HYMANS ROBERTSON

Investment Perspectives

Autumn 2020

In this issue:

Welcome

Welcome to our 2020 Autumn edition of Investment Perspectives

As the seasons change and the days get shorter, investors may be comforted by the gradual pace of change we see in nature, which of course contrasts to the unpredictable nature of the market and the economic cycle which ended abruptly in March. In this edition of Investment Perspectives, we explore the market recovery to date and some of the structural trends that the global pandemic has accelerated and that may persist in the economy even if we get some level of normalisation. This is of course balanced between the ever-looming thunder clouds of additional pandemic waves and the ray of light that a successful vaccine brings in 2021.

In his latest capital markets update, Chris Arcari provides a weather report on the global economy covering recent economic data and assets class activity and in the following articles our contributors explore some of the aforementioned structural trends including;

- The growing divergence between different regions, sectors and factors in global equity markets connected to technology i.e the 'new economy' vs. the 'old economy'. Andy Green puts this current environment in the context of history and reminds investors to be disciplined and resilient in current times;
- Penny Cochrane and Adam Porter discuss the pandemic's impact on e-commerce and working from home and the implications for retail, commercial, industrial and alternative UK property;
- Finally, Simon Jones provides information on the Taskforce on Climate-related Financial Disclosures ("TCFD") and the mandatory reporting requirements for larger pension schemes, which coincides with increasing investor awareness of climate issues which has risen to the fore during the pandemic.

I would also like to introduce readers to the new format of Investment Perspectives which will be an aggregation of timely monthly investment perspectives articles which will be published on our website.

I also hope everyone has a safe and happy seasonal period, especially in light of the exceptional circumstances we continue to find ourselves in this year and I look forward to a brighter and more sociable 2021.

David Walker
Chief Investment Officer
david.walker@hymans.co.uk
0141 566 7733

Capital markets update

Released: October 2020

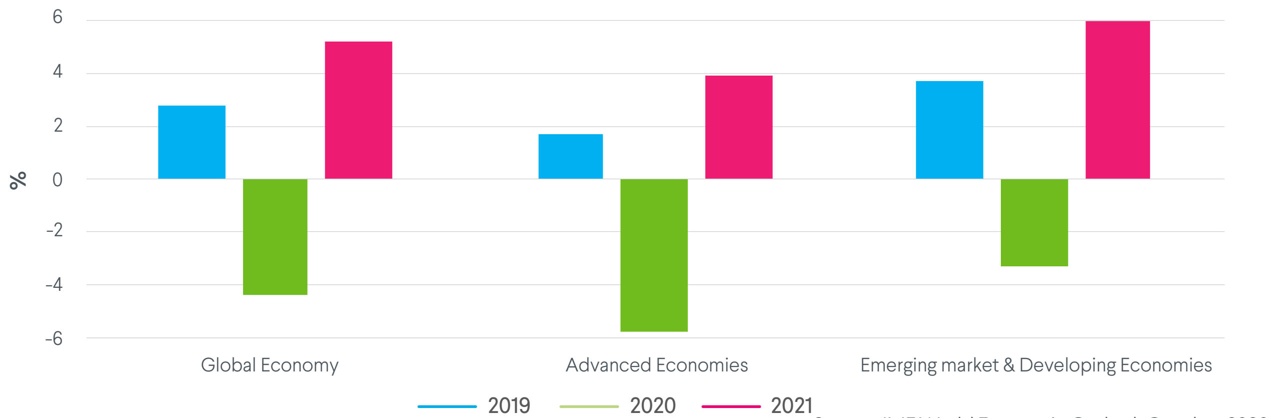
Global equity markets and sovereign bond yields rose, and credit spreads fell in Q3 amid a post-lockdown rebound in economic activity, a better than expected corporate earnings season and optimism over vaccine trials.

Buoyed by a recovery in Chinese activity, in particular, industrial metals prices rose 10.6%. However, while gold prices slipped back from record highs reached in July, they still rose 6.5% above end-June levels and oil prices slipped back as renewed restrictions weighed on demand expectations.

The Q2 global economic downturn was the sharpest contraction in modern history, but unprecedented fiscal and monetary support prevented it from being as bad as initially feared. The initial post-lockdown bounce in growth in large advanced economies was also stronger than anticipated. However, high frequency data, such as travel and navigation app usage, suggest the pace of recovery slowed over the summer, even before many economies, particularly in Europe, started re-imposing restrictions on activity. September's Composite Purchasing Managers' Indices, which combine manufacturing and services, pointed to continuing recovery in global activity, but at a more moderate pace in some regions. At a global level, the manufacturing sector appears to be faring better so far during the recovery, as a continued downturn in consumer services weighs on services activity.

The IMF World Economic Outlook forecasts global growth in 2020 will contract 4.4% this year followed by a 5.2% expansion next (Chart 1), leaving two-year global aggregate output a little above its end-2019 level. However, this is largely driven by the secular momentum of the Chinese economy. Elsewhere, the recovery in output is likely to be long, uneven and uncertain, with major advanced economies not expected to regain pre-pandemic output levels for several years.

Chart 1: IMF World Economic Outlook Growth Projections October 2020



Source: IMF World Economic Outlook October 2020

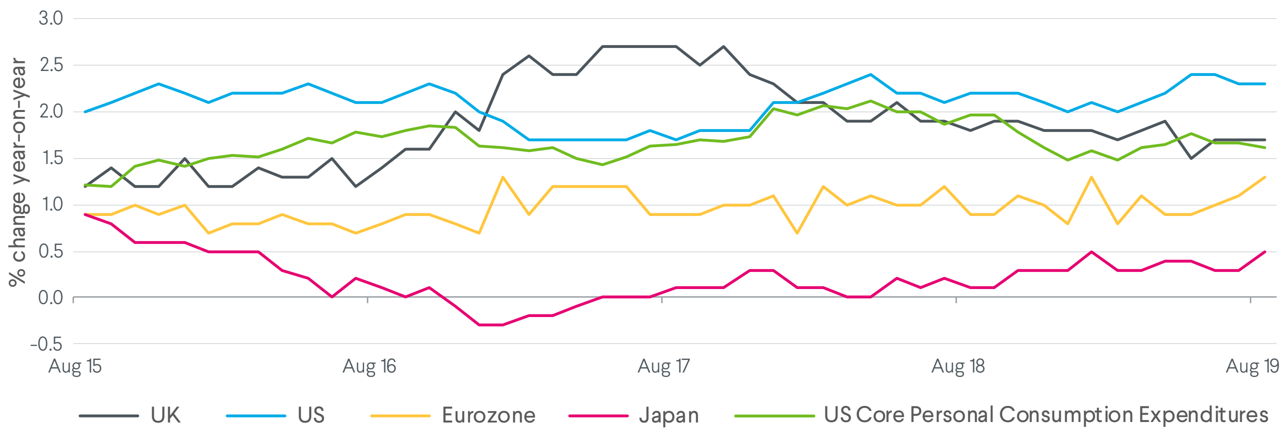
The IMF's near-term forecasts assume social distancing will continue in to 2021 but will fade over time as vaccine coverage expands and therapies improve, avoiding stringent national lockdowns. However, second waves of COVID-19 are increasingly evident, even in regions which had reduced transmission rates to low levels prior to re-opening. Latin America and Southern Asia are yet to see an end to their first wave.

