2017

The Issue of Climate Change within Investment Portfolios and the Impact on Investment Performance

IS THE LGPS DOING ENOUGH TO ADDRESS CLIMATE CHANGE?

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The Issue of Climate Change within Investment Portfolios and the Impact on Investment Performance

Summary

Climate change is becoming a greater factor in pension fund investment decision making. Recently the LGPS has been accused of not taking sufficient action to ensure that this issue is considered throughout the investment process.

There is evidence that, through a wide range of actions, both direct or indirect, funds are actively considering, reviewing and implementing their individual responses to the issues.

There are considerable headwinds to be faced. These are not insurmountable but need to be understood, reviewed and the implications considered and assessed. Good data remains one of the key challenges and it might be that working to improve the quality and consistency of metrics could be a particularly useful area for engagement in the near term.

Introduction

Climate change and how to address it within investment strategy is becoming an ever bigger issue for those with responsibility for pension funds. Members, those with fiduciary responsibility and contributors/beneficiaries want to see alignment of interests and there are many factors being brought to bear to encourage positive action.

There is a stick propelling funds to act; the Pension Regulator has already stated that funds must address climate risk specifically in their Investment Strategy Statement (ISS) as climate change poses systemic risks that can affect a fund's whole portfolio. There is also a potential carrot at the end of this stick as investment opportunities may encourage funds to address this. Bank of England Governor Mark Carney has stated that 'Financial decarbonisation of our economy is a major opportunity for long-term investors'. If pension funds are genuine long-term investors, then they may be well placed to benefit.

New regulations place clear responsibilities on LGPS Administering Authorities to meet Environmental, Social and Governance (ESG) policy formulation requirements and establish operational arrangement sin order to put their policies into practice. The position is currently developing as Administering Authorities establish pooling arrangements and determine relationships. PIRC has produced two papers recently exploring the responsibilities on Administering Authorities for ESG issues – Pension Funds, Pooling and ESG matters 9 February 2007) and Administering Authorities, Pooling and ESG Matters (May 2017)

How does a fund go about addressing this issue which protects investment returns yet meets expectations on Administering Authorities from many interested stakeholders? What considerations may it want to take into account and are the current murmurings that funds are 'not doing enough' justified?

Potential responses:

There are a number of possible responses, some of which are explored below. These can be undertaken singly or in combination.

Direct

1. Implement planned reduction or exclusion of high carbon investments such as thermal core extractors and tar sand companies.
2. Mandate specific allocations e.g. to renewable/sustainable energy
3. Mandate specific 'low carbon' investments e.g. low carbon index tracking (gaining some traction at the time of writing)
4. Monitor and assess the scale and direction of travel on specific climate change metrics on portfolios with the view of providing meaningful information to influence investment decisions and engagement agenda with asset managers and/or companies in which investments are made

5 . Engagement in order to influence improvements in risk exposure

Indirect

1. Become members of industry forums / initiatives to support engagement

2. Delegate to investment managers the implementation of a robust and measurable climate change response

Direct Responses

1 Implement planned reduction or exclusion of high carbon investments

There have been a number of high profile international funds that have attempted to realign their investments to actively exclude carbon intensive investments. The Norwegian State Reserve Fund has committed to removing all coal-related investments from its portfolio. Likewise in California, all state pension funds have been required by law to sell their investments in companies with more than half their revenues from coal mining.

However, without legal direction or change in legislation, exclusion of stocks or sectors remains a slightly grey area for UK pension funds. There has been considerable debate around whether the responsibility to maximise benefit to the members makes such an approach difficult or even impossible. This seems to have become clearer in recent years.

Goode in his 1993 report stated that:

Trustees are free to avoid certain kinds of prudent investment which they consider the scheme members would regard as objectionable, so long as they make equally advantageous investments elsewhere, and that they are entitled to put funds into investments which they believe the members would regard as desirable, so long as these are proper investments on other grounds. What trustees are not entitled to do is to subordinate the interests of the beneficiaries to ethical or social demands and thereby deprive the beneficiaries of investment or opportunities they would otherwise have enjoyed.

The Law Commission in 2014 went on to say that:

Trustees may also take account of non-financial factors, where they have good reason to think that the scheme members share their views and that the decision does not risk significant financial detriment.

So the issues for a fund choosing an exclusion policy would seem to be twofold – the need to demonstrate that the fund is not being financially damaged and the proof that the scheme members share the view.

The first of these is not straightforward. No timeframe is offered over which to judge the impact of an exclusion policy. Whilst back testing may give some comfort that performance would not seem be impacted, this cannot be proven in practise until long after the decision has been implemented.

