GLOBAL INVESTOR SURVEY ON CLIMATE CHANGE

ANNUAL REPORT ON ACTIONS AND PROGRESS 2011

IIGCC
Institutional Investors Group on Climate Change

Investor Network on CLIMATE RISK

Investor Group on Climate Change

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About Institutional Investors Group on Climate Change

The Institutional Investors Group on Climate Change (IIGCC) is a forum for collaboration on climate change for investors. IIGCC's ambition is to provide investors with a voice on climate change and engage with policymakers, companies and investors on addressing long-term risks and opportunities associated with climate change. The group currently has over 80 members, including many of the largest pension funds and asset managers in Europe, representing assets of over $10 trillion. In detail, the IIGCC's objectives are:

- To encourage the adoption of public policy solutions that ensure an orderly and efficient move to a low carbon economy as well as measures for adaptation which are consistent with long-term investment objectives.
- To encourage a pro-active approach on climate change amongst asset owners and asset managers in order to preserve and enhance long-term investment values.
- To improve climate-related disclosure, reporting and management of climate related risks and opportunities across different asset classes.

www.iigcc.org

About Investor Network on Climate Risk

The Investor Network on Climate Risk (INCR) supports 100 institutional investors with assets exceeding $10 trillion in addressing the financial risks and opportunities associated with climate change and related sustainability issues. INCR works with its members on climate-related investment practices, corporate engagement, and disclosure and policy issues.

INCR is coordinated by Ceres, a U.S.-based coalition of investors and public interest groups mobilizing sustainable business practices and solutions to build a healthy global economy.

Launched by 10 investors in 2003 at North America's first Investor Summit on Climate Risk hosted by Ceres at the United Nations, INCR has grown to include the leading North American institutional investors in shaping responsible investment practices among, state and city treasurers and comptrollers, public and labour pension funds, foundations, other institutional investors and a wide range of asset managers.

www.incr.com

About Investor Group on Climate Change

The IGCC represents institutional investors, with total funds under management of approximately $700 billion, and others in the investment community interested in the impact of climate change on investments. IGCC's 60 members aim to encourage government policies and investment practices that address the risks and opportunities of climate change, for the ultimate benefit of superannuants and unit holders. We also aim to:

- Raise awareness of the potential impacts, both positive and negative, resulting from climate change to the investment industry, corporate, government and community sectors;
- Encourage best practices approaches to facilitate the inclusion of the impacts of climate change in investment analysis by the investment industry; and
- Provide information to assist the investment industry to understand and incorporate climate change into the investment decision.

www.igcc.org.au

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1 Foreword

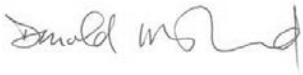
Institutional investors are becoming increasingly concerned that climate change poses a serious challenge to their investments. Despite growing evidence produced by climate science, global emissions continue to increase, and national and international policy responses remain inconsistent. Thus, the urgency of action by investors, companies and policymakers on climate change continues to grow.

This report provides the results of the second global survey of investment practices coordinated by the three investor networks on climate change – the IIGCC, based in Europe, INCR, based in North America and the Australia/New Zealand IGCC. The report provides an overview of the leading investment practices around the world on climate change and analyses the drivers for those practices.

It is clear from our survey results that credible and consistent climate change legislation and regulation remain critical to encouraging reallocation of institutional capital at scale. What the survey also shows is that leading investors are advancing their practices on a number of fronts; investing in climate change mitigation measures where they can now; and preparing to make further investments in future.

One of the greatest benefits of conducting the *Global Investor Survey* is the learning opportunity it provides for the institutional investment community. Even greater information sharing on climate related investment activities will be necessary in the future to reduce risk for all investors from a changing climate.

Despite the evidence of progress, shown in this report, there is still much scope for improvement in investment practice, and the investor networks will continue to encourage greater focus on climate related issues by asset owners and asset managers; to encourage asset owners to set clear expectations of their asset managers on taking account of climate risks and opportunities; to make appropriate changes to investment decisions; and to support improved transparency and reporting by all institutional investors on climate related investments. Most critically, we will continue to collaborate on an active dialogue with governments on adopting policies that accelerate investments in support of a low carbon economy.



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2 Executive summary

This is the second annual report on the results of the Global Investor Survey on Climate Change conducted by three investor networks – the Institutional Investors Group on Climate Change (Europe), the Investor Network on Climate Risk (North America) and the Investor Group on Climate Change (Australia and New Zealand) – whose members include many of the world's largest asset mangers and asset owners.

This report presents the key findings from the survey and, in doing so, provides an overview of emerging best practices on the integration of climate change considerations into investment processes. It is based on the survey responses from 42 asset owners and 51 asset managers that participated and is focused on actions taken during 2011. In aggregate the 93 investors that responded to this year's survey have assets in excess of USD12 trillion.

The membership of the three investor networks that publish this report represent global leadership on climate and investment behaviour. While this may be self-evident it is nonetheless worth highlighting – the activities they are undertaking showcase what a leading subset of investors are doing to better understand, plan for and, most importantly, manage the risks and opportunities as a result of climate change and climate policy.

The precise impacts of climate change are uncertain, both in terms of magnitude and timing. Yet one thing is increasingly certain – under most reasonable scenarios the costs of failing to prepare for climate change will be significant and these costs will increase with every year that action is delayed. This point is well understood and accepted by the vast majority of investors who responded to this survey.

