Environmental, Social and Governance (ESG) Report

2024

Foreword

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The implementation of Environmental, Social and Governance (ESG) principles into the running of the UK's pension schemes has now become well established. To some extent, this has been driven by the requirement for pension schemes to comply with the Task Force on Climate-related Financial Disclosures (TCFD) reporting requirements, although it should be emphasised that there is far more to ESG than just considering the impact of climate change. Former Pensions Minister Guy Opperman was an enthusiastic proponent of ESG, and his successor Laura Trott took up the mantle during her period in office. It is worth reflecting on why ESG is so important for pension schemes and to assess what remains to be done.

The FMLC effect: redefining ESG considerations for pension scheme trustees

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It's been five years since regulations were updated requiring pension schemes to set out (within their Statement of Investment Principles) their policies in relation to 'financially material considerations', with the definition of financially material updated to include ESG[1] considerations and climate change. This was a shift change after many years of such investment considerations being considered potentially 'ethical' and therefore detrimental to investment performance.

While the industry has come a long way since then and trustee knowledge has improved considerably, there can still be challenges for trustee boards to see the financial significance of environmental and social factors. One of the main reasons for this is because quantitative data points relating to such factors are hard to come by. Thankfully, guidance released earlier this year by the Financial Markets and Law Committee (FMLC) can help trustees ensure they meet their fiduciary duty to act in the best financial interests of members, while also considering factors many recognise as significant to the future of our global economy.

Why is quantitative data difficult?

The world as we know it is changing. These changes affect everything we own – whether we are investing sustainably or not – and will continue to do so in future. For example, we are currently experiencing an energy transition that will likely change the shape of our economy. It is well under way, changing energy sources mean changing energy prices, changing energy prices mean changing asset values. Another example is the increasing recognition of the importance of the resources around us, for example the natural environment, but sadly some of these resources show signs of depletion. Again, the price of these raw materials is changing as a result and with it the price of goods and, you guessed it, asset values. Because this is a changing world, we don't have lots of relevant past data points to refer to. This makes modelling potential financial impacts of our changing world difficult. But in a world that is changing around us can we afford not to be more conscious in our decision-making?

What does FMLC say?

In my view, the guidance from FMLC is particularly helpful to trustees due to two specific points raised:

- "Numbers and Narratives" – FMLC notes pension fund trustees will need to expect the reasons for their decision, made with regard to financial factors, should involve both numbers and words. Sometimes financial factors cannot be quantified, but it does not follow that they lack weight.
- Distinction between financial and non-financial factors – FMLC highlights that today, financial factors are broad. What at first may appear to be a 'non-financial factor' is actually 'financial' when properly understood. FMLC also highlights that what distinguishes a financial factor from a non-financial factor is the motive underlying its consideration, rather than the nature of the factor. For example, if as a trustee board you are considering the exclusion of a specific investment based solely on your beliefs, then this would not necessarily be a financial factor.

While the FMLC paper is guidance only, there is an open letter from the Work and Pensions Committee to the Department for Work and Pensions to consider its inclusion by The Pensions Regulator in its own guidance to trustees on decision-making.

[1] Environmental, Social and Governance factors

The FMLC effect: redefining ESG considerations for pension scheme trustees

Using 'storytelling'
Let's use FMLC's point that decisions can involve both numbers and words to illustrate an example.

If you are a gardener you may be aware of our topsoil crisis. We could run out of topsoil in the next 50 years. Yet 95% of our food is grown in topsoil[2].

Let's first consider the impacts on specific sectors. Clearly for the food sector this could cause serious issues and could impact on financial strength. In addition, the clothing sector could experience significant financial damage as cotton also requires topsoil. At this point we are starting to see an issue for specific holdings in the investment portfolio due to this topsoil loss.

Let's take this one step further and consider the macro-economic impacts of a loss of topsoil. Food shortages start to appear, and we see higher inflation coming through. We don't need lots of data points to see biodiversity loss can impact the pension schemes but working through a specific example can help to illustrate this point.

Interestingly with sustainability related factors you will see lots of interlinkages. For example, soil is a great carbon store, and soil degradation is releasing carbon into the atmosphere, further exacerbating climate change. Climate change has led to milder and wetter climates for some geographies such as the UK, with wet weather being one contributing factor to soil degradation.

How does Climate Change affect rainfall intensity globally?

Natural Climate (without human influence)

Warm, moist air rises to form clouds...

... and then falls as rain

Future Climate (with warmer air)

For every 1° more that the air warms, it can hold about 7% more water...

... creating heavier rain

Warmer air under climate change can create heavier rain

BARNETT WADDINGHAM
beyond the expected

How to implement in investment portfolios
Trustees are responsible for their schemes' investment governance arrangements, including determining investment strategy. The investment strategy clearly needs to take into account a number of scheme objectives from liquidity requirements through to the management of a myriad of risks, including sustainability.

In practice, the vast majority of pension scheme trustees delegate the day-to-day management of their investments to appointed investment managers. There is therefore an expectation the appointed investment managers will manage considerations such as biodiversity loss on behalf of the trustees. However, it's important trustees have confidence the selected investment manager is appropriately allowing for such risks both on appointment and throughout the relationship. We strongly encourage holding robust conversations with investment managers on their consideration of such risks within your investment portfolio.

Some pension schemes may also want to consider the opportunity presented by our changing world. There are fantastic investment opportunities available to help solve some of the issues we face in our society today. Such opportunities should be considered within the context of any schemes' wider objectives, for example end game plans and liquidity needs. Trustees can work with your investment consultant to explore such opportunities and consider their appropriateness.

Key takeaways

- The world is changing and this presents both risk and opportunity to pension schemes' investment portfolios. It can be difficult to assign numbers to this but by using narrative you can help build a picture of the changing world and its potential implications.
- Pension scheme trustees should hold robust conversations with investment managers to ensure sustainability related risks within the investment portfolio are appropriately managed.
- The changing world also presents an investment opportunity. Trustees can work with their appointed investment consultant to consider if this makes sense for their portfolio.

[2] The Soil Crisis — WeRadiate

Elevating ESG Practices Through Strategic Communication in Pensions

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Pension members today are better informed and more environmentally conscious than ever before, demanding transparency on the ESG impact of their investments. Pension funds must urgently update their ESG strategies and communicate them clearly to meet this demand. This dual focus on action and communication can position pension funds as sustainability leaders, building trust and engagement.

The impact that sustainable investment can have on our future is significant, which is why regulation is ramping up in this area. But to be seen as credible, even the most sustainable pension firms must carry this same ethic and rigour through to their supply chain. For member communications, this means measuring and assessing every aspect of their communications programme and asking if it is effective and sustainable.

