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PENSION POLICY & INVESTMENT COMMITTEE
Wednesday, 18 January 2023 at 10.00 am
Conference Room, Civic Centre, Silver Street, Enfield, EN1 3XA

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PENSION POLICY & INVESTMENT COMMITTEE
SUPPLEMENTARY AGENDA

Wednesday, 18th January, 2023 at 10.00 am in the Conference Room, Civic Centre, Silver Street, Enfield, EN1 3XA

Membership:

Councillors: Doug Taylor (Chair), Tim Leaver (Vice-Chair), Gina Needs, Sabri Ozaydin, David Skelton and Edward Smith

AGENDA – PART 1

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Responsible Investment: Overview and Next Steps

London Borough of Enfield Pension Fund

Prepared for:	The Committee
Prepared by:	Aon
Date:	18 January 2023

AON

Background and objectives

Background

- In 2021 and early 2022, we worked with the Committee to provide training on the rapid developments in the Responsible Investment (RI) space, including regulatory requirements that the pension industry needs to fulfil; and focus specifically on the Fund's climate-related objectives.
- It has been some time since the last discussion on this topic, over which the Committee's composition has changed and there have been wider developments in the market.
- These developments mean that it is an opportune time to re-evaluate the Fund's desired approach and next steps to align with this.

Objective

- This session is intended to:
  - Provide an overview of Responsible Investment
  - Explain why climate change risks and opportunities are important and how it is relevant to the Fund;
  - Reflect on your current approach and consider the next steps necessary to align with the Fund's desire to take its RI approach further;
  - Identify prospective actions following these considerations.

Agenda

1

Introduction to RI and current requirements

2

Why is climate and net zero important?

3

Recap of 2021 discussions and future roadmap

4

What are other LGPS doing?

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What is responsible investment?

And why is it important?

What is responsible investment?

The Principles for Responsible Investment (PRI) is a global organisation which aims to advance responsible investment across institutional investors.

PRI defines responsible investment as *a strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions* and *active ownership*.

PRI | Principles for Responsible Investment

Examples of ESG issues

There are many and varied Environmental, Social and Governance considerations

Environmental

- Innovation, clean tech and renewable energy
- Pollution and Waste
- Raw materials and water scarcity
- Climate change

Social

- Controversial sourcing
- Working conditions
- Product liability, consumer protection and cyber security
- Social impact reporting and human rights

Governance

- Diversity
- Executive compensation
- Transparency, disclosures, reporting
- Business ethics

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Why does it matter?

50%

reduction in carbon emissions needed over the next decade to limit the rise in global temperatures to no more than 1.5 degrees Celsius above pre-industrial levels by the end of the century

Source: IPCC

73%

of pension fund decisionmakers believe that climate change will impact on returns within a timeframe they are concerned about

Source: Aon

47%

of pension fund decisionmakers believe they have a duty and an ability to help tackle climate change

Source: Aon

Developing requirements

July 2019

Green Finance Strategy

UK Government launches the Green Finance Strategy, which aims to prepare the financial system for the transition to a low carbon economy.

UK Stewardship Code

Updated UK Stewardship Code sets high expectations of those investing money on behalf of UK savers and pensioners

December 2019

September 2020

Climate reporting for corporate schemes

Mandatory annual reporting for corporate pension schemes, starting with >£5bn schemes in 2021 and then others from 2022 and beyond.

Asset stewardship

Further regulations introduced for corporate pension schemes, requiring an annual review of the effectiveness of stewardship and engagement.

October 2020

September 2022

Climate disclosures for LGPS

UK Government issued a consultation on a proposal to require LGPS in England and Wales to report in line with the recommendations of the TCFD. **We expect TCFD to be compulsory for LGPS by 2023.**

GAD requirements for LGPS

Government Actuary's Department (GAD) has confirmed that there will be an expectation for firms to quantify the risk of climate change in LGPS valuation reports.

October 2022

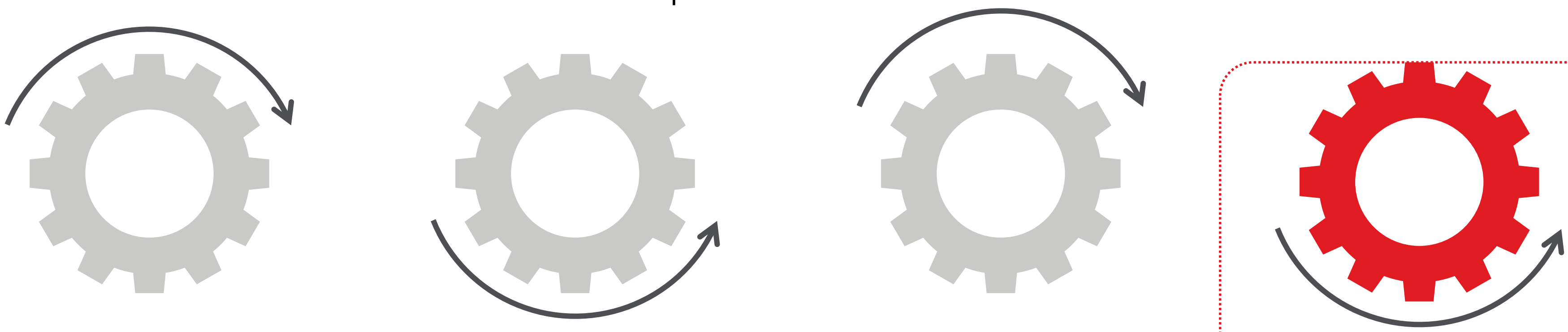
In more detail: TCFD and its purpose

The Task Force on Climate-related Financial Disclosures framework establishes a set of **eleven** clear, comparable and consistent recommended disclosures about the **risks and opportunities** presented by climate change.

The **increased transparency** encouraged through the TCFD recommendations is intended to lead to decision-useful information and therefore **better informed decision-making** on climate-related financial risks.

MHCLG has consulted on introducing mandatory TCFD-aligned reporting in the local government pension scheme (LGPS) in 2023. **As part of this, you will be asked to measure certain metrics and set targets for the Fund.**

The TCFD has structured its recommendations around four pillars:



Governance

Disclose the organisation's governance around climate-related risks and opportunities.

Strategy

Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's business, strategy and financial planning.

Risk Management

Disclose how the organisation identifies, assesses, and manages climate-related risks.

Metrics and Targets

Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities.

Why is climate and net zero important?

Climate change risk – an introduction

Climate change is one of the highest concern risks facing the world over the next 10 years, as identified by the World Economic Forum in each of its last 5 years' risk assessments.

This is even more relevant today…

The world's climate is already 1°C warmer today, on average, than it was relative to pre-industrial levels. We are currently on a 4.1-4.8°C warming path relative to pre-industrial levels by the end of this century, with catastrophic consequences for ecosystems and humanity.

Physical Risks

The risks that occur as a result of physical events, such as extreme weather

Opportunities

Associated with the transition to a green / low-carbon economy

Transition Risks

The risk associated with realignment of our economic system towards low-carbon, climate resilient or carbon-positive solutions, including changes in political policies

Winners and losers will emerge as part of the transition, creating risks but also opportunities

Why is this important to the London Borough of Enfield?

Climate emergency

- The Council declared a climate emergency in Summer 2019

Objective by 2030 and 2040

- The Borough's 2020 Climate Action Plan sets out its objective to *"become a carbon neutral organisation by 2030, and a carbon neutral borough by 2040"*

What does this mean for the Fund?

The Council listed *"All council funds and investments (relating to pensions) divested of fossil fuels by March 2025"* and *"Develop and agree a Pension Fund Investment Strategy which increases the level of investment in low carbon and fossil free equities and funds whilst still meeting obligations to pension fund members"* as actions within its 2020 Climate Action Plan.

The Committee should expect the Council to consider the fossil fuel exposure and carbon emissions of the Fund.

Source: Climate action | Enfield Council

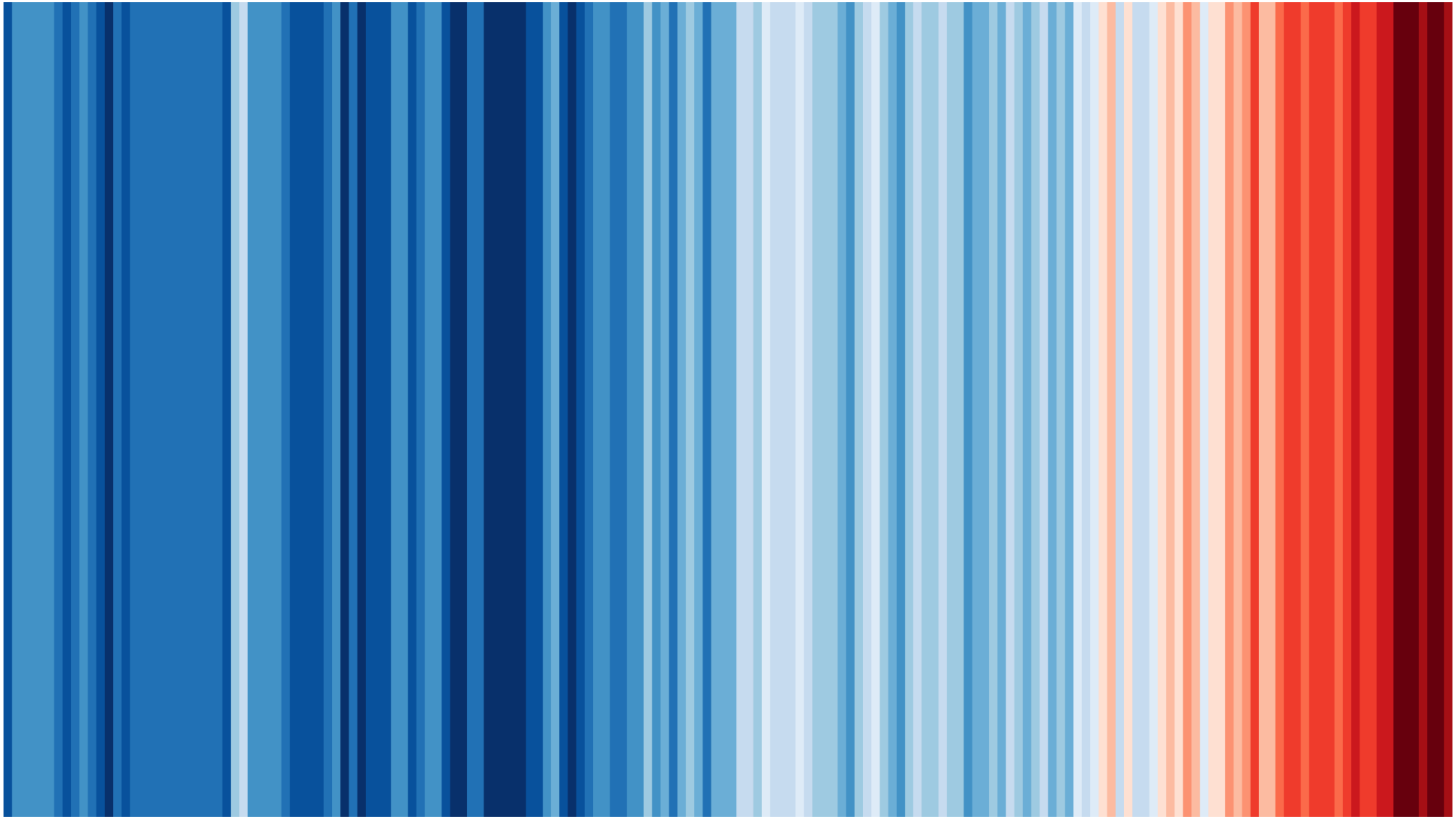
How big was the pandemic impact on emissions?

