Report for: Pensions Committee 14th January 2016

Item number: 8

Title: Low Carbon Investing

Report authorised by: Tracie Evans, Chief Operating Officer (CFO)

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Ward(s) affected: N/A

Report for Key/ Non Key Decision: Non Key decision

1. Describe the issue under consideration

1.1 The fund has a passive approach to equity investing using market capitalised based indices. Concern has been raised as to the future performance of carbon intensive industries as Government's world wide take action to manage the risk of climate change. The Council is a supporter of reducing carbon emissions and the Pensions Committee has been asked to consider the implication of the Paris summit on its investments in carbon intensive industries. This paper considers alternative approaches to managing carbon exposures and reducing the associated risks within the fund's investments.

2. Cabinet Member Introduction

2.1 Not applicable.

3. Recommendations

3.1 That an implementation plan to switch one third of passive equities into the MSCI Low Carbon Target Index is developed for the next Committee meeting.

4. Other options considered

4.1 The paper discusses alternative options.

5. Background information

Introduction

5.1 At the September meeting the Committee requested an opportunity to discuss calls for disinvestment from coal related businesses. This was followed up with a training session on 19th October when a presentation was received from a representative from Healthy Planet who discussed the health implications of burning fossil fuels and the rational for their call to freeze and disinvest from fossil fuels.

5.2 The sentiment expressed by Committee Members at the training session is that active engagement will have more effect on corporate behaviour than disposing of investments. Recognising the pressure to be seen to be considering alternatives, there was also a request that additional information be provided on investing via low carbon indices.

5.3 This note is a follow up to the debate at the October training session.

5.4 Subsequently, a petition has been received from approximately 2,500 residents calling for disinvestment from businesses involved in exploration and production of coal and tar (oil) sands and to freeze any new investments in fossil fuel companies. The resolution (appendix 1) will be debated at Full Council, who can request that the Pensions Committee consider changing its investment policy but cannot instruct the Committee to do so.

5.5 This paper mainly considers the options around low carbon investing, including complete disinvestment from coal and oil sands. Reference is also made to the engagement activities being carried out by the LAPFF and the scale of current fossil fuel investments.

Current Investments in Coal, Oil Sands and Fossil Fuels

5.6 As of mid December, the fund had equity investments of £724 million spread across six regional indices. Each of these indices has a fossil fuel sector, which varies between 1% (Japan) and 9% (UK). The aggregate monetary value of our exposures to the fossil fuel sector is £39 million. The fossil fuel definition is based on the companies with any of the following sub-sector classifications - exploration & production, integrated Oil & Gas, oil equipment & services, pipelines and coal.

5.8 The coal subsector of the fossil fuel sector is relatively small, virtually non existent outside of emerging markets, with a Haringey monetary exposure of £215,000. However, companies involved in coal production are likely to be classified elsewhere e.g. mining, due to their wider business activities.

5.9 Estimating the exposure to oil sands is more difficult as there is no oil sands sub-sector. The Rainforest Action Network has compiled a listing of companies involved in oil sands production. Haringey's exposure to these companies is £18 million, represented in the main by the large oil companies e.g. BP, Shell, Exxon & Chevron. There are also a number of specialists, mainly Canadian based oil sands producers. Disinvesting from oil sands would in effect require disinvestment from a large part of the fossil fuel sector.

5.10 As discussed in the Mercer paper excluding a particular sector or sub-sector from Haringey's investment portfolio but retaining the current passive approach is feasible, with some cost implications. Excluding named companies across multiple sectors targeting say Coal, will be more challenging (costly).

Engagement Activities

5.11 The October training session considered the impact of engagement activities, in particular the activities of the Local Authority Pension Fund Forum, of which Haringey is a member.

5.12 Of particular relevance is the support that the LAPFF has given to resolution seeking companies to develop strategic plans consistent with action being taken to manage climate change. Samples of the shareholder resolutions supported by the LAPFF are listed in appendix 2. Of particular interest is the Chevron resolution in which increased flexibility of dividend policy is called for to enable income and assets that can no longer be invested profitably to be returned to shareholders.

5.13 The above resolutions have been developed and supported by investors in the USA, UK and globally and indicate the positive role that engagement should play in directing corporate activity. Although Haringey is not able to vote on these resolutions due to the structure of our investments we are discussing with L&G to ensure that they support the resolutions.

