Summary

- Several pension funds around the world are divesting their holdings in fossil fuels, including California Public Employees' Retirement System (CalPERS), Swedish fund AP4 and the Danish PKA. In the UK, Waltham Forest Pension Fund and the Environment Agency Pension Fund are front runners of fossil fuel divestment.
- Pension fund trustees looking to divest from fossil fuels will need to be confident that the strategy is in the best financial interest of the members.
- Looking ahead, 'green' DC default funds are expected to grow, along with tighter regulations relating to what funds declare about fossil fuel investment in their SIP (Statement of Investment Principles) and other member documents.
- Despite the challenges, expectations are that the number pension funds adopting divestment strategies will grow.

The extinction of fossil fuel investment?

In recent years, increasing attention has been placed on pension fund investors' holdings in fossil fuels, with a number now moving away from investment in these fuels. So, is now finally the time that pension fund investors turn away from fossil fuel investment? Andrew Williams find out

As the quest to tackle the impacts of climate change gathers pace, several pension funds around the world are recognising the contribution they can make by divesting holdings in fossil fuels.

A prominent global example is the California Public Employees' Retirement System (CalPERS), which has adopted a strategy of selling shares in companies that generate at least 50 per cent of their revenues from coal mining by 2017.

Meanwhile, one of the early front runners in the UK is the £735 million Waltham Forest Pension Fund, which in September became the first British fund committed to fully divesting from fossil fuels by immediately freezing all new investments in the so-called Carbon Underground 200 and phasing out existing ones over a five-year period. Another early leader is the Environment Agency Pension Fund, which has partially divested its holdings in fossil fuels and committed to invest 15 per cent of the fund in low carbon investments and decarbonise the fund's shareholdings in coal by 90 per cent, and oil and gas by 50 per cent, before the end of the decade.

There are also signs that the trend towards fossil fuel divestment is heating up across Europe. In 2012, Swedish fund AP4 adopted the MSCI Low Carbon Leaders Index to evaluate individual industrial sectors and systematically exclude companies that possess large fossil fuel reserves or perform poorly in terms of their greenhouse gas (GHG) emissions.

"These indexes aim to allow investors to hedge climate risk without sacrificing financial returns and are designed to include companies with significantly lower carbon emissions and fossil fuel reserves than the broader market. They overweight carbon-efficient companies while minimising their exposure to large current and future carbon emitters," says MSCI global head of ESG indexes Thomas Kuh.

In 2015, PKA, one of the largest pension service providers for labour market pension funds in Denmark, also decided to divest holdings in 31 coal mining companies. As part of the strategy, companies generating 25 per cent or more of their business from coal-related activities must demonstrate plans detailing how the risk of climate change is, and will be, integrated in their business or face exclusion from the PKA portfolio.

"Even before COP21, it was obvious that coal would be facing tough times due to new climate regulation, cheap and lower emitting gas and the growth of renewables. These are all factors challenging the financials of coal. Not even the Donald Trump's of today will be able to stop the transition to a green economy, because at the end of the day sustainability always trumps unsustainability," says PKA responsible investment analyst Pelle Pedersen.

Stranded assets

According to 350.org UK divestment network coordinator Ellen Gibson, a key advantage of divestment is the fact that it

offers funds a way of addressing carbon risk in their investments, as well joining a global movement calling for strong action on climate change.

"Fossil fuel investments are risky financially, especially to long-term investors like pension funds and we know that, currently, asset managers aren't doing nearly enough to mitigate this risk. By divesting, funds can act to mitigate this risk to their members' financial futures, as well as ensuring there will be a safe and equitable world to retire into," she says.

That said, she argues that the impending pooling of LGPS funds represents a potential hurdle to funds keen on divesting and highlights the "huge amount of uncertainty" about how pensions will be controlled and managed in the future, which she believes is making some schemes fearful of doing things they perceive as risky or out of the ordinary.

Elsewhere, Bristol City Council's Redland ward Green Party Councillor, Martin Fodor, who is part of a group of campaigners urging the Avon Pension Fund to divest from fossil fuels and invest in energy efficiency, renewable energy and energy storage, thinks that the advantages of divestment are fund stability and growth in the long term.

"We have all heard warnings from major figures in the financial and scientific community about stranded assets, the imperative to leave fossil fuels in the ground, and the accelerating evidence of climate change caused by emissions. We are therefore making sure the funds get early investment advantages and do not get left behind when opportunities are already taken up by others," he says.

On a more cautionary note, Sackers associate director Ralph McClelland stresses that pension fund trustees looking to divest from fossil fuels will need to be confident that the strategy is in the best financial interest of the members. In his view, the benefits of taking such steps would need to outweigh any possible downsides from a financial perspective.

"In ordinary circumstances, for a pension scheme, a divestment strategy should not be an ethical issue but should be justifiable on financial grounds. From the legal perspective, trustees do not need to focus exclusively on maximising returns, they can also take into account the need to appropriately manage risks. This means that trustees may be able to accept lower returns in the short term if they are persuaded that they are taking on less risk over the investments term," he says.

In terms of fossil fuels, McClelland believes that this might enable trustees to conclude that a complete or partial divestment from the fossil fuel sector is appropriate from a risk perspective because of concerns around the broader, long-term impact of climate change and the impact that might have on the sector.

"Trustees will also need to consider whether divestment, rather than engagement, is the right approach to the risks they see associated with companies deriving their income from fossil fuels," he adds.

Looking ahead

Looking ahead, the Institute and Faculty of Actuaries' Resource and Environment Board chair Nico Aspinall predicts several trends in the near future. To begin with, he expects to see a wave of DC green defaults – particularly following the recent decision of the HSBC UK Pension Scheme to adopt a climate-change focused Legal & General Investment Management (LGIM) multi-factor fund as the equity default option for its DC scheme – which he believes "sets a precedent others will have to listen to".

Secondly, he expects tighter regulations relating to what funds declare on the issue in their SIP (Statement of Investment Principles) and other member documents. Finally, he expects a major 'stranded assets issue' in the next few years, perhaps caused by a major fossil fuel company being wound up and damaging pension scheme asset values, which will tend to focus the mind further.

"Those who act now can protect themselves against the stranded asset risk and the fiduciary risk of malinvestment claims," he says.

Elsewhere, Swedish pension fund AP4 senior portfolio manager for global equities, Mikael Johansson, points out that although climate risk remains one of the major risks asset managers currently face, the transformation to a low carbon society also brings several opportunities for an investor – not least through the mandate it provides to be long term in an often short-term market.

Even so, AP4 senior manager, corporate governance and communications Pia Axelsson admits that a key challenge facing funds interested in divesting is the need to identify scalable approaches that have developed KPIs (key performance indicators) like carbon footprints, chiefly to enable them to assess and create a strategy that will contribute positively to returns at not too high a risk.

"There is a lot of more awareness today about climate change and its challenges, and work is being conducted globally that will provide more information that can be evaluated and that will create investment opportunities," she adds.

Despite the undoubted challenges, Gibson is confident that an increasing amount of pension funds will opt to adopt divestment strategies in the coming years – and points to the total explosion in the engagement of funds in these issues over the past year.

"Now there are these innovative schemes out there leading by example, I expect we'll see more and more making similar commitments," she says.

Written by Andrew Williams, a freelance journalist