Investment Committee consultation – some questions answered

What is the SEC Unit Trust Pool?
The SEC Unit Trust Pool is an investment vehicle operated by the Scottish Episcopal Church to facilitate the pooling and management of investments held by the General Synod, Dioceses and congregations of the church. It provides the opportunity for dioceses and congregations to benefit from professional management of their investments at lower fees than they are likely to otherwise achieve. All of the General Synod's investments are held in the UTP. Currently all dioceses and about 190 congregations also invest in the UTP.

How is the SEC Unit Trust Pool managed?
Whilst the Investment Committee comprises professionals with a wide range of experience of the investment management industry, it would not be possible for it to manage the SEC's funds directly. The management of the UTP is based on a statement of investment objectives agreed with the Administration Board and Standing Committee. The Investment Committee is responsible for appointing and overseeing a Fund Manager. The Fund Manager is then responsible for recommending options for and implementing an investment strategy that is likely to achieve the SEC's investment objectives. The Committee meets with the Fund Managers (currently Baillie Gifford) to review the fund's performance at least twice a year. It keeps investment strategy under continuous review and, working with the fund manager, makes appropriate changes to reflect changing market conditions. The Committee values this collaborative relationship with Baillie Gifford. It believes many other fund managers would be less likely to work in this manner given the relatively small size of the UTP portfolio.

How big is the SEC Unit Trust Pool?
As at 31 October 2018 the total value of the UTP was £74.7m. Approximately two-thirds relates to the General Synod's investments – the balance being diocesan and congregational investments. (Whilst this may appear a large sum it is relatively small compared with many of the investment portfolios fund managers will manage on behalf on institutional clients.)

How much income does the Unit Trust Pool produce?
In 2018 distributions totalling £2.2m were paid by the Unit Trust Pool. The General Synod received about £1.45m with dioceses and congregations receiving a total of £750,000.

How dependent is the SEC on the income produced by the Unit Trust Pool? What is the income used for?
The extent to which dioceses and congregations rely on income produced by their UTP investments will vary. For some it will form a significant part of their income making a contribution to general running costs (stipend, maintenance of church buildings etc) whilst for others it may be a relatively small income restricted for a specific purpose.

The General Synod is very dependent on income derived from its UTP holdings. In 2017 UTP distributions accounted for approximately 60% of its income. Some of the income is used for specific restricted purposes such as work with overseas mission partners, supporting retired clergy and helping dioceses fund the costs of their bishops. The majority of the income is paid to the General Fund and is therefore a major element in funding a range of provincial activities including the training of clergy and lay readers, the central safeguarding office, running the annual youth camp, engaging with a number of ecumenical and inter-faith partners and organisations, revision and publication of liturgies, promoting the SEC through press and electronic media, and generally supporting the dioceses and congregations of the SEC. Funds are also used to provide financial support to dioceses and congregations for a variety of purposes including assisting in meeting the costs of some stipends and salaries, mission initiatives, costs of curates, buildings maintenance and development.

What are the investment objectives underlying the management of the Unit Trust Pool?
Given the SEC's reliance on income derived from the UTP, the primary investment objective is to generate an income stream that will increase steadily in line with inflation without eroding the value of the underlying investments in the fund. Allied to this is the aim to limit excessive volatility – essentially this means, wherever possible, minimising the risks of loss of fund value and income in periods of economic downturn whilst maximising returns in periods of economic growth.

What happens if the investment objective is not met and income falls?
The impact on dioceses and congregations of a reduction in income would vary according to the extent to which they are dependent on income from the UTP.

Given its dependence on income from the UTP any significant reduction in such income would have an impact on the General Synod's finances. Whilst in the short term the impact could be mitigated by the use of reserves, in the medium to longer term it would be necessary to reduce expenditure or to increase income from other sources. The only other large source of income is quota – it accounted for approximately 31% of total income in 2017. It is clear from the comments made during General Synod 2018 that some congregations are finding it increasingly difficult to pay quota and this contributed to the decision to reject the proposed inflationary increase in quota in favour of a quota 'freeze'. It therefore appears that there may be only limited scope to increase quota to compensate for any reduction in UTP income. In the absence of any other sources of income it therefore appears likely that any significant reduction in UTP income would ultimately result in the need to materially reduce expenditure in some way.

