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LGPS: Next steps on investments

Storebrand Asset Management, UK

October 2023

Introduction – basis for our response

Storebrand Asset Management (SAM) is the largest private asset manager in Norway and our sole business is asset management, providing a broad range of investment services to over 300 institutional clients and managing approximately £83.4 billion as at 30 June 2023. SAM was the first Norwegian company to establish a sustainable investment department in 1995 and we have one of the most experienced environmental, social and governance (ESG) teams in the Nordic region.

SAM manages £845m in assets on behalf of the UK Local Government Pension Scheme, in products designed to reduce climate-related investment risk in both global and emerging markets equities. We have engaged closely with the LGPS on climate risk management, reporting and our product offering.

At SAM, our flagship, climate-aware equity product range (the "Plus Funds") includes both Global Equities and regional strategies in Emerging Markets, Swedish Equities and European Equities. It is designed and led by a climate change specialist portfolio manager and managed by a team with a proven ability to successfully combine portfolio construction expertise with sustainability data and insights. The same team has managed the range since the launch of the first, global equity, vehicle in 2016. Our UK LGPS clients are invested in the Global and Emerging Markets strategies within the Plus Funds range.

The Plus Funds are market leading and designed to evolve with ever improving climate science, policy and data. This means they are at the forefront of the SAM offering on climate risk minimisation and reflect our best ideas in this area. For this reason, this response is focused on the way we manage and report on climate change risks in the SAM Plus Fund range.

In 2021, Lauren Juliff, Climate and Sustainability Lead at SAM UK, undertook a research project on the management of climate related risk in the UK LGPS which was submitted as her thesis for an MSc in Climate Change at Kings College London. This involved interviews with LGPS stakeholders and, alongside our own experience with clients in this market, has informed our response to this consultation. A copy of the thesis can be provided on request.

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Summary of our Response:

- The failure to incorporate sustainability beliefs as a defining feature of pooling at the outset has hampered the project. One of the clear points of conflict between funds and pools is around lack of unity on investment beliefs and how those beliefs are represented in investment strategies. This pooling review is a good opportunity for funds and pools to reflect on their investment beliefs, goals and targets and form better-aligned partnerships on that basis.
- Due to the decision-making hierarchy, varied local stakeholders and different interpretations of fiduciary duty and sustainable or responsible investing in the LGPS, it is not reasonable to expect a one-size-fits-all approach.
- There is no single definition of 'value' or 'performance' and local authority funds have quite different opinions on what defines value, often reflecting their beneficiaries' views. Value for money does not mean the cheapest possible investment strategy and many factors, including sustainability, can lead to improved long-term performance.
- There is "*no consensus*" across the LGPS funds and pools on how to manage climate risk. This is most apparent in the approach to net zero target setting across the scheme.
- Our research demonstrates that there is no such thing as passive Paris alignment. Despite attempts by the EU to define the rules of a Paris Aligned Benchmark (PAB) or Climate Transition Benchmark (CTB), there is a difference in risk exposures and performance depending on which brand of PAB or CTB is selected. This means funds can be exposed to unknown, unintended and unmanaged risks in the very part of their portfolio which is designed to be low governance.
- We believe that a reconsideration of what constitutes a 'passive' investment strategy is necessary to achieve the primary pooling objective of value for money and meet the needs of LGPS beneficiaries.
- Now that alternative pooling approaches are being considered it is an opportunity to reposition sustainable investment strategy as a core, defining investment belief. This could allow partner funds to access investment vehicles that better align with their objectives, may create more constructive partnerships and lead to greater scale in pooled assets. Importantly, it may allow more effective delivery of "*value for money*" to beneficiaries.
- Reporting that focuses on net savings does not indicate delivery of value for money. Cost savings do not account for more sophisticated or tailored investment approaches, access to less liquid assets or increased focus on sustainability and reporting.
- We agree that cross-pool investing could be beneficial for the LGPS. This might be a way in which funds can seek strategies that align with their investment beliefs and allow them to achieve their specific goals related to sustainable investing and value for money.

Question 1: Do you consider that there are alternative approaches, opportunities or barriers within LGPS administering authorities' or investment pools' structures that should be considered to support the delivery of excellent value for money and outstanding net performance?

The consultation document highlights that pension funds, in particular the LGPS, are under "substantial pressure on a number of fronts" including "environmental issues". Separately the consultation document refers to varied progress across the scheme in terms of the benefits delivered by pooling. Our research on the management of climate related investment risk in the LGPS[1] shows that the success of the pooling project was hampered by not considering sustainable investment in the early stages. This has led to a lack of unity on certain key issues such as net zero policy and created problems for pools in aligning sustainable investment strategies and making available appropriate investment vehicles that meet the needs of their diverse partner funds.

