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LGPS focus:

Nurturing change

David Harris, head of sustainable investment, FTSE Russell

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Smart sustainability

David Harris explains how a smart sustainability index can give pension providers controlled, sustainable exposure

A major recent shift has been observed with asset owners moving from a 'tokenistic' approach to environmental, social and governance (ESG), to integrating it into core investment strategies. The pensions industry is considering ESG themes, including the transition to a green economy, as an integrated part of their investment philosophy and processes. Asset owners, including DB schemes, are citing ESG risks as central to their fiduciary responsibility. FTSE Russell recently surveyed 200 asset owners globally and asked what was their strongest motive for incorporating ESG considerations into their investment decisions. The top motive was not 'societal good' but rather 'avoid long-term risk'.

In responding to these trends and meeting the changing requirements of our clients, FTSE Russell has developed an approach that combines a commitment to ESG with the sophistication of smart beta indexes. We are calling this combination of sustainable parameters and risk premia via factor exposure within a single index solution 'smart sustainability'.

The launch of the innovative FTSE4Good Index 15 years ago was one of the first clear and decisive moves into the sustainable space by an index provider. At the time, the index appealed largely to the retail rather than the institutional market. However, in the intervening years we have seen a profound change in asset owner attitudes to ESG, with a growing appreciation of the economic drivers associated with sustainability, as well as the reality and growing risks associated with the transition to a green economy.

This trend has been reinforced by a swathe of multinational, institutional- and country-level legislation and directives designed to mitigate global warming, improve corporate working practices, and strengthen corporate governance. In relation to climate change these include, and are often framed by, the over-arching Paris Climate Agreement made between more than 200 governments in 2015, which aims to limit increases in average global temperatures to 2°C.

There have also been a number of investor-focused initiatives, including the Montreal Pledge launched by the Principles for Responsible Investment, the G20 Green Finance works stream co-chaired by the People's Bank of China and the Bank of England, and the Financial Stability Board's Taskforce on Climate-related Financial Disclosure.

The accelerating global trend towards the reduction of greenhouse gases presents all investors with a range of risk factors to consider. Mark Carney, the Governor of the Bank of England, set out in a speech at Lloyd's of London that there were three key risks to financial stability due to climate change: liability risks, transition risks, and physical risks.

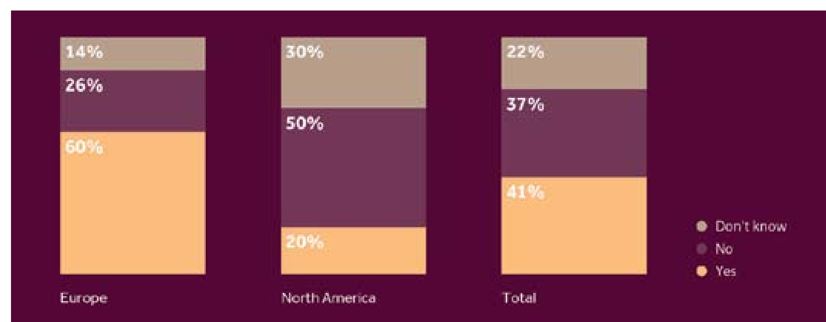
These risks have also been picked up by the UK Institute of Actuaries (IFoA), the international professional body for actuaries. In May this year the IFoA sent a 'Risk Alert' to all its members drawing their attention to the "material risk" that climate change poses, stressing its members' responsibility to "consider how climate-related risks affect the advice they are providing".

The results of the FTSE Russell smart beta survey for 2017 clearly illustrate the extent of the shift in attitudes. Among asset owners who are using, evaluating or planning to evaluate smart beta index-based strategies, 41 per cent anticipate applying ESG considerations to a smart beta strategy. While the move towards ESG appears to be global, it is most pronounced among large European institutional investors.

