superannuation Scheme, USS, we, us, our and similar, as a way of collectively referring to entities and/or other constructs within the USS Group – rather than referring to a specific entity and/or other construct. Whilst this document may make use of forms of collective reference, each entity or other construct has a distinct role within the USS Group, and the use of forms of collective reference and simplification within this document do not change this.

# Contents

# Introduction

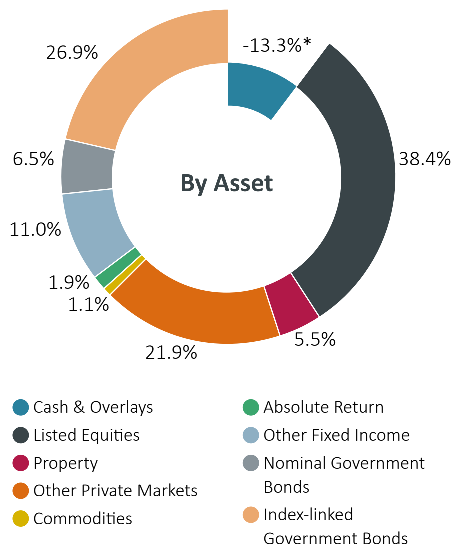
Welcome to the first Stewardship Code report from the Universities Superannuation Scheme. The focus of this report is the scheme's response to the 12 Stewardship Principles developed by the Financial Reporting Council (FRC). Principle-by-Principle, we describe how we implement our commitments to the UK Stewardship Code and summarise our responsible investment activities and outcomes across all of our asset classes, with a particular focus on the financial year 2020-2021.

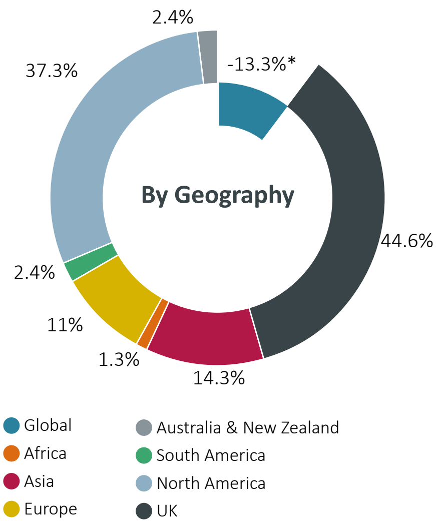
We are proud of the progress we have made, both in terms of our broader responsible investment thought processes, and also in our engagements with public and direct investments and how they are responding to Environmental, Social and Governance (ESG) challenges. In our inaugural report, we are particularly pleased to highlight some of the significant steps we have taken to integrate ESG factors into our investment philosophy, as part of our longstanding commitment to responsible investment, as well as offering reflections on the outcomes we have achieved and how we might strengthen our approach in the coming years.

## About Us

USS, the Universities Superannuation Scheme, is the principal pension scheme for universities and higher education institutions in the UK. We are the largest private pension scheme in the UK, with some £68 billion in assets under management. USS's in-house manager, USS Investment Management (USSIM), acts as principal manager and advisor to the scheme, including the appointment and monitoring of a number of other external investment managers. We manage almost 70% of our assets in-house.

## Where we invest




*Denotes leverage

## Our commitment to stewardship

As a pension fund with liabilities extending decades into the future, it is in USS's interests to encourage the companies, assets and markets in which we invest to focus on delivering sustainable investor value.

We believe that investing responsibly, by integrating material environmental, social, ethical and corporate governance (ESG) issues into investment decision making, and engaging as long-term owners, both reduces risk and positively impacts fund returns. We also believe that the way a company is run and overseen, and how it manages its environmental and social risks, such as its approach to climate change or health and safety, will impact the long-term financial returns that it will make for its investors.

The Trustee Board has both led and supported the Scheme's Responsible Investment (RI)-related activities for many years: our first policy on RI was launched in 1999, the first team members were appointed in 2000, and our first work on climate change risk and opportunities was undertaken in 2001, when USS first assessed the implications of climate change for institutional investors.

Furthermore, USS considers that these policies should be applied across the asset classes in which we invest as consistently as possible – both public and private – and whether internally or externally managed. USS's approach to responsible investment revolves around the effective stewardship of all our assets, focusing in particular on sustainability and good corporate governance.

## Our approach

Our activities as a responsible investor fall into three core areas:

1. **Integration:** We seek to include financially material ESG considerations within investment decision-making processes. By integrating material ESG considerations with a financial bearing into our investment methodology, USS seeks to identify mispriced assets and enable our portfolio managers to make better investment decisions to enhance long-term performance. We do this as we believe additional returns are available to investors who take a long-term view and are able to identify where the market is overlooking the role played by material ESG considerations in corporate and asset performance. Systematic mishandling of ESG issues can also be an early indicator of wider mismanagement or financial problems. There is good evidence that poor corporate governance decisions affect the interests of long-term investors.

2. **Engagement, voting and stewardship:** As a long-term investor we believe we have an obligation to act as stewards of the assets in which we invest and to behave as active owners, using our influence to promote good ESG practices. We believe that such stewardship can both help prevent or avoid value destruction and reduce the negative impacts companies can have on the environment and society.

3. **Market transformation activities:** Universal investors are those who, like USS, have holdings that are so diversified that their investment returns are impacted by the returns from the economy as a whole, as much as any specific industries or companies. USS believes that we have a role to play in promoting the proper functioning of markets, from which we benefit as a universal investor. This includes engagement with policymakers and regulators in markets in which we invest, to articulate the concerns of asset owners and long-term investors. We seek to ensure that externalities and systemic market failures, such as pollution, climate change or systemically weak corporate governance standards, do not affect market-wide, long-term economic performance.

# 2020: Activities and highlights

Despite the COVID-19 pandemic, we sustained and strengthened our stewardship activities in 2020. Boxes 1 to 4 below present some specific highlights.

## 1 Taking action on the sustainability of investments

In early 2020, USSIM began a detailed review of a selection of sectors in which the scheme invests. It looked for differences between what industry financial models predicted on returns and what we could reasonably expect to happen over the long term. We concluded that, in several cases, the outcomes predicted by the market did not appropriately consider the potential financial impact of certain specific risks, including ESG.

As a result, we excluded certain sectors from our investment universe as they were deemed to be financially unsuitable over the long-term. These included: tobacco manufacturing; thermal coal mining (to be burned for electricity generation) specifically where it comprises more than 25% of revenues, and certain controversial weapons. We are already well on our way to fully pulling out of investments under our direct control in these sectors and will have ceased to invest in them by the end of May 2022 at the latest.

## 2 Our changing investment portfolio

In early 2020, USSIM moved a significant proportion of the scheme's equities from a concentrated portfolio to an interim external manager. This formed the first step in a long-term strategy to change the developed market equity investing – away from our traditional concentrated stock-picking and towards a longer-term thematic approach – integrating ESG and other long-term factors into portfolios. We believe that the impact of ESG issues and other long-term factors will be critical drivers of investment returns as well as risks, and they should shape the portfolio in the years to come.

As a consequence of this move from a relatively concentrated portfolio to a much broader and more diverse spread of investments, we have also increased our participation in collaborative engagements, working more widely with other investors to promote good practice. We were an early leader in collaborative engagement and involved in the establishment of several collaborative initiatives which support stewardship activities and collective engagement in the UK and other markets. We are proud that the scheme recognised the gravity of climate change and founded the IIGCC in 2001; that we were involved in the development of the United Nations-backed Principles for Responsible Investment (UNPRI) and were a founder signatory; and that we were founder members of the Transition Pathway Initiative in 2017. The climate change case-study in box 3 illustrates our approach.

## 3 Taking action on climate change

We were one of the first pension funds in the world to recognise climate change as a risk to our investments and we believe collaboration is key to positive action. For example, we founded the Institutional Investors Group on Climate Change (IIGCC) and continue to participate in its policy and other working group. We also actively worked with our investor partners for over a decade to address the issue in different markets around the world.

We are proactive in our support for a number of global engagements designed to improve corporate behaviour. This is shown by our work as part of the Climate Action 100+ initiative with Royal Dutch Shell – led by the Church of England Pension Fund and Dutch asset manager, Robeco – the outcomes of which have been ground-breaking. In 2018, Shell committed to reducing its carbon emissions by 50% by 2050, to help align the company with the Paris Agreement. Subsequently, in both 2020 and 2021, it committed to taking significant additional action on climate change, including a target of achieving net-zero emissions by 2050 or sooner. This encouraged others in the sector to make similar statements.

We are proud to be recognised by the UNPRI in its 2020 Leaders' Group for our work on climate change related activities.

Member of the PRI
2020 Leaders' Group
Climate reporting

## 4 External manager monitoring

USSIM has a detailed RI due diligence and monitoring process for external fund managers (for both public and private markets). These questionnaires are similar in content, with the due diligence version establishing a baseline set of data which then form the basis for the proposed biennial monitoring programme. We have also introduced a scoring system to be better able to benchmark and rank the ESG performance of the external managers, an example of which is available online. More details of our approach to external managers is provided in Principle 8.

As a result of this work, we were delighted to be identified by the UN-backed Principles for Responsible Investment (UNPRI), as one of the signatories in its 2019 inaugural Leaders' Group for our activities associated with the selection, appointment and monitoring of external managers in listed and private markets. This put the scheme in the top 10% of asset owners.

## Looking ahead

We believe that the scheme can always improve its approach to RI, and continually look for ways to improve its practices and policies. In 2021/2022 we will focus on strengthening our approach to stewardship in three areas.

First, we will strengthen our approach to stewardship in corporate bonds. To date, we have generally dealt with corporate bonds as part of our stewardship efforts on listed equity. While this has delivered many improvements, we are aware that this approach is imperfect: issuers that are not publicly listed tend to get ignored, and the governance issues around bonds (e.g. investor rights, investor disclosures) tend to get less attention than needed.

Second, we have recently made a Net Zero by 2050 announcement. Implementing this ambition, which applies to all of our assets, will require us to carefully consider where we invest, and how we use our influence with the companies and other assets in which we invest and with policymakers. We have played an active role in the development of the IIGCC Net Zero Investment Framework, and are currently exploring how we might use the framework to measure our current performance and to develop a strategy to get to net zero.

Finally, the process of preparing this report has reinforced the importance of ensuring that we have a systematic approach to ESG data collection and analysis across portfolios, including public markets, private markets and our direct investments. This will help us understand ESG risks in a portfolio-wide context, so that we can ensure that we effectively manage those risks and opportunities.

# USS Stewardship Code Report 2021: A principle-by-principle account

# Section 1: Purpose and Governance

## **Principle 1:** Purpose, strategy and culture

### Principle 1

Signatories' purpose, investment beliefs, strategy, and culture enable stewardship that creates long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.

### Our purpose

As the principal pension scheme for universities and other higher education institutions in the UK, our purpose is predicated on our unique position within the investment industry: *working with employers to build a secure financial future for our members and their families*. In pursuit of our purpose, it is our duty to invest in the financial interests of all our members and beneficiaries.

### Our beliefs

At the heart of our organisation is a long-held belief that promoting high standards of ESG, and allocating responsibly to companies and other assets, will protect and enhance the value of our investments by reducing the risks associated with investing. We also believe it enhances our ability to meet the pension promises made to members by our sponsors. That is why active ownership and stewardship, as well as assessing investment risk in all its forms, are fundamental to our approach to managing the assets entrusted to us.

### Our culture and values

Our organisational values underpin our approach to investing responsibly. They are clearly defined and built on three pillars of **integrity**, **collaboration** and **excellence**. These values guide what we do, including how we invest, and how we act as stewards of the assets in our portfolio.

#### Integrity

- We always do the right thing
- We put our members' interests first
- We take decisions for the long term

#### Collaboration

- We work towards a common goal
- We take responsibility for our own actions
- We are straight-talking and respectful in our dealings with each other

#### Excellence

- We set high standards for ourselves and our colleagues for the benefit of our members
- We adapt and innovate to achieve the best outcome
- We bring our best selves to work, every day

## Stewardship: Putting our purpose, beliefs, culture and values into practice

We express our purpose and values through how we invest, how we manage our members' assets and how we meet our members' needs (we discuss how our approach meets our members' needs under Principle 6). As active owners, we focus on sustainability and good corporate governance. We also ensure the investment managers who are selected and appointed by our Trustees consider all financially material considerations including ESG factors related to the selection, retention and realisation of investments.