The impact of a re-tightening of restrictions or, in a worst-case scenario, renewed national lockdowns which undermine the recovery or trigger a double dip remain key risks.

Employment and labour force participation at a global level remains well below pre-pandemic levels. US unemployment continues to fall from April's 14.7% peak and though labour markets have been far more resilient in the UK and Europe, the number of job cuts is rising and may accelerate as government support schemes are scaled back.

After rising more than expected in July, UK CPI inflation fell in August as the Eat Out to Help Out Scheme came in to effect. Globally, every major economy has seen its core inflation rate fall since end-2019 (Chart 2) and, though this is driven to a great extent by extreme price weakness in travel and clothing, which will abate, continued caution amongst businesses and consumers should keep a lid on inflation in the short term. Nonetheless, consensus forecasts are still for a fall in inflation this year to be followed by a modest increase in 2021.

Chart 2: Core CPI inflation



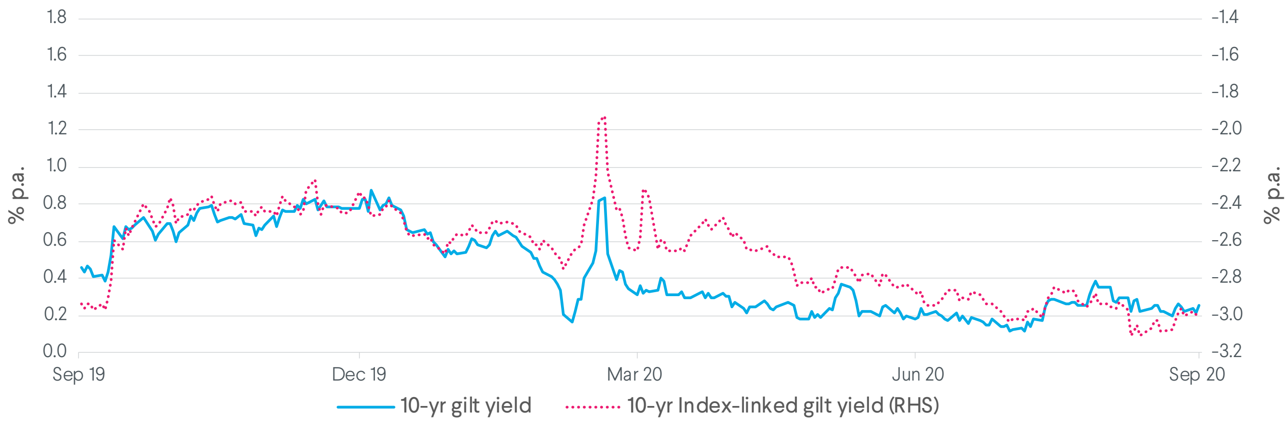
Source: Datastream

The weak inflationary backdrop has prompted further accommodative shifts from central banks. The US Federal Reserve's shift to "flexible" average inflation targeting, allowing above-target inflation to make up for periods of below-target inflation, likely means interest rate rises are even further away than previously envisaged. The Bank of England remain equivocal about the use of negative interest rates but market pricing suggests negative interest rates will be introduced at some point in 2021.

Government bonds

The behaviour of the major government bond markets in the third quarter suggested markets were focusing on the very subdued interest rate and inflation outlook, shrugging off the near-term economic bounce and massive fiscal deterioration. US 10-year treasury yields were little changed, German yields moved further into negative territory and UK 10-year yields rose slightly over the quarter.

Chart 3: 10-year government bond yields



Source: Bank of England

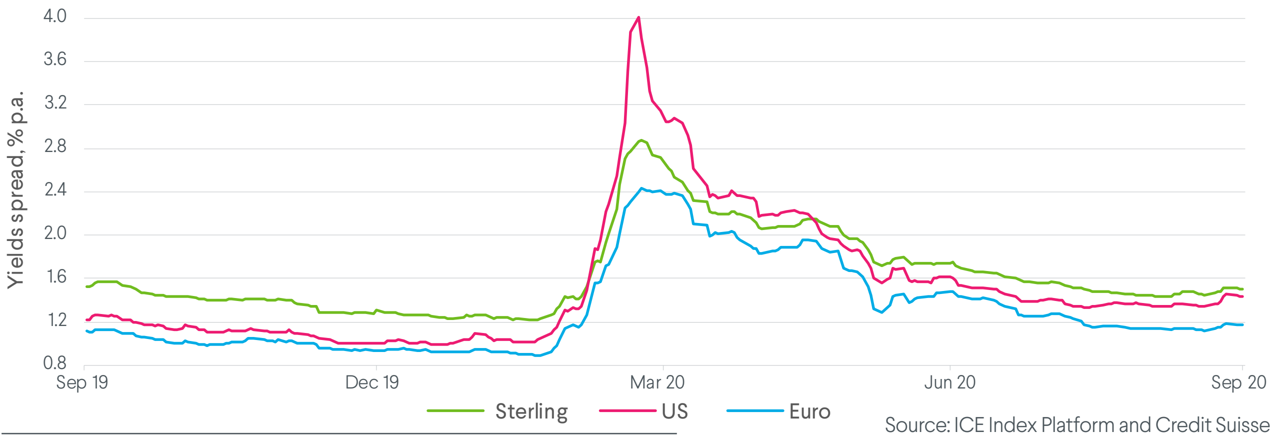
Equivalent UK index-linked yields edged below end-June levels (Chart 3). The delayed outcome of the consultation on the use of RPI as an inflation measure may have alleviated some medium-term downward pressure on implied inflation even as actual inflation fell. Swap market pricing[1] implies a probability in the region of 60% that RPI will be aligned with CPIH with no compensation.

Real and nominal gilt yields remain at very unattractive levels. But, while forecasts for UK growth and inflation continue to provide fundamental support, any rise in yields is likely to be very gradual and limited.