In response, FTSE Russell has developed two different types of data sets to help asset owners better understand and evaluate ESG risks. The first is based on FTSE Russell's ESG Ratings data model. It measures how well companies manage operational risk exposures and evaluates over 4,100 companies on 14 different 'themes' such as health and safety, anti-corruption, tax transparency, climate change, and water use. Based on a precise and clearly defined methodology, a tiered data set of ESG ratings are calculated, which reflect each company's overall exposure to, and management of, ESG risks.

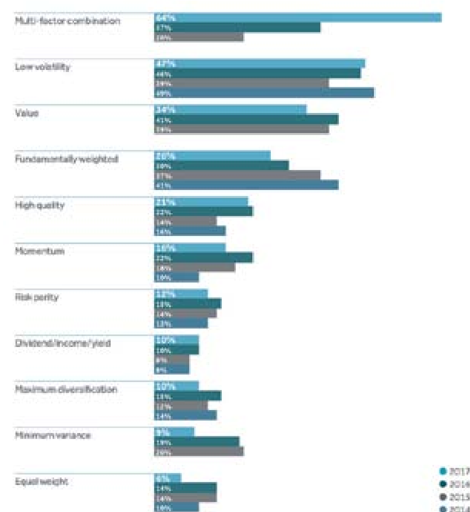
The second data set – the FTSE Russell Green Revenues Low Carbon

Do you anticipate applying ESG considerations to a smart beta strategy?



Source: FTSE Russell, Smart beta: 2017 global survey findings from asset owners
Segment = Have a smart beta allocation OR are currently evaluating smart beta strategies OR are planning to evaluate smart beta strategies in the next 18 months

What type of smart beta strategies are you currently using?



Source: FTSE Russell, Smart beta: 2017 global survey findings from asset owners

Economy (LCE) data model – focuses on the revenues companies generate from green products. The Green Revenues (LCE) data model, which includes detailed corporate financial history, covers 13,500 companies (99 per cent of global market capitalisation), of which more than 3,000 have green revenues from one or more of the 60 LCE green industrial subsectors. The model is based on line-entry level revenue data from constituent companies, collected and collated by FTSE Russell analysts according to a rules-based and transparent process, and mapped across a new industrial classification system specific to the green economy, the Low Carbon Economy Industrial Classification System™. FTSE Russell's sustainable investment data platform enables users to drill down to companies' data attributes, conduct portfolio analysis, measure exposures and perform attribution analysis.

The increased focus on ESG has coincided with the rapid rise in investors' adoption of smart beta index-based strategies. Market demand is now moving from single factor index-based strategies (eg value, quality, yield, size, volatility and momentum) to strategies combining a number of factors (multi-factor). The FTSE Russell smart beta survey for 2017 shows that among asset owners with a smart beta index allocation, multi-factor combination strategies have grown from 20 per cent in 2015, the first year asked, to 64 per cent in 2017. Not surprisingly, we are now seeing a growing desire for an integrated approach that achieves different factor and sustainability objectives in a consistent manner.

The concept of a Smart Sustainability index provides investors with tools to assist them in implementing sustainable investment strategies with greater sophistication than in the past. By incorporating ESG considerations with a smart beta index methodology, a single Smart Sustainability index can now allow asset owners to address their investment beliefs on both traditional risk premia and ESG parameters.

In creating such indexes, FTSE Russell can combine a wide range of sustainable investment data into a single Smart Sustainability index solution. To see how this works, consider the design of the new FTSE All-World Climate Balanced Factor Indexes. It applies factor tilts based on four risk premia factors (volatility, quality, value and size) and integrate this with three climate parameters. FTSE Russell uses a unique and transparent methodology, a system of sequential tilts which can be applied consistently to 'traditional' risk premia factors as well as to sustainability parameters. This contrasts with a composite index approach, which is akin to applying separate allocations to each different element of the smart beta and sustainability methodology and consequently does not consider the interactions between each component.