It is also encouraging that this year's investor respondents are taking stronger and more concrete steps to address the challenge of climate change and, in doing so, are helping catalyse solutions that other mainstream investors will no doubt rely on in the years ahead.

The survey results also make clear that European and Australian investors continue to lead their peers in North America in terms of overall engagement in addressing climate change. That said, large US funds are doing some noteworthy work, especially in regard to direct company engagement through shareholder resolutions.

The main message from this year's survey is that members of the investor networks have retained, and in many cases, boosted their commitment to addressing climate change in their investment activities despite wider economic and financial challenges and continuing policy uncertainty. However, more progress is needed in translating climate-related investment policies, research and risk assessments into investment decisions that reduce climate risks to portfolios and seek to capture climate-driven investment opportunities.

Other key report highlights of investor activities are provided below, further discussion of which can be found in the corresponding chapters.

Chapter 4 – Investor perceptions and commitment

- The majority of respondents view climate change as a material risk and make reference to this in their investment policies.
- 57% of asset owners conducted formal or informal climate risk assessments of their portfolios.
- To date, 26% of asset owners have made changes to their investment strategy or investment decision-making as a result climate risk assessments. Whilst this may seem low, the message is a positive one given the continued uncertainty around global climate policy negotiations.

Chapter 5 – Engagement

- The investor networks continue to facilitate high-level and successful public policy engagement activities by members (e.g. the Global Investor Statement on Climate Change and national climate policies).
- Corporate engagement remains primarily focused on listed equities but other asset classes are increasingly given attention by investors (e.g. real estate, private equity and corporate bonds).

Chapter 6 – Selection and monitoring of external investment managers

- The majority of asset owners (78%) consider climate change integration in manager selection, but mandates are rarely awarded solely on the basis of climate considerations.
- Climate change issues are included as criteria in Requests for Proposals (RFPs) and due diligence processes but rarely (as yet) included in Investment Management Agreements (IMAs).
- Asset owners are increasingly focusing on monitoring existing managers on climate issues – 53% of owners do this. The regional breakdown is: Australia, 63%; Europe, 41% and North America, 57%.
- Less than 18% of asset owners have set clear expectations of their managers on climate change.

Chapter 7 – Assessing and analysing climate risk

- Investors continue to conduct climate risk assessments of their portfolios using quantitative and qualitative approaches.
- A price for carbon is reflected in company evaluations where relevant (e.g. European Utilities) but given the low value currently attached to carbon the impact is generally immaterial.
- Confidence in carbon footprint data is still a limiting factor in the wider uptake of this type of analysis by investors.

Chapter 8 – Climate change investment opportunities

- Asset owners continue to allocate to themed investment strategies such as clean energy, energy efficiency and sustainable timber.
- Evidence of growing interest amongst larger funds in low carbon passive strategies.
- Over half of investors (63% of asset managers and 62% of asset owners) invest in climate solutions. The most common asset class for these strategies are developed market equity, private equity and infrastructure.

Chapter 9 – Consideration of climate risk across all asset classes

- Equities continue to receive most investor attention in terms of monitoring climate risk. However other asset classes are subject to climate related monitoring and assessment – for example real estate, infrastructure and fixed income.
- A minority of investors are avoiding or divesting from assets due to climate concerns.

3 Introduction

The annual investor survey of climate-related investment practices is in its second year of including the three regional investor networks – Europe, Australia/New Zealand and North America. It provides an overview of best practice by members of the global network, focusing on the integration of climate change considerations into investment processes.

This report is based on the survey responses from the 42 asset owners and 51 asset managers that participated. The survey focused on actions taken during 2011. It should be noted that members based in New Zealand did not complete the survey and thus the regional breakdown for the analysis includes Europe, Australia and North America. The networks would like to thank these members for the time they committed to completing the survey and also those that participated in follow-up calls.

Methodology / chapter summary

This project was divided into four distinct stages: the investor survey, verification of responses, analysis of data and production of the final report.

The regional investor networks commissioned Mercer to assist them in developing two surveys – one for asset owners (including those with internal asset managers) and one for asset managers. The surveys were based on the questions used in the preceding IIGCC questionnaire, with some modifications, in order to allow for year-on-year comparison of results where possible.[1]

As in previous years, Mercer was asked to conduct follow-up interviews with respondents selected from each region to verify survey responses as well as obtain further information that could be used in the case studies.

The final report considers the results of both the surveys and the verification calls. It provides evidence on how investors are building their knowledge of climate change and taking account of the issue in their investment decision-making and engagement activities.

The remainder of this report is structured as follows:

- **Chapter 4** provides an overview of investors' perceptions of climate change and the degree of firm-wide commitment demonstrated by investors.
- **Chapter 5** highlights how investors are individually and collaboratively encouraging policymakers to provide a policy framework that is supportive of long-term investment decision-making and the move to a low carbon economy. This is in addition to the engagement efforts being conducted to raise corporate standards.
- **Chapter 6** provides an overview of whether and how asset owners include climate change considerations in the selection and monitoring of external asset managers.
- **Chapter 7** describes how asset managers, including internal managers of asset owners, implement carbon evaluation processes across their portfolios.
- **Chapter 8** explores the drivers and challenges related to climate-related thematic investment opportunities and the extent to which asset managers and asset owners allocate funds to these investments.

[1] Please see **http://www.iigcc.org/iigcc-investor-statement** for further information on previous annual reports published by the IIGCC.

- **Chapter 9** provides an overview of how asset managers and the internal managers of asset owners integrate climate change considerations into investment analysis or due diligence process across all asset classes.

