Climate action, investment, TCFD and stewardship – an LGPS perspective

March 2022

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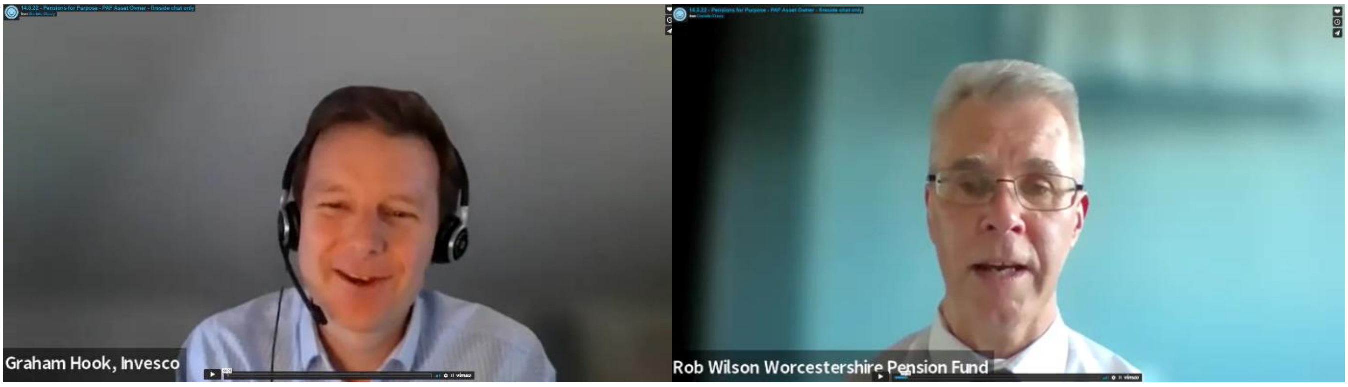
Pensions for Purpose's quarterly 'asset owner only' event for the Paris Alignment Forum, sponsored by Invesco.

