Agenda Item No. 4 (b)

DERBYSHIRE COUNTY COUNCIL

PENSIONS AND INVESTMENTS COMMITTEE

4 November 2020

Report of the Director of Finance & ICT

INVESTMENT STRATEGY STATEMENT, RESPONSIBLE INVESTMENT FRAMEWORK & CLIMATE STRATEGY CONSULTATION

1 Purpose of the Report

To advise the Pensions and Investments Committee (the Committee) of the outcome of consultation in respect of Derbyshire Pension Fund's revised Investment Strategy Statement (the ISS), and inaugural Responsible Investment Framework (RI Framework) and Climate Strategy.

To seek approval for the ISS attached as Appendix 1, the RI Framework attached as Appendix 2 and the Climate Strategy attached as Appendix 3.

2 Information and Analysis

The Consultation

The ISS, RI Framework and Climate Strategy were approved by Committee for consultation on 9 September 2020. The consultation process opened on 23 September 2020 and ran until 21 October 2020.

Derbyshire Pension Fund's (the Fund) stakeholders were asked for their comments on all of the above documents. The consultation narrative included:

- a brief description of the Fund and the Local Government Pension Scheme
- a high-level summary of each of the documents
- a link to the Committee's papers
- a signpost to the additional information included in the Frequently Asked Questions (FAQs)
- details of how to respond to the consultation

The proposed ISS, RI Framework and Climate Strategy, together with the FAQs, were attached to the consultation page.
In order to make stakeholders aware of the consultation, the Fund:

- sent letters to over 82,000 individual members of the Fund (many members have multiple memberships)
- signposted the consultation in a Bulletin emailed to over 300 Fund employers
- included a link to the consultation on the landing page of the Fund's website
- emailed members of Committee and members of the Pension Board to inform them that the consultation was live

The letter to members of the Fund included details of the forthcoming member self-service solution (including the required notice that Annual Benefit Statements will be available online next year); the consultation; and details of the McCloud remedy.

The deadline for providing comments on the consultation was extended, in early October, from 14 to 21 of October when it became apparent that the post was taking longer than usual to arrive due to the current pandemic. An email was sent to the Fund's employers notifying them of the extension and the news item on the Fund's website was updated accordingly.

Officers of the Fund also held a virtual meeting with representatives of Divest Derbyshire and Derbyshire Pensioners' Action Group to discuss the proposed Climate Strategy at their request. A survey carried out by representatives of these two groups was circulated to members of the Committee in July 2020. It was reported that a majority of respondents: had little knowledge about how their pensions are being invested; were concerned about investments being made in fossil fuel industries; wanted more say in how the Fund's money is invested; and wanted greater communication and consultation to take place between the Fund's managers and its members.

Derbyshire Pension Fund Consultation Comments
The Fund received 49 responses to the consultation from the following respondents:

Scheme Member	15
Scheme Member & Local Taxpayer/Local Resident	5
Scheme Member & Local Councillor	1
Local Taxpayer/Local Resident	8
Local Councillor	2
Scheme Employer	1
Local Group	2
Undisclosed	15
Total	**49**

The vast majority of responses related to the proposed Climate Strategy, with a small number of comments on the proposed ISS and RI Framework. The comments on the proposed ISS were largely related to climate risk, although the proposed increased allocation to infrastructure was welcomed by one respondent.

Five respondents welcomed the ability to provide comments via the consultation, however, eleven respondents either questioned whether the consultation was meaningful or said it too difficult to take part in. Three respondents suggested that a Citizens' Assembly would provide a more appropriate way of consulting with stakeholders.

Seven respondents suggested that the Fund should make investment decisions on an ethical basis rather than relying on a responsible investment approach to investment which aims to incorporate environmental, social and governance factors into investment decisions.

There were six respondents who said they don't believe that a strategy of engagement is effective and between them gave the following reasons:

- engagement is 'slow and complicated'
- there is no evidence of 'any multinational company changing its core business model in response to investor pressure'
- it is not the responsibility of the Pension Fund to 'shepherd oil majors into improving their ESG practices'
- the only influence the Pension Fund has is 'withdrawing your money'
- engagement has proved 'ineffective'

Forty respondents want the Fund to divest from fossil fuels investments on the basis that:

- there is financial risk due to the global transition to a more sustainable economic and environment model (including the risk of stranded assets)
- global oil demand 'is widely thought to have already peaked'
- fossil fuels are not a sustainable energy source
- 'renewables are now cheaper than fossil fuels in every major region in the world'
- 'carbon is causing the Climate Crisis'

Amber Valley Borough Council's response to the consultation reported that the Council had voted to support the following motion at its meeting on 30 September 2020:

'Having declared a Climate Emergency in July 2019, Amber Valley Borough Council calls for the Derbyshire Pension Fund to disinvest its remaining funds in fossil fuels and to invest in renewables.'

This follows similar motions from Chesterfield Borough Council, passed by full Council in July 2020, and from Derby City Council, passed by full Council in March 2018.

Thirty-two respondents think that the proposed targets for reducing the carbon footprint of the listed equity portfolio, investing in low carbon and sustainable investments and achieving a carbon neutral portfolio by 2050 are not ambitious enough.

Twenty-three respondents want to see a greater increase in the allocation to renewable investments, with seventeen respondents asking the Fund to invest at least 80% of the portfolio in low carbon and sustainable investments by the end of 2025.

Fourteen respondents want the Fund to achieve a portfolio of assets with net zero carbon emissions by 2030 on the basis that:

- the target of achieving net zero by 2050 'is not considered to be compatible with the Paris Agreement which requires a significant cut in emissions over the next ten years'
- a neighbouring administering authority of an LGPS fund has recently voted to achieve net zero by 2030
- many local authorities are now pledged to be carbon neutral by 2030

Fund Response to the Consultation Comments
The comments on the consultation process itself will be considered before the Fund next consults with its stakeholders. Some respondents welcomed the set of Frequently Attached Questions attached to the consultation. However, all suggestions for improving written communications to stakeholders will be considered.

Responsible investment is more compatible with the Fund's trustee-like responsibility to scheme members, scheme employers and local taxpayers than ethical investment which is based on beliefs about what is morally right and wrong.

Engagement is a slow process with few 'quick wins'. However, the Pension Fund is a long-term investor and takes a long-term approach to its stewardship activities. The evidence that collaborative engagement between like-minded investors is influencing company behaviours is starting to come through, particularly with a number of the companies, including some of the major oil companies, who are adapting their business models to take into account climate change. Influence is lost when an investor divests and there is a risk that ownership moves into the hands of less transparent and less accountable investors.

The Fund's investment managers will continue to assess the transition strategies of all investee companies as part of the assessment of the sustainability of companies' earnings.

Renewable opportunities are being assessed by the Fund on a continual basis and the increased allocation to low carbon and sustainable equities included in the revised ISS represents a major transition for the Pension Fund. At the same time, it is essential that the Fund takes into account the risks associated with renewable investments (technological, operational, political, regulatory) and that the Fund continues to invest in a well-diversified portfolio of assets.

Net zero aligned for a pension fund, is currently considered to mean implementing an investment strategy that is consistent with achieving the goal of global net zero emissions by 2050. This definition is from the Institutional Investors Group on Climate Change (IIGCC) which is the European membership body for investor collaboration on climate change, with 230 members (mainly pension funds and asset managers), across 16 countries, with over €30 trillion of assets under management.

Pension funds invest in a range of different countries and asset classes and rely on the actions of countries and companies to progressively transition to net zero. Further details on the meaning of net zero and the current targets for some of the major economies and major corporates, together with the asset class specific issues and challenges of achieving net zero, are set out in Appendix 4. A net zero target before 2050 is not currently achievable for the Fund alongside the Fund's risk and return objectives which aim to ensure that sufficient assets are available to meet benefit payments whilst keeping employer contribution rates as stable as possible.

It is recognised that climate change recognition by companies is constantly evolving and new approaches and practices are constantly emerging, therefore, it is proposed that targets for carbon footprint and low carbon and sustainable investment in the Climate Strategy will be reviewed in three years' time (rather than the five years proposed in the consultation), and will thereafter be reviewed on at least a three yearly basis' in recognition of evolving practice and concerns raised by stakeholders.

The proposed timetable also takes into consideration the rapidly evolving methodologies for assessing the impact of future climate-related scenarios, the ongoing evolution of countries' climate policies, the development of companies' climate-related disclosures, and the expected increase in the availability of suitable investment products.

3 Considerations

In preparing this report the relevance of the following factors has been considered: financial, legal and human rights, human resources, equality and diversity, health, environmental, transport, property, and prevention of crime and disorder.

4 Background Papers

Files held by the Head of Pension Fund.

5 Officer's Recommendations

That the Committee:

5.1 Notes the outcome of the consultation in respect of Derbyshire Pension Fund's revised Investment Strategy Statement, and inaugural Responsible Investment Framework and Climate Strategy.

5.2 Confirms that no changes to the revised Investment Strategy Statement are required based on the outcome of the consultation and approves the revised Investment Strategy Statement attached as Appendix 1.

5.3 Confirms that no changes to the Responsible Investment Framework are required based on the outcome of the consultation and approves the Responsible Investment Framework attached as Appendix 2.

5.2 Agrees that the Fund will review the carbon footprint of the listed equity portfolio together with the low carbon and sustainable investment targets on a triennial cycle from the date of approval of the Climate Strategy.

