Low carbon transition: What does it mean for a pension fund?

August 2019

www.pensionsforpurpose.com

This blog, by Karen Shackleton, originally appeared on Mallowstreet and is reproduced here, with their permission.

In June 2019, the UK government set itself a target of cutting greenhouse gas emissions in the UK to almost zero by 2050. As we face summer storms, flooding and gale force winds, in the UK, the need for drastic action is becoming increasingly clear. But what does this mean in practice for a UK pension fund?

I have written before about the importance of trustees discussing their investor beliefs before implementing a low carbon investment strategy. Below, I have set out three possible scenarios, arising from those discussions, and set out what an investment strategy might look like for each of those scenarios.

Scenario 1: Financial risk approach

The trustees wish to take environmental/climate change risks into account where these will have a detrimental impact on returns, but they do not wish to express a view on climate change. The focus should remain financial, i.e. delivering the best risk-adjusted return for their members.

In this scenario, the trustees could be described as responsible investors. They recognise that there may be a detrimental financial impact on their portfolio if they ignore these risks, so seek to ensure that they are taken into account by their investment managers.

Possible implementation: conversations with all the investment managers on how they process ESG risks. Review of their voting policy. Discussion around how the managers are engaging with companies to ensure value is maximised. Ask managers to talk through a portfolio holding that is potentially exposed to environmental risks, highlighting how they processed those risks and how it has impacted their buy/sell decision-making.

Scenario 2: Sustainability approach

The trustees seek to reduce the carbon emissions/carbon footprint of their investments thematically across the whole portfolio, without negatively impacting the headline risk-adjusted return.

In this scenario, the trustees could be described as sustainable/ethical investors. They recognise that there may be a financial impact on their portfolio from climate change and they want to set themselves goals to reduce their carbon footprint/emissions to support the transition to a low carbon economy, but without significantly impacting the pension fund's headline objectives.

Possible implementation: trustees set carbon reduction goals and a timeline for achieving these. Measurement of current portfolio's carbon emissions and carbon footprint so that improvements can be reported on as the low carbon strategy gets underway. Discussion about divestment vs optimisation (tilting away from high carbon footprint companies across all holdings). Move passive strategies to low carbon alternatives. Possible reappointment of managers towards those who have a preference for low carbon strategies.

Scenario 3: Impact approach

Not only do the trustees wish to reduce carbon emissions, but they intentionally want to support those companies involved in the transition to a low carbon economy as well as investing in sectors such as renewable energy,
because they see the return opportunities that these investments could well provide.

In this scenario, the trustees are much more intentional in their approach. They recognise the risks associated with climate change, as well as the opportunities, and want to engage in strategies that both focus on risk mitigation and capturing the return opportunities via environmental impact investing.

Possible implementation: The trustees set carbon goals and a timeline for achieving these. They also agree on their preferred allocation to environmental impact investments.

Once actions outlined in Scenario 2 have been fully agreed, trustees then additionally start one or more manager selection exercises for impact investments that both meet their environmental impact goals but which still deliver to the broader growth/inflation-seeking/defensive goals of the pension fund as a whole. Positive impact is then measured and reported on by the investment managers.

This can't wait

For many pension funds, the scenarios above will be a journey, moving from 1 to 2 to 3 over time. But time is a luxury we do not necessarily have when it comes to climate change… so I would urge trustees to begin on that journey as soon as reasonably practical.