5.14 Research into actions by other local authorities (appendix 5) indicates that engagement remains the most common approach to managing carbon risks, with measurement of carbon 'footprint' and plans to reduce 'footprint' also in use.

Low Carbon Indices

5.14 The October training session also requested investigation into the use that low carbon based indices. The attached report from Mercer's (appendix 3) discussed the options.

5.15 The Mercer report recognises a range of possible options:

- Passively invest in market index excluding coal or fossil fuels.
- Passive investing in an index constructed on a low carbon basis.
- Active management in seeking to exploit value adding opportunities from a low carbon economy.

5.16 The last option will be considered in a separate paper in which an allocation to renewable energy is discussed but could also be applied to the residual equity portfolio. The Mercer paper does not examine active equity options as to date these have not been favoured by the Committee.

5.17 Neither does the Mercer paper discuss passive ex fossil fuel investments. For completeness, information will be provided at the meeting on the performance of an ex fossil fuel portfolio, noting that it will be heavily influences by recent changes in oil prices.

5.18 Mercer's preferred passive approach to low carbon investing is to utilise L&G's capacity to invest in line with the MSCI World Low Carbon Target Index Fund. This index reweights the constituents of the MSCI global (market capitalisation) index to reduce exposures to carbon emissions by 80% yet targeting a return closely correlated with the standard index. The reduced carbon exposure is achieved by a reduction in exposure to the major oil companies. Appendix 4 compares country, sector and top 10 holdings between the standard and Low Carbon indices and indicates that the changes to the sector weightings are relatively small.

5.19 The performance of the low carbon index is shown below. There is a noticeable outperformance over the 1-5 year periods for the low carbon index. In utilising this approach, the additional management and transaction costs will dampen expectations of an excess returns.

Performance of MSCI World Low Carbon Index Fund (%)

	1 y	3y	5y
MSCI World Low Carbon Target	4.32	14.20	11.26
MSCI World	3.86	13.94	10.88

5.20 The Mercer's paper suggests that managing part of the portfolio against the Low Carbon index is a viable way to manage carbon related risks in the portfolio. It is not necessarily an expectation that additional value will be created, rather the risk around carbon will be managed and the portfolio will be seen to have a reduced carbon footprint.

5.21 L&G currently manage £200 million from the Environment Agency Pension Fund against this index. The EAPF is at the forefront on sustainable investing and its use of this index provides a degree of re-assurance.

5.21 It is suggested that a starting point will be to transition one third of the equity portfolio to this index. There are a number of implementation points discussed in the paper e.g. phasing of the transition, whether the CIV can support this investment, fees and costs etc. The recommendation is that an implementation plan is developed for the April meeting.

6. Comments of the Chief Financial Officer and financial implications

6.1 The Committee will need to consider carefully their duties to beneficiaries and employers before pursuing exclusionary. The proposal to utilise low carbon indices is supported by the investment consultant on the grounds that the expected returns should be consistent long term with the main index.

7. Comments of the Assistant Director of Corporate Governance

7.1. The Assistant Director of Corporate Governance has been consulted in the preparation of this report, and makes the following comments.

7.2. Whilst the Pensions Committee has the Constitutional authority to adopt the Recommendations contained in this report within its terms of reference, it is under a legislative duty to take “proper advice in relation to the appointment [of an investment manager]”. The objective to be achieved, is – in summary - to illicit an assurance that there are reasonable grounds to believe that the proposed investment manager has the requisite level of ability and practical experience to make decisions on behalf of the administering authority.

7.3. The duty is discharged by reference to the terms of paragraphs 5.18 – 6.1 and 8.4 of the report.

8. Comments from the Independent Advisor

8.1 The Fund currently has a Strategic Allocation of 60% to Listed Equities. At present the Fund invests in Listed Equities utilising what might be described as a “pure” market capitalisation approach. Utilising this approach the Fund is invested in companies solely in proportion to their size within the indices utilised. As the Committee will be aware I have reservations regarding the appropriateness of utilising this approach on its own particularly given that the majority of the Fund's assets (£658m as at 30 November 2015) are invested in this manner. This traditional or "pure" market capitalisation weighted approach has a clear tendency to become biased towards speculative over-hyped stocks and is over dependent on mega-cap stocks.

