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Momentum conference,
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Climate change matters:

Reflections from a pension fund

10 December 2010

The Railways Pension Funds and Responsible Investment: Climate Change is an Investment Issue

- Railways Pension Trustee Company Limited is corporate trustee of various final salary UK railway industry pension schemes with over 350,000 beneficiaries – one of the largest UK occupational pension schemes and Railpen Investments acts as the investment arm of the corporate trustee.
- Total assets of more than £17 billion across different asset classes including alternatives managed by multiple external fund managers with global exposure.
- We are a long term investor with long term commitment to pay pensions - hence the importance of long term performance (and climate change).

The Railways Pension Funds and Responsible Investment: Climate Change is an Investment Issue

- Corporate governance has a vital part to play in bringing about sustained performance and we believe that that that shareholder value can be improved through constructive consultation and engagement with companies and wider responsible investment initiatives.
- Long standing supporter of better corporate governance for over 15 years - we were one of the first UK pension funds to adopt active UK corporate governance & voting policy in 1992 & now also voting in the USA, Europe, Japan, Singapore, HK & Australia.

The Railways Pension Funds and Responsible Investment: Climate Change is an Investment Issue

- We work with other like-minded asset owners & investors including our own external fund managers in various forums, as well as various proxy voting information services, including a UK voting & engagement alliance with the Universities Superannuation Scheme launched in 2010.
- Now turning our attention to ES as well as G and to climate change and the implications for long term investment in particular.
- Various initiatives - investor supporter of the Carbon Disclosure Project (CDP) since 2000 and became UN PRI Asset Owner signatory and publicly endorsed new UK Stewardship Code in 2010 with quite a lot in between.

Responsible Ownership – putting the ES in ESG

- UK pension fund trustees required by law since 2000 to disclose the extent to which social environmental and ethical (SEE) matters, if at all, influence the selection, retention and realisation of investments.
- Only a disclosure requirement - no obligation to make socially responsible investments - and does not affect the overriding fiduciary duty.
- Fiduciary duty still to act in the best interests of beneficiaries and not to do anything that might prejudice their best interests.

Responsible Ownership – putting the ES in ESG

- The Megarry Judgement 1984 in the UK Chancery Court seemed to decide that “best interests” usually mean “best financial interests” implying that other considerations outweighing the financial will be rare, and the burden of proof will be on the trustees.
- Legal opinion is changing and recognises the realities of modern portfolio management eg Freshfields Bruckhaus Deringer, as adviser to UNEP FI, argues that the integration of environmental, social and governance (ESG) issues into investment analysis, so as to predict financial performance more reliably, is clearly permissible and is arguably required in all jurisdictions.

Responsible Ownership – putting the ES in ESG

- In any case doing nothing is not a feasible option and not in the interests of long term value and our own stakeholders - employers and members - expect more and we can no longer hide behind an outdated view of the fiduciary duty.
- UN Principles for Responsible Investment (PRI) provide a framework.
- We strongly support, for example, the Carbon Disclosure Project and the EITI because they are good for business and are all about better disclosure.
- Both companies and investors need to appreciate that corporate social responsibility is a serious obligation that cannot be wished away.

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Climate Change: Adaptation Matters – “Managing the Unavoidable ”

- Climate change is long term and has significant potential economic and financial implications for long term investors and their beneficiaries.
- Climate change and global warming receive a great deal of attention from the media, not to mention the scientific community and politicians, but should it matter to long-term investors like pension funds? We are not climate change experts but recognise that scientific opinion has identified a major risk (which for us is financial and economic).
- Major investment implications in adapting to climate change from an economic and financial perspective. Not just about geography – will sooner or later have profound effects on global economic activity.

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Climate Change: Adaptation Matters – “Managing the Unavoidable ”

- Broad consequences of climate change now increasingly well understood but significant uncertainties around how unavoidable climate change will impact on specific companies or specific sectors and much less attention has been given to the investment consequences.
- We believe that companies must evaluate the risks and opportunities associated with the need to adapt to climate change. These risks and opportunities, like any other business risk, should be identified and integrated into overall corporate risk management and strategic planning processes.

Climate Change: Adaptation Matters – “Managing the Unavoidable ”

- Published in January 2008 our initial report on “Managing the Unavoidable: Understanding the Investment Implications of Adapting to Climate Change ” with USS and other partners:
  - the major direct, physical climate change and weather-related risks and associated opportunities to companies
  - the potential implications for cash flows and capital
  - the disclosures required by investors to enable them to evaluate corporate exposures to climate change risks
- Final report published in November 2009 following further work on oil & gas, utilities, real estate and property sectors.
- Although focused on quoted equities, implications extend to other asset classes.

Time for 77 Questions and more

- “Managing the Unavoidable” adaptation project underlined the limited understanding (including our own) of the investment implications of climate change.
- We needed to look at our own investment managers, as well as at portfolio companies, and to gather information on what they were doing on climate change
- We commissioned a study (still in progress) from Trucost to measure the carbon footprint of our equities portfolios to give us a better idea of our carbon exposure by sector, companies and managers

Time for 77 Questions and more

- But we also wanted to know more about how our investment managers approach climate change issues
- Worked in 2009 with HSBC and Linklaters to design climate change investment risk audit to elicit information on all aspects (including the legal and fiduciary duties)
- Sent in early 2010 to a sample of our managers across all asset classes as climate change potentially affects all types of assets and received 26 replies representing all classes
- Only about gathering information – no consequences for manager tenure – not intended to be a rigorous scientific sample to be extrapolated beyond our own managers but helped confirm and dispel preconceptions

Climate Change Investment Risk Audit Highlights

- Overall the level of climate change awareness is not great although there is increasing recognition that it is a potential investment issue that clients are beginning to ask about. Climate change generally seen as a sub-set of ESG rather than a broad theme.
- Legal Section E designed to probe on fiduciary duty – climate change not considered part of fiduciary duty so much as part of the investment process or client instruction.
- Managers consider that ultimate responsibility for climate change risk lies with asset owner rather than asset manager. None of the houses in our sample had sought special legal advice on climate change issues.

Climate Change Investment Risk Audit Highlights

- Some difference (but not that much) between asset classes:
  - Property (unsurprisingly) probably most aware & note Jones Lang La Salle thought piece “From Sandbags to Solar Panels” on future-proofing UK real estate for climate change resilience
  - Private Equity also more aware of climate change and the investment opportunities in clean tech
  - Not ignored by public equity either but not in the lead either
  - Some awareness on the part of hedge funds
  - But fixed income is very much a laggard (and more generally on ESG issues)

Climate Change Investment Risk Audit Highlights

- Size of house also a factor with larger managers providing better responses but with some notable exceptions and outliers at both ends of the spectrum.
- Little evidence of systematic approach to climate change – no standard way of assessing and often considered on case by case basis – and limited understanding of distinction between mitigation and adaptation.
- No real answers on how to reflect long term effect of climate change in investment process.
- But risk audit exercise has been helpful and will be repeated (with possible modifications) and some material will be used in RFPs going forward.