Case studies are used to highlight best practice across all of these areas and to provide examples of ongoing efforts amongst the networks. Where appropriate, the report highlights the (positive and negative) trends in investors' activities.

4 Investor perceptions and commitment

Headline messages

- **The majority of respondents view climate change as a material risk and make reference to this in their investment policy.**
- **57% of asset owners conducted formal or informal climate risk assessments of their portfolios.**
- **To date 26% of asset owners have made changes to their investment strategy or decision-making as a result of climate risk assessments. Whilst this may seem low, the message is a positive one given the continued uncertainty around global climate policy negotiations.**

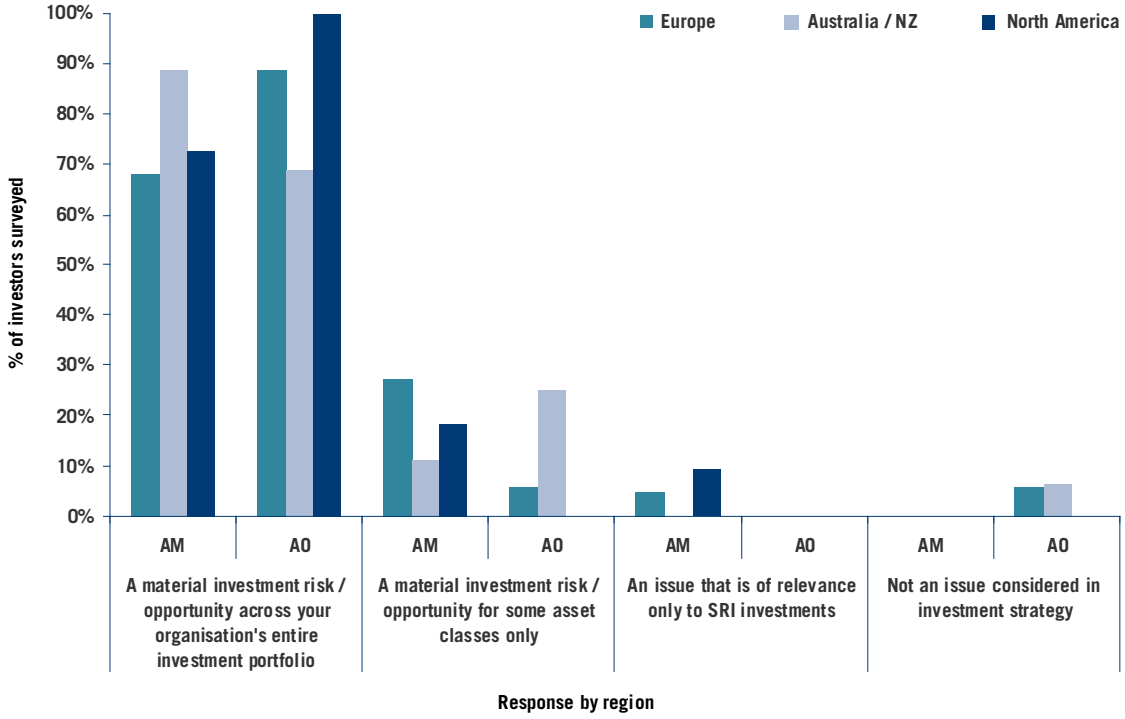
This chapter focuses on the survey questions that addressed the strategic and operational commitment of respondents, for example whether investment policies specifically reference climate change, whether portfolio climate risk assessments are conducted, and the extent of third party advice on climate and related issues.

Materiality and policy references

The majority of responding asset owners (83%) and asset managers (77%) stated they view climate change as a material risk or opportunity across their entire investment portfolio. Following on from this, a similar proportion make reference to climate risk in their investment policies – 67% of asset owners and 78% of managers. The lower figure for asset owners could be explained by the fact that investment policies typically address environmental, social and governance (ESG) issues in general rather than singling out climate explicitly although the asset owner figure has increased from 57% in 2010. This trend is encouraging as asset owners will generally require their asset managers to adhere to their investment policies. It is important, therefore, that asset owners establish clear policies as part of the process of setting expectations for their managers.

This difference between managers and owners is borne out by a number of comments in the survey that indicated climate is "just one risk among many", both in terms of general financial and ESG risks. This reflects the numerous investment risks that require consideration rather than a lack of regard for climate. Many of these additional investment risks are short-term in nature and/or more easily quantifiable. As a result they can "crowd out" climate risk, a long term issue that is not currently quantified in a uniform and reliable way across the entire investment market.

Figure 1 **Perception of climate change amongst investors**



Risk assessment at the asset class level – asset owners

Asset owners were asked whether and how they assess climate risk in their portfolios and, where an assessment was conducted, whether they made any changes to their strategies as a result. Chapter 7 discusses asset manager approaches to assessing climate risk.

A wide range of activities are evident from the survey responses. Some investors are struggling to define the investment risk specific to climate change whereas others have established formal processes for identifying climate (and other ESG) risk at the asset class level.

Over half (57%) of asset owners declared that they formally or informally assess the climate change risks to their assets, and 31% said they try to quantify these risks in some way.

Formal portfolio assessment tends to focus on the assignment of an ESG rating or ranking for each security within the investible universe. This type of best-in-class assessment generally encompasses a broad set of ESG issues of which climate change constitutes a subset. Specialist third parties typically conduct this analysis for asset owners. Asset managers are more likely to purchase this data and aggregate it with their own analysis.

