Andrew Williams considers how pension funds' investment choices can help make a difference with tackling climate change

Summary
• Institutional investors are increasingly aware of the physical and transition risks posed by climate change.
• In recognition of this fact, a growing number of investors are exploring how best to reduce these risks by decarbonising their portfolios and investing in low-carbon assets as part of their investment strategies.
• Potential responses range from divestment strategies, investing in greener solutions and greater engagement with companies held to investing in tilted indices in an effort to reduce carbon risk and physical climate risk analysis.

Institutional investors around the world are continuing to face up to the challenges posed to their investment strategies as a result of severe and ongoing climate change. So, what have been the main recent trends and developments in pension funds' efforts to tackle climate change? Generally speaking, how best can pension funds as institutional investors help to tackle impacts through their investment strategies? And what practical, concrete steps can they take when implementing investment, or divestment, strategies to tackle climate change?

Wake-up call

There is now a growing recognition across the financial sector as a whole that climate change, and efforts to address it, have a significant impact on investor portfolios and the type of investments that are financially sound over time. As the Institutional Investors Group on Climate Change's (IIGCC) CEO, Stephanie Pfeifer, explains, work undertaken by the Task Force on Climate Related Financial Disclosures (TCFD) and the Bank of England has provided a wake-up call to investors by highlighting how the physical and transition risks posed by climate change are material, and need to be addressed. As a result, a growing number of investors are now increasingly looking to reduce these risks to decarbonise their portfolios and invest in low-carbon assets as part of their investment strategies.

"We have also seen increasing support from pension funds and other investors for governments to take greater action on climate change by putting in place the policy needed to support a transition to a global low carbon economy," says Pfeifer.

"The Global Investor Statement to Governments on Climate Change, which IIGCC helps lead, has now been signed by over 470 investors globally, with $34 trillion of assets under management. Its call for greater action on key issues such as global carbon pricing, eliminating fossil fuel subsidies and the phase-out of coal, among other examples, highlights the contribution the investor community is making on key policy issues," she adds.

Elsewhere, Insight Investment's senior ESG analyst, Joshua Kendall, points out that, while it has been widely accepted that investors should pay attention to climate change in their investment practices and processes, much of the analytical work to date has focused on the listed equities, property and infrastructure space. However, given that "fixed income investments represent approximately 55 per cent of large pension funds investment portfolios", he argues it is vital that more tools and processes are developed to support fixed-income decision making of critical climate-related themes.

Role of funds

In recognition of the fact that fiduciary responsibility lies at the core of investors' strategies, Pfeifer believes it is critical that pension funds assess and manage risks to their portfolios as recommended by the TCFD. In her view, such assessments should cover both transition and physical risks related to climate change. In addition to reducing exposure to climate-related risks, she observes that this process also helps steer investments towards lower carbon asset classes.

"But investors can go further by actively seeking to increase their holdings in assets that help support delivery of the Paris Agreement goals. We have seen significant growth in products and instruments designed with this in mind, such as the growing number of low-carbon and climate related indices now available. IIGCC has also recently announced an initiative that will support investors in aligning their portfolios with the goals of the Paris Agreement," she adds.

Kendall also reveals that, during June, 2019, the European Commission announced sweeping reforms to how investors, both asset managers and pension funds, should commit to the disclosure requirements of the TCFD.

"We believe the TCFD provides a comprehensive framework for financial market participants to think about their risks and appropriate strategies to tackle climate change," he says.

Meanwhile, although activities differ, Impax Asset Management's co-head of equities, Bruce Jenkyn-Jones, identifies a number of 'headline' investment strategies that funds could adopt, ranging from divestment strategies, investing in solutions and greater engagement with the companies that they hold, to investing in tilted indices to reduce carbon risk and physical climate risk analysis.

"We would say that pension funds have either been leading the way, very active, dipping their toes into these waters or doing nothing. What is positive is that in the past few years the latter group is getting smaller and smaller. Those funds leading the way, like the Environment Agency and Brunel, are doing all of these things," he says.

Elsewhere, ShareAction's senior campaigner, Lauren Peacock, urges funds to reduce exposure to high carbon companies, increase exposure to low carbon solutions, practice good stewardship and consult members.

"Action should also be made public where possible to encourage best practice. In order to avoid future global warming, which will affect returns across the board, the investment industry needs to signal to policy makers that more needs to be done," she says.

Concrete steps

When it comes to taking concrete steps to tackle climate change, Kendall thinks it is vital that pension schemes and institutional investors begin by clarifying their beliefs around responsible investment and establish a policy that provides a clear guide for decision making. Once this is in place, for investors who manage their own portfolios, he would urge them to use a range of third-party data providers and advisers who can assist in adapting the portfolio to reflect these views.

For those who use third-party investment managers, he also argues it is "vital to choose a partner they are confident has the capabilities to implement their approach". In doing so, he identifies key areas to question managers on, which could include a thorough examination of their investment capabilities and experience in implementing climate-related analysis, as well as an investigation of their research and engagement record and examples that can demonstrate experience in investing in line with climate change-related objectives.

Meanwhile, ShareAction's senior research analyst, Felix Nagrawala, believes that, in order to take strong action on climate change, funds should adopt a two-fold approach. Firstly, engaging with companies to increase climate-related disclosure to decarbonise their operations, and secondly increasing low-carbon investments. In his view, such strong engagement involves time-bound objectives on which to hold companies to account, coupled with escalation procedures when these objectives aren't being met – enabling funds to vote on climate-related shareholder resolutions, and even file resolutions, when insufficient progress is being made by companies.

"At the same time, another key component of a robust climate strategy is asset allocation. In order to support the low carbon transition, a massive amount of capital needs to be allocated to low carbon solutions: 90 trillion by 2030," he says.

"Pension funds account for over half of assets controlled by asset owners globally and hence must play an instrumental role in allocating the necessary capital. Our research has found that on average only 1 per cent of assets under management are being explicitly set aside by pension funds to support the low-carbon transition, while leading funds are allocating up to 20 per cent and setting targets to increase their allocation even further," Nagrawala adds.

Ultimately, Pfeifer argues that how a fund best responds to climate change will somewhat depend on its own characteristics and it will need to choose an appropriate strategy accordingly. That said, she highlights a number of clear steps any fund can take to integrate climate-related risks and opportunities into investment processes. Most important is to firstly understand exposure and vulnerability across a portfolio, something she views as key to identifying which assets to focus on in developing an investment strategy. Funds can then consider ways to reduce their exposure to climate-related risks, build greater resilience across portfolios and identify opportunities for new investments.

"This can include divestments or choosing greener assets or instruments over time. Adopting an active ownership approach to stewardship of assets is also an important step that pension funds can take. This involves engaging with the companies in which a fund invests on the issue of climate change," she adds.

Written by Andrew Williams, a freelance journalist