How to build an impact portfolio

For institutional investors, putting big environmental and social commitments into practice may require a change of approach - and a bit of courage

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VISIONS 20/30

N.B. This essay is an edited version of the transcript of Graham's 20/30 Visions interview, which you can watch at www.bridgesfundmanagement/2030Visions.

I've always had an interest in ESG investing; in fact I'd been working with the CFA on developing its ESG investing certificate. So when the opportunity came up to lead the investment team at the Environment Agency Pension Fund (EAPF) and start turning some of the great commitments and strategies they had into investments, that was an opportunity I couldn't turn down.

The Local Government Pension Scheme (LGPS) funds were going through pooling at the time – where they had to join a pool and centrally manage their investments through commingled vehicles. So a large part of the focus was on making sure that structure was right and there was good alignment. But the EAPF had also committed to get to Net Zero by 2050 (it's since come forward to 2045) and more work needed to be done to realise that.

A key aspect of this was our impact or 'targeted opportunities' portfolio. This was a £300m+ private markets allocation (so about 4-5% of EAPF's assets) set up specifically to back innovative strategies that could move the dial in terms of environmental and social change.

ALIGNING OBJECTIVES

Getting from an overarching climate commitment to specific portfolio decisions is quite a stepwise process, and it's important to take your time over each of those steps to make sure you get them right.

The most important, we found, was having a really clear sense of what your objectives are. Making a commitment to Net Zero is easy to say; but there are a lot of sub-objectives behind that, and you need to be clear on exactly how you're going to get to those. Decarbonisation is one; but there's also moving to the positive side by investing in climate solutions and promoting those companies that are doing particularly well on these aspects.

Then there are other supporting elements. For instance, how do you make sure that your investments are managed in a way that is aligned to your overall strategy?

One of the first barriers we found at EAPF was that the benchmarks we gave to our investment managers weren't aligned with the Net Zero investment strategy. As a former fund manager myself, I know you never stray too far from your benchmark! So one of the first things that we did, in collaboration with Brunel (the pool that the Environment Agency was part of) was to develop Paris-aligned benchmarks, which are benchmarks aligned with getting to Net Zero by 2050.

For example, in equities, we had a passive tracking to the MSCI Low Carbon index. But this had a relative decarbonisation target: to have 50% less carbon than the main index. So it wasn't necessarily aligned with getting to Net Zero – because Net Zero requires you to decarbonise the actual portfolio, and invest in climate solutions, rather than have your levels driven by where the market is. So when the EU produced the Paris-aligned benchmark criteria, which set out all these aspects and genuinely reflected an investment strategy that got you to net zero, that was something we wanted to adopt. It helps to tease out those companies that will thrive in a post-carbon world, and underweight those which are not adapting.

One benefit of working at the Environment Agency is that it has had a long

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Sustainable forestry is one area where natural capital can deliver strong returns for investors, if you get the right trees on the right land - as the Environment Agency Pension Fund found in Paraguay

Photo by Ruben Hanssen on Unsplash

record of Responsible Investment. It has been working for decades with managers that are leaders in this field (of which Bridges was one). And if you have that stable of managers who are already on board with what you're trying to do, they react very positively to these changes.

As for our pooling partners: one of the really pleasing things about being part of that pool was seeing others come along the journey we'd been along a few years earlier. The fact that EAPF had a track record of success in these strategies was helpful in that. But there was also great leadership from Faith Ward within Brunel on responsible investment, and in combination with our expertise, that actually led to a closing of the pack: other funds actually challenged the EAPF about whether we could go a little bit further. That was really refreshing.

What drove this? The science that we have now; the overwhelming change in the preferences of our members and consumers; the understanding that we are, almost inevitably, moving to a post-carbon world and need to adapt to that. There is an industrial revolution happening whereby carbon will largely disappear from the economy. There are lots of opportunities for those that embrace that change, and lots of risks for those that don't.

We always had to battle with the really outdated theory that in order to do good, you had to give up returns. Because of the way society has been changing, and wanting more purpose from the companies they deal with, that's just not true. In fact, you're more at risk if you don't have purpose.