The answers to these questions are often not as simple as they seem. Prioritising digital over print, for example, assumes it is more sustainable and engaging to members - a belief often reinforced by the simplistic claims of unintentional greenwashers. The sustainability of paper as a raw material is well documented - it is a regenerative material - and research backs up the heightened engagement offered by physical communications over digital. These are important considerations when making decisions. For example, a missed or unread email can trigger a cascade of follow-on queries, spiralling internal costs and, as a result, increased carbon emissions.

So, as new generations join the pensions market, if you want to achieve high levels of sustainability and engagement, the ability to implement a channel-agnostic communication strategy that utilises both print and digital is vital.

In this system, each medium can serve its purpose, delivering the right message through the right channel at the right time, ensuring it resonates and can be understood by the end member. You also need to be able to measure the carbon impact of your communications programme. Tracking and forecasting the carbon and cost efficiency of the changes you propose will help you to make accurate and sustainability-boosting long-term decisions.

Communications efficiency comes from accurate data. Keeping member details enables powerful personalisation, ensures relevance and reduces follow-ups caused by incorrect information, which ultimately increases carbon emissions. Analysing response rates and engagement metrics helps refine future strategies, boosting member engagement and optimising resource use. This targeted approach supports sustainability goals by cutting communications waste, reducing costs and carbon emissions as a result.

Pension organisations should assess the lifecycle of their communications, including content, materials, and delivery methods. They can opt for sustainable packaging by reducing mailing pack weight, choosing smaller formats, using recyclable materials, and selecting eco-friendly shipping options. For instance, switching from C4 to C5 envelopes reduces raw materials and lowers carbon emissions due to smaller delivery size. Additionally, first-class delivery often has a higher carbon footprint as it involves standalone household deliveries, while five-day services consolidate deliveries. Unless time-sensitive regulatory requirements apply, companies should favour more sustainable delivery options.

Elevating ESG Practices Through Strategic Communication in Pensions

Highlighting Environmental Practices in Communications

With Generation Z entering the workforce, employers must adapt to shifting needs and expectations. Deloitte's 2024 Gen Z and Millennial Report reveals that 86% of this group value a sense of purpose in their work, and 44% have declined job offers due to ethical concerns about potential employers. This underscores the importance of not only setting ESG targets but also transparently communicating progress and practices to stakeholders.

Pension funds can use their communications to highlight environmentally responsible practices. For instance, when sending out printed communications, organisations can include information about their efforts to reduce their carbon footprint of the communication, such as:

- Sustainable Sourcing: Emphasising the use of recycled or sustainably sourced materials in printed communications.
- Eco-Friendly Practices: Discussing initiatives such as double-sided printing, minimising paper size, and ensuring that all materials are recyclable.
- Carbon Footprint: Providing members with information about the carbon footprint associated with that specific communication and the steps taken to reduce it.

By highlighting these aspects in their messaging, pension funds can show their commitment to sustainability and encourage member participation. However, caution is needed, as a significant portion of a pension company's carbon footprint comes from its investments. Organisations must ensure that communications do not mislead consumers about the sustainability practices or targets of their core business activities. Furthermore, firms must be able to measure their carbon footprint accurately and be able to validate any claims made.

The Social Dimension of ESG

While the environmental aspect of ESG often gets the most attention, the social dimension is just as vital. Social factors like financial inequality, ethical supply chains, and inclusive employment practices are key in integrating ESG principles.

We're living through an age when ESG awareness is arguably higher than ever: the work of various environmental activist groups is a mainstay in global news, and almost 90% of adults in the UK have made changes to their lifestyle in response to environmental issues. It's clear that consumers care about sustainability, but to a certain extent their hands are tied by the choices available to them.

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To tackle financial inequality, pension companies should ensure all members, regardless of socio-economic status, have access to the tools for a secure retirement and understand the importance of using them. Information overload can lead to inaction or the "ostrich effect," making clear, actionable communication crucial in educating pension members. Key focus areas for member education include:-
Make it Personal: Use interactive tools like retirement planners, digital statement videos, and budgeting tools to show members the impact of their current savings on future retirement outcomes. These help members better understand their financial situation.

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- Workshops and Webinars: Host regular webinars and virtual workshops on financial topics to engage members. These sessions provide a platform for real-time Q&A, offering a more personalised and interactive learning experience.
- Targeted Campaigns and Communications: Deliver tailored educational content via email, SMS, or print at key life stages. For instance, members in their 30s may need advice on balancing pension contributions with saving for a house, while those nearing retirement may need guidance on drawing down pension funds efficiently.

On a broader scale, pension funds can drive social change through their partnerships and supply chains. Schemes must ensure that suppliers, including communication providers and investment partners, operate ethically. This involves assessing whether suppliers prioritise diversity and inclusion, set carbon net-zero targets, and uphold fair labour practices to reduce the risks of modern slavery and human rights abuses.

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These issues are important not only from a social justice perspective but also in terms of Scope 3 carbon emissions, which include those from a company's supply chain and third-party providers. Partnering with suppliers who measure their emissions and have set carbon net-zero targets helps organisations achieve their own sustainability and carbon net-zero goals.

In conclusion, sustainability is not just about reducing environmental impact, but also creating efficient communication strategies, whether print or digital. The most effective approach minimises resource use while delivering clear, relevant, and actionable messages. As demographics shift, a sustainable approach will be vital for attracting and retaining a more environmentally conscious and engaged customer base.

Equally, the social aspect of ESG is crucial. Providing accessible, meaningful information to address financial inequality and promote diversity and inclusion is key to successfully implementing ESG strategies and fostering long-term member engagement and loyalty.

As a trusted partner to some of the world's leading organisations, including many leading pension organisations, Paragon has an ongoing responsibility to build a sustainable business, and to contribute to a sustainable economy and planet by supporting clients in managing their environmental and social impacts.

Working with a communications partner that has similar sustainability goals, and the capabilities to deliver on them, can help your organisation to meet its ESG objectives.

Fiduciary duty: Do modern ESG issues require regulatory intervention?

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How far can pension schemes trustees go when taking account of ESG issues, including climate change, in relation to scheme investments? Are fiduciary duties evolving to keep pace or is it time for regulatory change?

Pension scheme trustees have specific fiduciary duties relating to scheme investments, as they manage the scheme for the benefit of its members. These fiduciary duties are not derived from a single source; rather, they have evolved from case law, overlaid by certain statutory provisions, including the Pensions Act 1995 and the Occupational Pension Schemes (Investment) Regulations 2005.

The basic legal principles that comprise trustees' fiduciary duties have remained stable over time. However, how they should be applied in context of modern ESG issues, and particularly climate change, raises new questions.

