



## **PENSIONS COMMITTEE**

**2 November 2020**

<b>REPORT TITLE:</b>	<b>INVESTMENT STRATEGY PROPOSALS</b>
<b>REPORT OF:</b>	<b>DIRECTOR OF PENSIONS</b>

### **REPORT SUMMARY**

This report provides Members with outline proposals for changes to MPF's investment strategy and seeks approval for officers to work with the Fund's independent advisors to develop and implement the proposals.

A letter received from Medact Liverpool and a response from the Chair is attached at appendix 1. The letter and response are pertinent to the strategy proposals.

Appendix 2 to this report contains exempt information. This is by virtue of paragraph(s) 3 of Part 1 of Schedule 12A of Local Government Act 1972 i.e. information relating to the financial or business affairs of any particular person (including the authority holding that information).

### **RECOMMENDATION/S**

That Members approve the outline investment strategy proposals detailed in the appendix.

That Members authorise officers to work with the Fund's independent advisors to develop and implement the proposals with regular progress reports to the IMWP and this Committee.

That Members approve the engagement of specialist investment advice and the additional staffing resources required to support the development and implementation of the investment strategy proposals.

That members note the letter from and response to Medact Liverpool.

## **SUPPORTING INFORMATION**

### **1.0 REASON/S FOR RECOMMENDATION/S**

- 1.1 A robust investment strategy is fundamental to the Fund delivering on its pension promises. Mitigation of climate risk is a prudent and necessary course of action for long-term investors.

### **2.0 OTHER OPTIONS CONSIDERED**

- 2.1 A number of options have been considered in the preparation of the investment strategy review. Those deemed most suitable for the Fund have been modelled at a high level and will require further detailed work before being adopted and implemented.
- 2.2 Members could take no action but this would increase the likelihood of adverse financial impacts from climate change and not be consistent with the Fund's investment beliefs and RI policy. With the current direction of government policy, it is likely that further steps will be mandated for pension funds in time.
- 2.3 In its RI policy, MPF considers that a holistic approach to investing must consider ESG factors from the outset and at all stages of the decision-making process: from investment beliefs and strategy, across all asset classes and in the strategies selected. Such an approach is consistent with MPF's view of its fiduciary duty to seek optimal investment outcomes that are in the best interests of all of its scheme participants, having regard to a prevailing public service ethos and to the long-term stability of the wider financial system. The intention is to be a responsible custodian of assets on behalf of members by managing the issues arising from poor practice or irresponsible behaviour with a risk-based approach rather than developing an ethical or moral basis for decisions which can be problematic in discharging fiduciary duties.

### **3.0 BACKGROUND INFORMATION**

- 3.1 MPF's investment strategy is reviewed formally when the triennial valuation is undertaken by the Fund's actuary. The Funding Strategy Statement is revised in the light of the actuary's calculation of the funding position and assumptions around future investment returns. Additionally, reviews occur quarterly at Medium Term Asset Allocation meetings and Investment Monitoring Working Parties. The Fund's investment strategy has evolved over time as markets and asset classes have developed.
- 3.2 In conjunction with the Fund's triennial valuation at March 2019, a more detailed review of investment strategy and asset allocation was undertaken which, for the first time, incorporated the consideration of climate risk through climate scenario modelling. In view of the Fund's improved funding position, a revised asset allocation was developed and approved by this Committee in February 2020 which reduces the Fund's equity risk by reallocating assets from equities to alternatives over time. Work has continued on the Fund's investment strategy and the management of climate risk.

