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Will Pension Funds Go Green?

The UN's international agreement to limit greenhouse gas emissions could change the way pension funds invest our money.

On many fronts the 2015 UN climate change conference (the 21st edition of the COP) in Paris seems to have been a success. Two weeks of discussions, involving experts from nearly 200 countries, led to the signing of an international accord to fight global warming. This remarkable progress, after more than 20 years of efforts, marks a turning point in the climate change debate opening the discussion up to an even wider audience in different industries and segments of society.

Pensions funds, like many large institutional investors, have flirted with green investments for some time now, with some of the more forward-thinking funds diversifying their portfolios by investing in companies which actively mitigate climate change, either through the generation of green energy (such as solar or wind power producers) or by improving energy efficiency (manufacturers of emission-cutting devices and systems).

Green projects usually include multiple technologies at different stages of maturity requiring different types of financing vehicles. Institutional investors can access such projects via equity (including green indices formed by listed companies), fixed income (notably green bonds) and direct investment through private equity or green infrastructure funds. Green investment banks are also part of this alternative investment space.

A good example is that of a renewable energy developer focusing on community-scale projects in the UK. The company is approaching its £100 million (USD 145 million) funding goal with assistance from the Greater Manchester Pension Fund (GMPF) which invested about 10 percent of this target. The project has also attracted investments from other players in the pensions domain, including Scotland's Strathclyde Pension Fund. Another example is Sweden's AMF pension fund, which has invested in the UK Green Investment Bank's offshore wind fund and acquired important stakes in offshore wind farms.

A sector that emerges slowly

But on the whole , green investments are still modest. In a report released some years ago, the OECD attributed this to scale issues, noting the market size for green bonds is still small and illiquid. Regulations and lack of knowledge do not help the cause. In 2011, pension funds' asset allocation to green investments represented less than one percent. Given that green funds remain small scale, investing in them involves important transaction costs.

As investment in green initiatives moves ahead slowly, pension funds are also looking to limit their investments in polluting companies – and invest more in clean and responsible companies. Many pension funds owith shares in big oil and energy companies are planning to divest from firms with big carbon footprints, insisting that pension-holders would not want their money to fund global warming. This was exemplified when more than 10,000 people signed a 2015 petition calling on ABP, the Dutch pension fund, to drop its holdings of oil, gas and coal stocks.

In the US, two of the world's largest pension funds, CalSTRS and CalPERS in California, have committed to sell fossil fuel investments with the aim of limiting the impact of climate change. Meanwhile assets under management involved in socially responsible investing, which includes climate change mitigation among its objectives, almost **trebled from 2007 to 2011 in Europe**, a move led by pension funds.

Movements for cleaner investments have been emerging over the years, including some with a focus on the pensions market. FairPensions has been campaigning for major institutional investors to adopt 'responsible investment', using shareholder power to hold companies to account and ensure good governance.

Policy makers too are starting to adopt the idea. A new French law makes it mandatory for investors to disclose the carbon footprint of their portfolios. In the fall of 2015 the US Labour Department issued bulletin 2015-01, which tells pension funds what factors to use when choosing investments, including climate change. Now investors can consider a company's environmental, social and governance records, as long as they do not compromise their fiduciary obligations of maximising returns on investments. Recently twenty-six MPs across five political parties in the UK called on their pension scheme to ditch fossil fuel investments as momentum behind the divestment movement accelerates.

Is it possible to kill two birds with one stone?

All these actions sound great: pension funds can save the planet while growing the investments of future pensioners. Yet, reallocating the funds containing the pensions of millions of current and retired workers would take many years, and incur considerable expense. There are even fears among global institutions, including the World Bank, about the risk of huge financial losses if the world's nations act to slash carbon emissions. For pension funds to be convinced to go green, moving to alternative investments has to make sense financially. Avoiding investment in high carbon firms altogether may even seem unrealistic in some cases. Take the US, where energy and utilities sectors and the like, represent more than 20 percent of the market.

And here lies the dilemma. Pressure to divest from polluting companies, especially those that deal with fossil fuels, is intense. But so is the pressure for pension funds to maintain investment returns, which is normally the fiduciary responsibility of fund managers. The reality is the market is driven by returns, not ethics. The wider social implications are large as these returns are crucial to ensure that future retirees maintain an adequate retirement income and a good standard of living.

A big dilemma…that disappears

However, the problem is solving itself. As forthcoming climate policies are likely to make the activities of high-carbon industries increasingly unprofitable, a pension fundthat takes care of the planet does not have to sacrifice financial returns.

Divestment from high-carbon industries increasingly makes sense on the grounds of pure financial risk, particularly if fossil fuel sources become "unburnable" due to tightening restrictions on carbon emissions, a scenario becoming more likely after the UN's Paris meeting. This possibility of stranded assets in the near future (i.e. a sudden devaluation) is often referred to as the "carbon bubble".

With this in mind, there is both a strong ethical and financial case for divesting from fossil fuels.

It seems that the stars may be aligning for this cause. The recent collapse of the oil price could help smooth the "high return" vs. "low-carbon" dilemma, with oil companies' declining profits making the exclusion of energy companies from pension funds an even more profitable move. Furthermore, while investing in companies producing climate change solutions may sometimes be risky (many of these companies being new and volatile), recent data shows otherwise. MSCI, a stock market index company, showed that since 2010 the "ex-fossil fuel" stocks have grown by 170 per cent, outperforming stocks with investments in fossil fuels which grew by 162 per cent. Meanwhile, other studies have found that, in certain countries, ethical pension funds which invest in companies that introduce cleaner production methods have achieved a financial performance **as high as conventional pension plans** .

The way forward: low-carbon index funds

Today there are more and more funds that mimic the risk and return on benchmark indices, while slashing the amount of carbon emitted. Green index funds have grown in an expanding atmosphere of socially responsible investing and some pension funds have taken the lead to invest in them – often driven by pure financial motivations. For instance, New York State's Common Retirement Fund for public employee pensions, will put $2 billion into a new investment fund created by Goldman Sachs that prioritises companies with smaller carbon footprints. Goldman says the historical performance of the basket of stocks matches the performance of the Russell 1000 (a stock market index of US stocks) while reducing carbon emissions by 70 percent. In Europe, France's FRR (fonds de réserve pour les retraites) and Sweden's AP4 are among the pension fund that have started investing in low-carbon indices foreseeing a good performance.

Although green indices are not new (FTSE released a version in 2001, and Standard & Poor's started in 2009), they are only now starting to gain appeal. Environmentally aware investment funds have the potential to perform well, but there is still a need for empirical evidence and further discussion. We should now be asking whether "sustainable" assets produce the type of returns that suits pension savings: long term, uncorrelated to the stock market and with steady revenue streams. And will pension funds need to offer ex-fossil fuel options to clients if they wish to remain competitive?

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