Credit

Global credit spreads ended the third quarter lower (Chart 4), as sentiment continued to recover. Although defaults have continued to rise and are likely to remain elevated, expected levels of future default eased over the quarter. Ongoing accommodative central bank policy and a rebound in economic activity have allowed companies to raise new finance, bolstering their ability to navigate the downturn. The proportion of the US high yield market trading at distressed levels has fallen towards average levels and the pace of net downgrades to credit ratings has slowed dramatically.

Chart 4: Investment-grade corporate credit spreads



Source: ICE Index Platform and Credit Suisse

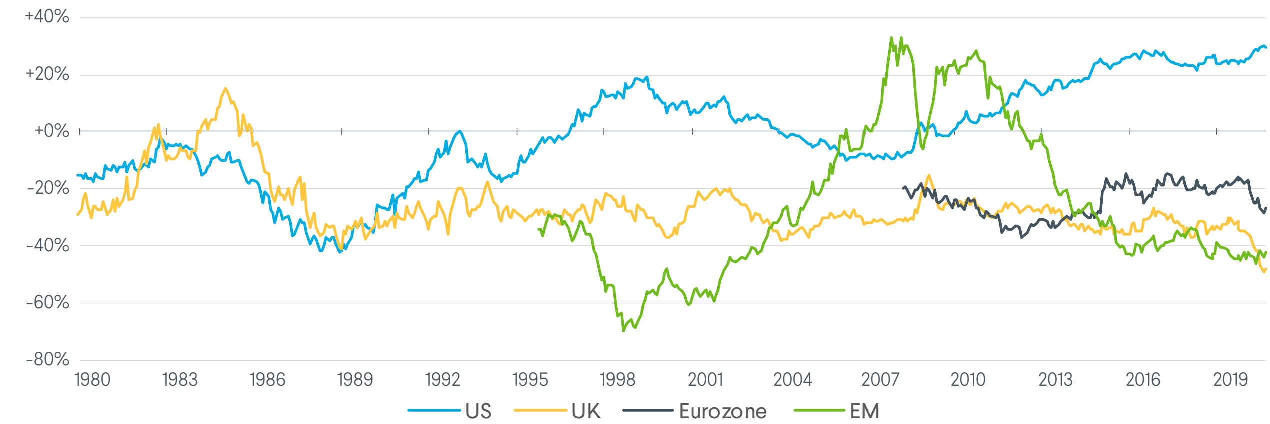
1 BMO Monthly CPI Update: average 10-year gap between RPI and CPI in 10 years' time currently priced at 0.37% p.a. versus a long-term assumption of 0.90% p.a.

Global investment-grade spreads are now broadly in-line with historic medians, but sterling investment-grade spreads have fallen below their (slightly higher) historic median. Global speculative-grade spreads remained marginally above long-term median levels at the end of Q3.

Equities

Global equity markets produced a total return of 7% in Q3, supported by the ongoing improvement in the macroeconomic backdrop and a US earnings season that outperformed expectations. In general, cyclical sectors tended to outperform defensive sectors, although there were a few exceptions. Concerns over future energy demand were reflected in horrendous performance from the oil & gas sector; provisions for potential loan losses, low interest rates and flat yield curves continue to weigh on financials. Consumer goods did well as retail sales rebounded and consumer confidence improved following the initial easing of lockdown restrictions. Technology had an unspectacular third quarter, but the ability of technology companies to generate strong sales growth through the pandemic has heavily contributed to outperformance by the US market year-to-date.

Chart 5: Shiller price/earnings ratio relative to MSCI World Index



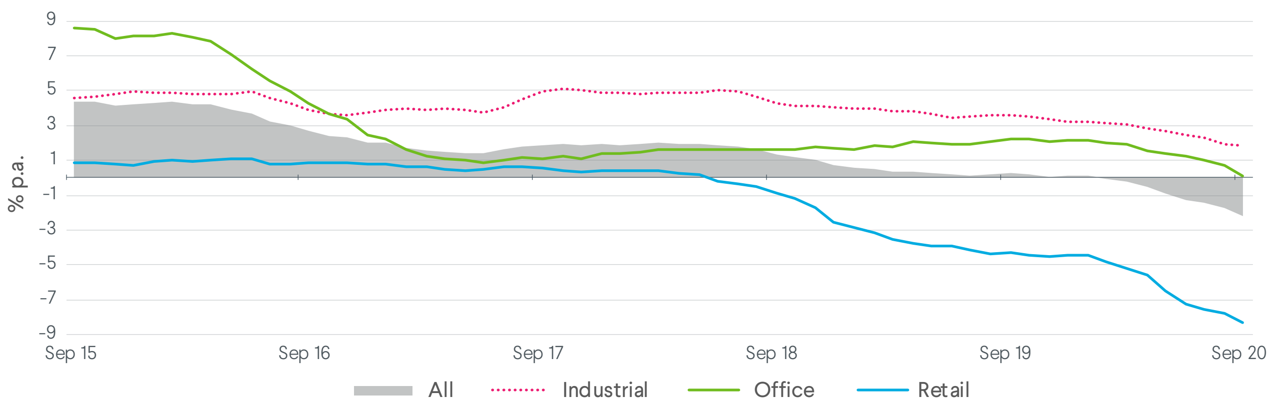
Source: Datastream

With prices rising as a downturn in reported corporate profits started to feed into historic numbers, global equity valuations, in aggregate, moved further above long-term averages. More striking is the divergence of valuations across regions (Chart 5). Notwithstanding any fundamental support for the performance of the technology sector, the US is now at its greatest premium to MSCI World for decades. In contrast the UK, weighed down by its higher than average exposure to financials and oil & gas sectors, looks cheap relative to history.

Property

The rolling 12-month total return on the MSCI UK Monthly Property index continued to decline in the third quarter, although the deterioration has moderated over the last couple of months. Capital values, in aggregate, have fallen 7.8% in the year to August, predominantly due to an 18.6% fall in the retail sector – retail capital values continue to fall month by month, but declines in office valuations have slowed, while industrial valuations have actually edged higher in the third quarter.

Chart 6: UK property rolling 12-month annual rental growth



Source: MSCI UK Monthly Property Index

In aggregate, annual rental growth is negative (Chart 6) and a recent survey of UK commercial property published by the Royal Institute of Chartered Surveyors shows rent expectations and occupier demand are the worst they have been since the Global Financial Crisis. Significant amounts of rent due in the third quarter remain unpaid, although, with more businesses re-opening, collection rates have improved compared to last quarter. There has also been a sufficient increase in transaction and letting activity to encourage valuers to remove material uncertainty clauses from the vast majority of UK commercial properties subject to recent valuation. This has allowed most core balanced property funds that had suspended redemptions to re-open by the end of September.