What concerns does the Investment Committee have and how has it addressed them?
The Committee has been concerned that the lack of diversification of asset classes in the UTP portfolio could result in an increased likelihood of significant volatility in both income and capital values. Whilst it acknowledges that the UTP fund managers, Baillie Gifford, have achieved consistently good results to date with the current portfolio structure, it is concerned that the economic outlook will change in the future and believes that a move to a more diversified portfolio will mitigate these risks and so has explored a number of different options. Over the last five years the Committee has considered strategies offered by other fund managers, and the possibility of introducing other asset classes such as property into the Baillie Gifford portfolio, but until recently had not identified an alternative way of managing the fund that would significantly reduce the risk of volatility, without an adverse effect on fees.

A new development in 2018 was the introduction of a Multi Asset Income (MAI) fund by Baillie Gifford. MAI is expected to provide an income yield that will meet the UTP distribution objective, but also sources that income from a variety of asset classes hitherto unavailable to the UTP such as infrastructure and property, and at an attractive management fee. The diversification offered by MAI will help to keep volatility low and the sustainability of the distribution more certain. The Investment Committee met with Baillie Gifford three times to discuss the new fund and the possibility of investing in it. The Committee was unanimous in its decision to invest in MAI and agreed to transfer part of the portfolio to it when it was launched in August. As outlined below the Committee also wishes to increase the investment in the new MAI fund by transferring more of the existing portfolio to it.

How is the Unit Trust Pool currently invested?
There are currently three elements to the Unit Trust Pool. Most of the fund is invested in pooled funds managed by Baillie Gifford. The consequence of investing in pooled funds is that we do not directly own any of the assets underlying the fund – we own units in the fund managed by Baillie Gifford. We have no control over which equities, bonds and other assets are in the fund. Part of the Unit Trust Pool is invested in a segregated fund in which we do directly own the equities. Whilst the decision on which equities to hold remains with Baillie Gifford we instruct them regarding certain prohibited restricted categories in which, for ethical reasons, they cannot invest into on our behalf. The current interim mix of funds is:

Multi Asset Income	35%	pooled multi asset fund
Long Term Global Growth	35%	pooled equity fund
Global Income Growth	30%	segregated equity fund

What change is being proposed – and why?
The Investment Committee is keen to have greater flexibility to implement appropriate asset allocations and to use appropriate pooled funds to increase the likelihood of the investment objective being achieved and to control costs. The Committee recognises that the strategies required to meet the investment objective will change over time. The changes made in the last year were largely designed to address concerns regarding the previous investment in corporate bonds and are considered to be an interim stage in a broader revision of investment strategy. The Committee wishes to increase the diversification of the portfolio with a view to further limiting volatility and reducing the likelihood of any reduction in income from the UTP. It wishes to reduce its exposure to income producing equities whilst retaining an interest in growth generating equities to produce a more balanced portfolio. The Committee therefore proposes to sell the segregated Global Income Growth fund, reduce the holding in the Long Term Global Growth Fund and increase the holding in the new Multi Asset Income fund to achieve the following allocation:

Multi Asset Income	70%	pooled fund
Long Term Global Growth	30%	pooled equity fund

What is current Ethical Investment Policy?
The Ethical Investment Policy adopted by General Synod in 2013 is reproduced in full at the end of this note. The policy prohibits direct (but not indirect) investment by the Unit Trust Pool in companies in which in excess of 15% of turnover is derived from tobacco, armaments, gambling and pornography. General Synod 2017 added to these companies deriving over 10% of their revenues from the extraction of thermal coal or tar sands. The policy also encourages investment in companies with good governance and environmental practices and recognises some dependence on the fund managers' active engagement with company management in meeting this objective.

How does the proposed change impact on the Ethical Investment Policy?
It is only possible to apply the list of excluded categories of investments detailed in the ethical investment policy to investments directly held by the UTP. For some years it has therefore applied to approximately a third of the UTP - specifically the assets held in the Global Income Growth fund. The policy cannot cover investments held in pooled funds. The move to being 100% invested in pooled funds (i.e. indirectly held assets) would therefore effectively render the UTP's list of prohibited categories of investment inoperable.