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What is the fiduciary duty?

In general terms, trustees are required to:

- exercise their investment powers for their "proper purposes", namely the provision of members' pensions
- take account of factors which are relevant to that purpose, this will usually mean those that are financially material (this may be consideration of risks as well as returns), and
- do so in accordance with the "prudent person" test. Broadly, this is the principle that trustee investment powers must be exercised with the care, skill and diligence a prudent person would exercise when dealing with investments for someone else for whom they feel "morally bound to provide".

These principles have most recently been confirmed by the Financial Markets Law Committee (FMLC) in their recent paper, Pension Fund Trustees and Fiduciary Duties – Decision-making in the context of Sustainability and the subject of Climate Change.

Despite this, trustee fiduciary duties continue to be mischaracterised and it is still not unusual to hear people refer to a trustee's duty to "maximise returns," a notion stemming from the 1984 case of Cowan v Scargill. However, context is crucial, and the circumstances in which the trustees in that case were exercising their investment powers must also be taken into account. This is not to suggest that Cowan v Scargill is bad law, but rather that its judgment must be understood in its proper context. Cowan v Scargill remains a valid authority on the legal principle that trustees must exercise their investment powers for their proper purposes (specifically, to provide pensions for members and not for political reasons). However, it is a misinterpretation to see the case as imposing an absolute duty to maximise returns. This will be clear to anyone familiar with how trustees of defined benefit pension schemes often utilise hedging instruments, bulk annuities, and liability-driven investment strategies. Are these investments made for the purpose of "maximising returns"? Obviously not. Yet, they do fulfil the goal of ensuring that members' pensions can be paid.

"Financial" and "non-financial"

It is trite law to say that trustees must take account of all "relevant" factors in their investment decisions. Factors that are "relevant" in this context may include those that could either enhance or detract from expected returns, as well as those that may increase or decrease risk. Such factors are typically referred to as being "financially material". With regard to ESG, it is now widely recognised that the physical risks of climate change and the UK's transition to a lower-carbon economy could pose significant financial risks to pension schemes. When these risks are financially material to a scheme, trustees should take them into account in their investment decisions, in line with their fiduciary duties.

Fiduciary duty: Do modern ESG issues require regulatory intervention?

Trustees cannot make investment decisions solely to express their disapproval of unethical behaviour by a company. However, in some cases that same conduct may be considered to impact the longer-term financial prospects of the company in question and so could become a relevant financial factor for trustees to take into account. So, the line between financial and non-financial can start to become blurred. A check-point for trustees is to ask themselves what their real motive is in deciding whether to take a factor into account in their investment decision making. This will be instructive as to whether trustees are acting on a financial factor or something else.

The grey area

Where things can become particularly tricky is when trustees start to consider broader issues such as systemic market risks and the quality of life of beneficiaries. Arguably, both of these could be relevant factors in trustees' investment decision making. Certainly, well-functioning markets and a world that's not on fire ought to be in the best financial interests of pension funds and their members. And many will argue that this alone should legitimise trustees adopting strategies such as rapid de-carbonisation or impact investment, even if there is some negative financial impact in doing so. But there is a problem and that is one of causality. Is it really credible for one board of trustees to base their investment decision making on a premise that the external impact of investments will bring about a tangible benefit to the scheme and its members in ways other than the direct financial performance of the investments themselves? What if each trustee board is just too small to make a difference with its own investments?

This question was partially addressed in the Law Commission's 2014 report but the view expressed was that for a decision to be justified on financial grounds, the anticipated benefits to the portfolio should outweigh the likely costs to the portfolio. In other words, the financial benefit must not be "too remote and insubstantial" and must accrue to the fund itself, not to the social good in a more general way. This was referenced somewhat tangentially by the FMLC in their report, which stated that whilst some "wider economic or systemic climate change-related issues may have been characterised as 'too remote and insubstantial' in the past, pension fund trustees will need to reappraise this in a context where, for example, physical, transition and litigation risks are now apparent and material." The FMLC stopped short, however, of saying that trustees might be able to prioritise external impact over more direct risk and return considerations.

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However, things may be about to change. The parliamentary Work and Pensions Committee have recently sought industry views on fiduciary duties. A significant part of this discussion focused on whether a "legal change to the definition of fiduciary duty" is necessary. A varied array of responses to this question have been put forward by industry groups, including how such a change might look in reality. The Department for Work and Pensions have also been canvassing industry opinion.

Thus far, it is fair to say that the pensions industry has generally been cautious of tinkering with trustee fiduciary duties but one doesn't have to look too far to see developments in parallel areas of the financial system.

Proposals have been raised in relation to company law in the proposed Better Business Act. This act sets out a reform to UK legislation aimed at changing the way companies operate by integrating social and environmental responsibilities into their core duties. The initiative, led by a coalition of over 500 businesses, organisations, and individuals, seeks to amend s.172 of the UK Companies Act 2006 to ensure that companies not only prioritise shareholder interests but also take into account the needs of stakeholders like employees, communities, and the environment. Could a similar wider duty be imposed on pension trustees?

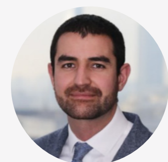
In addition, on the continent, suggested amendments to Institutions for Occupational Retirement Provision II have also included updating the prudent person rule to ensure the consideration of "sustainability preferences of members and beneficiaries in the investment decisions for institutions for occupational retirement provision". Although not directly applicable now to the UK it is interesting to see how the issue is developing elsewhere.

Productive finance is a concept now firmly on the Government's agenda, and in general terms relates to providing equity and funding to UK businesses in order to grow the economy. The Mansion House speech led to a package of reforms focused on bolstering investment in the UK, with pension schemes playing a key role in achieving this aim. The reforms seek to "increase returns for pensioners, improve outcomes for investors and unlock capital for our growth businesses". How more investment in productive finance is going to materialise is still to be seen but it raises the question of how does such investment interplay with a trustee's fiduciary duty to invest in the best interests of scheme members?

Elsewhere various civil society groups have noted the obligation under regulation 4(2)(a) of the Occupational Pension Schemes (Investment) Regulations 2005 that pension scheme assets "must be invested in the best interests of members and beneficiaries" and questioned whether it is really in members best interests that their pension savings be channelled in businesses that will degrade the environment into which they hope to retire. It is perhaps not too much of a leap to envisage further legislation prescribing additional factors that trustees might take into account when determining what is in scheme members' best interests.

There is no doubt that this is likely to continue to be a topic of considerable development in the months and years to come.