Economic activity significantly decreased…

But how much did emissions decrease by?

-?%

Global temperature change (1850 – 2021)

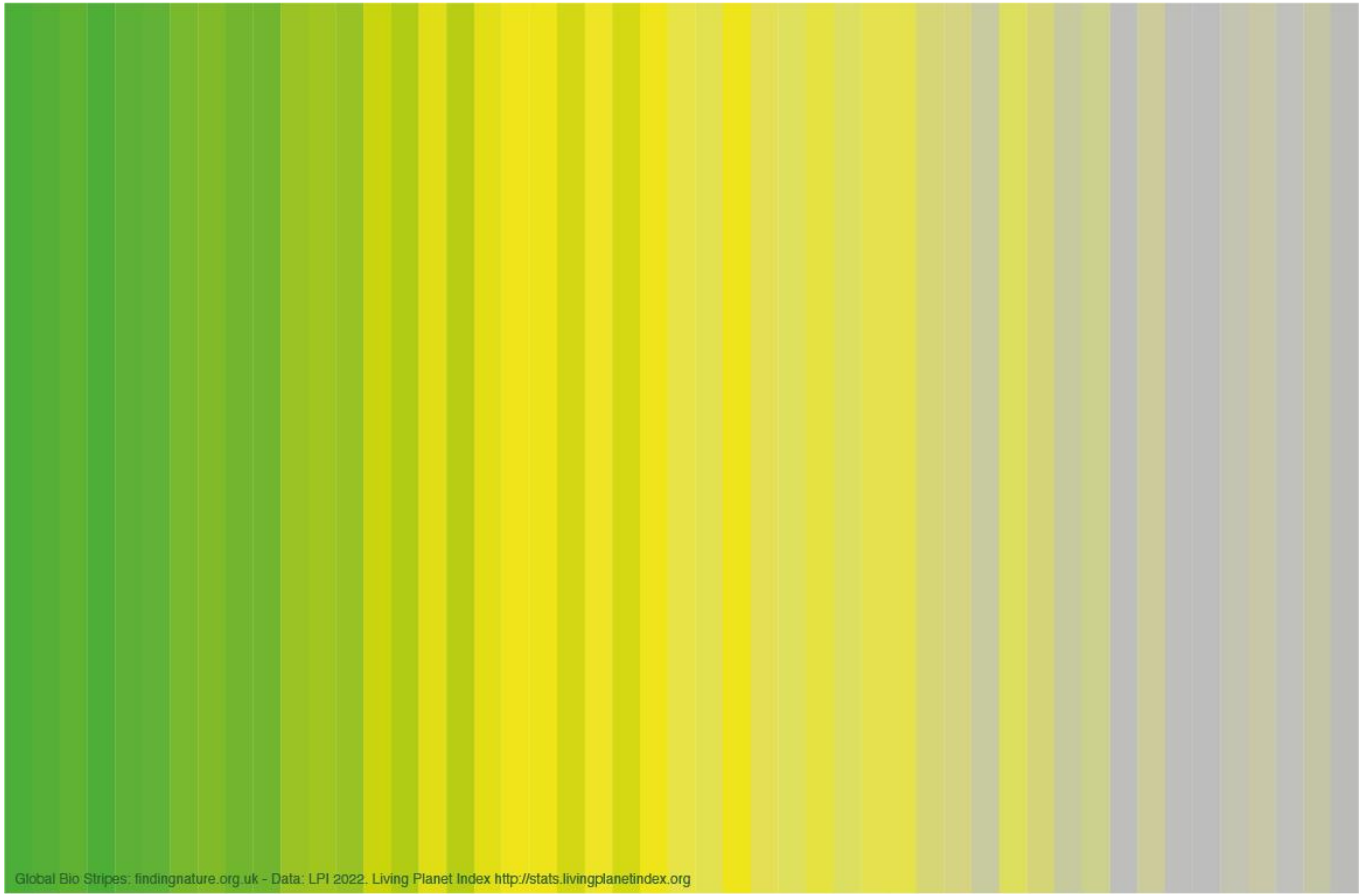


The world is getting hotter

These ‘warming stripe’ graphics are visual representations of the change in temperature as measured over the past 100+ years. Each stripe or bar represents the temperature in that country averaged over a year.

Source: Ed Hawkins, National Centre for Atmospheric Science, University of Reading (https://showyourstripes.info)

Global change in biodiversity (1970 – 2021)

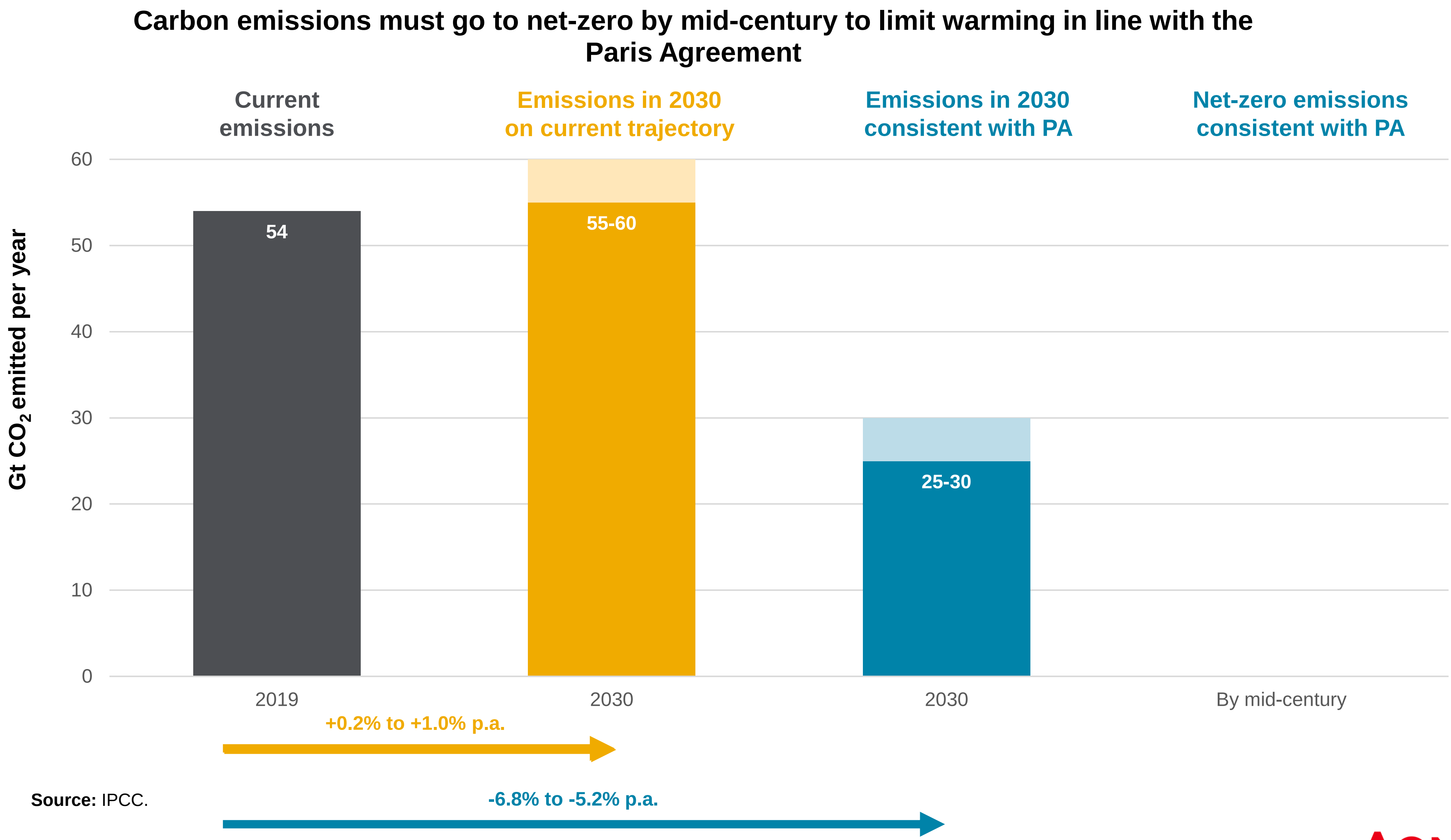


The world is losing biodiversity

These 'loss stripes' are visual representations of the change in levels of biodiversity as measured by the Living Planet Index. the decline of wildlife is a loss of vibrancy and colour, the green becoming grey. The global stripes start green in 1970 and turn grey as we enter the 2000s.

Source: Professor Miles Richardson, University of Derby (https://findingnature.org.uk)

What has to happen?



Source: IPCC.

What has to happen?

Structural changes to the energy system

Oil peaks no later than 2025-2026

Thermal coal production decreases by broadly 80% to 2030

Renewables comprise approximately half the electricity generation mix from 2030

Electrification of transport

Internal combustion engine (ICE) vehicle demand drops to near-zero

Falling costs of electric vehicles drive mass adoption of ultra-low emissions vehicles (ULEVs)

ULEVs comprise broadly 70% of passenger vehicles by 2040

Land use

Deforestation virtually eliminated by 2030; afforestation and reforestation efforts ramp up substantially

Investment opportunities emerge: yield-enhancing technologies, bioenergy production

Recap and roadmap

Actions you can take to reduce climate risk

Commit

E.G: To a net zero pathway *(note: this was the topic of Committee discussions in 2021, and at that time the Committee was considering an internal (non-public) objective of 2030)*

Be active

Invest, divest, engage, across all asset classes *(note: the 2020 Climate Action Plan produced by the Borough commits the Fund to divestment by 2025).*

Collaborate

With partners to influence and innovate.

Engage

With service providers e.g. London CIV; fund managers; etc. *(note: Aon developed a framework for this in early 2021, which could be reinvigorated).*

Seek to understand

Your climate risks and potential to contribute to solutions *(note: the Fund has previously undertaken carbon data analysis, and we understand this was to be undertaken again in 2022).*

Communicate

Report progress openly and transparently.

Key takeaway

If the Committee reaffirms its desire to set a Net Zero objective and reinvigorate this area, a full project plan will be required.

Pathway to net zero

1

Engagement

Work directly with investment managers to ensure they are aligned. This could mean:

- Regular meetings with managers to understand and challenge investments and stewardship decisions
- Requesting managers to complete net zero scorecards to review progress towards goals
- Setting expectations and escalation processes for when these are not met

2

Allocate

Away from “slow movers”; to “aligned”, low, zero or negative carbon assets, and offsets.