On most issues European and Australian owners are ahead of those based in North America. However, on this issue North American asset owners match the commitment of those in Europe – in both regions half of the asset owners responding have developed a formal or informal framework for identifying climate risk. In Australia the figure is 69%.

Changes to strategy and processes

A key positive message coming out of this section of the survey is that asset owners are making changes to their investment strategy or decision-making based on their assessments of climate risk. Over half (55%) of asset owners state that a climate risk assessment is conducted, with 48% of these investors making changes based on the assessment. Overall, 26% of asset owners in this year's survey have made changes based on their assessment of climate risk. Whilst this may seem low, the message is a positive one given the continued uncertainty around global climate policy negotiations. A common approach to reducing exposure to climate risk is to increase a portfolio's exposure to assets that are assisting the transition to a low carbon economy such as sustainable timber and clean energy. For further detail on how asset owners are managing climate risk please refer to Case Study 1 which provides an update on how participants of the Mercer Climate Change Scenarios report continue to make changes to their investment strategy and policies.

Case study 1 Climate Change in Strategic Asset Allocation Decisions

In last year's report we highlighted the actions taken by our members that participated in the Mercer 'Climate Change Scenarios' project.

We decided to follow-up on what had been achieved since then to highlight to members how consideration of climate risk can be integrated into investment strategy and asset allocation decisions.

AustralianSuper

The Australian asset owner, AustralianSuper manages USD43 billion in assets.

As a consequence of the report's findings and analysis of AustralianSuper's current asset allocation, a review of the climate change risks across various assets in its portfolios was conducted. The actions resulting from the review are aimed at reducing the impact of climate change on the investment portfolio and to protect its assets and include:

- **Carbon footprinting the Fund's entire equities portfolio with a focus on its investments with Australian managers. This data was utilised to guide engagement activities.**
- **Carbon valuation analysis on its equities portfolio, factoring in the Australian carbon price scheme.**
- **A high level assessment of the impact of climate change-related policies and potential environmental impact on its top 20 property and infrastructure assets.**
- **Contracting of a specialist engineering firm to undertake a thorough assessment of the physical risks that could impact its infrastructure assets due to climate change up to the years 2030 and beyond.**

Environment Agency Pension Fund

The Environment Agency Pension Fund (EAPF) is one of the UK's largest local government pension schemes with approximately USD3 billion of assets. The scheme has two sub-funds based on the profile of its members – an 'active' fund for contributing members since 1989 (including those who have subsequently become deferred members or pensioners) and a 'closed' fund for those retired or deferred before 1989. Since 2003 the EAPF has placed responsible investment at the heart of its Active Fund's investment strategy, based on the belief that doing so will bring higher financial returns over the duration of its liabilities.

Over 2011 and 2012, the EAPF undertook a full review of its investment strategy. Specifically, the Fund is focusing on the following areas as part of its long-term goal of "greening" its investment strategy:

- As part of the strategy review, the EAPF has agreed to introduce additional exposure to climate sensitive assets such as timber, sustainable infrastructure and green bonds.
- In line with its commitment to RI, the EAPF is in the process of assessing the sensitivity of its new strategy to the three risk factors of Mercer's "TIP framework" (technology, impacts and policy). This analysis is in addition to an assessment of traditional risk factors such as equity risk premium, credit premium, and small cap premium.
- The EAPF has assessed its exposure to climate change risk under the new investment strategy against a selected number of peers.

This process will be concluded in the second half of 2012.

BT Pension Scheme

BT Pension Scheme (BTPS) is one of the UK's largest asset owners with USD58 billion assets under management, and aims to demonstrate leadership on sustainable investment. In response to the Mercer study, BTPS is monitoring the potential impact of different climate scenarios across its assets and liabilities and is considering how to effectively hedge risks arising from climate change policy uncertainty.

For example, BTPS helped to develop and invest in a low-carbon tilted passive equity index with the intention of delivering returns similar to those of the broader index with a markedly lower carbon risk exposure.

BTPS has also developed an overarching sustainability policy detailing and guiding its approach to the integration of longer-term risk factors in its investments.

CalPERS

CalPERS, one of the world's largest investors with assets of approximately USD234 billion, is one of the founding members of the INCR. During the twelve months since participation in the Climate Change SAA project, CalPERS has focused on the development of a formal implementation framework to guide the integration of ESG issues across its entire investment portfolio, of which the core environmental (E) theme is climate change. As a result of this, work undertaken in 2011 focused on the development and adoption of the framework. Looking forward, the Fund will utilise the report's findings in its next strategic asset allocation review.

The regional breakdown for asset owners making changes based on their internal assessment of climate risk shows a similar level for European (28%) and Australian (31%) asset owners, with 13% of North American owners doing so. Some investors provided a rationale for why their climate risk assessment did not result in any changes – most commonly investors stated that they were still trying to determine how to address their findings in terms of practical and feasible actions.

Training

Consistent with previous surveys, the level of resources applied to responsible investment is higher amongst asset managers than asset owners. This is a reflection of the resources available to asset managers relative to their asset owner peers rather than a greater commitment to managing climate risk amongst asset managers.

Training on climate change is practiced by the majority of responding asset managers (82%, compared to 85% in 2010). Training was generally provided through standard investment meetings and internal workshops, with some managers outsourcing this to third parties.

Asset owners generally have fewer internal investment staff overall, and this translates to fewer dedicated internal Responsible Investment (RI) staff. Training levels were much lower amongst asset owners (41%, compared to 45% in 2010).