Decarbonisation: a net zero blueprint for your whole portfolio



Ben Popatlal
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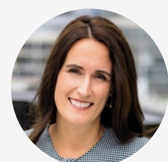

Lesley-Ann Morgan
Global Head of Pensions and Retirement,
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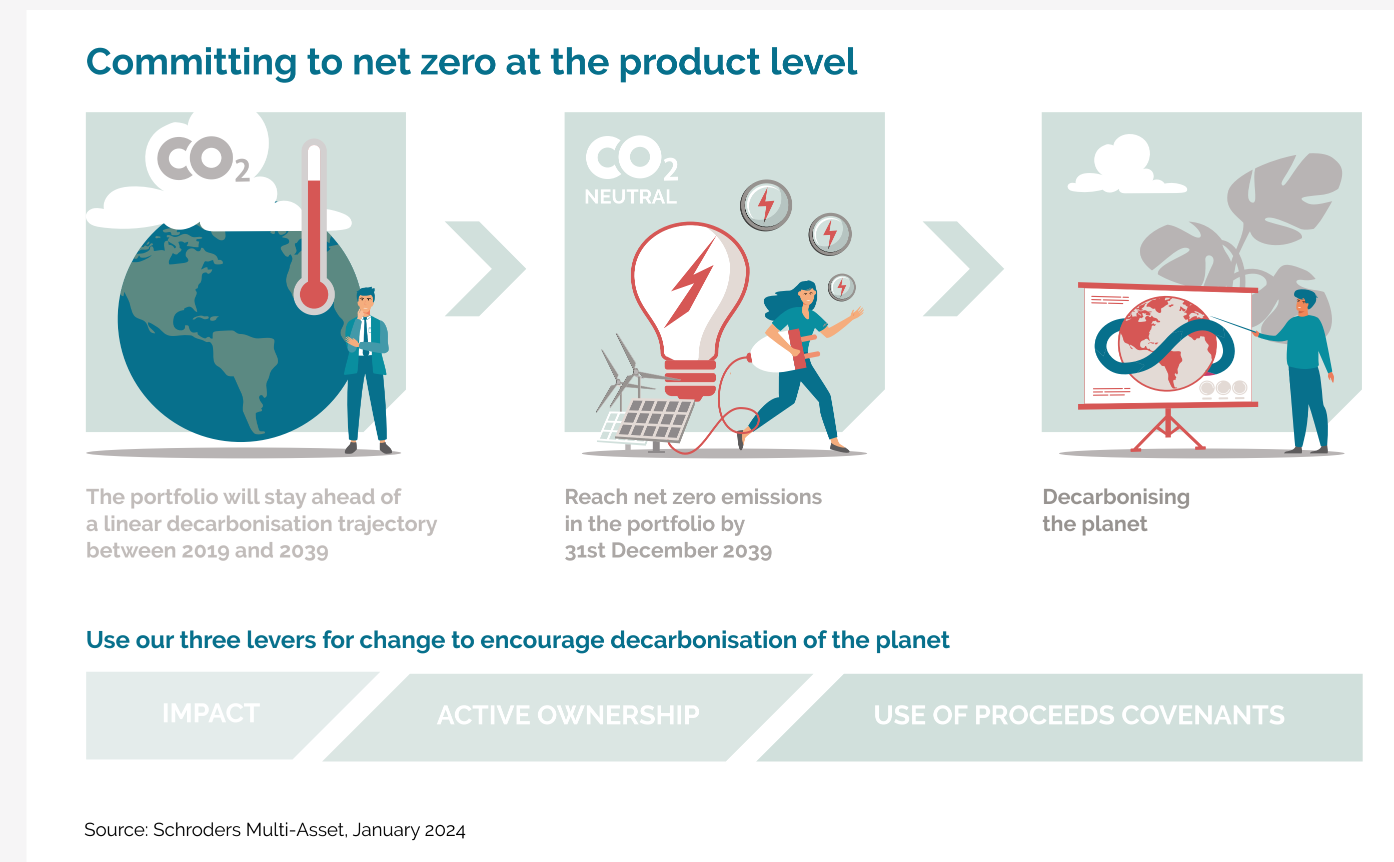
Adding the dimension of sustainability – in this case, decarbonisation – to your portfolio construction process does not mean changing your approach entirely. We don't need to rewrite the book on portfolio construction to add this chapter on sustainability. In this article, we share our method for decarbonising a portfolio which invests in multiple asset classes, building on Schroders' three-part decarbonisation guide for asset owners published last year. We use this approach in our own Multi-Asset decarbonisation strategy at Schroders.

A portfolio cannot decarbonise in a vacuum

In any decarbonisation investment strategy, it is crucial to distinguish between the portfolio and the planet. It is easy to simply decarbonise the portfolio; we can do that through divestment. But by doing so, we would a) significantly compromise the investment integrity of the portfolio, which is an unacceptable trade-off, and b) we would have very little – or probably no – impact on real world decarbonisation. We believe it is necessary to articulate our approach to decarbonisation as a feedback loop between the portfolio and the planet. Figure 1 illustrates this feedback loop.

Figure 1:
Our ability to decarbonise our portfolio depends in large part on the decarbonisation of the investment universe



As we pursue decarbonisation of the portfolio, it is necessary to be aware of the universe within which we operate. Maintaining a balanced and effective feedback loop is important for maintaining investment integrity as we augment the portfolio with a decarbonisation objective. Different strategy types within our portfolio can help us achieve this balance in different ways.

Many strategy types, one decarbonisation goal

There are many ways to classify investment strategy types. As we introduced decarbonisation into our investment equation, we felt it helpful to frame a new classification of strategy types.

Our own particular investment philosophy is to be unbiased with respect to underlying strategy type; in our multi-asset decarbonisation strategy we use whichever underlying strategies we need, in whichever proportions we feel appropriate, to deliver on our objectives. We try and choose the best tool for the right job at any given time. But even for asset owners that are inclined towards certain strategy types over others, the concepts we share overleaf should be useful.

