COP26 and the journey to net zero: DB Schemes Q&A

How as a Trustee can I tell if my manager is greenwashing?

I think the more pertinent question is: "how can I tell if my underlying investee companies are greenwashing?", and that's where your managers really need to do their homework.

Some bonds, particularly sustainability linked bonds (where the coupon can step up or down depending on if sustainable KPIs are met) have definitely been accused of greenwashing, where their sustainability targets linked to the relevant bonds just aren't seen as ambitious enough.

Investment into sustainable fixed income assets is an area you can (and should) really challenge your manager on, as part of your ongoing engagement with them.

Given the existence of 'Greenium', (giving up return), is it consistent with trustees' duties to invest in such bonds?

The greenium used to be fairly volatile but stabilised over the course of 2020. Asset managers predict that the greenium should decrease over the medium term as more and more green bonds come to the market (reducing the current supply-demand imbalance).

As for trustees' duties, it really comes down to the individual pension schemes and the weight they place on ESG or responsible investment to determine if a specific allocation to green/sustainable bonds is in-line with their investment beliefs and strategic objectives.

In the absence of explicit client instructions, managers will invest where they believe valuations make sense or have the potential to add value. For example, the initial green gilt issue exhibited a greenium at the point of issue but this greenium expanded materially on the secondary market in light of significant demand (i.e. yields fell / prices rose), giving managers the ability to sell down the green gilts purchased at a profit for clients.

A 5bp greenium may be fine if gilts paid a real yield or a nominal of 300, but when they pay 100 or less? That's material, surely?

It is material, but this was the first green gilt issue, so it was not too surprising that it attracted strong investor demand, including demand from overseas.

As the UK looks to build out the green gilt curve, it is anticipated that the greenium will become less material (i.e. the differential between equivalent green and "vanilla" gilts will diminish).

However, the initial greenium on the first green gilts expanded materially on the secondary market. This gave managers the ability to sell the green gilts at a profit, so while selling down the gilts in the short term isn't really in keeping with a desire to drive real world positive change over the long term, the relative materiality of the greenium can be offset somewhat if managers are opportunistic and sell to lock in gains.

Surely strong investor demand will turn the "greenium" into a discount not a premium?

The greenium refers to the amount of yield that investors give up, rather than the pricing of the bond. Stronger investor demand would increase the pricing, which would decrease the yield, and increase the "greenium" versus a conventional bond (assuming the demand for the conventional bond remains the same!)

Do you expect the current level of “greenium” to persist over the longer term?

The order book for the first green gilt was 10x oversubscribed and the order book for the second issuance was 12x oversubscribed, so you can see there’s currently significant demand in the market.

The first green gilt had a 1.5bp greenium (or 1.5bp lower yield than the equivalent "vanilla" gilt) at the point of issue, and the second issue's initial greenium came in around 2bps. Initial trading suggests that these greeniums have widened out materially on secondary markets.

The greenium across all sustainable fixed income assets really does vary by sector, credit rating and maturity, with longer dated bonds tending to have a slightly higher greenium. This proved true with the second green gilt issued, which was a longer-dated bond than the first green gilt. As more green gilts are issued, and the supply-demand imbalance reduces over the medium term, we would expect the greenium to reduce.

I’ll also take this opportunity to plug our very own Hymans’ podcast on green bonds which was released in November, where we talk more about the greenium and other aspects of sustainable fixed income assets.

How accurate are Microsoft's estimated measurements of supply chain carbon emissions?

2020 was the first year that Microsoft have estimated their Scope 3 (full supply chain) emissions. The calculation / projection method has not been shared but in any case, we would expect all estimates to improve over time.

More importantly, in their 2020 announcement, Microsoft have detailed how they expect each internal division and external supplier to reduce their respective carbon footprints year-on-year (through the use of a Microsoft carbon pricing scheme which gets more expensive over time).

We think this is a good example of how large organisations can make real world changes, while using their purchasing power to force suppliers in the chain to meet higher standards as well.

Do you have any examples of where L&G excluded a company from your portfolio on Net Zero Grounds, and the reasons why?