- 3.3 In March 2016, Members recognised the implications of the Paris Accord and resolved that the Fund should align its strategy to the Paris goals, principally to limit the rise in global temperature to 1.5 degrees Celsius by achieving net zero carbon emissions by 2050. Following Paris, much discussion has centred on the practical challenges of quantifying progress against a net zero goal. Investors have needed to be able to define 'net zero' in portfolio terms and in a way that is consistent with the scientific consensus on climate change. The most recent report of the Intergovernmental Panel on Climate Change found that global emission levels will need to peak and begin a rapid decline within the present decade in order for the world to remain on track to achieve the goals of Paris.
- 3.4 In 2018, a review of the Fund's Responsible Investment (RI) Beliefs took place and Members adopted a revised Statement of Beliefs on RI in January 2019 to safeguard the future sustainability of the scheme. It was recognised that ESG factors will materially affect investment performance over the long-term and a strong RI policy is entirely consistent with a responsible asset owner's fiduciary duty. A strengthened RI strategy chimes with the Fund's core philosophy about the importance of actively managing risks.
- 3.5 In reviewing the Fund's investment strategy, as the Fund's strategic advisor, Aon have sought to suggest ways in which fund governance can be simplified, returns can be enhanced without a commensurate increase in risk and recommended consideration of additional assets and investment products that deliver these objectives with an emphasis on sustainability. The detail of the proposals is set out in appendix 2 to this report.
- 3.6 Officers, together with our independent advisors, have discussed the proposals with Aon and the likely implications for the Fund. In general, there is a consensus that the proposals should be adopted (with some minor revisions to reflect the effect of current arrangements). A presentation to Members followed by a discussion with them of the proposals took place at the IMWP in September with a view to recommendations being developed and a report brought to November's Pensions Committee.
- 3.7 In the light of the climate risk scenario analysis undertaken by Aon, the Fund has been developing its climate risk strategy to ensure the resilience of its broader investment strategy over short, medium and longer time horizons. The Fund's climate risk strategy has been developed with the understanding that this implies rapid transition to a low carbon economy which, in terms of the Fund's investment portfolio, requires that we mitigate our risk (by seeking to reduce the carbon emissions associated with the portfolio) and allocate investment to climate solutions. This has led us down the path of decarbonisation, whereby we have identified our carbon exposures and implemented measures to reduce exposure (including using a low carbon index in our passive portfolio, as well as very actively engaging with portfolio companies to move them onto credible emissions reduction pathways e.g. through the Climate Action 100+ initiative); and actively investing in low carbon economy assets (such as renewable energy projects) through our infrastructure portfolio.

With changes proposed to assets and benchmarks as a consequence of evolving best practice, factor analysis and the changing market environment, there is the opportunity for investment strategy and the underlying mandates to be redesigned at the same time to build in climate risk and ESG considerations in a consistent and structured way.

- 3.8 The current statutory requirement is for LGPS funds to set out in their Investment Strategy Statements “how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments” (Reg 7(2)(e)). The accompanying 2016 guidance states:

*When making investment decisions, administering authorities must take proper advice and act prudently. In the context of the local government pension scheme, a prudent approach to investment can be described as a duty to discharge statutory responsibilities with care, skill, prudence and diligence. This approach is the standard that those responsible for making investment decisions must operate.*

*Although administering authorities are not subject to trust law, those responsible for making investment decisions must comply with general legal principles governing the administration of scheme investments. They must also act in accordance with ordinary public law principles, in particular, the ordinary public law of reasonableness. They risk challenge if a decision they make is so unreasonable that no person acting reasonably could have made it.*

*The law is generally clear that schemes should consider any factors that are financially material to the performance of their investments, including social, environmental and corporate governance factors, and over the long term, dependent on the time horizon over which their liabilities arise.*

*Although schemes should make the pursuit of a financial return their predominant concern, they may also take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision.*

Since the guidance was issued, climate risk has increasingly come to the fore as a significant long-term risk with shorter-term implications which has been recognised by this Committee and additional steps have been taken to align the Fund’s strategy to the Paris goals, within the broad parameters set by the statutory guidance. The Department for Work and Pensions is presently consulting on policy proposals to require trustees of larger private sector occupational pension schemes and authorised schemes to address climate change risks and opportunities through effective governance and risk management measures. Although there is no certainty that equivalent proposals will be mandated for LGPS funds, it is apparent that this is something that forward-looking funds should assimilate in their investment strategy.

It is proposed that the implementation of these changes is accelerated by MPF to recognise the magnitude and urgency of the challenge.

- 3.9 The proposals by Aon recommend specific actions to integrate ESG holistically across the Fund. As set out in appendix 2 and discussed at the IMWP, this can be

achieved in our fixed income assets with limited disruption but will be more challenging to implement in our equity portfolios. In parallel with this, the Fund will be increasing exposure to infrastructure and other alternative assets with particular attention to investments such as renewable energy that support our investment strategy goals.

