Environment Agency Pension Fund update

Date: 18 June 2015

EAPF commits to Low Carbon index for Global Equities

As the next step in our strategy to manage and reduce climate risk in our investments, the Environment Agency Pension Fund (EAPF) has transitioned its portfolio of passively managed global equities (which invests broadly in most global companies) to a new fund, to be run against the new MSCI Low Carbon Target World Index (the Index). The amount involved is around £280m, over 10% of the Fund.

Background: Market engagement

We have had a comprehensive approach to climate risk for many years (see www.eapf.org.uk/investments/climate-risk). In 2013 we benchmarked our entire listed portfolio for "stranded assets" (exposure to fossil fuel reserves), and we identified our most significant exposure to stranded assets was in the passive equity portfolio. At the time, there was no suitable index to replace standard market capitalisation indexes.

We began a dialogue with the industry, talking to the leading index providers. MSCI clearly understood what we were looking for, and took this on board in the development of their new Low Carbon Target Index. After due consideration of this index, and further market research, we were able to confirm that it met our requirements, and was suitable for using for our global passive equity allocation.

Taking a risk based approach

The Index is constructed by first setting a target for how much it should vary in value against the standard index (of 0.3% p.a.). This level means the index has negligible additional short term financial risk for us. It then seeks to reduce carbon exposure as much as possible within that limit. It focuses on both companies' carbon emissions, and on their exposure to fossil fuel reserves (or stranded assets). Doing both is sensible because we cannot be sure how climate policy will develop, and because they can offset each other in addressing financial risks.

This approach to managing carbon exposure is very much in keeping with our strategy on climate change, which is to treat it as a long term investment risk. This means we materially reduce our carbon exposures through a risk based approach, rather than, for example, simply excluding one particular area.

Reducing carbon exposures

The new Index provides a substantial reduction in climate risk - around 75-80% in terms of exposure to greenhouse gas emissions, and 85-90% in exposure to fossil fuel reserves compared to the standard benchmark. Many companies with high emissions or high fossil fuel exposures are zero weighted, including nearly all coal companies, as a result of the index construction process. However, the index does have some, significantly reduced, exposure to fossil fuel companies – typically where the companies are focused on gas or have other sources of value – reflecting its risk based approach.

Analysis and engagement

Furthermore, as this index is based on companies' performance on climate factors, if companies improve by reducing their emissions or reliance on fossil fuel reserves, they will increase their chance of being included in the index. This means the Index can be used to support dialogue and engagement with companies to improve their carbon performance or change their climate strategy.

Implementation

We are the first major investor to use this index, being the founding investor in a new fund based on the index which will be managed by Legal & General Investment Management and which is open to UK institutions.

We think the approach of the index is very robust from a fiduciary duty perspective and we hope other institutional investors will be interested in the fund or the index as they seek to address climate risk. With low risk against the standard benchmark, significant reductions in carbon exposure, and with passive management fees, we think this fund could be a compelling option for a wide range of long term investors.

We are pleased to discuss with other institutional investors our use of this index or our approach more widely to climate risk; please contact Mark Mansley, Chief Investment Officer at mark.mansley@environment-agency.gov.uk or Faith Ward, Chief Responsible Investment & Risk Officer at faith.ward@environment-agency.gov.uk

For information on the L&G fund contact Mark Vickery or Tom Graham on 020 3124 3181 or mark.vickery@lgim.com

For further information on the MSCI Index, visit www.msci.com/msci-low-carbon-indexes or contact Faisal Butt, Vice President, at faisal.butt@msci.com

Important notice