In terms of who conducts training, asset owners are more likely to use third parties (typically their asset managers or advisers) whereas the managers in this year's sample typically use internal specialists.

Advice

The survey data suggests that the use and quality of investment advice related to climate change is variable. Less than half (41%) of asset owners sought climate-related advice in 2011. Areas where advice was used included manager search and selection processes, climate-related investment opportunities, benchmarking and strategic investment advice. Of those responding, only 26% said the advice was adequate. Recognising the current limitations in the market for advice in this area in North America, INCR has begun a project of engagement by asset owners and asset managers with investment consultants on clarifying and improving expectations, expertise, advice and services on climate change and other ESG issues.

Reporting

The trend in levels of reporting on climate activities is unchanged from last year – the majority of respondents provide some form of reporting (76% of asset owners and 82% of asset managers) although levels of public reporting on climate were lower. In aggregate 52% of asset owners and 60% of asset managers reported publicly in 2011.

European asset managers provided the most public reporting in 2011 (64%) followed by Australian (61%) and North American (46%) managers. Amongst asset owners Europe and North America produced the most public reports (67% and 63%, respectively) with just 31% of funds based in Australia reporting publicly on climate activities.

Historically, Australian asset owners have taken a more progressive approach to responsible investment – and in particular to climate change as an investment issue – than their North American counterparts. This particular finding is therefore not representative of market practice, indicating that reporting and disclosure is not always an accurate measure of general market activity.

5 Engagement

Headline messages

- **The investor networks continue to facilitate high-level and successful public policy engagement activities by their members (e.g. the Global Investor Statement on Climate Change and national climate policies).**
- **Corporate engagement remains focused primarily on listed equities but other asset classes are increasingly given attention by investors (e.g. real estate, private equity, corporate bonds).**

Investor engagement on climate change takes place on two fronts – public policy and at the corporate level. Whilst corporate engagement has historically been the focus of most investor attention, increasing effort is being applied to engaging public policy makers at the national, regional and international levels. This chapter considers investors' engagement efforts in both arenas.

Investor action on public policy

Public policy engagement is important not just because of the likely physical and economic impacts of climate change but also because of the importance of well designed and implemented climate policy for promoting investment in the markets for clean energy and related technologies.

Engagement remains a valuable tool for institutional investors in encouraging the development of policy related to climate change. The three networks continue to facilitate the majority of public policy engagement for respondents – 80% of asset managers and 83% of asset owners stated that they predominantly use the networks for public policy engagement. This can be attributed to the ongoing success of the investor networks in influencing public policy development and a preference for collective action on policy issues.

The investor networks' efforts have focused on both global and local issues – the joint global investor statement continues to receive wide support. The 2011 Statement, developed jointly by IIGCC, INCR, IGCC Australia/New Zealand and UNEP FI and supported by the PRI's Advisory Council, was the biggest of its kind to date, with over 295 signatories representing more than USD20 trillion in assets. It was substantiated by a major report, which considers the nature of investment-grade climate and energy policy drawing from examples around the world.[2] The Statement was distributed to all of the G20 heads of state and other key policymakers and received global press attention. The 2011 global investor statement is often referred to as evidence for growing investor demand for more effective policy frameworks.

More detailed examples of how each of the three investor networks undertook domestic policy engagements during 2011 are highlighted below:

[2] UNEP Finance Initiative, IIGCC, INCR and IGCC; *"Investment Grade Climate Change Policy: Financing the Transition to a Low-Carbon Economy"* (2012)

IIGCC – Europe

- IIGCC engaged with the EU Commission, EU Parliament and national governments on developing a low carbon agenda, emphasising the need for policies providing transparency, longevity and credibility.
- IIGCC facilitated a dialogue between a group of institutional investors from around the world and the UNFCCC on the policy framework that would support a reallocation of capital towards lower carbon assets.
- IIGCC participated in the dialogue on climate policy through public statements, public consultation processes and private meetings on policies ranging from carbon pricing to energy efficiency and explaining the asset allocation decision frameworks of institutional investors.

