Case study: Making pensions more climate-resilient

Merseyside's long-horizon approach to sustainability

About the client

Profile

Merseyside Pension Fund (MPF) has £8.9B in assets and nearly 140,000 scheme members. *

Over recent years, MPF has sought to future-proof its pension promises against the systemic risks posed by climate change.

Specifically, MPF wished to integrate sustainability parameters into the fund's investment beliefs and policies.

A key step came in January 2019, when MPF joined forces with FTSE Russell and State Street Global Advisors to implement a new sustainable investment strategy.

This came in the form of a £400M allocation to a passive equity portfolio tracking the FTSE All-World Climate Balanced Comprehensive Factor Index.

*As of 3/31/2019

Client objectives

- Future-proof the pension fund's investment strategy against climate change and other sustainability risks
- Continue MPF's tradition of taking a progressive and collegiate role in engagement on environmental, social and governance ("ESG") issues
- Take advantage of the opportunities provided by the global transition towards a low-carbon economy
- Retain exposure to the key drivers of long-term equity market returns

Index criteria

- The FTSE All-World Climate Balanced Comprehensive Factor Index incorporates three key climate change considerations alongside exposure to five equity factors
- Climate change considerations are reflected in the index via carbon emissions, fossil fuel reserves and green revenues
- The index also provides balanced exposure to five factors that tend to contribute to long-term equity market performance: quality, value, momentum, low volatility and size

The need

For Merseyside Pension Fund (MPF), the decision to integrate climate change and sustainability parameters into its investment beliefs and decision-making processes was not a sudden one. Instead, it was the result of a multi-year review of the fund's exposure to climate change risks.

Along the way, MPF made sure to consult with a cross-section of internal and external stakeholders. The fund has also been transparent about the steps being taken, reflecting its long-standing and progressive role in stewardship and engagement on ESG issues.

Throughout the review process, MPF was particularly conscious of the need to manage its fund's assets in a way that reflects its long-term liabilities to pension fund members.

Newer members of MPF may still be drawing pensions after 2100, so the fund has to recognize the systemic risks posed by climate change, as well as the investment opportunities being thrown up by the ongoing transition to a low-carbon economy.

For MPF, a step change in the sustainability debate came in December 2015, when 195 countries came together in Paris to sign the landmark COP21 agreement.

Under COP21, signatories agreed to limit global warming to a maximum of 2°C during the current century and to reach carbon neutrality (net zero emissions of greenhouse gases) by the end of the century.

This policy change has important implications not only for governments and regulators, but it also creates a range of risks and opportunities for businesses and investors.

Around the world, other regulatory initiatives affecting pension funds are reinforcing this direction of travel.

In 2015, the UK Law Commission found that consideration of ESG factors by pension trustees is entirely consistent with their fiduciary duty to beneficiaries.

In the same year, France passed a new law on energy transition for green growth. Article 173 of this law mandates portfolio-level reporting on a "comply or explain" basis on exposure to ESG, greenhouse gas and green economy parameters.

And in the United States, a 2015 revision to the Employee Retirement Income Security Act (ERISA) means that ESG integration is now consistent with a pension scheme's fiduciary duty.

In this environment, a key question for many pension fund trustees to address is the following:

"How can we integrate our investment beliefs on sustainability and risk premia into a passive portfolio to target better long-term risk-adjusted returns?"

> "We wanted to be a pioneer for other investors who were looking to address the same issues."
>
> Owen Thorne, portfolio manager, monitoring & responsible investment at the Merseyside Pension Fund (MPF)

MPF wins three IPE Awards for its climate risk strategy

In December 2019 MPF won three awards at the annual Investment and Pensions Europe (IPE) Awards ceremony, the premier event for European pension funds.

MPF at the 2019 IPE Awards

- Climate Related Risk Management (winner)
- Factor Investing (winner)
- Credit & Alternatives (winner)

The index solution

In early 2019, MPF made a £400M commitment to a passive equity portfolio tracking the FTSE All-World Climate Balanced Comprehensive Factor Index. This represents a third of the fund's overall passive equity allocation.