Decarbonisation: a net zero blueprint for your whole portfolio

Figure 2:
Decision-makers with responsibility for the whole portfolio should use different strategy types for different purposes

	Lower Carbon	Climate Action	Climate Solutions
Description	Lower carbon emissions strategies closely match the investment performance of a benchmark, but with lower emissions. A quantitative optimisation is run to achieve this favourable balance.	Climate action means prioritising decarbonisation of the underlying companies in the portfolio, as opposed to the portfolio result	Climate solutions focus on parts of the investment universe that are driving decarbonisation in the real world. We can use these strategies to seek financial opportunity from transition. These will typically have higher emissions in the near-term.
Active investment risk			
Emissions profile			
Engagement scope			
Engagement potency			
Input v output management	Output	Input	Input
Portfolio v planet (sustainability benefit)	Portfolio	Portfolio and planet	Planet
Risk vs opportunity	Risk	Risk and opportunity	Opportunity

Source: Schroders

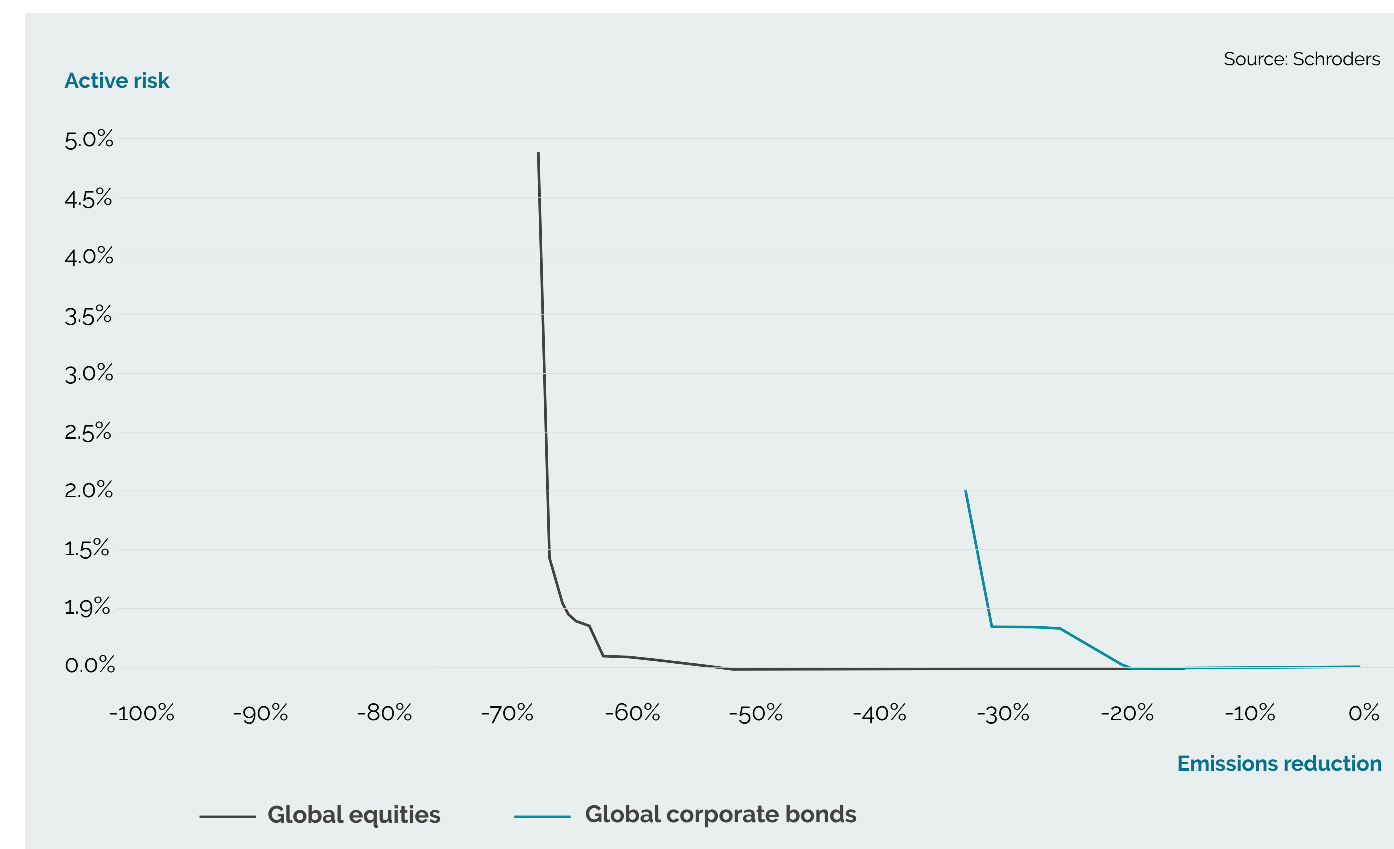
While technically we can manage a portfolio's emissions directly, doing so fails to recognise that the portfolio operates within an investable universe which is set for us by the world at large. The portfolio's emission-reduction efforts must be consistent with what the investable universe affords us, or else we risk compromising the investment integrity of the portfolio. That critical threshold, where pursuing an additional unit of emissions reduction finally breaks the portfolio, is what we call the breaking point. Ex post emissions can be managed directly in the portfolio, but only up to the breaking point. Beyond that, ex post (past events) emissions are not manageable directly, and we must focus on managing ex ante (future events that are based on forecasts or predictions rather than concrete results) inputs to the portfolio, as we have always done.

The chart opposite (figure 3) shows that emissions can be managed (reduced) directly for a global equity portfolio and global corporate bond portfolio, but only up to a certain breaking point. We need not point out where the breaking points are on this chart!

