

PENSION FUND COMMITTEE – 10 SEPTEMBER 2021

PASSIVE EQUITY ALLOCATION

Report by the Director of Finance

RECOMMENDATION

- 1. The Committee is RECOMMENDED to determine any changes to the current allocation to passive equities, and if appropriate, to the current commitments set out in the Investment Strategy Statement.**

Introduction

2. The Committee last reviewed its allocation to passive equities in March 2020 as part of the fundamental asset allocation review. The review was undertaken alongside the development of the Climate Change Policy, and the Committee were keen to ensure that any decision met both the overall funding objectives, as well as the new objectives set out in the Climate Change Policy.
3. As a consequence, the Committee determined to switch 5% of its then allocation to UK passive equities to the Low Carbon portfolio available through Brunel. The decision was made to achieve an immediate reduction in the carbon intensity of the Fund's investments, whilst acknowledging that the Low Carbon portfolio had a number of limitations in terms of meeting the requirements of the Climate Change Policy. The Committee therefore also agreed to ask Brunel to develop further passive portfolios that were more consistent with the objectives of their Climate Change Policy, and the Paris Agreement, and earmarked the remainder of the UK Passive allocation to be switched, once a suitable alternative passive portfolio was available.
4. The request for Paris aligned passive portfolios was supported by other Funds within the Brunel Partnership and Brunel subsequently worked with others in the investment industry to develop suitable offerings. New climate related benchmarks have now been developed in conjunction with FTSE Russell and new portfolios based on these benchmarks are being made available by Legal and General Investment Management and added to the Brunel suite of portfolios.

The New Climate Related Benchmarks

5. Following discussions between officers from Brunel and the Client Group, the view was taken that rather than developing specific climate related benchmarks for the Brunel Funds, Brunel should be tasked with working with others in the investment industry to develop new standard climate related benchmarks. It was felt that such an approach benefitted by setting a consistent definition and

set of metrics against which performance can be assessed and allowing Brunel and the underlying Funds to collaborate more readily with other investors to bring pressure on others to deliver the real world changes required if the world is going to keep temperature rises below 1.5°. The development of an industry standard benchmark would also reduce the costs of the Fund.

6. In conjunction with FTSE Russell, Brunel have developed two families of benchmarks – the Paris Aligned Benchmark and the Climate Transition Benchmark. Both benchmarks meet the definitions set under the EU Taxonomy as set out in EU Regulation 2016/1011. They are also consistent with the Institutional Investors Group of Climate Change (IIGCC) Net Zero Framework. Both benchmarks are consistent with the Paris Agreement.
7. Both benchmarks target:
 - A minimum 80% reduction in fossil fuel reserves
 - Annual reductions in carbon emissions of 7%
 - Increasing allocations to those companies on net zero pathways
 - An 100% increase in green revenues
 - Overweighting companies with higher Transition Pathway Initiative (TPI) Management and Performance Scores
 - The ability to phase in scope 3 metrics as and when these can be measured on a more consistent and standard basis.
8. The Paris Aligned Benchmark is more aggressive in its approach to delivering these targets. It sets an immediate reduction of 50% in carbon emissions over the period September 2020 to September 2021. The Climate Transition Benchmark has a similar target of 30%. Both benchmarks are designed to achieve net zero by 2050 but follow different paths with the CTB having a smaller initial reduction but with greater annual reductions thereafter.
9. To enable it to hit the more aggressive targets, the Paris Aligned Benchmark includes a greater number of exclusions. Both benchmarks exclude:
 - controversial weapons,
 - tobacco,
 - companies guilty of OEDC violations or excluded from the United Nations Global Compact (which sets target behaviours in respect of human rights, labour law, the environment and anti-corruption measures as well as seeking to advance societal goals),
 - or companies deemed to cause significant harm (no clear definition).
10. The Paris Aligned Benchmark also excludes:
 - Coal – companies that generate more than 1% of revenues from the exploration, mining, processing etc of coal
 - Oil - companies generating 10% or more of revenues from the exploration, extraction, distribution or refining of oil fuels

- Gas – companies generating 50% of more of revenues from the exploration, extraction, manufacturing or distribution of hydrocarbons, hydrogen and carbon monoxide mixtures present in gaseous state
 - Electricity producers – based on carbon intensity and % revenues
11. The Climate Transition Benchmark has no specific fossil fuel exclusions and cannot underweight in aggregate the high intensity sectors, therefore investing in the higher performing companies in these sectors.
 12. At the time of writing this report, FTSE Russell had launched the Paris Aligned family of benchmarks, and are expected to launch the Climate Transition Benchmark in the next couple of months. Within the Paris Aligned Benchmark family, there is no UK only benchmark. Given the make up of the UK market, and the exclusions hard wired into the Paris Aligned Benchmarks it is not felt that a UK version of the benchmark could be appropriately diversified. It is expected that there will be a UK only version of the Climate Transition Benchmark.