The FTSE All-World Climate Balanced Comprehensive Factor Index performs two key functions simultaneously: it incorporates three climate change and sustainability parameters but also provides exposure to five equity factors (equity factors are shared characteristics among stocks that have been shown to provide specific risk or return outcomes over time).

The index is part of FTSE Russell's "Smart Sustainability" range. Our smart sustainability indexes combine sustainability parameters and factor risk premia within a single index solution. They reflect the growing demand among professional investors for the incorporation of both factors and ESG data into investment tools.

The FTSE All-World Climate Balanced Comprehensive Factor Index is constructed from a starting universe of stocks from the FTSE All-World Index, FTSE Russell's flagship global equity benchmark. It follows a transparent, rules-based construction process and is reviewed twice a year.

Sustainability parameters—three areas of focus

The FTSE All-World Climate Balanced Comprehensive Factor Index uses three complementary parameters to ensure lower exposure to fossil fuel producers and polluters, and greater exposure to companies transitioning to. a low-carbon economy.

Fossil Fuels

The index methodology reduces exposure to companies that own or are engaged in the exploration of production of fossil fuels or the suppliers of equipment and services to the fossil fuel industry.

Carbon Emissions

The index methodology reduces exposure to companies that emit high levels of CO_2 relative to other companies in the same ICB sector.

Green Revenues

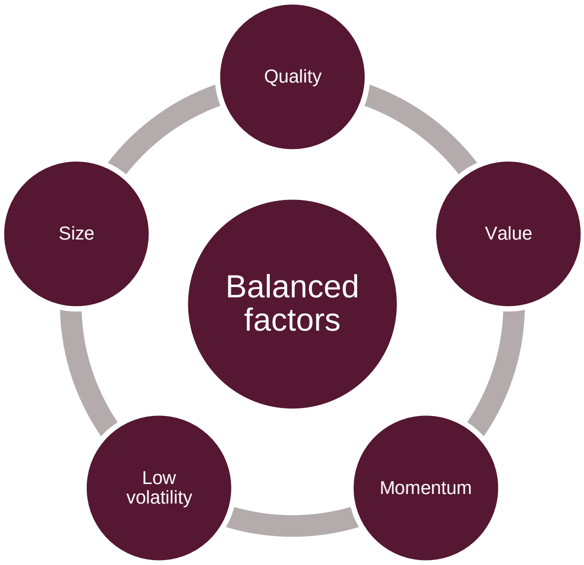
The index methodology increases exposure to companies that produce goods, products and services that allow the world to adapt to, mitigate or remediate the impacts of climate change, resource depletion and environmental erosion.

Balanced exposure to five equity factors

At the same time, the FTSE All-World Climate Balanced Comprehensive Factor Index retains balanced exposure to five equity factors.

- Quality (over time, high quality companies tend to perform better than lower quality companies)
- Value (over time, stocks that appear cheap tend to perform better than stocks that appear expensive)

- Momentum (recent price performance tends to persist)
- Low volatility (over time, stocks with lower volatility tend to perform better than stocks with higher volatility)
- Size (over time, smaller companies tend to perform better than large ones)



“As one of the larger pension schemes in the UK, we have consistently taken a progressive role in active stewardship and engagement on ESG issues, and we have had a long-standing interest in climate change. Recently it’s been apparent that the rate of climate change is accelerating; the global transition to a low-carbon economy and a more sustainable future is well underway, and the policy responses towards climate change are accelerating, too, so it became incumbent on us to take account of these macro trends at an inflection point in the world of responsible investing.”

Owen Thorne, portfolio manager, monitoring & responsible investment at the Merseyside Pension Fund (MPF)

Additional information

[FTSE All-World Climate Balanced Comprehensive Factor Index Factsheet]

[FTSE Russell's Green Revenues data model >]

About FTSE Russell

FTSE Russell is a leading global provider of benchmarks, analytics and data solutions with multi-asset capabilities, offering a precise view of the markets relevant to any investment process. For over 30 years, leading asset owners, asset managers, ETF providers and investment banks have chosen FTSE Russell indexes to benchmark their investment performance and create investment funds, ETFs, structured products and index-based derivatives. FTSE Russell indexes also provide clients with tools for performance benchmarking, asset allocation, investment strategy analysis and risk management.

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