Mersey's long horizon: why pension schemes can lead on climate change

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The long-term investment timeframe that pension schemes take poses enormous challenges but can also lead to innovative investment approaches to difficult issues. In this Q&A, Owen Thorne, portfolio manager, monitoring & responsible investment at the Merseyside Pension Fund (MPF) talks to Henry Odogwu and explains how the fund approached the climate change challenge.

How long has addressing climate change been an issue for the scheme?

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.

MPF stakeholders have been strongly supportive of the view that ESG factors are financially material and that their integration in investment strategy is consistent with fiduciary duty. But it's fair to say that the Paris Agreement was a turning point in terms of a realisation that action on climate change needed to be larger scale and targeted at both risk and opportunity. At that point, it was determined that the fund's Responsible Investment policy be brought into line with the goals of the Paris Agreement.

The direction of travel on responsible investing (RI) and environmental, social and governance (ESG) issues in UK and Western Europe is clear: regulators are acting. This affirms our view that urgent action on climate shaped by a policy response to Paris (however mixed) was a much more likely scenario than an ongoing business as usual scenario.

How did you address this investment challenge?

Paris was a strong factor in persuading us to undertake a strategic review of our exposure to climate-related financial risk; and to consider decarbonisation plans in mitigation. Throughout the process we consulted with a cross-section of internal and external stakeholders of the fund. It was clear to us that the global transition to a low-carbon economy and a more sustainable future was well underway, and seemed to be accelerating. It was also apparent that our approach should not compromise on our ability to deliver investment returns while managing climate change risk.

Because of that review, we allocated a third of passive equities in our £9 billion portfolio to a low carbon index-based strategy, with a tilt to a number of equity factors. The index achieves our targeted reduction in carbon emissions intensity and fossil fuels reserves, but also increases exposure to "green revenues", and over time we expect will generate a return in line with or ahead of the market.

Does climate change pose a problem for pension schemes like MPF, which operate with very long-term time horizons?

As a pension scheme open to new members, we are aware that those new members could be participating in the scheme for a long time, creating pensions liabilities 80 years into the future, which must be funded.

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We therefore must operate with a very long time horizon. For MPF, 2050 is not that far along in terms of our event horizon. And our existing liabilities to pay pensions to our members exceeds beyond the year 2100. That's how long-term we have to be in terms of looking at liabilities and risks, which of course include the systemic risk posed by climate change.

Do you hope other schemes will follow suit?

Many schemes are taking action and many trustees and scheme managers are now looking at their options. They have formed the view that "business as usual" as a course of action is not viable and may well prove incompatible with their fiduciary duty. Addressing climate risks in portfolios is becoming the norm in the sense that you would not consider an investment proposal that did not take a view of material risk of climate change.

As one of the larger pension schemes in the UK, MPF has consistently taken a progressive and collegiate role in active stewardship and engagement on ESG issues. As a result, we have been very open about how we are trying to position our passive strategy as a solution to a problem, and it's something we hope can shortcut the challenges for future users.

In that sense, we wanted to be a pioneer for other investors who were looking to address the same issues. We are saying that you do not have to accept the norm hitherto – you can have an approach that delivers the appropriate risk-adjusted return with the co-benefit of addressing climate risk in a forward-looking way. We do hope this will stimulate further action from investors.

Is this part of a wider movement towards more interest in climate change and in responsible investment in general?

It has been very gratifying to see the upsurge of interest from the public in terms of ideas around climate change and responsible investment. Investment products are aligning to individual investors' values and providing a real service to real people, and chiming with a demand from the public mood for authenticity from brands and institutions. It's pleasing to see this, and I think investment will need to become more reflective of beliefs and values of investors.