

Paper by: Head of Environmental Finance and Pension Fund Management

Subject: Greening the Active Pension Fund Investment Strategy

Recommendations

The Board is asked to note and welcome the progress made to “green” the Active Pension Fund investment strategy.

1.0 Introduction

- 1.1 At its February 2009 meeting the Board received a paper that described the work of the Environmental Finance and Pension Fund management team on corporate environmental governance, environmental accounting, environmental reporting, and positive linkages to the financial performance of business.
- 1.2 The purpose of this agenda item is to update the Board following a request by the Chairman on the innovative work that the Pensions Committee and officers have been doing on responsible investment and how we have “greened” the investment strategy of the Active Pension Fund, and used it to influence behaviour in the wider investment world.
- 1.3 This paper will be supported by a slide presentation. Also attached for information is a “Responsible Investment Review” that has been prepared as part of our membership of the United Nations Responsible Pensions Initiative (UNPRI).

2.0 Context

- 2.1 The Environment Agency has pensions responsibilities for ca 50,000 people whose pension benefits are met by the “Closed Fund” or the “Active Fund”.
- 2.2 The focus of this paper is on the Active Fund which has a growing and maturing membership. It has assets of £1.2bn arising from its 21,000 members that comprise 12,000 contributing employees and 9,000 ex-employees. The assets of the Active Fund belong to its members and not to the Environment Agency.
- 2.3 The ownership and purpose of the Active Fund precludes it being used for any of the Environment Agency’s regulatory and operational work, and it is managed and accounted for entirely separately from the Environment

Agency's other activities and finances by the Pensions Committee appointed by the Board.

- 2.4 It is currently estimated that the Active Pension Fund will be paying out pension benefits (to pensioners, spouses and dependant children) for 140 years until at least the year 2150.
- 2.5 The Active Fund's investment strategy by necessity must be financially prudent (risk v return) and long term, and legally its assets must be invested by its "trustees" (in our case the Environment Agency's Pensions Committee) in the best long term financial interests of the fund's beneficiaries.
- 2.6 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 (that could reduce investment returns) and opportunities like clean technology (that could generate higher investment returns). Ignoring or not taking into account these (and other) financial risks and opportunities in the fund's investment strategy is a potential breach of this fiduciary duty.
- 2.7 This legal position has been verified by an international legal review for the United Nations and by the Pensions Committee's specialist legal advisor.

3.0 Overview

- 3.1 The Environment Agency's Pensions Committee has gone about greening the Active Pension Fund in two phases, between 1996-2002 and 2003-2009, linked to the fund's triennial valuation and investment strategy review cycles.
- 3.2 Between 1996 and 2002 the Pensions Committee changed the Active Fund Statement of Investment Principles (following the 1995 Pensions Act) to incorporate social, ethical and environmental considerations. The Pensions Committee also decided to allocate 2% of the fund into "pilot" investment mandates with an environmental theme. The first pilot focused on engaging with companies with poor environmental performance. We invest in all companies when we invest via funds that track market indices (40% of the EAPF). then use our fund managers (and a specialist company Hermes) to engage with poor performers. The second pilot was focused on using environmental signals to select "best in class" companies. We also became one of the founder members of the Institutional Investors' Group on Climate Change.
- 3.3 Between 2003 and 2009 the Pensions Committee used the lessons learnt from the pilots as it has developed its approach. We have also taken into account a growing body of evidence that indicates that better governed companies who actively manage environmental risks are more financially sustainable in the long term. We have developed specific strategies and policies with respect to corporate governance and environmental issues and our investment mandates now require all fund managers to take account of financially material environmental issues when making investment decisions. We have also appointed some fund managers whose investment ethos is based around investing in sustainable businesses and others who invest in green technologies. We were also the first Local Government Pension Scheme pension fund to become a signatory to the UN Principles of Responsible Investment.

- 3.4 Over the period 2005-2008 the Environment Agency has won numerous awards for its innovative approach to the financially and environmentally responsible investment of our Active Pension Fund.

4.0 Our strategy and approach

Investment and company research

- 4.1 To inform our latest investment strategy we commissioned global research by 'Innovest Strategic Advisors' (now part of Risk Metrics) on corporate environmental governance and financial performance. To assess the impact of the 2006 Companies Act on UK listed companies we have also commissioned 'Trucost' to review the environmental disclosures of the FTSE all-share companies. The next report will be published in 2010.

Investment strategy and asset allocation

- 4.2 To develop our latest investment strategy and asset allocation we used professional investment advice from traditional and specialist investment consultants (Mercers, Rathbone Greenbank and B-Finance) and our own in-house expertise on sustainable responsible investment (SRI) to integrate financially material sustainability and environmental issues into our investment mandates.

Supporting strategies and policies

- 4.3 To support the Active Fund investment strategy we developed a corporate governance strategy and environmental overlay strategy which our fund managers are required to adopt and implement for us. To back up these supporting strategies we also developed specific policies to determine our voting stance on shareholders' environmental resolutions at company AGMs.

