Southwark Pension Fund: the Journey to Net Zero Carbon Emissions

Southwark Pension Fund was one of the first London funds to commit publicly to reducing its exposure to fossil fuels over time. It is now one of London's most progressive funds, leading the way towards net zero carbon emissions in its investments.

Southwark Pension Fund is one of 89 local authority funds across the country, 32 of which sit within Greater London. There has been a political drive across a number of years to introduce greater pooling across the industry, where a number of funds will centrally group their funds in order to achieve greater efficiencies. Southwark sits as part of the London Collective Investment Vehicle (London CIV). Although pension funds have the option to invest with the pool, responsibility of decision-making sits with the individual funds and should be based within their investment strategy and policies. Each fund is responsible for its own strategy and its ability to cultivate sufficient assets to meet its primary responsibility of being able to pay pension payments as they fall due. Funds are permitted to have secondary goals such as investing in such a way to have positive environmental impact, provided these secondary goals do not negatively infringe on their primary responsibility.

Early Days of the Southwark Strategy

Historically, the Pensions Advisory Panel (PAP) have been mindful of wider council commitments to meet carbon neutrality by 2030. Following a staff survey in 2015, it was ascertained that one of many member concerns was the environmental impact of the pension fund's investments. This formed the basis for the decision to update the investment strategy to align the pension fund with this wider target of 2030. Following the assessment of a clear investment case, a commitment was made in December 2016 to reduce the Fund's exposure to fossil fuels. In March 2017, this commitment was incorporated into the Fund's Investment Strategy Statement and a revised investment strategy was launched: 'Moving toward a reduced fossil fuel exposure" which set out actions that would be taken in the short, medium and long term. It outlined the objective to eliminate exposure to fossil fuels over time, with the fund reducing exposure to fossil fuel companies in a risk-controlled way. The investment strategy statement outlines the principles within which the investment strategy can be implemented. This includes details of how the fund is structured in order to maintain diversification in assets to mitigate investment risks and protect and maintain fund value, regardless of market conditions, in order to satisfy its primary objective of meeting pensions payments into the long-term. As part of this strategy, the fund committed to ensuring that the whole of the fund was being considered, rather than selective categories and to establish best practice processes to monitor and measure the carbon footprint of the fund.

At the time of the 2017 statement, there was acute awareness of the limited number of low-to-no carbon products available in the investment market and the impact this may have on the speed with which carbon reduction could be achieved. As focus on pooling of funds grew, it became increasingly apparent that the future direction of travel for pooling arrangements and subsumption of individual funds by pools could potentially compromise the independent strategies of funds to achieve their own carbon goals. The fund continues to monitor the product opportunities available through the London CIV, but products that match the fund's urgency in terms of carbon targets are yet to be found.

Carbon Emission Measurement of a Diversified Fund

One of the key areas of focus in the early stages of the fund's journey to net zero was to find a reliable method of measuring the entire fund's carbon emissions, rather than being selective in its approach to measuring asset classes. The fund measures the carbon footprint of a number of its assets through a third-party provider, in order to ensure independence in sourcing the data and to mitigate potential optimism bias that may be present were investment managers to offer this information themselves. Officers of the fund are in frequent communication with this third-party provider to ensure accuracy of output and clarity in methodology.

Any assets which have emissions which cannot be accurately measured are given proxy emissions values using available information. It is important to note that officers of the fund are acting with prudence where assessing proxy values. Proxies will only be reduced where there is clear information indicating a reduction, in order to ensure the fund is not overstating its progress. There are ongoing communications between the fund and its external fund managers with a view to obtaining comprehensive information that would reduce or eliminate the need for proxies.

A further level of prudence is added through measurement of the fund's net zero assets. The fund has holdings in a number of net-zero asset classes, primarily through sustainable infrastructure. However, the magnitude of their offsetting cannot be accurately ascertained at this time. In order to support the reliability of total fund measurement, these assets are classed as zero carbon, rather than reducing the overall carbon emissions of the fund. Progress towards accurate measurement of this offsetting is ongoing and officers of the fund continue to engage with fund managers to achieve this.

March 2017 to December 2021: Carbon Footprint Highlights
Between 2017 and 2021, the fund focused on the short-term goals of the 2017 investment strategy statement. This included movement of passive equity funds into low carbon specific passive equity funds, removal of carbon investments from active equity managers and investment into new zero-carbon infrastructure products, such as windfarms. Across this period, the fund continued to lobby the market for new green products and standardisation of measurement processes of the carbon footprint to support benchmarking across the sector.

As a result between September 2017 and March 2021, the Fund's carbon footprint reduced by 38.3%, whilst maintaining strong investment performance. This demonstrated that investment performance can be maintained alongside reducing carbon exposure. Given this reassurance, the decision was made to move to the next stage, and in December 2021 the investment strategy was relaunched as an 'Investment Strategy to Achieve Net Carbon Exposure by 2030'. This set out updated actions to be taken in the short, medium and long term.

