	Pension Fund Committee **18 April 2024**
Title	**Responsible Investment Update**
Date of meeting	18 April 2024
Report of	Interim Executive Director of Resources (S151 Officer)
Wards	All
Status	Public
Urgent	No
Appendices	Appendix A – Investment Framework Discussion Document
Officer Contact Details	David Spreckley, Head of Pensions and Treasury – 020 8359 6264 – david.spreckley@barnet.gov.uk

Summary

This paper and Appendix provide an update on the work being undertaken to progress the Fund's Responsible Investment approach.

Specifically, Officers have considered with the Chair and our advisors the broader governance implications from considering Paris Aligned Equity Funds and Nature Based Assets like Timberland.

In particular, there may be an inherent risk of divergence from a "balanced market" approach when investing in Paris Aligned funds. The Committee should understand these risks with supported evidence before proceeding with such investments and this paper sets out some of these considerations which will be explored more formally through advice over the summer.

More broadly, considering Paris Aligned funds has prompted a wider discussion around investment philosophy and governance considerations for the Fund. Appendix A expands on this together with suggested next steps.

We will use time at the Committee meeting to talk through this work and we would welcome Committee views on this approach during the meeting.

Recommendations

The Committee is asked to consider and comment on the approach set out within Appendix A. and to note the contents of this report.

1. Why This Report is Needed

Context

1.1 To help Barnet Council achieve its ambitious climate change goals, the Barnet Pension Fund has devised a strategic plan known as the 'BarNetZero 2030 Model Portfolio'. This plan outlines how the pension fund could, in theory, align its investments with climate-friendly objectives and work towards achieving a nearly zero carbon footprint by the year 2030.

1.2 Details of this model were set out within our Responsible Investment paper shared at the 2 November 2023 Pension Fund Committee meeting. Background papers are listed in the appropriate section of this report.

1.3 Our Model Portfolio has informed two workstreams:

- First, seek to reduce the carbon footprint in our core investments (i.e. our equities, bonds and property), aligning them with the goals set by the 2015 Paris Agreement. We believe this can be achieved without taking on excessive risks, although this point needs to be tested.
- It then subsequently sets an approach where we would allocate a portion of our investments to 'offsetting' assets to neutralize any remaining carbon emissions generated by our portfolio.

1.4 The Responsible Investment Paper at the January 2024 meeting set out background around Paris Aligned Funds and Nature Based assets (link to here).

Activity Since 11 January 2024 Committee meeting

1.5 Subsequent to the 11 January 2024 Committee meeting Officers have considered, with the Chair and the Fund’s advisors Hymans, the broader governance implications from considering Paris Aligned Equity Funds and Nature Based Assets like Timberland.

1.6 In context, for its equity investments, the fund adopts, broadly, a passive market balanced investment approach and switching to Paris Aligned Funds could mean that, over time, the Fund deviates away from this.

What is a “Passive Balanced Market Approach”?

1.7 A passive balanced market approach for equities involves constructing a diversified portfolio of stocks that mirrors the overall market while also accounting for different sector exposures and risk factors. This strategy typically begins by allocating assets across various sectors of the economy, such as technology, healthcare, consumer goods, and financials, among others. By spreading investments across different sectors, investors aim to reduce the impact of sector-specific risks on their portfolio's performance. This sector allocation is often based on the relative weights of sectors in a broad market index (e.g. MSCI World Index).

1.8 In addition to sector diversification, a passive balanced market approach for equities may also incorporate exposure to different risk factors or investment styles, such as value stocks or growth stocks. These factors have been shown to influence stock returns over time and can provide additional diversification benefits. For instance, an investor may allocate a portion of their portfolio to value stocks, which are characterized by lower price-to-earnings ratios and higher dividend yields, and another portion to growth stocks, which typically exhibit higher earnings growth rates. By including exposure to various factors, investors aim to capture different sources of returns and mitigate the impact of market cycles and fluctuations on their portfolio's performance.

1.9 Overall, this approach seeks to provide a well-rounded exposure to the equity market while maintaining a passive investment stance and minimizing active management decisions.

Implications of moving equity holdings away from a broadly passive market balanced approach

1.10 A Paris Aligned fund can be expected to deviate away from a market balanced approach as it prioritises investing in companies that are meeting their commitments under the Paris Agreement at the expense of those that do not.

1.11 Deviating from a purely market-balanced approach to equities in a pension scheme can have significant implications, particularly if the strategy takes an intrinsic position different from a balanced market approach. Here are some considerations specific to the equity element of the investment strategy:

1.12 **Concentration Risk:** If the pension scheme tilts its equity portfolio towards specific sectors, industries, or regions, it increases concentration risk. While this may lead to outperformance if those areas perform well, it also heightens vulnerability if those segments underperform or face adverse market conditions.

1.13 **Factor Exposure:** Departing from a balanced market approach may involve emphasizing certain investment factors, such as value, growth, size, or momentum. Each factor carries its own risks and potential returns. For instance, a tilt towards value stocks might lead to higher returns if value stocks outperform, but it could underperform if growth stocks dominate the market.

