Non-Executive Report of the: **Pensions Committee** 20th June 2019	TOWER HAMLETS
Report of: Neville Murton, Corporate Director, Resources	**Classification:** Unrestricted
Revised Investment Strategy Statement	

Originating Officer(s)	Bola Tobun, Investment & Treasury Manager
Wards affected	All wards

Summary

This report introduces a revised Investment Strategy Statement (ISS), which has been updated to reflect the decision made after the work done on carbon and environmental footprints of the Fund. The report reminds the Committee of its approach in managing the Fund carbon risk is by reducing risk through targeted reduction in its exposure to fossil fuel assets.

The report also outlines the recent decisions made by the committee, increasing the Fund allocation to the Low Carbon Strategy from 15% to 20% and also allocating 5% of the Fund total assets to renewable energy. This is an attempt to support transition towards a low carbon economy through positive investment in renewable energy and at the same time, meeting the Fund strategic investment requirements.

The Committee will continue to engage with fossil fuel companies via organisations such as LAPFF in order to influence their future strategies with the aim to influence a wider move from fossil fuels in the world economy.

REASONS FOR URGENCY

The report was not published five clear days in advance of the meeting. Therefore, before this item can be considered at this meeting, the Chair of the Committee would need to be satisfied that it is necessary to consider Revised Investment Strategy Statement at this meeting, the Committee may also take the view that it is important that there should not be an extended period without any member oversight.

Recommendations:

Pensions Committee are recommended to:

- note the report and
- approve the revised Investment Strategy Statement attached as Appendix 1 of this report.

1. REASONS FOR THE DECISIONS

1.1 The Investment Strategy Statement has been set out to reflect the funding position of the Fund and the investment beliefs of the Committee.

1.2 Adherence to the principles set out in the Strategy will enable the Fund to take an ordered and prudent approach to the management of its assets, helping to manage the long term costs associated with the Pension Fund.

1.3 The full consideration and approval of the ISS ensures that the Pensions Committee are fulfilling their responsibilities as quasi Trustees of the Fund and that the Fund's investment objectives and policies are clearly set out in line with the Local Government Pensions Scheme (Management and Investment of Funds) Regulations 2016.

1.4 The Investment Strategy Statement (ISS) is a statutory document for LGPS funds, as required by Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016.

1.5 There has been a change (amendments to the Social, Environmental or Corporate Governance section to reflect work carried out and investment beliefs of the Committee) to the Fund's investment strategy since the last ISS was approved in March 2018; this report brings back a revised copy of the ISS incorporating these changes.

2. ALTERNATIVE OPTIONS

2.1 The Committee could decide to continue with its existing statement. It is however, considered best practice to publish a revised updated statement which reflects the up to date Fund position and investment beliefs of the Committee.

3. DETAILS OF REPORT

AMENDMENTS TO THE ISS

3.1 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 Regulation 7 requires the Administering Authorities to publish and maintain an Investment Strategy Statement which includes, amongst other items, details of the authority's policy on how social, environmental and corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments.

3.2 The Tower Hamlets Pension Fund's policy, based on guidance from the Law Commission, is to take into account any factors which are financially material and affect the financial sustainability of investments. These may include Environmental, Social and Governance (ESG) factors, such as carbon risk. The Fund does not make investment decisions on the basis of non-financial factors.

3.3 The Pensions Regulator specifically references climate risk in its Defined Benefit investment guidance, stating that 'Most investments in pension schemes are longterm and are therefore exposed to long-term financial risks. These potentially include risks relating to factors such as climate change, unsustainable business practices, and unsound corporate governance.

Despite the long-term nature of investments, these risks could be financially significant, both over the short and longer term'

3.4 Taking all of the above together, the Committee considers it appropriate to take climate risk into account as a material financial risk within its investment strategy. The remainder of the paper sets out actions taken by the Committee to address this risk.

