APPENDIX B

SUFFOLK PENSION FUND: INVESTMENT IN TOBACCO COMPANIES

OPINION

1. I am instructed to advise Suffolk County Council ("the Council") in its capacity as an administering authority for the purposes of the Local Government Pension Fund. This Opinion confirms advice previously given in consultation, and expands somewhat upon that advice in the light of further information.

2. The full Council recently decided to become a signatory to the Local Government Declaration on Tobacco Control. It passed a motion that it:

   > ". . . asks the Pension Fund Committee, having regard to its fiduciary duty and with the necessary agreement of other employers of the Pension Fund, to replace investments in tobacco with other holdings, which are considered comparable in terms of the balance of risk and return."

3. Pursuant to that resolution, the Pension Fund Committee has arranged for the obtaining of some investment advice, to which I refer further below, about the implications of disinvestment from tobacco interests. My advice has now been sought as to the legality of any such course of action.

4. In March 2014 I wrote an opinion for the Local Government Association, which it has placed in the public domain. It was not directed specifically to the question of tobacco investments, but addressed (amongst other matters) the extent to which an administering authority was entitled to have regard to social and ethical considerations in determining its approach to investment. Those instructing me are familiar with the opinion, and I need not repeat my reasoning here. I concluded that it was legitimate for wider considerations of this nature to be taken into account,

but only where that would not risk causing significant or material financial detriment to the fund.

5. My view of the law remains as set out in my opinion for the LGA. I do not think that it was a view which was out of line with that which most lawyers in the field would already have held, and I note that the Law Commission has subsequently expressed substantial agreement with my approach: see paragraph 4.78 of its paper *Fiduciary Duties of Investment Intermediaries* (HC368, June 2014), adopting the concept of "significant financial detriment". At paragraph 5.56 of the same paper, the Law Commission puts what I think is the same point in a different, and to my mind helpful, way when it says that the aim of trustees must be to achieve the best realistic return over the long-term. An administering authority is not a trustee as such, but it is in a closely analogous position.

6. I would add that I am not aware of any body of informed legal opinion which suggests that it would be legitimate for pension fund trustees, or an LGPS administering authority, to pursue an investment policy which would risk significant financial detriment to the fund, however compelling the trustees or the authority might regard the broader reasons for such a policy as being[1].

7. Against this legal background, what are the facts as the Pension Fund Committee or the Council's officers have ascertained them to be? The Suffolk fund has placed the investment of its assets in the hands of a number of investment managers. All three of the fund's active equity managers have investments in tobacco companies by way of direct shareholdings. There is also indirect investment in tobacco stocks, through the fund's holdings in a number of pooled funds, invested both in equities and in corporate bonds. The direct investments currently amount

[1] I am not considering here the type of case in which all or the vast majority of beneficiaries would have a shared and strongly held view of particular matters, which they would prioritise over their financial interests. Such a case will almost certainly never arise in the LGPS context.

to some £40 million, which represents about 2% of the overall value of the fund, and the indirect investments amount to some £8.9 million. I also note that the LGA has published a report on this issue in September 2012 prepared jointly, for the Pensions Committee of Norfolk County Council, by that authority's officers and Hymans Robertson LLP. This Norfolk report (which the LGA suggests is a useful source pending any further information) indicated that, at the time, tobacco companies had an index weight of 5% in the FTSE All Share index. More recent advice from Hymans Robertson to the Council indicates that in June 2013 the tobacco sector accounted for 4.6% of the FTSE All Share index, and 1.4% of the FTSE All World index.

8. The Council has sought views on the possibility of tobacco disinvestment from each of its active managers, from a fourth investment manager whose mandate is to deliver an absolute return with low volatility and minimum risk to capital, and also from Hymans Robertson, who are the actuaries to the Suffolk fund. The responses indicate that the direct cost of disinvestment would be relatively low (although not entirely negligible). I will also assume for present purposes that any disinvestment decision would admit of being implemented over a reasonably extended period, so avoiding the financial disadvantage which might result from being forced to sell very quickly or at an inopportune moment. I will also leave aside any potential issues there might be as to precisely which companies' stocks and bonds would be covered by a disinvestment policy (e.g. whether it would apply to tobacco distributors or retailers, or to manufacturers of ancillary products), although this is no doubt a matter which would need to be addressed by any disinvestment decision.

9. As I read the responses of the active investment managers, there is a reasonable degree of consensus between them. Unsurprisingly, they do not suggest that it is possible to quantify exactly what the opportunity cost of declining to invest in tobacco would be. However, they all consider that there would be at the least the potential for some material disadvantage