The second would seem more easily evidenced, simply by asking the members and stakeholders directly. However, when considered in detail it is clear that to be able to make informed decisions, significant information needs to be provided and consequences understood. Such an approach needs to recognise that any arrangements need to be able to manage further requests for exclusions for such contentious investments as tobacco / arms etc. A critical issue is will disinvestment improve climate change outcomes when compared with trying to influence outcomes with other like-minded investors.

An associated issue is how companies that deal with/ support companies that are on the Climate Change high impact scale are treated. If their turnover with the company is greater than say 60%, is it added to the exclusion list?

This approach is in early stages with a small number of LGPS funds. South Yorkshire are divesting from coal and tar sands companies, and Waltham Forest have made a commitment to start to divest from certain fossil fuels over a 5 year period.

2 Mandate specific allocations e.g. to renewable energy

Another possible approach would be to incorporate specific allocations to low carbon investments. Some funds including Greater Manchester, Strathclyde, Lancashire and Oxfordshire have already invested, and others are looking to invest, in projects such as renewable energy as part of their infrastructure allocations.

To date investments of this type have not been easy particularly in funds acquiring the necessary expertise in order to undertake adequate due diligence on specific investments and benchmark them against funding objectives. Future returns have been difficult to predict and model. Government policy (both domestically and overseas) in respect of climate change issues has not been consistent and there remain many issues around such details as access to the grid and the infrastructure around this.

Current pooling initiatives must surely allow more funds the opportunity to go down this route as scale is so important for renewables to be a viable investable proposition

3 Mandate specific ‘low carbon’ investments e.g. low carbon index tracking

The index providers have come up with a number of 'low carbon' indices which seek to provide returns consistent with the major market indices but with a lower carbon footprint. There are currently two approaches – the MSCI indices do this by re-weighting the index to reduce exposure to carbon emissions (achieved mostly through reducing oil & gas). LGIM, through their Future World fund, incorporates a 'climate tilt' to reduce exposure to companies with worse-than-average carbon emissions and fossil fuel assets, and increases exposure to companies that generate revenue from low-carbon opportunities. The FTSE Green Revenues index series also seeks to maximise exposure to companies that will benefit from the low carbon economy.

These approaches are not without difficulties. The MSCI index only tracks direct emissions (from data that may be incomplete and inconsistent) so omits the effect of indirect emissions (such as automobiles or technology). The FTSE index has only a back tested track record and would seem therefore difficult for funds to commit to at this stage.

A number of LGPS funds are looking at possibly using these indices whilst Haringey has already shifted part of its equity allocation to the MSCI Low Carbon Target index.

4 Monitor and assess the scale and direction of travel on specific climate change metrics on portfolios

Since 2013, UK listed companies in the UK have had to disclose their annual greenhouse gas (GHG) emissions in the directors' report and in the US, the SEC requires companies to disclose material financial information about their exposure to climate risks. There is however no current requirement for UK investors to monitor or disclose climate change metrics.

In 2014 a number of international funds and managers signed what is known as 'The Montreal Carbon Pledge' committing to measure and publicly disclose the carbon footprint of their investment portfolios on an annual basis. Currently the Environment Agency Fund is the only LGPS fund to have signed up to this initiative however other funds within the LGPS such as Strathclyde are using climate change metrics to better understand this element of their portfolios.

Carbon auditing provides a measure of carbon emissions which can be linked to the company's revenue to provide a measure of carbon intensity. A fund is provided a weighted measure of their carbon footprint together with that of their benchmark index calculated in the same way. Measurement methodology will vary by provider but basically will follow a process where greenhouse gas emissions will be measured for each company in the portfolio. They are then compared to the company revenue to create a comparable measure of carbon intensity. The intensity is then weighted by the portfolio's holding to create a measure that can be compared directly against a market index measured in the same way.

Funds can obtain metrics on their investment portfolios from a number of sources but, as with so much relating to this field, these methodologies are still in a relatively early stage. There are issues around the incomplete nature of the information available for such metrics and the skew within the data provided towards larger and developed market companies. The metrics do not incorporate indirect emissions, the data for which is currently still relatively patchy and inconsistent.

Once reliable and consistent data can be obtained the question arises around how effectively it can be used. Clearly it would be helpful for funds to understand better the climate change risks in their portfolios and be able to fully consider how to mitigate them.

Better data may be available soon, as a result of the FSB Taskforce on Climate Related Financial Disclosure who in July 2017 released its final recommendations. The Task Force has developed a voluntary framework for companies to disclose climate related information in their financial filings.