1.14 **Active Management Complexity:** Moving away from a passive, market-balanced approach to a strategy with intrinsic positions often entails active management. This shift introduces complexity, requiring skilled portfolio managers capable of identifying mispriced securities or exploiting market inefficiencies to generate alpha. (note that there are Passively run Paris Aligned Funds that could mitigate this risk)

1.15 **Performance Expectations:** Pension schemes must carefully consider the performance expectations associated with deviating from a balanced approach. While the strategy might aim for higher returns, there's also the possibility of underperformance relative to benchmarks, which could impact the scheme's ability to meet its long-term obligations.

1.16 **Volatility and Risk Management:** An intrinsic position in equities could result in heightened volatility compared to a market-balanced approach. Pension schemes need robust risk management frameworks to assess and mitigate the increased volatility, ensuring it remains within acceptable tolerance levels.

1.17 **Stakeholder Communication:** Communicating the rationale behind the shift in equity strategy is essential to manage stakeholder expectations. Pension scheme members, employers and other stakeholders need to understand the reasoning behind the decision, as well as the potential implications and risks involved.

1.18 **Costs and Fees:** Transitioning to a strategy with intrinsic positions may involve higher costs, including fees associated with management, research, and trading. The Fund would need to evaluate whether the potential benefits of the new strategy outweigh the additional costs incurred.

1.19 **Monitoring and Evaluation:** Ongoing monitoring and evaluation of the equity strategy are essential to ensure it remains aligned with the scheme's objectives and risk tolerance. Regular performance reviews, risk assessments, and adjustments may be necessary to maintain the effectiveness of the chosen approach.

1.20 In summary, moving to a Paris Aligned Fund, which may imply moving away from a broadly balanced approach, is not trivial and has caused Officers to reflect and try to articulate what it believes is the broad investment philosophy for the Fund and play this back to the Committee for clarity.

Presentation on the Fund's Investment Philosophy

1.21 Appendix A, which the Head of Pensions and Treasury will talk through in the meeting, attempts to articulate a broad framework which we will look to evolve and incorporate into the Fund's Investment Strategy Statement.

1.22 Appendix A also sets out next steps for considering Paris Aligned Funds and Nature Based Assets

2. Alternative Options Considered and Not Recommended

2.1 Not applicable in the context of this report.

3. Post Decision Implementation

3.1 Not applicable in the context of this report.

4. Corporate Priorities, Performance and Other Considerations

Corporate Plan

4.1 The Pension Fund Committee supports the delivery of the Council's strategic objectives and priorities as expressed through the Corporate Plan, by careful monitoring of the Pension Fund activities with a view to ensuring the overall sustainability of the Pension Fund.

4.2 Sustainability of the Pension Fund is a crucial pillar in allowing the council to fulfil its wider objectives.

4.3 The Pension Fund is also developing its NetZero and Stewardship policies which feed into the wider objectives around Planet, Places and People.

Corporate Performance / Outcome Measures

4.4 Not applicable in the context of this report.

Sustainability

4.5 Not applicable in the context of this report.

Corporate Parenting

4.6 Not applicable in the context of this report.

Risk Management

4.7 Risk management is central to the LGPS. LGPS pension funds are in themselves risk management tools, managing the risk that future employer income streams will be able to meet future pensions liabilities by creating a reserve from which future liabilities will be met. Good governance is essential to managing the risks of the pension fund.

Insight

4.8 Not applicable in the context of this report.

Social Value

4.9 Not applicable in the context of this report.

5. Resource Implications (Finance and Value for Money, Procurement, Staffing, IT and Property)

5.1 Risks that are not mitigated or managed can have a financial penalty to the Fund.

6. Legal Implications and Constitution References

6.1 The Council's Constitution – Part 2B section 15.1 includes within the responsibilities of the Pension Fund Committee. The terms of reference for the committee includes: To have responsibility for all aspects of the governance, investment and administration of the London Barnet Pension fund, including, but not limited to the following: To ensure compliance with all Local Government Pension Scheme statutes, regulations and best practice."

7. Consultation

7.1 Not applicable in the context of this report.

8. Equalities and Diversity

8.1 Pursuant to the Equalities Act 2010, the Council is under an obligation to have due regard to eliminating unlawful discrimination, harassment, victimisation and any other conduct that is prohibited by or under the Act; advancing equality of opportunity between persons who share a relevant 'protected characteristic' and those who do not share it; and fostering good relations between persons who share a relevant 'protected characteristic' and persons who do not share it. The 'protected characteristics' are: age, disability, gender reassignment, pregnancy, and maternity, race, religion or belief, sex and sexual orientation, marriage and civil partnership.

8.2 The rules governing admission to and participation in the Pension Fund are in keeping with the public sector equality duty. The Public Sector Equality Duty requires public authorities in carrying out their functions, to have due regard to the need to achieve the objectives set out under s149 of the Equality Act 2010. Good governance arrangements will benefit everyone who contributes to the fund.

9. Background Papers

9.1 Further discussion on the Fund’s Responsible Investment approach can be accessed from the following links:

Pension Fund Committee 31 January 2023:

Developing the Funds Responsible Investment strategy - update.pdf (moderngov.co.uk)

Pension Fund Committee 4 July 2023

230704 Responsible Investment Update - Cleared.pdf (moderngov.co.uk)

Pension Fund Committee 11 January 2024
20240111 - Responsible Investment Update Governance.pdf (moderngov.co.uk)