In practice, our responsible investment approach means we consider the potential impact of ESG factors on our investment decisions. We analyse and assess the impact of these factors in our investments, across all asset classes, regardless of market or structure and both before we invest, and during the life of our investment.

Long-term stewardship is central to our fiduciary duty to our members. In line with our sponsors' covenant and liability profiles, we invest for the long-term and expect to own companies and investments for many years. This is particularly true of the direct investments the scheme makes.

We believe the way a company is run, and manages environmental and social issues (such as its approach to climate change or diversity and inclusion) will impact the long-term financial returns it will generate for its investors. We conduct enhanced due diligence before making direct investments and also monitor post-acquisition stewardship activities of the assets held in our portfolio.

**At USS, we put responsible investment into practice by:**

**Integrating environmental, social and corporate governance factors** into our investment decisions across every asset classes.

**Engaging, voting and applying stewardship.** We use our influence as a major institutional investor to promote good ESG practices.

**Working with policy makers and regulators** to ensure the concerns of long-term asset owners and investors are clearly understood.


## Case-study: Climate stewardship

Supported by the Board, Moto, one of USS's direct transportation-related assets has been focussing on energy efficiency and reducing emissions. At one of its sites it has been taking a three-stage approach:

- Reducing energy demand through passive design measures
- Reducing energy consumption via efficient plant/equipment systems/ central controls
- Using renewable energy to further reduce demand, pollution and CO2 emissions

This has included the installation of a biomass boiler, which provides heating and hot water through the combustion of fuels from a sustainable source, and LED lighting for outside parking areas with energy efficient controls and 'dark sky' fittings to reduce the risk of light pollution.

The site is also providing 12 EV charger spaces, with an additional 12 to come.

The learnings from this project will be shared with other sites in the asset's portfolio.

# **Principle 2:** Governance, resources and incentives

## Principle 2

Signatories' governance, resources and incentives support stewardship.

## Our governance structure

We believe a strong organisational governance structure, paired with a commitment to investing responsibly for the long-term, provides the necessary pathway to deliver effective stewardship today and develop and build on our approach for the future.

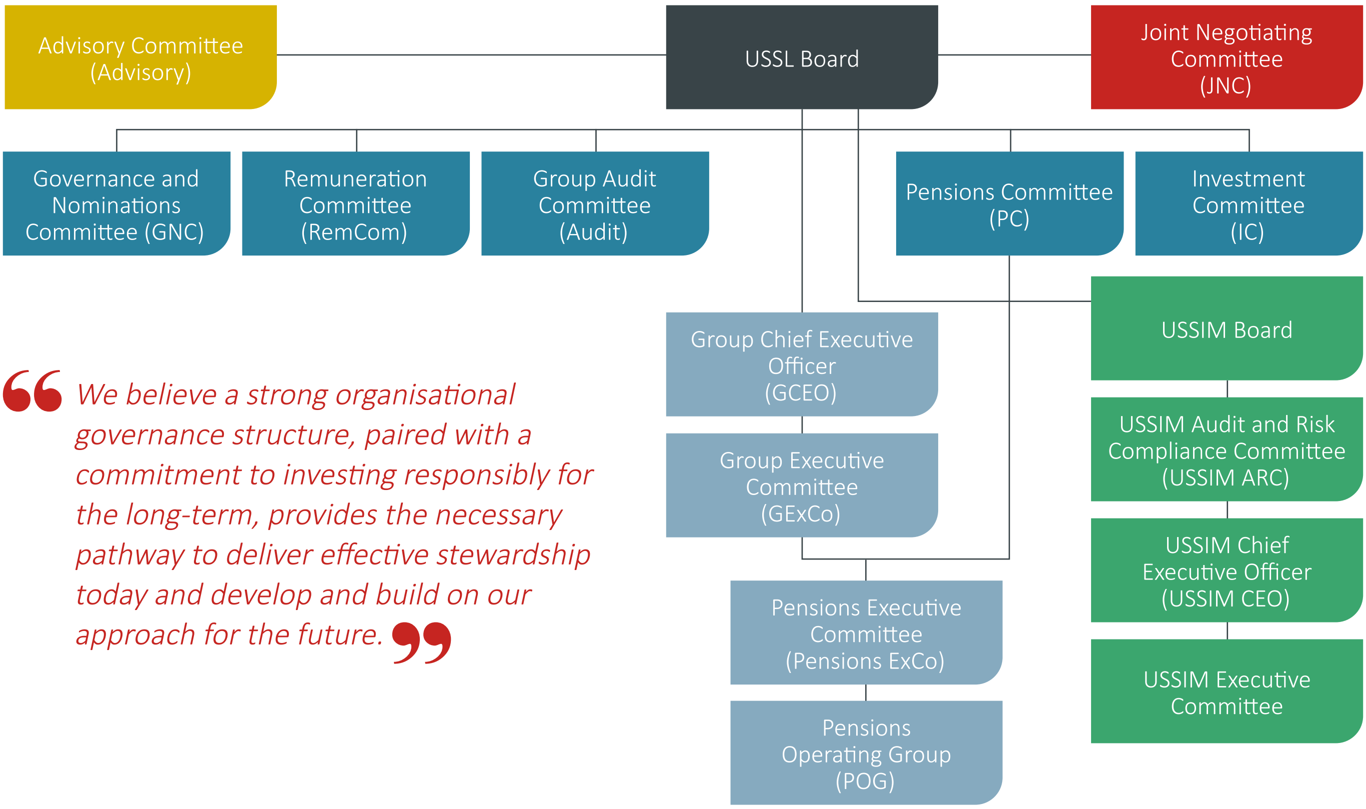
As an organisation, we are structured and governed in a way that supports our commitment to responsible investment and stewardship of our members' assets. Universities Superannuation Scheme Limited (USSL) is the Corporate Trustee that runs and manages the scheme, with a Group Executive Committee that looks after day-to-day operations.

The Trustee board is responsible for the overall leadership, strategy and oversight of USSL and the wholly-owned subsidiary, USSIM, that invest the Scheme's assets, including the appointment and monitoring of a number of other external investment managers.

This board comprises:

- Four directors appointed by Universities UK
- Three directors (one of whom is the pensioner member) appointed by the University and College Union
- Between three and five (or between 1 September 2019 and 1 February 2021, six) independent directors

## USS Group Corporate Governance Structure




> *We believe a strong organisational governance structure, paired with a commitment to investing responsibly for the long-term, provides the necessary pathway to deliver effective stewardship today and develop and build on our approach for the future.*

The board agrees the responsible investment (RI) strategy and formally reviews the responsible investment team's activities annually, signing off key focus areas and policies. This includes reviewing the effectiveness of our stewardship processes and includes discussion of whether our resourcing, expertise and approach are appropriate to managing our members' assets and meeting our members' needs.

Our RI strategy is implemented and monitored by USSIM. Our Statement on Responsible Investment sets out detailed information on how we consider ESG factors when we invest, and how this is communicated and demanded of our internal and external managers. Organising ourselves in this way enables the investment function to take the initiative in implementing the scheme's ESG polices. The in-house nature of USS means the board is closer to the assets than is the case for the majority of UK pension funds.

**The board has supported the scheme's climate change activities since 2001, when the scheme completed its first assessment of the implications of the issue for institutional investors. In addition to an annual responsible investment reporting and review cycle, the board receives other inputs on ESG management as and when deemed necessary. It also receives regular updates on the climate change-related activities in which the scheme's executive are involved.**

## Our stewardship resourcing

We have built a dedicated in-house RI team (see "Specialist Expertise", below) that works with internal managers and monitors external managers and assets, ensuring material ESG factors are integrated into investment decisions. The team also ensures managers act as stewards of those assets. This activity is overseen by the USSL Investment Committee, which provides assurance to the board that its policies are being implemented.

## Specialist expertise

We established specialist in-house RI resource two decades ago. Today, we have one of the largest responsible investment teams of any UK pension scheme, comprising seven experienced ESG professionals. This team represents the scheme's interests in the ownership and stewardship of its assets and helps the scheme take a leadership position on a spectrum of ESG issues. These range from climate change (USS set up the IIGCC in 2001), ensuring UK listed companies comply with the Modern Slavery Act (USS participates in an ongoing Rathbones-led collaboration on this issue), and seeking assurances from large mining companies on their approaches to indigenous community rights (following the destruction by Rio Tinto of the 46,000 year old Aboriginal heritage site in Juukan Gorge, Australia).

Our RI team biographies can be found on page 44 of this report.

## Clear responsibilities

Our RI team is organised into two groups. One focuses on public market integration and stewardship, including voting and engagement, while the other is responsible for external managers – in both public and private markets – and direct asset due diligence and monitoring.

The whole team works with the internal asset managers to ensure the integration of ESG risks into investment decision making across asset classes where they are considered material. It also works with other USSIM teams, delivering oversight and monitoring of external managers.

The team leads much of the stewardship activity that encourages both listed companies and other portfolio assets to manage better climate change-related and other ESG risks. In addition, USS's internal fund managers frequently engage directly with companies and other portfolio assets on ESG issues both individually and in conjunction with the specialist team. Pre-Covid 19, daily formal and informal interactions promoted the collaboration and sharing of insights between our investment specialists and responsible investment team. During the pandemic, well-established practice meant that whilst more challenging, these interactions have been able to continue remotely.

*“Having an in-house RI team drives better coordination of activities across the scheme and means both directors of the trustee board and the executive have direct access to expertise on the investment implications of ESG issues.”*

Engagement meeting notes and voting letters for publicly-listed companies are shared systematically with portfolio managers via an Internal Research Home (IRH) function on Bloomberg. This provides USS's equities, credit and RI teams with a record of how we voted and our view of the specific company's ESG practices. RI notes, voting records and engagement notes are also included alongside investment cases and decision notes. Various ESG data are also recorded in the investment case on equity 'tear-sheets', which are reviewed in preparation for company meetings.

A member of the RI team also attends Global Emerging Markets (GEMs - our active portfolio) meetings to discuss ESG issues resulting from research and engagements. All votes against management in our active portfolio are reviewed with the relevant manager prior to the vote being cast, along with other points of contention.

### Additional resources

In addition to our RI team, we also use external service provides to support our RI activities. For example, Minerva provides our proxy voting platform.

We do not usually engage via service providers because we have an in-house team that engages with companies in our portfolio as we consider this approach to be advantageous because the engagement remains aligned with the investment analysis conducted by the internal portfolio manager.

Notwithstanding this point, we have chosen two external providers where language and cultural nuances in engagement would point to more local service providers engaging on our behalf.

- Governance for Owners Japan Engagement Coalition (JEC) who engage on our behalf with Japanese companies where disclosure and language can be a barrier.
- We also utilise the services of Asia Research and Engagement (ARE) as with their specialist Asia focus they add additional resources in what is an increasingly important market.

Both of these organisations provide collaborative engagement services. In selecting the organisation that undertake this for us we have looked at both ESG and local knowledge, and importantly engagement experience in delivering stewardship and other RI related services (including proxy voting support).

While we find these third-party providers extremely valuable, we are clear that the final responsibility for investment, stewardship and voting decisions remains with us.

## Performance management: Motivating our teams to achieve our responsible investment goals

Delivering RI outcomes, fulfilling our purpose and operating in line with our values is the responsibility of everyone in our organisation. We empower our teams to do their part, and consider how they are incentivised to meet RI-related goals as part of our performance management process.

As part of this, we ensure individual behaviours that incorporate ESG considerations are rewarded. This involves assigning a qualitative score that reflects individual performance and contribution to the achievement of objectives set. Colleague assessment reflects both what was achieved and the manner in which it was done, ensuring behaviours are fully reflected in how we reward.

For the USSIM investment team, the score may also reflect a qualitative assessment of investment activity. For non-investment employees, the score will reflect the achievement of objectives related to an individual's role and function. In addition to specific ESG key performance indicators (KPIs) for relevant investment staff, the incorporation of ESG in investment-related activities could impact the remuneration of all members of staff, whether they are front-line investors or not.

