Net zero through fiduciary management

Sophie Dapin explores transitioning to net zero through fiduciary management

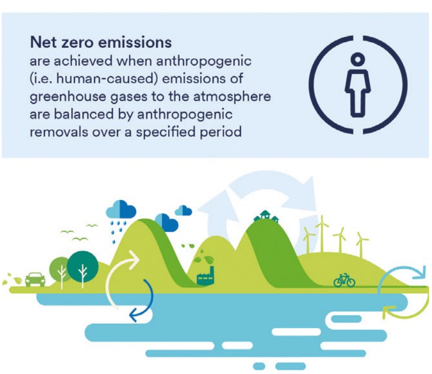
This year, we have seen a flurry of governments, companies and pension schemes the world over announcing net-zero carbon targets. These targets play a crucial role in global efforts to limit warming in alignment with the goals of the Paris Agreement.

But it is not just the Paris Agreement and the 2021 COP 26 climate summit that have sped up the race to net zero when it comes to UK pensions.

It is increasingly recognised that UK pension schemes need to ensure their portfolios are positioned both for the risks and the opportunities ahead while, at the same time, complying with an increasing amount of regulation.

The term 'net zero' gets discussed all the time, but what does it really mean? Here's how the Intergovernmental Panel on Climate Change (IPCC) defines it[1]:

Net zero emissions



For a pension scheme to achieve this, the aggregate emissions across all its underlying portfolios need to achieve this.

We will now explain why trustees should care, actions to take and how fiduciary management addresses key challenges.

Why should pension scheme trustees care?

Climate change will be a defining driver of the global economy, society and markets. All investors, including pension schemes, won't be able to avoid its impacts and accompanying risks to investment portfolios.

Trustees must ensure sure that when reallocating from fossil fuels to low carbon, portfolios tilt towards the likely winners from the climate transition and avoid the worst losers.

Crucially, as well as risks there are also opportunities. Pension schemes have significant influence over the flow of investments in the economy and are well placed to invest in opportunities that will lead towards a lower-carbon economy.

Regulation is also key in the drive towards net zero for pension schemes. Recently, the UK became the first major economy to ensure pension funds are legally required to report on the risks of climate change within their portfolios. Schemes over £1 billion will report in line with the Task Force on Climate-Related Financial Disclosures (TCFD).

Part of this regulation is the 'metrics and targets' requirement. The Pensions Regulator has given examples of targets a scheme may consider in its guidance and some are explicitly related to carbon reduction. For example, one target they suggest is to "reduce their carbon intensity by 15 per cent by 2023 and align with their decarbonisation trajectory up to 2030"[2].

Although encouraging schemes to set decarbonisation targets is helpful, there are risks involved. For example, indiscriminately adopting this approach can lead to overvalued securities like those from the dot com bubble, with potential for a strong market correction occurring. The technology, media and telecom sectors have changed the world, but not before significantly impairing value for investors.

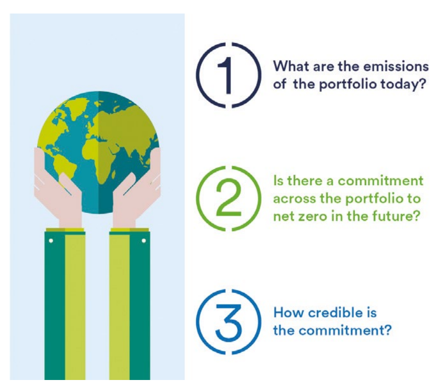
What should pension scheme trustees do?

The first step is to ask the right questions. Before embarking on this journey, trustees need to build their own capabilities and ensure that their providers can demonstrate 'climate competency'. Trustees need to be confident that those providing advice to the scheme have the knowledge and expertise to manage climate-related risks and opportunities.

An investment-led fiduciary management approach can provide significant efficiencies for trustees. With the fiduciary manager directly responsible for the engagement with underlying companies and their emissions targets, compared to having a separate adviser and asset manager, this provides a direct link to those underlying companies.

There are three key questions that trustees should ask their providers:

Three key questions for trustees



better understand the risks climate change poses to investments and to integrate this into their investment decision-making.

Stopping at 'what are the emissions of the portfolio today?' and focusing only on minimising today's emissions is a risk. This could encourage behaviours that lead to overly-concentrated portfolios in certain sectors. It also risks missing out on the bigger picture.

It is crucial for pension schemes to focus on the journey to net zero, rather than solely focusing on being net zero today.

If you move the portfolio too early there are diversification challenges given the current small pool of companies with credible net zero plans. However, if you move too late, there are risks to the value of the assets the scheme invests in.

How might a fiduciary arrangement approach help?

A fiduciary management approach provides significant benefits regarding net-zero targets. It delivers these benefits across three key areas:

1- Effecting real change

Setting a net-zero target should not just focus on changing a portfolio to improve current scores. This is about engaging with companies to improve the portfolio by effecting change to the real economy. Simply divesting from some carbon-intensive companies and passing them on to another buyer won't suffice.

Pension scheme trustees are in a unique position to bring about this kind of change if they put their assets to good use under an effective stewardship programme. For example, Schroders have written to the leaders of UK FTSE 350 companies, calling on them to prepare and publish their plans for decarbonisation. We are then able to track progress across the market.

2- Data

It is not a straightforward task to collect, process, understand and report on the data needed to form a full picture of your portfolio's net-zero status.

Today's carbon emissions and intensity data form a good starting point for analysis, but are backwards looking and far from the whole picture.

We have invested heavily in our proprietary research and tools to deal with data challenges. This helps our fund managers across asset classes to better understand the risks climate change poses to investments and to integrate this into their investment decision-making.

3- Applications across different asset classes

Understanding the application of net zero across different asset classes is an immense challenge for pension schemes. Company emissions data is more mature for listed equities and bonds,. Pension schemes typically have high allocations to alternative asset classes where this methodology is less well developed.

Recognising this, the Institutional Investors Group for Climate Change have produced a Net Zero Investment Framework [3]. This is a useful tool for pension schemes and currently covers how to approach net-zero investments in listed equities, corporate and sovereign bonds and real estate.

Our closeness to the underlying data and integrated approach means we are able to consistently apply this framework across our fiduciary management client portfolios.

Conclusion

Transitioning in a few decades from a global carbon-powered energy system, built up over hundreds of years, to one that is carbon-free, will require significant and rapid transformation to the global economy. Pension scheme trustees need to be prepared for the impact on their portfolios.

Having the right governance structure in place to deal with this is crucial. There are significant benefits to an integrated and investment-led fiduciary management approach.

Written by Schroders fiduciary manager, Sophie Dapin

In association with Schroders

[1] https://www.ipcc.ch/sr15/chapter/glossary/
[2] https://www.thepensionsregulator.gov.uk/en/document-library/consultations/climate-change-guidance/guidance/targets
[3] https://www.iigcc.org/resource/net-zero-investment-framework-implementation-guide/