COLUMBIA THREADNEEDLE INVESTMENTS

PENSIONS WATCH – ISSUE 18: WHAT'S BEEN HAPPENING AND WHAT'S ON THE HORIZON IN THE WORLD OF PENSIONS

Chris Wagstaff, Head of Pensions and Investment Education, Columbia Threadneedle Investments and Honorary Senior Visiting Fellow, Finance Faculty, Bayes Business School – City, University of London

As the world transitions to a less carbon-centric economy, in this edition of Pensions Watch we focus on the emerging best practice among those pension schemes and asset owner collaborations taking the lead in establishing a road map to net zero.

The increasingly central role of climate risk management[1]

Pensions Watch has long maintained that successfully running a pension scheme has increasingly become a complex exercise in risk management.[2] Central to this exercise and ever more critical to the success of scheme outcomes is managing the Environmental, Social and Governance (ESG) risk factors, particularly the potential physical and transition climate risks, attaching to a scheme's asset holdings.[3] After all, a failure to act more decisively in stemming the myriad sources of greenhouse gas (GHG) emissions, curtailing the financing of carbon emitting technologies and in seeking to change industry and individual company behaviours and business models, could result in a deeply impaired economic and financial system. This would, in turn, severely inhibit the ability of asset managers to generate and pension schemes to derive sustainable investment returns and expose schemes to unacceptably high and largely unmanageable risks.[4]

So how should pension fiduciaries seek to manage these climate risks and what can we learn from those schemes and asset owner collaborations taking the lead in establishing a road map to net zero, as the world transitions to a less carbon-centric economy?[5]

Learning from the leaders – a short case study

There are four levers by which to address climate risk and capture the associated opportunities – namely portfolio construction, manager and mandate selection, stewardship and advocacy. With that in mind, perhaps a good place to start is with the simple and transparent approach to climate change risk management adopted by NEST (National Employment Savings Trust), the defined contribution (DC) workplace pension master trust, set up by the UK government in 2010.[6] Managing over £12bn for more than 10m members (thereby representing one third of the UK workforce), NEST frames the rationale for its climate change risk management policy, not as an altruistic exercise, but as a means by which to safeguard the future of its pensions savers from a prospectively more austere and inhospitable

[1] This edition of Pensions Watch supplements editions 1, 7 and 16, which also consider aspects of climate change risk management and reporting on climate risk exposures. See: https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-november-2020/; https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-7/; and https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-16/.
For more on the climate challenges faced by pension funds and the potential solutions, see: There is no Planet B: Why climate change risk management is the world's hottest topic and how asset owners and asset managers should be responding. Chris Wagstaff. Columbia Threadneedle Investments. June 2020. See: https://www.columbiathreadneedle.co.uk/en/inst/insights/there-is-no-planet-b/

[2] Most textbooks characterise risk as the range of uncertainty surrounding an expectation about a future outcome. Others, the possibility that more things could happen than probably will happen. Indeed, as events rarely unfold in the way we initial expect, while others occasionally catch us off guard by seemingly surfacing from nowhere, it pays to expect the unexpected. Nowhere is this truer than within the world of pension scheme management. This is where the late Donald Rumsfeld's infamous 2002 quote comes in: "There are known, knowns. These are the things that we know. There are the known, unknowns… [the] things that we know we don't know. But there are also unknown, unknowns… the things we don't know we don't know." While ridiculed at the time, Former US Secretary of Defence, Rumsfeld was simply pointing out that while the sources of some risks – the known, unknowns – are known and might even be quantifiable, others – the unknown, unknowns – the bolts from the blue, or Black Swans, cannot always be anticipated, let alone quantified. As pension scheme management is littered with known, unknowns and unknown, unknowns, pension fiduciaries, must ensure that the uncertainties surrounding future outcomes are efficiently managed within acceptable tolerances.

[3] For a defined benefit pension scheme, this also extends to the impact on the sponsor covenant and the scheme's liabilities.

[4] An alarming, albeit slightly tangential, example of how climate change could turn the world upside down is provided by Bill Gates in his recently published book, *How to Avoid a Climate Disaster*, in which he writes: "During the age of the dinosaurs, when the average temperature was perhaps 4 degrees Celsius higher than it is today, there were crocodiles living above the Arctic Circle."

