Addressing the impacts of climate change
Investing in the future

Faith Ward - Chief Responsible Investment and Risk Officer, Environment Agency Pension Fund

Chris Panteli – Editor, Portfolio Institutional (updated from the original article first appeared in Portfolio Institutional).

Introduction

The Environment Agency Pension Fund's Chief Responsible Investment and Risk Officer Faith Ward talks to the Editor of Portfolio Institutional Chris Panteli about how the scheme intends to address climate risk.

In October 2015 the Environment Agency Pension Fund pledged to become the first scheme to run its assets in accordance with the UN-agreed principles of preventing global temperatures from rising by more than 2ºC. The move will see the £3bn scheme cut its exposure to coal by 90% by 2020 and reduce its exposure to oil and gas by half.

Chris - Can you talk me through how you aim to achieve the plans announced last year and the process which led you there?

Faith - The truth is we don't actually have all the answers yet on that one. We were a partner in Mercer's Investing in a Time of Climate Change study and that analysed our whole fund, and set it against 4different, but possible, climate change outcomes. What that demonstrated was that we are actually in a robust position in terms of those scenarios; we are probably one of the most resilient funds out there in terms of having taken action and integrated climate risk in our thinking over the years. However, that is quite different from actually keeping within 2 degrees, which is the scenario that they call 'transition'. This scenario enables the fund to perform well financially and enables us to see at a strategic level that fulfilling the 2ºC objective iscompletely compatible with our fiduciary duty. We started to embed it in terms of how we manage the whole fund.

From the top down, we looked at it strategically across all of the asset classes, the countries and sectors and have made some strategic allocations to investing positively to a low carbon economy. From the bottom up, we have limited our holdings in some of the most carbon intense companies, but from a financially-driven way of dealing with it. And this is all complemented with engaging and supporting those companies and funds that are actually changing what they are doing to respond to the challenge.

And so while we think all these different pieces are contributing to staying within 2 degrees, whether the sum of the parts can actually withstand external scrutiny as fulfilling the 2 degrees measure is definitely the biggest challenge we need to meet. We don't exactly know what a 2ºC investment strategy looks like yet, but what we do know is we want to be active participants in answering that question. Because we think it is a question that needs to be answered not just by our fund but more broadly by the whole industry.

Chris - How do you measure climate risk and how is that actually translated into the portfolio?

Faith - Well I think there aren't any single measures yet for climate risk when you look across the entire portfolio, across all asset classes. We use things like the Mercer research, which looks at what the impacts might be from a strategic asset allocation perspective and what the sensitivities are through different scenarios and what financial impacts that might have. That gives you a helpful element of translating that risk at a strategic level. We use carbon footprinting on all our equities and our active bonds to look at the risk exposure from greenhouse gas emissions. We feel that is the area through either carbon pricing or other regulations which will have a financial impact. But I don't think there is one single measure, it is a case of being able to see how do we assess it for each asset class and try and build that picture over time.

Chris - Do you see some assets being run in-house as a result of the changes?

Faith - In short, no. We feel the expertise to do a lot of this work sits with the asset managers that we have employed. The one area that we have brought partially in-house is our exposure to private equity and that's been largely driven by a couple of issues. One is the move away from fund of funds-type instruments within the LGPS, largely driven by reducing costs. And the other is we feel confident of being able to find these opportunities ourselves and to make a few, significant allocations. So our portfolio in private equity will become more concentrated.

Chris - Are there criteria for those investments?

This is an area where we are applying sustainable capitalism concepts, where the funds selected provide strong, often double-digit financial returns, but are also proactively contributing to long term social, environmental or economic benefit. This might be through job creation or innovative ways of delivering goods and services using fewer resources, usually therefore contributing to our climate change work as well.

To date, we have made 3 investments in that space. We've got the Climate Solutions Fund, run by Generation Fund Investment Management, which does what it says on the tin. We have made an investment with Bridges Ventures, which is a real estate private equity fund that looks at making investments in under-served areas, so very much driving economic development and employment and socially responsibility in those investment areas. The third is a venture capital firm based in San Francisco called the Double Bottom Line, which again looks at innovations and people – they supported Elon Musk's development of Tesla Motors, working with him to ensure manufacturing jobs stayed local. They have very much put sustainability at the heart at how they select or invest in companies, thinking much more broadly beyond the environmental issues, about how an organisation is handling human capital within their remit.

Chris - So how big an allocation are we talking about?

Faith - Total allocation for private equity is about 5% of the portfolio and we are looking to build it up by allocating to 2 to 3 funds a year, in the region of half to 1% of the fund. So quite sizeable contributions of anywhere between £15m to £30m. But we are being very particular about it. We are looking for just 2 to 3 compelling opportunities a year.

Chris - Did you consider engagement before settling on the divestment approach?

Faith - Engagement is quite a core part of what we are committed to do. Where we have significant exposure and the assessment of the company suggests that there is potential for success and we think there is potential for the company to address the issue, then engagement is obviously a sensible strategy. Disinvestment has been a smaller part of our approach, largely because we have been already underweight fossils for some time. Disinvestment has been applied as part of our risk based review of our passive portfolios, where we have exited very small, less diversified holdings where the potential for transition was lower.

Chris - Do you feel the 2020 deadline you've set yourself is achievable?