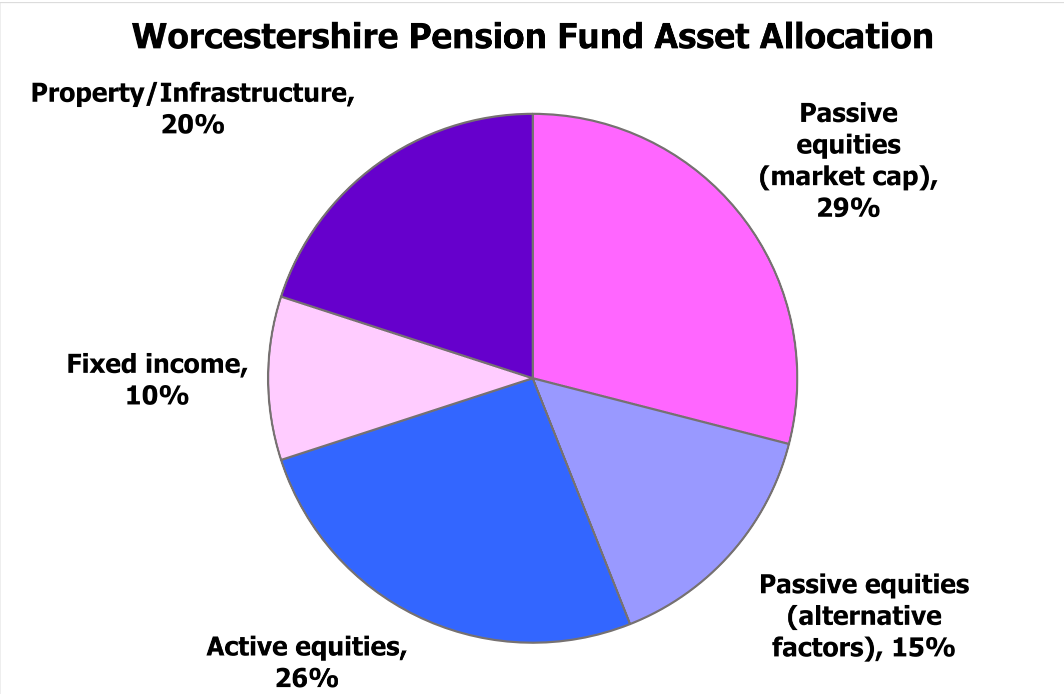
In conversation…



At a Pensions for Purpose Paris Alignment Forum asset owner event on 14 March 2022, **Graham Hook of Invesco** invited **Rob Wilson of Worcestershire Pension Fund** to share **how their pension fund has responded to the climate emergency** over the past two years. (Video available **here**). Graham posed several insightful questions to Rob, who answered them in a transparent and encouraging manner, allowing other asset owners to learn from Worcestershire Pension Fund's experiences. This is a write-up of the fireside chat and a summary of some of the shared insights from delegates.

Background to the Worcestershire Pension Fund

Rob explained that the Worcestershire Pension Fund is approximately £3.5 billion in size and has over 64,000 members split roughly equally between employees, deferred and pensioners.



Source: Worcestershire Pension Fund

The Pension Investment Sub-Committee has a long-standing Chair who is pragmatic and knowledgeable. This is a decision-making committee, but any changes to investment strategy are agreed by the Pensions Committee into which the Sub-Committee reports. They also have a Pension Board which has governance responsibilities over the Pensions Committee. The Chair of the Pensions Board is Roger Phillips (also Chair of the Scheme Advisory Board). They have an independent investment adviser: Philip Hebson.

The pension fund is part of the LGPS Central (LGPSC) pool, with eight fellow partner funds who work well together most of the time. The pool is now delivering on the products that are required and LGPSC have a strong responsible investment team who are very supportive.

When did Worcestershire Pension Fund first start thinking about a climate action approach and what prompted that?

Rob took over the Pension Investment Manager post back in March 2018 just at the time when the LGPS Central Pool was created. He attended several seminars at that time including the first Pensions for Purpose annual conference in November 2018 (this was **his first introduction to the "spectrum of capital"**). As a result of these seminars, he began to explore responsible investment (RI) and climate risk in more detail, including challenges such as how to measure impact. The pension fund also had good engagement from the RI team at LGPSC who were looking to develop and agree stewardship plans and this included reporting on climate risk.

Rob considered **how to improve the RI and engagement information and how to highlight the climate change risks** for the Fund at the Committee meeting in November 2018. This focused on how the Fund considered RI to be relevant to its performance across its different asset classes. He also highlighted that there were some **investment opportunities** arising from environmental and social challenges which could be captured, so long as they were aligned with the pension fund's investment objectives and strategy. It was at this time that he also applied for the 2018 Stewardship Code and was successful.

This report to the Committee highlighted the merits of **engagement versus exclusion** and Rob presented the Local Authority Pension Fund Forum (LAPFF) quarterly engagement reports to help inform his members. The committee agreed that the fund's voting policy and principles should be in line with that of LGPSC and actioned by Hermes EOS stewardship services.

In June 2019, Rob presented a report to the Committee on the pension fund's voting activity, which had been provided by LGPSC. This highlighted that the Responsible Investment Working Group (of which he was a member) and LGPS Central were proposing to develop a **Climate Risk Monitoring Platform**. This would provide four optional deliverables:

- Assistance drawing up a climate change framework and strategy.
- An annual climate change risk report tailored to individual funds' requirements comprising
    - Climate scenario analysis, fund wide, all asset classes
    - Carbon metrics scorecard (carbon footprint, stranded asset analysis etc
    - Annual climate stewardship plan.
- Annual training of the Pensions Committee.
- A Task Force for Climate-related Financial Disclosures (TCFD) report for public disclosure with the pension fund's annual report.

The pension fund also **agreed an LGPSC stewardship plan** focusing on climate change, single-use plastic, technology & disruptive industries, and tax transparency.

In December 2019, the committee realised that, as part of their strategic asset allocation review, the reasons for investing responsibly were growing and that they should **consider whether or not sustainable investment products were suitable for the Fund**.