The Task Force's recommendations are structured around four thematic areas that represent core elements of how companies operate: governance, strategy, risk management, and metrics and targets. These areas reflect the type of information investors expressed that they need to make better, more informed decisions. The Task Force also developed guidance to assist companies in developing their disclosures to meet those needs. They set out the disclosures that a wide range of users and preparers of financial filings have said are essential to understanding a company's climate related risks and opportunities.

Widespread adoption will provide investors, banks and insurers with that information, helping minimise the risk that market adjustments to climate change will be incomplete, late and potentially destabilising.

Indirect

1 Become members of industry forums / initiatives to support engagement

LAPFF

The Local Authority Pension Fund Forum (LAPFF) is a collaborative shareholder engagement group which comprises 72 LGPS funds. LAPFF works to press companies for alignment of their business models with a 1.5 to 2 ^{0}C scenario and an orderly low carbon transition. It also partners with the Investor Network on Climate Risk (INCR) who leverage the collective power of its members to promote improved investment practices, policies, disclosure and corporate governance practices on the business risks and opportunities posed by climate change.

TPI

The Transition Pathway Initiative (TPI) was set up to enable asset owners to make informed judgements about how companies with the biggest impact on climate change are adapting their business models to prepare for the transition to a low carbon economy. The funds supporting the TPI have committed to use the results in a number of different ways, including informing their investment decision-making, engagement with companies, dialogues with fund managers and with policy makers.

Measured by company public disclosure and from initiatives such as CDP (carbon disclosure project), the TPI submissions are graded into five different levels which range from level 0 (unaware of, or not acknowledging, climate change as a business issue) up to level 4 (strategic assessment).

The initiative will provide investors with a relatively high level method of differentiating between different companies on preparedness for climate change in terms of business strategy. However, as per the metrics discussed above, the results depend on the indicators used and the weightings they are given.

The Environment Agency and West Midlands pension fund are founder members. LAPFF is also a member.

IIGCC

The Institutional Investors Group on Climate Change (IIGCC) provides investors with a collaborative platform to encourage public policies, investment practices, and corporate behaviour that address long-term risks and opportunities associated with climate change.

It advocates for credible public policy solutions that will enable an efficient move to a low carbon economy.

Currently Bedfordshire, Environment Agency, Islington, Newham, LPFA, Kent, South Yorkshire, West Yorkshire, West Midlands and GMPF are members of this group.

2 Delegate to investment managers the implementation of a robust and measurable climate change response

Years ago funds that had a particular concern around ESG issues would invest directly in ethical funds through specialist managers. These investments tended to be small scale and over time these mandates had all but disappeared as funds chose instead to engage with the companies in which they invest through specialist engagement firms or collaborative groups as discussed above, or they chose to delegate these responsibilities to their investment managers.

Fund managers now routinely report on how they have voted and the level of engagement they have had with the companies in which they invest. Many of the managers will also be participants in the initiatives and groups discussed in the previous section.

Currently this is the approach taken by many LGPS funds (often in combination with engagement through LAPFF or some other initiatives). The depth and extent of activity is sometimes difficult to evaluate from the limited information provided by asset managers who tend to concentrate their reports on specific engagement activity. Funds need to be sure that the engagement is at a level sufficient to meet their requirements

Are Funds Doing Enough?

In their submission to the Pensions Regulator, Local Government Pension Scheme and Climate Risk, ClientEarth and ShareAction argued that LGPS funds were 'failing to comply with their legal duties and/ or putting members savings at risk' because of the way that they were dealing with the issue of climate change in their investments.

- Whilst funds recognise the need to encompass the implications of climate change, we would argue that they currently face some headwinds. The lack of rigorous data in order that assessments can be more transparent and more consistent
- Judgement as to how to make market allocation decisions in such a space?
- If environmental decisions (climate change, carbon/fossil fuel reduction etc.) are to be taken into account at every stage of the investment, thinking about divestment is necessarily challenging , from for example from emerging markets, because the data quality is opaque or insufficiently robust?
- Sustainability itself remains challenging as it is a balance between funds' fiduciary responsibilities to maximising investment returns and hence the growth in asset values and maintaining employers' contributions at reasonable cost
- The low carbon/ environmental indices have limited (or only back-tested) track records
- Defining the measurement period over which these investments are measured? How does a fund deal with their 'greenest' manager potentially underperforming for a sustained period of time?