Individual personnel have ESG-related KPIs that are relevant to their roles. These may relate to topics such as:

- Their work with the RI team to integrate RI/ESG metrics and stewardship into their investment practices and processes (e.g. in 2019 and 2020, we had a particular focus on strengthening our approach in global emerging markets and in public credit)
- Their work on integrating specific ESG issues into investment models and tools (e.g. in 2020, we had a particular focus on incorporating climate change into long-term projected return analysis and scenario analysis, and on evaluating the impact of ESG tilts on returns)
- Supporting the scheme in achieving its ESG goals (e.g. our new net-zero ambition)
- Upholding USS's commitment to being an active and responsible owner of assets through adhering to voting and engagement policies

# **Principle 3:** Managing conflicts of interest

### Principle 3

Signatories manage conflicts of interest to put the best interests of clients and beneficiaries first.

## Our commitment

In line with our stated value of integrity, our members' interests come first. This includes a pledge to meet the highest possible standards of openness and accountability, and ensure that we conduct our business with honesty and transparency. We ensure legal and regulatory requirements are fully complied with and we expect all employees to continually meet the highest standards expected of them in their client and business activities. Any action in contradiction of this position is taken extremely seriously and we are committed to applying the full extent of internal and external sanctions as appropriate.

## Our position

As a beneficial owner with in-house investment management and responsible investment capabilities, and serving only one client, USSL does not face many of the potential conflicts of interest that commercial fund managers may need to address. Nevertheless, we monitor for potential conflicts of interest on an on-going basis.

## Ensuring robust practice

We ensure we comply with legal and regulatory requirements and expect all employees to meet the highest standards in their client and business activities. We take any contradiction of this position extremely seriously, and are committed to applying the full extent of internal and external sanctions as appropriate.

**USS has a Conflicts of Interest Policy and USS Group reviews its policies and processes on this aspect of our operations at least annually. This review involves an assessment of actual and potential conflicts, including in relation to responsible investment and stewardship activities**.

USS Group also maintains a Register of Conflicts of Interest. This includes an assessment of the inherent and residual risk of each actual or potential conflict we identify, along with the controls in place to manage or mitigate them. Our Code of Conduct also provides a clear statement of ethical standards, including a duty to act with reasonable care, skill and diligence in the best interests of scheme beneficiaries, and to avoid or manage conflicts of interest.

The USS Compliance Team maintains a list of securities and other assets in which USS group staff members have holdings, and there are processes in place to ensure any dealing in stocks held by the fund avoid conflicts of interest. Our compliance team also maintains a restricted list and personal account dealing policies to mitigate trading related conflicts. This includes restricting stocks held by the scheme if a potential conflict arises.

## Being prepared for when a conflict may arise

As we have noted, as a beneficial owner with in-house investment management and responsible investment capabilities, and serving only one client, USSL does not face many of the potential conflicts of interest that commercial fund managers may need to address. However, one instance where a conflict may arise is outlined below:

### Scenario

A staff member could potentially hold an external role with a firm that USS Group has business dealings with, or which requires excess time or resource which may detract from the time and attention they should be paying to their role as an employee and the duty to act in the best interests of USSL. To mitigate this type of conflict:

- USS Group maintains an External Appointments policy
- New joiners are required to complete an external positions declaration
- Staff are required to declare any new external positions for approval
- Any external positions that may result in a potential or actual conflict will be recorded into the conflicts of interest register along with how such conflicts have been mitigated. A Register of Actual and Potential Conflicts is maintained on an ongoing basis
- There is an annual Compliance declaration requiring staff to confirm that they have no external positions that have not previously been declared

# Principle 4: Promoting well-functioning markets

**Principle 4**

Signatories identify and respond to market-wide and systemic risks to promote a well-functioning financial system.

## Fostering sustainable markets for a sustainable future

As a pension fund with in-house investment expertise and liabilities extending decades into the future, we are unequivocal that an active approach to responsible investment and stewardship is critical to cultivating well-functioning markets over the long term.

We are a long-term advocate of the need for an investor voice in policy development because we believe engagement with policy makers on ESG and related factors improves how markets operate. We also recognise that stronger markets lead to stronger economies, which strengthen the fiscal position of governments. Therefore, our engagements with policymakers also aim to protect or enhance our investments across asset classes, from public equities to sovereign debt.

For 20 years, we have highlighted market-level engagement as a specific objective of USS's RI strategy. Our engagement with policymakers and governments internationally covers issues such as stewardship and accounting regulation. It also includes listing rules, shareholder protections, corporate governance, transparency and disclosure, and climate change.

To strengthen our voice, we also engage on these matters alongside other investors through collaborations such as the Asian Corporate Governance Association, Institutional Investors Group on Climate Change, International Corporate Governance Network and the Australian Council of Superannuation Investors (see Principle 10 for further detail). We have met with government representatives, regulators and SOE's in markets as diverse as South Korea, Australia, Hong Kong, India, Canada, the US, South Africa, the Netherlands, Japan, Brazil and the European Commission over the years. For example, in 2019 (the last year such a trip was possible) a member of our RI team engaged with various Japanese regulators as part of an ACGA study tour. This included meetings with the METI (Ministry of Economy, Trade and Industry), the Financial Services Agency (FSA), and the Japan Stock Exchange. Issues discussed included corporate governance, the Japanese stewardship code and its implementation, corporate reporting, climate change, and board diversity: all systemic issues.

We have also made submissions to policy consultations and discussions, examples of which are highlighted in boxes 1 and 2, below. Under Principle 7, we discuss how our approaches to stewardship – company engagement and policy engagement – and investment decision-making are integrated.

**1.** In January 2020, we wrote to the US Securities and Exchange Commission about its proposed rule amendments to address proxy advisors' reliance on the proxy solicitation exemptions in Rule 14a-2(b). We expressed concern about the proposal that proxy advisors share advance copies of their recommendations with issuers. We argued that proxy advisors are agents of institutional investors, not of issuers, and stated that such a process would not be helpful to the proxy voting process as it had the potential to compromise the independence of the research, to introduce additional costs and complications to an already compressed process, to create additional barriers to entry and to negatively impact competition in the proxy advisory market. We also expressed concern that the SEC's proposals to change voting thresholds would significantly raise the percentage vote a proposal must receive to be resubmitted, making it more difficult to submit and sustain proposals.

**2.** Also in January 2020, we wrote to the Japanese Financial Services Agency about its proposed revisions to the Japan Stewardship Code. In our letter, we welcomed the proposed extension of the Stewardship Code beyond Japanese public equities to other asset classes. We also welcomed the extension of the Code to encourage stewardship beyond a traditional focus on corporate governance. We suggested that the Code should be clear about the importance of asset owners, in particular those with fewer stewardship resources, engaging with their external managers and other service providers on stewardship, thereby promoting stewardship through the entire investment chain.

## In Focus: our action on climate change

Climate change – as a key systemic risk – has been an enduring area of focus for USS. It is also an issue that exemplifies our approach to stewardship.

As a long-term investor, we recognise that climate change presents critical issues for us now, and will do in the future. For instance: rising sea levels will impact property and infrastructure asset valuations, weather events will disrupt supply chains and corporate activity and public policy changes and regulation to support the transition to a low carbon future will create winners and losers. We were one of the first pension funds in the world to recognise climate change as a risk to our investments and we believe collaboration is key to positive action. For example, in 2001 we founded the IIGCC and continue to participate in its policy and other working group. We have actively worked with our investor partners for over a decade to address the issue in different markets around the world.

Examples of our policy engagement work on climate change in 2020 included:

- Responding to the UK government's consultation: Taking action on climate risk: improving governance & reporting by occupational pension schemes
- Participating in consultations and engagements with DWP / BEIS on TCFD reporting. We supported the proposals as we believe that such reporting will lead to more pension fund engagement on climate change, and therefore hopefully better attention to climate-related issues. We highlighted the importance of taking a system-wide approach and of sequencing the introduction of reporting requirements, noting that Asset Owners would only be able to report in a meaningful way if other actors – e.g. asset managers (across asset classes) and, indeed, underlying assets – also reported this information

> *"Climate change is not only a policy issue, but also a stewardship one and has been a central theme in many of our engagements, as evidenced throughout this report."*

[1] Companies greenhouse gas emissions can be classified in three scopes: Scopes 1, 2 and 3
Scope 1 emissions are direct emissions from company-owned and controlled resources (e.g on-site fuel combustion, emissions from vehicles owned or controlled by a firm, releases from industrial processes.
Scope 2 emissions are emissions from the consumption of purchased electricity, steam, heat and cooling.
Scope 3 emissions are all indirect emissions – not included in scope 2 – that occur in the value chain of the reporting company, including both upstream and downstream emissions.

# **Principle 5:** Review and assurance

**Principle 5**

Signatories review their policies, assure their processes and assess the effectiveness of their activities.

We have a proactive and transparent approach to internal and external review and assurance, and take appropriate action where and when necessary.

Our RI policies and statements are available on our public website (uss.co.uk) and we submit regular reporting and monitoring of the scheme's activities to the board and its investment committee. Data elements that appear in our annual report and accounts, for example on voting data, are also formally audited by the scheme's external auditors.

The RI team reports to the board annually, where the board agrees the scheme's RI and formally reviews the RI team's activities, signing off key focus areas and policies. It receives additional input on ESG management, where necessary, and undertakes training on RI-related issues. The team also reports formally to the investment committee twice a year.

For additional monitoring and assurance, our Audit, Risk and Compliance and Managers and Mandates Committees also receive regular reporting on ESG due diligence and monitoring (volumes and ratings), and track voting process implementation and performance.

The scheme has also established detailed external manager monitoring programmes to assess and ensure its responsible investment policies are being implemented (see Principle 8).

We recognise the importance of external assurance processes and respond annually to the UNPRI's signatory survey. Based on our responses to this survey, in 2019, the UNPRI named us as leaders for our approach to selecting, appointing and monitoring external managers (see also Principle 8 below), and in 2020 we were recognised us as leaders for our approach to climate change.

## ESG Internal Audit 2020/21

The scheme's RI activities are part of the USS internal audit programme. This is an independent appraisal function established by the board, which carried out an ESG-specific audit during the financial year 2020/21. We will report on the results of the audit and of the improvement measures adopted as a result in our 2021 Stewardship Report.

The objective of this audit was to assess the design and operating effectiveness of the controls and governance of USSIM's adherence to its ESG policy, along with the internal and external reporting of ESG information.

In scope of the audit was:

- Review of USSIM's ESG policies, principles and controls to understand the process for developing them and how they account for ESG issues within investment decision making
- Assess whether the controls relating to USSIM's ESG policies and principles are operating effectively, including how they are governed (e.g., reviewed and updated)
- Assess whether the controls in place for monitoring and adhering to USSIM's ESG policies and principles are designed and operating effectively. This included the impact on controls over ESG related activities of any changes in working practices as a result of COVID-19, and any new or interim key controls introduced into ESG related activities in response to COVID-19 (insofar as these controls remain within the scope of our review)
- Review the controls relating to the validation of ESG information (such as external manager due diligence) and the internal and external reporting of ESG information to assess whether they are operating effectively. This included the controls the ESG team has in place to ensure the data provided to them is complete, accurate and valid

# Section 2: Investment Approach

## **Principle 6:** Client and beneficiary needs

**Principle 6**

Signatories take account of client and beneficiary needs and communicate the activities and outcomes of their stewardship and investment to them.

We have proudly served as a not-for-profit Corporate Trustee since 1974, and employ more 500 people in London and Liverpool. During the period to 31 March 2020, USS paid out nearly £2bn in benefits to 74,608 pensioner members. We also have 204,753 active and 180,353 deferred members who are accruing benefits with us and whose interests we seek to serve.

### Helping our members stay engaged and informed

With such a large and unique membership, effective and efficient communication is key.

Our members are increasingly aware of and engaged with the interconnected ESG factors that may impact their investments. Our communications professionals respond to this by regularly reviewing our written, digital, regular and ad hoc communications to ensure they continue to meet member needs and expectations.

Our principal communications outlet for our members is our website, www.uss.co.uk, which features a dedicated section on responsible investment, and our RI reports. Here we publish reports and information on, amongst other things, the following:

- Our Responsible Investment Statement
- Our approach to exclusions
- Our voting policy
- Our policy to address voting in our securities lending programme
- High level case-studies across asset classes in our responsible investment reporting and through video explainers such as USS & Thames Water: Working together to make a better future
- A socio-economic, community and biodiversity report for our real estate portfolio

We recognise that effective communication is not a one-way process. Our members' views are critical as we invest for their long-term futures.

In October 2020, we invited members to share their views on sustainable investment, including beliefs on their general importance and on particular sectors and activities, through a survey in collaboration with Maastricht University.