Karen Shackleton (Pensions for Purpose) ran a training session for the members on ESG and impact investing and the spectrum of capital on 31 January 2020. She also introduced the Sustainable Development Goals (SDGs) as a concept to measure impact investment. This was followed up in May 2020 with a second Pensions for Purpose workshop, which helped the committee identify several SDGs where the pension fund could have the biggest impact whilst ensuring that it either maintained or enhanced returns.

Thinking first about strategy, how did you go about working with the committee to get clarity on their preferred strategic direction?

The workshops in January and May 2020 (which included all the members including the Board) provided vital training so that the committee could be in the position to make informed decisions. They were also mindful that they wanted to have a position on the whole pension fund, whereas the Climate Risk report by LGPSC was only able to report on equities. **The workshops allowed them to agree the direction of travel** in terms of the spectrum of capital **and the agreed targeted SDGs**, shown below:

Economic Goals
- SDG 8 - Decent Work and Economic Growth
- SDG 9 - Industry, Innovation & Infrastructure
- SDG 12 - Responsible Consumption & Production

Climate Goals
- SDG 7 - Affordable and Clean Energy
- SDG 13 - Climate Action

Health Goal
- SDG 3 - Good Health and Wellbeing

What they needed was a starting point, which they could use to inform their strategic direction and to challenge areas that were not aligned to their goals. Rob had some discussions with Surrey Penson Fund, because they were exploring SDG total fund analysis as well.

Worcestershire Pension Fund put a tender out for the work, and Minerva were the organisation that they felt could best provide a total fund analysis by qualitative and quantitative measures.

To ensure he brought members with him, Rob created a working group led and chaired by the members and attended by independent advisor Philip Hebson, as well as Karen Shackleton from Pensions for Purpose. This working group met monthly and received progress updates from Minerva.

They had further workshops with all the members, to listen to **the findings from Minerva and to digest the outcome of their first Climate Risk report from LGPSC**. This was followed by a 'Review and Next Steps' workshop in early February 2021, with follow up conclusions reported to the Committee in early March 2021. The key recommendations were therefore taken and agreed at Committee on 16 March 2021.

MINERVA ANALYTICS

This had some challenges, because there had been a change in membership and a new Chair of Pensions from around April 2021, it meant bringing new members up to speed quickly.

Your baseline measurement involved mapping your entire portfolio to the Sustainable Development Goals. What challenges were there in doing this? How did that analysis help the committee agree on the investment strategy going forward/what were some of the key insights that you learned?

Some of the challenges included:

- Identifying a company that could do this with meaningful output for all their assets.
- Accepting that this was a new area and the industry had no consistent performance ESG measurement apart from probably carbon metrics.
- Ensuring it focused on what Worcestershire Pension Fund wanted, particularly in terms of the report on the SDGs being agreed by members and ensuring members were on board.
- Delivering meaningful conclusions and recommendations that they could act upon.
- Deciding how often they would repeat this type of exercise accepting that the industry may move on a lot.

The analysis helped the Committee to:

- Confirm that the SDGs prioritised should be included in the Investment Strategy Statement because the pension fund was invested in a significant number of companies which were aligned to these SDGs.
- Map their spend against the SDGs using the World BM Alliance SDG2000 (the pension fund had 51% of its listed assets invested in these companies). Using Minerva's knowledge of best practice, the remaining 30% were assessed via interview and an analysis of their reporting information to gain an insight into their ESG awareness.
- Support the investment beliefs for the Investment Strategy Statement by showing the potential for better long-term risk-adjusted investment returns.

Some of the key insights to share included:

- This will help a pension fund's thinking on how to target future climate/sustainable investments.
- This is not an exact science so should be treated as a useful tool/exercise to inform the direction of travel for the pension fund.
- This should be reviewed every two or three years because, compared to this initial report, the industry may move on substantially in terms of measuring ESG impact.
- Go into the process with your eyes open and accept the conclusions, but then be clear on what actions the pension fund needs to take as a result.
- Tremendous progress can be made from private markets managers following such an exercise.

