

Item No. 10.1.	Classification: Open	Date: 31 October 2022	Meeting Name: Pensions Advisory Panel
Report title:		Zero Carbon Investment Strategy: Low Carbon Equity Update	
From:		Senior Finance Manager, Treasury & Pensions	

Recommendations

1. The pensions advisory panel is asked to:
 - i. Note that the Fund's holdings in the Legal and General Investment Management (LGIM) Low Carbon Target Index Fund will be transitioned to the LGIM Low Carbon Transition Fund.
 - ii. Note the approach to this transition and the benefits to the Fund towards achieving its net-zero carbon target.
 - iii. Note the enhancements to be implemented by BlackRock in the MSCI World Low Carbon Target Reduced Fossil Fuel Select Fund, and how this will assist the Fund in its journey towards achieving its net-zero carbon target.

Background

2. The Fund's 30% strategic allocation to passive index tracking equities is held with LGIM and BlackRock. This allocation has been transitioned in a managed way as set out below, to protect the value of the Fund, from developed market equities to low carbon equity funds.
3. In January 2018 PAP agreed an initial investment of 50% of the existing BlackRock developed market equity assets into a new BlackRock low carbon target index fund. An investment of £150m of existing LGIM developed market equities into their low carbon index fund was also agreed.
4. The agreed approach was that performance of these investments would be monitored to ensure the required levels of risk and return were maintained, with the expected reduction in carbon intensity also being achieved. Once reassurance was obtained regarding this, the balance of holdings with each manager would then be transitioned to the low carbon funds.
5. The initial transfer of BlackRock assets to their low carbon equity fund was completed in April 2018, and the LGIM transfer was completed in June 2018.

6. Following a review of performance, the remaining BlackRock passive developed market equities were transitioned to the low carbon fund in April 2021. The sale of the remaining LGIM equities to fund the new ESG priority allocation and sustainable infrastructure commitments also took place in April 2021.

Current Benchmark Methodology

7. The MSCI Low Carbon Target Index is designed to minimise the carbon exposure within the parent index. This is achieved through adjusting the existing free float market capitalisation weighting of companies within the parent index to be underweight those companies that have a higher proportion of carbon emissions relative to sales and those that have a high potential carbon exposure relative to market capitalisation.
8. The index also seeks to maintain a low tracking error as well as low sector, country and regional biases to that of the parent index.

Carbon Footprint Measurement – Approach

9. The current approach to measuring the carbon exposure of the Fund's equity holdings is to calculate the carbon intensity (scope 1 and 2 emissions/\$m sales) for each portfolio company and calculate the weighted average by portfolio weight.
10. LGIM and BlackRock have replaced the above approach with EVIC as this has been recommended by regulators as the approach to be applied going forward. The EVIC approach is to calculate the weighted average carbon intensity normalised by enterprise value including cash (unit: tons of CO₂/\$m enterprise value including cash).
11. The Fund's current measurement provider (Sustainalytics) uses the first approach above. Work is currently being conducted on identifying the most suitable approach to carbon footprint measurement going forward, to ensure both consistency of measurement across fund holdings and application of the most up to date approaches to measurement.

LGIM Low Carbon Transition Fund

12. A number of solutions have been put forward for consideration by LGIM. However, taking into consideration the Fund's investment objectives, investment strategy, and the role of passive equity within the Fund's asset allocation and diversification, the Low Carbon Transition Fund has been identified as the most suitable option.
13. The Low Carbon Transition Fund applies detailed methodology including exclusions and the creation of a climate score.

Climate Objectives

14. Initial 70% emissions intensity reduction vs. benchmark (including Scope 1, 2 and 3), with further decarbonisation to reach net-zero by 2050.

Approach to Moving Holdings to Low Carbon Transition Fund

15. The Fund's holding in the MSCI World Low Carbon Target Index will be transitioned to the new low carbon transition fund with a phased approach. Fifty per cent of the holding (approx. £115m) will be transferred to the new fund in January 2023. The investment performance and carbon footprint of the new holding will be monitored over the following six months and, subject to satisfactory performance, the balance will then be transitioned. This approach will protect the Fund against any underperformance.