The Fund may wish to consider alternative investments if the current managers’ engagements illustrate progress is not in line with expectations.

3

Collaborate

What can we invest in to aid the real world transition and accelerate our own?

The Fund should collaborate with its investment managers to encourage the provision of data and information.

The Fund may wish to engage with industry initiatives to drive change.

Journey towards net zero is not straightforward

There are many ways to reduce the carbon footprint of investment portfolios, however, it is important to set a framework and milestones, and assess them regularly to monitor your journey towards the end goal.

The spectrum of potential actions

There are a range of approaches to achieve emissions reduction. A mix of these would be needed to achieve any meaningful interim and long-term target reduction.

Engage

Reallocation and replacement actions could affect the Fund's expected return and level of diversification.

We suggest **first pursuing a process of engagement** with managers (conveying expectations and gathering data).

If manager responses are unsatisfactory then reallocation or replacement should be considered.

Reallocation

Considering the mix and types of investments can be an appropriate starting point.

Liaison with LCIV should be ongoing to determine how they will support Funds in attaining net zero objectives.

Within property and infrastructure, implementation options are becoming more established (e.g. renewable energy infrastructure, timberland).

Replace

Replacing poorly performing managers (or those without credible carbon reduction targets) with lower carbon offerings.

Requires using analysis from monitoring and engagement exercises.

The pace of carbon footprint reduction is slower, but more meaningful to the medium term reduction in planet's carbon footprint, arguably more important from a risk mitigation perspective.

It is possible to markedly and quickly reduce the carbon footprint by reorganising the allocations to the existing managers and/or replacing with new managers.

Suggested next steps

Monitoring

Carry out a reporting exercise to **gather data on the ESG characteristics and TCFD recommended climate metrics**

Evaluate Targets

Following a review of the data, **consider tangible actions and pathways** to ascertain if a net zero target can / should be committed to

Engagement Plan

Use portfolio data, discussions to date, NZIF, to **develop an engagement plan (targets, criteria, escalation strategies)** to support the Fund's priorities

Asset Allocation

Consider asset allocation decisions to **rebalance or replace existing holdings with low carbon solutions**

Your actions should inform communication…

Your members

…are likely to be interested. Communicating as you progress will help to proactively address questions.

London CIV

…will need to be involved, particularly in light of any mismatch in target setting (e.g. 2040 vs 2030).

Your managers

…should understand your objectives, and provide you with transparency on their own progress. Engagement is fundamental.

The wider public

…are likely to look to the LGPS for action, and public campaigns will scrutinise actions (both taken and not taken).

What are other LGPS doing?

Other LGPS with net zero targets

Environment Agency Pension Fund

Set a goal to make its investment portfolios net zero by **2045** and halve emissions by **2030**. They are **5 years** ahead of their target.

South Yorkshire Pensions Authority has set a goal to make its investment portfolios net zero by **2030**.

Net zero target by **2050** across its whole portfolio.

Net zero by **2040**.

Net zero by **2030**.

Net Zero target by **2040**.

Net zero by **2030**.

Key takeaway

Over 50% of LGPS have now set Net Zero targets. Focus on this area will increase and it is important that the Fund is equipped to manage this.

What are we supporting others with?

Defining beliefs

Committee and key stakeholders completing a short survey in order to gather a broad range of views and agree their collective beliefs.

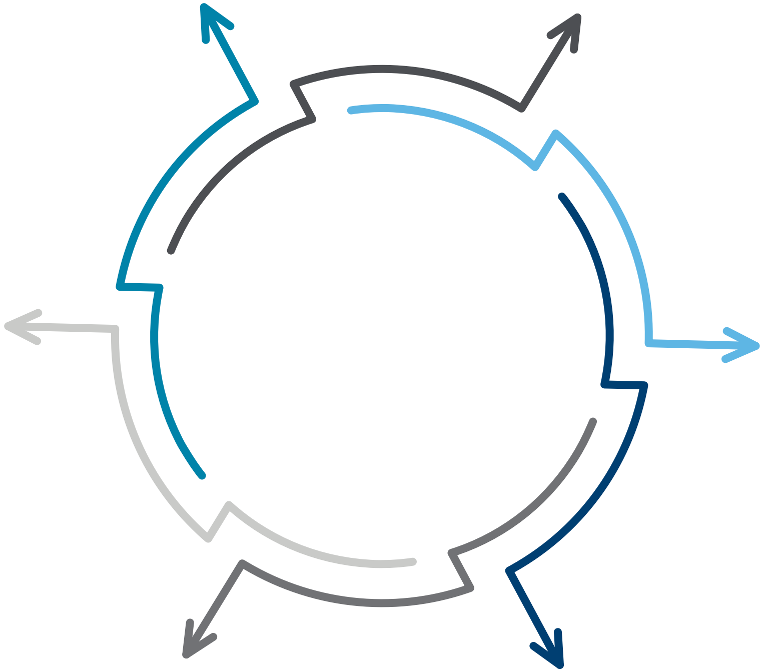
Developing an RI Policy

Drafting a document to sit alongside the SIP which details Committee RI beliefs and policies

Engaging & reporting

Engage with members and other stakeholders, and deciding how to share the Fund’s policies and objectives.

Monitoring and reporting on progress regularly.



Review of managers

Investigate how effectively fund managers are considering ESG factors using Aon’s ESG ratings

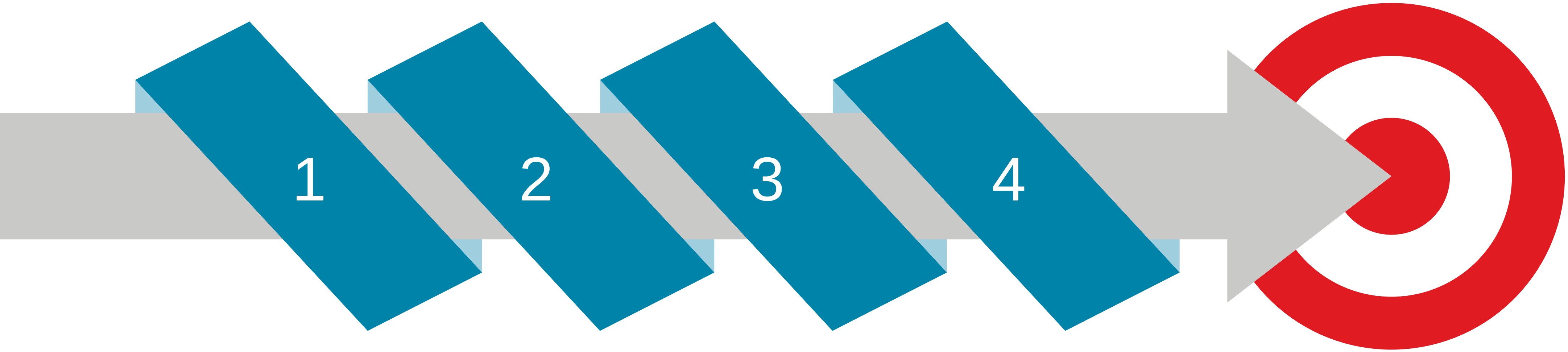
Manager selection

Incorporate ESG capabilities into future manager selection exercises.

Modelling climate change

Consider how climate change could impact on funding level through both assets and liabilities using scenario analysis.

Themes of activity



Implementing climate strategies

Several Funds are gearing up for TCFD; some Funds report on a voluntary basis already.

Examples:

Fund A – establishing a TCFD Action Plan to prepare over an 18-month timeframe

Fund B – already reports, but seeking to enhance.

Interrogation of stewardship action

The Stewardship Code revisions have prompted Funds to consider how they apply the Code's principles across all asset classes.

Examples:

Fund C – not currently a signatory, but planning to apply in 2022

Fund D – 2012 Code signatory; has reapplied under 2020 Code

Net Zero commitments?

Many funds are grappling with a degree of stakeholder pressure to commit to net zero emissions across their portfolio by a specified date.

Examples:

Fund E – Commitment by 2030

Fund F – Adopting a 'wait and see' approach, depending on peer action

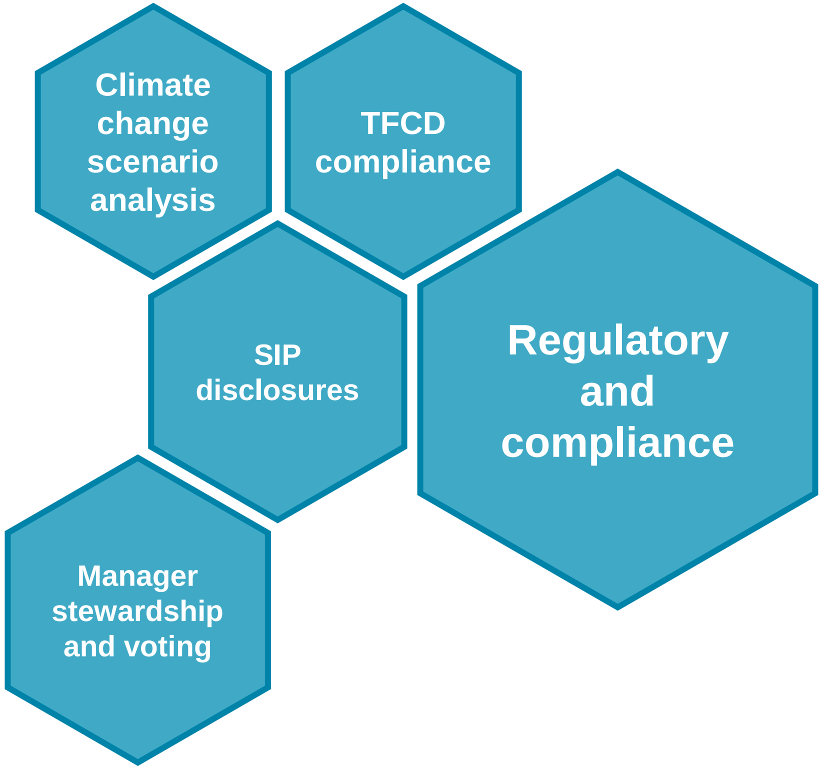
Stakeholder communications

An increasingly prominent area. We are assisting several Funds in how they communicate with members and the public.