Conclusion

Unprecedented policy support has, for the moment at least, eased the worst fears about the scale and duration economic downturn and goes some way to explain the sustained revival in investor sentiment. However, a surprisingly strong short-term economic bounce has already lost steam and the risks remain high while COVID-19 remains endemic in much of the world. It is increasingly difficult to justify prices even taking a relatively optimistic economic outlook.

We retain our underweight position to equities: not only does the outlook for earnings remain highly uncertain, but valuations are once again beginning to look a little stretched. A challenging fundamental backdrop and demanding valuations also lead us to remain underweight property. With investment-grade spreads moving below long-term median levels, we would now be more neutral between investment- and speculative-grade in corporate credit markets and have a modest bias in investment-grade portfolios towards asset-backed securities. Given our overall cautious assessment of risk assets, we continue to advocate holding more cash than required by strategic considerations. For those reluctant to hold cash within growth portfolios, non-directional assets – such as insurance-linked securities, macro hedge funds and absolute return diversified growth funds – may offer an attractive alternative, though these assets will require some assessment of active manager skill.

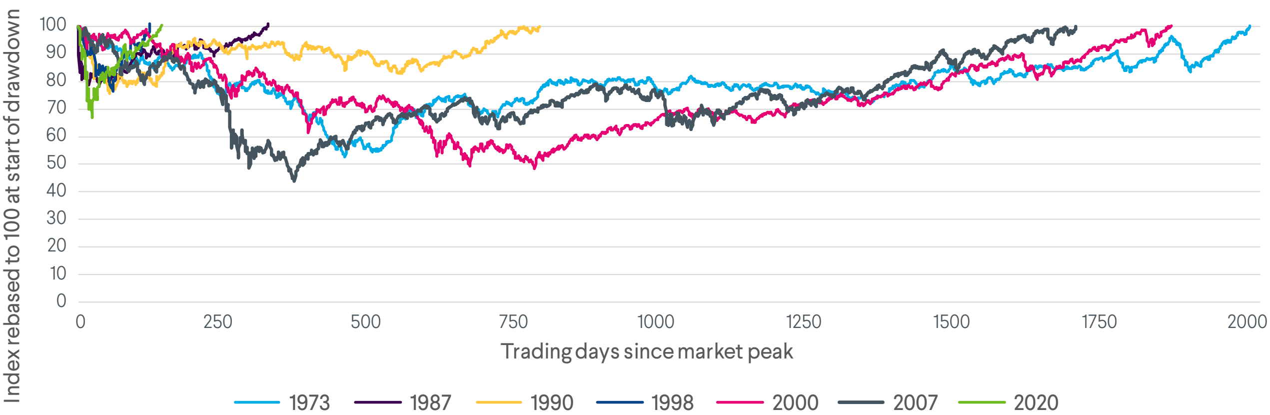
Equity investing: applying discipline and resilience in current times

Released: October 2020

In the first quarter global equity markets fell by 20%. Since then we have experienced a 27% rise up to the end of the third quarter, leaving global markets just into positive territory. In total, this represents a +48% increase from the lowest point on the 23rd March, giving 2020 it's place in the economic history books as one of the sharpest drawdowns (ending the longest bull-market) and quickest recoveries on record. Chart 7 shows that global equities took just 141 trading days to return to the previous heights reached in mid-February, compared to an average of around 1,000 trading days for other bear markets to reach their pre-crisis level.

The key point to note here is that no market cycle is the same and certainly the COVID-19 pandemic has been incomparable in terms of its impact on global equity markets. This article investigates the recovery and its implication for investors.

Chart 7: MSCI World (price) bear markets greater than 20% drawdown since 1970 in local currency terms

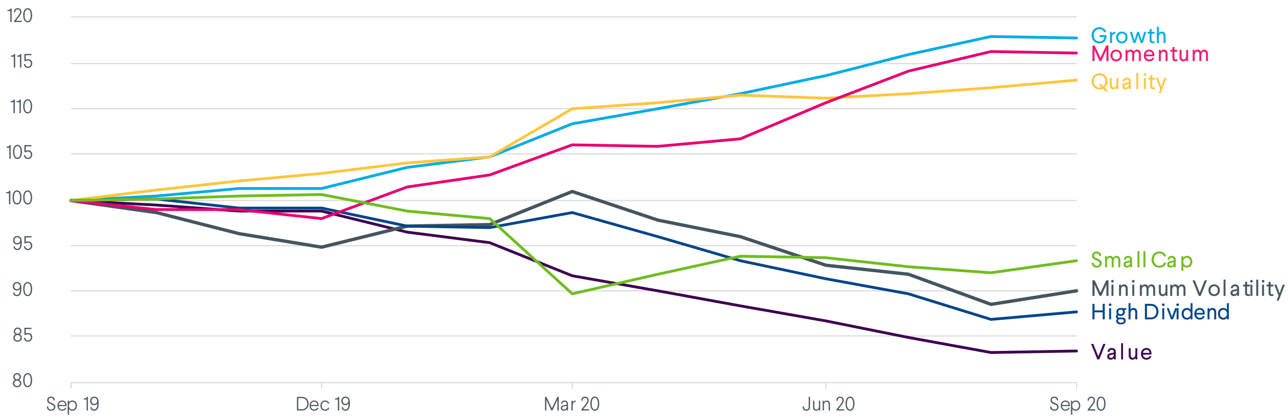


Source: DataStream

The speed of the recovery can largely be attributed to swift central bank and government action that helped to stabilise markets that were, at times, in free-fall in mid-March. One could argue that these were policy actions tested and remembered from the financial crash just over a decade ago.

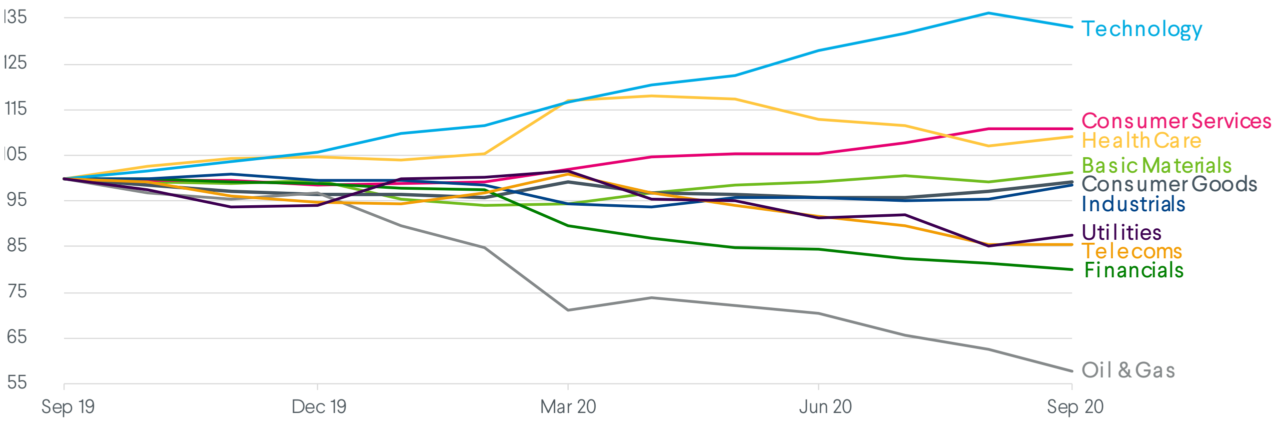
However, this rebound has been far from a uniform picture and the variation in returns across markets has been huge. Within regional equities, we see how well the US market has performed (+11% year to end of September) and how dismally UK equities have fared (-19% year to end of September) in local currency terms. Drivers of regional returns have reflected the often-interlinked sector and factor composition of each market.