The government recently consulted the market on increased legal requirements for climate risk management and reporting in the LGPS. A recent study by KPMG found that "*ESG and sustainable finance regulations are putting the most pressure*" on the financial services industry[2]. Increased availability of data and reporting intensifies the focus on how pools and underlying partner funds are managing climate risk. Due to the decision-making hierarchy, varied local stakeholders and different interpretations of fiduciary duty and sustainable or responsible investing in the LGPS, it is not reasonable to expect a one-size-fits-all approach.

The government proposes that pooling should deliver "*excellent value for money and outstanding net performance*". There is no single definition of 'value' or 'performance' and local authority funds have quite different opinions on what defines value, often reflecting their beneficiaries views. Value for money does not mean the cheapest possible investment strategy and many factors, including sustainability, can lead to improved long-term performance.

The pooling model was built upon the principle that local authority funds remain individually responsible for investment strategy and delivery of benefits to members, and pools are responsible for implementing investment strategies. However, if underlying partner funds are not aligned in terms of investment beliefs and targets then pooling assets is more difficult to achieve as different investment vehicles are required. An area where this has become apparent is in the management of "passive" listed assets in line with a variety of different approaches to managing climate risk and target setting.

Net zero targets and "passive" investing

It has been widely reported and discussed that there is "*no consensus*" across the LGPS funds and pools on how to manage climate risk[3]. This is most apparent in the approach to net zero target setting across the scheme. Councils and their pension funds have been under increasing pressure to set net zero targets and many LGPS funds have responded – but with a variety of target dates ranging from 2030 to 2050. On the other hand, most funds do not have a specified net zero goal or are wary of committing to targets when methods and metrics for measuring progress are still undetermined. At present, 6 of the 8 pools have set net zero goals.

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[1] Juliff (2021): The Management of Climate Related Investment Risk in the UK Local Government Pension Scheme

[2] Financial services regulatory pressure grows with ESG rules the main culprit (investmentweek.co.uk)

[3] George (2022) LGC: Revealed: the council pension funds with net-zero target dates

It is challenging for pools to manage this fund level diversity in targets and strategies, particularly in the areas the government suggests should be pooled quickly or perhaps managed in house, such as passive equities – which often represent the bulk of assets. The Investment Association[4] has emphasised that for low-cost investment strategies, such as index-based/passive investments, it is generally more beneficial for pools to outsource portfolio management than to build the necessary internal resources. Further, before any mandate is given for funds to transition passive assets quickly there should be some consideration of what defines "passive" investing, or the pooling project risks its ability to achieve "*value for money and outstanding net performance*".

Our research demonstrates that there is no such thing as passive Paris alignment[5]. The path to a net zero economy remains necessarily uncertain in line with ongoing developments in climate science, policy, technology and data. Portfolio strategies aiming to align with the goals of the Paris agreement, or 'net zero', will require a similar level of flexibility and adaptability. In the past 5 years there have been many attempts to design and deliver passive ESG / low carbon / climate aware / Paris aligned index tracking funds. Experience shows us that such indices often become defunct as the market develops and better, more sophisticated data becomes available. This can lead to additional costs as funds or pools need to transition to the latest available 'low carbon' or 'Paris aligned' index. Another problem is that, despite attempts by the EU to define the rules of a Paris Aligned Benchmark (PAB) or Climate Transition Benchmark (CTB), there is a difference in risk exposures and performance depending on which brand of PAB or CTB is selected. This means funds can be exposed to unknown, unintended and unmanaged risks in the very part of their portfolio which is designed to be low governance. The sources of difference occur due to different data inputs, screening criteria or portfolio construction methodologies and can lead to considerable levels of risk (represented as tracking error) between different types of PAB or CTB and between the new indices and their parent benchmarks[6].

We believe that the only "passive" investment strategy is managed to a market cap weighted benchmark, where companies are organised according to a clear methodology This belief is backed up by academic research[7], as well as our own lengthy experience in managing index-tracking funds. There are many subjective decisions required when building any ESG-related, climate aware or Paris aligned benchmark / index tracking fund. Those decisions should be made by a specialist portfolio manager who takes accountability for the investment outcome and ongoing management of the strategy. The resources, experience and expertise required to manage a broad range of sustainability concerns, including climate risk, and meet increasing regulatory requirements in this area should not be underestimated.

