INVESTMENT PORTFOLIO – CLIMATE CHANGE STRATEGY

Introduction

1. This report seeks endorsement of the Fund's initial Climate Change Strategy and approval for its publication. The Climate Change Strategy will consolidate the Fund's views, policies and approach to managing climate related investment risk into one document. It will also set out the Fund's priorities regarding engaging with companies and investment managers on this topic and set the Fund's initial climate change targets.

Recommendation

2. The Committee is asked to endorse the Fund's Climate Change strategy, including the proposed climate targets, and agree that it will be published on the Fund's website.

Background

3. In April 2020 the Fund published its revised Investment Strategy Statement which considerably strengthened the Fund's approach in respect of managing climate change related investment risk.

4. The Fund formally acknowledged that there is a significant risk from holding fossil fuel based and other high carbon footprint investment assets. These assets posed a particular risk in that markets could re-price them in response to growing public concerns over climate change and the response of policy makers to this concern. Therefore, the Fund proposed that it should adopt a precautionary approach to climate change investment risk and set out a programme of activity in order to identify, quantify and actively manage the potential risk.

5. The first step was to commission a climate risk assessment of the Fund's investment portfolio. The results of this assessment were presented to a joint meeting of the Pension Fund Committee/Local Pension Board on 17 July 2020. Members received a detailed presentation from LGPS Central (LGPSC) Ltd, which included the following key findings:

   - The Fund's equity portfolio (the one area where comprehensive carbon metrics data is available), has a carbon footprint (CO_2 emissions per $m of revenue generated) which is 30% below the general market as represented by the FTSE All World Index.
   - The Fund's equity portfolio has less exposure to companies with fossil fuel reserves and to those exploiting coal reserves than the general index.
   - The survey also revealed the Fund has more investments with companies who use clean technology than the general market.
   - The Fund's carbon footprint and other carbon metrics had improved since the Fund took the decision to invest over £500 million in a new LGPS Central climate factor fund in October 2019.
   - The report also considered the risk and return characteristics of the Cheshire Fund's investment portfolio under various climate scenarios including an

increase in global temperatures of 2, 3 and 4 degrees centigrade. Under all scenarios the review found there would be a minimal impact on the expected annual investment returns for the Fund projected to 2050.

- The review could not draw any firm conclusions regarding the carbon footprint of the Fund's bonds portfolio as the general poor availability of carbon metrics in this asset class hampers efforts to benchmark the Fund in this sector.

6. Following consideration by the Committee in September 2020, the Fund published a revised version of the Climate Risk Report, reformatted to comply with industry best practice as set out by the Taskforce on Climate Related Financial Disclosures (TCFD). To assist scheme members and members of the public, a summary key findings document was also published, and a media release issued to publicise the TCFD report and its key messages.

7. At the same September Committee, Members reviewed the full range of recommendations contained in the Climate Change Risk report and agreed a programme of work to implement all recommendations. One of the most important recommendations was for the Fund to produce and publish a Climate Strategy which will include a Climate Stewardship plan. This is now presented to the Committee for endorsement.

Cheshire Climate Strategy

8. The full draft Climate Strategy is included as an Appendix to this report. The Strategy includes a number of important policy statements, commitments and targets which Committee will want to consider:

    i) The Fund explicitly commits to support the Paris Climate Agreement, which seeks to limit increases in global temperatures below 2 degrees centigrade. By extension, the Fund expects all investee companies to align their business activities with the Paris Agreement.
    ii) The Fund accepts that climate change is a long-term material risk and therefore it is correct that the Fund consider it as an integral part of its statutory fiduciary duties.
    iii) Climate change may impact the Fund through asset pricing, life expectancy, employer covenants, long term inflation and interest rates.
    iv) The Fund believes that the transition to a low carbon world economy presents both risk and opportunities and therefore, the Fund will consider climate change as a part of all asset allocation, manager selection and individual investment decisions.
    v) The Fund intends to decarbonise its investment portfolio with the aim of being carbon neutral by 2050.
    vi) To support the long-term aim of net zero by 2050 the Fund will set specific shorter-term targets to lower the carbon footprint of its equity portfolio year on year compared to the general market.

9. In respect of setting climate change targets, the Investment Sub-Committee considered a number of options at its meeting on 13 November 2020.