Companies can be excluded if they are not aligned with our investment beliefs. These include:

- Companies who are involved in the manufacture of controversial weapons
- Companies who violate the guidance of the UN Global Compact
- Companies with high coal usage

We have long prioritised company engagement over exclusion. Through our approach to active ownership, we have sought to improve companies' standards by engaging with them and using our voice. However, when combined with engagement and voting, and to help mitigate investment risks, targeted exclusions can also be a very powerful tool

Our company-wide policies on thermal coal and controversial weapons means that we exclude from all discretionary investments issuers generating more than 30% of revenues from thermal coal, mining and extraction, as well as those involved in the manufacture of cluster munitions, anti-personnel landmines, and biological and/or chemical weapons.

Elsewhere, exclusions under our Climate Impact Pledge are applied across all LGIM Future World funds and a number of other strategies. Our Climate Impact Pledge began as a programme focused on 80 companies, with divestment sanctions associated with a single fund. It has now expanded to over 1,000 companies, with potential exclusions applied over £58 billion of our assets (as at March 2021), including all auto-enrolment default funds in L&G Workplace Pensions and the L&G Mastertrust.

We are rated A+ for our responsible investment strategy and active ownership from the UN Principles for Responsible Investment and we are ranked #1 among asset managers for our approach to climate change in separate independent reviews by NGO's ShareAction and InfluenceMap. Further details on our policies and practices can be found on the L&G website.

How does L&G's Cala Homes' investment support its ESG investment strategy?

The UK's housing gap – the difference between current housing stock and the number needed for everyone to have a decent home to live in – is estimated to be over one million. The housing crisis is putting home ownership out of reach for many, and the biggest social impact comes from the lack of affordable and social rental homes.

Cala Homes are working to deliver 3,000 new affordable homes a year from 2023. Their housing developments look to help solve the housing crisis, especially in towns and cities outside of the southeast of England. Cala acknowledge that their commitment to building more housing will inevitably impact on their carbon emissions, but the firm's balanced and measured approach to their commitments means they are considered holistically, in the broader context of Cala's vision for inclusive capitalism.

Cala note the following:

- *We have set Paris aligned carbon intensity reduction targets for the assets on our Group's balance sheet.*
- *Climate-related targets are now part of our Executive remuneration scorecard from 2021.*

- *In March 2021, we launched a climate solution to enable investment management clients to quantify climate risks and temperature alignment of their assets.*
- *All new homes we build from 2030 will be designed to operate with net zero carbon emissions. Work on reducing embodied carbon is continuing.*
- *Our operational carbon footprint (occupied offices and business travel) will be net zero from 2030.*

Do you have any examples of the sort of things you look for in investee companies / borrowers, in terms of desirable characteristics from an RI / Net Zero perspective, that could help trustees work towards their own Net Zero goals (e.g. if included in portfolio guidelines)?

Legal & General Retirement's focus to date has been on portfolio decarbonisation of the assets on our balance sheet to align with the Paris objective, targeting Net Zero carbon emissions by 2050 to help limit the increase in global temperature to 1.5C above pre-industrial times. We measure the portfolio carbon emissions' intensity metrics of our portfolios, in units of carbon dioxide equivalents and measured in tonnes (tCO_2e) and are targeting a reduction of 50% by 2030 (compared to 31 December 2019).

LGIM also manages buy and maintain credit assets for DB clients, and incorporates three pillars to its Responsible Investing approach to ESG:

1) ESG integration: Given their financial materiality, evaluating ESG factors (alongside traditional financial metrics) is an integral part of the credit research process.

2) Active engagement: As one of the largest asset managers and a leading responsible investor, LGIM believes in Active ownership and that it can use its scale and influence to help ensure the companies in which it invests are delivering long-term sustainable value for its clients.

3) Climate leadership: LGIM believes that climate change represents a material systemic risk for long-term investors. Each year we publish our Climate Impact Pledge and hold c. 1000 companies accountable by publishing their climate performance in a 'traffic light' system - companies are 'named and famed' or 'named and shamed' as we encourage firms to put sustainability at the heart of their strategy and take action to move towards net-zero carbon emissions by 2050.