Among other things, members indicated that ESG issues were important to them, as well as providing direct feedback on individual areas which will help us review the guidelines that govern our ethical investment options later on this year.

Keeping our members informed of material developments that may impact their investments is critical. Notably, in June 2020, we announced our actions that resulted from an internal strategic review, including our decision to make our first set of divestments in certain sectors (see Principle 7 for further detail).

We are also developing more regular content such as Q&A's for the website and member newsletter articles as well as video content for Facebook as a more visually compelling way of engaging with our members. This will more specifically cover USSIM, its investments and ESG. We are also planning a number of member webinars during the rest of the year with a focus on USSIM and specifically our developments in ESG.

Additionally, in 2020 USS, including board members and senior management, held several discussions with member groups such as Ethics for USS/Divest USS and the Universities and Colleges Union (UCU).

USS is responsive to media engagement and also writes occasional thought leadership content and blogs covering ESG and responsible investment. For example, Balancing ESG reporting and stewardship, an article for Funds Europe, and It's Not Just About The Money – The Role Of Investors In Society for the 2020 ICGN yearbook.

# **Principle 7:** Stewardship, investment and ESG integration

## Principle 7

Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities.

### Our Investments

Our asset class and geographic mix – and the specific companies, entities and sectors we invest in within these asset classes and geographies – means that we do not have a one size fits all approach to prioritising ESG issues for assessing investments. Instead our approach to prioritisation for our voting and engagement activities is based on the following criteria:

- The size of our holdings in the entity or the size of the asset, portfolio company and/or property
- The home market of the asset or portfolio company
- The materiality of ESG factors and their effect on financial and/or operational performance
- Their ESG scores, and their rankings in specific benchmarks, in particular the Transition Pathway Initiative and the Workforce Disclosure Initiative
- Specific ESG factors with systemic influence (e.g. climate or human rights)
- The adequacy of public disclosure on ESG factors/performance
- Bribery and corruption-related issues

### Potential ESG issues

The USS Statement on Responsible Investment provides the following list of ESG issues which can be used when assessing investments and deciding on priorities for voting and engagement:

- bribery & corruption risk management
- climate change
- consumer and public health
- corporate governance
- customer satisfaction
- cyber security
- environmental performance management
- executive remuneration
- health and safety
- capital practices
- human rights
- innovation; research and development (R&D)
- intellectual capital management reputational risk
- succession planning
- the social impacts of corporate activity
- stakeholder relations
- supply chain management
- transparency and disclosure

Once we have prioritised assets, portfolio companies or other entities for voting and engagement, we define our objectives for engagement and determine whether we will conduct individual engagements, engage in collaboration with other investors or whether others will engage on our behalf (see Principle 2).

## Our approach

Having an in-house Responsible Investment function allows us to **integrate our stewardship and our investment decisions** across the scheme.

### Listed equity and credit

As expressed in our core beliefs (Principle 1), we feel strongly that promoting high standards of ESG practice and allocating responsibly to companies and other assets, will protect and enhance the value of our investments by reducing the risks associated with investing. It follows, therefore, that active ownership and stewardship, as well as assessing investment risk in all its forms, are fundamental to our approach to managing the assets entrusted to us.

Our philosophy of integrating engagement and investment decision-making is central to the way in which we manage our listed equity and credit investments. In doing so, we ensure our views on a company's approach to managing ESG issues, together with its responsiveness to investor engagement is explicitly discussed and taken into account by our investment teams. We do this in a variety of ways, including:

- Engagement meeting notes and voting letters are shared systematically with portfolio managers via an IRH page on Bloomberg. This provides the Equities, Credit and Responsible Investment teams with a record of how we voted and views of the firm's ESG practices
- For public equities, voting records, engagement notes and reviews of a company's approach to various ESG issues are included alongside the investment cases and decision notes. In addition, various ESG data are also recorded in the investment case on the tear-sheets which are reviewed in preparation for company meetings
- Third party scores, ratings and assessments of ESG risks are made available through the IRH page. We have access to MSCI ESG ratings and reports in Bloomberg which we take into account when assessing individual investment opportunities. When reviewing new credit investment opportunities or existing investments within the portfolio, the team reviews rating agencies reports, many of which now explicitly incorporate a review of ESG factors
- A member of the RI team attends Global Emerging Markets (GEMs- our active portfolio) meetings to discuss ESG related issues resulting from research and engagements
- All votes against management for our active portfolio are discussed with the relevant portfolio manager prior to the vote being cast and other points of contention are also discussed
- A research note outlining the investment case is completed by a portfolio manager for every active position in the USS Equity Portfolio. Corporate governance scores and the environmental and social scores are automatically embedded in the template of this document. In addition, the responsible investment team may complete a report ("RI Perspective") outlining the material ESG risks and opportunities that are relevant to the company
- The RI team also contributes to the investment process through specific research and analysis on key company specific issues. Company engagements will frequently involve both the internal portfolio manager and a member of the RI team. Such engagements also normally involve an internal pre-meeting and depending on the outcome, a post-meeting discussion between RI and the Portfolio Manager will also take place

### Sovereign debt

USS utilises a proprietary tool, first developed in 2008, which ranks countries based on ESG factors. For the Emerging Market Debt (local currencies) portfolio, the composite index ranking is one of the core tools used in portfolio construction. The results of the composite country score is combined with a fundamental credit assessment and integrated with two other factors to formulate the investment strategy.

Positive ESG country scores are viewed as an indicator of lower future default risk and negative ESG scores are viewed as being an indicator of higher future default risk. Our investment approach attempts to avoid countries where the risk of default is increasing, to improve the quality of the portfolio and better match the risk appetite (in sovereign debt) to the scheme. ESG country rankings contribute to this analysis but are not the only input. This ESG country analysis is also built into our emerging markets decision making processes.

### Taking a view on Turkey

USSIM exited the scheme's active listed equity investments in Turkey in 2020 on broad governance and social concerns. USSIM had previously been underweight Turkey relative to our index due to concerns arising from both our ESG scoring at a country level (incorporated in our asset allocation and screening process) and fundamental research. With ESG factor risks rising in Turkey, USSIM believed deteriorating governance and social stability posed a threat to equity returns and USSIM reduced our country equity weighting to 0%.

## Private Markets/Direct Assets

For direct assets, the relationship between stewardship and investment decision-making is broadly similar. ESG engagement by the responsible investment team is shared directly with the Private Markets Group (PMG) team in writing and in regular presentations and updates to the Portfolio Review Committee.

Examples of our direct investments include stakes in renewable energy assets including onshore and offshore wind, G. Network (a fibre network company) Thames Water, Moto (motorway service stations), holdings in infrastructure assets like Heathrow, and a significant property portfolio.

Responsible investment is an integral part of the selection and retention of directly held private assets. This is particularly important in our direct investments as we expect to own them for many years and we have the ability to directly influence board composition, strategy, corporate social responsibility activities, and remuneration.

ESG due diligence is undertaken for all direct deals and presented within the slide deck prepared for the internal USSIM oversight committees. This due diligence process seeks to identify any material legal, ethical, governance, reputational, environmental and social risks that could potentially affect the value of the investment and explores whether there are appropriate processes in place to mitigate these factors. It is underpinned by site visits by the deal team, extensive commercial, legal and operational due diligence for the assets. If appropriate, the scheme will also appoint specialist external advisors and consultants to assess ESG risks and performance if these are deemed material for the asset under investigation.

For direct private markets assets, USS will typically have board representation and material influence at the company to affect and oversee ESG performance. Additionally, the responsible investment team, working alongside the USS directors on the board, will undertake ESG reviews.

Once we are invested, we follow an ESG review process that was formalised in 2017/18 using market leading frameworks. We assess the level of commitment shown to high quality corporate governance including the structure and functioning of the board of directors, the control environment and processes and transparency and disclosures. Each of these factors are scored against best practice to identify how the governance at the business could be improved.

For environmental and social issues, we typically use the Global Real Estate Sustainability Benchmark (GRESB- which USS helped to establish in 2009) Infrastructure framework. This is an internationally accepted environmental and social performance assessment process for property and infrastructure assets and funds. We also conduct face-to-face ESG review meetings with representatives of the company to discuss how the asset's managers are addressing ESG risks and opportunities. The purpose of these assessments is to compare the current ESG management at our assets with best practice and to identify recommendations for improvement. Past recommendations have covered contractor oversight, human capital management, air pollution, health & safety and community relations.

Recommendations are made to the PMG's Portfolio Review Committee whose members have the ability to influence investee companies. Our Board membership of direct assets gives us greater access to information on management issues including ESG risks and more direct influence on a company's strategy and priorities. We expect each Board to monitor progress over time, including reducing its environmental impact, lowering its operational costs and improving its financial performance. For larger companies, it is already normal business practice to report such metrics both internally and externally. For example, Heathrow's Sustainability strategy is available online here.

Our process-driven approach to the integration of stewardship and investment means that **any information gathered through stewardship feeds directly into our acquisition, monitoring and exit decisions**. This information includes our assessment of the company or entity's approach to managing a specific ESG issue (see the "ESG Issues" list above for examples), of its performance on the specific issue in question, and of its openness or responsiveness to engagement.

It is infrequent for a specific insight or data point from engagement to fundamentally alter an investment view. In meetings and discussions, we tend to focus most attention on those insights that challenge or potentially challenge our view (e.g. if it appears that a company is not managing ESG issues as well as we would have expected).

## Taking action on the sustainability of investments

In early 2020, USSIM began a detailed review of a selection of sectors in which the scheme invests. It looked for differences between what industry financial models predicted on returns and what we could reasonably expect to happen over the long term. We concluded that, in several cases, the outcomes predicted by the market did not appropriately consider the potential financial impact of certain specific risks, including ESG.

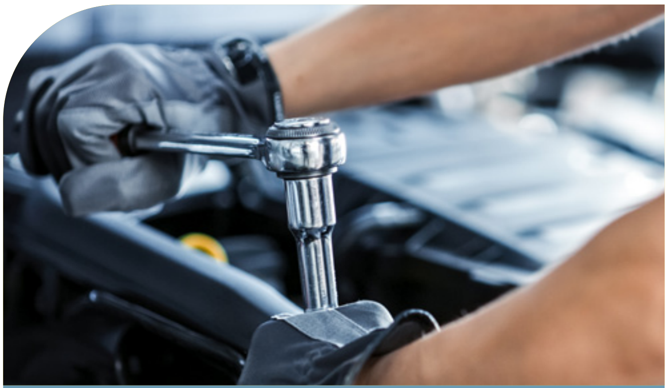
As a result, we excluded certain sectors from our investment universe as they were deemed to be financially unsuitable over the long-term. These included: tobacco manufacturing; thermal coal mining (coal to be burned for electricity generation), specifically where they made up more than 25% of revenues, and certain controversial weapons. We are already well on our way to fully pulling out of investments under our direct control in these sectors and will have ceased to invest in them by the end of May 2022 at the latest.

This was a major development for us with the clear aim of keeping the financial promises made to hundreds of thousands of members in the higher education sector while fostering well-functioning markets for the long term. These exclusions will be kept under review and may be changed or added to, and will be made across both the defined benefit and defined contribution sections of USS.

## Case-study 1: CNOOC

In Q1 2021 the RI and GEMs teams engaged with Chinese oil & gas producer CNOOC. This engagement covered a range of financially material items including:

- The company's shift towards gas and away from oil, and how this aligns CNOOC with China's national policy goals on a cleaner environment and increased gas consumption
- The company's wind investment plans
- China's emissions trading scheme and the likely timing and cost impact of CNOOC's involvement here
- The company's accident record and whether good performance here was compatible with their ongoing strong cost control and their impressive performance in avoiding COVID-19 related production disruption



## Case-study 2: Hyundai Motor

We engaged with Korean auto manufacturer Hyundai Motor alongside our Global Emerging Market colleagues in Q1 2021. Discussion topics included:

- Environmental issues, such as Scope 3 emissions and how earnings estimates might be affected should carbon prices be introduced
- Social issues such as accidents and labour expense, with a particular focus on the latter as it can have a significant effect on profitability and the company has suffered strikes in the past
- Product quality, as we had noted that product warranty expense had increased, risking both margins and the company's brand due to frequent recalls
- The potential for a corporate restructuring once the global pandemic eases
- Gender diversity on the company's board

## Case-study 3: NATS

NATS, working with other air traffic control organisations and airlines, have been considering how they can help the sector reduce emissions. The reductions in flights resulting from Covid provided an opportunity to test rerouting over the Atlantic, one of the busiest air routes in the world. Rather than directing airlines through specific corridors, air traffic control has been permitting aircraft/airlines to choose the most efficient route, which includes making use of the jet stream. This project has been able to demonstrate that such routing enables airlines to reduce fuel consumption and therefore carbon emissions in a sector where such reductions are difficult, as reported by CNN Business February 2021.