10. A significant factor in these deliberations was the recognition of the paucity of reliable carbon data across many asset classes. This absence of data severely curtails the Fund's ability to set evidence-based climate change targets at total portfolio level i.e. across multiple asset classes.

11. Key principles which Members wished to adhere to when setting climate change targets included:

    - Any targets should be meaningful and measurable to be relevant;
    - Shorter term targets accompanied by plans to deliver were preferred as things are changing so rapidly in this area;
    - Targets should support forward momentum, and their implementation should not trigger forced redemptions;
    - The Fund should proceed with caution, not expeditiously, and fully consider any cost to the Fund in terms of potential lost income.

12. Following the discussion at Investment Sub-Committee, the following revised climate change targets are proposed for adoption by the Fund:

    i) **A commitment to reduce the carbon footprint of the Fund's equity portfolio by 7.6% per year**.
    This would ensure the Fund's equity portfolio is aligned with the recommendations of the United Nations Environment Programme's report (published November 2019), which stated that global greenhouse gas emissions must fall by 7.6% per year between 2020 and 2039 to deliver the Paris Climate target of reducing the rise in global temperatures to 1.5C. Proposals contained in agenda Item 9 , elsewhere on the agenda, will enable the Fund to deliver on this commitment for the next 3 years.

    ii) **A commitment to reduce the carbon footprint of the Fund's equity portfolio to a level 50% below that of the general equity market by the end of 2023**.
    As at end of December 2019 the Fund's equity portfolio was already 30% below the FTSE All World index so moving to 50% below will represent a significant change. Again, plans are included elsewhere on the agenda to enable the Fund to deliver on this commitment.

    iii) **The Fund will seek to invest an increasing proportion of total Fund assets in low carbon and sustainable assets**.
    The paucity of carbon emissions data across many asset classes makes it impossible to set a meaningful target for this commitment at present. The Fund will regularly review this with a view to setting a target once sufficient data is available.

13. The Fund believes that the above targets can be delivered without jeopardising its fiduciary duty to act in the best long-term financial interests of members and employers. However, when considering all investment decisions which are presented to the Committee with a view to reducing the Fund's carbon footprint, additional analysis will be presented to show, as far as possible, any likely positive or negative impact on investment returns. In this way, the Fund will be able to clearly demonstrate that it is acting in accordance with the requirements of the LGPS Investment Regulations.

14. The Climate Change strategy also includes a summarised version of the Fund's climate stewardship plan, setting out the engagement objectives that the Fund seeks to achieve. Key objectives include:

    - More regular and detailed reporting on carbon emissions by companies.
    - Transparency on funding and links to industry bodies that may work against the net zero objective.
    - Full alignment of business plans with the Paris Agreement with carbon reduction targets to demonstrate progress.

15. The engagement objectives are underpinned by the Fund's continuing belief that businesses are capable of transforming their business model to succeed in a low carbon economy and such a transition is more likely to happen with the support and engagement of committed and engaged responsible investors.

Conclusion and Next Steps

16. The publication of the Fund's first Climate Change Strategy represents an important landmark in the Fund's evolving approach to managing climate related investment risk. If the Committee endorse the draft strategy, then it will be finalised and published on the Fund's website before the end of December 2020.

17. In early 2021 the Fund will review its Investment Strategy Statement and Responsible Investment (RI) policy and incorporate the new Climate Strategy into the RI policy.

18. The Fund will continue to work to implement all remaining recommendations in its Climate Risk report and the Committee will receive regular progress report on all aspects of its climate related risk management approach.

Cheshire Pension Fund Climate Change Strategy

DRAFT AND PRE-DESIGN

Introduction

1. This Climate Change Strategy sets out the Cheshire Pension Fund's approach to managing the risks and opportunities to its investment portfolio from climate change.

2. The publication of a separate Climate Change Strategy reflects the Fund's view that there is a significant material risk from climate change to the value of the Fund's investment assets and this risk needs to be actively monitored and managed.

Climate Change Risk

3. Climate action failure is *the* stand-out, long-term risk the world faces in likelihood and impact according to the 2020 Global Risks Report from the World Economic Forum. If 'business as usual' continues, the world could heat up by about 5 degrees by 2100 which would cause profound societal damages and significant human harm. According to the Intergovernmental Panel on Climate Change (IPCC), greenhouse gas (GHG) emissions need to fall by 45% vs 2010 levels by 2030 in order to avoid the worst effects of climate change.