IGCC – Australia / New Zealand

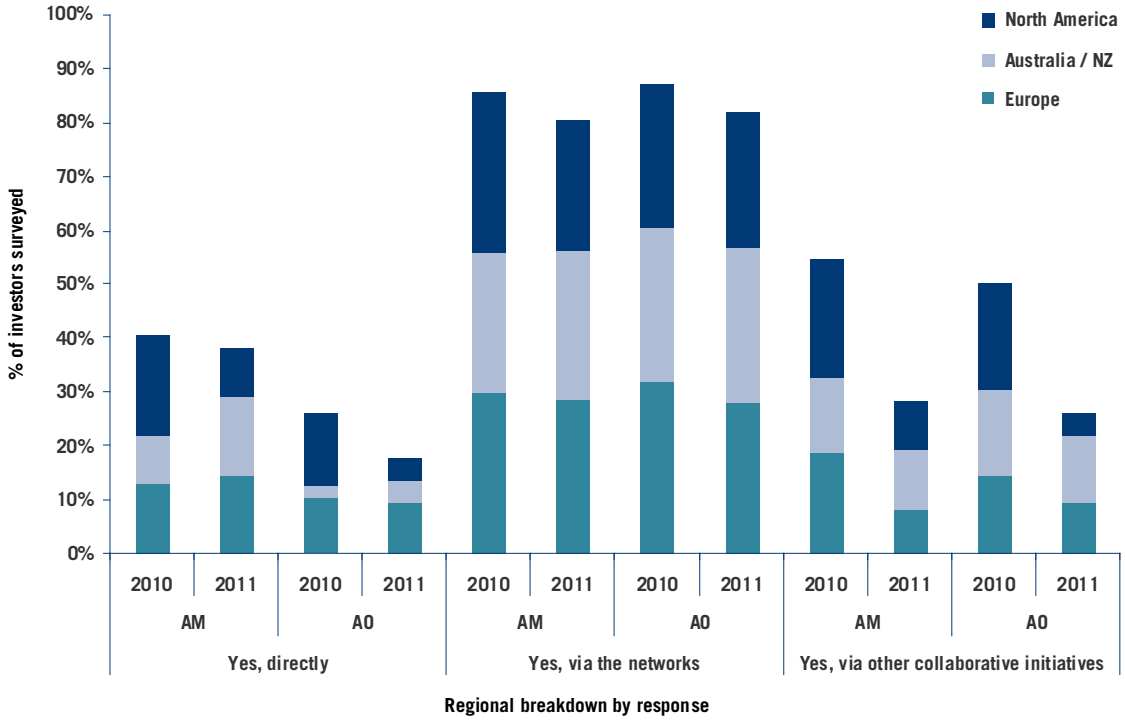
- IGCC participated on the Australian Government's Climate Change Policy Roundtable with the CEOs of major corporations and business associations. The panel was the key business reference group for feedback on government climate policy.
- IGCC provided substantial input into the design of the Clean Energy Finance Corporation via its member Low Carbon Finance Working Group both via public consultation processes and follow up meetings with government representatives charged with designing the institution.
- IGCC's member CEO panel contributed to public debate on climate policy with public statements on the importance of long term, transparent, market based climate policies.
- IGCC successfully coordinated investor activities in Australia related to the package of measures that are being implemented from 2012 onwards, starting with the carbon price.

INCR – North America

- INCR members sent a letter and engaged with members of the US Congress urging defeat of a resolution that would have effectively rescinded key US EPA regulations on emissions of mercury and other toxic air pollutants from electric power plants.
- INCR members sent a letter to members of the US Congress supporting the extension of the Production Tax Credit, a key financial incentive that supports the finance of wind energy facilities.
- INCR contributed to the successful collaborative engagement in the US with investor action resulting in the continuance of the Global Warming Solutions Act – a California state law that aims to reduce GHG emissions. A proposition sponsored by three oil companies – Valero Energy Corp., Tesoro Corp. and Koch Industries – to suspend the Act was defeated in November 2010 after effective investor advocacy against the repeal effort.

In contrast to the collaborative activities coordinated via the investor networks, the past 12 months has seen a decrease in participation within other collaborative initiatives as a method for engaging policy makers on climate change across all regions (see Figure 2, below). For asset owners, direct engagement remains a less utilised method due to constraints on resources and time, and the belief that acting in collaboration with other like-minded investors is more likely to succeed in gaining traction with policy makers due to their collective size and influence.

Figure 2 **Type of engagement with policy makers**



Raising corporate standards

The majority of investors continue to conduct corporate engagement (i.e. dialogue with their investee companies) in an effort to influence corporate strategy or behaviour. Historically, such dialogue has focused on the listed equity portion of portfolios. However, investors are increasingly exercising their ownership rights within asset classes such as private equity and real estate, which provide similar rights of ownership and therefore influence.

As would be expected the engagement approaches adopted differ between managers and owners. Asset managers mostly engage directly with investee companies (69%) and to a lesser extent in collaboration (59%). Asset owners are much more likely to engage collaboratively (74%) than directly (38%). This is to be expected as only the very largest asset owners have large enough equity stakes in their portfolio companies to have an influence – pooling assets and resources therefore makes sense.

Whilst investors are these days spending more time on other asset classes, engagement efforts with respect to climate change remain focused on companies within listed equity portfolios. The vast majority of investors with an allocation to developed market equity (67% asset managers; 86% asset owners) engage with their investee companies.

Other asset classes where corporate engagement is commonly undertaken include corporate bonds (29% asset managers; 21% asset owners), real estate (37% asset managers; 29% asset owners), private equity (18% asset managers; 24% asset owners) and infrastructure (18% asset managers; 12% asset owners). An interesting point to note is that mainstream asset managers appear to engage on listed equity holdings more frequently than managers that specialise in thematic climate change funds (92% mainstream managers; 55% specialist managers).

Case study 2 Collaborative engagement and measuring engagement success

New York State Comptroller's Office

New York State Comptroller (NYSC) is the sole trustee responsible for the management of New York State's USD150 billion Local Retirement System for public employees. During 2011, New York State Comptroller's Office engaged with CMS Energy (a US energy utility) via direct contact with support by Ceres. Engagement was in response to the Environmental Protection Agency's implementation of Clean Air Act requirements for large new or modified stationary sources, including power plants, to obtain permits that include greenhouse-gas emission limitations. These requirements are scheduled to take effect in the first half of 2012. NYSC felt that CMS Energy had not provided sufficient evidence of its plans to adhere to the Clean Air Act. NYSC took the step of proposing a shareholder resolution to encourage CMS Energy to do more.

