PASSIVE EQUITIES AND CLIMATE CHANGE

Report of the County Treasurer

Please note that the following recommendations are subject to consideration and determination by the Committee before taking effect.

Recommendation: (1) that the Committee considers switching the current investment in UK Passive Equities to the new UK Passive Climate Transition Benchmark (CTB) Fund when it is launched later in the Autumn.
(2) that the Committee approves the transfer of the current Smart Beta Passive allocation to the new World Developed Passive Paris Aligned Benchmark (PAB) Fund when it is launched later in the Autumn.

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1. Introduction

1.1 Over the last two years the Devon Pension Fund has significantly strengthened its policies towards how it addresses climate change within its investment strategy. The Investment and Pension Fund Committee at its February meeting resolved to commit the Fund to achieving net zero investment portfolios by 2050. In June, the Committee agreed to a revised policy statement in support of that commitment that:

- Set interim targets for progress by 2030.
- Set a 5% target for investment in renewable energy infrastructure (consistent with the Fund's current strategic asset allocation).
- Recognised the impact of strategic asset allocation on the Fund's carbon footprint.
- Further strengthened the Fund's expectations with regard to the work that Brunel and the Local Authority Pension Fund Forum do on behalf of the Fund.

1.2 A key element of the Fund's investment strategy is the allocation to passive equities, which accounts for over half of the allocation to equities and over 25% of total Fund investments. This report therefore addresses the role that passive investment plays within the investment strategy and how that fits in with the Fund's policies on climate change.
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2. Passive Investment

2.1 The Fund's investment strategy splits the allocation to equities between passively and actively managed funds. Passively managed funds track established indices by owning all the shares in the relevant index in proportion to their weighting in the index (their market capitalisation or market cap weighting), whereas actively managed funds will give full discretion to fund managers to choose which companies to invest in.

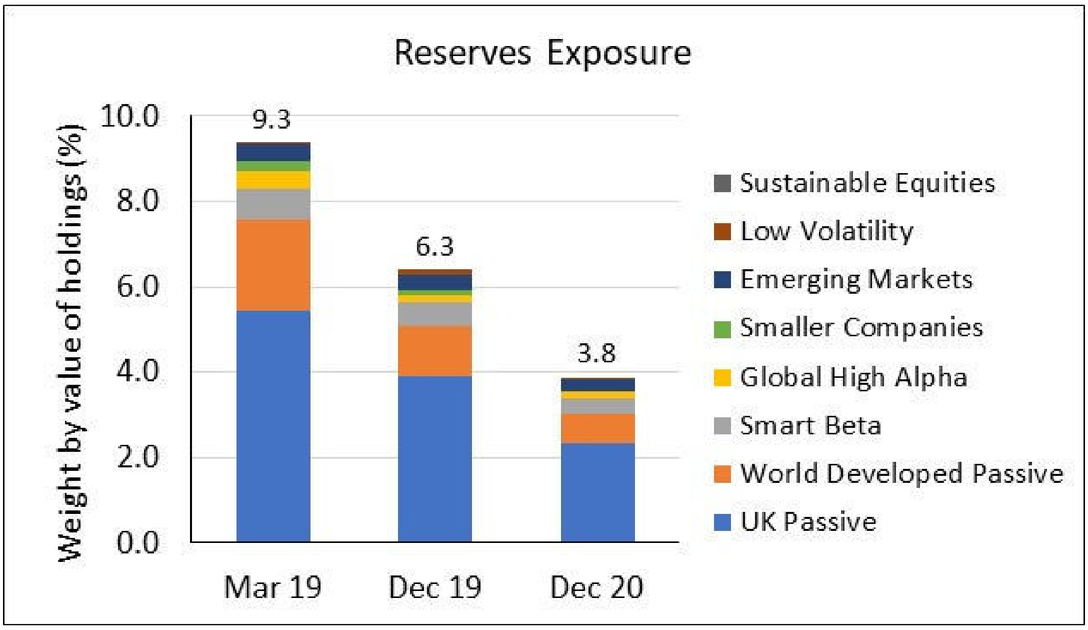
2.2 Passive investment has the following advantages:

- **Management costs are significantly lower**. Active managers will need to employ considerable resource in analysing companies and exercise significant skill in deciding which companies they should be invested in. A passive manager just buys everything in the index at the index weight, so less resource and skill is required. As a result the management fees for active funds can be 40-50 times higher than for passive funds.
- **Lower relative risk**. Investing in a passive fund will deliver a return equivalent to the return of the index. The return from an actively managed fund will depend on the level of skill exercised by the fund manager in selecting companies. If they perform well, they can achieve a better return than the comparable index, which justifies the additional management fees, but if they get it wrong, then they will deliver a lower return.