## Case-study 4: Australian Toll Road

USS is a significant shareholder in a Toll Road in Australia where we have board representation. Both the asset's Strategic and Sustainability Management Plans set clear goals to reduce energy consumption across the asset, which in addition to being financially efficient also reduces greenhouse gas emissions and therefore contributes to addressing climate change. It has been estimated that a change from high pressure sodium vapor (HPS) lighting to LED lighting would reap a 20-25% reduction in costs and emission across over 4,000 light fittings. LED technology also has the added advanced in that the lighting provides an order of magnitude longer service life reducing both maintenance events and traffic disruption.

The plan is to replace 1000 Tunnel lamps by June 2021 as, because the tunnel lighting runs 24 / 7 this action will provide the greatest net benefit. Subject to appropriate funding, the plan will then be to replace the 3,000 open-road freeway lamps with LEDs by December 2021, although this may take longer if the funding support proves difficult to obtain.

The company and its board view this programme as a major step towards reduction in green-house gas emissions.

# **Principle 8:** Monitoring managers and service providers

## Principle 8

Signatories monitor and hold to account managers and/or service providers.

USS's RI strategy applies to all the assets in which the scheme invests, whether this is via portfolios run by USSIM or by external managers. Approximately 30% of our assets are managed externally, and we have processes in place to assess and monitor how potential or existing managers are addressing ESG-related factors. We class our oversight of external managers as stewardship activities as we are "engaging" with them to improve practice. We address ESG issues prior to appointment and then on a regular and ongoing basis post investment. This involves the RI team reviewing external managers' responsible investment-related policies, processes, resources, reporting and stewardship activities, with managers ranked against in-house assessment frameworks. The frequency and type of monitoring is tailored to the mandate and asset class.

The scheme has a Senior Responsible Investment Advisor and another team member dedicated to oversight of external managers. All new fund managers are subject to comprehensive due diligence to evaluate the managers' approach and commitment to responsible investment and stewardship, and to ensure that these external managers meet our needs.

### Our due diligence questionnaires

In 2019, we updated our RI due diligence and monitoring processes for external managers and fund managers (for both public and private markets) into standardised questionnaires. These questionnaires are similar in content, with the due diligence version establishing a baseline set of data which then from the basis for the scheme's biennial monitoring programme. We also introduced a scoring system to enable the benchmarking of the ESG performance of the external managers. Figure 1 presents an extract from our monitoring framework (which mirrors our due diligence questionnaire) showing the issues on which we assess managers and how they might then be scored (or rated) and a sample is available online here.

**Figure 1: Extract from USS PE Manager Monitoring Framework[2]**

| Rating/ KPIs | RI Policy & Process | Capacity/Governance | ESG Due Diligence | Stewardship & portfolio management |
|---|---|---|---|---|
| **3-Outstanding, exemplary**<br><br>**USS likely to note & commend some aspect of RI practices** | • Comprehensive ESG and RI related Policies and statements- no gaps.<br>• Applicability to USS assets clearly defined.<br>• Accountabilities within the firm clearly articulated.<br>• Policy(ies) updated within last 24 months.<br>• Evidence and references to ESG included in fund DDQs and data rooms and LP communications- offered as core to GP proposition. | • Evidence of commitments to capacity building for market e.g.<br>- Commitment to TCFD<br>- Leadership role in diversity & inclusion.<br>• Material references to ESG in LP reporting and deal documentation.<br>• ESG KPIs for firm and/ or portfolio companies set by GP & reflecting materiality.<br>• Use of climate change scenario tools & ESG research providers.<br>• GP sustainability/ CSR/ESG policies / reporting public on web.<br>• Candid detailed PRI report.<br>• Public profile, leadership on ESG shared at events. | • Evidence via case-studies of ESG considerations in due diligence.<br>• Detailed disclosures in response to RI questioning.<br>• Likely use of expert consultants.<br>• Comfortable talking off-cuff, open and confident answers.<br>• PMs involved in ESG discussions.<br>• Possible sharing of information from PMIC packs.<br>• Evidence that DD findings link to inclusion of ESG in value creation plans and valuations. | • Evidence that ESG is systemically included in portfolio reviews and monitoring processes.<br>• Material information obtained / used by fund managers.<br>• ESG shortfalls addressed at portfolio companies/progress tracked by GP.<br>• Asset managers involved- often alongside ESG expertise. Clear governance processes in place (links to policy above) and record keeping.<br>• Ability to identify- and share with LPs-awareness of key ESG risks within fund portfolios.<br>• Processes in place to prioritise engagement/stewardship activities.<br>• Firm and/or investee asset / KPIs identified /targets set.<br>• Likely systems in place to evidence and track ESG performance data. |

[2] https://www.peievents.com/en/wp-content/uploads/2020/02/USS-PE-ESG-Assessment-Template-March-2020.pdf

The reviews rate the funds across the following key areas:

- RI policies and processes
- ESG integration
- stewardship (or asset management practices for private markets)
- voting (for listed equities)
- collaboration
- market wide / public policy activities
- reporting

Since 2019 we have referenced our commitment to the TCFD, the UNPRI and UK Stewardship Code in our template Investment Management Agreements (IMAs) for public markets, and private equity fund side-letters. We request reporting and ask our managers to commit to responding to ad-hoc data requests on ESG or stewardship to support USS analysis or scheme reporting. Whilst we have not always been successful in achieving the proposed template wording, our negotiations and starting position sends a strong signal to managers, emphasising the importance placed on RI considerations at the scheme.

## Tailoring due diligence to specific asset classes

Our due diligence questions vary across asset classes in line with the specific attributes of those asset classes. For example, in public equity mandates, we consider the consistency of the manager's voting policy with USS's approach and review voting records to gain insights into alignment with engagement activities, investment decisions or public position statements, and to ensure that they meet our needs and expectations on stewardship. Within this, we may also consider the consistency of voting records between different markets and the manager's public policy statements or review the handling of a specific vote compared to USS's position on the same resolution where we have an in-house holding. We also consider the manager's involvement in collaborative initiatives and how ESG-related activities are communicated to investors and other stakeholders.

In private markets (e.g., private equity funds), we are often considering making a commitment to a fund where the assets have not yet been acquired – so-called blind pools. In these situations, our due diligence will focus on policy and processes and, where possible, case-studies from previous funds on which we base ESG-related questions. All new General Partners (GPs) and external fund managers are asked to complete a USS RI GP Due Diligence Questionnaire regarding their approach to ESG matters. The questionnaire closely aligns to ESG matters raised in the PRI's Limited Partner (LP) questionnaire which USS helped to develop. We ask for information on how ESG risks and opportunities are assessed in the due diligence process and how they are managed across the portfolio. We encourage the provision of case-studies to evidence the GP's existing approach and where materials are available, will ask about ESG matters relating to previous or current investments. This focus on previous funds enables us to assess how well ESG factors have been incorporated in previous investments and whether we can expect that the new fund will meet our needs. We also review GRESB reports if available for property or infrastructure funds.

## Ongoing monitoring and review

Our monitoring of external managers does not stop post-investment. We regularly follow up to assess if their approach has changed and whether they are delivering on any commitments made in the initial due diligence. The frequency and type of monitoring is tailored to the mandate and asset class. For example, for fund managers investing in public markets, we review voting histories, company engagement case-studies and ESG integration. We include RI-related questions within USS's quarterly monitoring questionnaires to ensure material changes to RI policies, activities or concerns arising with portfolio assets are tracked and managed.

Fund monitoring for both public and private asset managers and meetings with managers are coordinated with the relevant internal teams. In addition, the outcomes of the monitoring assessment are shared with our PMG and the Investment Product Management (IPM) teams (responsible for public markets manager appointment) as well as with the Managers and Mandates Committee.

While the RI team plays a key role in monitoring our external managers on ESG, our colleagues in the IPM team and PMG, who manage these relationships day-to-day, are also heavily involved in the oversight. For example, PMG team members are typically also members of the Limited Partners' Advisory Committees (LPAC's) of the private market funds in which USS invests. These committees typically meet once or twice a year and will often include ESG topics and updates on the meeting agendas, providing an additional forum for USS to monitor and challenge our fund managers on RI-related matters.

We undertake a more detailed, deep-dive, review as part of our monitoring process, meeting with representatives from the investment management firm for a more detailed face-to-face discussion on ESG. Ahead of these meetings, we research the portfolio companies or other assets in which a fund has invested to identify relevant ESG risks or opportunities that can be interrogated further with the fund manager. This process, which we have adapted for both public and private market managers, is designed to identify areas of strength and weakness in RI, and divergence between their stated approach and actual implementation, and to allow comparisons to be made across USS's different external managers, especially when they are working within a similar asset class. The information can also help to inform USS's future allocations to a private equity manager as the data and views collected feed into the due diligence process for assessing new commitments. In situations where we find that the manager has not met our expectations, we may decide not to make future allocations or to reduce or remove existing allocations.

## Other service providers

In addition to our external fund managers, we also assess the ESG competence of the investment consultant the scheme employs to provide support for and assurance to the trustee. ESG issues were included in the Request for Proposals for the process run for the appointment of these consultants.

## Process oversight

Our RI oversight of external managers is reported to internal USSIM Managers and Mandates Committee and the Audit Risk & Compliance Committee on a quarterly basis, to the Investment Committee semi-annually and is included in an annual update for the Trustee Board.

USSIM's approach to external manager monitoring was profiled in the RI Annual Report in 2019 and examples of manager engagements – covering both public and private markets managers – are reported as case-studies in our PRI submissions. In 2019, USSIM were pleased to be showcased on the PRI's inaugural Global Leaders Group for our approach to RI for external managers.

## Our process for private equity

In the specific case of private equity, we assess GPs on ESG issues on a regular and ongoing basis, irrespective of the type of investment (for example, special situations, debt funds or buy-outs) and we provide feedback to PMG managers on our views. The assessments are conducted within the context of the LP/GP relationship, where the GP has ultimate responsibility for investment decisions and portfolio assets. We monitor the GPs to ensure that ESG issues are being properly managed and to encourage improvements in ESG performance. Our monitoring assesses GP responsible investment-related policies, activities and resources. The RI team also undertakes research into the portfolio companies or other assets in which a GP has invested, including any co-invests, to identify ESG risks or opportunities that can be interrogated further with the GP. The team also undertakes research to understand how GPs engage with portfolio companies on these issues. A member of the RI team meets with representative members of the GP to discuss the processes, actions and outcomes associated with the management of ESG issues within the portfolio. The information collected during monitoring also helps inform USS's future allocations to a private equity manager, as information collected is used in the due diligence process for new funds.

## Monitoring outcomes

### In brief: 2020 Manager Monitoring Activities

We welcomed a refreshed emphasis on ESG during the year at one of our US GPs, which included updated ESG policies, a consultant hire and strong statements on ESG in their 2020 fund raising Due Diligence Questionnaire, following our earlier feedback that their ESG programme was dated and overly narrow.

We signalled our disappointment with another US GP regarding the lack of reference to ESG within its pitch book and fundraising presentations from investment partners. This lack of reference was surprising given the materiality of ESG themes to the strategy, the explicit ESG commitments in the fund DDQ and the firm-level commitments on responsible investment and stewardship. We indicated that we will continue to monitor progress as the fund deploys capital.

We escalated our concerns with a European GP regarding their practices for the agreement of conflict waivers. Sign-offs had drifted to one-to-one conversations with individual LPs (particularly post-COVID) rather than being collectively discussed at the fund's Advisory Boards. Following formal engagement with the GP's managing partners, good governance practices have resumed.

In 2020, we also saw a multi-year engagement rewarded when another GP finally agreed to adopt in-camera sessions for LPAC's to facilitate full-participation from overseas LPs in fund governance.