What initial steps did you take to reduce the carbon footprint of the portfolio and what sort of percentage reductions did you achieve from those moves? Which asset classes did you start with?

Worcestershire Pension Fund examined the Climate Risk report provided by LGPSC which helped identify the Fund investments that were high in carbon footprint. These were the equity assets, particularly in passive equities.

They then sought information from LGIM on their low carbon factor funds and asked for comparisons on returns and carbon footprint for their factor fund investments, particularly the value and low volatility factors.

They also compared this to the existing Pool Climate Factor Fund and found that they could protect, and hopefully enhance returns, by moving out of the value and low volatility strategies and going into the LGPSC Climate Fund and the existing LGIM Quality factor. This led to a switch of around £300 million.

The committee also explored moving to ESG tilts on their LGIM market capitalisation passive fund but postponed this and decided to revisit the decision after investing in active sustainable equities in May 2022 (around £200 million will be invested).

They reduced their carbon footprint by a further 5% below the benchmark (the fund had seen a drop of 23% in 2020 and a drop of 28% in 2021).

How did you approach the question of whether to disinvest in high-carbon funds / firms or whether to seek change through stewardship approaches? You decided to sign up to the Stewardship Code 2020 and were one the first signatories to be approved. What did this involve and what ongoing challenges do you face to adhere to that code?

In terms of the Stewardship Code 2020, Rob recommended ensuring that the code requirements have been read carefully. There was a lot of work in obtaining evidence, since this was outcome-focused and needed input from relevant managers. It was important that he covered all the points within the individual principles that the code was requesting, even if this meant reporting that he had not done a particular part or where the pension fund was looking to act in the future but had not yet done so.

The LGPSC RI and Engagement team provided a lot of support and examples particularly around engagement. They also provided an action plan as to what type of evidence to incorporate.

Rob recommended trying to cover all assets, not just listed equities.

There are ongoing challenges to maintain impetus and address areas where the Financial Reporting Council (FRC) highlighted that they required improvements. Rob strongly recommended involving pools/asset managers early on. He felt it was important not to reinvent the wheel but to look at what others have provided: the FRC provide examples of good practice.

One of the areas Worcestershire Pension Fund will be focusing on is to make more effort to engage with the wider members of the pension fund, to get their views on E, S & G. He recognized that this was a challenge with so many members.

You have recently reviewed your investment beliefs and agreed the strategy for the next 12-18 months. Had the committee's views changed much and how did you go about getting a new consensus?

Rob organized a follow-on workshop for the Pensions Committee to revisit their actions from the ESG audit and asked them a number of specific questions on SDGs, climate and the spectrum of capital to seek their views via a voting app (Mentimeter). This was used as a discussion point within the workshop.

He emphasized that targeting the SDGs should remain focused on the financial risk/return if there was to be any desire to add any new goals to the existing beliefs. SDG 12 - Responsible Consumption & Production - stood out as an SDG that met these criteria and it was agreed to extend the beliefs to include this, in the expectation that this will lead to better returns for the fund over the long term.

The Committee reviewed whether to introduce climate targets. The general feeling was that in 2022 it would be good to explore and agree an internal climate target for the pension fund and speak to managers about how they would align to this target, but that this was something that could be rolled out publicly later. Science based targets on the whole fund with broad interim deadlines would be preferred, to avoid the pension fund becoming a hostage to fortune on individual parts of the portfolio. A first step might be to consider targets that other LGPS funds are setting and to seek their views on how easy these have been to adhere to.

The Committee also considered the spectrum of capital and the S in ESG. There was more caution about proceeding further along the spectrum of capital at this stage although this reflected concerns over the investment thesis: could social impact investments really deliver market-rate, risk-adjusted returns? The committee seemed willing in principle to consider this and further exploration of this will be taken forward.

How has your pool, LGPS Central, fed into your climate strategy?