4. As a long-term asset owner, the Fund would like to see stable, well-functioning and sustainable markets which will foster long-term value creation and sustainable returns. Climate change cuts across industries, markets and economies and is a risk that cannot be fully diversified. How companies manage climate-related transition and physical risks and opportunities is highly likely to affect long-term profits and company returns. The Fund will endeavour to take a holistic approach to managing climate change risk and to act in a manner that will enable the broader transition towards a low-carbon economy through a combination of portfolio construction, engagement and policy advocacy.

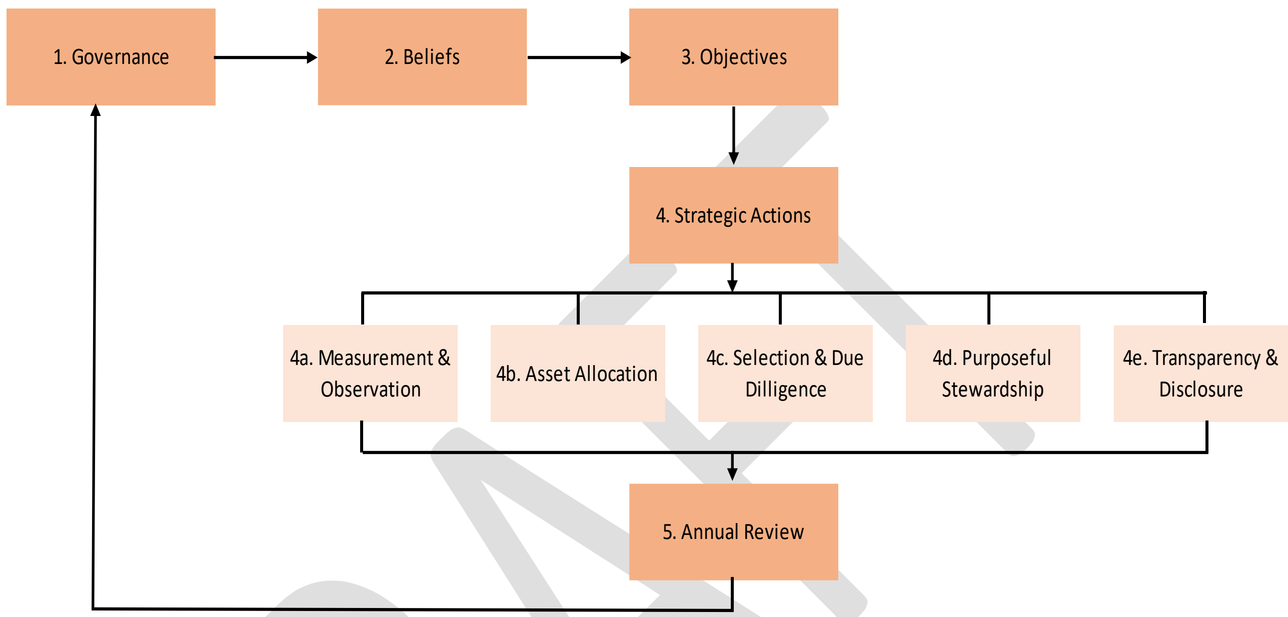
Governance of Climate Change Risk

5. The Pension Fund Committee is responsible for endorsing the Fund's policies and procedures including the Fund's *Climate Change Strategy.* Responsibility for the implementation of the Strategy is held by the Head of the Cheshire Pension Fund and the Finance and Investments Manager. The Pension Fund Committee will review the strategy on a bi-annual basis and agenda time will be scheduled twice a year for discussion of progress on the strategy.

6. The Fund is committed to providing decision-makers with appropriate training, including specialised training on climate change. The Investment Sub-Committee includes responsible investment (including climate change) as a standing item on the Investment Sub-Committee agendas, and investment managers' quarterly performance reports are required to include a specific briefing on responsible investment (including climate change as relevant).

7. As a primarily externally managed Fund, the implementation of much of the management of climate-related risk is delegated onwards to portfolio managers, with oversight from Fund officers. Where appropriate, the Fund's asset pooling company, LGPS Central Ltd, assists in assessing and managing climate-related risks.