5.3 Approves the Climate Strategy attached as Appendix 3.

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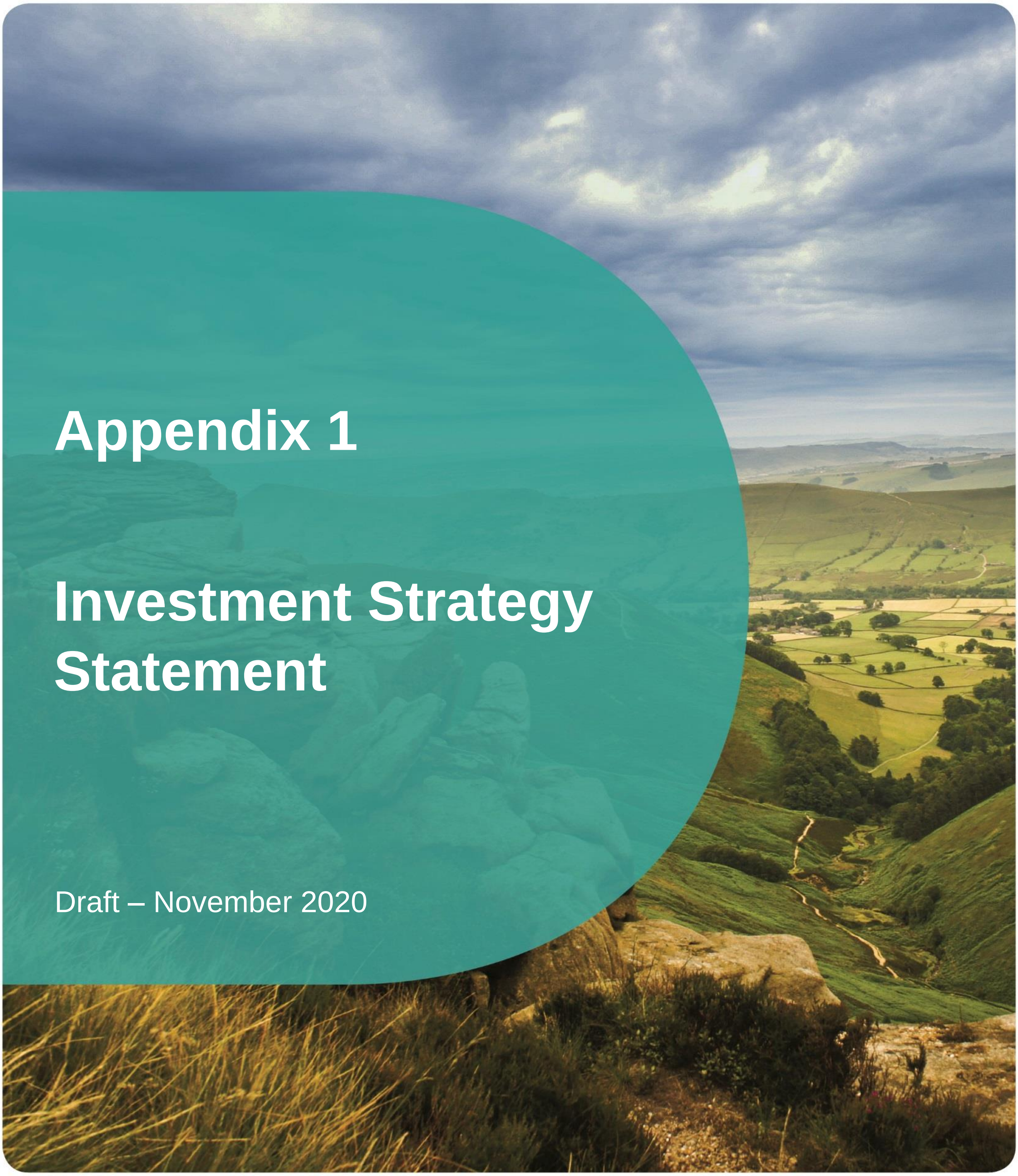

Appendix 1

Investment Strategy Statement

Draft – November 2020

County Hall, Matlock, Derbyshire, DE4 3AH
Administered by Derbyshire County Council

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Introduction

This is the Investment Strategy Statement (the ISS) of Derbyshire Pension Fund (the Fund), which is administered by Derbyshire County Council. The ISS is drawn up in compliance with Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (the Regulations) and has been prepared following consultation with such persons as Derbyshire County Council considered appropriate.

The ISS will be reviewed following any material change in the factors which are judged to have a bearing on the stated investment policy and at least every three years as required by the Regulations.

The primary objective of the Fund is to ensure that over the long term the Fund will be able to meet all benefit payments as and when they fall due. These payments will be met by contributions resulting from the funding strategy or asset returns and income resulting from the investment strategy. The funding and investment strategies are, therefore, inextricably linked; the Funding Strategy Statement can be found on the Fund's website at: [link]

Fund Governance

Derbyshire County Council is an administering authority for the Local Government Pension Scheme in accordance with Local Government Pension Scheme Regulations 2013. The Pensions and Investments Committee (the Committee) is responsible for discharging Derbyshire County Council's statutory function as the administering authority for the Fund.

The Committee is responsible for determining the Fund's investment policy, monitoring performance and overall stewardship of the Fund. Members of the Committee act in a similar manner to trustees and take advice from Anthony Fletcher, the Fund's Independent Adviser and from the Director of Finance & ICT and the Fund's in-house investment managers.

A proportion of the Fund's investments are managed on an active basis by the Fund's in-house Investment Team, and by LGPS Central Limited, a company established to manage investments on behalf of eight LGPS pension funds across the Midlands. Where the appropriate skills are not available internally, or through LGPS Central Limited, external managers are used.

In 2015, Derbyshire Pension Board was established to assist the administering authority to ensure the effective and efficient governance and administration of the Local Government Pension Scheme.

Full details of the Fund's governance arrangements, including the governance arrangements for the LGPS Central Pool, are contained in the Governance Policy and Compliance Statement which is published on the Fund's website: [link]

Investment Objectives

The Committee has agreed a long term investment strategy that aims to maximise the returns from investments within acceptable levels of risk, contributes to the Fund having sufficient assets to cover the accrued benefits, and enables employer contributions to be kept as stable as possible.

The investment strategy takes into account the following beliefs:

- A long term approach to investment will deliver better returns
- The long term nature of LGPS liabilities allows for a long term investment horizon
- Asset allocation is the most important factor in driving long term investment returns
- Liabilities influence the asset structure; funds exist to meet their obligations
- Risk premiums exist for certain investments; taking advantage of these can help to improve investment returns
- Markets can be inefficient, and mispriced for long periods of time; therefore there is a place for active and passive investment management
- Diversification across investments with low correlation improves the risk/return profile
- Secure and growing income streams underpin the ability to meet future liabilities
- Responsible investment can enhance long term investment performance
- Investment management costs should be minimized where possible but net investment returns after costs are the most important factor

Strategic Asset Allocation Benchmark

The Committee aims to balance risk and reward by apportioning the Fund's assets over a range of asset classes to achieve the Fund's goals, to manage risk and to match the investment horizons. The objective is to generate a return that is at least equal to the investment return assumed by the actuary in the actuarial valuation. The assumed investment return is used by the actuary to 'discount' the Fund's liabilities to a present day value. The actuarial valuation at 31 March 2019 was prepared on the basis of an investment return of **3.6%** over the next 20 years.

For the longer term, the assumed investment return beyond 20 years is expressed as a margin above long term 'risk free' interest rates. The margin represents the excess return that should be available to the Fund from investing in riskier assets (e.g. equities) and is known as the asset outperformance assumption (AOA).

At the 31 March 2019 valuation, the AOA was 1.8% over a long term UK bond yield of 1.5% giving a longer term investment assumption of **3.3%**. The 31 March 2016 valuation was prepared on the basis of a single discount rate of 4% (1.8% AOA & long term UK bond yield of 2.2%). The lower discount rates used for the March 2019 valuation reflects lower expected investment returns going forward.

The Strategic Asset Allocation Benchmark (the Benchmark) for the Fund has been formulated in consultation with Anthony Fletcher, following the completion of the 2019 triannual valuation conducted by Hymans Robertson, the Fund's actuary. The Benchmark takes into account the required level of return and an appropriate balance between generating long term investment returns and exposure to investment risk. The Benchmark includes a wide variety of asset classes, in order to diversify sources of risk and return, and equity allocations spread by geographic regions. It takes into account the future expected returns from the different asset classes, the historic levels of volatility of each asset class and the level of correlation between the asset classes.

The Fund's asset classes are allocated into three categories:

- Growth Assets: largely equities, plus other volatile higher return assets such as private equity
- Income Assets: assets which are designed to deliver an excess return, but with more stable return patterns than Growth Assets because income represents a large proportion of the total return of these assets
- Protection Assets: lower risk government or investment grade bonds, together with cash

The asset allocation of the Fund is reviewed on a quarterly basis, and tactical positions around the Benchmark are agreed by the Committee following advice from the Fund's in-house investment managers and the Fund's Independent Adviser.

