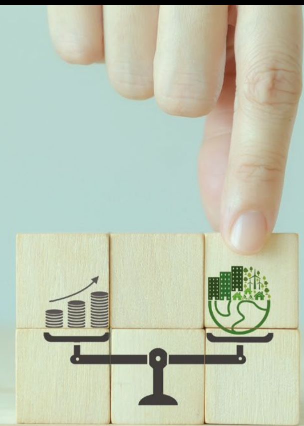
Summary
• Challenges faced by pension funds in considering climate-related issues across different asset classes include the availability of data, as well as the unique climate related risks and opportunities presented by different exposures across geographies, sectors, and asset classes.
• A key piece of advice is to start on the journey even if data is imperfect and challenges remain. It is better to start than to try and wait for the perfect landscape to appear.
• Tools that will enable broader comparability across asset classes and sectors are advancing rapidly.

Rising to the challenge



Abigail Williams considers climate-related issues across asset classes

In the ongoing quest to improve ESG performance, a growing number of pension fund investors are focusing on the management of climate-related issues in their portfolios, despite the challenges it may bring.

Challenges

According to Pensions for Purpose founder and chair, Karen Shackleton, the primary challenge faced by pension funds in considering climate and climate change-related issues across different asset classes is the availability of data. In particular, "although climate change data is better with listed assets, especially equities, private markets remain more elusive around data because of a lack of regulatory frameworks, standardised data reporting and general transparency in a way that applies to most of the private markets".

Other challenges highlighted by Shackleton include distinguishing between decarbonisation and climate solutions, as well as not declaring a public net-zero goal and a lack of clarity in investment beliefs.

"Listed assets generally focus on decarbonising either through sustainable strategies or by divesting, whilst climate solutions, like renewable energy natural capital investment and so forth, play more naturally to the private markets. Both help a pension fund on their net-zero journey, but pension funds need to be clear on the difference," she says.

Differentiated approach

Elsewhere, LGIM head of responsible investment strategy, Amelia Tan, observes that there are at least two key challenges facing pension funds in addressing climate change in their portfolios. Firstly, as asset owners that invest across different geographies, sectors and asset classes, these different exposures "each present unique climate-related risks and opportunities".

"Hence, pension funds should consider a differentiated approach depending on these specific risks and opportunities. For example, when considering climate transitions in emerging markets, we need to determine how countries can decouple greenhouse gas (GHG) emissions and GDP growth while solving for energy poverty," she says.

Secondly, while data and methodologies to assess climate risks have "certainly matured", she says that some exposures are still faced with limited availability and quality of data, particularly in private markets.

"The good news is that listed securities have fairly reasonable coverage in terms of Scope 1 and 2 emissions and the regulatory environment is generally supportive of improving disclosure. There is still room for advancement in terms of Scope 3 emissions disclosure, as well as disclosure of credible plans for companies' climate-related targets," she adds.

According to LGIM head of sustainability solutions, Caroline Ramscar, investors have traditionally thought about equities when considering climate change in their portfolios and had the ability to influence outcomes, given the ability to vote on the stock.

"However, this view is outdated, with understanding growing of the collective power of bond investors to effect change by pushing for improvements in the disclosure of ESG information and engaging with companies on ESG considerations.

"If these concerns are not taken seriously, then companies may struggle to raise debt or find that it costs them more to do so," she says.

Data availability

For the Impact Investing Institute programme coordinator, Sophia Omar, one of the key challenges that many pension funds looking at climate-related issues have is allocating across private markets and private equity.

"Private markets are where we see some of the greatest opportunities for addressing key climate challenges, including infrastructure for renewables and innovations in emission reduction technologies such as carbon capture and biodiversity," she says.

Omar also reveals that many pension funds are already making "exciting investments" in this area, and the institute has highlighted many examples including Nest's investment in Octopus energy and Nottinghamshire Pension Fund's direct investment in Nottinghamshire Community Energy.

She says the institute has also highlighted a wide range of investable opportunities across asset classes in emerging markets that address the most common concerns of institutional investors, for example around currency, liquidity or ticket sizes.

"Although progress has been made, high-quality, reliable and, crucially, comparable data across the climate space still poses challenges to pension funds when choosing investments," she adds.

Meanwhile, UKSIF head of policy and communications, Oscar Warwick Thompson, observes that challenges remain around reporting and data quality for various asset classes beyond listed equities, including sovereign debt and private debt, where carbon footprint reporting remains more nascent.

"More accurate disclosures across various asset classes would lessen investors and other firms' current reliance on data estimates for certain companies in their portfolios, a particular issue for unlisted and smaller companies in portfolios. Government, regulators, and industry should look to work together to address these data availability issues and more broadly widen their focus to assess the specific contribution that each asset class, beyond listed equities, can play in the transition to net zero," he says.

Advice

Even if there are data imperfections and challenges to be overcome, Shackleton stresses it is "better to start than to try and wait for the perfect landscape to appear".

For Tan, the best advice is to begin with a clearly stated objective of what pension funds are trying to achieve when considering climate-related risks and opportunities. Next, funds "will want to be able to assess their portfolios".

"Capabilities are advancing rapidly that will enable broader comparability – climate change modelling toolkits like *Destination@Risk*, a proprietary modelling tool that we have developed at LGIM, are enabling asset owners to assess which climate scenarios corporate and sovereign issuers are aligned with based on past performance and forward-looking commitments relative to sectoral decarbonisation pathways," she says.

In Tan's view, pension funds can then use these inputs in portfolio implementation, whether "through avoiding the laggards, tilting towards leaders, or investing directly in issuers that enable the transition".

"None of these options are mutually exclusive. That said, pension funds are increasingly recognising that they are universal owners – the diversified nature of their investments means that they effectively own a broad slice of the economy. If so, climate change must be considered a systemic risk that cannot be completely diversified away from their portfolios. Hence, active ownership is an important tool in raising market standards across the board," she says.

"I would also advise that the consideration of climate-related investments should be treated as per any other investment and follow the same steps – what is the governance in place? How do we evidence this? And how do you work with your asset manager to get the data you need to make an informed decision?" adds Ramscar.

Future trends

When it comes to assessing potential growth in this area moving forward, Shackleton observes that the market has moved fast in recent years and sees no reason why it shouldn't continue to do so.

"Yes, there are lots of innovative investment opportunities, ranging from vertical farming, to carbon offset investments, to biodiversity solutions that all address real-world global challenges and deliver positive impact, and yet still offer investors a strong return," she says.

Elsewhere, Omar observes that the industry is moving away from a very narrow focus on carbon emissions to "a broader understanding of the ways in which things like biodiversity loss and land usage play out in the climate space".

Ultimately, Warwick Thompson thinks the issue lies with decision-useful data that is available rather than the quantity of data alone that investors can use to inform their allocation of capital.

"We are seeing more focus in the industry on how climate change and sustainability-related factors can be addressed across a wider range of asset classes, and we hope to see this trend continue in the coming years," he says.

"We also expect the climate-related information and disclosures available to pension funds and other investors to gradually improve over time. In the UK context, this is already happening to an extent due to the mandatory roll-out of TCFD across the whole economy by 2025, and this needs to continue," Warwick Thompson adds.

Written by Abigail Williams, a freelance journalist

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