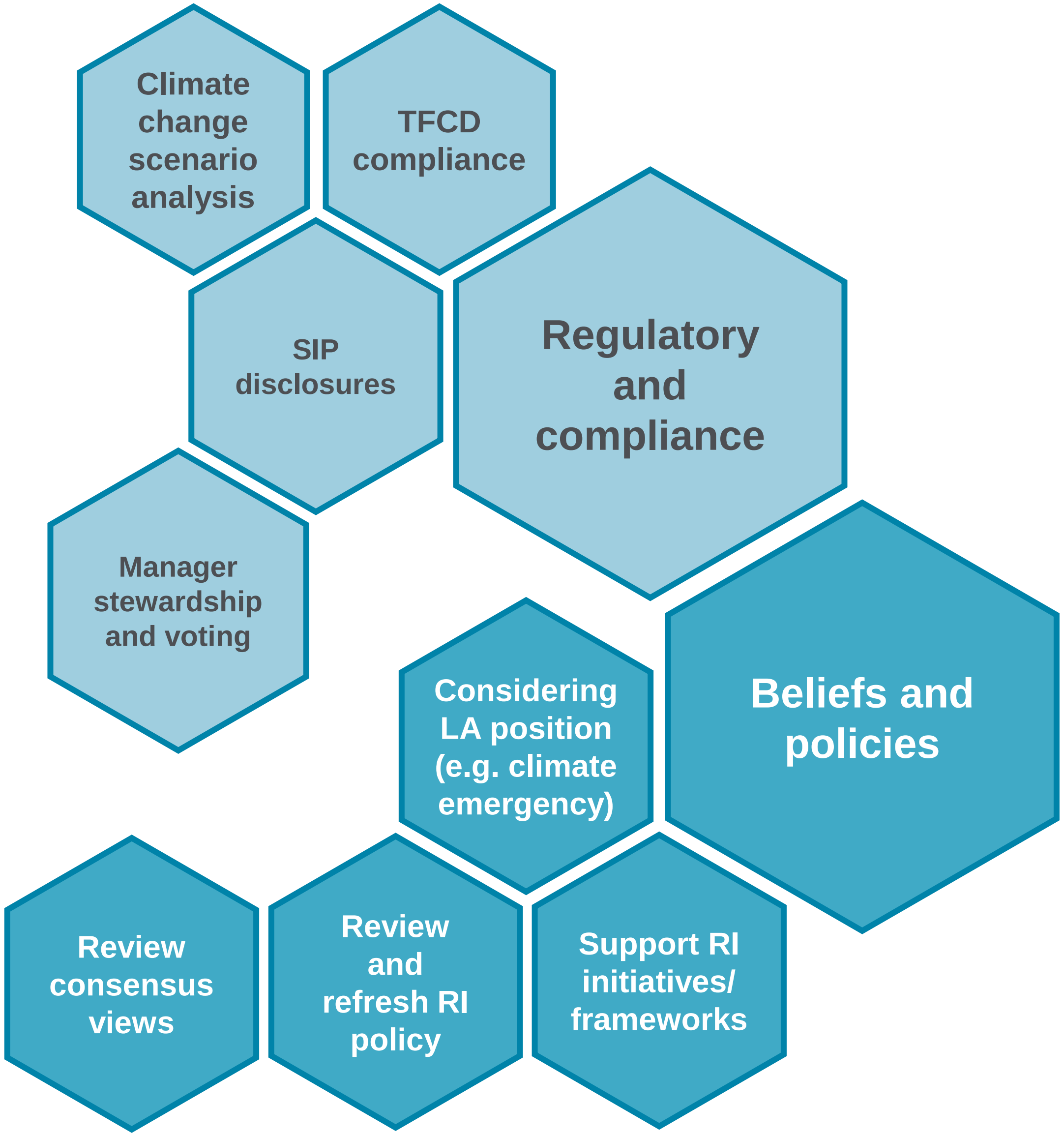
Example:

Fund G – targeted by campaign groups over fossil fuel exposure; developed quarterly reporting and proactive strategy