The Fund's Final Benchmark, together with an Intermediate Benchmark designed to allow the Fund to manage the transition risk towards the Final Benchmark, is set out in the following table:

Asset Category	Intermediate Asset Allocation	Intermediate Permitted Range	Final Asset Allocation	Final Permitted Range	Performance Benchmark
Growth Assets	**56.0%**	**+/- 8%**	**55.0%**	**+/- 8%**	
Total Quoted Equities	*52.0%*	*+/- 8%*	*51.0%*	*+/- 8%*	
-UK Equities	14.0%	+/- 6%	12.0%	+/- 4%	FTSE All Share
-North America	6.0%	+/- 6%	-	-	FTSE World N America
-Europe	4.0%	+/- 4%	-	-	FTSE AW Developed Europe Ex-UK Net
-Japan	5.0%	+/- 2%	5.0%	+/- 2%	FTSE World Japan
-Pacific ex-Japan	2.0%	+/- 2%	-	-	FTSE All World Asia-Pacific ex Japan
-Emerging Markets	5.0%	+/- 2%	5.0%	+/- 2%	FTSE Emerging Markets
-Global Sustainable	16.0%	+/- 16%	29.0%	+/- 8%	FTSE All World
Private Equity	4.0%	+/- 2%	4.0%	+/- 2%	FTSE All Share + 1%
Income Assets	**24.0%**	**+/- 6%**	**25.0%**	**+/- 6%**	
Property	9.0%	+/- 3%	9.0%	+/- 3%	IPD UK Quarterly Property Index
Infrastructure	9.0%	+/- 3%	10.0%	+/- 3%	LIBOR 3m + 2%
Multi-Asset Credit	6.0%	+/- 2%	6.0%	+/- 2%	40% Libor 3m + 3% / 30% ICE BofA Global High Yield Index, GBP / 30% S&P & LSTA Leveraged Loan Index, GBP
Protection Assets	**20.0%**	**+/- 5%**	**20.0%**	**+/- 5%**	
Fixed Income	6.0%	+/- 2%	6.0%	+/- 2%	FTSE UK Gov Fixed All Stocks
Index Linked Bonds	6.0%	+/- 2%	6.0%	+/- 2%	FTSE UK I-L All Stocks
Global Non-Government Bonds	6.0%	+/- 2%	6.0%	+/- 2%	50% ICE GBP Non-Gilt Index (ex EM) / 50% ICE Global Corporate Index (ex GBP and EM), hedged to GBP Base
Cash	2.0%	0 - 8%	2.0%	0 - 8%	Sterling 7 Day LIBID
Total	**100.0%**		**100.0%**		

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The Intermediate Benchmark is expected to come into effect on 1 January 2021, with the Final Benchmark expected to come into effect on 1 January 2022 at the latest.

Asset Classes

All financial instruments are open to consideration by the Committee. The Fund currently invests in quoted and unquoted securities of UK and overseas markets, including equities, government and non-government bonds, multi-asset credit, property, infrastructure and cash, either directly or via pooled vehicles. Derivatives are used to hedge the currency exposure of the overseas government bond holdings. The use of derivatives may be extended further in the future for the purpose of efficient portfolio management or to hedge other specific risks. The introduction of any new financial instrument/asset class or any extended use of derivatives will only be considered by the Committee following the receipt of appropriate training and advice from suitably qualified persons.

Growth Assets

Equities

Equities are classed as growth assets with the potential to provide returns in excess of inflation from growth in both capital values and income. Reinvested income accounts for a large proportion of long term equity returns. As equity returns are linked to company revenues and profits, investing in equities increases exposure to volatility. Investors expect to be compensated for that volatility by higher returns.

Over the last 50 years, in the UK, equities have provided a real return (after inflation) of 5.3% pa, compared with a real return of 3.4% pa from long dated government bonds and 1.0% pa from cash. Over the last 20 years, the respective real returns were 1.8% pa, 3.1% pa and -0.3% pa. In the US, the real returns over the last 50 years were 6.1% pa from equities, 4.1% pa from 20 year government bonds and 0.7% pa from cash. US respective real returns over 20 years were 3.8% pa, 4.8% pa and -0.5% pa.[1] Despite the increasing correlation between the majority of developed equity markets, investing in selected different geographic regions still provides portfolio diversification and investing in emerging markets generally provides access to higher economic growth rates and exposure to different economic drivers of return.

[1] *Source: Barclays Equity Gilt Study 2020*

Private Equity

Private equity investment refers to investment in unquoted, privately owned companies. Investors expect to receive an illiquidity premium for investing in this asset class and target returns above those expected from publicly quoted equities. Returns from private equity primarily come from capital growth, rather than income when investments are exited (realised) following a period of business growth/transformation. Private equity offers access to a broader universe of companies than the publicly quoted space.

Income Assets

Property

Property investments have traditionally been split between three different sectors: office; retail and industrial. Increasingly within the asset management industry, exposure to niche sectors such as student accommodation and exposure to debt secured against property assets is also included within the property asset class. Returns from this asset class come from rental income and the change in market values. Rental income has accounted for a large proportion of total returns over the long term. Given the relative stability of rental income, which gives property bond like characteristics, the returns from property are generally expected to fall between the returns from equities and those from bonds.

Property investment can be carried out directly via the purchase of physical properties or indirectly via the purchase of pooled vehicles or property company shares. The majority of the Fund's property exposure is gained via direct investment; pooled vehicles are used to gain exposure to niche sectors and overseas assets. The Fund's exposure to property debt is currently contained within the allocation to corporate bonds.

Infrastructure

Infrastructure offers access to long term predictable cash flows, which are often linked to inflation. A low correlation to the business cycle and the other major asset classes provides diversification benefits and long investment horizons. The majority of the Fund's infrastructure investments are in developed European core assets (long term assets with regulated returns) and social PFI concessions (typically schools, hospitals and military accommodation).

Multi-Asset Credit

Multi-asset credit typically relates to sub-investment grade corporate bonds and includes private debt, high yield debt and asset-backed securities. Multi-Asset Credit offers a predictable income stream and a yield pick-up relative to sovereign bonds and investment grade corporate bonds reflecting the increased risk of default.

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Protection Assets

Sovereign & Corporate Bonds

Bonds offer predictable streams of income and predictable returns if held to maturity. They are held as stabilising assets to reduce volatility and to provide diversification. As pension funds mature they can be used to provide liquidity and to match liabilities as they fall due.

The Fund holds conventional fixed income, index-linked and investment grade corporate bonds. Index linked bonds are regarded as a particularly good match for pension fund liabilities. The majority of the Fund's government bond holdings are issued by the government of the United Kingdom; the currency exposure of any overseas sovereign bonds holdings is hedged to sterling.

Cash

Cash management for the Fund comprises cash held in the Fund's cash accounts (i.e. bank and money market funds) and cash held in the custodian's bank account in respect of segregated mandates.

The Fund holds cash to fulfil its daily liquidity requirements, and depending on market conditions, also as a protection asset. The Fund's cash balances are managed by Derbyshire County Council's Treasury Management Team in line with the Fund's annual Treasury Management Strategy.

Each of the Fund's segregated mandates has a cash account with the Fund's custodian. Cash in these accounts is held primarily for the investment managers' day to day liquidity requirements and fluctuates depending on trading activity and dividend income. Each segregated mandate includes a maximum cash limit.

Risk

The overall risk for the Fund is that its assets will be insufficient to meet its liabilities. The Funding Strategy Statement, which is drawn up following the triennial actuarial valuation of the Fund, sets out how any deficit in assets compared with liabilities is to be addressed.

Underlying the overall risk, the Fund is exposed to demographic risks, regulatory risks, governance risks and financial risks (including investment risk). The measures taken by the Fund to control these risks are included in the Funding Strategy Statement and are reviewed periodically by the Committee via the Fund's risk register. The primary investment risk is that the Fund fails to deliver the returns anticipated in the actuarial valuation over the long term. The Committee anticipates expected market returns on a prudent basis to reduce the risk of underperforming expectations.

It is important to note that the Fund is exposed to external, market driven, fluctuations in asset prices which affect the liabilities (liabilities are partially estimated with reference to government bond yields) as well as the valuation of the Fund's assets. Holding a proportion of the assets in government bonds helps to mitigate the effect of falling bond yields on the liabilities to a certain extent. Further measures taken to control/mitigate investment risks are set out in more detail below:

Concentration

The Committee manages the risk of exposure to a single asset class by holding different categories of investments (e.g. equities, bonds, property, alternatives and cash) and by holding a diversified equity portfolio, spread by both geography and market sectors. Each asset class is managed within an agreed permitted range to ensure that the Fund does not deviate too far away from the Benchmark, which has been designed to meet the required level of return with an appropriate level of exposure to risk, taking into consideration the level of correlation between the asset classes.

Volatility

The Benchmark contains a high proportion of equities with a commensurate high degree of volatility. The strong covenant of the major employing bodies enables the Committee to take a long term perspective and to access the forecast inflation plus returns from equities.

Performance

Investment managers are expected to outperform the individual asset class benchmarks detailed in the overall Strategic Asset Allocation Benchmark. The Fund's performance is measured by an independent provider and reported to the Committee on a quarterly basis. The Committee takes a long term approach to the evaluation of investment performance, but will take steps to address persistent underperformance.

Liquidity

Close attention is paid to the Fund's projected cash flows; the Fund is currently cash flow positive, in that annually there is an excess of cash paid into the Fund from contributions and investment income after pension benefits are paid out. The Fund expects to be cash flow positive for the short to medium term. Despite the growing proportion of illiquid investments in the Fund, a large proportion of the assets are held in liquid assets and can be realised quickly, in normal circumstances, in order for the Fund to pay its immediate liabilities.

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Currency
The Fund’s liabilities are denominated in sterling which means that investing in overseas assets exposes the Fund to a degree of currency risk. The Committee regards the currency exposure associated with investing in overseas equities as part of the return on the overseas equities; the currency exposure in repect of the Fund’s Income Assets and Protection Assets is hedged back to sterling.

Stock Lending
The Fund does not currently participate in any standalone stock-lending arrangements. As part of the LGPS Central pool, the funds managed by LGPS Central Limited do participate in stock-lending arrangements, and LGPS Central Limited has put controls are in place to protect the security of the Fund’s assets.

