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Report on East Sussex Pension Fund actions taken after October 2019 Full Council motion on climate change

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The East Sussex Pension Fund has for a number of years been among the leaders within the LGPS in addressing the challenges to climate change. A report commissioned from Trucost in September 2017¹ found that carbon emissions from the Fund's active equity portfolio was already very substantially lower than the equity index and a responsible investment policy has been in place since 2018.

In October 2019 East Sussex County Council passed a motion requesting the Pension Fund Committee to request the Fund with its investment consultants to investigate the long term risks and opportunities associated with climate change, and to consider its approach to investment in fossil fuels. In response the Committee engaged an ESG specialist, PIRC, to conduct this review, plus a separate report by an ESG scoring specialist, Vigeo Eiris, to analyse the portfolio's carbon footprint and the progress towards Energy Transition.

The PIRC review acknowledged the Fund's robust starting point, saying that the level of detail in the responsible policy in existence demonstrated the Fund's 'stated aim of being a leader in this area within the LGPS'². They also noted it was in full compliance with its statutory and regulatory requirements in respect of ESG and, despite its limited resources, was well positioned relative to other LGPS funds as well as being the leader within the ACCESS pool.

The Vigeo Eiris analysis³ looked in detail at portfolio investments' weighted average carbon emissions (scope 1 and 2) and also how successfully they are progressing towards a lower carbon economy (i.e. Energy Transition). They found the Fund's portfolio carbon emissions were 61% lower than the benchmark and modestly (6%) ahead on Energy Transition. They also highlighted companies and areas where engagement could be most productive.

While these reports were being prepared, the Committee created an ESG Working Group to allow more time to research what other investors, both within the LGPS and outside, were doing, to consider changes to the Responsible Investment Policy and to understand the consultants' recommendations in detail. Members of the Group had meetings with six⁴ other investors, and a range of index providers and managers. The Working Group also had detailed calls with PIRC and Vigeo Eiris.

¹ Presented at 26th February 2018 Pension Fund Committee meeting

² P4 of PIRC report presented as item 7 Appendix 1 at 22nd June 2020 Pension Fund Committee meeting

³ P3 of Vigeo Eiris report presented as item 6 Appendix 3 at 22nd June 2020 Pension Fund Committee meeting

⁴ Church Commissioners, Royal London Asset Management, Osmosis, Greencoat Capital, Lothian Pension Fund, Greater Manchester Pension Fund

The Vigeo Eiris report highlighted that major sources of carbon emissions within the portfolio were the passive indices managed by UBS through the ACCESS pool. They were cheap to manage but, as passive strategies, were unable to reduce exposure to fossil fuels. The ESG Working Group recommended moving £880m, or approximately 50% of the Fund's entire investment exposure, out of these passive investments to new managers with better alignment.

In order to align the Fund's portfolio more closely with its ambitions, the ESG Working Group together with the Fund's investment consultants considered two main strategies: investing in lower carbon passive indices to reduce carbon emissions and investing in positive impact funds to help fund the transition to lower carbon energy. In making recommendations it was mindful of its fiduciary duty to reduce the risk of financial detriment to stakeholders.

The recommendation made to the June 2020 committee was to invest £400m into positive impact active strategies, £400m into a better aligned passive strategy in order to keep costs down and a further £80m into listed infrastructure. Smart beta low carbon indices were considered but rejected because of the lack of confidence in the robustness of ESG scoring metrics when used to allocate at scale⁵.

In doing this, the Fund took into consideration both the higher cost of the new managers and also the limited choice of Funds offered by the ACCESS pool which it is a member of. The Fund has historically allocated its equity investments 50% into passive and 50% into active, though for legacy reasons the actual split has been nearer 75% passive and 25% active over the last five years.

Hymans Robertson, the Fund's investment consultant, were asked to recommend shortlists of managers for these three categories to the Working Group and, over the summer of 2020, a total of three impact managers, four lower cost passive strategies and three listed infrastructure managers were interviewed by Hymans Robertson and Officers. Because of the pandemic restrictions, all these meetings were conducted on-line.

The Investment Working Group⁶ recommended the following allocations:

- £400m investment to Storebrand's Global ESG Plus, an 'index aware' fund which replaces fossil fuel exposure (approx. 9% of the index) with a larger number of smaller 'climate solutions' companies.
- £200m investment to Wellington's Global Impact Fund, which invests in innovative companies whose core products and services address some of the world's major social and environmental challenges.
- £200m investment to WHEB's Sustainability Fund, which focuses on companies that generate positive social/environmental impact identifying structural growth themes.
- £80m investment to Atlas Listed Infrastructure Fund, which aims to minimise exposure to the disruptive effects of climate change and climate change policy.

At the 21st September 2020 meeting, the Pension Fund Committee adopted a new and more detailed Responsible Investment Policy as part of a revised Investment Strategy Statement. This reaffirms signing up to the United Nations Principles of Responsible Investment and the revised UK 2020 Stewardship Code as well as reporting according to the recommendations of the Taskforce for Climate Change Disclosure. The Fund has also become a member of [IIGCC](#) and [Climate Action 100+](#) and remains an active member of [LAPFF](#).

⁵ For example, Berg, Koelbel, and Rigobon 'Aggregate Confusion: The Divergence of ESG Ratings' MIT Sloan research paper 5822-19.

⁶ The ESG Working Group was merged into the standing Investment Working Group with effect from this meeting.

At the same meeting the Pension Fund Committee discussed and reaffirmed its stated investment belief that engagement is a much more effective way of mitigating climate change risk than blanket divestment. It agreed the Investment Working Group's recommended allocations to managers, and the transition of the £880m to the four mandates detailed above was effected in full in the fourth quarter of 2020.

The Fund has as a consequence reinstated the 50%/50% active/passive split and reduced the Fund's fossil fuel exposure by more than 50%. However, the greater active allocation will mean a higher investment management cost. The Investment Working Group considered this worth paying so that the Fund's assets are invested in a more sustainable way.

Most of the remaining fossil fuel exposure is contained in the legacy UBS passive mandates, which are being reviewed as the next stage of the process. This is a good reminder that investment is a journey which never comes to an end, and that the Fund and its advisors review its portfolio continuously as it becomes aware of new evidence. East Sussex Pension Fund is also in the forefront among the ACCESS partner funds in moving the ESG agenda forward. The pool has, for example, just appointed a new ESG consultant responsible for supporting its Responsible Investment Agenda.

The Fund stays on course by adhering to its investment principles. These include diversification, making investment decisions in a considered way on the basis of good evidence and data, and a policy of engagement with companies rather than blanket divestment. It also takes care, with the help of its advisors, to ensure that it remains compliant with all legislation and statutory guidance both from fiduciary and ESG standpoints.