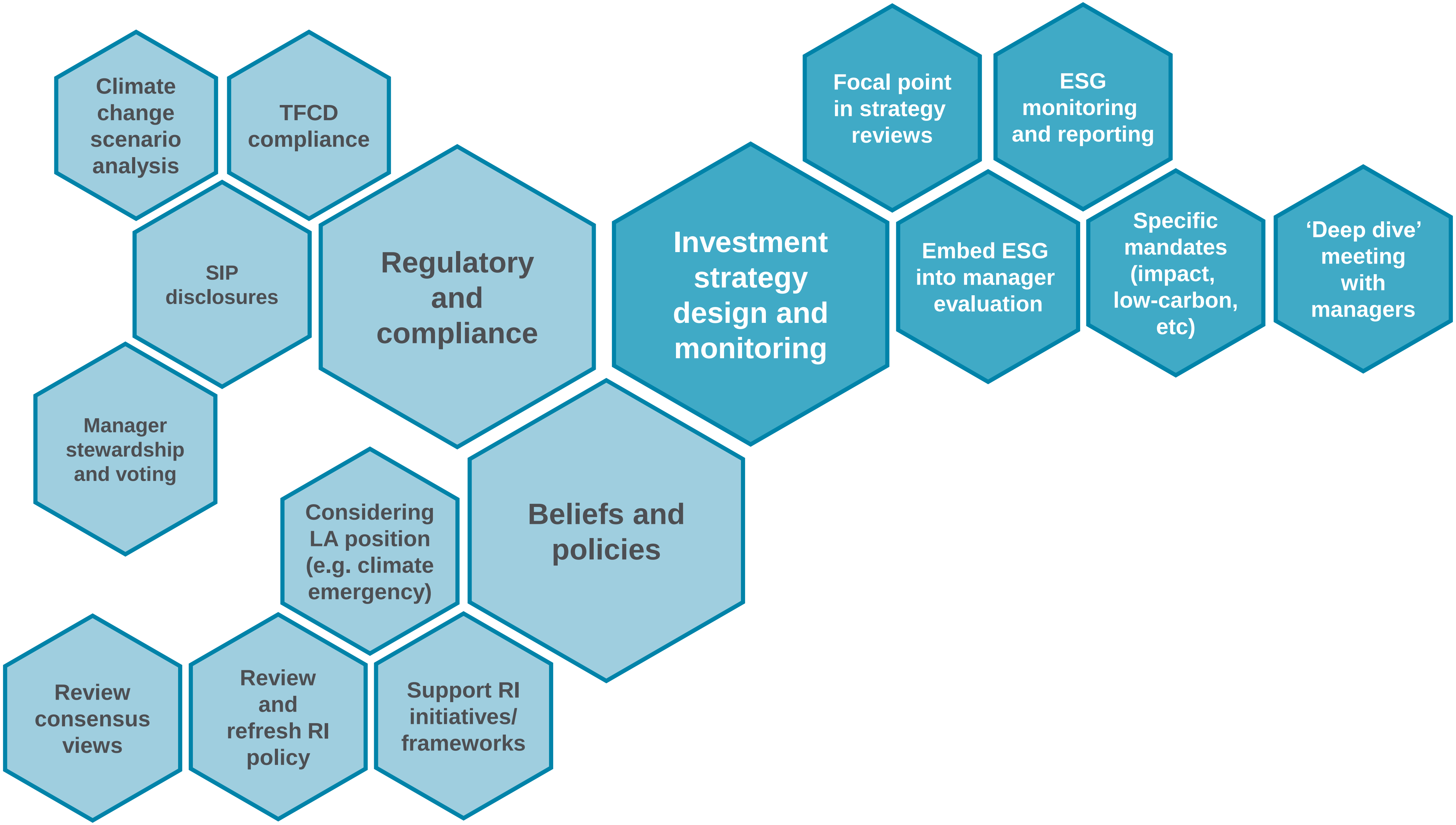
What other Funds are doing



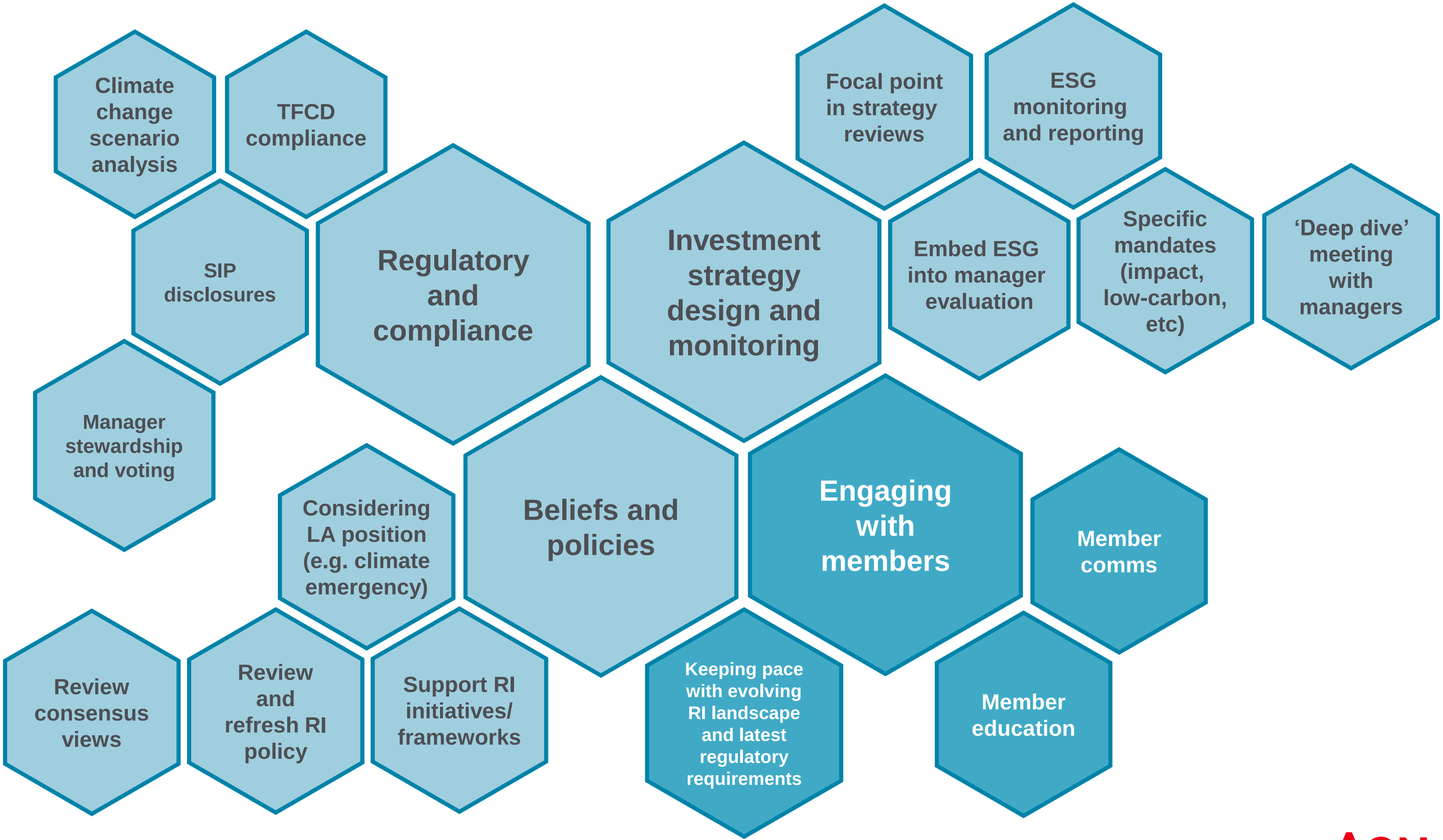
What other Funds are doing



What other Funds are doing

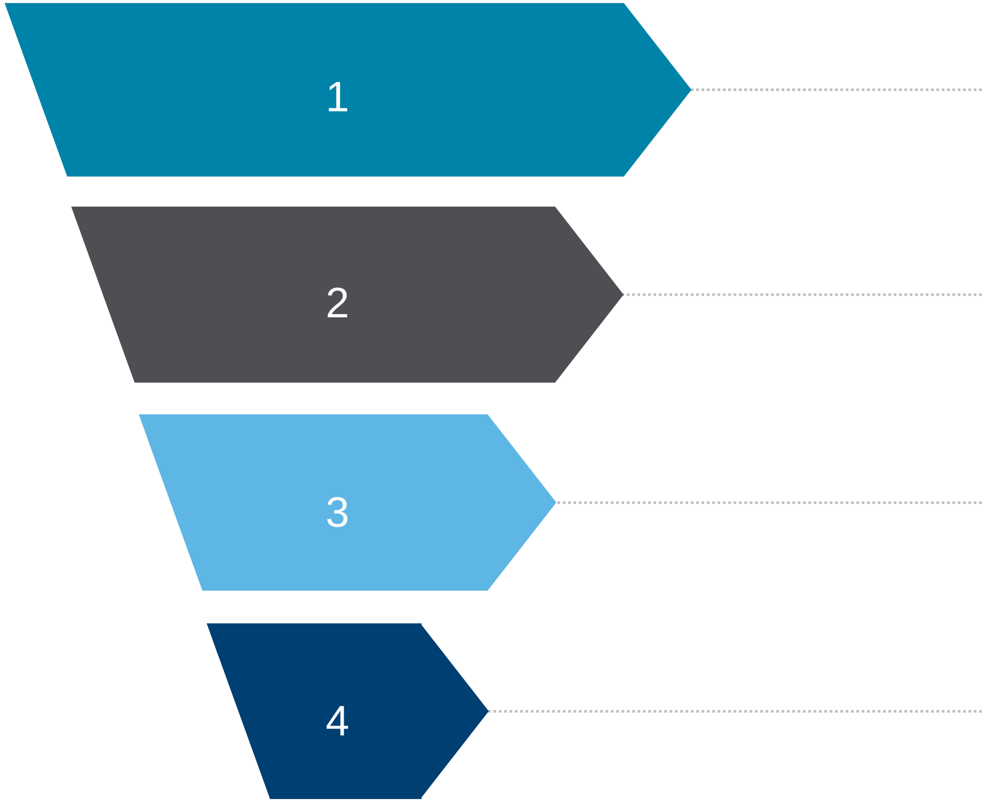


What other Funds are doing



Summary

Potential Next Steps



Agreeing objectives

Previously, the Committee was highly focused on climate actions and implementing a comprehensive strategy. Reaffirming this is the ***'first next step'***.

Develop a plan

Having agreed on priorities and objectives, a plan should be developed to support the Fund achieving these outcomes.

Monitoring your profile

Understanding the Fund's 'ESG profile' can provide a valuable insight into, e.g., the climate footprint of your current investments.

Further training and workshops

This is a large area and will be under significant regulatory attention in the near term. Exploring this in more depth will help you develop your understanding further.

Key takeaway

To further develop the Fund's approach, we recommend devoting some time to do so thoughtfully.

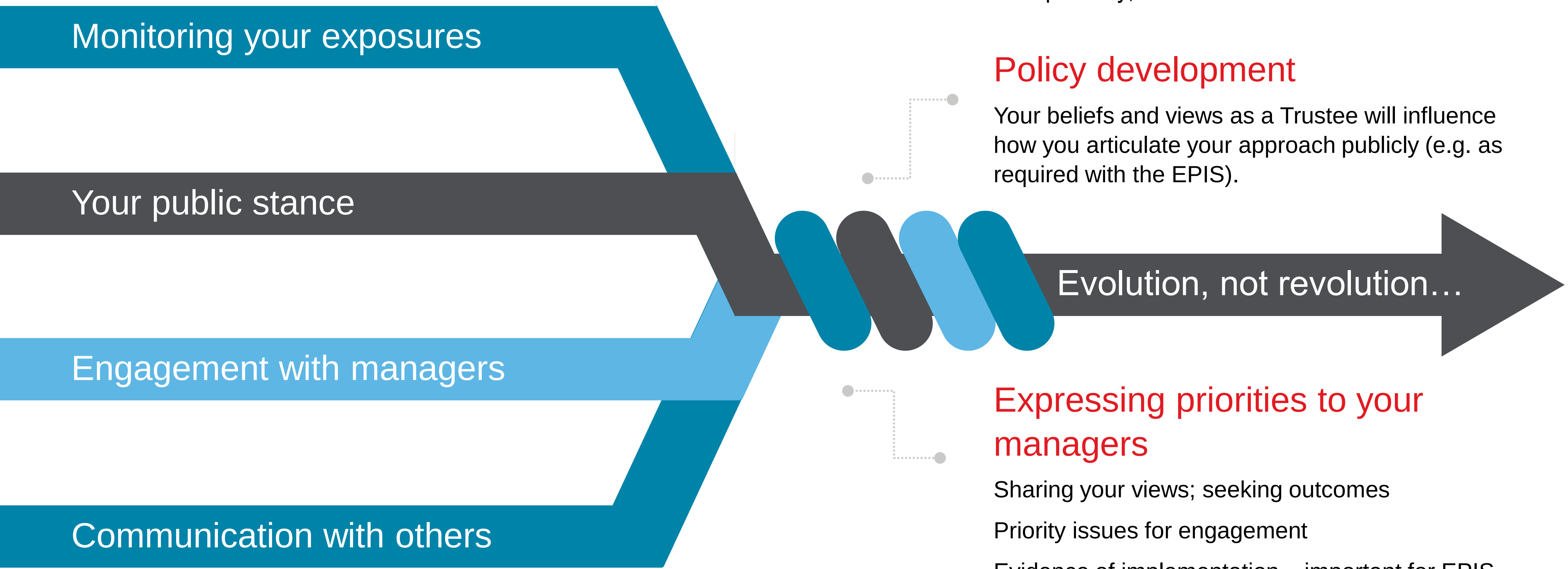
Areas to consider…

Monitoring could include…

ESG scores; carbon exposure; manager transparency; and Aon's views

Policy development

Your beliefs and views as a Trustee will influence how you articulate your approach publicly (e.g. as required with the EPIS).



Expressing priorities to your managers

Sharing your views; seeking outcomes

Priority issues for engagement

Evidence of implementation – important for EPIS

Members and the Sponsor

Incorporating your approach and activities into member communications

Hearing from the Sponsor: assessing alignment with World Duty Free's priorities

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Market & Portfolio Update

January 2023

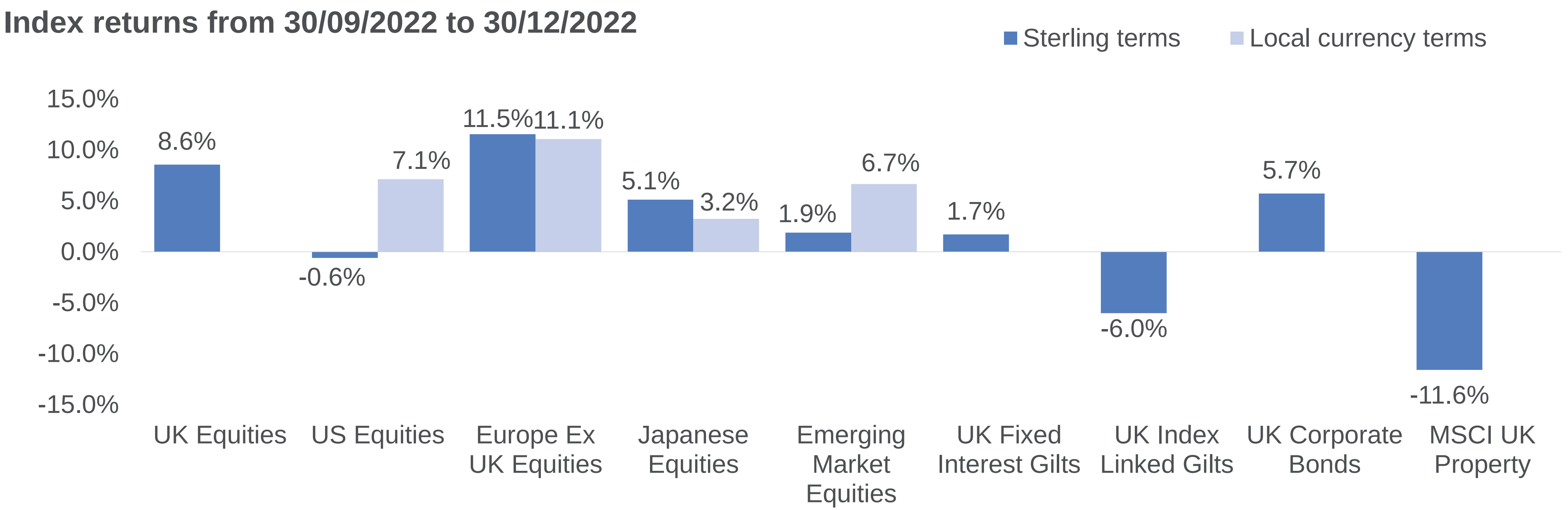
Prepared for: London Borough of Enfield Pension Fund