Custody
The risk of losing economic rights to the Fund’s assets is managed by the use of a global custodian for custody of the assets, regular scrutiny of the Fund’s providers, and the maintenance of independent investment accounting records.

LGPS Central Pool

Derbyshire Pension Fund is part of the LGPS Central Pool (the Pool) with the LGPS funds of Cheshire, Leicestershire, Nottinghamshire, Shropshire, Staffordshire, West Midlands and Worcestershire. The Pool has been established in accordance with Government requirements for the pooling of LGPS investment assets. Collective investment management offers the potential for substantial savings in investment management fees, increased opportunities for investor engagement and access to a shared pool of knowledge and expertise.

The eight administering authorities of the pension funds within the LGPS Central Pool are equal shareholders in LGPS Central Limited. LGPS Central Limited (the Company) has been established to manage investments on behalf of the Pool, and received authorization from the Financial Conduct Authority in January 2018. The Company launched its first sub-funds within an Authorised Contractual Scheme collective investment vehicle in April 2018, and has launched several additional sub-funds since that date.

The transition of the Fund’s assets into products offered by the Company is likely to take several years. In February 2019, the Fund transitioned its Non-Government Bond portfolio into the LGPS Central Global Active Investment Grade Corporate Bond Multi Manager Fund. LGPS Central Limited also provides the Fund with general advisory services in respect of the Fund’s Japanese and Asia-Pacific Ex-Japan Equity portfolios. Responsibility for determining the Strategic Asset Allocation Benchmark and the tactical quarterly asset allocation positions remains with the Fund.

Robust governance arrangements have been established both within the Company and within the wider Pool to ensure that the Company operates effectively and meets the objectives of the pension funds within the LGPS Central Pool.

A Joint Committee, set up in accordance with provisions of the Local Government Act 1972, provides oversight of the delivery of the objectives of the Pool, the delivery of client service, the delivery against the LGPS Central Pool business case and deals with common investor issues.

A Shareholders' Forum, comprising one shareholder representative from each of the participating administering authorities, oversees the operation and performance of LGPS Central Limited and represents the ownership rights and interests of the shareholding councils within the LGPS Central Pool.

To support the Joint Committee and the Shareholders' Forum, a Practitioners' Advisory Forum has been created, consisting of Officers from each of the shareholding councils within the Pool. This forum provides day-to-day oversight of the Operator, scrutinizing the delivery of products, investment performance and investment costs, monitoring customer service and the delivery of wider investor services, such as voting and responsible investment.

Responsible Investment

The Fund's approach to responsible investment, together with the management of climate-related risks and oppourtunities, are set out in the Fund's Responsible Investment Framework and Climate Strategy. Copies of the Fund's Responsible Investment Framework and Climate Strategy can be found on the Fund's website at [link]

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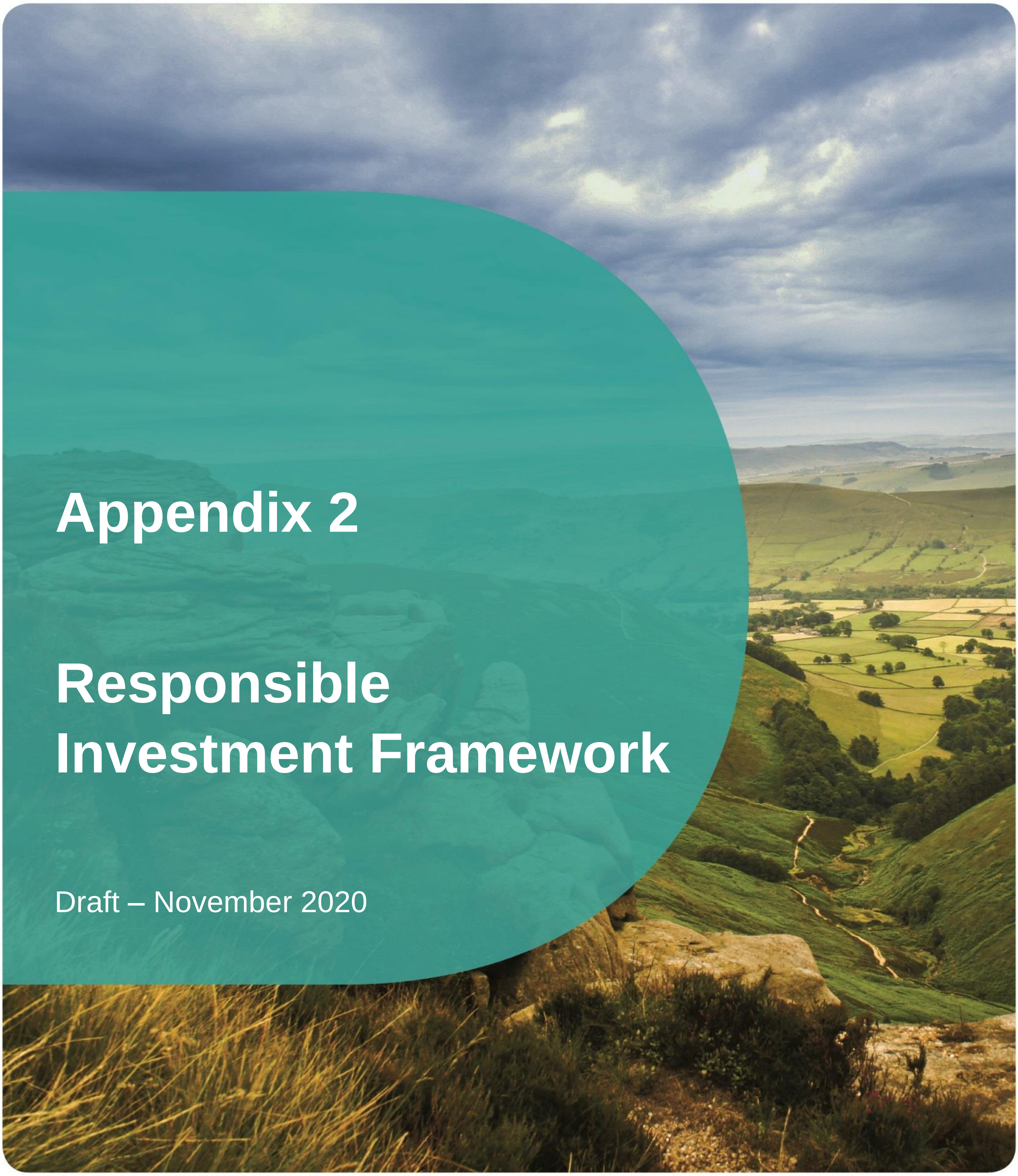


Appendix 2

Responsible Investment Framework

Draft – November 2020

County Hall, Matlock, Derbyshire, DE4 3AH
Administered by Derbyshire County Council

1. Introduction

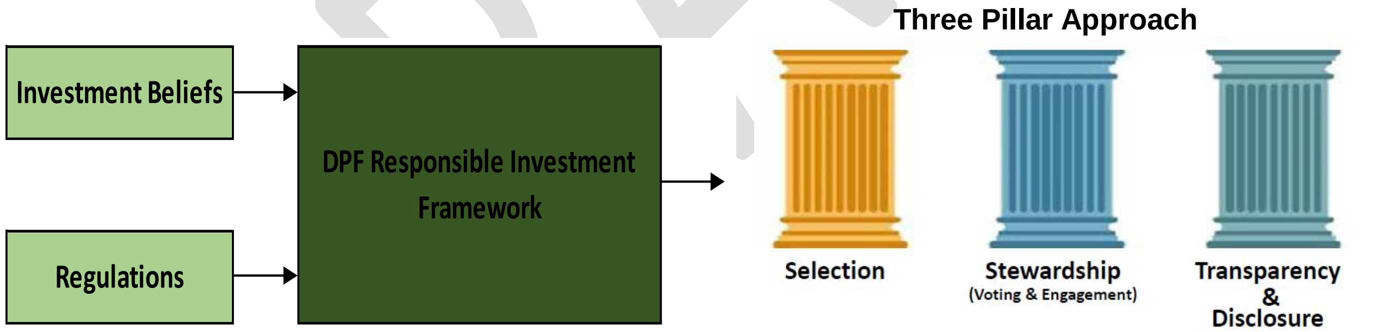
This Responsible Investment Framework (RI Framework) sets out Derbyshire Pension Fund's (the Fund) approach to responsible investment (RI) which includes the integration of environmental, social and governance (ESG) considerations into the investment process and Fund stewardship and governance activities.

The Pensions and Investments Committee (the Committee) is responsible for reviewing and approving the Fund's policies and strategies, including the RI Framework. The RI Framework works in tandem with the Fund's Climate Strategy, Investment Strategy Statement and Funding Strategy Statement aligning with the Fund's investment beliefs and fiduciary duty.

The Committee will review the Responsible Investment Framework at least every three years, or at such time as the Commiteee determines it is appropriate to review the Fund's approach to RI.

Responsibility for the implementation of the Framework resides with the Head of Pension Fund and the Investments Manager.

The Fund takes a three pillar approach to the implementation of Responsible Investment as set out below:



2. Responsible Investment

Responsible investment is an approach to investment that aims to incorporate ESG factors into investment decisions, to better manage risk and generate sustainable, long term returns.[1] It has relevance both during the selection of an investment and after an investment decision has been made, through on-going stewardship activity which covers considered voting and engagement with investee companies.

Responsible investment is a core part of the Fund's fiduciary duty. It is distinct from

[1] PRI Principles for Responsible Investment

'ethical investment', which is an approach to selecting investments on the basis of ethical beliefs (beliefs about what is morally right and wrong).