Could we continue with current arrangement and apply the Ethical Investment Policy to part of the fund?
Yes. It would be possible to continue to hold part of the UTP in a segregated fund and apply the ethical investment policy to it as is done at present. The Investment Committee

understands that some may wish to pursue such an option. For the reasons outlined above the Committee is however of the view that from a strictly investment perspective, that that is not the best option to pursue at this time.

Could we move all funds from pooled funds to a portfolio managed on our behalf fully consistent with our Ethical Investment Policy?

Whilst it would be possible to move all funds to a segregated fund managed in accordance with our ethical investment policy this would result in reduced diversification and increased risk. A portfolio invested solely in equities would be more volatile, and the Committee considers that an income stream derived solely from equities would be less dependable than that from the suggested approach. The impact of management fees is also an issue to consider. The fees charged by fund managers will vary depending on the administrative costs of the fund. For this reason pooled funds generally attract lower management fees than segregated funds because the costs are shared. The extra administration for a fund manager in running a diversified portfolio with a bespoke ethical investment policy would be likely to result in higher fees. Fees are calculated as a percentage of the value of the fund and therefore even an apparently modest difference in fee levels can have a significant impact on the level of distribution. (For example, a 0.3% increase in fees reduces the amount available for distribution by 0.3% - roughly equivalent to a 10% reduction in the level of distribution.) Given the relatively small size of the UTP portfolio it is likely to be more difficult to gain the desired level of diversification in a segregated fund thereby increasing the risk of greater volatility in the fund's income.

Do Baillie Gifford provide ethical funds that we could use?

The demand for ethically screened pooled funds is increasing. Baillie Gifford has introduced a small number of such funds in the last few years and is likely to develop others with a variety of investment objectives and ethical policies. The Investment Committee has considered investing in such funds but has not yet identified any that would be consistent either with the desired increased diversification of underlying investments or to provide the growth element of the UTP. We understand that Baillie Gifford will consider the possibility of introducing an ethically screened version of its Multi Asset Income fund which would be consistent with current objectives and therefore of interest to the Investment Committee.

Would the Investment Committee consider investing in any of the other ethical pooled funds in the future?

The Investment Committee recognises the importance of ethical investment and would favour the use of ethical pooled fund if they were consistent with meeting the investment objective. It would therefore consider using Baillie Gifford's other ethical funds if it thought it was appropriate to do so. The scope for investing in such funds would be increased if there was no longer a requirement to retain a segregated fund specifically for ethical purposes.

What about engagement aspects of the Ethical Investment Policy?

Through its membership of the Church Investors Group (CIG) and The Institutional Investors Group on Climate Change (IIGCC) the SEC is able to work with other likeminded investors in engaging with a range of industries and companies in seeking to influence their approaches to a variety of ethical and social issues and their impact on business practices. Members of both the Investment Committee and the Church in Society Committee have attended meetings of the Church Investors Group and have found them to be a useful forum in which to engage with others on ethical investment issues. The influence of the CIG cannot be underestimated. Through corporate engagement and shareholder resolutions at AGMs, they have been pivotal in improving the governance of a number of major corporations. The proposed change in investment strategy would have no impact on our membership of CIG and IIGCC – the SEC's voice would continue to be heard.

More information regarding CIG can be found at: https://churchinvestorsgroup.org.uk/

What is the Fund Manager's approach to ethical investment in relation to their pooled funds?
Like most fund managers, Baillie Gifford have an Environmental, Social and Governance team which influences the decisions made by its investment managers.

Environmental, social and governance (ESG) refers to the three central factors in measuring the sustainability and ethical impact of an investment in a company or business. These criteria help to better determine the future financial performance of companies and therefore influence an investment manager's view of specific investment opportunities. This approach, increasingly adopted by fund managers, seeks to set investment decisions in a wider context than a list of prohibited of types of investment such as that detailed in the SEC's ethical investment policy. Whilst the ESG approach may result in the exclusion of similar types of investments there will inevitably be occasions when investments are held in pooled funds that would be excluded by our ethical policy. (For example there is currently a small holding in British American Tobacco plc in the Multi Asset Income fund. The holding represents about 0.4% of the value of the total MAI fund)

Baillie Gifford are also signatories to both the UK Stewardship Code and the UN Principles for Responsible Investment.