- The LGPS is heavily committed to equity and other growth assets which have served the sector extremely well (returns circa 6%p.a. ahead of inflation over twenty and thirty years). But what about alternative investment options?
  Hedge funds, active currency etc. have provided mixed returns for funds' over the last decade but, whilst above (soft?) benchmarks such as cash or cash plus a percent or two, have lagged real assets significantly. These investments have little or no low carbon/sustainability credentials

Investment Strategy

It has been proposed that climate change be considered at every stage of the investment process. It is probably worth going through these stages and considering the issues at each point

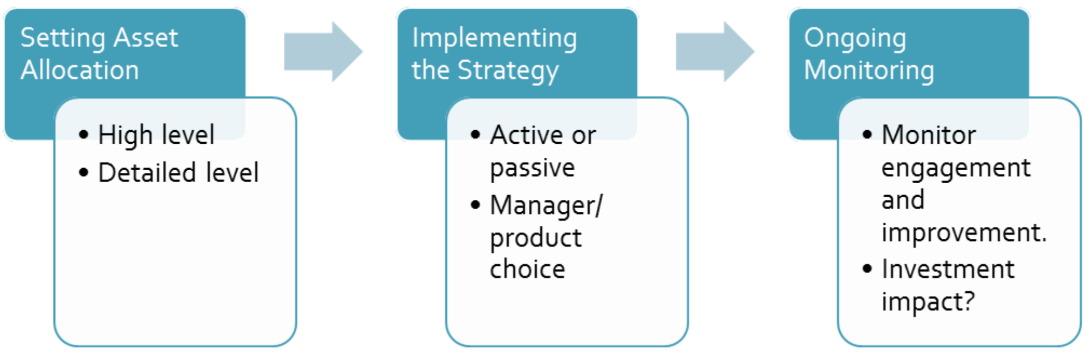
In the paper of May 2017 'Administrating Authorities, Pooling and ESG Matters' PIRC proposed that a fund has options as to the extent it will consider and address ESG issues. These options hold true for carbon investment.

A fund can choose:

1. to meet minimum regulatory expectations
2. to exceed regulatory minimums, have a higher level of engagement and demand a greater accountability from their managers
3. to adopt a high conviction approach, ensuring they use their ownership rights to maximise their impact on carbon related issues and concerns, commensurate with their Investment Strategy Statement.

Depending upon the approach taken funds will respond differently at each stage.

A fund is obligated to set an investment strategy that should deliver the return required to meet all current and future liabilities. The process is shown below:



- The strategy begins with a split between assets to be held for protection and assets to be held for growth based on the risk appetite of the fund and the required level of return. This modelling is based on long-term market returns. At this strategic level some funds will decide that climate change need not be considered directly because it is assumed that the returns from carbon neutral/sustainable/carbon reduction assets will produce returns in line with current market indices. Other funds may try to quantify the impact of climate change on asset returns (such as the Mercers Climate Change Study of 2015), however any such modelling has the issues of coverage, accuracy, assumptions etc. discussed before.
- Beneath the high level asset split, funds then typically apportion more detailed allocations – here they decide whether they want to incorporate alternatives/property, whether they want government bonds/credit etc. At this level the environmental considerations may start to have an impact. Should funds invest in assets whose carbon intensity can't be measured/where engagement is impossible? If so to what level? Again, funds may decide that the data set is insufficiently robust to make decisions based on environmental factors at this level.