Faith - We felt we had drawn a line in the sand and wanted to engage with companies by saying: "Well you've got 5 years to show that you can make progress and then we'll have a look at where everything's at." We felt the 5 year time horizon was quite a healthy one for businesses to really think about this and how they can embed impacts of climate change into their own business strategies. It gave them a reasonable timeframe to look at it without us automatically saying, "Okay, we're going to disinvest you" as a first response. We have reserved the right, however, when we are reviewing their progress in 2020, to use exclusions for the first time if we feel some companies aren't really making sufficient progress and therefore present a financial risk from their inaction.

Chris - So does that mean there will be no change in management until that time?

Faith - We don't expect there to be any changes. That's partly because we have been embedding this within our thinking for such a long time that most of our managers consistently best their benchmarks when it comes to carbon emissions. Overall we have reduced our active footprint by 50% since we started measuring it in 2008.

Chris - Your Chief Pension Officer Dawn Turner was quoted as saying that not reducing fossil fuel investments would be a breach of your fiduciary duty to members. Is that the case?

Faith - What we have said is not addressing your fund's fossil fuel exposure, in light of the evidence emerging and recommendations from the Intergovernmental Panel on Climate Change and the International Energy Agency, who suggest that 80% of fossil fuels need to stay in the ground if we are to keep global mean temperature increase to less than 2ºC, would be a clear breach of the long term financial interests of members.

It is about looking at that exposure and trying to reduce it, but it is more subtle than just wholesale disinvestment. We do feel that the market will naturally decarbonise and if engagement s a core part of that then that is entirely appropriate. What we are concerned about is that not enough asset owners and pension funds actually know what the level of risk is.

Chris - Is this part of an ongoing strategy, then?

Faith - A big decision last year was to move our entire market cap index, which is about 10% of the fund, to work against the MSCI Low Carbon World. That decision was made after we did the carbon footprinting and fossil fuel exposure of the fund in 2013, what that showed was the majority of the fossil fuel exposure and high carbon emissions was actually in our passive portfolios. And while we feel it is appropriate to hold some oil and gas companies and extractive companies, we feel that climate risk is something you need to actively manage. We felt we didn't want it sat within our passive portfolios. The important thing for us was the MSCI low carbon benchmark through optimisation, reduces the carbon emissions by 80% and fossil fuel exposure by 90% of the index whilst staying within 30 basis points tracking error. So it is achieving quite a lot of impact in terms of climate change while minimising the financial implications. The remaining part of our passive portfolio, factor drive indexation, will change to incorporate carbon risk within the next 12 to 24 months. That will put the fund and our strategy in a pretty robust position. And it would be fair to say we have been literally inundated with providers wanting to look to shape and come up with solutions for that challenge as well as lots of interest from other pension funds, so I think that is another area that people are looking for solutions for.

Chris - So you've received a positive response from other pension funds to these changes? Is it something they're looking to implement themselves?

Faith - The response has been huge. It started to pick up throughout the whole of 2015 but following the Paris Agreement in December 2015, we have been overwhelmed with enquiries from other pension funds. People are saying, "Can you come and talk to our committees about what work you have done? How it has worked and how did you put it together?" There has been a huge amount of interest in how to take this forward. I think they are quite encouraged, particularly once we have demonstrated our approach is a combination of investment, de-carbonisation, which has an element of disinvestment – but it is not entirely disinvestment-driven – and also the strong commitment to engagement. We have been doing quite a lot of presentations and one-to-one peer support and not only within the UK; conversations have includes funds as far and wide as Australia, New Zealand and USA, so we work across time zones to help other pension funds.

Chris - It must be a great feeling, but it sounds like a job in itself. You're practically acting as a consultant on the subject.

Faith - Yes, definitely. We have been quite vociferous in challenging investment consultants to step up. They really need to up their game and support their clients and get the message across to fund managers. Mercer have obviously been leading the field with their work in this space, but even with them, we have been very active in making sure that this isn't just a project. We want to ensure this fundamentally changes the way investment consultancy goes forward, how they support their clients in thinking about the risks. That doesn't mean that they have to radically change things but they just need to be aware of the risk. This is no different from any other risk and it should be part of that risk dashboard.

Chris - Is the message getting through?

Faith - We have heard some very positive signals from Mercer and other investment consultants. I think they have got to get their heads around a lot of it themselves to see how they can do it. The other intermediaries that we have been quite active in talking to – but this is going to be a much longer term project – is the actuarial profession. We feel that actuaries are incredibly well-placed with their skill base to quantify long-term risk

Chris - How can actuaries help investors deal with climate risk?

Faith - I think they are perfectly placed to do that. The actuarial profession is the one profession that can really make a difference to climate change by translating long-term uncertain risks to near term action. Actuarial models do not place limitations on growth, despite the fact that we know climate change will limit some of those growth scenarios. There are also actuarial implications in terms of some of societal shifts that may well have on some of their longevity assumptions. I have also made the parallel with actuaries between climate change and longevity. Longevity was an issue that really wasn't addressed at the right time and wasn't got to grips with, so we are having to deal with the consequences of that now. My challenge to the actuarial profession is: don't make the same mistake twice.

Chris Panteli

Chris Panteli is editor of Portfolio Institutional and has covered the pensions industry for more than 10 years at titles including Professional Pensions and Pensions Insight.

Faith Ward

Faith is the Chief Responsible Investment and Risk Office for the EAPF and leads engagement with the fund management industry and is involved in industry wide initiatives to improve standards in responsible investment, corporate engagement and fund governance and reporting.