Item No. 10.3.	Classification: Open	Date: 31 October 2022	Meeting Name: Pensions Advisory Panel
Report title:		Zero Carbon Investment Strategy: BlackRock Absolute Return Bond Fund	
From:		Senior Finance Manager, Treasury & Pensions	

Recommendation

1. The pensions advisory panel is asked to note the options set out in this report to replace the Fund's strategic allocation to the BlackRock Absolute Return Bond Fund (BARBF).

Background

2. The Fund currently has a 5% strategic asset allocation to the BARBF. The BARBF'S objective is to aim to deliver absolute returns on a 12 month basis in any market conditions. However, an absolute return is not guaranteed over a 12 month or any other period. The fund is actively managed and is not constrained by any benchmark. Investors can compare the performance of the fund using the 3 month Sterling overnight index rate (SONIA) compounded in arrears.

3. The BARBF has underperformed its benchmark over time. Also, within the pension fund's carbon emissions classification applied to each investment mandate, the BARBF sits within the 'red' legacy investments category as it is not actively targeting reduced carbon emissions.

Performance and Carbon Emissions – BARBF

4. The net performance against benchmark and weighted carbon intensity are set out in the following tables:

	Fund	Benchmark	Relative Return
1 year	(2.40)	2.51	(4.91)
3 years	1.74	3.75	(2.01)

Date	Weighted Carbon Intensity tCO2 emissions/$m
September 2021	10.2
December 2021	8.7
March 2022	6.8
June 2022	11.2

5. Given both the underperformance and carbon exposure of the fund, there is a need to identify a suitable replacement for this holding within the pension fund's strategic asset allocation.

Options to Replace the BARBF Holding

i. BlackRock Sustainable Absolute Return Bond Strategy (BSARBF)

6. The BSARBF applies an extension of the ESG integration in the BARBF. It invests in global fixed income assets and has a green bonds allocation. The underlying sectors in the portfolio are tilted towards companies and issuers that demonstrate a positive E, S or G impact.

7. The fund's approach is to remove carbon intensive issuers and to invest in companies setting targets or alignment metrics. It therefore invests in companies on the transition pathway to decarbonisation. This approach could potentially lead to a fluctuation in the carbon exposure of the fund over time.

ii. Green/Climate Transition Bond Strategies

8. Aon's advice, including the considerations to be made regarding investment in such strategies, is set out in paragraphs 12 and 13 below.

9. One of the key considerations of investing in such strategies is the implications on expected returns and volatility. The underlying holdings of some of the green bond/climate bond strategies in the market have been observed to have shorter durations and higher credit spreads compared to the holdings in a standard bond strategy.

10. Green bonds can often be exposed to a higher level of political risk compared to a straight vanilla bond due to factors such as greenwashing which can have an impact on the spread applied to the bond. Additionally, the vast majority of green bond portfolios tend to pursue a long-only strategy and limit the use of derivatives which would otherwise provide protection in a volatile market and weakened economic outlook. As such replacing the existing BARBF with green bonds will change the investment characteristics of the fund and would therefore need to be considered in terms of the impact on the wider investment strategy.

iii. Tender for new Bond Mandate

11. In order to ensure a suitable replacement for the Fund's investment in BARBF can be identified, a tender for a new bond mandate may be considered.

Aon Advice

12. One of the main challenges with the fixed-income universe is the pace at which it has been able to integrate ESG factors into the investment process compared to equities. This is largely driven by the complex, broad nature of the asset class with different borrower types (corporate, country, consumer); instrument types (bonds, loans); quality (investment grade, high yield); maturity (short versus

longer duration); and place in the capital structure (senior versus junior). As such, fixed-income managers have historically struggled to develop an ESG framework and low-carbon investment strategy that can be applied to the various sub-asset classes. In addition, the wide spectrum of debt instruments has made it difficult to accurately capture data on ESG practices. Thus, there is a limited availability of suitable low-carbon investment products within the fixed income universe.

13. ESG factors are currently integrated into Blackrock's fundamental analysis using a proprietary framework to assign an ESG risk rating to all debt issuers. Having reviewed the investment opportunity that has been proposed by Blackrock with our internal research terms, the level of ESG integration within the Sustainable Absolute Return Bond Fund (BSARBF) appears to be nothing other than an extension of the current process to include further exclusions when assessing fixed-income issuers. As such, in our view, making an investment into the Fund will add very little value in the context of the Fund's objectives to reduce the portfolio's overall carbon-weighted exposures as well as reach net-zero by 2030.

Consideration of Upcoming Investment Strategy Review

14. It is recommended that the PAP should hold off making any concrete decisions with respect to the Fund's holdings in the BARBF until the outputs and analysis generated as part of the upcoming investment strategy review are discussed at the December PAP meeting.

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

Community Impact Statement

15. No immediate implications arising.

Equalities (including socio-economic) Impact Statement

16. No immediate implications arising.

Health Impact Statement

17. No immediate implications arising.

Climate Change Implications

18. No immediate implications arising.

Resource Implications

19. No immediate implications arising.

Legal Implications

20. No immediate implications arising.

Financial Implications

21. No immediate implications arising.

Consultation

22. No immediate implications arising.

AUDIT TRAIL

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