Chart 8: Global factor performance relative to the MSCI All Country World Index



Source: DataStream

Chart 9: Global sector performance relative to the FTSE All-World World Index



Source: DataStream

How have global equities performed in the recovery?

Charts 8 & 9 show the returns measured monthly for different factors and sectors relative to their broader global equity market index from September 2019 to 2020.

Chart 8 shows so called value, small cap, high dividend and minimum volatility stocks have all suffered over the year, with the divergence from growth, quality and momentum accelerating after the crisis. This is not surprising - value stocks tend to underperform in an economic downturn (let alone a complete closedown) as these stocks are often concentrated in cyclical areas of the market such as financials, oil & gas and materials, which have all underperformed this year (Chart 9). These areas are over-represented in the UK market which partly explains the UK market's underperformance over the year.

While the underperformance of value stocks may be representative of a more traditional end to the market cycle, the performance of minimum volatility and high dividend yield stocks relative to MSCI ACWI is less traditional. These stocks tend to be concentrated in more defensive sectors such as utilities, telecoms and generally more mature, traditional markets and therefore we might have expected them to outperform the market at least during the initial volatility.

Utilities provided some protection as markets tumbled in March, but not a lot – regulated utilities have the resilience of domestic consumer use, but lockdown measures meant that commercial consumption was effectively turned off overnight. They were already at stretched valuations so could only provide limited protection, and then they were always going to lag in a market rally.

Similarly, telecoms would be seen as defensive and might have been expected to perform better given customers on fixed contracts and companies have static revenues - but lockdown has meant increased switch to digital and so their costs have increased during the pandemic to maintain and invest to meet the additional demand for services. Essentially, they have not benefitted from the huge rise in domestic internet use, unlike some other areas of the market.

On the flip side, if we look at growth, quality and momentum stocks, they have all outperformed significantly over the year, parallel to the outperformance of the technology sector where a number of these stocks reside (but not exclusively). The pandemic was a catalyst for technological adoption, and to adapt a saying, forcing 10 years of advancement in 10 days on a large percentage of the global population. In previous market cycles, we might have expected technology to sell-off further than the broader market, due to the higher levels of speculation involved in valuation, which have on occasion been the cause of bear markets. However, the pandemic's influence on consumption and working patterns caused the sector and more broadly, digital companies, to provide the greatest resilience; record low government bond yields have acted as a tailwind for some of the higher growth stocks as the present value of future expected earnings increased.

In particular, the 5 largest capitalisation stocks in the index (Facebook, Apple, Amazon, Alibaba, Microsoft) have all benefitted from the complete shift in consumer behaviour resulting from COVID-19 which catapulted them and the US (excluding Alibaba) market forward. While their leadership of the recovery has led to higher stock concentration in global equity markets than pre-crisis, we would caution against drawing comparisons with previous 'tech bubbles' as these stocks all make money and they are no longer pure tech companies – instead they are all beneficiaries of increased internet use, a trend that is likely to remain sticky even after the pandemic under the new global economy.

What does this mean for global equities?

Public equity markets are highly efficient at pricing the short-term based on the information available today, as demonstrated by the outperformance of technology at the expense of sectors where business models were fundamentally compromised by the lockdown measures. However, predicting the future beyond the short-term is more difficult.

While they have provided greater resilience, will the rise in price multiples of growth or 'new economy' stocks run out of steam? Will there be a catalyst, such as a vaccine, for a return to pre-COVID society lifestyle, without which many of the value or 'old economy' stocks could remain cheap for a long time, or worse fail?

The reality of the environment we are in today means that we do not know where the virus, the economy or markets will be in 6 months let alone 2 years' time. That means we are facing the greatest range of potential outcomes most us have seen. With all this uncertainty, we believe it is asset allocation should remain balanced and disciplined – to use the old goldilocks porridge analogy: not too hot, not too cold.

Perhaps the only certainty is uncertainty. The pandemic's unique influence on global equity markets and the dispersion of the recovery highlights the difficulty predicting equity market outcomes in any economic environment. This is exactly why we like diversified multi-factor equity strategies that avoid trying to 'time' factor swings and instead try to capture and maintain exposure to all parts of the market and rebalance to them in a disciplined way.

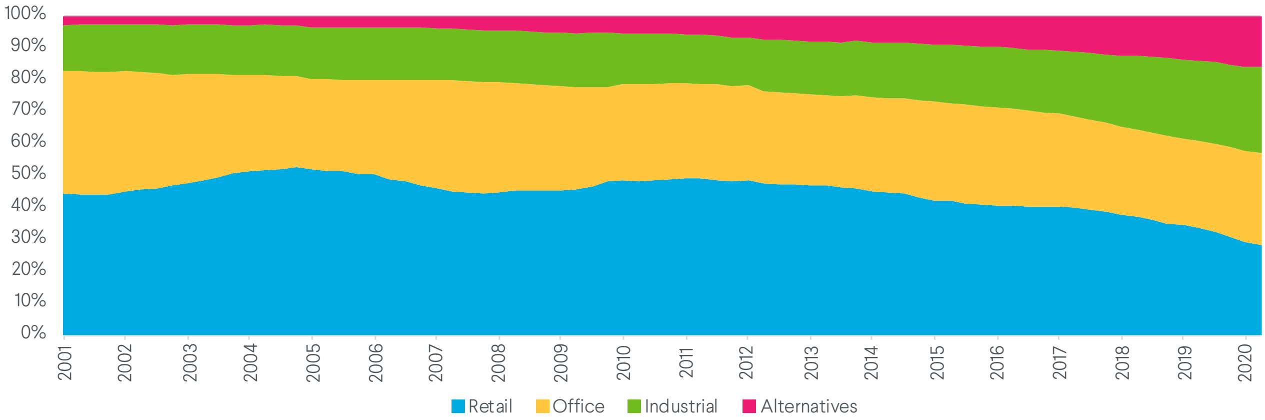
Andy Green
Partner
andy.green@hymans.co.uk
0131 656 5151

UK property: a changing landscape

Released: November 2020

The UK property market has been undergoing structural change for a number of years, attributable to changes in urbanisation, demographics and investor sentiment. As Chart 10 shows below, the makeup of the broader market (represented here by the MSCI UK Quarterly Property Index) has been changing over the last two decades.