Effective management of financially material ESG risks should support the requirement to protect investment returns over the long term. The Fund's investment team seeks to understand relevant ESG factors alongside conventional financial considerations within the investment process, and the Fund's external investment managers are expected to do the same. Non-financial factors may be considered to the extent that they are not detrimental to the investment return.

ESG factors include:

Environmental	Social	Governance
Climate Change (including physical risk and transition risk)	Working Conditions (including slavery & child labour)	Executive Pay
Resource Depletion	Health & Safety	Bribery & Corruption
Waste & Pollution	Employee Relations	Board Diversity
Deforestation	Community Relations	Tax Strategy
		Political Lobbying
		Disclosure & Transparency

The Fund's Strategic Asset Allocation Benchmark includes an allocation to Global Sustainable Equities. Sustainable investment managers are regarded as managers who invest in companies with a long term approach to sustainability where the effective management of environmental, social and governance risks and opportunities is an integral part of the strategy to create a sustainable business. Companies with strong ESG business practices have the potential to create additional value for shareholders.

Within the Global Sustainable Equities allocation, the Fund will consider impact investment managers who invest in companies which aim to contribute to a more sustainable world, by seeking to effect positive social and enivironmental change, while generating investment returns.

The Committee recognizes its responsibility to act in the best interest of the Fund's employers and scheme members, whilst seeking to protect local tax payers and employers from unsustainable pension costs.

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3. Investment Beliefs

The Fund's investment beliefs as set out in the Fund's Investment Strategy Statement are as follows:

- A long term approach to investment will deliver better returns
- The long term nature of LGPS liabilities allows for a long term investment horizon
- Asset allocation is the most important factor in driving long term investment returns
- Liabilities influence the asset structure; funds exist to meet their obligations
- Risk premiums exist for certain investments; taking advantage of these can help to improve investment returns
- Markets can be inefficient, and mispriced for long periods of time; therefore there is a place for active and passive investment management
- Diversification across investments with low correlation improves the risk/return profile
- Secure and growing income streams underpin the ability to meet future liabilities
- Responsible investment can enhance long term investment performance
- Investment management costs should be minimized where possible but net investment returns after costs are the most important factor

4. Regulations & Statutory Guidance

The Responsible Investment Framework works in tandem with the Fund's Investment Strategy Statement. The Framework and Investment Strategy Statement have been developed in accordance with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016, statutory guidance, and best practice.

5. Engagement & Collaboration

The Fund adopts a strategy of engagement with companies to influence behaviour and enhance value, rather than adopting a divestment approach, believing that this is more compatible with the administering authority's fiduciary duties and supports responsible investment.

Engagement allows the Fund to use its influence as an active owner, with other like-minded investors, to improve ESG practices in investee companies, influence that would be lost through a divestment approach. It is recognised that change takes time, as a long term investor the Fund takes a long term approach to its stewardship activities.

6. Remuneration and Cost Management

Executive remuneration and investment management costs are important, particularly in low-return environments. Fee arrangements with fund managers and the remuneration policies of investee companies should be aligned with the Fund's long-term interests.

7. Climate Change

The Committee recognises that financial markets will be impacted by climate change and by the response of climate change policy makers. Risks and opportunities related to climate change are likely to be experienced across the whole of the Fund's portfolio. The current understanding of the potential risks posed by climate change, together with the development of climate- related measurements and disclosures, are still at an early stage, and there is considerable variability in the quality and comparability of carbon emission estimates. It is recognised that it will take time for companies to adapt to the changing regulatory and market positions.

Reflecting the potential material effect of climate change, and the response to change climate, on the assets and liabilities of the Fund, a separate Climate Strategy has been developed, a copy of which can be found on the Fund's website at [link]

8. LGPS Central Limited

The Fund is part of the LGPS Central Pool (the Pool) with the LGPS funds of Cheshire, Leicestershire, Nottinghamshire, Shropshire, Staffordshire, West Midlands and Worcestershire (the eight Partner Funds). The Pool has been established in accordance with Government requirements for the pooling of LGPS investment assets. LGPS Central Limited has been established to manage investments on behalf of the Pool, and received authorization from the Financial Conduct Authority in January 2018. The Company launched its first sub-funds within an Authorised Contractual Scheme collective investment vehicle in April 2018, and has launched several additional sub-funds since that date.

LGPS Central Limited has developed a Responsible Investment & Engagement Framework (LGPSC Framework) incorporating the investment beliefs and responsible investment beliefs of the eight Pension Funds within the LGPS Central Pool which will be applied to both internally and externally managed investment mandates. The LGPSC Framework contains the following beliefs:

- Long-termism: A long-term approach to investment will deliver better returns and the long-term nature of LGPS liabilities allows for a long-term investment horizon.
- Responsible Investment: Responsible Investment is supportive of risk adjusted returns over the long-term, across all asset classes. Responsible investment should be integrated into the investment process of the Company and its investment managers.

- Diversification, risk management and stewardship: Diversification across investments with low correlation improves the risk return profile. A strategy of engagement, rather than exclusion, is more compatible with fiduciary duty and more supportive of responsible investment, because the opportunity to influence companies through stewardship is waived in a divestment approach. Even well-diversified portfolios face systematic risk. Systematic risk can be mitigated over the long-term through widespread stewardship and industry participation.
- Corporate governance and cognitive diversity: Investee companies and asset managers with robust governance structures should be better positioned to handle the effects of shocks and stresses of future events. There is clear evidence showing that decision-making and performance are improved when company boards and investment teams are composed of cognitively diverse individuals.
- Fees and remuneration: The management fees of investment managers and the remuneration policies of investee companies are of significance for the Company's clients, particularly in a low-return environment. Fees and remuneration should be aligned with the long-term interests of our clients, and value for money is more important than the simple minimisation of costs.
- Risk and opportunity: Risk premia exist for certain investments; taking advantage of these can help to improve returns. There is risk, but also opportunity in holding companies that have weak governance of financially material ESG issues. Opportunities can be captured so long as they are aligned to the Company's objectives and strategy, and so long as there is a sufficient evidence base upon which to make an investment decision.
- Climate change: Financial markets could be materially impacted by climate change and by the response of climate policy makers. Responsible investors should proactively manage this risk factor through stewardship activities, using partnerships of like-minded investors where feasible.

In collaboration with the eight Partner Funds, LGPS Central Limited has identified four themes that will be given particular attention in its ongoing stewardship efforts. The four themes, which will be reviewed after three years, are: Climate change; Single-use plastics; Fair tax payment and tax transparency; and Technology and disruptive industries. The Partner Funds and LGPS Central Limited believe that identifying material core themes helps direct engagement and sends a clear signal to companies of the areas that the Partner Funds and LGPS Central Limited are likely to be concerned with during engagement meetings.

LGPS Central Limited also supports the Fund through the annual preparation of a Climate Risk Report which supports the Fund in the preparation of the Fund's Climate Related Disclosure Report prepared in alignment with the recommendations of the Taskforce on Climate-related Financial Disclosures.

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9. Implementation

The Fund aims to put its Responsible Investment Strategy into practice through actions both before (selection) and after the investment decision (stewardship).

As a largely externally-managed pension fund, the identification and assessment of RI factors is also the responsibility of individual investment managers appointed by the Fund.

The Fund aims to be transparent to its stakeholders through regular, high quality disclosure.

9.1 Selection

ESG factors are integrated into the Fund's investment decision making process where those factors are financially material within the context of the investment mandate. As part of the investment manager due diligence process, the Fund obtains a copy of the potential investment manager's RI or stewardship policies which sets out how RI factors are integrated into the investment manager's investment process.

9.2 Investment Manager Monitoring

Existing investment managers are monitored on a regular basis to review the integration of ESG risks into the portfolio management, and to understand their engagement activities.

9.3 Company Engagement and Engagement through Partnership

The Fund's strategy is to engage with its investee companies either on its own or through partnerships on a range of financially material ESG investment factors to protect and increase shareholder value. These partnerships include:

- The Local Authority Pension Fund Forum (LAPFF): a voluntary association of the majority of Local Authority pension funds based in the UK with combined assets of over £300bn. Membership of LAPFF provides the Fund with independent research and advice on RI risks of companies to inform further stakeholder engagement; advice on the governance practices of companies; and a forum to engage with companies to improve governance practices
- LGPS Central Limited: the Fund's pooled investment operator
- Hermes EOS: Hermes EOS is engaged by LGPS Central Limited to expand the scope of its engagement programme, especially to reach non-UK companies

The Fund will develop an Annual Responsible Investment Stewardship Plan, and hold constructive dialogue with investee companies on RI issues (either on its own or through partnerships), and where practicable, participate in the development of public policy on RI issues.

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9.4 Voting

The Fund places great importance on the exercise of voting rights. The Fund's voting policy covers the Fund's directly held investments in the United Kingdom and North America. The Committee has appointed Institutional Shareholder Services (ISS), a specialist third party voting service provider to make recommendations on casting votes in respect of the Fund's directly held UK listed investments. Voting is carried out in line with recommendations from ISS, whose voting principles cover four key tenets on: accountability; stewardship; independence; and transparency. The Fund also periodically receives voting alerts from the LAPFF on certain resolutions. If the voting alert from the LAPFF conflicts with the voting service recommendation, due consideration is given to all the arguments before the vote is cast.

The Fund has appointed Wellington Management (Wellington) in a discretionary capacity to manage its directly held North American investments, including voting in line with local practice. Wellington have policies and procedures to ensure that they collect and analyse all relevant information for each meeting, applying their proxy voting guidelines accurately and executing votes in a timely manner.