## Case-study 1: Private equity engagement

We met with a private equity fund manager and were not impressed with their response to our monitoring questionnaire and their answers to portfolio-based questions. Following the meeting, we sought further materials from the manager to confirm our conclusions and poor rating. We discussed our concerns with the lead relationship manager in PMG and agreed to escalate concerns with the GP.

We requested a further meeting with the GP and were pleasantly surprised with the developments that had taken place in the intervening months. The firm was undertaking a holistic review of its position, policies and resourcing of ESG. It had convened a cross-firm ESG Committee with senior support from the CEO and two senior partners and representatives from the deal teams, HR, IT, Legal, Compliance, Public Affairs and Communications. It had also strengthened its due diligence processes in relation to litigation, reputation, cyber security and data protection-related risks.

In response to our feedback, the GP acknowledged that it needed to enhance its portfolio monitoring on ESG. It explained that it was working with consultants and internal teams to consider the best approach for the GP and for their approach to value creation.

## Case-study 2: External manager escalation

Following an initial review in 2020, one manager scored very poorly in our responsible investment ratings framework. The manager had struggled to articulate its approach to ESG integration, stewardship and engagement for our equity strategy. Upon further investigation it also became apparent that stocks in our portfolio were not being voted due to an error from their service provider in the vote set-up.

We raised our concerns with our Managers and Mandates (M&M) Committee. Over the course of Q3 and Q4 2020 we escalated our engagement with the manager to call for clearer rationales of the fund's position on responsible investment and to re-establish voting for the fund.

Some progress was made through 2020 including a commitment to strengthen ESG and stewardship resources with the creation of a new role, and new reporting on responsible investment. These improvements have in turn led to an improvement in their rating in our responsible investment ratings, although we continue to maintain a red flag on the manager.

In conjunction with the M&M Committee we have committed to further engagement with the manager to agree key milestones and timescales for improvement. Further action will be considered if these milestones are not met

## Climate Change Reporting

We have consistently asked our external managers across asset classes (both public and private) to consider reporting against TCFD requirements and we are pleased to note that a number are doing so. For example, we actively encourage our private equity managers to provide the data needed to complete TCFD reporting: In 2020, one of our PE managers signed up as a supporter on the TCFD and another published its first TCFD report.

# **Principle 9:** Engagement

### Principle 9

Signatories engage with issuers to maintain or enhance the value of assets.

## Taking an active approach to engagement

*"Being an engaged owner is one of the most effective ways of influencing positive change at an asset level."*

This is why we seek to be active and engaged stewards and encourage companies to make positive changes. We believe that this level of engagement can both help prevent or avoid value destruction and reduce the negative impacts companies can have on the environment and society.

As discussed under Principle 7, we select and prioritise engagement based on a variety of factors including: the size of our holdings in the entity or the size of the asset, portfolio company and/or property; our views on the materiality of ESG factors on financial and/or operational performance; specific ESG considerations; and the company's general practices, processes and performance on ESG issues. We also pay attention to controversies and interests; for example, our more recent engagement with Vale (a Brazilian mining company) was catalysed by the Brumadinho tailings dam collapse and with Rio Tinto by its destruction of the 46,000 year old Aboriginal heritage site in Juukan Gorge.

We enter into numerous engagements with companies in our portfolio for a variety of reasons. Some of these engagements are to clarify our understanding of the company's approach to managing an issue or to get comfort that the company is allocating sufficient resources to managing an ESG risk. On some engagements there will be an objective; examples include our engagement with Mexican cement company Cemex and on the UK Modern Slavery Act (see below).

**We use a variety of engagement methods**, including engaging individually with the company or entity, collaboratively engaging with the entity alongside other investors (see Principle 10), filing/co-filing / submitting a shareholder resolution or proposal (which we do very rarely), publicly engaging the entity (e.g. open letters), voting and divesting or implementing an exit strategy. The specific strategies we use, and the sequence in which we use them (see further detail in Principle 11) depend on the issues in question, the mechanisms of influence (formal and informal) available to us, and the characteristics of the investment made (e.g. lock-in periods, liquidity).

In 2020, as a result of changes in our public equities portfolio, we reviewed our approach to stewardship and engagement.  We concluded that, with the shift to larger and therefore more diverse portfolios, it made sense for us to participate in a broader range of collaborations and to support more collaborative engagements (see Principle 10 and also the case-studies below).  This change to more diverse portfolios also led us to conclude that, over time, we need to move from a holdings-focused approach to prioritisation to a more issue / theme-based approach.

We are currently reviewing our approach to credit. Historically, we have mainly engaged with those credit issuers who also issue shares, and it is fair to say that most of our engagement has emphasised those issues that are of concern to equity investors.

*"As USS has built its internal capacity on credit, we have recognised the opportunity to broaden the universe of issuers we engage with and to explore whether there are credit-specific ESG issues we should engage on. Developing our ESG and stewardship capabilities in credit is one of our priorities for 2021."*

Finally, while the discussion in this section has focused on listed equity and credit, we engage across all of our asset classes (see the examples presented in other sections of this report). In addition, as noted in Principle 8, we have a detailed process for due diligence and monitoring of our external managers across asset classes (we view our monitoring programmes as engagements with our managers) and we engage with policymakers (see Principle 4).

## Engagement examples and outcomes

### (ongoing or concluded in the preceding 12 months)

#### Human capital management at a directly held asset

One of our assets has historically had high rates of staff turnover with knock-on implications for management time, staff competence and therefore frontline ability to deliver quality services. The asset's board and management has made human capital management a focus area. Between 2015 and 2019 there was approximately 30% reduction in staff turnover, and the target is to reduce staff turnover by another 33% by 2025. The actions taken included improving work scheduling (e.g. working notice/planning is now available three weeks in advance enabling employees to plan ahead), managing staff scheduling and rotas via an app enabling rapid exchange of information, and paying above the national living wage. The asset has seen an overall improvement in employee engagement scores year on year – reinforcing the importance that a focus on people is critical for business success.

#### Boohoo: supply chain management

Following the exposé of supply chain issues in UK garment manufacturing (as a result of the Covid outbreak in Leicester) we committed to participate in an Investor Forum led engagement with the company and the sector. We are also participating in the Workforce Disclosure Initiative (WDI), a ShareAction sponsored project, which organised a collaborative engagement around supply chain management in the fast fashion sector.

#### Brazilian meat processing companies

In an attempt to encourage these companies to improve tracking processes in their supply chains and thus avoid illegal sources (frequently associated with burning of the Amazon to clear land), we have joined a PRI led initiative to encourage meat processing companies to sign up to an independent tracing scheme.

#### Cemex - net zero

As part of the CA100+ collaborative project, we are one of the lead investors engaging with the Mexican cement company Cemex. Often overlooked, cement is very carbon intensive (both in terms of energy use and CO2 emitted during the production process). It is, therefore, one of the sectors where transition planning will be essential to achieve the Paris targets.

#### Japanese Banks and Climate Change

USS participated in a collaborative engagement facilitated by Asia Research and Engagement which targeted Japanese banks and their role in financing climate change and, in particular, coal. The collaborative engagement group sought to improve integration of climate change risks and opportunities into strategy for banks across the region.

As part of this collaborative engagement USS voted in favour of a shareholder resolution at the AGM of Mizuho requesting that they disclose climate risks and publish a plan to ensure its investments are aligned with the Paris Agreement. The resolution gained support from 35% of investors who voted and was the first resolution of this type in Japan. As part of our regular AGM engagement programme, USS wrote to the company explaining that we supported the resolution as we would welcome enhanced transparency and disclosure on the specific processes and strategies, including targets and metrics, employed by the bank to align the business and investments with the goals of the Paris Climate Agreement. We believe greater disclosure would help investors understand the risks arising out of this issue.

These points have also been raised with Mitsubishi UFJ Financial Group and Sumitomo Mitsui Financial Group. The engagement has extended to Singapore banks and in Q4 2020 focused on Chinese banks.

### Mining Tailings Ponds

Since 2019, USS has supported the Investor Mining & Tailings Safety Initiative. Led by the Church of England Pension Board and the Swedish APs, this project has stemmed from two Brazilian mining disasters – Brumadinho (Vale) in 2019, and Samarco (BHP and Vale) in 2015 – where tailings ponds collapsed leading to significant loss of life. Working with investors, mining companies and the sector's representative body (ICMM) a set of guidelines for tailing pond monitoring and management have been developed with the aim of minimising the risk of such disasters in the future. In addition to these collective efforts, we also engaged directly with both the companies on their responses to the disasters.

### Mining companies and First Nations communities / Indigenous peoples

Following the destruction by Rio Tinto of the 46,000 year old Aboriginal heritage site in Juukan Gorge, Australia, USS and a group of investors (including Hesta, CBUS, Church of England Pensions Board, Council of Ethics for the Swedish National Pension Funds and ACSI) sent a letter to the top 71 international mining companies and all other major companies that operate in Australia. The letter sought assurances on the issue of indigenous community rights and social license. As with the issue of tailings dams, the specific incident has revealed a much wider issue to address across the mining sector. As a result, we were keen to indicate both a serious concern as well as a desire to work with the industry to better understand how this can be addressed. We were deliberately not prescriptive in recommending actions at this point as we intend to begin a dialogue with the sector. The responses from the letter are being collated and will be acted on in 2021.

### Marine Microplastic Pollution

Scientific evidence is emerging that microplastics are causing significant harm to marine biodiversity and ecosystems at a time of heightened public awareness and support for action in tackling plastic pollution in the marine environment. In collaboration with the Marine Conservation Society (MCS), institutional investors are engaging with the manufacturers of domestic and commercial washing machines with a request to fit, as a standard feature, filters to their products to prevent plastic microfibres entering the world's marine ecosystems. Filter technology is currently available and today is not systematically utilised across the industry. The aim of the engagement is to influence the companies to commit to having factory fitted plastic microfibre filters fitted as standard in all new machines by the end of 2023 (i.e. should be in production, not that they commit to the concept by 2023). France has announced that it is introducing such legislation which will take effect in January 2025. USS are one of the funds engaging with Samsung as part of this project.

### Modern Slavery Act engagement

USS joined with Rathbones and approximately 20 other funds with £3.2trn AUM, to engage with 22 FTSE350 companies that had failed to meet the Section 54 reporting requirements of the Modern Slavery Act 2015. The engagement was successful, with 20 out of the 22 target companies becoming compliant with the Act by 31st December 2020. This engagement was also shortlisted for a PRI award for the category 'Stewardship Project of the Year'.

# **Principle 10:** Collaboration

**Principle 10**

Signatories, where necessary, participate in collaborative engagement to influence issuers.

## Collaboration is key

We firmly believe that purposeful engagement and meaningful investor collaborations are the keys to stewardship success. It is clear that our interests can be furthered by collaboration with like-minded investors and engagement with government, industry and regulators. Collaboration adds weight to individual company engagements and to addressing market wide systemic failures. The additional influence, the shared learning, and the greater efficiency associated with collaboration, means that it is a central and critical part of our approach to stewardship.

**Our Statement of Investment Principles (SIP) notes: "Where collaboration is likely to be the most effective mechanism for encouraging issues to be addressed, the Trustee expects its investment manager to participate in joint action with other institutional investors as permitted by relevant legal and regulatory codes". The scheme's Investment Beliefs also highlight a commitment to collaboration, stating "the fund's interests are further protected from adverse impacts by collaboration with like-minded investors and engagement with government, industry and regulators".**

## Our commitment to collaboration

We were early leaders in collaborative engagement and involved in the establishment of several initiatives which support stewardship activities and collective engagement in the UK and globally. Since 2000, the scheme has dedicated considerable effort to founding and ensuring the ongoing success of collaborative responsible investment initiatives, and addressing systemic barriers to incorporating ESG issues in investment. This commitment to collaboration is reflected in the market-wide transformation work and collective initiatives that USS has been and is associated with. For example, we were founders of the IIGCC (2001) and GRESB (2009), and were founder signatories to the UNPRI in 2005/6, and the TPI in 2017. More generally, we are active in a wide range of responsible investment, stewardship and ESG-related collaborations (see page 35 for a list of our main collaborative partnerships and affiliations).

## Collaboration in focus

In 2020, a shift in equity allocation led a significant increase in the breadth of our portfolio, resulting in us becoming even more of a "universal owner" with exposure to an extremely wide spectrum of assets. This change in our portfolios has necessitated a move away from a holdings-focused approach to one where prioritisation is based on issues and themes-based approach. We therefore took the decision to participate in a broader range of collaborative engagements than we had previously done. We have also placed more emphasis on collaboration as part of our questioning of investment managers in our monitoring and due diligence processes.