Fund manager contracts

- 4.4 To inform our fund manager selection process we monitor the "green" fund manager market and the performance of "green" investment funds and products. We have also developed a rigorous approach to the selection and appointment of our fund managers and require them to meet both our financial requirements and environmental criteria that are included in our investment management contracts.

Joint research and promotion

- 4.5 To influence other pension funds and asset managers we have published joint research with our UK public equity manager on carbon management and carbon neutrality of the FTSE all-share companies, a case-study on sustainable investment with our private equity fund manager, and a benchmarking study of the greenness of unlisted property funds with our property manager.

Collaboration with other funds and investors

- 4.6 To influence the wider investment world and businesses in which our fund managers invest, the Active Pension Fund is a signatory to the UN Principles of Responsible Investment (UNPRI), Carbon Disclosure Project (CDP), and Forestry Disclosure Project (FDP). We are also members of the UK Sustainable Investment Forum (UKSIF), Institutional Investors Group on Climate Change (IIGCC), and the Environmental Investment Network (EIN). We have also worked with the Local Authority Pension Fund Forum (LAPFF).

Fund benchmarking

- 4.7 To assess our progress on “greening” the Active Fund we participate in a number of annual benchmarking exercises, including the UNPRI global annual assessment and verification, EU/UK peer reviewed pension and investment award schemes, the UKSIF & CIPFA survey of 89 LGPS funds, and an annual survey of UK pension funds by ‘Fair Pensions’.

5.0 Progress made to date

Public equity

- 5.1 We have made significant progress in appointing fund managers who integrate sustainability and environmental considerations into their investment process, including positive stock selection, engagement on environmental issues with companies, and voting on shareholders environmental resolutions at company AGMs.

Private equity

- 5.2 Our fund manager is a leader in responsible private equity ensuring that each fund they select for investment signs up to responsible investment principles. Around 30% of the assets we have allocated to this fund manager have been invested in financially robust clean technology funds.

Property

- 5.3 Our fund manager carries out environmental reviews before investing in a property fund. So far the manager has invested in one explicitly “green” fund and we have co-published a benchmarking study with them on the greenness of other unlisted property funds to inform future thinking and strategy. We think there is further scope for property funds to promote and adopt more energy efficiency practices.

6.0 Overall impacts

Financial performance

- 6.1 Since we changed our investment strategy in 2005 our two most consistent and best financial performers have been Sarasin (global public equity) and Robeco (global private equity) who integrate sustainability and environmental considerations most strongly into their investment processes. In 2008 we replaced two under-performing managers with two new managers (Generation and Impax) where sustainability and environmental performance are used to inform investment decisions.

Mitigating and measuring our negative environmental impact

- 6.2 Over the last four years we have measured, as at 31 March each year, the environmental footprint of our public equities compared with the market index. It is pleasing to report that our footprint has declined every year. As at 31 March 2009 it was 22% less than that of our investment index. We are one of the first funds in the world to decrease our environmental footprint.

Assessing and developing our positive environmental impact

- 6.3 By working with one of our fund managers (Impax) and FTSE in 2009 we have estimated that 14% of the holdings of the Active Fund are positively contributing to environmental improvement. Around 23% are invested in sustainable businesses (positive stock selection) and around 87% covered by responsible investment practices by our fund managers (research, engagement, voting).

Wider influencing role

- 6.4 By winning various awards and being highly rated in benchmarking exercises the Active Fund is regarded in the UK and EU as a leader in responsible investment, corporate governance, and green investment, and other funds seek our advice to emulate our success. Much of the work we have been undertaking for the last 5 years is now seen as best practice.

7.0 Next steps

- 7.1 The Active Pension Fund's long term investment strategy is due to be reviewed towards the end of this financial year, and any changes required and agreed will be implemented in 2010 and 2011.
- 7.2 The investment strategy review will also be linked to the 31 March 2010 triennial actuarial valuation of the funds' assets and liabilities which will determine the Environment Agency's future employer contributions to the Active Fund for the period 2011-2014.
- 7.3 Whilst financial considerations will be paramount the investment strategy review will be used as an opportunity to revisit and update the Active 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.

- 7.4 The next phase of “greening” the Active Fund investment strategy is likely to involve reducing financially material risks and investments that could be increasingly 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.
- 7.5 By working with our fund managers and the new FTSE classification of environmental businesses we are now able to interrogate the "revenue streams" of our portfolio from this perspective.
- 7.6 A growing number of companies in the developed and developing world are tapping into the global "green" stimulus packages of the US, EU, UK, Japan, China etc. Currently around 14% of the Active Fund is invested in a diverse range of companies where a proportion of their revenues (at least 20%) are derived from environmental services.
- 7.7 Leading economists (Stern et al) are predicting that “lower carbon” businesses may comprise 40% of the global economy after 2030. In 2016 we plan to assess if 25% of our fund is invested in companies that positively contribute to the global “green” economy.

8.0 Implications for Wales

- 8.1 There are no special implications for Wales arising from this paper. The Environment Agency Wales is represented on the Environment Agency’s Pensions Committee.

9.0 Conclusion and recommendations

- 9.1 The Board is asked to note and welcome the progress made to “green” the Active Pension Fund investment strategy.

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