Chart 10: Sector composition of MSCI UK Quarterly Property Index



Source: MSCI.

This article examines existing structural trends and the impact of the pandemic in either accelerating or stalling these trends, looking across each of the four sectors: retail, office, industrial and alternatives.

Retail: all doom and gloom?

The pandemic and lockdown have certainly exacerbated a pre-existing crisis in retail, a sector already struggling. The growing number of vacancies paired with the fact that investors are actively looking to reduce their retail exposure over the last few years has meant that capital values and the overall performance of the sector has taken a significant hit.

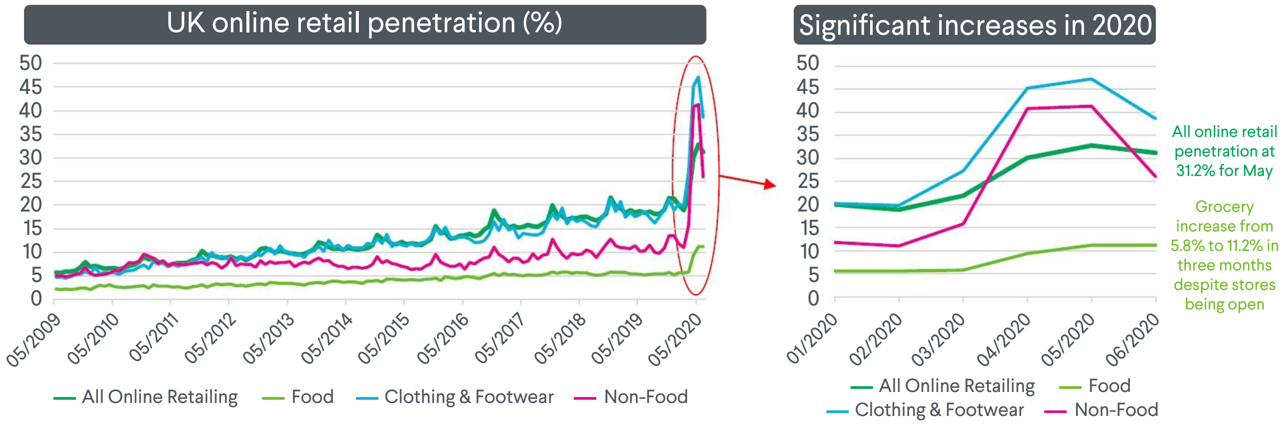
Uncertainty around retailer performance and rising vacancies across the country will likely add downward pressure to rents, a picture worsened by the macro elements: should unemployment increase considerably or there is prolonged uncertainty, consumer spending will be hit, which will mean further pain for the retail sector in general.

However, essential retail, such as supermarkets, has fared much better and is generally well valued by investors for being typically long-term, inflation-linked leases.

Industrials: logistics and the rise of ecommerce

There has long been a rise in online shopping to the detriment of bricks and mortar retail. With the national lockdown affecting non-essential shops, this caused a massive spike in ecommerce activity as spending shifted online. Online ecommerce penetration jumped from 19% to 32% from February 2020 to May 2020 with a slight decrease since. Chart 11 below breaks this out by sector:

Chart 11: The growth of E-commerce in the UK



Source: CBRE and the Office for National Statistics.

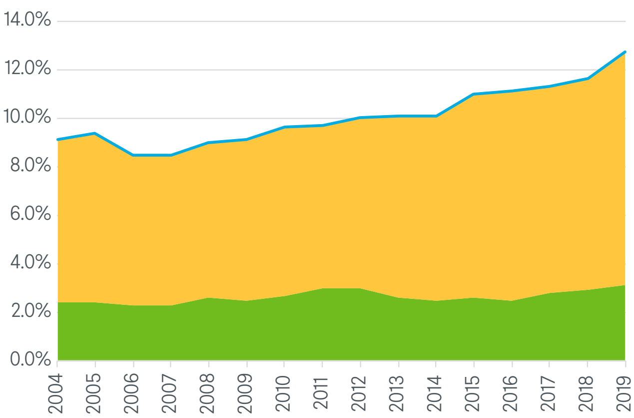
Logistics, a sub-sector of industrials, has been a popular allocation for investors for some time. In fact, the second quarter of 2020 saw a record take-up for UK logistics property, mainly driven by ecommerce-related functions, and this sector has proven resilient in terms of rent collections during the pandemic. This is a spike in activity previously fuelled by tenants seeking to secure both larger warehouse spaces and smaller, "last-mile" facilities close to city centres.

Offices: working hard or hardly working?

The trend of flexible, or remote working, and for more flexible co-working spaces had already begun to grow in favour in the UK. With lockdown forcing the vast majority of office workers to work from home, this trend has become the "norm", and indicates a shift in demand.

Pre-pandemic, employees who were working from home at least part of the time were a relatively small proportion of the workforce but had been growing as demonstrated in Chart 12.

Chart 12: The rise in home working



Source: Federated Hermes and Morgan Stanley ResearchStatistics.

A survey by Morgan Stanley has indicated a significant acceleration of this trend with all demographics and sectors indicating a preference to work from home more frequently in the future. In addition, nearly three-quarters of an Institute of Directors' survey respondents indicated that they would encourage staff to increase working from home post-pandemic. This change of demand is set to change the dynamics of the office sector, but we may not see the impact for a few years as companies are unlikely to break current leases and will make any changes at lease renewal stage.

Alternatives: mixed fortunes

Alternatives is a catch-all sector for assets outside of the main three sectors: retail, office and industrials. Within alternatives, hotels and residential (typically purpose-built rental accommodation rather than individual houses and flats) are the most established sectors but there has been a more recent emergence of student accommodation and healthcare underpinned by similar fundamentals: changes in demographics, a rise in middle-class incomes and urbanisation.

Residential property has, by far, proven itself to be the most resilient sector during the crisis and this is no real surprise as it is expected that the population will continue paying for its housing costs whenever possible. Student accommodation has also proven more resilient than expected with initial data showing lower than expected vacancy rates as universities have taken on more domestic students.