In the FTSE All-World ex CW Climate Balanced Factor Indexes, the three climate parameters achieve the following;

1. Reduced exposure to companies with carbon intense fossil fuel reserves
2. Reduced exposure to companies with higher carbon emissions through tilting the weights of companies within a sector based on their relative operational carbon emissions
3. Increased exposure to companies leading the industrial transition to a low carbon economy through 'green revenues' from goods, products and services.

This 'Smart Sustainability' index launched in November 2016 and was developed in cooperation with HSBC Bank UK Pension Scheme and Legal & General Investment Management (LGIM). HSBC Bank UK Pension Scheme used it as the basis for its DC equity default option, worth £1.85 billion, through LGIM's new pooled Future World Fund that tracks the index.

This is the start of the next phase in the evolution of both smart beta and sustainable investing. FTSE Russell is providing a flexible framework and tools to combine a variety of sustainability and risk premia factors together into new indexes. The new era of ESG integration into passive investment has dawned.

Written by David Harris, head of sustainable investment, FTSE Russell

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Summary
• In George Osborne's 2015 summer budget it was announced that 89 local government pension schemes (LGPS) should be combined to form a group of far larger, pooled investments of around £25 billion each. The deadline in which these pools should be operational is April 2018.
• The decision to pool the funds was aimed at dramatically reducing the running costs for the multitude of very different schemes, improving governance and improving investment into infrastructure. But the idea was initially met with a mixed bag of opinions.
• Project POOL said over the very long term, the costs of transition and establishing and running the pools will be more than recouped by savings and other benefits.
• Based on current asset allocations and market values, and allowing for future asset growth in the range 3 to 5 per cent per year, the estimated eventual savings in year 10 values could grow to be in the range £190 million to £300 million per year.
• Capacity could be one of the issues facing the newly-formed pools as they may be directed towards a few selective funds, though this could be mitigated to some extent by a broader selection of managers. Some pools are looking at passive as a way of allocating.

Jumping into the pool

Sandra Haurant analyses developments within the local government pension schemes' pooling sphere and what needs to be done ahead of the April 2018 deadline

Time moves fast and the announcement in George Osborne's 2015 summer budget that 89 local government pension schemes (LGPS) should be combined to form a group of far larger, pooled investments of around £25 billion each, is still fresh in many minds. And yet, while that may seem recent, the April 2018 deadline by which these pools should be operational is also approaching rapidly.

Initial reactions

The decision to pool the funds was aimed at dramatically reducing the running costs for the multitude of very different schemes, improving governance and improving investment into infrastructure. But the idea was initially met with a mixed bag of opinions. For some, it was simply not enough. Centre for Policy Studies research fellow Michael Johnson was quoted in the *Financial Times* in January 2016 saying: "What we are witnessing is mere tinkering, masking the fundamental truth that the LGPS is not sustainable." Johnson said the government should move away from defined benefits (DB) altogether and instead provide a defined contribution pension scheme.

Others suggested that combining funds was an unwieldy task that would cause more problems than it would solve. It demands, after all, the bringing together of one of the largest DB schemes in the world and the largest DB scheme in England and Wales – with some 13,000 employers, 5.3 million members and assets of £217 billion, according to the LGPS advisory board's 2016 annual report. Some said the challenges of matching and bringing together multiple pension schemes, finding those that sufficiently shared investment philosophies and management approaches, were too great to be of benefit. And then there were the governance issues involved.

"There was some initial reaction to it from many stakeholders and participants, who probably wanted to test the theory that bulking up and making these larger pools would be able to deliver any kind of cost savings and improved governance as well as ability to invest into infrastructure, which were all of the things that DCLG were looking for," Aon Hewitt head of public sector investment consulting Dave Lyons says.

"But a lot of those implicated collaborated on a piece of work called Project POOL, and I think that having done that recognised that there were indeed potential benefits, and that this was something that they should embrace."

Project POOL

Project POOL had three main aims: to produce an evidence-based and objective analysis of pooling options; to enable LGPS stakeholders to gather round one or a small number of options that satisfy the government's criteria; and to form a basis

of discussion between the LGPS and government on the best way forward. The collaborative project drew a number of conclusions including the most appropriate approach to management, structure, governance, and, of course, the cost-saving potential.