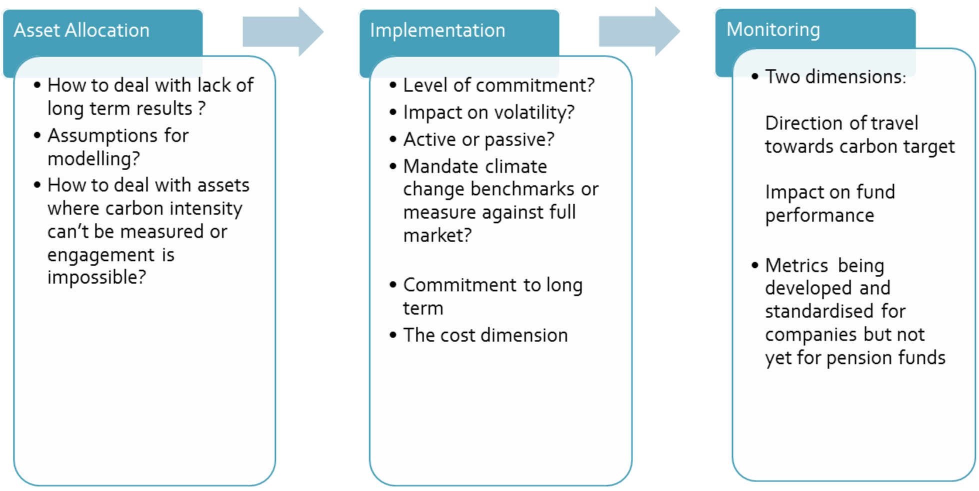
  Tailored products e.g. infrastructure, social housing, timber, agriculture etc. with some inherent inflation protection accessed through private markets may allow funds to engage positively with providers. Funds need to recognise however, that such investments are relatively illiquid, will not generate returns in the near term and, as funds head precariously into 'cash flow negative' territory, may have to become forced sellers of more liquid assets such as equities.
- Once the detailed allocation has been defined, funds then decide to invest passively or actively in each area and appoint managers. Here environmental decisions can have a large impact. Funds can appoint equity managers with specialist expertise in engagement, or ones who offer specific products as detailed above. Funds will have some decisions to make around how the new mandates are funded – from their active or passive equity portfolios, and the level of investment – a 'toe –dipping' approach, or, if they are committed to the approach the full equity allocation? Within their infrastructure and property allocations there are also opportunities for specialist products and investment types that will meet these criteria. Funds may choose to appoint or retain managers who undertake the environmental impact decisions as part of their overall investment process. All managers will take some account of this, as these factors will have an impact on share price and therefore performance. Funds can engage with their managers to ensure that they have engagement

policies in place and that they understand the impact on their investments of moving to a low carbon environment.

- However, unless funds actually move to mandates where the manager is given a different benchmark (such as the FTSE Green Revenues, FTSE AW ex CW climate Balanced Factor), they must be aware that any restrictions that are imposed will have an impact on performance. This impact could be either positive or negative but either way can make it difficult to identify what part of the return achieved is due to manager skill and what is due to any constraints.
- At this stage too, funds will have to understand that implementing some of these approaches come at a cost. The new indices are expensive and there could be indirect costs in terms of performance and risk. Pooling again should assist but only if enough funds demand their platforms support such investments.

- Once the Fund has set and implemented its strategy and structure and appointed managers, there is the opportunity for ongoing engagement. This can be done directly by funds with sufficient resources and specific mandates (less so however when funds invest with the passive 'giants'), or through membership of one or more of the bodies discussed above. Pooling of assets should help, or importantly, be encouraged to leverage funds' engagement activities.

- The Fund needs to monitor all its decisions. It needs to monitor its direction of travel with regard to any carbon reduction targets that it has committed to and it needs to measure the impact on return and volatility of the strategies implemented.



In Conclusion

We would assert that the accusation that the LGPS is not taking its responsibilities seriously enough is overstated. Funds have a great many responsibilities that need to be balanced. The vast majority of funds have taken some steps towards being active in addressing some of the substantial climate change issues this area, most through engagement activities and through dialogue with their investment managers.

It is difficult to see currently how environmental factors can be taken into account at the strategic asset allocation level. Those who propose that it should be, have not yet proposed a workable mechanism to implement it.

Exclusion or phased reduction of high carbon stocks will have an impact on performance and risk, and this needs to be understood and, where possible, quantified.

Funds that commit to such a path will need to ensure that they are genuinely long-term investors and be prepared to live with potential short or medium term differences in return. Many funds have historically focussed on the short/medium term and short-term relatively poor performance was one of the key reasons ethical funds fell out of favour. Exclusion also effectively ends any possibility for engagement with that company.

A move towards low carbon mandates will again have an impact on performance and risk and is likely to incur additional costs relating to benchmarking. It may be in this area that pooling will be particularly useful – offering bespoke mandates and allowing these additional costs to be spread across participants.

Managers understand that the move to a low carbon economy will impact differently on individual stock and sector values and many incorporate this as part of their overall investment process.

Many funds are currently engaged in discussions with their managers over their policies and engagement around climate change. Funds and managers that have undertaken carbon foot-printing have been able to identify the key contributors to their foot-print and are using this to focus engagement.

One of the key issues remains that of data, and it may be that one of the near-term areas of engagement for asset owners should be to work to get the data set widened and improved.

We shall continue to track the mandates, managers and benchmarks used by LGPS. The tight weave of the multiple interactions around this area will be difficult to unpick and attribute but over time the performance picture should become clearer.

Recent buoyant asset growth and a general improvement in funding levels has allowed funds to focus on climate change. With the prospect of a lower return environment, rising inflation, increasing fund maturity and challenging demographic and political changes ahead, this focus may well change in terms of risk focus. The LGPS needs to balance near-term issues whilst recognising its role as a true long-term investor.