The shareholder resolution read as follows:

> *"Shareholders request that the Company adopt quantitative goals for the reduction of greenhouse gas and other air emissions in anticipation of emerging EPA regulations; and that the Company report to shareholders by September 30, 2011, on its plans to achieve this goal, including plans to retrofit or retire its existing coal plants. Such a report may omit propriety information and be prepared at reasonable cost."*

As a result of this process CMS took a more positive approach to engagement resulting in the resolution being successfully withdrawn due to the Company agreeing to report to shareholders with the required information. The success of the engagement follows the success of a similar resolution filed in 2010 with another electric power company, which resulted in the company announcing the retirement of six old coal-fired plants in order to reduce emissions.

6 Selection and monitoring of external managers

Headline messages

- **The majority of asset owners (78%) consider climate change integration in manager selection but mandates are rarely given solely on the basis of climate considerations.**
- **Climate change issues are included as criteria in Requests for Proposals (RfPs) and due diligence processes but rarely (as yet) included in Investment Management Agreements (IMAs).**
- **Asset owners are increasingly focusing on monitoring existing managers on climate issues – 53% of owners do this. The regional breakdown is: Australia, 63%; Europe, 41% and North America, 57%.**
- **Less than 18% of asset owners have set clear expectations of their managers on climate change.**

Asset owners sit at the top of the investment food chain. As a result they are in a position to influence the behaviour of the asset managers and advisers whose services they employ. If asset owners demand integrated analysis of climate and other ESG factors alongside financial factors, asset managers and advisers are obliged to respond.

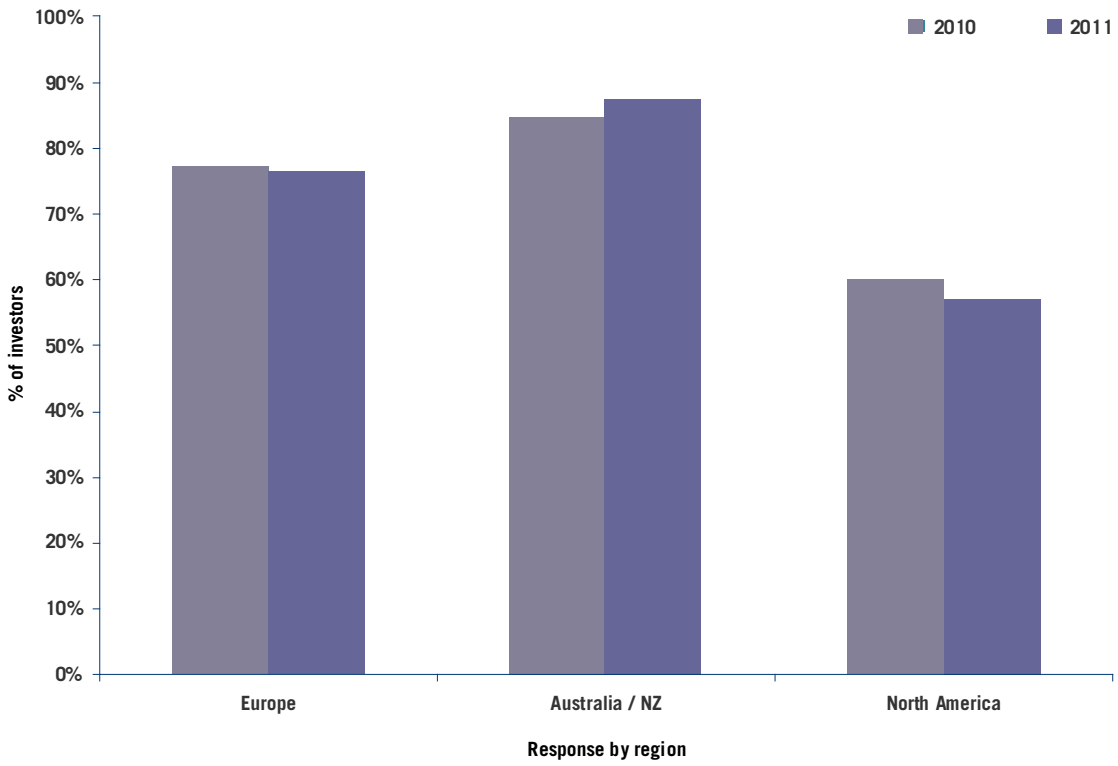
Conversely, if asset managers believe climate to be a material risk across the entire investment portfolio (and 77% of the managers in this survey do) then their asset owner clients should expect to see the consideration of climate change by managers in investment decision-making. Whether this occurs in practice can be determined by asset owners when they conduct manager selection processes and also through the regular monitoring meetings they hold with (external) asset managers.

This chapter considers the responses of asset owners that employ external asset managers on whether and how they include climate change considerations in manager selection and monitoring processes.

New appointments

Including climate change criteria in an investment mandate from the very beginning is the ideal way to establish the issue as important to the portfolio. Most asset owners in this year's survey (78%) consider the extent to which managers integrate climate change into their investment process and ownership activities. Figure 3, below, shows the regional breakdown and compares this year's responses to those from last year.

Figure 3 Consideration of climate by asset owners in selection process for new managers



In most cases asset owners are considering climate factors alongside other ESG issues – especially for standard mandates (such as a global equity strategy). However, considering climate as an issue in selection processes does not translate into the final decision being based the level of climate integration by a given manager.

