

A greener tomorrow

The Environment Agency's Howard Pearce tells *Public Service Review's* Laura Ferguson about the changing role of the organisation's pension fund...

The Environment Agency's Active Pension Fund is a final salary scheme open to all its employees, and has 22,000 members. The fund is 94% funded and has assets in excess of £1.7bn, and so is one of the largest funds in the Local Government Pension Scheme (LGPS). As well as providing retirement benefits to users, the fund's innovative investment strategy integrates financially material environmental risks and opportunities.

Historically the fund followed a fairly traditional investment approach that took little account of environment, social and governance (ESG) issues. In 2003 however, following poor investment returns and considerable criticism from some employees and the national media, the Environment Agency renewed its fund investment strategy and fund manager structure to increase its financial returns and integrate ESG issues.

Here *Public Services Review's* Laura Ferguson talks to Howard Pearce, Head of Environmental Finance and Pension Fund Management at the Environment Agency, about how its pension scheme is delivering results financially while also being environmentally credible.

What is the Environment Agency's current pension fund investment strategy?

Our investment strategy is to maximise our risk adjusted returns while also taking into account the relationship between good environmental management and long-term sustainable business profitability.

Over the last 10 years our fund has matured. As a result, we have reduced our equity risk exposure from a very high level to its current more moderate level, and increased our allocation to gilts and bonds. The fund has also diversified into alternative asset classes with small allocations to private equity and property to boost returns.

The environmental overlay strategy is rolled-out across our entire investment portfolio. We recognise that when the strategy is applied to investments in equities, bonds, gilts, property and private equity, this will involve considering different approaches, constraints, risks, opportunities and potential benefits.

Our main influence will be through our strategic asset allocation, manager structure, manager selection, performance benchmarks, monitoring, and reporting –

and not by getting involved in the day-to-day investment decisions, which is the role of our external fund managers.

Our fund managers are encouraged to use research on various environmental risk and/or 'green' performance rating and ranking tools to identify and avoid financial risks attributable to environmental issues, such as climate change, which could impact negatively on investment returns.

The fund managers' performance is monitored, meaning they need to justify and explain any financial investment decisions – for example on stock selection – which in our view are environmentally controversial. We favour the positive selection of good and sustainable stocks over negative screening.

Are the main principles of the Environment Agency replicated in the pension fund?

The pension fund seeks to align the principles of the Environment Agency within our pension fund investment strategy. This works at a strategic level via the Active Fund Environmental Overlay Strategy, and in our approach to responsible investment through being members of the UN Principles of Responsible Investment (PRI).

In a nutshell, our pension fund is invested to pay to pensioners who will be living well into the next century. Therefore, we want them to have a long and happy retirement in a clean and safe environment; we do not want their longevity to be reduced by pollution or climate change.

Is the pension fund in line with UN PRI Initiative?

It is entirely consistent with this fiduciary duty for the fund, investment strategy and fund managers to take into account financially material environmental risks like climate change, which could reduce investment returns, and opportunities like clean technology, which could generate higher investment returns. Ignoring or not taking into account these and other financial risks and opportunities within the fund's investment strategy is a potential breach of this fiduciary duty.^{1,2}

Why has action been taken to re-tender the current active pension fund?

As part of good governance we keep our investment mandates under regular review and consistent with

good pension fund management. As such, we will re-tender mandates when there are issues of performance, process, team changes and reporting that do not meet our expectations.

Recently, we tendered an emerging markets equities mandate and appointed Comgest, and also tendered our pension fund administration, awarding a new contract to Capita Hartshead. At present, we are re-tendering our actuarial, benefits and investment advisory services in collaboration with six other LGPS pension funds in the South West of England.

Is sustainable private equity well matched to the Environment Agency's Active Pension Fund?

Private equity is suited to pension fund investment because it is a long-term investment that can provide good financial returns in the future. This is a useful characteristic as pension funds tend to mature over time. There is no single path to sustainability. Still, technological advances in areas such as renewable energy technology, materials technology, and information and communication technology all point to the possibility of meeting the needs of a growing world population in a satisfactory way without sacrificing natural or social capital.

The vast majority of fast growing companies with exciting new sustainable technologies are too small to be listed on stock exchanges. Therefore, the only way to invest in these companies that can offer highly attractive investment returns and at the same time contribute to sustainability is through investing in private equity.

Sustainability is certainly gaining momentum in the private equity industry. This can be seen by the increasing number of dedicated sustainable private equity funds coming to the market. These funds typically focus on new forms of energy, food, eco-agriculture, nutrition technology and new ways of utilising resources more efficiently. Observing the market for new energy technologies, it is clear there is a strong demand for innovative energy technology solutions in the fields of renewable energy (biomass, solar, wind and hydro) and decentralised generation systems (such as fuel cells and micro-turbines). Also, the potential for private equity investments in the water sector is very large, given that the demand for water will continue to increase in the coming years, both in quantitative and qualitative terms.

Has it been problematic sourcing fund managers to invest against environmental risks and opportunities?

When selecting our investment advisers and appointing external fund managers, we use a robust procurement process. This includes ensuring they understand global ecology, environmental risks and opportunities, as well as economics, financial performance criteria and value for money.

Our environmental criteria include: the relative quality, integration and impact of internal and external

environmental research used in external managers' investment strategy, stock selection and performance reporting processes; and the level of resources that external managers have available for this work.

We are committed to responsible investment and are striving for all our fund managers and investment service providers to be cosignatories of the UN PRI.

Does good environmental governance help to deliver a better financial performance overall?

Well-governed companies reduce the risk to shareholder value and will, over time, produce more sustainable returns compared to poorly governed companies. Research was undertaken in 2004 before our new investment strategy was implemented in 2005, and we are going to update this research during 2011. Over the last five years, the environmental footprint of our actively managed equities has been reduced by 30% and delivered a financial performance 2.5% above the market index benchmark.

What are your expectations for the development of the Environment Agency's pension fund by 2015?

The Active Pension Fund's long-term investment strategy currently under review links to the 31st March 2010 triennial actuarial valuation of the funds' assets and liabilities. While financial considerations will be paramount, the investment strategy review will be used as an opportunity to revisit and update the Active Pension Fund's asset allocation, corporate governance and environmental overlay strategies. We will also review our current investment mandates and fund managers' performance and make any changes that are needed.

The next phase of 'greening' the Active Pension Fund investment strategy is likely to involve reducing financially material risks and investments that could be negatively affected by the financial impacts of climate change, and conversely exploiting investment opportunities aimed at adapting to – and mitigating – climate change that could produce good returns.

In 2002, we had around 2% (£20m) invested in a 'green' fund. In 2010, around 13% (£205m) was invested in the environmental sector seeking 'alpha' (must have 20% or more revenues from green or clean technology). In 2015/16, we expect and plan to assess if 25% of our fund is invested in companies that positively contribute to the global 'green' economy.

¹ This view has been supported by the Freshfields reports for the UNEP FI. www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

² www.unepfi.org/fileadmin/documents/fiduciaryII.pdf



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