To follow are specific examples of our company and issues-based collaborative engagements. Other examples are presented elsewhere in this report, in particular under Principle 7.

## Case-study: Collaborative engagement on cybersecurity

Cybersecurity poses a significant threat to investors, capital markets and countries alike, a notion we are beginning to see reflected in regulation such as the EU Cybersecurity Act 2019. In 2020, we continued to participate in a collaborative engagement looking to initiate a dialogue around the measures in place to mitigate the threat (and impact) of a cyber-attack among organisations. This engagement is led by Royal London Asset Management, and included active participation from UK asset owners USS, Border to Coast, Nest, Brunel and RailPen.

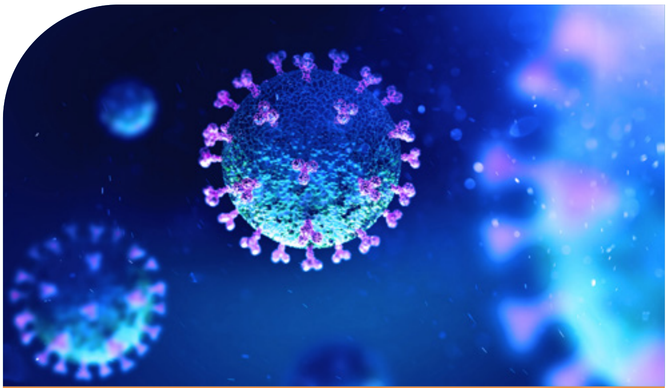
We identified 15 companies in our portfolio holdings to contact initially through this engagement. The targeted companies are equity holdings and span across a number or sectors including healthcare, retail and utilities. The purpose of this engagement is to understand impending cyber risks faced by the targeted sectors, and to discuss the extent to which the companies' cybersecurity strategies managed this risk. Through the interactions of the group to date, we are establishing a baseline for best practice and disclosure, and are identifying information gaps to agree next steps and areas for improvement.

The findings have also allowed the investor group to engage more effectively with other companies on the topic through to 2021, as we envision cybersecurity to present an ongoing threat to society and our economy if it is left unmanaged.

## Case-study: Paris Aligned Accounts

USS is amongst a group of investors that has written to 36 of Europe's largest companies through the Institutional Investors Group on Climate Change (IIGCC) to call on them to reflect properly the implications of global commitments to limit temperature increases to well below 2°C, and ideally to 1.5°C (the Paris Agreement) in their financial statements. Companies receiving the letter were selected based to their exposure to decarbonisation risks, as economies transition away from fossil fuels in line with the Paris Agreement. This includes the largest listed European firms by revenue across the energy, transport and materials sectors. A few examples include, Anglo American, BASF, BMW, BP, Deutsche Lufthansa, EDF and Shell.

The 37 investor signatories to the letter collectively represent $9.3trn in assets under management or advice, underscoring the growing significance of the issue for the sector. This included global investors such as J.P. Morgan, Aegon, Northern Trust, and the Church of England Pension Board, with the letter authored by Sarasin & Partners.



## Case-study: Collaborative engagement with UK food producers on Covid response

In the second half of 2020, we participated in a collaborative engagement looking to initiate a dialogue to understand how the Hilton Food Group and Associated British Foods respond to the Covid crisis and employee wellbeing. This engagement was led by Aviva and included active participation from likeminded asset managers and owners representing over £1 trillion.

As noted in proposals from industry representatives that key workers in the sector should be on the list of early recipients for Covid vaccine, the nature of food processing means that workers face extra challenges and a higher risk of contracting Covid-19. Given this, the engagement group initiated a dialogue to understand, amongst other things, current guidelines within factories to make facilities Covid secure and to whether full-pay is allowed to anyone taking Covid-related absence (irrespective of contractual status).

## Our Collaborative Partnerships and Affiliations

ACGA

Council of Institutional Investors® The voice of corporate governance

ICGN International Corporate Governance Network

IPF Investment Property Forum

IIGCC The Institutional Investors Group on Climate Change

PENSIONS AND LIFETIME SAVINGS ASSOCIATION

PRI Principles for Responsible Investment

Transition Pathway Initiative

**For more on collaboration, in our description of how we implement Principle 7, we explain how we select issues for engagement and in Principles 7 and 11 we discuss how we select strategies for engagement (including escalation strategies where appropriate).**

# **Principle 11:** Escalation

### Principle 11

Signatories, where necessary, escalate stewardship activities to influence issuers.

## A preference for proactivity and constructive discussion

We prefer to engage proactively and constructively with companies. This may be in writing, or in individual or collective meetings. We generally expect companies to advise us when there are material changes and issues which impact long-term shareholders, such as strategy, capital structure, sustainability, and governance. We strongly encourage companies to inform us early about issues relevant to the business so that we maximise the time available to discuss and, as appropriate, resolve the issue.

USS's default position is to be supportive of the board and management. We assume discretionary changes will be applied to board and executive arrangements when necessary on the basis that the rationale will be disclosed to investors. When appropriate and where we have concerns, we may put forward proposals to companies for the board's consideration. In order to establish, develop and maintain relationships we endeavour to have a regular and consistent process of engagement with companies.

## Escalating should the need arise

> *We generally find that constructive, proactive dialogue enables most issues to be resolved and appropriate strategies or actions to be agreed.*

However, we recognise that this is not always the case. In certain situations, it is because there are legitimate differences of opinion about the correct course of action. In such situations, and if we are satisfied that management has appropriately listened to and reflected on our concerns, we will support management although we may continue to engage with management on the issue or to monitor performance on the issue in question.

> *If boards do not respond constructively to our engagement, then the fund will consider whether to escalate its action, for example, by using the full range of stewardship tools available.*

If we decide to escalate, we will use the strategies or approaches that are most likely to deliver the outcomes that we desire or, at least, clearly signal our views to management on the issue in question. In broad terms, we have a variety of escalation strategies that we can and have deployed. These – depending of course on the specific assets and asset class – include:

- Writing to the company to highlight our concerns
- Voting against appropriate proposals at shareholder meetings (see further Principle 12 where we discuss our approach to voting)
- Meeting with management specifically to discuss concerns
- Meeting with the Chairman, senior independent director, or independent directors
- Expressing concern through the company's advisers
- Collaborating with other investors regarding our concerns, subject to applicable regulations

- Speaking to the market regulators regarding our concerns
- Making a public statement at the company's meeting
- Releasing a press statement, either singly or jointly with other investors relating to the issue
- Submitting resolutions at a shareholder meeting
- Requisitioning a General Meeting
- Other legal remedies, e.g. we were the lead plaintiff in the successful Petronas class action following significant corruption at the company leading to loss of shareholder value (see related news release)
- In extremis, selling our shares in the company

## Setting clear expectations for managers

For our investment managers, we define our expectations of stewardship in mandates. As noted in Principle 8, we monitor their stewardship performance as a standard part of our monitoring processes. We challenge them if we feel that they are not delivering on the stewardship commitments they have made to us (e.g. the issues they are active on, the resources they are devoting to stewardship or the intensity of their stewardship efforts). If we are concerned about an investment manager's performance, and if the investment manager has not improved following feedback from us, we have a range of options.

These can include:

- Notifying the external manager about their placement on a watch list
- Engaging the external manager's board or investment committee
- Reducing our exposure to the external manager until any non-conformances have been rectified
- Terminating the contract with the external manager (or not reappointing them) if failings persist over a period of time

# **Principle 12:** Exercising rights and responsibilities

**Principle 12**

Signatories actively exercise their rights and responsibilities.

## Exercising our voting rights: A global perspective

Having the right to vote on decisions made by the boards of the companies in which we invest is one of the most effective tools we have for holding them to account, encouraging good governance and driving improvements. We therefore regard exercising our right to vote as fundamental to our role as investment stewards. This means that as part of the scheme's commitment to being a long-term, active and responsible shareowner, our base intention is to vote globally on all the companies in which we invest.

Given our commitment to voting our shares in all markets, we developed the scheme's proprietary **voting policy and principles** in-house, to best reflect the scheme's needs. Within them, we outline the scheme's expectations from investee companies, reflecting international best practice- including the UK Corporate Governance Code- and we set out these expectations in our Ten Stewardship Principles. We also apply these expectations to companies listed outside the UK and to companies quoted off the main UK market, although we tailor them to take account of local market standards and best practice.

**Abstaining or voting against management** are not decisions we take lightly. USS's default position is to be supportive of the board and management. That said, we have a robust approach to applying our voting policy and do consistently vote against management where we feel it is not serving our best interests as a shareholder.

## Our voting process

USSIM uses a number of proxy advisory firms to provide a summary of the proxy information released to the market. We use the information provided by these proxy advisory firms alongside other sources, including outcomes from engagement meetings, discussions with our industry peers, and our portfolio managers' perspectives to reach a final voting decision. Individual votes and recommendations aim to improve the overall corporate governance of the company. Our voting decisions are, therefore, tailored to the circumstances of the company and focused on the overall improvement of the company's corporate governance and management of environmental and social issues. Individual vote decisions for priority holdings[3] (see Principle 7) are reviewed and confirmed by the in-house responsible investment team, working closely with USSIM's portfolio managers.

## Our Ten Stewardship Principles

The following principles underpin the voting decisions that are taken in markets in which USS invests. Further information on how we apply these principles is available on our website.

1. Long-term value creation
2. Environmental and social issues
3. Capital governance
4. Shareholder rights
5. Equal treatment of shareholders
6. Accountability to shareholders
7. Effective leadership and oversight
8. Alignment of interests
9. Checks and balances
10. Transparency

[3] prioritisation for voting and engagement activities is based on the following criteria, for further detail see Principle 7:
- The size of our holdings in the entity or the size of the asset, portfolio company and/or property
- The home market of the asset, portfolio company and/or property
- The materiality of ESG factors and their effect on financial and/or operational performance
- Their ESG scores, and their rankings in specific benchmarks, in particular the Transition Pathway Initiative and the Workforce Disclosure Initiative
- Specific ESG factors with systemic influence (e.g. climate or human rights)
- The adequacy of public disclosure on ESG factors/performance
- Bribery and corruption-related issues

Non-priority stocks, for example stocks held in our quant funds, are voted by a dedicated voting analyst at our main proxy research and platform provider in accordance with the USS voting policy.

When we vote against management, we will usually write to the company to explain our concerns. We see this as an important way of providing feedback and encouraging change – that is, it's a form of engagement. We may escalate the vote by voting against additional relevant resolutions or against individual directors if concerns raised in previous years have not been addressed in the current year.

In accordance with best practice, we publish a list of our **global equity holdings** and our **voting records**, and **have done so for almost 20 years**. Where we have voted against management or abstained on a resolution we include a brief comment to explain why. As with writing letters, we see this as an important way of providing feedback and encouraging change.

For our external investment managers, we have a section dedicated to voting in our responsible investment Due Diligence Questionnaire (see Principle 8). We seek to understand the voting chain and to document this within new IMAs to ensure clarity about each party's responsibilities. Reviewing managers' voting policy, voting records and decisions on specific cases is a standard part of our monitoring process. We also review the vote case-studies. Where there are inconsistencies with our voting decisions, we seek to understand these inconsistencies as part of our regular discussions with the managers.

## Stock lending

USS has an active **stock lending** programme. To ensure that the scheme is able to vote all its shares at important meetings or where USS is a significant shareholder, USS has worked with service providers to establish procedures to restrict lending for certain stocks and recall shares in advance of shareholder votes. Where we hold 3% or more of the issued share capital of a company, stock is recalled systematically. In other circumstances we monitor the meetings and proportion of stock on loan and will restrict and/or recall lent stock on a case-by-case basis, e.g. in the event of a contentious vote or in relation to engagement activities, further to discussion with the portfolio manager. We will also always hold at least one share in a stock to ensure that we get notification of impending voting deadlines.