The IIGCC has developed a Net Zero Investment Framework which we propose to adopt as a tool to achieve this. <https://www.iigcc.org/download/net-zero-investment-framework-consultation/?wpdmdl=3602&masterkey=5f270ef146677>

The framework, launched in August 2020 for consultation, provides the first-ever practical blueprint for investors to maximise the contribution they make in tackling climate change and achieving net zero emissions globally by 2050. It aims to provide a comprehensive set of recommended actions, metrics and methodologies, which following finalisation, will seek to enable both asset owners and asset managers to effectively become 'net zero investors'. Its objectives are to support the decarbonisation of the real economy, help minimise the negative impacts of climate change, and seize investment opportunities.

- 3.10 The Fund's fixed income holdings have performed strongly over the past 10 years as interest rates have declined significantly. Over the past decade, our conventional bond holdings have returned over 6% p.a. and inflation-linked gilts more than 10% p.a. Given that future returns from UK government bonds are anticipated to be negative, particularly in real terms, the Fund will seek to diversify to some extent into alternative credit strategies. Whilst this brings additional credit risk to the fund, such downside risk is more than offset by the re-allocation away from equities. The ambition is for the fixed income mandates to have explicit ESG requirements consistent with the Fund's RI policy.
- 3.11 The intention is that a similar discipline is followed for the Fund's equity mandates as they are reassessed in the light of Aon's broader proposals.
- 3.12 As set out in section 3.9, capital will continue to be deployed into private market assets consistent with the RI policy.

#### **4.0 FINANCIAL IMPLICATIONS**

- 4.1 Specialist investment support in developing the investment strategy proposals, climate benchmarks, mandate design and manager selection will need to be procured.

#### **5.0 LEGAL IMPLICATIONS**

- 5.1 There are none arising from this report.

#### **6.0 RESOURCE IMPLICATIONS: STAFFING, ICT AND ASSETS**

- 6.1 Additional staff resources in the areas of ESG/investment management, and support functions are essential to the successful delivery of this strategy. As set out in section 7 and the appendix, the investment strategy changes may be disruptive and costly to implement but this can be mitigated by appropriate planning, commitment of

resources and reporting. It is anticipated that the cost savings identified through expanded internal management will provide a useful counterbalance to the costs involved in implementing the revised investment strategy.

If agreed, the proposals will reinforce the drive to deliver improved performance and cost savings through increased internal management and collaborative working with our pool partners.

## **7.0 RELEVANT RISKS**

7.1 Climate risk is a significant consideration particularly for long-term investors such as the Fund. The Pensions Climate Risk Industry Group have highlighted that all pension schemes are exposed to climate-related risks, whether investment strategies and mandates are active or passive, pooled or segregated, growth or matching, or have long or short time horizons. Recent research by the International Monetary Fund has specifically identified that stock prices do not reflect future climate risk:

“a sudden shift in investors’ perception of this future risk could lead to a drop in asset values, generating a ripple effect on investor portfolios and financial institutions’ balance sheets”.

- 7.2 The investment strategy changes may be disruptive and costly to implement. This can be mitigated by appropriate planning, commitment of resources and reporting.
- 7.3 The IIGCC report notes that “a critical challenge for credible alignment by investors is the availability of robust pathways for net zero emissions and investment trajectories broken down by sector and region.” The use of pathways based on the science to shape portfolio targets and measure alignment will help to manage this potential issue.

## **8.0 ENGAGEMENT/CONSULTATION**

8.1 The Fund’s Investment Beliefs were subject to consultation with a range of stakeholders and approval by Pensions Committee.

## **9.0 EQUALITY IMPLICATIONS**

9.1 No equality issues arising from this report.

## **10.0 ENVIRONMENT AND CLIMATE IMPLICATIONS**

10.1 The recommendation is to align the Fund’s asset portfolio with the Paris goals and achieve net zero emissions by 2050.

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**APPENDICES**

Appendix 1 Medact Liverpool Letter Received/Response from Chair  
Appendix 2 Exempt – Investment Strategy Review.

**BACKGROUND PAPERS**

None

**SUBJECT HISTORY (last 3 years)**

<b>Council Meeting</b>	<b>Date</b>