A significant proportion of the Fund's assets are managed through pooled products, where the voting activity is carried out by external investment managers. These principally relate to funds managed Legal & General Investment Management (LGIM).

Voting activity is carried out in accordance with LGIM's voting policy, and is based on a set of corporate governance principles. Previous engagement with an investee company also determines the manner in which voting decisions are made and cast. Voting activity is combined with direct engagement with the investee company to ensure that the investee company fully understands any issues and concerns that LGIM may have and to encourage improvement. LGIM utilises the voting invormation services of ISS and Institutional Voting Information Services (IVIS) to conduct thorough analysis and research on investee companies.

The Fund expects an increasing proportion of its assets to be managed by LGPS Central Limited going forward, as assets are transitioned into its pooled products. LGPS Central Limited's Responsible Investment & Engagement Framework will be applied to both internally and externally managed investment mandates.

Copies of LGIM's and LGPS Central Limited's Stewardship Reports are presented to the Committee on a quarterly basis.

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9.5 UK Stewardship Code

The Fund is a Tier 1 signatory to the Financial Reporting Council's (FRC) UK Stewardship Code 2012. A copy of the Fund's statement of compliance with the code can be found on the Fund's website at: FRC

The UK Stewardship Code has recently been updated (2020 Code); the updated code came into effect on 1 January 2020. The 2020 Code consists of 12 Principles for Asset Managers and Asset Owners, with a focus on the activities and outcomes of stewardship, not just policy statements.

Organisations that want to become signatories to the 2020 Code will be required to produce an annual Stewardship Report explaining how they have applied the 2020 Code in the previous twelve months. To be included in the first list of signatories, organisations must submit a final report to the FRC by 31 March 2021. The Fund intends to fully comply with the 2020 Code.

10. Transparency and Disclosure

The Fund aims to keep its stakeholders aware of RI activities through:

- Making its Responsible Investment Framework, together with the supporting Climate Strategy, public documents
- Reporting to Committee on the stewardship activities (including voting decisions) of the Fund's principle investment managers on a quarterly basis
- Providing a summary of the Fund's RI activities in the annual report
- Reporting annually using the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD)
- Reporting on progress against the RI Stewardship engagement goals every two years

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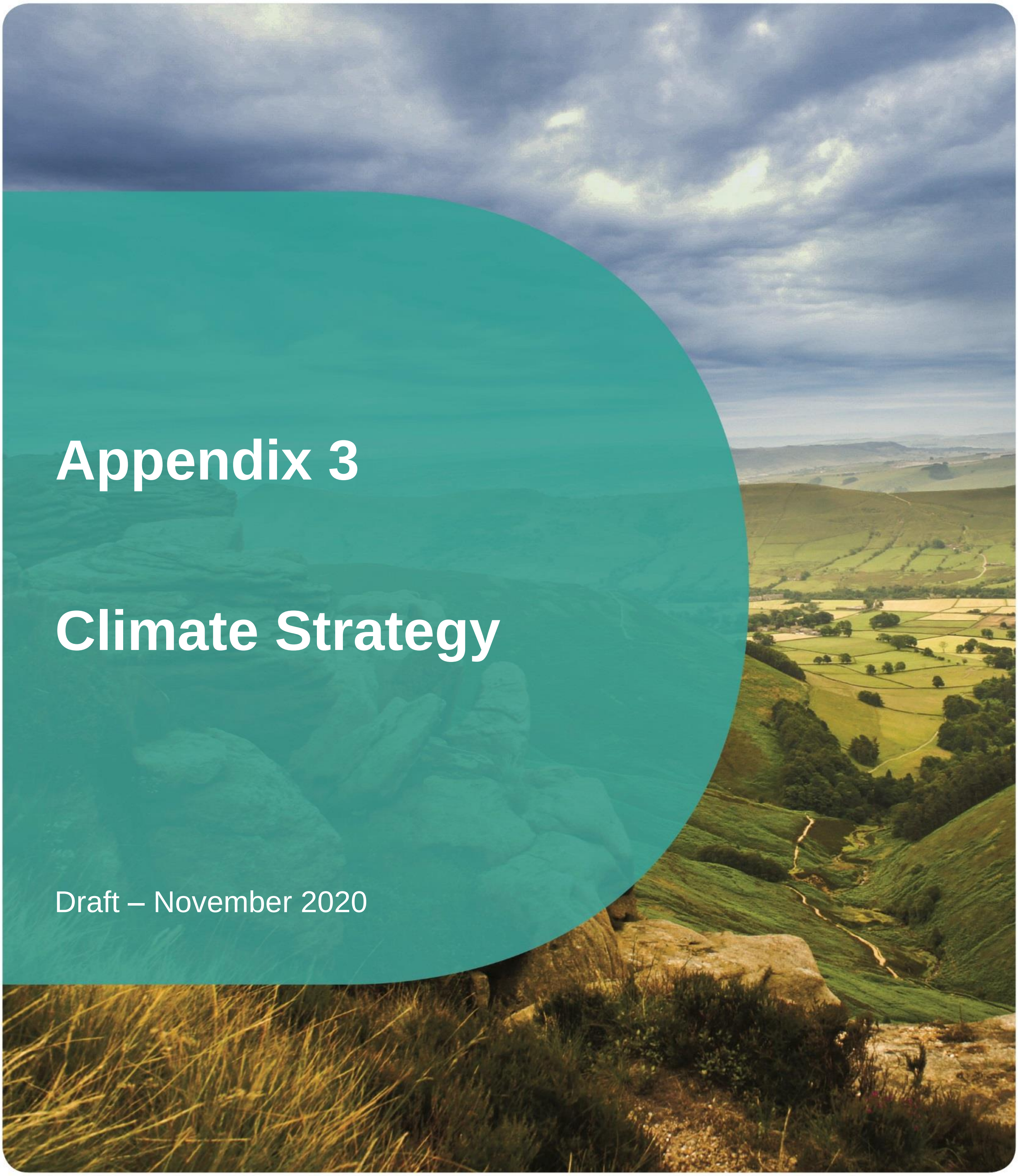

Appendix 3

Climate Strategy

Draft – November 2020

County Hall, Matlock, Derbyshire, DE4 3AH
Administered by Derbyshire County Council

1. Introduction

This Climate Strategy sets out Derbyshire Pension Fund's (the Fund) approach to addressing the risks and opportunities related to climate change.

The Fund supports the ambitions of the Paris Agreement[1] and aims to achieve a portfolio of assets with net zero carbon emissions by 2050.

The Pensions and Investments Committee (the Committee) is responsible for reviewing and approving the Fund's policies and strategies, including the Climate Strategy. The Climate Strategy works in tandem with the Fund's Responsible Investment Framework, Investment Strategy Statement and Funding Strategy Statement.

The development of a separate Climate Strategy reflects the potential material effect of climate change, and the response to climate change, on the assets and liabilities of the Fund.

The Committee will review the Climate Strategy at least every three years, or at such time as the Committee determines it is appropriate to review the Fund's approach to addressing the risks and opportunities related to climate change.

Responsibility for the identification and management of climate-related risks, together with the implementation of the Fund's Climate Strategy, resides with the Head of Pension Fund and the Investments Manager.

2. Climate Change

Human activities are estimated to have caused approximately 1.0°C of global warming above pre-industrial levels. Most of this warming has occurred in the last 35 years, with the five warmest years on record taking place since 2010. The observed global mean surface temperature has risen from around 1950 onwards. Over 97% of climate scientists (Source: NASA) agree that this trend is the result of greenhouse gas (GHG) emissions which are being trapped in the atmosphere and creating a 'greenhouse effect' – a warming that occurs when the atmosphere blocks heat radiating from Earth towards space. These climate scientists have observed that these climactic changes are primarily the result of human activities including electricity and heat production, agriculture and land use change, industry, and transport.

This is causing more frequent and more extreme weather events and world governments have started to respond. The signatories to the 2015 Paris Agreement committed to keeping the global temperature rise this century to well below 2.0°C compared with pre-industrial levels and to aiming to limit the increase to 1.5°C (Article 2(1)a). The Paris Agreement commits signatories to the establishment of Nationally Determined

[1] Paris Agreement – To hold the increase in the global temperature to well below 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5°C above pre-industrial levels – ratified by 189 parties.

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Contributions (NDCs), which are intended to be individually equitable and collectively sufficient to achieve Article 2(1)a. It is estimated that under current global policies (and assuming successful implementation), the world is heading towards a warming of 3.2°C.

The low-carbon transition is already underway, with a number of governments and institutions around the world intensifying their climate change policies, and corporates responding in turn.

Investors are exposed globally to the risks and opportunities presented by climate change adaption and mitigation. Investors have an important role to play in the transition to a low carbon economy, influencing company behaviours and encouraging the development of better climate-related disclosures. However, investors cannot effect material change alone. Governments, policy makers, consumers, companies and investors all have a role to play in the transition to a low carbon economy.

If policy and corporate action does not progressively transition towards the net zero goal, it will be extremely challenging for investors to achieve a portfolio of assets that has net zero emissions in 2050.