Source: Schroders Multi-Asset, January 2024

Schroders

Figure 3:
Breaking point for the global equity and corporate bond universes



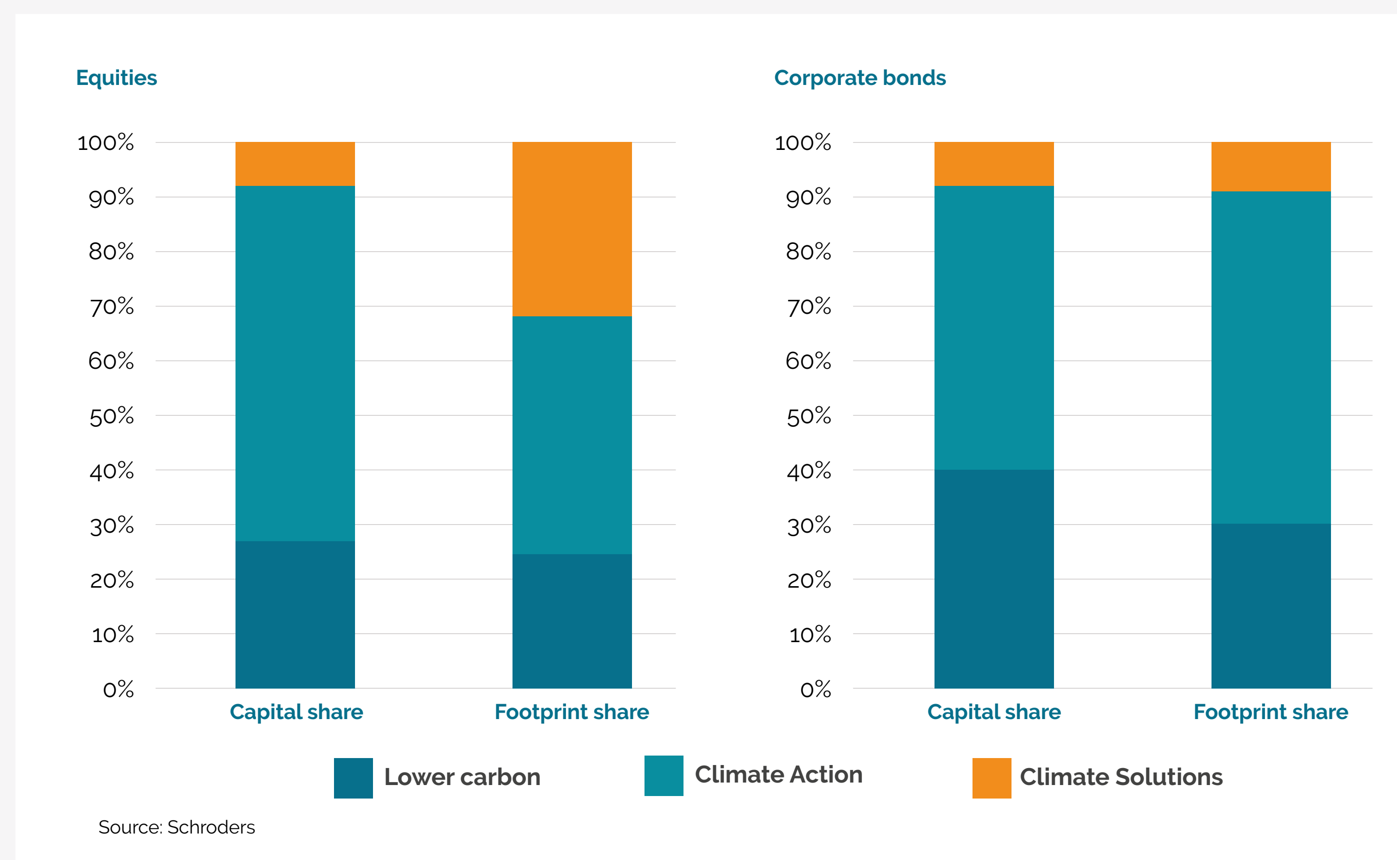
Our Y-axis is a humble measure of point-in-time active risk: the degree to which the portfolio's weights differ from the emissions-agnostic starting point. We have done the same exercise with other measures of risk, including conventional tracking error volatility, concentration at security, country and sector level, and factor exposures. The important point is that risk is felt differently by different asset owners, investable universes differ, and so the breaking point is specific to the investor.

Figure 3 shows the scope for ex post management of the portfolio emissions output using 'lower carbon' strategies is only possible up to a breaking point. It is also true that a focus on ex post management of emissions does not contribute in any way to a reduction in broader universe (or planet) emissions. 'Climate action' strategies, therefore, play a key role in managing the feedback loop between portfolio and planet. Finally, as we recognise that transition can bring attractive investment opportunities, asset owners should consider allocating to 'climate solutions' strategies too, including private assets.

Decarbonisation: a net zero blueprint for your whole portfolio

Figure 4 illustrates how climate action strategies dominate the capital allocation, but climate solutions strategies contribute the higher proportion of portfolio footprint, especially for the equity portion of the portfolio. This mismatch between the amount of capital allocated to a strategy type vs the share of portfolio emissions that it generates is to be expected, given the types of assets in these strategies. For example, climate solutions strategies are often invested heavily in infrastructure and energy transition assets which have high current emissions in the portfolio but the potential to reduce emissions in the real-world.

Figure 4:
Climate solutions have a high footprint share, relative to capital deployed