Other sectors within alternatives have had a much more mixed picture with UK hospitality suffering especially in areas dependent on business travel. Within the healthcare sector, the sector has suffered general reputational damage due to its handling of the pandemic in care homes and the outlook remains to be seen.

So what next? looking further afield

The UK is now officially in a recession. While we have seen some recovery in GDP, there are differing views, even within the Bank of England, as to how protracted the recovery will be amid assertions that some sectors may not fully recover.

With capital values likely to continue to face downward pressure well into 2021, total return expectations among those property investors brave enough to make forecasts over the next 3-5 years have low single digit returns for UK commercial property. Income returns should mitigate the declining capital values but we do not believe we have yet reached the bottom of the current property cycle.

In time, we expect core property allocations among investors to look markedly different to current allocations. There are potential parts of the property market investors may look to target to mitigate against the current risks to UK commercial property.

The UK Private Rental Sector is a nascent sector but rapidly growing, supported by a chronic shortage of supply caused by under-development and an increase in the population. People are renting for longer as it takes a lot longer to save a deposit to buy a house. This is a demand trend we expect to continue, which will further support this sector going forward.

According to LaSalle Investment Management, the UK real estate market in 2018 was only around 6% of global institutionally owned real estate. While the UK has always been attractive for foreign capital as it is a relatively liquid market backed by a strong legal framework, a global allocation to property can provide diversification from the enhanced opportunity set. While there is no doubt that real estate markets outside of the UK are undergoing similar trends, particularly in retail, a focus on resilient sectors internationally could be of benefit to investors with a property allocation.

Finally, ESG is now firmly on the agenda in major real estate markets as investors look to manage climate change risks especially. Asset managers predict that it will become almost impossible to sell buildings that aren't climate friendly, requiring further investment to bring them up to standard. Highly efficient buildings can mean higher levels of operational performance, lower emissions and lower cost of capital.

Summary

The UK commercial property market is changing, both due to structural change already underway pre-pandemic, but also due to the decline of the current property cycle. Brexit will also bring further short-term uncertainty. But the question remains as to what a Balanced Core property allocation will look like over the longer-term?

We expect balanced funds to transition to a more defensive allocation focusing on longer leases and high-quality tenants, moving away from retail to focus more on industrials and resilient alternatives, including residential. Investors may also wish to consider allocating capital beyond the UK property market to diversify exposure and help mitigate declining returns over the short and medium-term.

Penny Cochrane
Investment Research Consultant
penny.cochrane@hymans.co.uk
0207 7082 6381

Adam Porter
Investment Research Consultant
adam.porter@hymans.co.uk
0207 082 6243

Climate risk: Taskforce on Climate-related Financial Disclosures reporting to become mandatory for larger pension schemes

Released: August 2020

- TCFD is a framework for managing and reporting climate-related risks and opportunities;
- The Government is consulting on mandatory TCFD reporting and compliance with climate governance requirements for pension schemes with assets of £1bn or more;
- Master Trusts and Collective Defined Contribution schemes also fall within the scope of the proposals. Consideration is also expected to be given to the requirements for LGPS funds by MHCLG;
- Governance requirements would commence on 1 October 2021 for schemes with at least £5bn of assets and on 1 October 2022 for schemes with at least £1bn of assets;
- Schemes will be required to submit their first TCFD report within seven months of their scheme year ending after 1 October 2021 (2022 for £1-5bn schemes) but no later than 31 December 2022 (2023);
- The proposals address requirements for scenario analyses and use of metrics and targets. It seems likely that schemes will be required to calculate the Weighted Average Carbon Intensity of their portfolios;
- Pension schemes will need to publish their TCFD reports online.

The UK government has published proposals that will make reporting against the framework set out by the TCFD compulsory for larger pension schemes over coming years. Further, the proposals will require that pension schemes put in place appropriate governance arrangements to ensure that climate risks and opportunities are being considered, thereby discouraging tick-box reporting.

Background

These proposals follow the draft guidance issued by the Pensions Climate Risk Industry Group ("PCRIG") in March 2020 and the subsequent introduction of powers in the Pension Schemes Bill to require climate risk governance and reporting by pension schemes. The government has also signalled a future intent to consult on "Paris alignment reporting" and the potential obligation for pension schemes to report on the implied warming potential of a portfolio.

Proposed governance requirements

TCFD is a holistic framework for the disclosure of climate-related risks and opportunities. It is currently a voluntary framework utilised to various degrees by corporate entities. The framework has four dimensions which are: governance, strategy, scenario analyses and metrics & targets.

Pension schemes will be required to follow the broad recommendations of the TCFD in framing and implementing an approach to managing climate risk, as set out below. The Government expects to issue statutory guidance on the approach to be adopted although schemes will be able to follow their own approach and explain deviations in practice in their reporting.

Table 1: Climate related Financial Disclosures Framework

TCFD area	Requirements
Governance	• Establish and maintain oversight of climate-related risks and opportunities • Establish and maintain processes that allow the trustees to satisfy themselves that those managing the scheme are assessing and managing climate-related risks and opportunities
Strategy	• Identify climate-related risks and opportunities that will impact the investment and, for DB schemes, funding strategy of the scheme over different time horizons • Assess the impact of identified risks and opportunities on the scheme's investment and, for DB schemes, funding strategy
Scenario analysis	• At least annually, assess the resilience of the scheme's assets, liabilities and investment and, for DB schemes, funding strategy to climate-related risks in at least two scenarios (including one scenario that reflects an annual temperature rise of 1.5 to 2 degrees.
Risk management	• Adopt and maintain processes for identifying, assessing and managing climate-related risks • Ensure the integration of climate-related risks into overall risk management
Metrics	• Select at least one GHG emissions and one non-emissions metrics against which to assess scheme assets against climate-related risks and opportunities • At least quarterly, obtain the Scope 1/2/3 emissions of the portfolio and calculate the selected emissions metric • At least quarterly, obtain the necessary data and calculate the non-emissions metrics
Targets	• At least annually, set one target to manage climate-related risk with respect to the chosen metrics and measure performance against this target at least quarterly.

Whilst metrics have not been specified, instead allowing trustees to select measurements which are appropriate to their own investment arrangements and governance process, statutory guidance is expected to specify the types of metric that may be employed. In particular, it is expected that the use of Weighted Average Carbon Intensity[2] (WACI) will be included in guidance as the preferred emissions-based metric.

Proposed disclosure requirements

Trustees will be expected to report on the application of their governance processes on an annual basis. The proposed form of the disclosures largely follows the various governance requirements, with the reporting being a standalone document and not necessarily repeated in full within an Annual Report.