The pool provided climate risk update reports in 2020 and 2021 with key benchmark information as well as providing a proposed stewardship plan which has helped inform the strategy. They have also reviewed the existing strategy to see if it is consistent with the report findings and provided presentations to the committee members. As well as the strategy, the Pool have provided support in formulating Worcestershire Pension Fund's TCFD report.

What advice would you give a pension fund thinking about embarking on a climate action strategy?

- Be mindful that the pension fund's key fiduciary duty is its ability to continue to pay the existing and future members their pension benefits.
- Worcestershire Pension Fund approached this from the point of view that investing in sustainable assets or low carbon funds should either maintain or enhance the fund's return.
- Ensure you have a baseline as a starting point. You can then access what actions you may want to take. for instance, targeting reduction in carbon intensive investments and having a focused stewardship plan.
- Look at what other funds are doing - there is plenty of information out there.
- LGPS funds, ask your Pool for support and advice.
- Train your members/trustees so that they can make informed decisions.

Shared insights

The fireside chat was followed by a wider discussion with 17 pension fund representatives.

The headline SDGs each have a list of more detailed, sub-SDG targets, but it was felt that this is a level of detail that is more appropriate for the asset manager, than for the pension scheme which needs to take a more holistic and strategic view. The SDGs were being used as a framework for the debate and subsequent monitoring rather than diving into the detail.

There was a sense that many private sector schemes could learn from the experiences shared by Worcestershire Pension Fund. There was a need for time to be spent thinking about this, training and expertise to be bought by the pension fund, all of which Worcestershire Pension Fund had done. Rob Wilson strongly advised bringing the trustees with you on this journey – this will be time well spent.

Larger corporate pension schemes were the leaders in the private sector and they were being proactive about climate strategies. However, this contrasted with smaller schemes where there was less experience, less consensus and where trustees were not placing climate action as a priority. Regulation was pushing the agenda forward for medium and smaller schemes, but this meant it was more of a tick-box exercise.

There was interest in the dynamic between the pool and the member funds. Was the pool leading on the discussion or was it the member funds? Rob Wilson felt that the team at LGPSC had been extremely helpful.

There was discussion about asset classes other than equities and bonds. Worcestershire Pension Fund had spent around eight months working on the investments to decarbonize the portfolio, so they are now pausing and allowing these changes to bed in. One of their asset allocation moves was to de-weight equities and allocate to infrastructure, so they considered renewable energy as part of this.

Philip Hebson, Independent Adviser to Worcestershire Pension Fund explained that they were keen to include the private markets funds and many of the managers had not been approached on this basis before. One of the interesting insights was that the American managers responded well and excellent progress in a short space of time had been seen.

Graham Hook of Invesco confirmed that they were now starting to see these sorts of requests coming through from investors on their private markets' funds. They had a two-pronged approach: making sure they serviced their clients who were requesting information, providing them with that data, and then making sure they adhered to new regulatory requirements, which required them to make their own disclosures.

The discussion turned to member engagement and how to consult. It was generally agreed that restricting member responses to multiple choice answers meant that member views could be channelled within an investment framework, rather than allowing individuals the freedom to express wider views that might not be appropriate given the pension fund's fiduciary responsibilities. Member engagement was particularly important for DC funds.

The conversation concluded with a question on Russia/Ukraine, the impact on energy prices and whether/how this might impact a pension fund's climate strategy. This, perhaps, is the topic for a future Pensions for Purpose discussion: the concern was that it could put into conflict the longer-term goals because of tactical decisions that might need to be made.

Forthcoming events

28 March 2022 – 10:00-11:00 GMT - Paris Alignment Forum online morning coffee with Baillie Gifford: 'Climate benchmarks – are they appropriate for an active mandate?' Karen Shackleton will present the key findings from **research** undertaken by Pensions for Purpose on the different types of climate indices used by asset managers and when pension funds may consider using different benchmarks. This will be followed by a fireside chat with Tim Gooding of Baillie Gifford, who will explain why Baillie Gifford decided to shift to a climate index for their flagship global equity strategy.

If you would be interested in joining or participating in the Paris Alignment Forum, please contact **Karen Shackleton**.