Prepared by: Aon

Date: 12 January 2023

Market update

Q4 2022 Index Returns

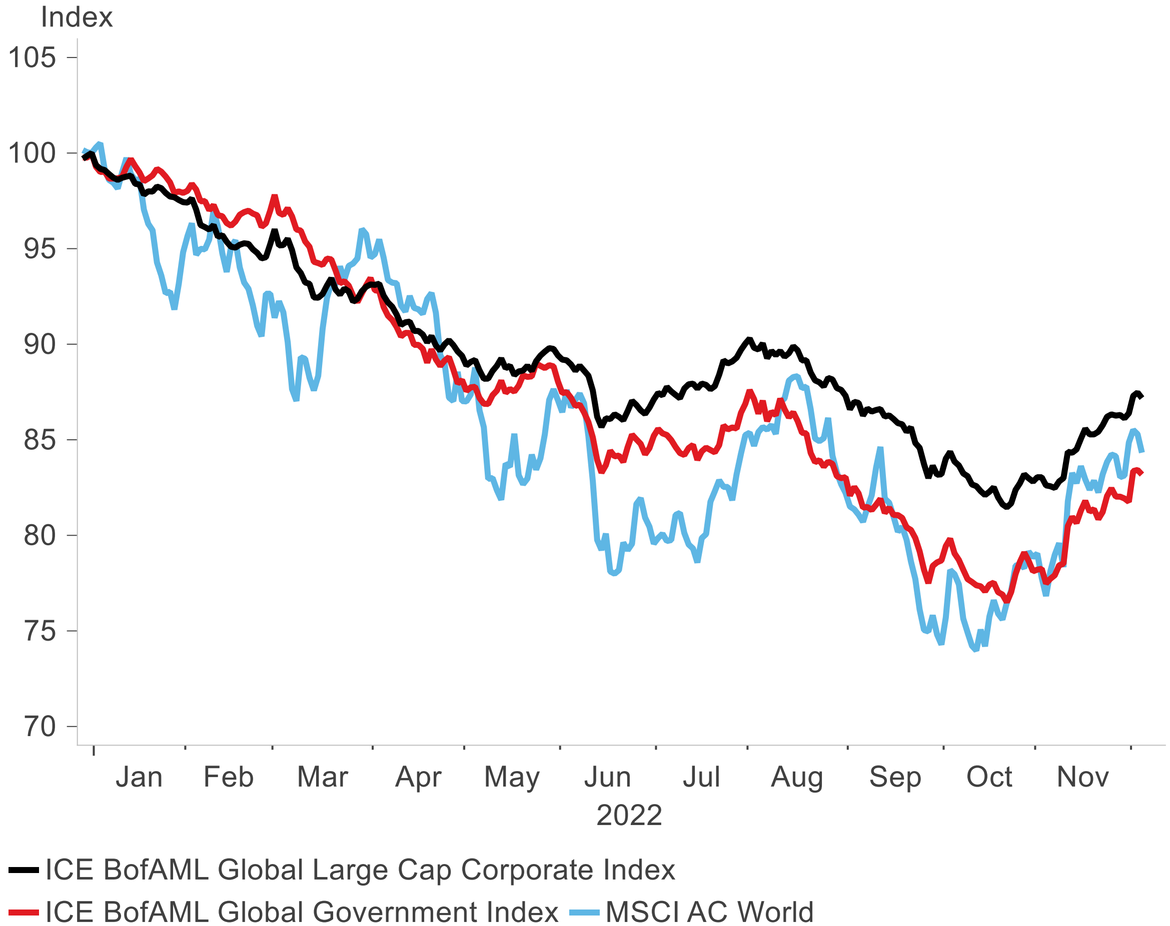


Source: FactSet, MSCI (Equities, Property), iBoxx (Corporate Bonds), FTSE (Gilts).

- Following widespread protests over China's so-called "zero covid" policy, Chinese authorities eased Covid-19 restrictions across major cities including Shenzhen and Beijing. It also announced plans to remove quarantine requirements for inbound travellers. Countries including the UK, the US, France, and India have imposed new Covid testing measures on visitors from China amidst reports of surging Covid cases in the country, although the EU resisted pressure for bloc-wide restrictions.
- The Bank of England raised interest rates by 50bps to reach 3.5%, the highest level since 2008. Six Monetary Policy Committee members voted for a 0.5% rate increase, whilst one member supported a larger 0.75% rise, and two members voted to keep rates unchanged.
- Both US and UK inflation eased in November, driven by a fall in energy prices. The US annual consumer price index (CPI) rose 7.1% year-on-year, down from the 7.7% recorded in October and less than economists' expectations of 7.3%. Meanwhile, UK CPI slowed to 10.7% year-on-year in November, down from the previous month's 11.1% and below economists' expectations of 10.9%.

A terrible year for the major asset classes – recent rally has been sharp but may not last

Equities and Bonds both perform very poorly



Source: Macrobond

- Both equities and bonds have suffered sharp falls in 2022.
- Resource-focused countries and sectors have outperformed – including energy, materials, UK, Canada.
- Weaker than expected US inflation has sparked a strong rally in the past 6 weeks, on expectations that central banks may stop raising rates.
- We do not believe that this is the end of the bear market yet, as inflation could persist for longer than currently expected.

Market Insights

Key questions for 2023

Interest rates

- **Consensus view:** Rates still have a bit more climbing to do but peak around mid 2023 and then start to come down
- **Risks to the consensus view:** Persistent inflation could keep rates high for much longer. But deep recession could force large cuts to rates

Bond Yields

- **Consensus view:** Will fall gently once rates peak and recession takes hold
- **Risks to the consensus view:** Similar to interest rates. All to play for here, and is key markets driver, as it was for 2022

Credit

- **Consensus view:** Credit spreads stay high but don't climb very much from recent ranges
- **Risks to the consensus view:** High interest rates for longer and recession could keep pressure on spreads (pressure from two ends!).

Equities

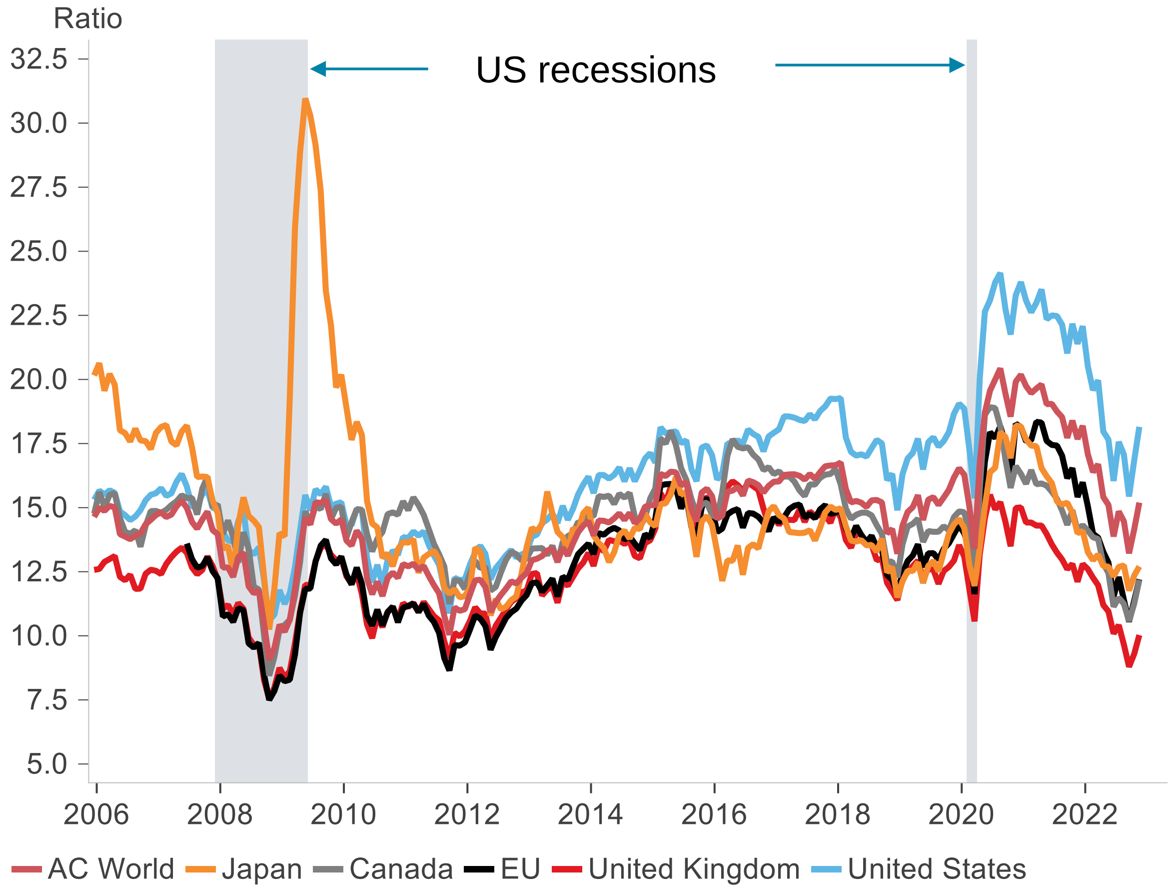
- **Consensus view:** Very mild recession will limit earnings pressure
- **Risks to the consensus view:** Squeeze between recession and interest rates staying high for longer – much the same as credit

Best scenario for markets?

'Soft Landing' – Growth slows but not too much, but enough to take pressure off interest rates

Equity valuations have improved, especially earnings-based measures

Equity Indices, MSCI, IMI (Large, Mid & Small Cap), Index, 12 Month Forward P/E

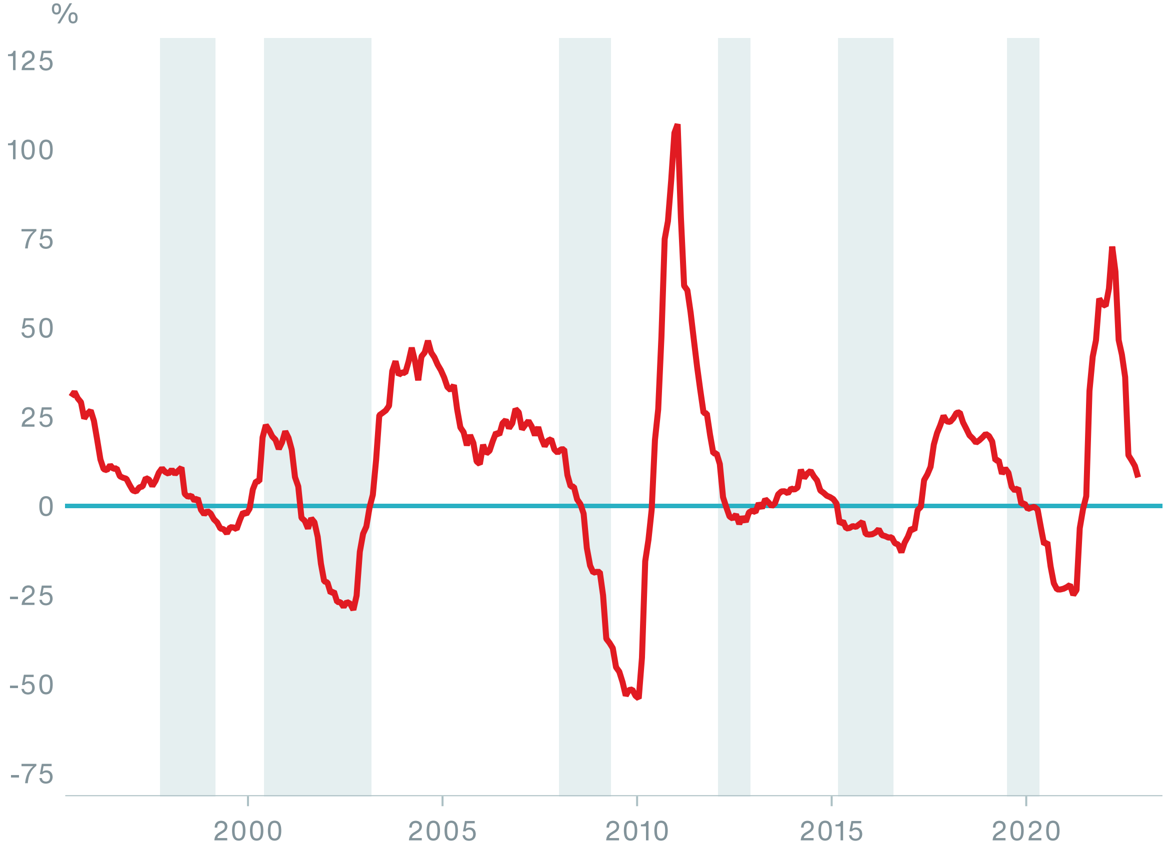


Source: Macrobond

- A very challenging year for equity market returns has resulted in much improved valuations.
- This is especially apparent in earnings-based valuation measures, such as forward and trailing PE ratios.
- The 12m forward PE ratios outside of the US have fallen to or below the lows reached during the pandemic and the GFC.
- We remain cautious, however, as corporate earnings expectations do not reflect a recessionary environment.