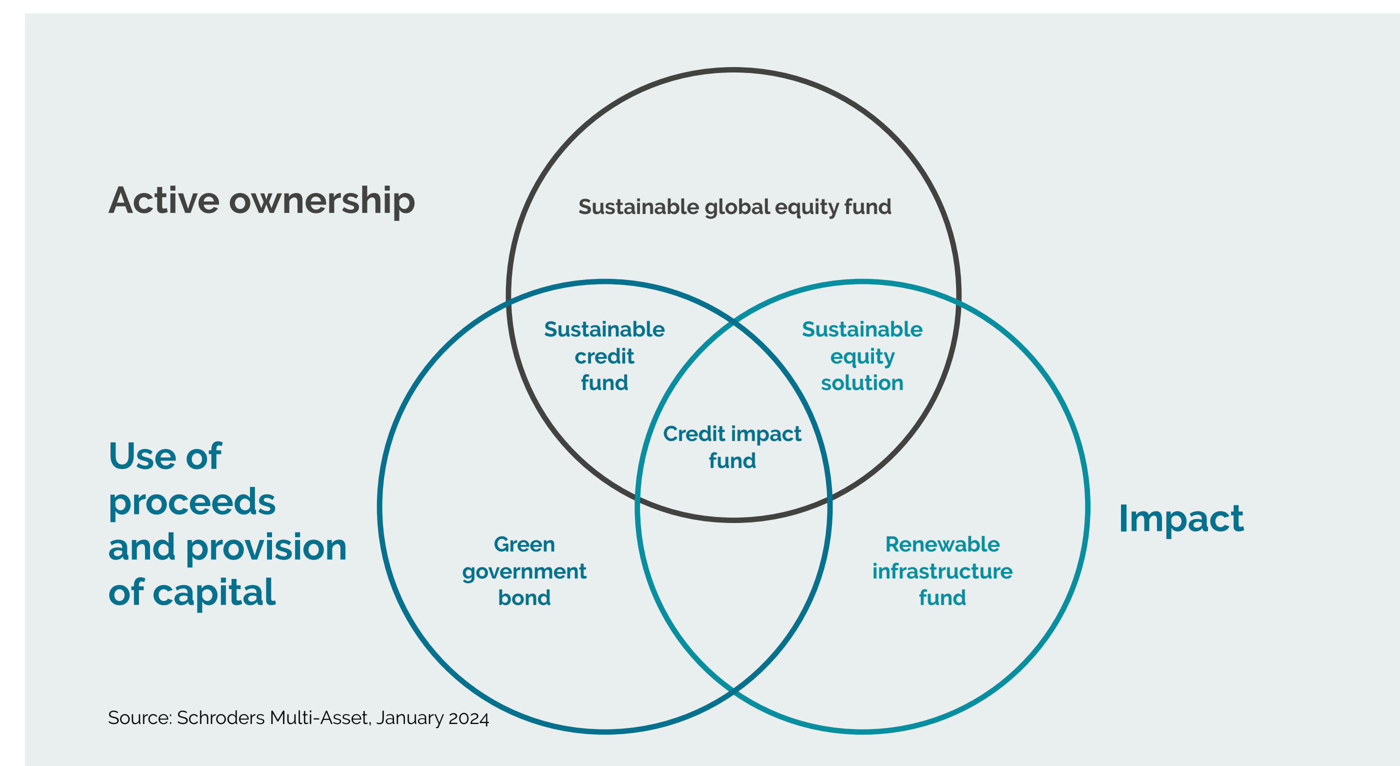


Source: Schroders

Schroders

Climate action and climate solutions strategies manage ex ante decarbonisation inputs that are under their control. For equities, that means prioritising engagement efforts, while for bonds, managers will look to assess and manage use of proceeds, in addition to engaging with issuers. For impact strategies, decarbonisation solutions, and alternative assets, decarbonisation impact can be more direct. We think these three 'levers for change' can be represented in a Venn diagram, shown in Figure 5, with circle sizes representing the proportionate exposure to that part of the Venn diagram. Asset owners should seek to map their holdings to the Venn diagram, and then evaluate those holdings in the context of the Venn diagram.

Figure 5:
Different asset classes have different decarbonisation levers for change associated with them



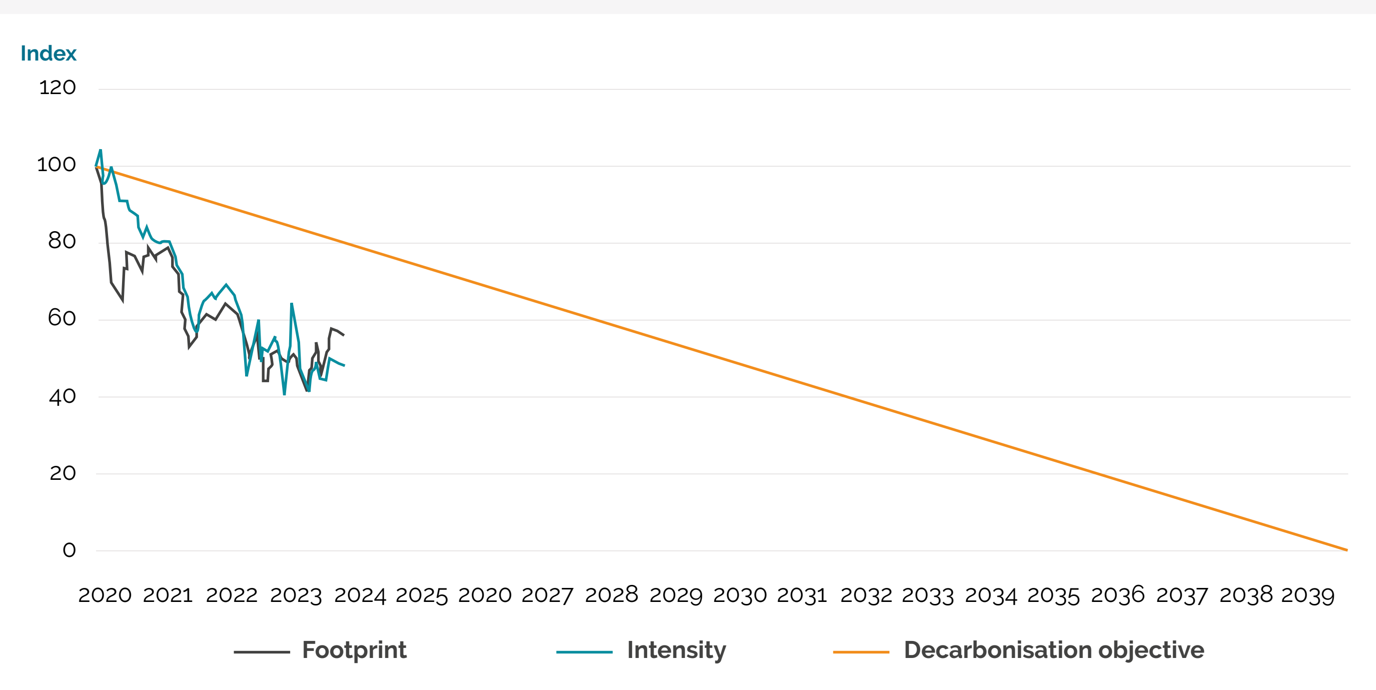
Source: Schroders Multi-Asset, January 2024

The key takeaway from this is that investors can take different decarbonisation-related actions with different asset classes. Perhaps more importantly, the use of different strategy types within asset classes can allow the whole portfolio to achieve different things with respect to decarbonisation, and with vastly different potency. No asset class or strategy type is unequivocally better than any of the others; they are just different, and asset owners should use them to the extent that they contribute to the portfolio's objectives.

Decarbonisation: a net zero blueprint for your whole portfolio

Bringing it all together
When decision-makers with responsibility for the whole portfolio look at their portfolio from the top down, they should have access to clear, transparent, and flexible views of the portfolio's emissions profile. For example, we have heatmaps which show us our emissions profile across asset classes, broken down by region and sector, which we can drill into for greater levels of granularity. We've argued that investors can, should, and will pull many different levers to decarbonise their respective portfolios, but in the end, the asset owner will need to summarise progress into one or two primary variables. For our own strategy, we have chosen carbon footprint (emissions normalised by enterprise value) for our ultimate ex post decarbonisation metric, but on our daily dashboards we monitor both carbon footprint and carbon intensity (emissions normalised by revenues).

Figure 6:
The portfolio is accountable to a long-term downward trend in footprint



Source: Schroders

Our decarbonisation tracker in Figure 6 is the chart that holds us accountable for everything that has taken place in our portfolio, at all investment levels. The breaking point – discussed earlier – acts as a floor for the blue and green lines at any given point in time but employing our levers for change will help to lower that floor. We certainly don't commit to a consistent rate of change in our footprint or intensity. The recent tick-up reflects an asset allocation decision to increase credit exposure at the end of 2023, which is something we retain the power to do regardless of the short-term decarbonisation impact. We might also decide, if we exhaust the footprint-reduction that our lower carbon strategies can deliver, to increase our allocation to climate action strategies. This may increase our footprint temporarily. We might decide to pursue, on investment grounds, a climate solutions opportunity, which will almost certainly increase our footprint temporarily. The key point is that we are accountable to a downward trend in our key decarbonisation metric or metrics.

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Conclusion

Augmenting our multi-asset strategy with an explicit decarbonisation objective did not mean re-inventing it entirely. We believe asset owners can incorporate their decarbonisation objectives across the whole portfolio by using this pragmatic approach.

