

Pension Fund reduces environmental risk without compromising financial performance

The UK Environment Agency has shown that pension funds can reduce the environmental impacts of investments by almost one-third – with no loss to financial performance. The Environment Agency Pension Fund (EAPF) (AUM £1.6bn) reduced the environmental footprint of actively-managed equity holdings by 30% between 2006 and 2010. Over this 5 year period the EAPF's actively managed equities have in aggregate outperformed the MSCI World Developed Countries Index benchmark by +2.5%.

Howard Pearce, Head of Environmental Finance and Pension Fund Management at The Environment Agency, said: "Environmental, social and governance (ESG) issues are increasingly important in assessing the quality of management and may affect the future performance and prospects of a company. Well-governed companies tend to produce better and more sustainable risk-adjusted returns than poorly governed companies."

While many institutional investors are starting to invest in environmental opportunities such as renewable energy, few have considered the environmental impacts of the operations and supply chains of companies that they invest in.

As the first pension fund worldwide to measure the environmental footprints of its equity investments over five years, the EAPF has been able to monitor the effectiveness of fund managers' efforts to manage the environmental impacts of their equity holdings. In 2010, the EAPF active equities were valued at £655mn and were associated with environmental costs totalling £19mn – equivalent to 3.3% of revenue from holdings. This is around one-third lower than the fund's environmental footprint of 4.7% in 2006, when higher environmental costs totalling £20mn were associated portfolio holdings valued at £559mn. The benchmark was linked to environmental costs totalling £22mn in 2010.

Shrinking the fund's environmental footprint has reduced its exposure to financial risk from environmental impacts, mainly due to fund managers' positive selection of stocks that are more environmentally efficient than the average for Index sector peers.

The fund's investment strategy aims to take account of the relationship between good environmental management and long-term sustainable business profitability. Its main influence is through strategic asset allocation, manager structure and selection, performance benchmarks, monitoring and reporting. Fund managers are encouraged to identify and avoid financial risks attributable to environmental issues, such as climate change, that could negatively affect investment returns. In line with the Agency's fiduciary duty, they are required to take account of financially material environmental risks before selecting investments and when meeting the senior management of investee companies. The EAPF favours investing on a positive "best-in-class" selection basis, and encourages fund managers to use engagement rather than negative screening.

They seek to influence the directors of under-performing companies to improve their management and financial performance, following EAPF principles aligned with the latest UK Stewardship Code. Their fund managers regularly engage with companies, directly or through specialist providers, to encourage them to improve environmental policies, governance, reporting, processes and practices. Following footprint assessments, the active equity fund managers engaged with companies with poor disclosure in their portfolios.

The year-on-year analysis of each portfolio's environmental footprint within the fund enables managers to monitor changes in company disclosure and environmental performance. Out of 130 companies held in the Active Fund for the past three years, 83 have reduced their environmental costs relative to turnover. Fund managers engaged with 97% of these companies at some point between 2006 and 2010.

Three of the six investment managers in place when active equity assets were assessed in March 2010 – Sarasin, Standard Life and Scottish Widows Investment Partnership (SWIP) – managed portfolios on behalf of the Environment Agency throughout the five-year period analysed. The other portfolios examined in 2010 have been managed by Impax, Generation Investment Management and RCM since 2008.

The EAPF mandates encourage equity managers to pay for the environmental footprint assessment so that they have some ownership of the results for their equity portfolios, and use them in investment management for the EAPF and other clients. The footprints reveal which companies have the weakest disclosure and environmental performance relative to sector peers, and which contribute most to the fund's exposure to environmental costs.

The fund have helped the EAPF to demonstrate that large institutional investors with diversified long term equity portfolios can measure, manage and reduce environmental risk without any financial loss. Pearce believes that reducing the environmental impacts of investments positions the fund well for the future. He explained: "We think that companies which address environmental risks and opportunities are more financially sustainable."

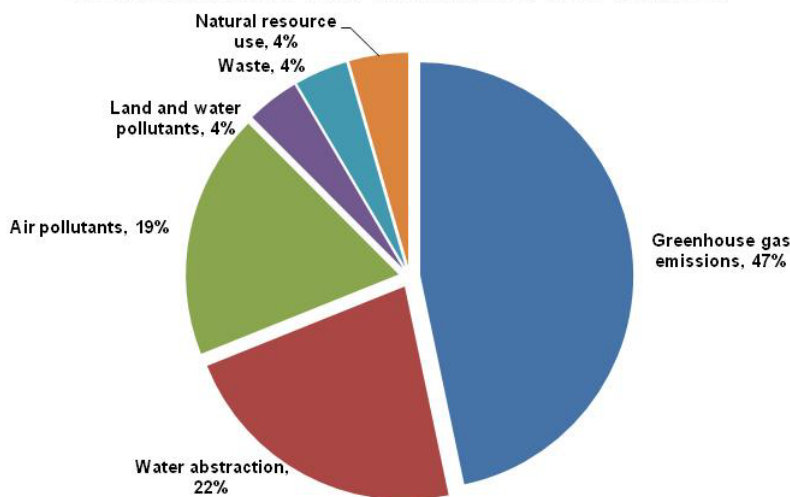
Notes

1. The environmental costs measured by research provider Trucost are based on quantitative data on the environmental impacts of 319 investee companies held in the consolidated portfolio and covered in Trucost's database. The environmental costs of impacts such as greenhouse gas emissions represent damages caused to the environment and human health, based on a review of environmental economics literature overseen by an independent advisory panel of leading academics. Different prices are applied to quantities of resources used and pollutants released in line with the costs of damages caused by these impacts. Each company's environmental costs and revenues are allocated to the fund in proportion to the amount of stock held.

Environmental costs and revenues apportioned to the fund are summed up to calculate its overall environmental footprint.

2. The footprint indicates the fund's potential exposure to environmental costs that are being increasingly internalised on to company balance sheets through rising input prices, taxes, cap-and trade schemes and pollution clean-up liabilities. As shown in a recent study by the UN Principles for Responsible Investment (PRI), environmental costs could reduce the value of portfolio assets in the long term. Funds invested in companies with production that is environmentally efficient relative to sector peers are likely to have smaller environmental footprints and lower exposure to environmental costs than funds invested in less efficient and more polluting firms.

Breakdown of Active Fund environmental costs by impact



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