The Fund recognises that:

- Human activities have caused a change in the earth's climate which presents material risks to human and eco-systems and to global economies
- A global co-ordinated policy response and a change in consumer behaviour will be required to limit the damaging rise in global temperatures
- Climate change is a long term financial material risk for the Fund, across all asset classes, and 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

The Fund believes that:

- The risks and opportunities of climate change should be considered as part of asset allocation decisions, manager selection decisions and individual investment decisions
- Diversification across asset classes, regions and sectors is an important risk management tool to reduce climate-related risks
- In order to fully integrate climate-related risk into the Fund's investment processes, the consistency, comparability and quality of climate-related data, including the identification and measurement of companies' Scope 3 emissions will need to improve
- The low-carbon transition is already underway, but the pathway is unclear, and the transition will not occur by focussing only on the suppliers of energy; the demand for energy must also be addressed

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- It is possible for a company to shift its business model in order to trive in the transition to a low carbon future; such a shift is more likely with the support and stewardship of responsible investors

3. Climate-related Objectives

The Fund aims to have access to the best possible information available on the risk and opportunities presented by climate change. This includes impacts to the Fund's investment strategy, or funding strategy, as a result of transition risks, physical risks and opportunities.

The Fund aims to ensure that its investment portfolio will be as resilient as possible to climate-related risks over the short, medium and long term. For an effective first line of defence, the Fund aims to integrate climate-related factors into the investment process, including the selection of investment managers.

The Fund intends to decarbonise its portfolio through its selection of investments and investment managers, with the aim of being carbon neutral by 2050.

4. Collaboration and Transparency

The Fund aims to collaborate with like-minded organisations to support the ambitions of climate-related initiatives and aims to be fully transparent with its stakeholders through regular public disclosure, aligned with best practice.

- The Fund supports the Paris Agreement on Climate Change
- The Fund will actively participate in selected initiatives that lend support to the Fund's Climate Strategy, including working with other like-minded investors to engage with high-emitting companies
- The Fund supports the Taskforce on Climate-related Financial Disclosures (TCFD) and adopts its recommendations for the Fund's climate disclosures

5. Strategic Actions

5.1 Measurement & Observation

The Fund recognises that the tools and techniques for assessing climate-related risks in investment portfolios are an imperfect but evolving discipline. The Fund aims to use the best available information to assess climate-related threats to investment performance.

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The Fund will make regular measurements and observations on climate-related risks and opportunities relevant to the Fund. This will include:

- Identification of the most material climate-related risks to the Fund
- Economic assessment of the Fund's asset allocation against plausible climate-related scenarios
- A suite of carbon metrics for the Fund's listed equity portfolio to allow the Fund to assess progress in responding to climate-related risks and opportunities, including: carbon intensity; weight in companies with fossil fuel reserves; weight in companies with thermal coal reserves; and weight in companies with clean technology. A more complete analysis of all of the Fund's assets classes will be carried out when reliable carbon-related data becomes available for non-listed equity assets
- Assessment of progression against the Fund's carbon footprint and low carbon & sustainable investment targets

Methodologies for assessing the impact of future climate-related scenarios, including the possibility of measuring against alignment with the Paris Agreement, remain at an early stage of development, and the Fund will support efforts to develop more reliable and comparable methodologies.

The Fund recognises that there is currently significant variability in the relevance, consistency, comparability and quality of companies' climate-related disclosures. The Fund supports adoption, and encourages disclosure, in line with the recommendations of the TCFD.

5.2 Asset Allocation & Targets

Where there is a credible evidence base, the Fund will integrate climate-related factors into asset class reviews, subject to the requirements of the Investment Strategy Statement and Funding Strategy Statement.

The Fund believes that portfolio-wide 'top down' targets are an important means to set direction and appropriate ambition for an investment strategy towards net zero, and to monitor whether that strategy is achieving expected outcomes. However, a focus on just a single top down portfolio emissions reduction target can incentivise a shift of assets within a portfolio from high to already lower carbon assets and sectors, rather than driving additional 'real world' emissions reductions from increasing investments in climate solutions that contribute to the achievement of the net zero goal. As a result, the Fund will aim to:

- reduce the carbon footprint (Scope 1 & 2) of the Fund's listed equity portfolio by at least **30%** relative to the weighted benchmark in 2020 by the end of 2025; and
- invest at least **30%** of the Fund portfolio in low carbon & sustainable investments by the end of 2025.

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The Fund will review the carbon footprint and low carbon & sustainable investment targets three years after the introduction of this strategy, and thereafter on, at least, a three yearly basis. The Fund expects to see a material increase in the targets in the period to 2030, and in each subsequent period, on the journey to a carbon neutral portfolio, taking into account the contemporary development of carbon-related data metrics and availability of suitable products across all asset classes.

5.3 Manager Selection and Monitoring

The Fund will assess material climate-related risk and opportunities, alongside other relevant investment factors, as part of the investment manager selection process.

As a largely externally-managed pension fund, the identification and assessment of climate-related risks is also the responsibility of individual investment managers appointed by the Fund. Existing investment managers are monitored on a regular basis to review the integration of climate-related risks into the portfolio management, and to understand their engagement activities.

5.4 Stewardship

The Fund's annual Responsible Investment Stewardship Plan will include a section on climate-related stewardship plans. This will set clear goals of engagement with investee companies and investment managers to manage risks and opportunities within the Fund's investment portfolio, focusing on those risks and opportunities which will have the greatest impact.

The Fund will collaborate with other like-minded investors where possible and the Fund will participate in selected collaborative initiatives where these support the Fund's climate-related objectives.

The Fund will make full use of its voting rights and will co-file or support climate-related shareholder resolutions where these support the Fund's climate-related objectives.

6. Transparency & Disclosure

The Fund will:

- prepare a TCFD Report every two years
- report on the progression against the Fund's carbon footprint and low carbon & sustainable investment targets every two years
- report on a suite of carbon metrics in the Fund's annual report
- disclose the stewardship reports of the Fund's key investment managers on a quarterly basis
- report on progress against the RI Stewardship Plan engagement goals every two years

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Appendix 4

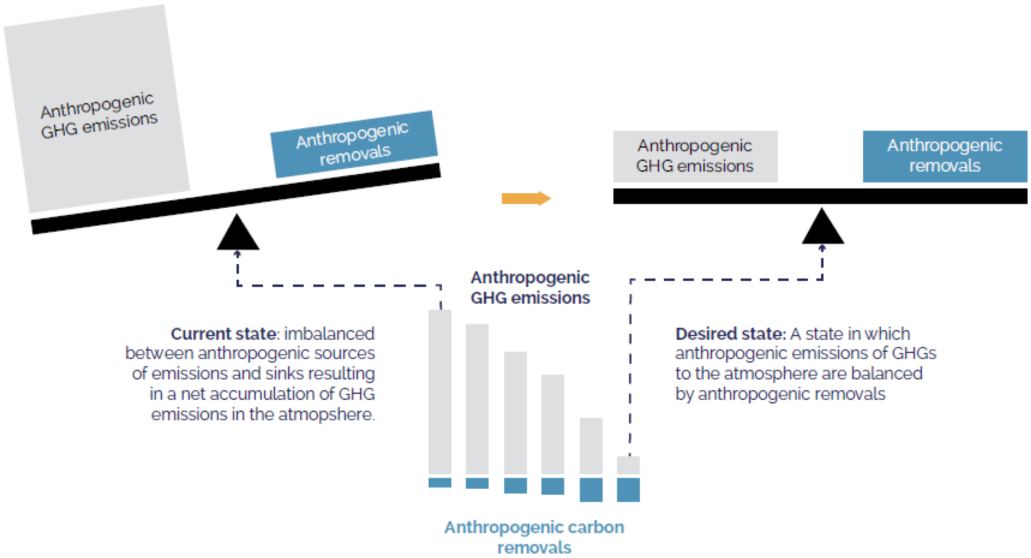
NET ZERO

Derbyshire Pension Fund's proposed Climate Strategy: The Fund supports the ambitions of the Paris Agreement and aims to achieve a portfolio of assets with net zero carbon emissions by 2050.

What does net zero mean?

The Intergovernmental Panel on Climate Change (IPCC) defines net zero as that point when 'anthropogenic emissions of greenhouse gases to the atmosphere are balanced by anthropogenic removals over a specified period'. (Anthropogenic – due to human activity.)

The Intergovernmental Panel on Climate Change (IPCC) is the United Nations body for assessing the science related to climate change.



Source: Science Based Targets Initiative September 2020

The Paris Agreement sets out the need to achieve this balance by the second half of this century.

The Paris Agreement

The Paris Agreement to substantially reduce global greenhouse gas emissions in order to limit the increase in the global temperature to well below 2^0C above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5^0C above pre-industrial levels has been ratified by 189 Parties (individual countries and the European Union).

Article 4 of The Paris Agreement states that to achieve this temperature goal, Parties aim to reach global peaking of greenhouse gas emissions (GHGs) as soon as possible, recognising peaking will take longer for developing country

Parties, so as to achieve a balance between anthropogenic emissions by source and removal by sinks of GHGs in the second half of the century.

Parties to the agreement are required to communicate their nationally determined contributions (NDCs) to cutting emissions every five years, with each successive NDC expected to represent ‘a progression beyond the previous one and reflect the highest possible ambition’.

Net Zero Commitments

The number of countries and companies committing to reach net zero emissions has increased rapidly over the last few years.

The Race to Zero campaign led by the High-Level Climate Action Champions (appointed following the United Nations Climate Change Conference – Conference of the Parties 21 - where the Paris Agreement was negotiated) estimates that almost **25%** of global CO_2 emissions and over **50%** of global GDP are covered by net zero commitments.