2.3 Therefore, the Fund has considered that there should be a balance between actively and passively managed funds to manage risk and management costs, while providing potential for out-performance.

2.4 However, because passive funds will invest in all the companies in the index, they will include exposure to companies that present a challenge from an environmental, social and governance (ESG) perspective. For example, Royal Dutch Shell and BP are among the largest companies in the FTSE All Share index, so the Devon Fund's investment in UK Passive Equities gives us significant exposure to those companies.

2.5 The UK market is a particular challenge, as oil and gas companies represent a higher proportion of the UK market than the global market. This is illustrated in the following chart showing the Fund's reserves exposure. The figures shown are on a value of holdings basis, which means the value of any company with fossil fuel reserves is included in full in the analysis, regardless of what proportion of their business relates to extraction.



2.6 While the chart shows good progress in reducing the Fund's reserves exposure, it also shows the impact of the UK Passive allocation which as at December 2020 comprised 17% of the total equity allocation but accounted for 62% of the reserves exposure.

2.7 While the reserves exposure of the World Developed Passive and Smart Beta Passive investments is less significant than the UK allocation, there will still be some degree of exposure within those funds. Looking at the wider carbon metrics, the Smart Beta has a higher Weighted Average Carbon Intensity (WACI) than the rest of the Fund's equity investments with the exception of the Active Emerging Markets allocation. The Smart Beta WACI of 419 tCO2e/mGBP compares with a WACI of 246 tCO2e/mGBP for the World Developed Passive allocation, largely as a result of a bias towards "value" style investments which tend to include more traditional industrial sector businesses rather than technology companies. This is also an issue to be noted.

2.8 The Devon Fund's policies in relation to stewardship and climate change include a significant commitment to engagement with companies, which will include those held through passive funds. Companies such as Royal Dutch Shell and BP are now setting emission reduction targets that do take account of downstream tier 3 emissions as part of their long term transition plans to diversify their business away from reliance on fossil fuels. This is a result of the significant engagement work lead by Climate Action 100+, supported by the Brunel Pension Partnership and the Local Authority Pension Fund Forum on behalf of the Devon Fund.

2.9 Nevertheless, the passive allocation will continue to provide significant exposure to "fossil fuel" companies in its current form.

3. Climate Transition and Paris Aligned Benchmarks

3.1 The Brunel Pension Partnership are seen as leaders in the investment world in their approach to climate change, and have recognised the issues involved with passive investment, whilst seeking to address climate change. There has been a lack of products within the market that would allow investors to invest passively whilst seeking to exclude significant exposure to fossil fuel reserves.

3.2 Brunel have therefore been working with FTSE Russell, who provide the indices that the Brunel passive funds managed by Legal and General Investment Management (LGIM) use, to develop new indices that are climate aware. The new benchmarks being developed are based on European Union Regulation 2016/1011 that established EU Climate Transition Benchmarks (CTB) and EU Paris-aligned Benchmarks (PAB) using methodology based on the commitments laid down in the Paris Agreement.

3.3 The key characteristics of these benchmarks are as follows:

CTB

- Minimum 30% reduction in both carbon reserves and operational emissions by 2030.
- 7% year on year reduction.
- Emissions relative to Base Universe must always stay below initial reduction threshold.
- Phasing in of Scope 3 emissions.
- Exclusion of any companies found or estimated by them or by external data providers to significantly harm one or more of the environmental objectives referred to in Article 9 of Regulation (EU) 2020/852 of the European Parliament & of the Council (8).
- Additional exclusions of controversial weapons manufacturers, tobacco producers (from December 2022) and UN Global Compact or OECD (Organisation for Economic Co-operation and Development) violations.