## Strengthening our voting processes

It is important that the votes we cast are accurately and efficiently transmitted to issuers. USS seeks to ensure the voting chain in place for the fund's assets are well understood. We have worked with our service providers to reduce the number of intermediaries in the voting chain wherever possible. Further, we have encouraged our service providers to review the opportunities to track USS's proxy votes and to work with their third parties to improve accountability in the vote chain. With reference to specific requests for vote confirmation, on occasion, we may contact the issuer, registrar, voting platform and/or USS's custodian for confirmation our proxy vote was sent/received through the various parties of a voting chain. This will generally be where we have a very important vote, or queries or concerns regarding USS's votes being reported at the meeting. The level of assurance we are able to obtain will be influenced by the specific vote chain in question.

## Ensuring our votes are registered

During 2020, we identified issues with the reception of our votes at one UK company annual general meeting. Whilst not altering the outcome of any resolution, the issue resulted in proxy votes in support of each resolution not being counted. Following our investigations directly with the company and our service provider, it was discovered that a fault in the registrar's processes prevented USS's AGM vote to be registered in time. Based on the findings, the registrar implemented additional control measures in order to prevent such issues from occurring again in the future.

## Updating our Voting Policy

The USSL board reviews its voting policy annually. In 2020, the annual review of our UK voting policy resulted in two significant changes:

- Climate disclosure: USS already has a process for voting against companies with poor ESG disclosure. We augmented this integrating data from the TPI into voting decisions. The TPI ranks companies on management quality in relation to its greenhouse gas emissions and of risks and opportunities related to the low-carbon transition. The aim of our voting will be to encourage companies to provide climate related data to investors and ensures that we catch the high emitters who are doing the least disclosure of climate data.
- Board diversity: USS changed its core voting policy from voting against companies where there is not at least one woman on the board (or where there is no strategy to improve board diversity) to one where we expect 33% of board members to be female.

## Strengthening our approach to voting on environmental and social issues

We have developed a more systematic way of integrating environmental and social issues into our voting process. This approach is based on company disclosure, the premise being that if investors are to integrate environmental and social considerations into their investment decision making processes, it is essential that companies disclose the requisite information about their performance on these important issues.

We have identified the following as key indicators that we expect companies to report:

- Quality and Timeliness of reporting on corporate social responsibility (CSR) issues
- Carbon Emissions
- Fatalities
- Ethical Business Practices: human rights, child labour and modern slavery

*"We hope that by making it clear these are important issues for investors, these actions will drive improved transparency on climate change and other ESG issues by companies. We also hope that this approach will facilitate a more integrated approach to corporate reporting, and the integration of environmental and social considerations into remuneration policies."*

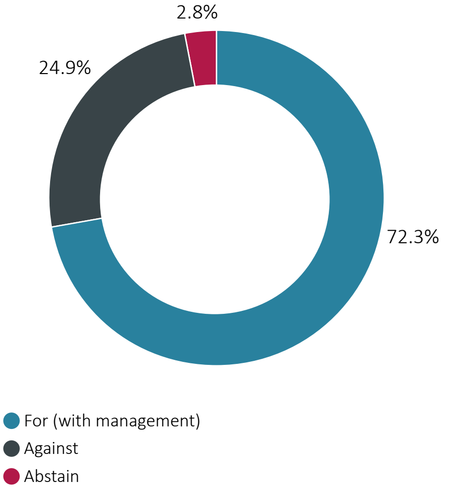
## Our Voting Activity 2020

In the table, below, we present our voting statistics for the period April 2020 to March 2021.

| Voting Statistics April 2020 - March 2021 | Response |
|---|---|
| How many companies did USS vote at? | 950 |
| How many meetings did USS vote at? | 1,066 |
| How many resolutions did USS vote on? | 13,553 |
| Of the resolutions on which USS voted, what percentage did we vote with management? | 72.3% |
| Of the resolutions on which USS voted, what percentage did we vote against management? | 24.9% |
| What percentage of resolutions, for which USS were eligible to vote, did we abstain from? | 2.8% |
| In what percentage of meetings, for which USS were eligible to attend, did we vote at least once against management? | 73.8% |

### USS Global Votes on Resolutions

**April 2020 - March 2021**



## Significant Votes (Outcomes)

### Case-study: Royal Dutch Shell plc.

| Date of Vote | Summary of resolution | Vote | Rationale for the voting decision | Outcome of the vote | Next steps |
|---|---|---|---|---|---|
| 19/05/2020 | AGM resolution 21- Request the Company to set and publish targets that are aligned with the goal of the Paris Climate Agreement to limit global warming to well below 2°C above pre-industrial levels. | Against | After careful consideration, we did not believe the proponent's resolution was in the best interests of shareholders. We voted against this shareholder resolution in light of the additional commitments Royal Dutch Shell had been making to address climate change and the Company's delivery on several commitments made between Royal Dutch Shell (RDS) and the Climate Action 100+ investors. USS has been actively participating in a collaborative engagement with RDS as part of the CA 100+ initiative for a number of years. To recap, in 2018 the company committed to reducing its carbon emissions by 50% by 20503. The critical point was this also covered the company's so-called Scope 3 emissions, i.e. those associated with the end use of its products (oil and gas) rather than the more traditional Scope 1 and 2 emissions which focus on the company's own generation of emissions. The CA100+ engagement continued and in April 2020, Shell committed to taking significant additional action on climate change including a commitment to achieving net zero emissions by 2050 or sooner (covering scope one, two and three emissions). This brings the company into alignment with the Paris Agreement and provides some confidence in the long-term sustainability of the business. | For 14%<br>Abstain 4%<br>Against 82% | About 4% of shareholders who voted abstained while about 82% voted against the resolution. USSIM continues to engage with the company and monitor progress. The ambitions set in April 2020 have been accelerated by new goals announced in February 2021 committing the company to reducing its net carbon Intensity (using its Net Carbon Footprint metric) by 100% by 2050 (increased from around 65% as stated in 2020), and by around 45% by 2035 (increased from around 30%). Further, the company committed to work with its customers to achieve the 100% (it should be recognised that RDS's direct emissions make up only 15% of this total). Starting at the 2021 AGM, RDS, the first company in the sector to do so, also committed to submitting an Energy Transition Plan for an advisory vote to shareholders and to update that plan every three years and seek an advisory vote on the progress made each year. |

## Significant Votes (Outcomes)

### Case-study: Mizuho Financial Group Inc.

| Date of Vote | Summary of resolution | Vote | Rationale for the voting decision | Outcome of the vote | Next steps |
|---|---|---|---|---|---|
| 25/06/2020 | AGM resolution 5 - Amend Articles to disclose plan outlining Company's business strategy to align investments with goals of Paris Agreement | For | USS participated in a collaborative engagement facilitated by Asia Research and Engagement which targeted Japanese banks and their role in financing climate change and in particular coal. The collaborative engagement group sought to improve integration of climate change risks and opportunities into strategy for banks across the region. As part of the collaborative engagement USS voted in favour of this shareholder resolution at the AGM of Mizuho Financial Group requesting the Company to disclose climate risks and publish a plan to ensure its investments are aligned with the Paris Agreement. As part of our regular AGM engagement programme, USS wrote to the company explaining that we supported the resolution as we would welcome enhanced transparency and disclosure on the specific processes and strategies, including targets and metrics, employed by the bank to align the business and investments with the goals of the Paris Climate Agreement. We believe greater disclosure would help investors understand the risks arising out of this issue. | For 35%<br>Against 65% | The resolution gained support from 35% of investors who voted and was the first resolution of this type in Japan. USSIM continues to engage with the company on its energy transition plans and how climate scenario analysis is integrated into its business strategy. |

## Significant Votes (Outcomes)

### Case-study: Bayer AG

| Date of Vote | Summary of resolution | Vote | Rationale for the voting decision | Outcome of the vote | Next steps |
|---|---|---|---|---|---|
| 28/04/2020 | AGM resolution 2- To approve the actions of the members of the management board; resolution 3- To approve the actions of the members of the supervisory board | Against | Following its acquisition of agribusiness Monsanto, the use of glyphosate in Bayer's Roundup weedkiller product has led to ongoing litigation as well as personal health and environmental impact issues. From the finalisation of the acquisition in May 2018 until July 2019 the Company's share price fell by approximately 45%. In 2020, Bayer set aside billions of Euros to settle the numerous lawsuits it faces by consumers claiming that the Company's glyphosate-based product is carcinogenic. USS continues to question the Company's judgment of legal and reputational risks associated with the Monsanto acquisition. Over the last few years we engaged with the Company to gain a better understanding of the Company's decision-making process and to express our continued disappointment with the Company's handling of the situation. As a result of our analysis, we made the decision to continue to vote against the resolutions asking shareholders to approve the formal discharge of responsibility of the management board (resolution 2) and the supervisory board (resolution 3) for fiscal year 2019. | **Resolution 2**<br>For 85%<br>Abstain 8%<br>Against 7%<br><br>**Resolution 3**<br>For 89%<br>Abstain 5%<br>Against 6% | USSIM continues to engage with the company and monitor progress. While we appreciate that this is only a minor positive step, we welcome the Company's commitment to disclose the number of abstentions received, for which there is currently no legal obligation in Germany. In 2020, about 8% and 5% of shareholders who voted abstained while about 7% and 6% voted against the resolutions to discharge the management board and the supervisory board respectively. We will review our position again in 2021, ahead of the Company's next annual meeting of shareholders. |

# Our responsible investment team

**Robert Campbell**

Robert Campbell re-joined USS in 2020 as a RI Senior Financial Analyst, having previously been an Investment Analyst on our Global Emerging Markets equities team (2019-20). He has worked as a Senior Manager on PwC's Valuations team (2020) and as a Portfolio Manager/ Analyst for Martin Currie Investment Management (2008-2019). He started his career as a financial journalist for EuroWeek (now GlobalCapital), carrying out this role from 2007-2008. He is a CFA charter holder and has an MA (Honours) in Economics from the University of Glasgow.

**Vikki Hoare**

Vikki joined the RI team at USS in March 2021 to focus on proxy voting, integration and stewardship in the scheme's public market portfolios. Vikki has worked in Responsible Investment for over ten years. Firstly, as an ESG Officer at a boutique long-only equity asset manager where she set up and ran their Environmental, Social, Governance approach and more recently at GAM Holdings as a Responsible Investment Analyst in their Governance and RI team. She focused on ESG integration and analysis, proxy voting and ESG engagement across asset classes with a particular focus on UK, Emerging Markets and Global equity funds.

**Helen Hopkins**

Helen Hopkins is Senior RI Advisor at USS Investment Management. Helen joined USS in 2007 and her current remit covers ESG due diligence and monitoring of the Scheme's external fund managers and real assets across public and private markets. Helen previously focused on stewardship and proxy voting for USS's internally managed equity portfolios. Helen has worked in the RI sector for over 20 years, commencing her career in RI at UKSIF in 1999, where she helped launch the Institutional Investors Group on Climate Change (IIGCC), Social Investment Taskforce and Eurosif amongst other initiatives.

**Philipp Kloucek**

Philipp Kloucek joined USS as a RI Analyst in February 2019 to focus on the integration and stewardship of Environmental, Social and Governance (ESG) issues in the scheme's public market portfolios. Prior to joining USS, he worked as an ESG Consultant for Institutional Shareholder Services (2016 - 2019) and as an ESG analyst for V.E (2010- 2016). Philipp holds an MSc in Environmental Engineering from Imperial College London and the CFA UK level 4 Certificate in Investment Management (IMC). He currently sits on the UKSIF Analyst Committee as well as Eumedion's Investment Committee.

**David Russell**

David heads the RI Team of USS Investment Management. With 20 years' experience in RI, David is a former Board member of the PRI Association and an advisor to the Board of the Institutional Investors Group on Climate Change. He is also on the Board of the International Centre for Pensions Management, the UK Investment Associations' Sustainability and RI Committee, the PLSA Sustainability Committee, and the FTSE Russell ESG Advisory Committee. He is also a founding member of the Transition Pathway Initiative's Steering Committee. Prior to USS, David has previously worked as an Environmental Manager for a UK retail company, and was for five years a University lecturer in Environmental Management. He has a Masters Degree in Environmental Impact Assessment.

**Edward Salibi**

Edward Salibi joined USS in 2020 as a RI Analyst. Ed supports the teams' activities associated with ESG due diligence and monitoring of the Scheme's external fund managers and real assets. Previously he worked for AXA IM as an Impact Research Analyst. He is a graduate of the University of Nottingham with a BA (Honours) in Politics and International Relations.

*We are in the process of appointing a Senior Analyst, Stewardship.*

USS

*For members, for the future.*

For further information on responsible investment and stewardship at USS, please contact:

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