Figure 2: Depiction of the Climate Change Strategy



Evidence-based beliefs related to climate change

8. The Fund believes that:

i) Climate change is a financially material risk for the Fund. It has the potential to impact our beneficiaries, employers and all our holdings across asset classes. Due consideration of climate risk falls within the scope of the Fund's fiduciary duty.

ii) There is overwhelming evidence that climate change is impacting the environment. This will have long-term consequences for our financial system. The Fund holds that the economic damages of climate change will outweigh the costs of precautionary mitigation.

iii) As a result of human activities, the world is warming at an unsustainable rate. Already the world is approximately 1°C warmer than pre-industrial levels. Unabated, such change would be devastating for our way of life.

iv) Climate change has the potential to impact the funding level of the Fund through impacts on employer covenant, asset pricing, and longer-term inflation, interest rates and life expectancy.

v) The Fund strongly supports the Paris Agreement on climate change.

vi) The Fund believes that a transition to a low-carbon economy is essential. This requires greenhouse gas emissions to decline to net-zero well before the end of this century. This will happen not only by focussing on the suppliers of energy but also, the demand for energy must undergo a major transformation.

vii) The Fund believes all companies should align their business activities with the Paris Agreement on climate change. It is possible for a high-emitting company to undergo this transformation and thrive in the transition to a low-carbon future.

viii) Investors have an important role to play in the transition to a low-carbon economy. The Fund believes the global economy will be less likely to realise a Paris-aligned energy transition were investors to cease influencing company behaviours.

ix) A global co-ordinated response is needed to limit the rise in temperatures. No individual investor is influential enough to act alone. Governments, policymakers, consumers, companies and investors all have a role to play. Acting in collaboration will increase the likelihood of an orderly transition to a low-carbon economy.

x) Climate-aware decisions can only be made with accurate, relevant, complete, and comparable data.

Objectives

Identify, understand and assess risks and opportunities

9. The Fund aims to utilise the best available information and tools to identify, understand and assess climate change risks and opportunities across regions and sectors that are material to our Fund. This includes both relevant climate-related transition and physical risks and opportunities likely to impact on the Fund's Investment Strategy and Funding Strategy.

Integration

10. The Fund intends to ensure that its investment portfolio; Funding Strategy and Employer Covenant Framework are resilient to climate change impacts.

11. To achieve climate change resilience, the Fund will ensure that material short, medium- and long-term climate change considerations play an integral part in the stewardship of our investment portfolio. This includes climate change integration in the selection and due diligence, and continuous monitoring of assets.

12. The Fund will seek to influence investee companies and fund managers through routine engagement and voting on climate change issues.

Climate solutions and decarbonisation

13. The Fund aims to promote the transition to a low carbon economy through identifying and investing in sustainable and low carbon products across all asset classes. The Fund will also aim to benefit from the opportunities posed by the transition to a low carbon economy.

14. To further support the low carbon transition, the Fund will continue to steadily decarbonise our listed equities portfolios.

Policy advocacy and transparency

15. The Fund will work alongside like-minded organisations to support the ambitions of the Paris Agreement. This includes advocating for Paris-aligned regulations and policies with governments, policy makers, the investment industry and other stakeholders.

16. The Fund will aim to be fully transparent with our stakeholders through regular public disclosure, aligned with best practice.

Strategic Actions

Measurement & Observation

17. The Fund recognises that methodologies for assessing investment related climate change risk are evolving rapidly and we will seek to use the best information available. The Fund will make regular measurements and observations on the climate-related risks and opportunities relating to investment performance. This will include:

    - Identification of the most material climate-related risks and opportunities relevant to the Fund;
    - Economic assessment of the Fund's asset allocation against plausible climate-related scenarios;
    - A carbon risk metrics assessment of the Fund's listed equities and fixed income assets. This includes the following metrics; Portfolio Carbon Footprint, Fossil Fuel Exposure, Carbon Risk Management and Clean Technology. The Fund aims to expand this type of analysis to other asset classes once reliable climate-related data becomes available.
    - Regular assessment of progress against the Fund's carbon reduction targets.

18. Recognising the deficiency of relevant, consistent and comparable climate-related financial data, the Fund will encourage disclosure and the adoption of the recommendations of the TCFD across our investment chain, including external managers and investee companies.

Asset Allocation and Targets

19. Where permitted by a credible evidence base, the Fund will integrate climate change factors into reviews of our asset allocation, subject to the requirements of the Investment Strategy statement (ISS) and Funding Strategy Statement (FSS). In light of this, the Fund will actively consider allocations to asset classes that improve our ability to meet our investment objectives.