PAB

- Minimum 50% reduction in both carbon reserves and operational emissions by 2030.
- 7% year on year reduction.
- Emissions relative to Base Universe must always stay below initial reduction threshold.
- Phasing in of Scope 3 emissions.
- Exclusion of any companies found or estimated by them or by external data providers to significantly harm one or more of the environmental objectives referred to in Article 9 of Regulation (EU) 2020/852 of the European Parliament & of the Council (8).
- Exclusion of companies obtaining 1 % or more of revenues from exploration, mining, extraction, distribution or refining of hard coal & lignite.
- Exclusion of companies obtaining 10 % or more of revenues from the exploration, extraction, distribution or refining oil fuels, or 50 % or more of revenues from the exploration, extraction, manufacturing or distribution of hydrocarbons, hydrogen and carbon monoxide mixtures present in gaseous state.
- Exclusion of electricity producers with a carbon intensity of lifecycle GHG emissions greater than 100 gCO2e/kWh (50%+ revenues).

- Additional exclusions of controversial weapons manufacturers, tobacco producers (from December 2022) and UN Global Compact or OECD violations.

3.4 It is anticipated that LGIM will launch the new funds during the Autumn, and the option to invest in the funds will then be made available by Brunel. There will be both CTB and PAB versions for World Developed Passive, but only a CTB version of UK Passive as the nature of the UK market means that it would be difficult to apply the additional PAB metrics. The specifications of these portfolios are attached at Appendix 1 to this report.

3.5 These are new indices, so have no real past history, but they have been back-tested by modelling past data to estimate what funds tracking the new indices would have delivered if they had been in existence. The back testing has indicated that the new indices would have provided a similar, and for the most part marginally better, return compared to the traditional equivalent indices. Therefore, the expectation going forward would be that over the longer term the new funds should deliver returns at least as good as the funds tracking traditional indices.

4. The Way Forward

UK Passive

4.1 As set out in section 2 above, the UK Passive allocation has significant exposure to Royal Dutch Shell and BP in particular and also to other mining companies. The Committee may be satisfied that the significant engagement effort undertaken on the Fund’s behalf, in collaboration with other investors, has had a major impact on the business strategy of those companies, and that our influence as shareholders is pushing them in the right direction and helping to address the issue of climate change and the need for a global reduction in carbon emissions.

4.2 If, on the other hand, the Committee feels that we should reduce our exposure to fossil fuel reserves, and to Royal Dutch Shell and BP, then the Fund would need to disinvest from the current UK Passive Fund which includes that exposure. The Committee are therefore asked to consider whether they wish to switch the current investment in UK Passive Equities to the new UK Passive Climate Transition Benchmark (CTB) Fund when it is launched later in the Autumn.

4.3 The return generated by tracking the new benchmark is likely to differ from the FTSE All Share return, due to the high impact of sector concentrations in the UK market, but back-modelling of ten year performance relative to the FTSE All Share shows tighter tracking than would have been expected. The management fee is likely to be slightly higher than the current UK Passive Fund fee.

Smart Beta

4.4 The Committee are also asked to approve moving the current allocation to Smart Beta Passive to the World Developed Passive PAB Fund.

4.5 When the initial allocation to Smart Beta was made eight years ago, the objective was to invest in a factor based approach that had the potential to out-perform the market cap weighted index, but at a lower cost than active management. However, it is now proposed to move the allocation as:

- After a promising start, performance has lagged the market index over the last year, three year and five year periods and since the inception of the investment. Therefore, it has failed to meet its original objective.
- When the investment was made, it was in the context of a much larger passive allocation than the current asset allocation. With the current higher allocation to actively managed equities there is less need for the current factor based solution.
- The high WACI in comparison with the Fund's other equity investments means that disinvestment would contribute to achieving the Fund's carbon reduction targets.