Corporate earnings forecasts have been revised lower, but not by enough to reflect a recession

12m growth in earnings per share, shaded areas are G7 recessions

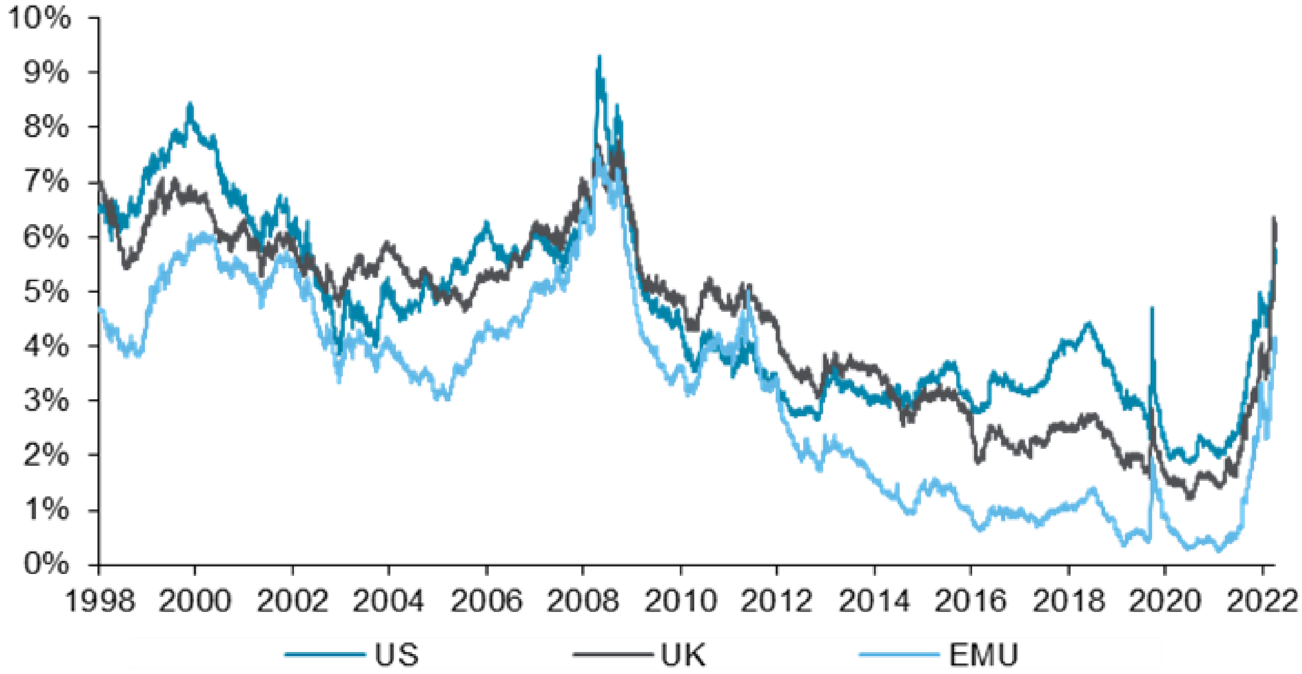


Source: Macrobond

- MSCI World earnings growth forecasts have more than halved this year, but remain at around 4% in 2023 and 2024. These are still relatively healthy expectations, especially if we do see a global recession.
- Earnings growth tends to contract in recessions, sometimes significantly. If this occurs, then current valuation measures will not turn out to be as attractive as some may think.
- Overall, we think that equity valuations are no longer expensive, rather than "cheap".

Investment grade yields have risen sharply but we remain more cautious on high yield bonds

Investment grade bond yields have risen to 2009 levels

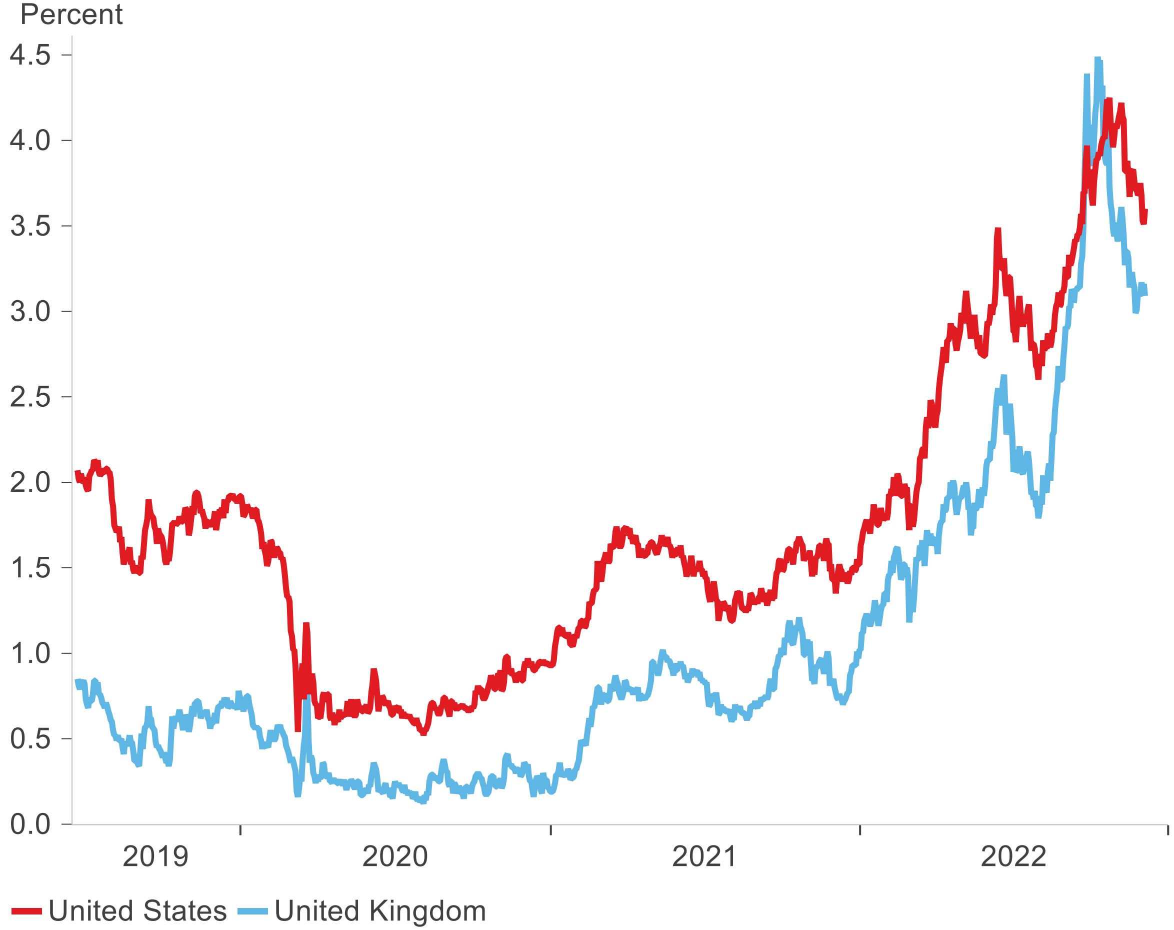


- UK investment grade yields now far exceed their 2020 spike level and are as high as in 2009. This has been driven simultaneously by the strong government bond bear market and rising credit spreads.
- We still think that credit spreads can widen further but current levels provide some cushion for IG credit returns relative to government bonds and we expect that high quality credit demand will start to return.

Source: Macrobond

Government bond yields have come off their peaks but remain much higher than last year

10-year government bond yields

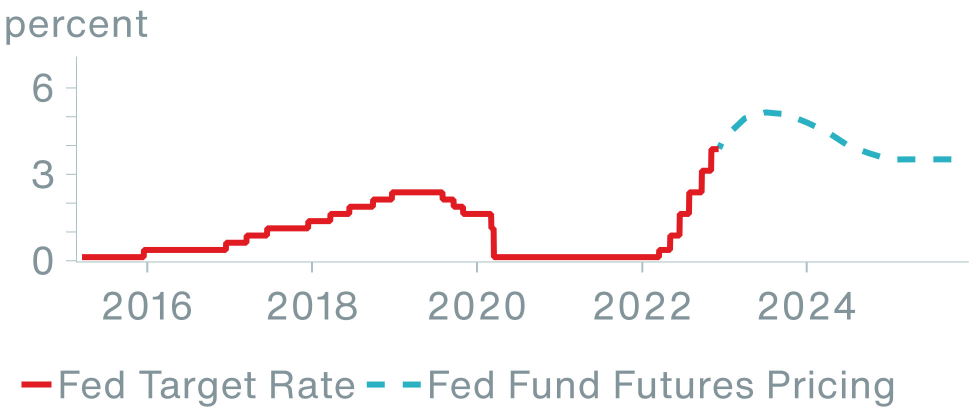


Source: Macrobond

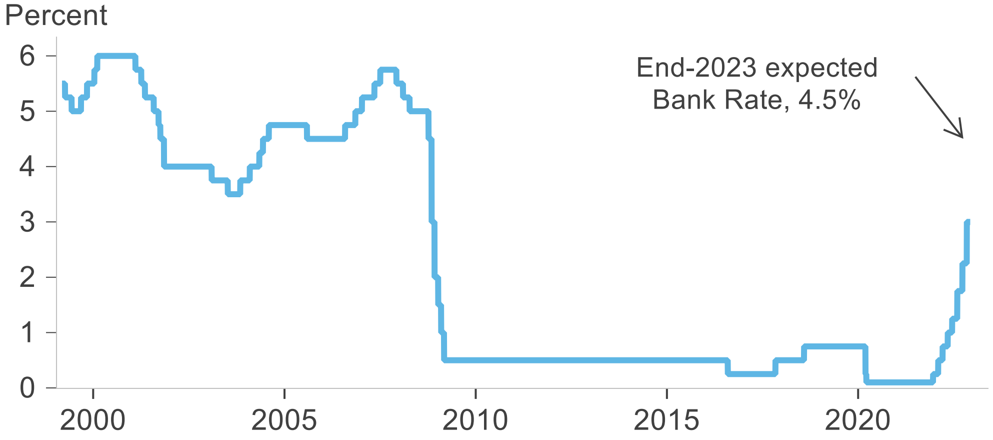
- G7 government bond yields have fallen sharply since the October rally began, on hopes of less monetary policy tightening. Yields remain higher than in 2021.
- Weakening growth may lead to further downward pressure in yields but we suspect high inflation will persist for much of next year, meaning yields are unlikely to fall back to pre-pandemic levels quickly.
- We expect further volatility and risks remain reasonably balanced.