The report concludes that: "Over the very long term, the costs of transition and establishing and running the pools will be more than recouped by savings and other benefits. However, in the short term the costs of implementing change and transitioning assets are likely to exceed the savings."

Nonetheless, savings will not be uniform by any means – there will, the report says, be "winners and losers," with the latter including those funds that currently use a high level of in-house management and who will likely face higher costs. Nonetheless, over the longer term, potential overall savings make it broadly beneficial. "Based on current asset allocations and market values, and allowing for future asset growth in the range 3 to 5 per cent per year, the estimated eventual savings in year 10 values could grow to be in the range £190 million to 300 million per year," it says.

Economies of scale

A large part of these savings is likely to be found in simple economies of scale. As PiRho managing director Phil Irvine states: "Given the larger sizes of asset pools (on average over £25 billion in the eight pools) then the key advantages are fee negotiations and sharing the governance burden."

Indeed, as Lyons says, the savings are already becoming apparent: "Within the passive management that a lot of LGPS funds utilise, we have already seen significant reduction in management fees just from what is effectively collective procurement. Fund getting together within their pool and going out to tender for a single passive manager across their group, which means we are seeing significant cost savings start to come through already."

But, as FTSE Russell director, asset owner group EMEA Jennie Baruxakis comments, there is some way to go yet.

"There have been some cost reductions for schemes, as they look to request a unified pricing model for their assets. Substantive cost reductions however, will not be apparent for a number of years, as the new company structures are established at operations bed down," she says.

And while the costs of investments can be reduced, there is, of course, no such certainty around returns. "Even with the pooling of the top investment talent directing investment decisions at the pension level, one can never guarantee performance. Pooling will not automatically guarantee that the chosen managers are in fact the managers producing the expected returns."

Nonetheless, the project is certainly taking shape, and momentum appears to be picking up.

"The speed at which they were asked to move this forward by the government was ambitious, but I think that on the whole *[the sector]* has responded very positively and enthusiastically," says Lyons.

"We've got eight proposed and established asset pools at the moment, which is quite a feat, as perhaps the biggest challenges they faced was to actually find a number of like-minded funds to collaborate with on this project."

For Johnson, the changes to LGPS may have looked like tinkering, but for Lyons "it's an absolute sea change."

GSAM head of UK institutional business David Curtis agrees. "People think about LGPS as a very different marketplace to how they used to think about it," he says. "When it comes to simple but obvious benefits like pricing, there has been a wholesale change in how the asset management market has approached LGPS, and I think that is a big advantage for LGPS already."

Challenges

Of course, there are still challenges ahead. "Capacity could be one of the issues facing the newly-formed pools as they may be directed towards a few selective funds," Baruxakis mentions, though she adds that this could be mitigated to some extent by a broader selection of managers. "In addition, some pools are looking at passive as a way of allocating assets where they know that they cannot all use the selected manager. There are other issues like governance, which are coming to fruition, as schemes look at how they are managing their governance responsibilities in the new pooled framework."

Autonomy could be an issue too – when a host of schemes that are used to operating in their own way are brought together, decision making processes can change. "From the current pooling efforts, we see that quite a lot of decisions are taken away from the schemes," says Baruxakis.

"Some schemes continue to hold tight to the investment decisions taken, and their committees continue to push to have their views and thoughts heard. As pooling takes effect, schemes do have a duty of care to ensure that they are making the right decisions for their members, and this should continue to see schemes involved in investment decisions."

But as we edge closer to the April 2018 deadline, there are plenty of reasons to be positive, says Lyons: "It is a massive project, not just in terms of the number of schemes and people, the amounts of assets, but the difference between schemes investment approaches, their investment management arrangements, and so on. It is a very substantial task, but I think LGPS has really risen to and shown itself to be a very formidable force for change."

Written by Sandra Haurant, a freelance journalist

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