- Recognise that the portfolio cannot decarbonise in a vacuum; rather, it operates in a feedback loop.
- There are different decarbonisation levers for change across asset classes, and decision-makers should employ different strategy types to do different things.
- The monitoring framework should be kept simple; only one metric, or maybe two, will matter in the end.

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The PMI / ESG Report 2024

Are private market investments an opportunity for pension investors looking to make an impact?

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Private market assets could help pension investors who want their pension pots to make a measurable difference to the environment and society as a whole, while also generating a financial return.

The size of the necessary investment to meet climate and sustainable development targets is too big for listed companies alone. However, private market assets could help provide capital for the new technologies, projects and innovative solutions to make progress towards these goals, while also helping pension savers who are increasingly keen for their money to potentially make an impact and generate a financial return.

Demand for funding to meet environmental and social goals is growing, and pension savers are increasingly keen that their money makes a difference while also delivering a financial return. Private markets offer investment opportunities which have the potential to make a measurable impact on the environment and society. This can help contribute to achieving the 17 global Sustainable Development Goals (SDGs) set by the United Nations which span social and environmental goals and can provide a useful framework for investors. SDG 3 for example is related to good health and wellbeing, SDG 7 to clean and affordable energy, and SDG 13 to climate action.[1]

Mansion House and beyond

Interest in private market assets has grown since the unveiling of the Mansion House Compact in the summer of 2023. Signed by some of the UK's largest pension providers, it aims to boost the UK's economic growth and increase the size of people's pension.

This is expected to be achieved, partly, by the largest defined contribution (DC) schemes investing 5% of their default funds in unlisted 'illiquid' assets, which can also be associated with the potential for higher financial returns. These can include private, usually smaller companies, infrastructure, real estate and natural capital investments in land and forestry.

In the UK, DC pensions have lagged defined benefit when it comes to investing in this market. Though private market assets usually have long-term characteristics, making them a potentially good fit, in practice the nature of DC pensions has made investing difficult. However, the emergence of a new type of fund – the Long Term Asset Fund – is now making access easier for DC pensions.

As well as the opportunity to diversify default funds further, private market investments can help with the drive towards net zero at country and global level. Unlisted companies can play a particular role in the transition to net zero through the development of climate solutions such as renewable energy and energy efficient technologies. Infrastructure to enable the transition to low carbon energy sources is also essential, for example, through grid improvements.

Boosting investment in private markets could also play an important role in addressing social issues, by financing things like social enterprises, social housing and charities.

Since 2018, private market assets under management have grown close to 20% per annum and totalled around US$13.1 trillion as of end-June 2023, according to McKinsey's latest Global Private Markets review.[2]

A sizeable challenge and opportunity

The United Nations (UN) Environment Programme Finance Initiative estimates that to keep global warming below the Paris-aligned target of 1.5OC, investments of some US$136-275 trillion in climate solutions will be needed by 2050.[3] This will include the funding of decarbonising energy, infrastructure, urban and industrial systems, and new and emerging technologies.

The World Economic Forum (WEF) has said in excess of US$30 trillion of extra investment will be needed by the end of the decade to meet the 2030 deadline for achieving the UN SDGs.[4]

While many large, listed companies are investing to help meet these targets, the scale of the need is too vast for them to do so alone. Private markets will be essential to provide the capital to develop and scale up the nascent technologies and financial solutions needed to make headway towards environmental and social targets. This can be done through a raft of opportunities to create value in projects that are rarely found in the listed sector.

Are private market investments an opportunity for pension investors looking to make an impact?

What are the opportunities in private markets?
Private markets can offer a wide variety of opportunities for those who want to create real-world change, including:

Infrastructure – the transition to net zero requires substantial investment in renewable energy and the decarbonisation of residual emissions. Estimates from organisations like the UN, World Bank and WEF, show that because of the size of the investment requirement, private capital will have a crucial role to play in helping countries achieve their pledges. As well as in renewable energy, investment will also be required for infrastructure that helps to tackle social inequality, such as digital infrastructure to improve financial inclusion.

Property – real estate has one of the largest carbon footprints of any sector of the economy, contributing around 37% of CO2 emissions globally.[5] It can also be viewed as a symptom of social inequality. But change is possible. For instance, by investing in commercial and domestic real estate that is more energy efficient and adaptable to the changing climate, emissions could be lowered. Equally important is the development and re-development of communities.

Private equity – for investors looking to make an impact, private equity is the most popular asset class.[6] This is because the ownership model, long-term nature, and focus on growth means that private equity can closely align with the aims of investing for impact. For example, value creation and enhanced profitability can be achieved through efficiencies in impact areas like waste management or lowering energy usage.

Private credit – rather than borrowing from banks or investors in public markets, companies can get funding through loans that come from private market asset funds or other investors via private markets.

Natural capital – some sectors of the economy currently have emissions that cannot be entirely eliminated. To counter this, carbon capture and sequestration have become important routes to help progress towards net zero targets. Investment in natural capital, like woodland or forest schemes, can play a key role in reducing carbon emissions and improving biodiversity. Private markets can offer access for investors and provide a vital source of capital.

It is important to note that as well as bringing opportunities for investors, private market assets also come with risks and challenges that include illiquidity, lower transparency, and the risks that come with investing in, for example, innovative technologies or early-stage businesses.

How the characteristics of private markets align with real-world change
Private markets have the potential to help pension providers meet scheme members' demand for investments that not only help grow their pension pot, but also have a positive societal impact.

They offer some attractive characteristics:

Wide range of opportunities – private markets can bring a broader range of investment opportunities than those found in listed companies alone. Projects and businesses active in social or environmental solutions, such as social enterprises enabling access to employment for people with disabilities, or small firms innovating decarbonisation solutions, can help pension providers deliver real-world change.

Early-stage investment potential – with many experts agreeing that the solutions we need to meet net zero targets have not been found yet, unlocking the innovation and entrepreneurialism of small businesses will be essential. What often holds them back is funding. Private markets can help provide early-stage funding for companies researching and developing new solutions.

Long time horizons – many of the potential solutions to societal or environmental challenges require long-term solutions and long-term investment. This aligns well with the long-term nature of pension investments.

Having an influence – Private market investment opportunities can offer greater opportunity for pension fund managers to directly influence, and even work with, a company's management team as they work towards meeting mutual goals.

Accountability – with fewer governance and regulatory requirements compared with listed-market companies, pension fund providers and managers have the ability to request that private companies focus their reporting on issues that particularly concern them.

An ideal match?
As we have seen, there are several areas where private market investments can help enhance progress on environmental and social challenges and bring about real-world change. Private investment will be crucial to meet many of the global targets that countries have committed to, while having the potential to deliver financial returns for savers and contributing to economic growth.

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