World Developed Passive

4.6 It is suggested that the current allocation to World Developed Passive be maintained for the present. The reserves exposure and WACI of the World Developed Passive allocation are lower than for the other two passive investments, and therefore a lower priority to address. If the Smart Beta allocation is moved to the PAB benchmark fund, then it will allow the Committee to compare the performance of the PAB fund with the pure market cap weighted allocation which can then inform future decisions.

Mary Davis
County Treasurer

Electoral Divisions: All

Local Government Act 1972:
List of Background Papers: Nil
Contact for Enquiries: **Mark Gayler**
Tel No: **01392 383621** Room: **G97**

Appendix 1

EPD.CTB Passive Developed Equities Climate Transition

Portfolio Objective	To provide exposure to equity returns and the global economy with lower exposure to carbon emissions and fossil fuels, while still low cost and liquid, and aligning to the Paris Agreement
Performance Target (net of fees)	To match the performance of the benchmark.
Benchmark	FTSE Developed World **CTB** Index TR UKPD (i.e. excluding emerging markets).
Investment Strategy and key drivers	This portfolio is invested in global developed equities, predominantly those that are constituents of the underlying index. Climate change is significant long-term risk to investments. This portfolio seeks to mitigate this risk by investing in accordance with a Climate Transition Benchmark approach which, compared to its market cap equivalent, aims to: • Reduced exposure to carbon reserves and operational emissions by a minimum of **30%** and a further 7% year on year from 2020 • 100% Increase Green revenue exposures • Increased exposure to companies with good climate governance (those companies with a plan to align to the Paris Agreement) • Increased exposure to companies that are demonstrating their ability to be Paris aligned Exclusions will exist inline with the European Union Taxonomy definitions. They include exclusions of: • Controversial weapons • Tobacco Producers, • UN Global Compact or OEDC violations • Any companies found or estimated by them or by external data providers to significantly harm one or more of the environmental objectives under the "Do No Significant Harm" definition o Currently this includes Pure play Coal and Pure play Tar sands companies The index will have a zero active weight to high impact sectors in aggregate
Risk/Volatility	Relative/active risk: very low.
Liquidity	High: This portfolio is highly liquid, with assets able to be added/withdrawn at short notice.
Income	Income will be reinvested in the portfolio but will be accounted for separately. The portfolio will not be managed to provide income.

Investment Styles	Passive to the Index. The index over time may show tilts away from areas of the market (value, growth, Size etc) that are counter to the Paris aligned objectives vs the market cap weight index. This effect maybe less than the PAB index due to the CTB Index including companies that are transitioning.
Responsible Investment	In accordance with Brunel policy, with following specifics: • Robust process to identify carbon and fossil fuel data inputs • Transparency on assumptions and modelling used to support tilts • Continual review of methodology to ensure it is efficient, optimal and reflects best practice.
Reporting	In accordance with the Reporting and Monitoring Framework plus additional information to be provided by the index provider/manager: • Tracking against the benchmark over various periods • Disclosure of emission and stranded assets exposure and changes.
Securities Lending	Permitted in accordance with underlying fund policies

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EPD.PAB Passive Developed Equities Paris Aligned

Portfolio Objective	To provide exposure to equity returns and the global economy with lower exposure to carbon emissions and fossil fuels, while still low cost and liquid, and aligning to the Paris Agreement
Performance Target (net of fees)	To match the performance of the benchmark.
Benchmark	FTSE Developed World **PAB** Index TR UKPD (i.e. excluding emerging markets).