to the pension fund. Alliance Bernstein suggest that it would not be straightforward to find alternative stocks, because tobacco offers an unusual combination of stable earnings and an attractive valuation, and it is likely that disinvesting from tobacco would make it necessary to hold an overweight position in other consumer staples. They indicate that since the inception of the Suffolk portfolio, tobacco has been the UK industry offering the best risk/return ratio. Newton are less explicit about any such disadvantages, but note that tobacco stocks have characteristics that make them attractive to longer-term investors. Blackrock offer the opinion that excluding tobacco stocks would increase the expected risk to the fund (measured by volatility) from a factor of 15.3 to one of 15.6, and reduce expected returns, in terms of a 5 year information ratio, from 0.34 to 0.30[2]. They also suggest that, since its inception, the Suffolk portfolio would have been some £2.7 million worse off if tobacco stocks had been excluded from it. The fourth investment manager, Pyrford International, is of course operating to a different kind of mandate. But it suggests that the removal of tobacco stocks would be detrimental to the return profile of the fund, and that if the Suffolk fund had been invested in the relevant portfolio from its inception[3] (at the level at which it has in fact invested in it), that removal would have left it some £235,000 per annum worse off. Advice received from Hymans Robertson in June 2014 suggested that the performance of the tobacco sector had been strong relative to the performance of the wider market, and that exclusion of tobacco stocks would have made little difference to the risk profile or volatility of the FTSE All Share and All World indices in the period since 2007, but would have depressed the average annual rate of return by about 0.5% (All Share, albeit this falls to 0.3% towards the end of the period) or 0.15% (World Share). I note that the Hymans Robertson advice to Norfolk CC in

[2] I do not claim to have a full understanding of the concepts being employed here, or of the precise significance of the specific figures cited. But I do think that the essential message is clear enough for present purposes, and no doubt the Council's officers will have a better understanding than I do.

[3] The impact since Suffolk's actual participation would be much less, but that appears to be too short a period to be very significant.

2012 was that exclusion of tobacco stocks did have an impact upon the volatility of return. One conclusion of the Norfolk report was that: "Tobacco companies have been strong historic performers but this [is] no guarantee as to future performance. As with most quoted companies, there are divergent views on their ability to continue to offer attractive returns in the future. However if the decision to exclude had been taken ten or twenty years ago this would have been to the financial detriment of the fund . . ."

10. Accordingly, whilst there are (as one would expect) some differences of view and differences of emphasis between those who have expressed opinions, and the position is not static over time, there is a reasonable consistency between what has been said.

11. In my opinion, on the basis of this material, the legal position is not hard to assess. Applying the approach set out in paragraphs 4 and 5 above, and on the basis of present information, I think that it would clearly be unlawful for the Council as administering authority to disinvest from the tobacco sector, however exactly that sector might be defined. The sector is significant, both to the fund, and to the range of available investments as represented in the leading indices. The evidence suggests that the general opinion is that disinvestment would have an impact both upon risk/volatility, and on return. Tobacco stocks have been better than average investment: that may change in the future, but there is no certainty or even probability that that will be the case. Whilst there may be room for argument as to exactly what degree of risk or detriment should be regarded as significant or material for these purposes, I do not see how any reasonable administering authority could conclude here that disinvestment did not risk material financial detriment. An authority seeking the best realistic return over the long term would not give up the ability to invest in the tobacco sector.

12. There is, of course, legitimate room for debate as to whether it would or would not be desirable for the investment of public sector pension schemes to be based upon broader considerations of the public interest. No doubt there are arguments that can be made on either side of that debate. However, this is, in my view, a political argument about whether the law ought to be changed. In the current state of the law, I do not think that disinvestment is a legitimate option for the Council.

13. I have seen references which indicate that some administering authorities have disinvested from tobacco. I have no detailed knowledge of any of those cases, but it appears that at least some of the authorities concerned may have acted on the basis of their opinion that tobacco will be a poor investment in the future (because of the risk of regulatory action or large-scale litigation). That of course would amount to action taken purely on conventional investment grounds, and not on the basis of any wider social or ethical considerations. I do not know what information or advice was acted upon in those cases. I would only comment that it is not a conclusion which the advice so far received by the Council would support, and that it would be a bold local authority which preferred its own judgment to that of expert advisors, or indeed which thought that it had a better informed view of the value of a stock in the light of future risks than did the market generally.

14. It is possible, at any rate in theory, that different or additional factual information might point to a different conclusion. It is certainly open to the Council to seek further information, or informed investment advice, if it considers it appropriate to do so. However, the Council has in my opinion already done at least sufficient to discharge its obligation to take reasonable[4] steps to inform itself properly before coming to a conclusion

[4] The test is reasonableness in the public law sense, i.e. it is a matter for the Council itself (in this instance acting through the Pension Fund Committee) to decide whether it has enough information, provided that its conclusion is a rational one.

not to disinvest, especially bearing in mind that such a decision would simply amount to a continuation of the status quo.

15. I have also been asked about the consultation which would be necessary in connection with a change of the Council's policy, as required to be set out in its statement of investment principles. This may be an academic question if the advice I have given above is accepted, since it would certainly then be difficult for the Council positively to propose any such policy change for consultation. However, the Council could, if it chose, seek views on the issue. Under r.12 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009, the Council would have a statutory obligation, in my view, to consult "such persons as it considers appropriate" before making a material change to its policy, and tobacco disinvestment would be a material change. It would be surprising if the Council did not consult at least with the fund employers, upon whom any financial cost of disinvestment would in effect fall. I think that the Council could lawfully choose not to consult with scheme members or their representatives (although there would certainly be nothing to stop it from doing so), subject at any rate to what its past practice has been about such matters.

<u>CONCLUSIONS</u>

16. The Council could lawfully take a decision about the issue of tobacco disinvestment on the basis of the information already obtained. As that information stands, it would in my view be unlawful for the Pension Fund Committee to adopt a policy of disinvestment.

17. My Instructing Solicitor should not hesitate to contact me if I can assist further.

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THE SUFFOLK PENSION FUND

AND IN THE MATTER OF
INVESTMENT IN TOBACCO
COMPANIES

OPINION

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Ref. MT