3.5 **Past Activities on Climate Change Issue**

1) The Pensions Committee began it's in depth consideration of carbon exposure towards the end of 2016. In December 2016 and February 2017, the Pensions Committee held strategy meetings to consider in detail the Fund's approach to investment in fossil fuels and management of the financial risks posed by climate change. At this meeting, the Committee considered and approved a set of recommendations reflecting both its recognition of these risks and a strengthened commitment to factor them into its investment approach

2) The approved recommendations made at its March 2017 meeting are set out below:
   a. *Commit to the UK Stewardship Code.*
   b. *Develop a policy statement regarding the London Borough of Tower Hamlets' approach to fossil fuel investment with a view to inclusion as a section within the new Investment Strategy Statement (ISS), which is the new name for the current Statement of Investment Principles.*
   c. *Review options for switching some of the UK passive mandate into a low carbon target index fund.*
   d. *Consider options for an initial* ***active investment*** *of approximately 5% of the Fund in a sustainability/low carbon or clean energy fund(s). Given the right risk/return profile, investment in such a fund would demonstrate the Fund's commitment to invest in clean and sustainable companies.*
   e. *Monitor carbon risk within the London Borough of Tower Hamlets Pension Fund and to appoint a specialist contractor to conduct a carbon footprint review of the Fund at an estimated cost of between of £5k to £20k.*
   f. *Continue engagement activities with the Fund's investment managers on their approach to fossil fuel and to promote consideration of climate change issues with managers when making investment decisions.*
   g. *Maintain an active approach to climate change issues with investee companies and look for further opportunities to work with others on* issues of ESG importance.

3.6 The Committee agreed to rebalance some of its investments as part of the three year strategy review of the asset allocation of the Fund. The following changes to the portfolio were agreed and implemented by November 2017:

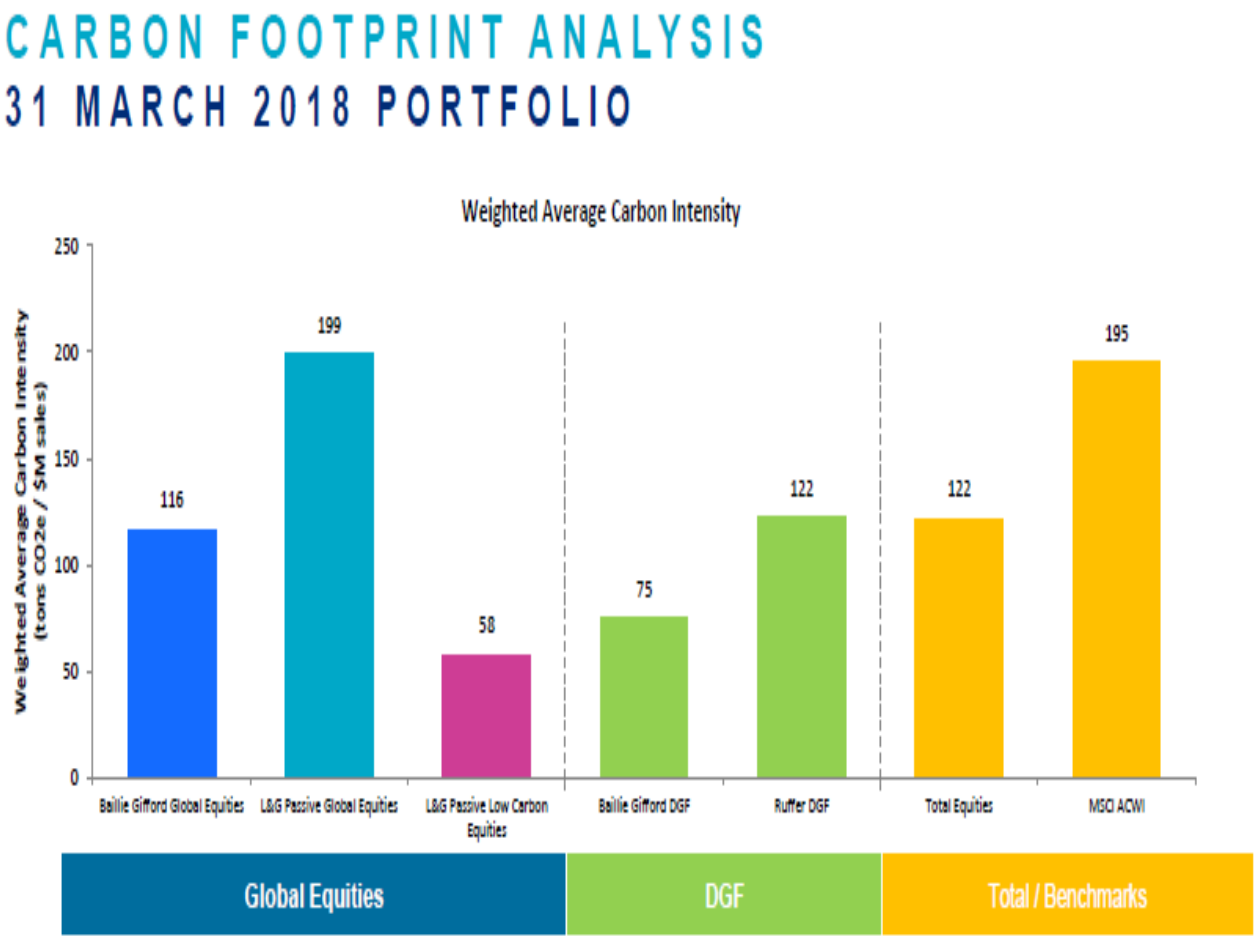
a) A reduction of total equity allocation from 60% to 50% of total assets, with the proceeds invested into multi-asset funds with much lower equity holdings (and hence lowers exposure to carbon-intensive assets).