20. In addition, the Fund believes that the setting of meaningful and measurable targets can be a meaningful aid to set, measure and demonstrate progress towards net zero. Therefore, as a result the Fund commits to:

- Reduce the carbon footprint (scope 1 and 2 emissions) [1] of the Fund's listed equities portfolio from its current 30% below the general market (the FTSE All World baseline) to 50% below by the end of 2023.
- The Fund will also reduce the carbon footprint of its listed equities portfolio by a minimum 7.6% each year. This would ensure the Fund's equity portfolio is aligned with the recommendations of the United Nations Environment Programme's report (published November 2019), which stated that global greenhouse gas emissions must fall by 7.6% per year between 2020 and 2039 to deliver the Paris Climate target of reducing the rise in global temperatures to 1.5C.
- The Fund will seek to invest in an increasing proportion of total Fund assets in low carbon and sustainable assets. The paucity of carbon emissions data across many asset classes makes it impossible to set a meaningful Fund wide target for this commitment at present. The Fund will regularly review this with a view to setting a target once sufficient data is available.

21. The Fund commits to review progress on delivering against these targets on an annual basis. The targets themselves will be regularly reviewed and the Fund expects to amend the targets as both the scope and quality of investment asset carbon data improves.

Selection, Due Diligence and Monitoring

22. When considering all new investment decisions, the Fund will assess the material climate-related risks and opportunities and the investment manager's approach to managing climate-related risks. Wherever possible, the Fund will fully assess the impact of all new investment decisions on the carbon footprint of the investment portfolio.

23. Appointed investment managers will be regularly monitored to ensure climate-related risk is fully integrated into the managers investment process. The Fund will also regularly monitor and review the managers climate-related engagement and voting activity.

Purposeful Stewardship

24. The Fund will develop an Annual Climate Stewardship Plan, which will set clear goals of engagement, particularly on Paris Alignment, with companies, fund managers, policymakers and other organisations of influence. It is clear that the transition to a low carbon economy will depend on policy intervention, changes in corporate behaviour and changes in technology. It is therefore critical that the Fund engages in these discussions to help shape the policy and business landscape. The Fund's engagement efforts are carried out through its asset pooling company LGPS Central Ltd and through other investment managers.

[1] Scope 1 Greenhouse Gas Emissions: Direct emissions from owner or sources controlled by the owner, including: on-campus combustion of fossil fuels; and mobile combustion of fossil fuels by institution-controlled vehicles. Scope 2 Greenhouse Gas Emissions: Indirect emissions from the generation of purchased energy

25. The Fund will use stewardship techniques to manage the risks and opportunities within our investment portfolio, focusing on the risks and opportunities of greatest magnitude. Engagement will be prioritised using the following criteria: perceived level of climate risk, considering carbon risk metrics; weight of the company in the portfolio; likelihood of achieving change; and ability to leverage investor partnerships. Climate related investment risk is not restricted to just companies in the energy sector; the Fund will therefore engage across all relevant sectors and on both the energy supply and demand side, including but not limited to fossil fuels, diversified energy, mining, cement, aviation and utilities.

26. The Fund will collaborate with like-minded investors where possible and be an active participant in selected collaborative initiatives that support the Fund's stewardship aims, such as the Climate Action 100+ (CA100+) engagement project. The objectives of this engagement activity with companies will be largely aligned with a Benchmark Framework launched by CA 100+ in September 2020. In line with this Framework, the Fund will ask companies to:

    i) Work toward providing disclosures consistent with the Framework enabling investors to assess a company's potential for long-term value creation;
    ii) Set an ambition to achieve net zero emissions by 2050 or sooner across all material GHG emissions, and establish short, medium, and long-term targets to support that ambition;
    iii) Work with investors on action plans to develop and implement net zero transition pathways toward achieving net zero emissions for specific sectors or value chains.

27. The Fund will make full use of its voting rights and will co-file or support climate-related shareholder resolutions where these align with the Fund's Climate Change Strategy.

Transparency & Disclosure

28. The Fund will prepare and publish a TCFD report annually, which will include our carbon risk metrics.

29. The Fund will disclose the stewardship reports of the Fund's key investment managers on a quarterly basis and report on progress against the Fund's Climate Stewardship Plan every year.

30. The Fund will report progress against its carbon footprint reduction targets every year.