Investment Strategy and key drivers	This portfolio is invested in global developed equities, predominantly those that are constituents of the underlying index.
	Climate change is significant long-term risk to investments. This portfolio seeks to mitigate this risk by investing in accordance with a Paris Aligned Benchmark approach which, compared to its market cap equivalent, aims to:
	• Reduced exposure to carbon reserves and operational emissions by a minimum of **50%** and a further 7% year on year from 2020
	• 100% Increase Green revenue exposures
	• Increased exposure to companies with good climate governance (those companies with a plan to align to the Paris Agreement)
	• Increased exposure to companies that are demonstrating their ability to be Paris aligned
	Exclusions will exist in line with the European Union Taxonomy definitions. They include exclusions of:
	• Controversial weapons
	• Tobacco Producers,
	• UN Global Compact or OEDC violations
	• Companies with:
	    o 1 % or more of revenues from exploration, mining, extraction, distribution or refining of hard coal & lignite
	    o 10 % or more of revenues from the exploration, extraction, distribution or refining oil fuels
	    o 50 % or more of revenues from the exploration, extraction, manufacturing or distribution of hydrocarbons, hydrogen and carbon monoxide mixtures present in gaseous state
	• Electricity producers with carbon intensity of lifecycle GHG emissions greater than 100 gCO2e/kWh (50%+revenues)
	• Any companies found or estimated by them or by external data providers to significantly harm one or more of the environmental objectives under the “Do No Significant Harm” definition
	    o Currently this includes Pure play Coal and Pure play Tar sands companies
	The index will have a zero active weight to high impact sectors in aggregate

Risk/Volatility	Relative/active risk: very low.
Liquidity	High: This portfolio is highly liquid, with assets able to be added/withdrawn at short notice.
Income	Income will be reinvested in the portfolio but will be accounted for separately. The portfolio will not be managed to provide income.
Investment Styles	Passive to the Index. The index over time may show tilts away from areas of the market (value, growth, Size etc) that are counter to the Paris aligned objectives vs the market cap weight index.
Responsible Investment	In accordance with Brunel policy, with following specifics: • Robust process to identify carbon and fossil fuel data inputs • Transparency on assumptions and modelling used to support tilts • Continual review of methodology to ensure it is efficient, optimal and reflects best practice.
Reporting	In accordance with the Reporting and Monitoring Framework plus additional information to be provided by the index provider/manager: • Tracking against the benchmark over various periods • Disclosure of emission and stranded assets exposure and changes.
Securities Lending	Permitted in accordance with underlying fund policies

EPU.CTB Passive UK Equities Climate Transition

Portfolio Objective	To provide exposure to UK listed equity returns (excluding investment trusts) with lower exposure to carbon emissions and fossil fuels, while still low cost and liquid, and aligning to the Paris Agreement
Performance Target (net of fees)	To match the performance of the benchmark.
Benchmark	FTSE All Share x IT **CTB** Index
Investment Strategy and key drivers	This portfolio is invested in UK Listed equities, predominantly those that are constituents of the underlying index. Climate change is significant long-term risk to investments. This portfolio seeks to mitigate this risk by investing in accordance with a Climate Transition Benchmark approach which, compared to its market cap equivalent, aims to: • Reduced exposure to carbon reserves and operational emissions by a minimum of **30%** and a further 7% year on year from 2020 • 100% Increase Green revenue exposures • Increased exposure to companies with good climate governance (those companies with a plan to align to the Paris Agreement) • Increased exposure to companies that are demonstrating their ability to be Paris aligned Exclusions will exist inline with the European Union Taxonomy definitions. They include exclusions of: • Controversial weapons • Tobacco Producers, • UN Global Compact or OEDC violations • Any companies found or estimated by them or by external data providers to significantly harm one or more of the environmental objectives under the “Do No Significant Harm” definition o Currently this includes Pure play Coal and Pure play Tar sands companies The index will have a zero active weight to high impact sectors in aggregate
Risk/Volatility	Relative/active risk: very low.
Liquidity	High: This portfolio is highly liquid, with assets able to be added/withdrawn at short notice.
Income	Income will be reinvested in the portfolio but will be accounted for separately. The portfolio will not be managed to provide income.
Investment Styles	Passive to the Index. The index over time may show tilts away from areas of the market (value, growth, Size etc) that are counter to the Paris aligned objectives vs the market cap weight index.

Responsible Investment	In accordance with Brunel policy, with following specifics: • Robust process to identify carbon and fossil fuel data inputs • Transparency on assumptions and modelling used to support tilts • Continual review of methodology to ensure it is efficient, optimal and reflects best practice
Reporting	In accordance with the Reporting and Monitoring Framework plus additional information to be provided by the index provider/manager: • Tracking against the benchmark over various periods • Disclosure of emission and stranded assets exposure and changes.
Securities Lending	Permitted in accordance with underlying fund policies