[5] Although perhaps stating the obvious, net zero means removing as much GHG emissions from the atmosphere as has been created. Of equal importance is for this transition to be a, so-called, just transition – that is, one that maintains full employment through training and reskilling and which transitions to a nature-positive world. The latter is expanded upon later in this paper.

[6] Unlike its master trust peers, Nest Corporation, the Trustee that runs the Nest scheme, is a public corporation, with its trustees chosen by the Secretary of State for Work and Pensions. It's accountable to Parliament through the Department for Work and Pensions but is generally independent of government in its day-to-day decisions.

world: one that could dramatically compromise risk-adjusted returns and therefore the size of members' pension pots. In so doing, NEST seeks to transition its assets to align with the Paris Agreement's +1.5°C global warming limit,[7] via a formal climate change policy which targets achieving net zero by 2050 latest. The multiple strands to its policy, which recognises climate change as both an unrewarded threat and as a potentially rewarded opportunity, comprise engaging with the businesses in which it invests to act sustainably; reducing investment in the biggest GHG polluters, while avoiding the most harmful fossil fuels; working to reduce the impact of climate change on nature and biodiversity; cutting ties with those asset managers that aren't aligned with the Paris Agreement; investing in renewables and green technology; and partnering with those asset owner collaborations which work collegiately to facilitate positive change.

NEST helpfully provides plenty of simple and highly relatable examples of how it's putting its policy into practice. For instance, owing to the lack of progress in managing their climate change risk, NEST recently divested its holdings in five energy companies, including Exxon Mobil. Additionally, it has given notice to those companies involved in arctic drilling, thermal coal or oil sands that it will divest by 2025, unless they plan to phase out these activities by 2030. Likewise, to encourage sustainability in the global food industry, against the backdrop of an exploding human population, NEST has joined the FAIRR Initiative, a global network of investors managing over USD23tn,[8] to push the big supermarkets away from intensive livestock production and other unsustainable industry practices. This highly relatable approach also extends to how NEST reports on the extent to which it has reduced the carbon footprint of its developed equities exposure, by citing the equivalent number of cars its climate policy has effectively taken off the road.[9] Moreover, to reinforce its 2050 commitment to net zero, NEST has recently introduced a new staging post to reduce carbon emissions by 30% in its equities and fixed income holdings by 2025, baselined against its 2019 portfolio.[10]

Many other, principally large defined benefit (DB), schemes have been enacting equally robust climate policies with similarly passionate verve, both within the private and public sector – the National Grid UK Pension Scheme, BT Pension Scheme (BTPS), and the Brunel Pensions Partnership pool of the UK Local Government Pension Scheme (LGPS) prominent amongst them.[11] However, the actions of two other LGPS funds shouldn't go unnoticed. One is the £2.5bn Clwyd Pension Fund which, having put the appropriate governance in place over the past 12 months to lay the groundwork for a progressive move into renewables, recently agreed a £50m investment to invest directly in Clean Energy projects in Wales. The other is the £3.5bn Worcestershire County Council Pension Fund which, in being an early adopter of the Stewardship Code 2020 and voluntarily publishing a climate-related disclosures report in line with TCFD recommendations,[12] has both mapped and begun aligning its entire asset portfolio to the UN's Sustainable Development Goals (SDGs).[13]

Are engagement and divestment mutually exclusive?

Of course, any discussion of climate change risk management wouldn't be complete without considering the long-running debate on engagement and divestment. Thankfully, the discussion is no longer a binary debate but one which is progressively moving towards the view that engagement and divestment are integral to one another and not mutually exclusive. Obviously, without engagement, company behaviours and business models are unlikely to change, at least not at the pace and quantum that is necessary for net zero to be achieved within the desired timescale. Indeed, all trust-based occupational pensions schemes are required to publish an annual implementation statement, which sets out how they've exercised their engagement strategy with investee companies over the course of