Fed funds rate is expected to peak at 5%, whilst rate cuts are priced in towards the end of 2023

Fed Funds Rate and Market Expectations



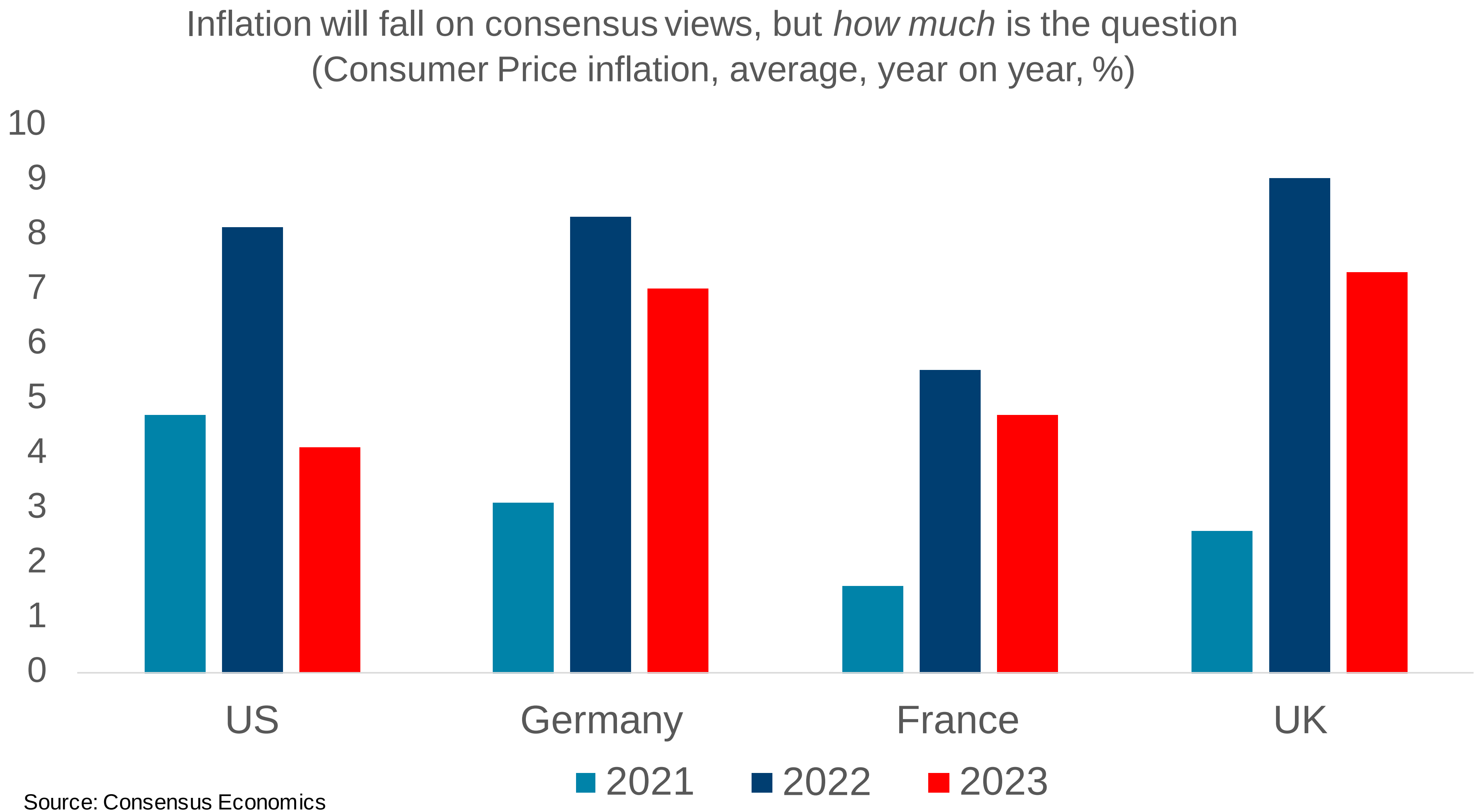
United Kingdom Bank Rate



Source: Macrobond

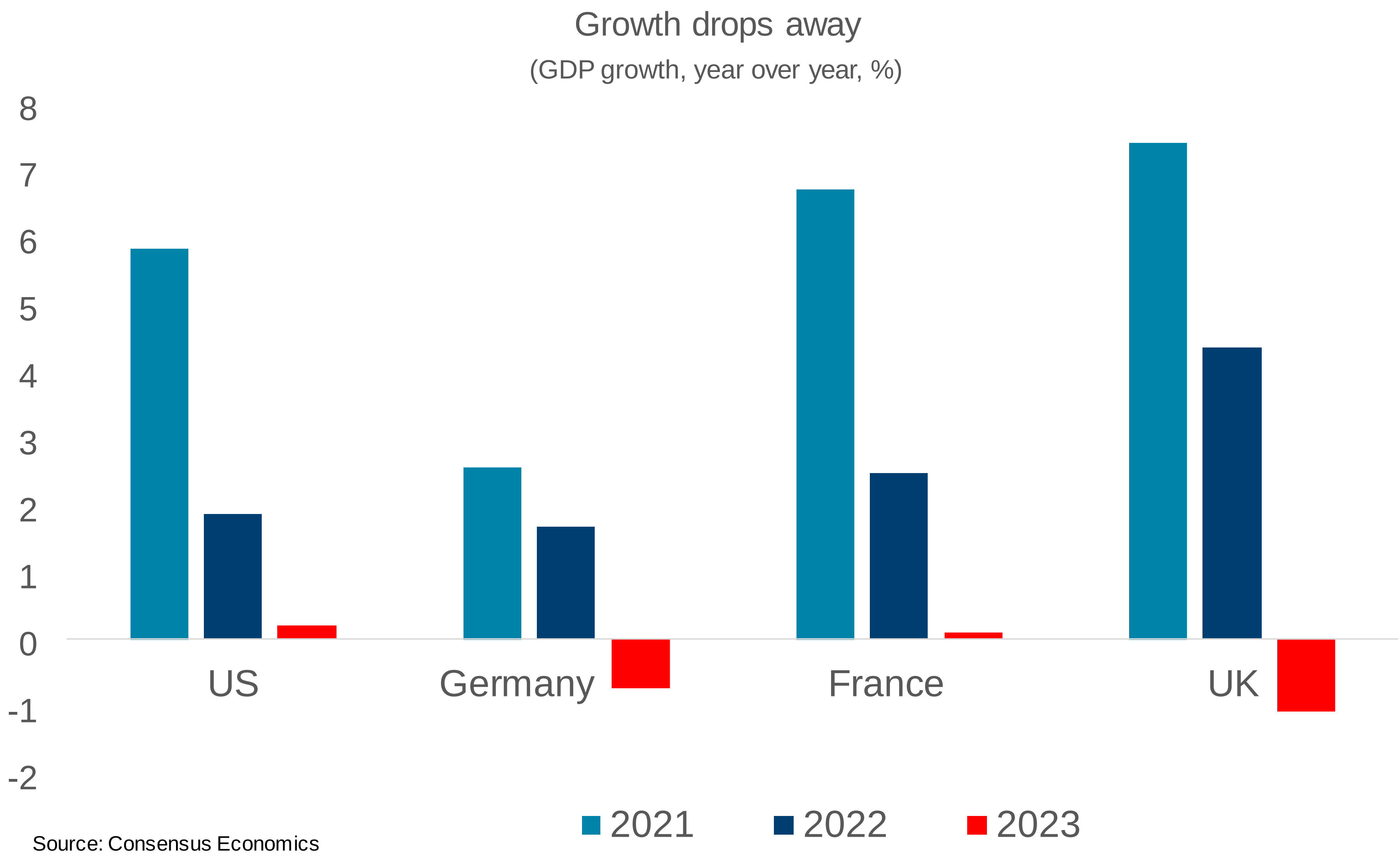
- The US Federal Funds rate is the key driver of asset markets globally and it has reached 3.75% - 4% already. Markets are expecting another 100bps by next summer. UK Bank Rate is expected to reach 4.5% by the end of 2023.
- Will this be enough tightening?
- By the end of 2023, rate cuts are expected in the US, not in the UK, which implies that the US will be in a recession by then. If inflation remains elevated, rate cuts might be off the table.

The inflation problem – consensus view



Source: Consensus Economics

The growth shortfall – consensus view



Source: Consensus Economics

Fund Valuation

Fund Valuation – 31 October 2022

	30 September 2022		31 October 2022		
	£m	%	£m	%	Strategic
Equities	**533.5**	**37.0**	**549.6**	**37.9**	**35.0**
BlackRock World Low Carbon	236.9	16.4	242.4	16.7	
Trilogy Global Unconstrained	0.8	0.1	0.8	0.1	
MFS Global Unconstrained	67.3	4.7	74.2	5.1	
London CIV Baillie Gifford	97.2	6.7	96.2	6.6	
London CIV JP Morgan	30.3	2.1	28.2	1.9	
London CIV Longview Partners	101.0	7.0	107.8	7.4	
Private Equity	**122.4**	**8.5**	**118.1**	**8.1**	**5.0**
Adams Street	122.4	8.5	118.1	8.1	
Hedge Funds	**76.9**	**5.3**	**75.0**	**5.2**	**0.0**
York Distressed Securities	3.8	0.3	3.3	0.2	
Davidson Kempner International	37.7	2.6	36.2	2.5	
CFM Stratus	35.3	2.4	35.6	2.5	
UK Property	**93.3**	**6.5**	**88.1**	**6.1**	**5.0**
Blackrock	41.0	2.8	38.8	2.7	
Legal & General	42.8	3.0	39.6	2.7	
Brockton	9.5	0.7	9.8	0.7	
PFI & Infrastructure	**71.2**	**4.9**	**70.5**	**4.9**	**16.0**
IPPL Listed PFI	45.0	3.1	44.9	3.1	
Antin	26.2	1.8	25.6	1.8	
Bonds	**277.7**	**19.2**	**281.9**	**19.4**	**24.0**
BlackRock Passive Gilts and ILGs	79.7	5.5	79.5	5.5	
Western Active Bonds	69.2	4.8	73.8	5.1	
Insight Absolute Return Bonds	31.9	2.2	31.6	2.2	
London CIV Multi-Asset Credit	50.4	3.5	50.7	3.5	
Diversified Liquid Credit	46.6	3.2	46.3	3.2	
Alternative fixed income	**75.0**	**5.2**	**75.0**	**5.2**	**5.0**
London CIV Global Bond Fund	75.0	5.2	75.0	5.2	
Inflation protecting illiquids	**113.3**	**7.8**	**112.0**	**7.7**	**10.0**
M&G Inflation Opportunities	66.7	4.6	65.5	4.5	
CBRE	46.6	3.2	46.6	3.2	
Cash	**80.5**	**5.6**	**80.6**	**5.6**	**0.0**
Enfield Cash	80.5	5.6	80.6	5.6	
Total Assets	**1443.8**	**100.0**	**1450.8**	**100.0**	**100.0**

Source: Northern Trust. Total might not sum due to rounding. Some valuations may be lagged.
Accounts for £75m from MFS Global Equity to LCIV Global Bond Fund.

Appendix

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