Net zero commitments include:

	Target Date
Economies	
China	2060
EU	2050
UK	2050
Companies	
Amazon	2040
BP	2050
British Telecom	2045
Shell	2050 or sooner
Tesco	2050
Unilever	2039

Measuring net zero

The goal of achieving net zero has been interpreted in a variety of ways. The Science Based Targets Initiative (SBTi) pioneers the use of climate science to guide corporate climate related ambitions. A recent report[1] developed by CDP (a company which runs a global environment disclosure system) for SBTi noted that corporate net zero targets to date differ across three important dimensions:

1. the range of emission sources and activities included
2. the timeline

[1] Foundations for Science -Based Net-Zero Target Setting in the Corporate Sector

3. how companies are planning to achieve their target

The report further noted that the three most common tactics in corporate net zero strategies are:

1. eliminating sources of emissions within the value chain of the company (i.e. a company's Scope 1, 2 and 3 emissions)
2. removing CO_2 from the atmosphere
3. compensating for value chain emissions by helping to reduce emissions outside of the value chain (e.g. direct investment in emission reduction activities and the purchase of carbon credits)

The following three guiding principles for corporate science-based net zero targets are proposed by the SBTi report:

- Reaching net zero emissions for a company involves achieving a state in which its value chain results in no net accumulation of carbon dioxide in the atmosphere and in no net-impact from other greenhouse gas emissions.
- In accordance with the best available science, the Paris Agreement and Sustainable Development Goals, companies should transition towards net zero in line with mitigation pathways that are consistent with limiting warming to 1.5^{o}C with no or limited overshoot.
- The mitigation strategy followed by the company should inform long-term strategies and investments that mitigate exposure to climate-related transition risks ensuring that the business model of the company will continue to be viable in a net zero economy.

Asset Owners

The **Institutional Investors Group on Climate Change (IIGCC)** is the European membership body for investor collaboration on climate change, with 230 members (mainly pension funds and asset managers), across 16 countries with over €30 trillion of assets under management. The mission of the IIGCC is to 'mobilise capital for the low carbon transition and to ensure resilience to the impacts of a changing climate by collaborating with business, policy makers and fellow investors'.

In May 2019, the IIGCC established the **Paris Aligned Investment Initiative (PAII)** to explore how investors can align their portfolios with the goals of the Paris Agreement, and to translate the Paris Agreement into a net zero framework for asset owners and asset managers, taking into consideration their different mandates and starting points.

The PAII notes that if policy and corporate action does not progressively transition towards the net zero goal, it will be extremely challenging for a large number of investors to achieve a portfolio of assets that has net zero emissions in 2050.

The **Net Zero Investment Framework (the Framework)** issued for consultation by the IIGCC in August 2020 provides recommended methodologies and actions which asset owners and asset managers should utilise to assess and undertake alignment of their portfolios towards net zero, in order to maximise their contribution to the decarbonisation of the real economy.

The PAII Net Zero Investment Framework considers that 'Paris aligned' investment means **implementing an investment strategy that is consistent with achieving the goal of global net zero emissions by 2050**.

The Framework states that delivering a net zero strategy should focus on achieving two alignment objectives:

- Decarbonising investment objectives in a way that is consistent with achieving global net zero greenhouse gas emissions by 2050.
- Increasing investment in climate solutions that are needed to meet that goal, such as renewable energy, low carbon buildings, and energy efficient technologies.

The Framework presents five components of a net zero investment strategy, setting out recommended approaches at the different levels of investment management, and for different asset classes.

COMPONENT	PURPOSE
Governance and Strategy	To set the overall commitment towards global net zero emissions, provide direction, and a basis for action. Monitoring and accountability for delivery of strategy and achievement of targets are also included.
Setting portfolio level objectives and targets	To set objectives and targets that: ▸ promote investor action that drives decarbonisation of assets ▸ increase investment in climate solutions ▸ define expected progress in emissions reduction and investment at the portfolio level, and measure achievement.
Strategic Asset Allocation (SAA)	To define an optimal asset allocation for the portfolio in order to help achieve alignment goals alongside standard risk/return objectives and other constraints, and specify the way in which asset allocation should be implemented – via choice of benchmarks and design of investment mandates – to achieve goals.
Asset class alignment: ▸ **Sovereign Bonds** ▸ **Listed Equity and Corporate Fixed Income** ▸ **Real Estate**	Assess the current and future potential alignment of assets to the global net zero goal, and their contribution to climate solutions, using relevant indicators and metrics. Incentivise assets to achieve decarbonisation and contribute to climate solutions, and thereby meet portfolio level targets, by: ▸ Using portfolio construction and investment decisions to increase capital allocation to more aligned assets and climate solutions, and withdraw investment from poor performing assets ▸ Using engagement, stewardship, and management to influence assets towards greater alignment
Advocacy and market engagement	To shift the policy environment to support decarbonisation and investment in climate solutions, and increase the ability of investors to take forward a net zero investment strategy. To encourage the market to provide the data, tools, and advice that underpins investors' investment strategy implementation.

The work done to develop the Framework has highlighted some of the challenges and complexities in managing a portfolio towards net zero and assessing alignment of assets. The Framework currently covers four major asset classes: sovereign bonds; listed equity; corporate fixed income; and real estate.

Further work will be undertaken in Phase II of the PAII to broaden the Framework to include two additional asset classes: infrastructure and private equity, and to address technical issues such as Scope 3 emissions and additional target methodologies.

Asset Classes
It is recognised that there are different issues to consider and different challenges to overcome in achieving net zero alignment within each asset class. Some of these issues/challenges are set out below for four of the main asset classes:

Sovereign Bonds

- It is not currently possible to assign carbon emissions to a sovereign bond, with the carbon intensity of a sovereign bond more reflective of the economy invested in and future carbon reduction targets of that country (e.g. UK Gilts and the UK Governments target to be net zero by 2050)
- The future carbon reduction targets of a specific country can be subject to rapid political and regulatory change
- Sovereign bonds are typically held for defensive purposes and focused on sovereign bonds with strong credit ratings in developed markets. As a result, there is a limited opportunity set for investors to use (e.g. UK Gilts, US Treasuries; German Bunds; Japanese Government Bonds)
- Increasing investor interest in green bonds (i.e. a bond that is specifically earmarked to raise money for climate and environmental projects typically by a multilateral development bank such as the World Bank or European Investment Bank) but there is a limited supply of these bonds and they may well have different risk profile and credit quality to a sovereign bond

Listed Equities

- Whilst listed equities are the most developed asset class in terms of measuring carbon emissions, measurement remains in its infancy, and there is a lack of complete and consistent carbon emission metrics, making robust and consistent benchmarking difficult
- The ability of corporate entities to transition to net zero is heavily reliant on global policy support and robust and consistent regulation
- Countries are moving at different speeds. For example, Emerging Markets account for an increasing share of global GPD but have higher emissions than developed markets and are expected to transition to net zero at a slower pace than developed markets. Investing in Emerging Markets

creates a trade-off between accessing potentially attractive investment returns and increased diversification but higher carbon emissions
- The majority of current disclosures are limited to Scope 1 & 2 emissions and exclude Scope 3 emissions which can be significant
- The current debate is focused on supply. The use of fossil fuels (including by-products) is embedded across the supply chains, production processes and sales channels of a significant proportion of the companies listed on the major global stock exchanges, and focusing solely on the energy producers is not addressing the demand side, which is equally as important
- It takes time for a business to property plan and execution a transition strategy and this is likely to vary significantly by business. Investors need to set realistic transition timescales and then monitor progression closely through collaborative and active engagement
- An increasing number of investors chasing 'green assets and sectors' increases the risk of pushing up the valuations to unsustainable levels
- Although renewable energy technology is developing quickly, renewable energy investments, together with related storage and transition assets, are exposed to technology and operational risks, and potential political and regulatory changes. Renewable energy assets should be held as part of a well-diversified investment portfolio but should not be viewed as risk free assets
- It is currently difficult to assess forward looking level of carbon-offsetting assets required to balance the portfolio to a net zero carbon position
- Demand for 'high quality' carbon offset assets (i.e. assurance that emissions exit, sustainable and are not double counted) is high and may outstrip supply, pushing up valuations and reduce overall investment returns
- Divestment from specified sectors and industries restricts the potential use of low-cost index funds
- The development of sustainable and low carbon products remains at a relatively early stage with some commentators highlighting the risk of 'greenwashing'. Early transitions into badly designed products is likely to result in duplicated transition costs
- LGPS investment pooling requirements potential limit the ability of individual LPGS pension funds to implement bespoke strategies and targets

Corporate Fixed Income

The majority of the issues/challenges for corporate fixed income are the same as those that apply to listed equities, however the measurement of carbon emissions data related to corporate fixed income is even more in its infancy than the measurement of carbon emissions data related to listed equities.

Real Estate

- The current lack of complete and consistent carbon efficiency & carbon reduction metrics, makes robust and consistent benchmarking difficult
- There is a risk of manager green washing and double counting of carbon emissions
- Measurement criteria can vary significantly. For example, should a property's emissions be based on the actual building or should it also take into account the tenants' upstream and downstream emissions (e.g. industrial units and big box distribution sheds)
- Refurbishment costs to improve the energy efficiency of an existing property portfolio may be high and lead to a dilution in the portfolio running yield
- The divestment of existing properties which fail to meet any future climate-related criteria may lead to book value losses, particularly at times of market illiquidity
- New builds are likely to have lower operating carbon emissions but often ignore significant emissions used during the development and construction phase
- Sector characteristics and carbon emissions need to be balanced against the need to maintain a geographically diversified portfolio spread across multiple sectors (e.g. offices; retain; industrial; alternatives; residential)
- An increasing number of investors chasing 'green properties and sectors' increases the risk of pushing up the valuations of these properties and sectors to unsustainable levels
- LGPS investment pooling requirements potentially limit the ability of individual LPGS pension funds to implement bespoke strategies and targets