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Climate Change: Opportunities and Risks

Climate Change is, quite literally, a hot topic in the investment industry. Not least now that the DWP are requiring pension schemes to "state their policy in relation to ESG including climate change".

Over the summer Rob Skelton, our Head of Investment Research attended a "Climate investing roundtable" hosted by CAMRADATA and Funds Europe[1]

This quarter, with kind permission of Funds Europe, we show Rob's contribution to the discussion. A full version of the discussions, with contributions from the other members of the panel[2] can be found here http://www.funds-europe.com/digital-editions/funds-europe/september-2018/#p=24

Funds Europe – Where do you see the most interesting opportunities within climate-related investing?

Rob Skelton – Many DB [defined benefit] pension schemes could benefit from access to less liquid, low-risk and income-generative assets. However, until recently, opportunities were concentrated in property and PFI contracts. Renewable infrastructure, solar farms and windfarms and biomass plants extend the opportunity set. The operational projects are of particular interest given their lower-risk nature. And of course, there's the potential for renewable energy to offer a natural hedge to some of the climate change risks faced through investing in the stock market.

There are, though, risks associated with such assets, not least the political ones. However, with diversified pooled funds available, the idiosyncratic risks of renewable energy can be diversified, even by smaller pension schemes.

[1] CAMRADATA, are one of a number of fund manager research databases utilised by our investment team and Funds Europe is a leading industry magazine

[2] These were Mike Clark, founder director or Ario Advisory, Diandra Soobiah, Head of responsible investment at Nest Corporation and Lydia Guett, an investment consultant at Cambridge Associates.

Funds Europe – Earlier this year, investment consultancy Mercer found that only 5% of European pension schemes have considered the investment risk posed by climate change. What can be done to advance climate-related investment beyond just this small group of leading funds?

Rob Skelton – When looking at risks, consultancy firms have focused on balance sheets for the year ahead. Climate change risks are too long-term to be picked up by this sort of standard analysis.

Once the industry focuses on longer-term risks and carries out sensible scenario testing on the pension scheme and sponsor, I think we'll see climate change risks being picked up.

That said, climate change risks are just one of many investment risks faced by pension schemes. Climate change risks will have to fight with scenarios like high inflation, low interest rates, market volatility and manager underperformance for trustees' attention. But where climate change mitigations offer investment opportunities in their own right, the question should be 'why not mitigate climate change risks?'

Funds Europe – Are ESG factors, mainly environmental, under-utilised in fixed income investing? Might ESG factors be able to play a role in credit analysis?

Rob Skelton – Time scales are of relevance here. Many fixed income mandates are short-dated in nature e.g. the fund manager might lend money for three months to five years. Climate change is unlikely to be a concern when lending over that timeframe.

However, a liability matching '*buy and maintain'* credit portfolio's lending might be over 20 or 30 years. The risk of climate change leading to defaults is important if you're lending money over that period and so it's important that the fund manager takes the risk seriously.

Funds Europe – Where do you see the topic of climate investing going over the next two years?

Rob Skelton – Over the next two or three years, the bulk of our clients will have carried out their next strategic review. Given we're incorporating long-term scenarios into these reviews, I'd hope that all of these pension schemes will have considered climate change risks. Whether they take any action will really depend on their timeframes and extent to which their investments and sponsor are exposed to these risks.

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Our view

The DWP requirement comes into force on 1 October 2019. By that time pension schemes need to have their policy on long-term risks, including ESG related ones, documented in their Statement of Investment Principles.

Documenting current practices may be a sufficient response for many schemes. However, with mitigations for long-term ESG and climate change risks becoming more readily available, a review of these practices may be a worthwhile exercise.

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