[7] Coming into force in November 2016, following its ratification by 146 countries, the Paris Agreement's central aim has been to strengthen the global response to the threat of climate change by keeping the global temperature rise this century *well below* 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5°C.
[8] The FAIRR Initiative is, a London-based, diverse and collaborative global investor network which, in focusing on ESG risks in the global food industry, provides cutting-edge research, best practice tools and collaborative engagement opportunities to help investors integrate these risks and opportunities, such as the rising popularity of non-dairy milks and plant-based alternatives to meat, into their investment decision-making and active stewardship processes.
[9] By end-2020, NEST's climate policy, applied since 2017 to its developed equity holdings, had effectively taken 236,561 cars off the road.
[10] NEST calls time on unresponsive energy companies. NEST press release. 21 December 2021.
[11] NEST, National Grid, BTPS and the Brunel Pensions Partnership are all signatories to the Paris Aligned Investment Initiative and have committed to drawing on the IIGCC Net Zero Investment Framework for their methodology. See: Signatories – Paris Aligned Investment Initiative. Also see footnote 32.
[12] The Task Force on Climate Related Disclosures (TCFD) framework was established by the Financial Stability Board with the goal of harmonising climate disclosures across the financial intermediation chain, including companies, banks, investors and pension funds. These disclosures are detailed in Pensions Watch – edition 7 (April 2021). See: https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-7/ and Pensions Watch edition 1 (November 2020). See: https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-november-2020/ Although some LGPS Funds are already voluntarily complying with annual TCFD disclosures, the recent consultation from The Department for Levelling Up, Housing and Communities (DLUHC) will result in a more definitive shaping of the rules on how the LGPS Funds should report on the climate-related impact of their investments.
[13] The United Nations' 17 Sustainable Development Goals (SDGs), introduced in 2015 and agreed by 193 member countries, set out to achieve, by 2030, defined sustainability goals for all (on everything from eradicating poverty and hunger to building liveable cities) regardless of income and wealth. Those SDGs that most closely align to achieving a just transition to a net zero carbon economy are: 3. Good Health and Wellbeing; 6. Clean Water and Sanitation; 7. Affordable and Clean Energy; 8. Decent work and economic growth; 9. Industry, Innovation and Infrastructure; 11. Sustainable Cities and Communities; 12. Responsible Consumption and Production; 13. Climate Action; 14. Life Below Water, and 15. Life on Land. The Worcestershire County Council Pension Fund specifically targets SDGs 6, 7, 8, 9, 11 and 13.

the year. However, even a thoughtful and well-structured engagement policy doesn't always lead to the desired outcomes, especially when climate risk factors need to be continually reassessed. This is when divestment increasingly comes into play – albeit as a last resort exit strategy.

That said, without overwhelming evidence of a climate risk premium being paid to those holding the worst emitters and laggards, for some schemes divestment is still seen as the default option, especially when there is a clear desire to eliminate exposure to high-carbon intensity sectors,[14] whether for reputational reasons, to align with member views, meet ethical considerations, or to allay fears over expected returns. After all, the imperative is for schemes to be ultimately rewarded for asset ownership.[15]

For example, across the North Sea, the mighty €278bn PFZW (Pensioenfonds Zorg en Welzijn) Dutch pension fund, one of Europe's largest asset owners, responsible for the pension provision of three million Dutch care and welfare sector workers, would seem to favour the divestment end of the engagement/divestment spectrum. With a long-standing commitment to responsible investment and having recently aligned itself with the Paris Agreement, PFZW has, in a particularly forthright move, given notice to those of its €4.5bn fossil fuel holdings[16] which fail, by the end of 2022, to do similarly. Even those who Paris-align their business models, risk divestment in 2024 if, by the end of 2023, they fail to devise a "convincing and verifiable" climate transition strategy, with explicit staging posts. Additionally, PFZW plans to tighten its revenue thresholds exclusion policy to those companies with coal and tar sands operations, to 5% from 30% and 1% from 10%, respectively.[17]

Of course, divesting carbon intensive assets and their associated emissions from one portfolio simply moves them to one or a number of other investors, potentially leaving society, the real economy and financial markets exposed to these risks. That is, unless the new asset owners successfully engage with the underlying companies. Similarly, shifting from a portfolio of developed market equities, for example, to a low carbon or climate transition index fund,[18] as many pension funds big and small have done,[19] doesn't always meaningly move the decarbonisation dial, or materially advance forward-looking company adaptation and transition agendas. That is, unless the asset manager applying the limited exclusions and positive and negative climate tilts (in accordance with the rules of the designated index), simultaneously applies an active voting and engagement policy to those index constituents which have yet to adapt their business models to meet climate change goals (but don't fall within the exclusion/negative tilt rules).[20] While some managers do, many don't.[21]