8.2 This report proposes that one third of the Funds investment in Listed Equities is potentially moved to the MSCI Low Carbon Target Index. From a diversification perspective this approach has clear merits. The MSCI Low Carbon Index while still based on a market capitalisation approach reweights the MSCI global (market capitalisation index) to reduce exposures to carbon emissions by 80%. The MSCI Low Carbon Index due to its construction will perform differently than "pure" market capitalisation indices which do seek to reduce or exclude exposure to particular factors. For example in periods of declining oil prices market capitalisation based indices with a bias to low carbon are likely to outperform traditional or "pure" market capitalisation indices while in periods of rising oil prices the opposite would be the more likely consequence. In order that utilisation of a low carbon market capitalisation index may make a material impact in terms of the Fund's approach to Listed Equity investing the proposal that a third of the Fund's Listed Equity allocation is invested utilising such an approach is appropriate.

8.3 The outcome of the international discussions, held in Paris from 30 November to 12 December 2015, involving negotiators from nearly 200 countries that resulted in an international accord to limit greenhouse gas emission clearly indicates that limiting exposure to companies involved in emitting high levels of carbon based emissions is potentially sensible from an investment viewpoint. The idea that in future significant levels of fossil fuel reserves may in effect be "stranded" in the ground has become clearly more likely as a result of the 2015 Paris accord. The outcome of the 2015 Paris climate management discussions support the view that the Fund amend its approach to Listed Equity investment to include an approach where a third of the Fund's Listed Equities are managed utilising the MSCI Low Carbon Target Index.

8.4 There are clear long term economic/investment arguments for restricting the Fund's allocation to companies with exposure to activities which result in high levels of carbon emissions (such as coal, oil sands and general fossil fuel activity). Such an approach can be achieved easily and at low cost by adopting use of the MSCI Low Carbon Target Index. Reducing but not eliminating the Fund's exposure to investments in fossil fuels means that the Fund can still seek, from an "owners perspective" to engage in engagement activities to persuade those companies involved in producing significant carbon emissions to consider whether, from an long term investment perspective, they might move away from their current activities towards less potentially environmentally damaging activities.

9. Equalities and Community Cohesion Comments

9.1 There are no equalities issues arising from this report.

10. Head of Procurement Comments

10.1 Not applicable.

11. Policy Implications

11.1 None applicable.

12. Use of Appendices

12.1 Appendix 1: Residents petition

12.2 Appendix 2: Sample LAPFF engagement activities

12.3 Appendix 3: Mercer's Report – Low Carbon Passive Equity Approaches

The information contained in Appendix 3 is not for publication as it contains information classified as exempt under Schedule 12A of the Local Government Act in that it contains information relating to the business or financial affairs of any particular person (including the Authority holding that information).

12.4 Appendix 4: Comparison on MSCI World and Low Carbon Indices.

12.5 Appendix 5: Carbon policies from other Local Authorities.

13. Local Government (Access to Information) Act 1985

13.1 The information contained in Appendix 3 is not for publication as it contains information classified as exempt under Schedule 12A of the Local Government Act in that it contains information relating to the business or financial affairs of any particular person (including the Authority holding that information).

Appendix 1

Residents Petition

We the undersigned call on Haringey Council to divest its own financial holdings and those of its pension fund from any business which is involved in the exploration or production of coal or tar sands within two years; and immediately to freeze any new investment in fossil fuel companies; because

1. Climate change is the gravest threat to our future and to the future of the natural world
2. We cannot burn more than a fifth of existing fossil fuel reserves and stay within safe limits, so these fuels are increasingly being seen as being unburnable (as recognised by Shell and the Governor of the Bank of England) and therefore investment in these fuels is becoming financially risky as well as morally indefensible
3. Coal and tar sands are the worst sources of carbon dioxide that causes climate change, and so the most risky financially
4. There is a growing movement to divest, particularly from coal and tar sands, supported by Ban Ki-Moon, Archbishop Desmond Tutu and World Bank President Jim Yong Kim; and including the Norwegian sovereign wealth fund, the Church of England, Oxford City Council and Oxford and Edinburgh Universities.