b) The 50% of assets allocated to the equity portfolio, 15% was allocated into a Morgan Stanley Composite Index (MSCI) Low Carbon index-tracking target strategy which aims to reduce the carbon exposure of the allocation

by some 70%, relative to the broad market index, whilst still expecting to perform broadly in line with the wider market over the long term.

3.7 The carbon footprint analysis was carried out on the Fund equity holdings with the following portfolios; LGIM (FTSE), LGIM (MSCI) and BG (GE) (MSCI) by the Fund Investment Consultant - Mercer as at 31 March 2017 and 31 March 2018. The outcome was the total Fund was 31% more carbon efficient than the MSCI ACWI benchmark as at 31 March 2017 and 38% lower in carbon exposure relative to the MSCI ACWI as at 31 March 2018.

3.8 The graphical outcome produced by Mercer is shown below and it demonstrated that the overall Equity portfolio exhibits 122tCO2e which is approximately 38% lower carbon exposure relative to the MSCI ACWI benchmark of 195tCO2e and each Equity mandate held by the Fund contributes to carbon efficiency of the Fund as follows:



3.9 As expected the weighted average carbon intensity (WACI) is concentrated within the below three listed sectors. The largest sector contributions from our Fund to carbon intensity as at 31st March 2018 were:

i) Materials holdings: c.23%
ii) Energy holdings: c.20%
iii) Utilities holdings: c17%

3.10 The table below summarises the carbon exposure of each portfolio with equity holdings as at 31st March 2018. Please note that Ruffer and Baillie Gifford DGFs do not have a broad equity market benchmark.

Portfolio	Total CO2 Footprint per £m holding (tCo2e/£m revenue)	Benchmark CO2 Footprint per £m holding (tCo2e/£m revenue)	Variance	Comment in relation to the benchmark – MSCI ACWI
Baillie Gifford GE	116	195	-79 or 40%	More efficient
LGIM Passive GE	199	195	+4 or 102%	Less efficient
LGIM Passive LC	58	195	-137 or 70%	Very efficient
Baillie Gifford DGF	75	195	-120 or 61%	More efficient
Ruffer DGF	122	195	-73 or 37%	More efficient
Total Fund Equities	122	195	-73 or 37%	More efficient