By contrast, the BT Pension Scheme (BTPS), the UK's largest private sector DB pension scheme, like many of its larger peers, puts carrot before stick in applying its climate risk management policy. Indeed, the BTPS engages with the top 70% of emitters in its equity, infrastructure and credit portfolios, giving each a 5-year timeframe to make material progress in creating a climate-resilient business model. Only when it's evident that engagement isn't working, does it resort to exclusion.[22]

[14] A number of pension funds are setting themselves carbon reduction targets along the lines of targeting a 50% cut in emissions by 2030. In so doing, there is a risk this will be achieved through divestment of high-carbon sectors – even if companies within those sectors have considered transition pathways. Consequently, sector diversification may be lost, e.g. if pension funds shift toward healthcare, technology, financials etc. at the expense of industrials, materials etc. See: Without 'buffer' on Net Zero commitments members could be forced to divest, Net Zero Asset Owner Alliance warns. Paul Verney. responsible-investor.com. 27 January 2022.

[15] Indeed, the introduction of ESG, notably climate change, risk factors into investment analysis sets a new investment challenge, in that climate change, and ESG risk factors more generally, move a traditionally two-dimensional risk and return analysis to a three-dimensional one. Additionally, whereas investment theory (and intuition) suggests that a constrained portfolio should underperform an unconstrained, *if* holding carbon intensive stocks isn't rewarded with a carbon risk premium, then their exclusion should result in the former outperforming the latter. Moreover, the performance of this constrained portfolio should potentially be bolstered by engagement that seeks to make bad companies good and good companies even better.

[16] As at end-Q321. See: PFZW to divest fossil fuel companies unless they align with Paris Agreement. responsible investor.com. 16 February 2022.

[17] To be Paris-aligned requires the exclusion of companies which generate more than 1% of their revenues from coal, more than 10% from oil, more than 50% from natural gas and high emitting electricity producers.

[18] Pensions for Purpose identifies 40 different climate benchmarks used by asset managers within the following four categories of climate benchmark: Low Carbon, Climate Transition (CTBs), Paris-Aligned (PABs), and Positive Impact. See: Industry trends in climate indices. Karen Shackleton and Lewis Kilbride. Pensions for Purpose. March 2022. Moreover, as more than 50% of global GDP/USD44tn of economic value generation is dependent on nature and its services (see: Half of World's GDP Moderately or Highly Dependent on Nature. World Economic Forum Davos, Switzerland. 19 January 2020), and following the publication, in February 2021, of the Dasgupta Review [see: Dasgupta, P. (2021), The Economics of Biodiversity: The Dasgupta Review. Abridged Version. (London: HM Treasury)], which puts biodiversity at the core of macroeconomic models of growth and development, discussions are now being had around the role of introducing the transition to a nature-positive world and of natural capital into climate benchmarks.

[19] This approach is increasingly being harnessed within DC default funds in an attempt to make DC more climate transition focused. However, this is not uncommon even within big DB, despite the move among this cohort to more bespoke climate benchmarks within segregated mandates. For example, earlier this year, the Universities Superannuation Scheme (USS), the UK's largest funded DB scheme, cut its absolute emissions by 30% by realising a £5bn portfolio of developed market equities and transferring the proceeds to a climate transition benchmark (CTB) index fund, which overweights companies that can demonstrate they are on the path to reducing GHG emissions, while eliminating those companies that do not meet UN SDGs. Although the transaction doesn't markedly move the decarbonisation dial for the planet in absolute terms, by way of mitigation USS did simultaneously invest £500m of new capital to bolster the £1.6bn already invested in renewables to support the move to electric vehicles, solar photovoltaic farms and wind power developments – an investment that should materially dial down emissions.

[20] Aside from index funds, there are also active fundamental funds, which in benchmarking themselves against traditional financial market indices *and* Paris-aligned benchmarks, can offer a more concentrated exposure to climate solutions.