INVESTING IN NATURE

Another objective we had was financing the transition. Pension funds, like many large institutional investors, hold a large element of bonds, which are effectively debt financing that you're providing to companies. We wanted some of that funding to be financing the transition: so providing companies that want to move to a more sustainable model with the finance they need to do that.

Our other objective was to invest in climate solutions. One (unstated but widely supported) target was to try and back innovative managers, so they could prove the concept that sustainable investment can generate really good returns. Unless you can get those first funds off the ground, it's very difficult for those concepts to become mainstream.

Natural capital is really important. The connection between climate and nature is completely inextricable: we'll never get to a Net Zero world if we continue destroying the most efficient and abundant asset that we have to combat climate change. So one of my last acts as CIO at EAPF was to get a proposal approved to allocate 4% of our strategic asset allocation to natural capital.

On a risk adjusted return basis, these investments can be incredibly attractive. For example, in sustainable forestry, the key is getting the right trees, in environments that really suit them, on land that is really cheap. We invested in a plantation in Paraguay: because it had such fast-growing trees, on such cheap land, that made for a very profitable business. There are really strong and attractive opportunities out there if you look in the right place.

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THE NEED FOR COURAGE

One barrier facing responsible investors is this reliance on past data – when we know the future will be very different. Take electric vehicles. My prediction for electric vehicles is an uncontroversial one: that we're at a tipping point now where they will just become the norm. But you wouldn't have been able to find the data to prove this five or ten years ago; the stars were not aligned in the way they are now in terms of costs, market share, infrastructure and so on.

So as an industry, we need to move towards looking to the future. We all get a comfort blanket from proven ideas that have worked in the past. But you can't invest in the past, you can only invest in the future. We need to be thinking much more about what the future holds.

And I think private markets have a role to play in that: private equity investors tend to be looking at where we're going in the future, not doing models of how the market worked in the past.

Ultimately, what everybody needs is a little more courage. Investment professionals (and I include myself in this) can sometimes be a little overwhelmed by career risk. But if we see really good opportunities that we believe can work, we really need to start backing them. And if we have the courage to make those investments, others will see it and come in later.

Step changes are always difficult. But if I was World King, as one of our former Prime Ministers dreamed about, I would have a proper carbon tax that was applied consistently.

The answer to most problems we have in our economy lies in externalities, those costs that are not borne by those who produce the cost. If you could make these costs internal and hold people to account, so they have to pay for them, it would solve most of our problems almost overnight.

IMPACT AT SCALE

I recently joined Phoenix Group, where I lead our sustainable investment strategy. Phoenix is a FTSE 100 company, the largest workplace pensions and life insurance company in the UK, with around £260bn of assets under administration, providing pensions for a quarter of the UK adult population.

So one of the attractions for me of going there was to take the ground-breaking approach that I'd learned at EAPF and apply it on a larger scale – almost 100 times larger in fact – to create change for a much larger group of people. But it will be based on the same very simple investment principles: being very clear about the objectives that you're setting, and understanding the risks and constraints that you're trying to manage.

Can we achieve the change we need? Two years ago, after COP26, I was really confident. Now I believe we need much more support from Government: there's a lot more that can be done in the environment and policy space to support the transition and help investors do that.

Personally I feel that until we are staring into the abyss, we won't have the rapid amount of decarbonisation that we need. I think that we are likely to overshoot, to go above 1.5°C, in the next decade. Maybe as we approach that, and we see more of the physical risks we've been seeing lately like floods and storms and fires – maybe that will be the catalyst we need to accelerate. I do think we will get there in the end; humanity has a way of always finding solutions to the biggest problems. But it will be very stressful before we get there.

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Graham has more than 25 years' industry experience in the UK, Europe and Australia, primarily helping asset owners efficiently implement their investment strategy. He is currently Responsible Investment Strategy Lead at Phoenix Group. He was previously CIO of the Environment Agency Pension Fund, where he was responsible for overseeing a £4.8bn investment portfolio, and prior to that, he helped establish, and led, the London-based Portfolio Solutions team at Macquarie Group. Graham is a board member of the IIGCC and former vice chair of CFA UK. Graham has qualified as a chartered Financial Risk Manager (FRM) and Chartered Alternative Investment Analyst (CAIA) and holds the Chartered Financial Analyst (CFA) designation.

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