It is noted that data availability may, in some circumstances, be limited and modelling approaches are continuing to evolve. The proposals therefore note that trustees will be expected to comply with scenario analysis and reporting on metrics "as far as they are able", recognising that the market will need to develop. It is expected that trustees will drive up standards of reporting by investment managers. Scenarios will be prescribed and must include a "global average temperature rise of 2 degrees or lower" scenario.

Trustees will be expected to publish their TCFD report on a public facing website. Although it is not expected that the TCFD report will be included within schemes' Annual Report and Accounts, the Report and Accounts will be required to provide a link to the TCFD report.

Trustees will also be expected to notify members of the TCFD report via the annual benefit statement and provide the Pension Regulator with the website address of the TCFD report.

2 Emissions per unit sales for each portfolio company, weighted by the size of the allocation to each company in the portfolio

Who's in scope?

The proposals will initially apply to:

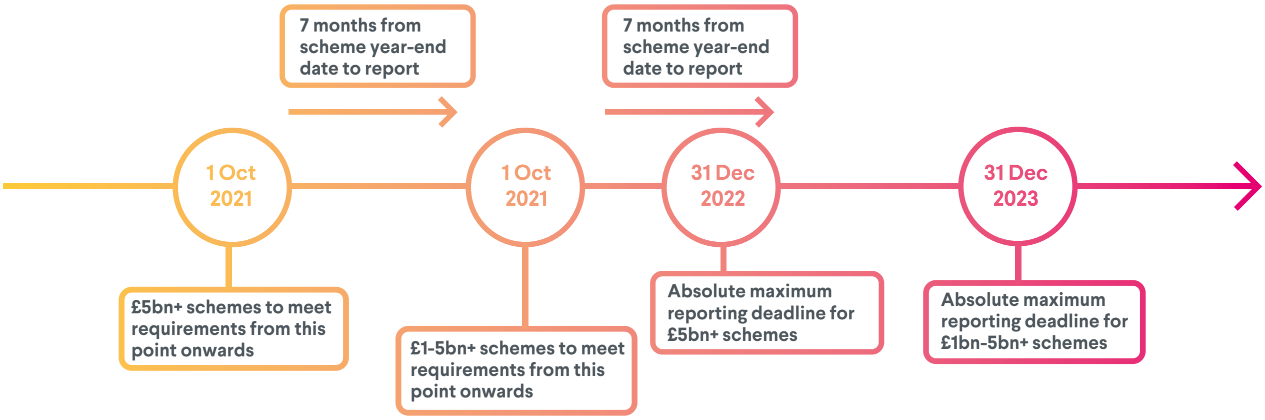
- Pension schemes with assets of at least £5bn at the scheme year ending on or after 1 June 2020; or
- Schemes which are authorised master trusts or authorised schemes providing collective money purchase benefits at 1 October 2021;

The proposals will subsequently be extended to include pension schemes with assets of at least £1bn at the scheme year ending on or after 1 June 2021, this test being made annually thereafter to determine whether a scheme will fall in scope.

Once in scope, schemes will remain in scope until assets fall below £500m.

Whilst the proposals only apply to trust-based schemes, the government has noted that the Ministry of Housing, Communities & Local Government "will make provision for the Local Government Pension Scheme, in line with their responsibility for the investment and governance of the LGPS". The FCA is also considering disclosure requirements for firms providing workplace pensions.

Diagram 1: Governance and reporting timescales



Governance – schemes will be required to meet the governance requirements from 1 October 2021 to the next scheme year end and then for full scheme years. For schemes with assets between £1bn and £5bn, the requirements will come into effect on 1 October 2022 and apply for the proportion of the scheme year from that date onwards.

Reporting – schemes will be required to complete and publish a TCFD report within 7 months of the first scheme year ending after 1 October 2021, but no later than 31 December 2022. For schemes with assets between £1bn and £5bn, the report must be made within 7 months of the end of the first scheme year beginning after 1 October 2021, but no later than 31 December 2023.

Penalties for non-compliance

The Pensions Regulator is expected to be given discretionary powers to fine trustees for inadequate reporting against the requirements. Mandatory penalties will apply in respect of total non-compliance.

Consultation

The Government was seeking views on the proposals no later than 7 October 2020 and as a result we have responded to the consultation with the following:

"We welcome the Government's consultation on mandating TCFD reporting requirements for pension schemes. Pension schemes can only contribute to the mitigation of climate risk by reallocating capital or by driving changes in behaviour. The continued focus on climate risk is welcome and we are particularly encouraged that this consultation steps beyond just disclosure to the underlying actions that trustees are expected to take in developing their approach. Looking beyond the risks associated with climate change to the potential opportunities to influence or create change must become a part of asset owners' mindset. The proposals may result in some schemes needing to report within relatively short timescales; trustees should therefore be familiarising themselves with these new requirements as soon as possible and work closely with their advisers to ensure they are ready for TCFD reporting."

Simon Jones
Partner & Head of Responsible Investment
simon.jones@hymans.co.uk
0131 656 5141

Market returns to 30 September 2020

	Yield % p.a.		Returns to 30 September 2020 (sterling, % p.a.)		
	30-June	30-Sept	1 year	3 years	5 years
EQUITIES					
Global	2.5	2.2	5.7	8.9	14.4
UK	4.7	4.6	-16.6	-3.2	3.5
Developed markets ex UK	2.3	2.0	7.2	10.2	15.4
Emerging markets	2.9	2.5	4.6	4.6	12.7
BONDS					
Conventional gilts	0.5	0.6	3.4	5.7	5.1
Index-linked gilts	-2.4	-2.3	0.4	6.4	7.5
Sterling corporate bonds	2.1	2.0	4.3	5.0	6.1
High yield (US) *	7.0	6.1	2.3	3.8	6.6
Emerging market debt*+	5.5	5.2	1.3	3.5	6.1
UK PROPERTY	-	-	-2.7	3.2	4.6
HEDGE FUNDS *	-	-	2.4	2.7	2.8
COMMODITIES *	-	-	-6.3	0.6	4.4

* Return in $ +Hard currency

Source Datastream:

FTSE All Share
FTSE World Developed ex UK
FTSE All World

FTA Govt All Stocks
FTA Govt Index Linked All Stocks
iBoxx Corporate All Maturities

BofA ML US High Yield Master II
JPM GBI-EM Diversified Composite
UK IPD Monthly

Credit Suisse Hedge Fund
S&P GSCI Light Energy

If you would like to find out more about any of the topics discussed in this publication, please contact your usual Hymans Robertson consultant or:

David Walker
david.walker@hymans.co.uk
0141 566 7733

Mark Baker
mark.baker@hymans.co.uk
0207 082 6340

Andy Green
andy.green@hymans.co.uk
0131 656 5151