[21] For instance, NEST seeks to address the risks and capture the opportunities associated with climate change, through its developed equities exposure, via its Climate Aware Fund, set up in 2017. This it does by broadly tracking the FTSE Developed Index, but over- and underweighting companies depending on their alignment with the transition to a low carbon economy. For example, a positive "tilt" is applied to companies providing renewable energy or those Paris-aligning their business models, while a negative "tilt" is applied to companies that are heavy carbon emitters, have fossil fuel reserves, or are not adapting their business models. Despite it being a low carbon index fund, it applies an active voting and engagement policy to those companies that need to adapt their business models to meet climate change goals. Also see: Voting Matters 2021. Are asset managers using their proxy votes for action on environmental and social issues? ShareAction. December 2021.

[22] Likewise, NEST is a good example of a scheme that puts engagement first and divestment second, by following a 3-year engagement program as part of its Climate Aware framework. Moreover, NEST has made clear to all investee companies that it will not support those companies it owns which don't proactively manage their exposure to climate risk, or do not engage with shareholders over their concerns. For example, in 2020 NEST publicly pre-announced its support for a shareholder resolution at Barclays, which ShareAction, a sustainability charity, had called, for the bank to set concrete targets to tackle climate change. On discussing the resolution with the Chair of Barclays, who acknowledged that the bank needed to do more, Barclays formally announced their commitment to be a net-zero bank by 2050, in line with the Paris Agreement.

Socialising the activities of the climate leaders

Much of the good work being undertaken by those schemes taking a lead in beating a path to net zero, is being supplemented by a number of asset owner-led collaborations. These variously assess companies' preparedness for the transition to a low carbon economy, engage with senior leaders across the financial system to transform finance to deliver a sustainable future and call on the world's largest corporate GHG emitters to materially improve their climate performance. These collaborations include the Transition Pathway Initiative,[23] Accounting for Sustainability (A4S)[24] and Climate Action 100+.[25]

The actions of climate leaders are also being promoted and socialised by a number of prominent asset owner forums. Principal among them is the Pensions for Purpose Paris Alignment Forum.[26] Crucially, in recognising that almost all schemes are at different stages of their climate journeys (as a consequence of their different sizes, levels of investment governance and climate commitment from their sponsors), the Paris Alignment Forum offers practical insights to those private sector schemes and LGPS pools seeking to advance their climate risk management credentials and optimise their climate risk management policies.[27]

So, what practical steps can be taken?

So, what have I learnt from my regular interactions with the Paris Alignment Forum, combining this with my own experience of working with schemes in formulating and implementing a climate risk management policy? Well:

1. Before even thinking about climate targets, in particular setting a net zero target, first ascertain your scheme's climate exposure and where you are on your climate transition journey. If you're a DB scheme, approach this as an integrated risk management (IRM) exercise, i.e. from a covenant, funding and investment perspective. Work with your advisers and asset managers in pinpointing exposures via key climate metrics and conducting climate scenario modelling to establish where the key stresses lie. (Of course, to derive the most benefit from the latter requires an appreciation of the analytics behind the former and an understanding of the requisite TCFD reporting).[28]
2. Ask your scheme sponsor (with the help of your covenant consultant if you're a DB scheme), to explain their net zero policy, what measures they're taking and what interim targets they've set to achieve this, and understand why the sponsor may want (aspects of) the scheme's climate policy to align with theirs. Often, this is to manage the sponsor's reputational risk.
3. Leverage your peer network by joining asset owner collaborations and forums, so that you may learn from and share ideas with your public and private sector DB and DC peers.[29]
4. Undertake measures to improve your scheme governance around climate (amongst other ESG) risk factors. This might include setting up an ESG sub-committee and bringing key scheme decision makers and stakeholders, notably the scheme sponsor, onboard with the scheme's climate journey.
5. With the requisite governance in place, embed climate (amongst other ESG) risk factors into all investment decisions. However, do so in line with the scheme's investment beliefs (which may need to be revisited if they haven't been reviewed for some time). After all, investment beliefs should act as the rudders by which to steer all investment and associated risk management decisions.[30]
6. With the help of your investment consultant and asset managers, compile and publish a responsible investment and climate change risk management policy with the inclusion of deliverable targets, ultimately a realistic net zero target,[31] using appropriate metrics and staging posts, and institute the means by which to track progress via regular actual versus policy gap analyses. Again, be guided by your investment beliefs.
7. Use existing frameworks, such as the IIGCC Net Zero Investment Framework[32] and TCFD-aligned metrics to help move your scheme along its journey to net zero. Perhaps also consider becoming a signatory to the former.
8. Ensure asset manager mandates align with the scheme's climate policy and targets, appreciating the difference between segregated and pooled mandates when it comes to influencing managers' voting on shareholder resolutions.