Now that alternative pooling approaches are being considered it is an opportunity to reposition sustainable investment strategy as a core, defining investment belief. Pools could work with specialist managers to design bespoke strategies incorporating their desired approach, which may not be entirely based on simplistic and systematic portfolio decarbonisation. Some may decide to integrate certain red lines around their investment universe, relating to activities such as human rights violations, the fossil fuel value chain and corruption and others may take a less exclusionary approach. This could allow partner funds to access investment vehicles that better align with their

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[4] Source: IA draft response to this consultation, LGPS: Next steps on investments.
[5] Climate Change Benchmarks: The Passive Pretenders
The Paris Alignment Paradox: Scoping Out Solutions
The Climate Data Conundrum
[6] Please refer to our research paper where we discuss this topic in detail.
[7] Mahoney, P.G. and Robertson, A.Z., 2021. Advisers by another name. Harv. Bus. L. Rev., 11, p.311

objectives, may create more constructive partnerships and lead to greater scale in pooled assets. Importantly, it may allow more effective delivery of "*value for money*" to beneficiaries.

The consultation document proposes to drive "*greater scale through fewer pools*". We reiterate that value for money is not solely a function of scale. Within the current LGPS decision-making structure, it must be ensured that there is enough variety available in terms of investment strategy implementation such that underlying funds can invest according to their values and beliefs and in line with their fiduciary duty, not least when it comes to sustainable or climate aware investing.

Question 2: Do you agree with the proposal to set a deadline in guidance requiring administering authorities to transition listed assets to their LGPS pool by March 2025?

We cannot comment on the practicalities of transition deadlines for funds and pools. However, we urge the government to allow all LGPS investors the time and opportunity to agree their goals and ensure the appropriate range of investment strategies is available within the pools. We believe that a reconsideration of what constitutes a 'passive' investment strategy is necessary to achieve the primary pooling objective of value for money and meet the needs of LGPS beneficiaries.

Question 3: Should government revise guidance so as to set out fully how funds and pools should interact, and promote a model of pooling which includes the characteristics described above?

The effective interaction between funds and pools and increased "*pool partnerships which have a higher degree of delegation, closer alignment of strategy and larger proportion of assets pooled*" is reliant on an alignment of investment beliefs. This concept is largely absent from the consultation document. The investment strategy and asset allocation set by a fund is informed by its financial ecology, influenced by multiple stakeholders. Therefore, funds are more likely to delegate to a greater degree if the pool can offer strategies aligned with their investment beliefs. This relies on pools being able to deliver low cost, core investment strategies which can be designed and managed with agreed and transparent sustainability and risk criteria. If there is a shift to fewer pools then a more optimal differentiating feature between pools might be according to sustainable investment beliefs, such that funds can find the right alignment for their investment strategies.

We support the response provided by the Investment Association to Question 3. The governance model should not risk stifling innovation or the ability of the funds and pools to respond to changing circumstances. Further, responsibility for paying beneficiaries remains at fund level, meaning local authorities must have the flexibility to invest according to their strategies and investment beliefs and the ability to challenge and scrutinise investment implementation.

Question 4: Should guidance include a requirement for administering authorities to have a training policy for pensions committee members and to report against the policy?

The government highlights that pensions expertise amongst decision-makers in the LGPS may be lower than those in private sector schemes due to the political nature of appointing pensions committees. Our research on the management of climate related investment risk in the LGPS shows that political influences and high committee turnover can also lead to different interpretations of the duties of the pensions committee and what constitutes 'fiduciary duty' in the context of sustainable investing. Given the amount of regulatory focus on sustainable investing, effective stewardship of assets and management of climate risk, we believe these areas should be prioritised in any member

training or education program. Further, pools and funds should look to more academic training on climate risk to avoid any inherent biases or lack of expertise in financial services and consultancy firms.

Question 5: Do you agree with the proposals regarding reporting? Should there be an additional requirement for funds to report net returns for each asset class against a consistent benchmark, and if so how should this requirement operate?

We support the Investment Association's response to question 5. Reporting that focuses on net savings does not indicate delivery of value for money. Cost savings do not account for more sophisticated or tailored investment approaches, access to less liquid assets or increased focus on sustainability and reporting.

We support efforts to ensure the provision of transparent and comprehensive investment performance data. This should be provided relative to the relevant index, agreed during the procurement process and both net of fee and gross of fee data should be shown.

We refer to our response to the government's consultation on the management and reporting of climate risk, where we highlight comparisons across funds as problematic. This is echoed by the Investment Association in its response to this consultation.

In addition, pensions committees, pools, investment managers, consultants and all financial services market participants are subject to increasing reporting requirements across the board. Adding more layers of reporting into the regulatory framework is not necessarily conducive to cost savings or delivering value for money.

Question 8: Do you agree that funds should be able to invest through their own pool in another pool's investment vehicle?

Yes, we agree that cross-pool investing could be beneficial for the LGPS. This might be a way in which funds can seek strategies that align with their investment beliefs and allow them to achieve their specific goals related to sustainable investing and value for money.

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