The net zero carbon commitment by 2030 by Southwark Council has set the Fund ahead of the majority of LGPS funds. Although reduction in carbon exposure in the Fund's investments takes the forefront of the fund's goals, the fund is approaching the task cautiously and in a way that will maintain appropriate returns on investment while managing risk. Not only will this ensure contributions remain affordable for both the Council and members of the fund, it is also key to meeting the fund's primary purpose which is to continue to be able to meet payments to pensioners as they fall due.

December 2021 onwards: a Continued Journey
Since the release of the initial strategy in 2017, the fund has been monitoring the carbon footprint of the entire investment portfolio and has achieved a reduction of 55.5% in carbon emissions at the end of September 2022, compared with those at March 2017. This has been achieved through changes to the 'low-hanging fruit' of the fund; the areas that can be easily affected to substantially reduce the overall footprint such as the movement of passive equities into alternative low-carbon equity funds. Changes past this point will require the fund to work through a number of iterations of investments to 2030 in order to achieve its net zero ambitions and progress is likely to slow in its pace.

Since 2017, the fund has moved around £1,162million of cash through capital drawdowns, transfers and divestments in aid of reaching net zero, with an additional £565million expected by the end of 2023-24, for a total movement of £1,726million. This total movement represents 86.6% of the fund's total value as at 30th September 2022. These movements are summarised by asset class below.

Asset Group	Commitment/ Market Value (£m)	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	Total (£m)
		£m	£m	£m	£m	£m	£m	£m	
Active Equity	245.7	2			4				6
Passive Equity	742.4		300	130		458	155	*155*	1,198
Absolute Return Bonds	130.8							*130.8*	130.8
Diversified Growth Fund	174.9						53.2	*121.7*	174.9
ESG Allocation - Alternatives	143.9					81.5	8.3		89.8
Sustainable Infrastructure	153.0			32	10.6	42.4	41.9		126.9
Total Movement		2	300	162	14.6	581.9	258.4	407.5	**1,726.4**

Looking to the Future

The next major step on the journey to net zero is a refreshed Investment Strategy as part of the fund's triennial valuation cycle. This revised investment strategy was approved by the PAP in December 2022 and the changes will be incorporated into an updated Investment Strategy Statement which will be tabled at the March 2023 PAP meeting for agreement.

A key change in this update is a revised strategic asset allocation. This allocation sets out what the optimum structure of the fund is in terms of investment in different asset classes such as equities and property. The central change for this iteration of the strategy is reallocation of diversified growth funds and absolute return bonds, which collectively represent 15% of the overall fund. Both of these asset classes are in the 'legacy' category of the fund's carbon categorisations and are historically some of the worst performers in the fund for carbon emissions. Of this 15%, 5% will be reallocated to the fund's existing allocation to low-carbon equity funds and 10% to a suitable low-carbon multi-asset credit fund, once available. Full divestment from the diversified growth fund is anticipated to occur across 2023/24 and the selection process for the new product is in early stages.

The fund also intends to transfer current holdings within the LGIM Low Carbon equity fund into an alternative equity fund that holds stronger carbon emission credentials. Given that the total value of the holdings in this equity fund currently sits at £310million, it is anticipated this will have a substantial positive impact on the fund's carbon reduction. This is expected to take place in two tranches, in order to monitor the impact this movement has on fund performance. The first tranche should complete by June 2023 and the second by the end of the financial year.

As the fund grows in terms of value and number of assets, it also looks to expand on its staff resources in order to manage the increased workload as a result. Not only will this help the fund achieve greater efficiencies, it further signifies Southwark Council's dedication to reaching net zero.

Obstacles to Achievement of Net Zero

The fundamental limitation to the fund achieving net zero by 2030 is that its primary responsibility is to ensure it maintains an adequate level of liquidity and its ability to meet pension payments over time. Although the fund has seen positive performance returns in recent years, moving into greener investment has not come without financial implications in the short term. The exclusion of investments in companies exposed to fossil fuel risks has reduced short term returns for the Fund, especially given this is a sector that has achieved strong returns in the past year and continues to do so.

Reduced investment performance could also have an impact on scheme employers. As part of the triennial actuarial valuation, employer contribution rates are calculated based on the assets of the fund and its ability to meet the expected pensions payments. Reduced investment returns will require scheme employers to pay higher contribution rates to maintain adequate funding. If reduced performance is seen across the LGPS as a whole, this may also lead to increased employee contribution rates.

Specific market risks and factors need to be addressed through the fund's investment strategy, with a prominent risk being that of inflation. Unfortunately, a number of the assets that can be employed by the fund to mitigate this risk are those that historically show poor performance for carbon emissions. A prime example of this is index-linked gilts, which currently represent 10% of the fund. Until there is a suitable alternative in the market, the fund will need to retain some of its assets which show higher carbon emissions.

The market for low-to-no carbon products is an obstacle within itself. The fund's progress to net zero can only move as quickly as the market itself does. Investment can only be made in products that demonstrate strong carbon reduction credentials and a strong investment case that meets the Fund's risk and return requirements. This limits the products available in an already scarce market. This issue is compounded by poor outcomes from the latest COP events and increased competition amongst investors to gain access to the few suitable products currently in the market.