[23] The Transition Pathway Initiative (TPI) is a global, asset-owner led initiative which assesses companies' preparedness for the transition to a low carbon economy and is rapidly becoming the go-to corporate climate action benchmark.
[24] A4S engages with senior leaders across the financial system, so as to transform finance to deliver a sustainable future.
[25] The Climate Action 100+ (CA100+) initiative is an investor-led initiative which engages with the world's largest corporate GHG emitters to improve their climate performance and ensure the transparent disclosure of emissions.
[26] Pensions for Purpose (P4P) exists as a bridge between asset managers, pension funds and their professional advisers, to encourage the flow of capital towards impact investment. P4P aims to empower pension funds to seek positive impact opportunities and mitigate negative impact risks. The Paris Alignment Forum was established by Pensions for Purpose to help pension funds and other asset owners on their journey towards alignment with the goals of the Paris Agreement, by sharing climate-related thought leadership written by P4P's Influencer members (asset managers, consultants and lawyers), by running free training workshops for trustees and by engaging in industry-wide conversation through quarterly all-stakeholder and asset-owner events.
[27] With particular thanks to Karen Shackleton and Mike Rogers at The Paris Alignment Forum, Kerry Perkins at Accounting for Sustainability (A4S), Tegs Harding at Independent Trustee Services and Doug McMurdo at Bedford Pension Fund for sharing their valuable insights. My thanks also go to Vicki Bakhshi, Director, Governance and Sustainable Investment, BMO GAM, for her thoughtful comments.
[28] The TCFD framework was established by the Financial Stability Board with the goal of harmonising climate disclosures across the financial intermediation chain, including companies, banks, investors and pension funds. These disclosures are detailed in Pensions Watch – edition 7 (April 2021). See: https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-7/ and Pensions Watch edition 1 (November 2020). See: https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-november-2020/
[29] Somewhat paradoxically, the notion of a transition alpha has begun to surface, in that the sharing of ideas may compromise the potential rewards to a scheme unilaterally moving into a decarbonisation asset class or strategy which has yet to attract widescale attention.
[30] See: https://www.robeco.com/en/insights/2022/01/podcast-stick-to-your-long-term-investment-beliefs.html
[31] Many pension schemes and sponsors alike are setting themselves increasingly ambitious net zero targets, often far in advance of the UK government's commitment to a 2050 target date.
[32] The Institutional Investors Group on Climate Change (IIGCC) Net Zero Investment Framework, is an investor-led initiative that sets out the key actions and methodologies that can be used by asset managers and asset owners to implement a Paris Agreement-aligned investment strategy, based on the expectation that governments and policymakers will deliver on commitments to achieve the +1.5°C temperature goal of the Paris Agreement. In essence, this comprises decarbonising investment portfolios in a way that is consistent with achieving global net zero GHG emissions by 2050, while increasing investment in the range of climate solutions needed to meet that goal.

9. Consider framing the risk budget applied to segregated mandates in climate risk tolerance terms, rather than traditional tracking error targets.
10. Engage with your investment consultant and asset managers in sourcing climate (impact investing) opportunities.[33]
11. Embrace the power of stewardship by becoming actively involved in shareholder resolutions and in making recommendations to policymakers.
12. Design a reporting framework around the climate targets set and decide how best to impart your policy and progress to all stakeholders, having regard for the scheme's statement of investment principles (SIP), annual implementation statement and TCFD reporting.[34]
13. Finally, in the (current) absence of perfect, standardised data and with an admittedly foggy path ahead, don't aim for spurious accuracy, or over engineer or over complicate what is very much an art, not a science. What matters is the scheme's broad direction of travel, not measuring everything to two decimal places![35]

There are, of course, challenges with taking a number of these suggestions forward, especially if a scheme's governance is not sufficiently well advanced and ESG fatigue has already started to set in. Indeed, with this, comes the temptation to treat climate change risk management as a tick box exercise and to do no more than legislation and regulation requires. However, a good starting point for such schemes is to nail down the more obvious and easily managed climate risks, notably within the scheme's equity holdings, and capture the more accessible climate opportunities. Believe me, it will be time well spent.