Aon's Advice and Recommendations

16. Aon believe that LGIM has an experienced and capable passive management team which takes a pragmatic approach to index tracking. The manager has the scale and structure to track a wide range of equity indices and has continued to deliver positive tracking differences across the majority of its fund range. Furthermore, LGIM's suite of ESG/low-carbon/impact/climate-focused funds sit amongst some of Aon's highest conviction strategies within this sub-section of the investment universe. As such, they believe that it is in the best interest of the Southwark fund to continue holding assets with LGIM when seeking alternative passive equity solutions that are aligned to the Fund's target of achieving net-zero by 2030 as a replacement for the MSCI Low-Carbon Fund.
17. Whilst Aon see merit in investing in many of the fund solutions available from LGIM, they believe that the low carbon transition fund is the most suitable option to meet the Fund's objectives.

Proposed Enhancements to the BlackRock ACS World Low Carbon Equity Tracker Fund

18. BlackRock continually evolve their index strategies to meet changing investor requirements and in response to changes in the investment environment. In February 2021, the benchmark of the fund was changed to the MSCI World Low Carbon Target Reduced Fossil Fuel Select Index. This change resulted in the carbon intensity reduction relative to the parent index (MSCI World Index) increasing from 50% to 75%.

Proposal to Evolve the Methodology

19. A number of changes will be made in November 2022 to evolve the methodology of the fund. These include a change to the threshold for revenue from thermal coal mining; phasing in scope 3 emissions; and introducing a new exclusion based on involvement with controversial weapons and very severe ESG controversies.

Proposed Enhancements vs Current

20. The enhancements to the existing fund will result in an initial increase in Scope 1 and 2 figures. However this will be aligned over time to achieve an 80% reduction relative to the index. The real initial improvement is with the inclusion of Scope 3 as demonstrated by a 77% reduction in carbon intensity.
21. The addition of Scope 3 will change the sector concentration in this new index as it is more evenly distributed over sectors, compared to Scope 1 and 2. As the changes are more aggressive, the tracking error will need to be increased.

Aon's Advice and Recommendations

22. Aon support these changes on the basis that they are a step forward in the right direction with respect to the investment universe reallocating capital to support a transition to a low-carbon society and will support with the Fund's ambition to further reduce the portfolio's carbon intensity and overall carbon-weighted exposures.
23. However, it should be noted that, in the context of the Southwark Fund's wider investment strategy, the changes being proposed are less 'aggressive' in nature in comparison to the changes that would be required in order to be in alignment to the Fund's goal of reaching net-zero by 2030.
24. On balance, taking everything into consideration, Aon advise that it is in the best interest of the Southwark Fund to continue holding assets with BlackRock in the short-term when seeking low-carbon passive equity solutions that are aligned to the Fund's target of achieving net-zero by 2030.

Conclusions

25. The transition of the LGIM holdings and the upcoming enhancements to the BlackRock fund will assist the pension fund's progress towards achieving its net-zero target. However, this is only one step on the journey to achieving net-zero carbon in the Fund's passive equity allocation. As net-zero carbon products develop and there is availability of suitable products in the market, the Fund will take further steps towards achieving the target. We will continue to monitor developments and work closely with both our advisers and investment managers to make further progress.

Community, Equalities (including socio-economic) and Health Impacts

Community Impact Statement

26. No immediate implications arising.

Equalities (including socio-economic) Impact Statement

27. No immediate implications arising.

Health Impact Statement

28. No immediate implications arising.

Climate Change Implications

29. No immediate implications arising.

Resource Implications

30. No immediate implications arising.

Legal Implications

31. No immediate implications arising

Financial Implications

32. No immediate implications arising.

Consultation

33. No immediate implications arising.

AUDIT TRAIL

Lead Officer	Duncan Whitfield, Strategic Director of Finance and Governance	
Report Author	Caroline Watson, Senior Finance Manager, Treasury and Pensions	
Version	Final	
Dated	7 September 2022	
Key Decision?	N/A	
CONSULTATION WITH OTHER OFFICERS / DIRECTORATES / CABINET MEMBER		
Officer Title	Comments Sought	Comments Included
Director of Law and Governance	N/A	N/A
Strategic Director of Finance and Governance	N/A	N/A
Cabinet Member	N/A	N/A
Date final report sent to Constitutional Team		20 October 2022