3.11 At the meeting of the Committee in March 2019, the following matters were agreed:

- Committee is committed to Fund decarbonisation - reducing fossil fuel investments by deploying Fund assets to alternative investments such as renewable energy, infrastructure, long lease asset and increasing allocation to Low Carbon Strategy and or investment into ex Fossil Fuel Fund, with the aim of reducing carbon intensity of the Fund significantly by 2022.
- A 5% allocation to renewable energy; investment to be made via London CIV platform, if the investment is available and if not available for the Fund officer to work in collaboration with other London Local Authorities (LLAs) officers to search and select appropriate strategy or fund for the Tower Hamlets Pension Fund to invest in;
- An increase of allocation to a Low Carbon passive global equity strategy from 15% to 20% of the total assets of the Fund;
- A target for overall Equity portfolio to be 60% lower in carbon exposure relative to the MSCI ACWI benchmark in 5 years and or;
- A target to reduce the Fund's relative exposure to future emissions from fossil fuel reserves (measured in tCO2e – million tonnes of CO2 emissions) by 50% over 2 valuation cycles; and
- Measure the reduction relative to the Fund's position as at March 2018 (which was 122tCO2e relative to the MSCI ACWI benchmark of 195tCO2e) and adjusted for Assets under Management (£AUM).
- To review target periodically to ensure that it remains consistent with the risks associated with investment in carbon assets and with the Committee's fiduciary duties.

3.12 The 5% re-allocation away from LGIM Passive Global Equities to Low Carbon passive global equity is expected to improve the carbon intensity of Tower Hamlets Fund further, given the positive contribution the current allocation has exhibited.

3.13 At present, the UK and wider global economies remain heavily based on fossil fuels; as we transition to a lower carbon economy new opportunities will continue to open up. At present, the Fund considers that fully excluding fossil fuels from its investment strategy would excessively restrict its investment

horizons; fossil fuel divestment is not cost or risk free and the Fund needs to balance the potential long term benefits of reduction with the risks of increased investment management costs and short to medium term losses. However, as the prevalence of fossil fuels within the wider economy reduces, these risks should also reduce, permitting further reductions in fossil fuel exposure.

3.14 The Committee also strongly believe that engagement with fossil fuel companies via organisations such as LAPFF in order to influence their future strategies should continue alongside the reductions in stock holdings in such companies. We believe that simply selling stocks, whilst reducing the fund's exposure, does not in itself achieve the impact of an overall reduction in the use of fossil fuels. Others will buy the stocks released and they may not wish to engage with the companies in order to influence the move from fossil fuel.

3.15 To date, the Fund's primary focus in terms of managing its carbon risk has been on reducing risk through targeted reduction in its exposure to fossil fuel assets. However, the Fund now also wishes to explore ways in which we can support progress towards a low carbon economy through positive investment in renewable energy and associated technologies, hence 5% allocation was made into renewable energy fund at the last committee meeting.

3.16 The publication of the Intergovernmental Panel on Climate Change (IPCC)'s report on the impacts of global warming of 1.5 °C makes clear that a rapid and orderly transition to other energy sources is increasingly urgent; whilst selective disinvestment from fossil fuel assets can be used to help manage the financial risks faced by the Fund, investing in the suppliers and technologies helping to drive change is a potential way for the Fund to actually contribute to the transition.

3.17 The Committee is planning to use the next investment strategy review to consider how the Fund could increase its positive contribution to the transition to a low carbon economy by increasing its investment in renewable energy, whilst meeting its own strategic investment requirements.

3.18 As part of the planned carbon risk audit, the Committee will consider an analysis of its energy exposure against the energy requirements for 2oC and 1.5oC future warming scenarios. This analysis can then be used to consider how the Fund might look to align its exposure to those scenarios.

3.19 The ISS must be reviewed and revised by the Council as administering authority when any material changes take place such as changes to the investment beliefs; changes to the types of investment held; or the balance between the types of investments in the Fund.

3.20 Having taken into account the risks associated with exposure to fossil fuel reserves, the Committee has approved a target set below and the updated ISS (page 14, section 9.8-9.9) incorporates the changes as set out below, to ensure that the ISS remains current:

- A target for overall Equity portfolio to be 60% lower in carbon exposure relative to the MSCI ACWI benchmark in 5 years and or;
- A target to reduce the Fund's relative exposure to future emissions from fossil fuel reserves (measured in tCO2e – million tonnes of CO2 emissions) by 50% over 2 valuation cycles; and

- Measure the reduction relative to the Fund's position as at March 2018 (which was 122tCO2e relative to the MSCI ACWI benchmark of 195tCO2e) and adjusted for Assets under Management (£AUM).