Why does all of this matter?

Transitioning to a low carbon, and ultimately a net zero emissions, economy (like any disruptive force) will invariably result in winners and losers. While some companies and economic sectors will disappear, or experience higher costs of doing business, others with the foresight and the ability to reinvent themselves – by transitioning to new low carbon technologies and/or offsetting their carbon emissions through carbon-capture technologies – stand to prosper, alongside those market entrants who emerge to tap into new areas of demand.

Of particular concern are the potentially monumental declines in the physical asset values of those companies that fail to anticipate regulatory, reputational and, particularly, transition risks or those unable to reinvent themselves. In extremis, many assets will be rendered uneconomic and, in popular parlance, become stranded. In such a scenario, this would leave those pension schemes that fail to act, exposed to unacceptably high and largely unmanageable risks – risks that should be identified, evaluated and managed far in advance of their impact materialising. Indeed, there is a very real risk of financial assets with either prominent underlying climate risks or strong climate-friendly credentials being materially repriced far in advance of company balance sheets, physical assets and the real economy being impacted. Therefore, if these asset repricing risks, which might otherwise compromise the ability to generate long-run sustainable returns, are to be properly managed, there is a potential first mover advantage to pension funds of overcoming the myopia surrounding climate change risk management. This is exactly what we're seeing from those far sighted, typically larger, pension schemes which have the governance to implement climate change risk management policies that frame climate risk as both an unrewarded threat and a potentially rewarded opportunity. Thankfully, this good work is being both supplemented and socialised by a number of asset owner collaborations and forums.

Ultimately, we need to create a UK pensions system that has resilience to both transition and physical climate risks. While the steady flow of legislation and regulation go some way to achieving this, collaborative asset owner-inspired measures continue to lead the way in helping smaller schemes, in particular, square the climate risk management circle. After all, to say what happens next in the world's climate journey is, in no small part, down to the actions of asset owners, particularly pension schemes, is no exaggeration. Indeed, pension schemes are not only very well positioned to be the catalyst for major transformative change, they have the potential to lead the world in tackling humanity's greatest systemic challenge to date.

[33] Noting that just 0.5% of $27tn global fund assets are currently aligned with the Paris Agreement. This drops to 0.2% when the Scope 3 emissions of organisations' supply chains are considered. See: CDP. October 2021. That said, climate opportunities in the private markets/illiquid assets space can also help address other challenges, such as providing sustainable cashflow generation to those mature DB schemes which are cash flow negative.
[34] All trust-based pension schemes with 100 or more members must set out, within their statement of investment principles (SIP), their policy on managing financially material climate risks, publishing this with an annual implementation statement, which discloses the extent to which the Trustees have followed the objectives and policies set out in their SIP, on a publicly accessible website. See: https://www.thepensionsregulator.gov.uk/en/document-library/strategy-and-policy/climate-change-strategy
[35] As Winston Churchill once said, *"Perfection is the enemy of progress."*

To find out more visit columbiathreadneedle.com

Important information: For professional investors only (not to be used with or passed on to any third party). Your capital is at risk. This material should not be considered as an offer, solicitation, advice or an investment recommendation. This communication is valid at the date of publication and may be subject to change without notice. Information from external sources is considered reliable but there is no guarantee as to its accuracy or completeness. This document is not investment, legal, tax, or accounting advice. Investors should consult with their own professional advisors for advice on any investment, legal, tax, or accounting issues relating an investment with entities apart of Columbia Threadneedle Investments. Issued by Threadneedle Asset Management Limited. Columbia Threadneedle Investments is the global brand name of the Columbia and Threadneedle group of companies. Registered in England and Wales, Registered No. 573204, Cannon Place, 78 Cannon Street, London EC4N 6AG, United Kingdom. Authorised and regulated in the UK by the Financial Conduct Authority. **Columbia Threadneedle Investments is the global brand name of the Columbia and Threadneedle group of companies.**
columbiathreadneedle.com
Issued 04.22 | Valid to 12.22 | J32262 | 4619048