Stanford | Steyer-Taylor Center for Energy Policy and Finance

INVESTING IN A NEW CLIMATE
How Pension Fund Investors Can Navigate Climate Exposure and Capitalize on Innovation Opportunities

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Workshop Summary

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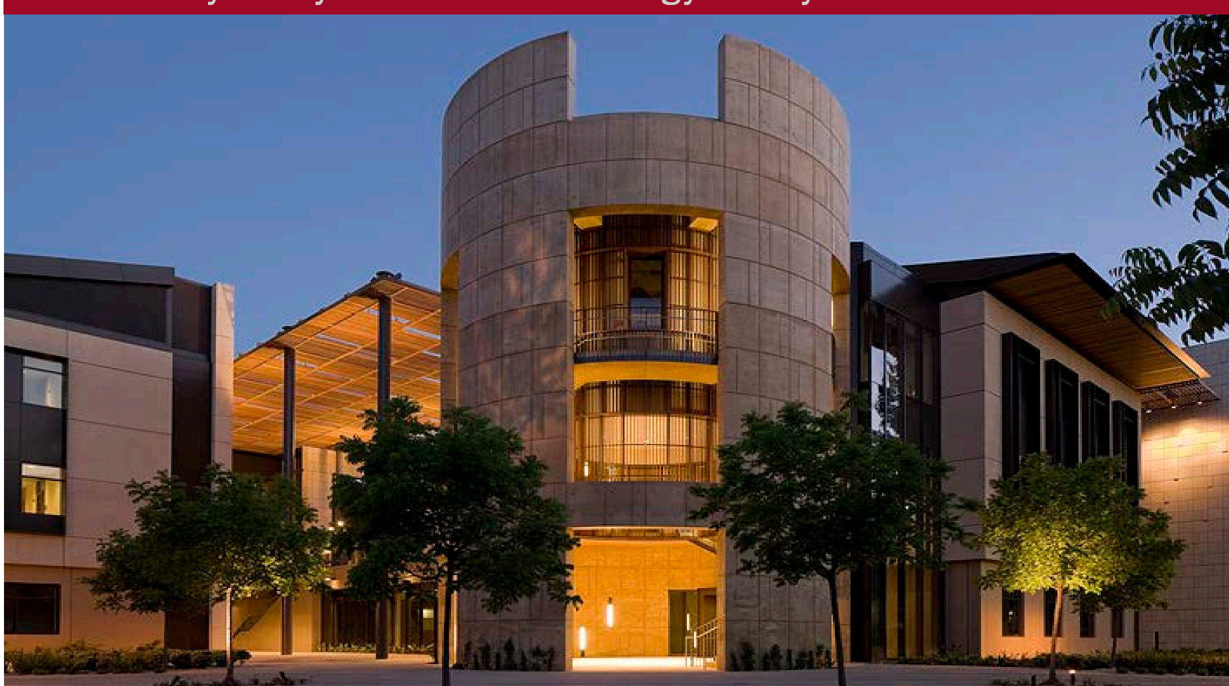

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Meeting Summary

Public pension funds face the significant challenge of growing assets to match escalating long-term liabilities. A 2014 Moody's study found that the 25 largest U.S. public pension plans face a shortfall of at least $2 trillion in unfunded liabilities. In addition, pensions are required by law to manage within the confines of fiduciary duty, defined by the U.S. Department of Labor as the need to act solely in the interest of plan participants.

Climate risk is gaining awareness as a significant issue that must be incorporated into asset management to capture opportunities and fulfill fiduciary duty. However, climate risk frequently becomes trapped on a spectrum that spans from divestment to environmental, social and governance (ESG) metrics that do not effectively capture risks and rewards from climate change. In June 2015, a select group of pension funds, asset managers and academic representatives met in New York City to discuss these challenges and the potential to better capture the evolving issue of climate change in investments.

Navigating Climate Portfolio Risk

The workshop began with discussion of a new framework for integrating climate risk in investments that considers multiple dimensions beyond stranded assets. Dimensions like water and food scarcity, natural resource availability, and opportunities like solar and wind power need to be considered by investors. Climate risk is happening now and is not just a long-term risk (examples like the California drought and the performance of coal stocks were utilized). The shortcomings of ESG metrics in public debt and equity portfolios were also examined, and investors were warned not to just accept a rating as evidence that the investment was good. Pension funds should separate the E from S and G to take advantage of climate change opportunities available to those with longer-term investment horizons.

Discussion Key Points:

- **Materiality matters.** Investors need to see climate risk as a material risk - for example, 30% of agriculture taken offline due to drought measures is material, not just climate-related risk. The definition of materiality, especially in public equities and debt, should change to reflect both short-term and long-term risks from climate change.

- **Consultants can be a hindrance.** The interests of consultants advising on investment decisions are not always aligned with a pension funds' interests. In particular, consultants create barriers to new products.. Pensions need to practice active engagement with current portfolio holdings because climate exposure is already impacting assets today, and the creation of new products takes time.
- **Devise more methods to measure ESG.** Pension funds want more ways to merge fiduciary duty with ESG. Helpful solutions would link measurement of ESG with benchmarks and prove funds are meeting return and fiduciary objectives.
- **Pension funds are often resource-starved.** Pensions need to understand what they are buying, particularly when it comes to ESG products, but understaffing prevents them from effectively researching investments.

Integrating Climate Change into Pension Fund Governance

The concept of fiduciary duty governs all investment decisions undertaken by pension funds and other asset owners. When attempting to integrate climate change considerations into investments, the asset owner cannot simply choose green investments. The fund can only invest in green instruments if returns are expected to meet or exceed other opportunities.

Discussion Key Points:

- **Keep records of investment decisions.** Pension funds should maintain records of the decision process surrounding every investment to provide evidence of fiduciary duty.
- **Proxy votes are required under fiduciary duty.** Pension funds can support active investment over a long-term investment horizon by voting proxies, especially those related to climate risk.
- **Cooperative proxy voting would help.** Pension funds would benefit from being able to talk to other asset owners to increase the influence of proxy voting and coordinate votes.

Seizing Climate Investment Opportunity

Pension funds wishing to capitalize on renewable energy and climate change investment opportunities are faced with a constantly evolving investment landscape.

Clean tech venture capital, infrastructure, private equity and public markets offer a variety of investment opportunities. Clean technology, still reeling from the recent shake-out, should be viewed through the lens of new technology cycles. New technology cycles start with a large buildup of companies, followed by a crash and survival of the fittest. Eventually the product reaches a critical mass of 1% penetration and long-term success. Firms like Generation Investment Management incorporate sustainability into the investment thesis across product lines – including public and private equity and debt. Finally, new products are being developed to complement pension funds' long-term horizons with lower fees.

Discussion Key Points:

- **Pension funds need to deploy capital more intelligently.** In 1950, the financial industry captured 10% of profits – today that number is 40%. The average pension fund is largely unaware of the amount they paying in fees through managers and funds. There is a need for more fee transparency across the board.
- **Consultant interests hinder the process (again)**. Paid investment advisors generally preserve the 'herd mentality' and hamstring the creation of new businesses and products that asset owners need.
- **Consultants' interests are not aligned with asset owners.** Consultants should be paid a percentage of performance rather than just commissions. Another solution suggested funding a new group aligned with pension fund interests to help them filter the most beneficial products.
- **Pension funds are understaffed.** If funds had more time and resources, most agreed they could find a lower-priced, better alternative manager almost every time, but have to rely on consultants instead.
- **Pensions need to collaborate more.** The best method to convince a board that doesn't understand your resource needs or business is to work with other funds.

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