Does the SEC engage with the Fund Managers on ethical issues?
As part of their regular reporting Baillie Gifford provide an update on their specific engagement with company management. In recent years there has been an annual meeting of the Investment Committee and representatives of the General Synod's Church in Society Committee with members of Baillie Gifford's ESG team. Representatives of the Church in Society Committee have also been able to meet directly with members of the ESG team. These discussions with the ESG team have been useful opportunities to gain a greater understanding of their approach and for the SEC to emphasise its desire for an appropriate ethical pooled fund. Indeed CIG encourages asset owners to influence fund managers so that they in turn develop more active ESG policies. (Given the relatively small size of the UTP portfolio it's unlikely that other fund managers of this size and reputation would be willing to engage with us to such an extent on ESG issues.)

What about changing the fund manager?
A change in fund manager is unlikely to significantly change the underlying issue. To provide the flexibility and diversification it considers to be necessary, the Investment Committee favours the increased use of appropriate pooled funds. The Committee has looked at ethical pooled funds offered by other fund managers but has been unable to identify any that meets its desire for increased diversification and reduced volatility. As a matter of course the Committee undertakes a review of fund managers on a regular basis. It is of the view that, given its good results with the previous portfolio structure, the good working relationship, the possibility of the desired diversification through the new Multi Asset Fund and the lack of suitable ethical funds elsewhere, there is no compelling reason to consider another fund manager at this time.

What are the implications of not adopting the proposed strategy?
As explained above it would be possible to continue to hold part of the UTP in a segregated fund and for it to be subject to the SEC's ethical investment policy, albeit at an increased cost. From an investment perspective this is likely to maintain unwanted exposure to volatility and a greater likelihood of distributions paid by the UTP failing to keep pace with inflation – or

being cut. The Investment Committee appreciates that for some it would perhaps be easier to comment on the proposed change if the options could be set out in clearer financial terms – with projected distributions and capital values being provided for the existing and proposed strategies. Such an approach would effectively place a ‘price’ on retention of the segregated fund with its ethical constraints. Unfortunately, given the number of factors involved it is not possible to produce such an analysis or to be more specific about the financial implications of retaining the status quo rather than adopting the proposed strategy.

ETHICAL INVESTMENT POLICY

The Investment Committee recognises its responsibilities optimising investment returns for the SEC Unit Trust Pool whilst striving to meet reasonable ethical investment expectations.

The Investment Committee aims to invest in companies that will not only successfully develop their business financially in the interests of shareholders, but also

(i) demonstrate responsible employment and good corporate governance practices;
(ii) are conscientious regarding environmental performance and human rights; and
(iii) act with sensitivity to the communities in which they operate.

The Investment Committee has also adopted strict ‘negative’ criteria as a significant element of the Ethical Investment Policy. No direct investment will be made in companies whose main business is in any of the following *restricted categories*:

- Armaments
- Gambling
- Tobacco
- Pornography

It is recognised that many companies will be involved, to some extent, in businesses in these *restricted categories.* Investment in such companies is deemed inappropriate where in excess of 15% of a company’s turnover is derived from businesses in the *restricted categories*.

The Investment Committee will exercise its discretion regarding exclusion from direct investment any company where it has material concerns regarding the ethical acceptability of the company's business model or operational activities.

In achieving these aims the Committee is dependent on its Fund Managers, and in particular the Managers’ active engagement with company management, both directly and via company AGMs, to influence the corporate governance and ethical practices in the companies in which the UTP invests.

Policy approved by General Synod 2013

General Synod 2017 agreed a number of resolutions in respect of Climate Change Action and Fossil Fuel Investments. A further restricted category of investment has therefore been added to those detailed above: no direct investment will be made in companies deriving over 10% of their revenues from the extraction of thermal coal or tar sands. The Ethical Investment Policy will be reviewed in the light of the resolutions passed by General Synod.