Discussion at the Climate Change Working Group

13. The Climate Change Working Group discussed the new climate related benchmarks when they met on 4 August 2021. Faith Ward and Laura Hobbs from Brunel joined the meeting to present on the work undertaken by Brunel and answer questions on the new benchmarks.
14. The Group noted the current allocations to passive portfolios were as follows:
 - UK – 3%
 - Developed World – 7%
 - Low Carbon – 5%
15. This 15% allocation is equivalent to a total investment of £470m. As at the end of June the Fund was overweight to these portfolios with a total investment of £530m
16. The Group discussed the limitations of the low carbon portfolio which it was felt had served a useful purpose at the point it was initially designed but was now limited in what further it could contribute towards meeting the objectives of the Paris Agreement, and delivering real world change. In particular, the optimisation principles on which it is based simply moves investments up and down the value chain. Overall exposure to the risks associated with fossil fuels is therefore not significantly reduced.
17. Questions were raised about the future investment performance of the various portfolios. It was noted that the new Paris Aligned and Climate Transition Benchmarks are targeted to deliver the same investment performance as their equivalent market cap benchmarks. Investment performance therefore should be a neutral consideration in any decision to re-allocate investments between passive portfolios.

18. There was some discussion on the current 3% allocation to the UK benchmark and whether it was necessary to retain any passive allocation to the UK markets. The Group were informed by the Independent Financial Adviser that given the small size of the current passive allocation to the UK market, and the current concentration of high impact companies within the UK market, it was his view that any allocation to the UK could be best managed through the allocations to the active portfolio.
19. There was limited discussion on the benefits of retaining an overall 15% allocation to the passive markets or whether it was appropriate to increase the allocations to the active markets where Fund Managers would have greater flexibility in investing in line with our Investment Strategy. It was noted that there was a significant cost benefit of retaining the allocation to the passive portfolios, and that the new Paris Aligned and Climate Transition Benchmarks had been designed to be flexible going forward to incorporate new scientific developments, including the addition of scope 3 emissions once more widespread and consistent metrics were available. As part of the discussion, Brunel indicated their intention to use the Climate Transition Benchmark as a secondary benchmark to assess the performance of all active equity portfolios.
20. The Group therefore were happy to recommend that the full 15% currently allocated to the passive portfolios could be switched to the new climate related benchmarks. It was further agreed that the full allocation could be against the developed world. Any decision to overweight the UK or the emerging markets was best delivered through the allocations to the active equity portfolios.
21. There was no consensus though in respect of allocating between the Paris Aligned Benchmark and the Climate Transition Benchmark. It was the view of Officers that the Climate Transition Benchmark more closely reflected the current wording within the Climate Change Policy. In particular, the Policy specifically states that the Fund will not operate a blanket divestment policy, and will support the principles of the Just Transition, providing a managed transition to protect the employees and communities current dependent on the fossil fuel industry. It is also noted that an 30% initial reduction in carbon emissions was consistent with the actual current carbon intensity of the Fund which was 25% below its benchmark according to the last Carbon Metrics report. This position was supported by some members of the Group, recognising that the Committee have previously acknowledged the resolution of the climate change risks needs to be much wider than simply focussing on just the fossil fuel industry.
22. Others within the Group felt that the Fund should be more ambitious and supported the more aggressive approach within the Paris Aligned Benchmark. It was noted that in terms of performance retrospectively calculated, the Paris Aligned Benchmark had marginally out-performed the Climate Transition Benchmark (which in turn had marginally out-performed the market cap benchmark), although both benchmarks were targeted to be investment performance neutral. Due to the higher number of exclusions, the Paris Aligned Benchmarks carried higher concentration and tracking risk.

23. The Working Group therefore wanted to Committee to consider the options of either transitioning the full 15% allocation to the Paris Aligned Benchmark for the developed markets, or the full 15% to the Climate Transition Benchmark for the developed markets. A potential compromise suggested was to allocate 5% to the Paris Aligned Benchmark reflecting the current allocation to the more aggressive low carbon portfolio, with the remaining 10% allocated to the Climate Transition Benchmark. Others suggested that a more even split or a 10% allocation to the Paris Aligned Benchmark were equally valid alternatives, but it was accepted that any allocation below 5% was not meaningful. It would be important though to provide a clear rationale for any split allocation to ensure there was no confusion in the message to be conveyed in making the new allocations.
24. The Committee are therefore invited to consider how it wishes to re-allocate the 15% allocation to passive equity portfolios to the new climate related benchmarks. A decision made today will enable the funds to transition as part of the launch to the new Brunel portfolios currently scheduled to take place before the December meeting of the Committee.
25. Following consideration of the detailed supporting information presented by Brunel on the two new benchmarks, the Officers do not see any significant financial or investment performance issues which impact on the decision. The current Investment Strategy Statement states that where there are two investment options that broadly aim to deliver the same investment objective the Pension Fund will prioritise the option that delivers the best fit to its climate change commitment. The Committee therefore need to determine which of the two new benchmarks, or which combination of the two best fits their current climate change commitment, or to any amendments to be agreed to the current commitments as set out in the Investment Strategy Statement.

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