4. COMMENTS OF THE CHIEF FINANCE OFFICER

4.1 The Investment Strategy Statement details the decision by Committee on how the Fund's assets will be invested. The Strategy set has been prepared to maximise returns of Fund's assets within acceptable risk parameters and also to facilitate a reduction in the burden of deficit funding that employers in the Fund are liable for.

4.2 The performance of the Fund's strategy is monitored through a quarterly report that is presented to the Committee. Recent performances have been good and generally either in line with or exceeded target.

4.3 The investment in MSCI Low Carbon index has reduced the Tower Hamlets Pension Fund exposure to carbon investments.

4.4 A carbon risk audit was carried out by Mercer in summer 2018 which assessed the operational carbon footprint and exposure to fossil fuel reserves of the Fund's equity portfolio, setting out where the Fund was most exposed in terms of assets at risk of stranding. The results of this assessment suggested that the greatest risk with regards to potentially stranded assets was concentrated in companies with coal reserves within the passive global equity mandates, however some concentration of oil and gas reserves was found within the fund's active Global Equity mandate.

4.5 After considering the results of the carbon risk audit, the Pensions Committee agreed that the target would be periodically reviewed to ensure that it remained consistent with the risks associated with investment in carbon assets and with the Committee's fiduciary duties.

5. LEGAL COMMENTS

5.1 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 govern the way in which local authorities are expected to deal with investment of pension funds. Local authorities should take a prudential approach to investment, demonstrating that they have given consideration to the suitability of different types of investment, have ensured an appropriately diverse portfolio of assets and have ensured an appropriate approach to managing risk.

5.2 One of the functions of the Pensions Committee is to meet the Council's duties in respect of investment matters. It is appropriate having regard to these matters, for the Committee to receive information about asset allocation and ensure that funds are being managed in accordance with the Administering Authority's Investment Strategy Statement.

5.3 The Investment Strategy Statement must include those matters set out in Regulation 7(2) of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016. Under Regulation 7(7) the administering authority must review and if necessary revise its investment strategy from time to time, and at least every 3 years, and publish a statement of any revisions.

5.4 The contents of this report and the recommendations set out ensure that the Administering Authority is compliant with the LGPS Regulations.

5.5 When carrying out its functions, the Council must have due regard to the need to eliminate unlawful conduct under the Equality Act 2010, the need to advance equality of opportunity and the need to foster good relations between persons who share a protected characteristic and those who don't (the public sector duty).

6. ONE TOWER HAMLETS CONSIDERATIONS

6.1 The employer's contribution is a significant element of the Council's budget and consequently any improvement in investment performance will reduce the contribution and increase the funds available for other corporate priorities.

6.2 A viable pension scheme also represents an asset for the recruitment and retention of staff to deliver services to the residents.

7. BEST VALUE (BV) IMPLICATIONS

7.1 This report helps in addressing value for money through planning to have a rigorous and robust investment strategy in place to aid in bridging the Fund's funding gap.

8. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

8.1 There is no Sustainable Action for A Greener Environment implication arising from this report.

9. RISK MANAGEMENT IMPLICATIONS

9.1 Any form of investment inevitably involves a degree of risk.

9.2 To minimise risk the Investment Panel attempts to achieve a diversification portfolio. Diversification relates to asset classes and management styles.

10. CRIME AND DISORDER REDUCTION IMPLICATIONS

10.1 There are no crime and disorder reduction implications arising from this report.

Linked Reports, Appendices and Background Documents

Linked Report

- [None]

Appendices

Appendix 1 – Revised Investment Strategy Statement, June 2019

Local Government Act, 1972 Section 100D (As amended)
List of "Background Papers" used in the preparation of this report

Officer contact details for documents:

- Bola Tobun Investment &Treasury Manager x4733