This is supported by the fact that whilst 43% of asset owners from the survey stated that manager selection decisions are influenced by climate change integration, in practice it is typically just one of many ESG issues that are considered for most mandates i.e. climate change criteria in isolation are unlikely to tip the balance or receive a significant weighting relative to other criteria. That said, for specific mandates climate change is more central to manager selection – for example energy intensive assets such as property and infrastructure or for 'themed' funds such as cleantech and renewable energy. The following quotes from asset owners responding to this year's survey help to illustrate these findings:

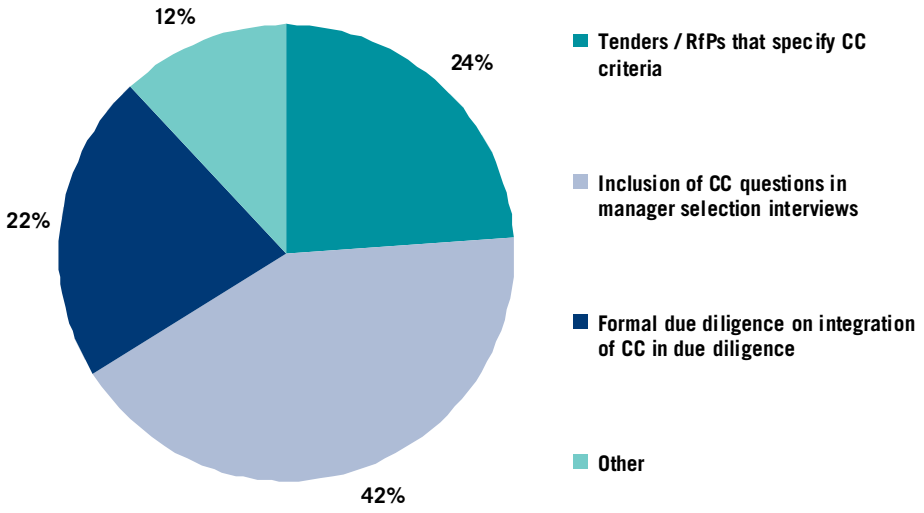
"While the extent to which a manager integrates climate change into their investment activities has influenced our manager selection, it is only one of a range of factors considered when appointing a manager."
Australian asset owner

"We do not apply a formal weighting [to climate factors] but the ability to integrate climate change effectively is considered a critical skill set for infrastructure and property managers in particular."
Australian asset owner

Formalising climate as an investment criterion

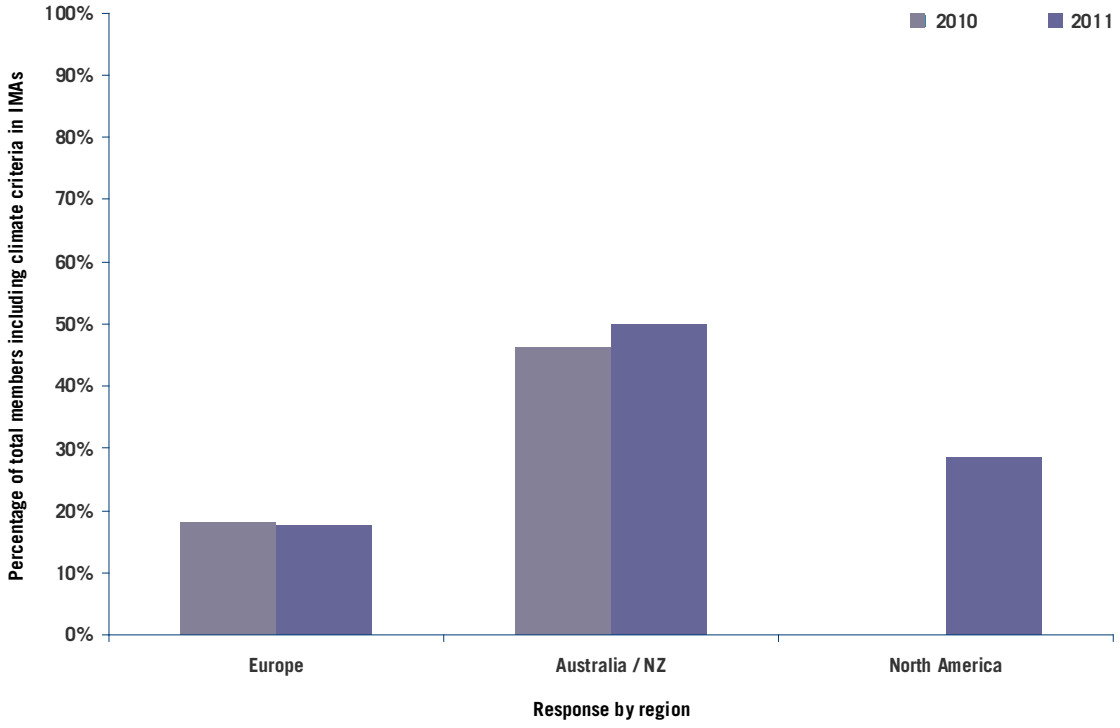
Embedding ESG, sustainability or climate change issues into investment mandates is still very much a work in progress for most asset owners. Almost 90% of asset owners that consider climate change integration when appointing external asset managers report that they include climate change criteria in RFPs, selection interviews or due diligence processes (see Figure 4).

Figure 4 Assessment of climate integration by asset owners in manager selection



However, few owners (33%) are then formalising this by including climate as a specific criteria in investment management agreements. The regional breakdown (see Figure 5) shows that owners in Australia are more likely to include climate criteria in IMAs than either their European or North American counterparts.

Figure 5 Inclusion of climate criteria in Investment Manager Agreements



The range of views on this point is highlighted in the following quotes from the survey respondents:

"The IMA places a number of obligations on our managers in relation to the integration and reporting of ESG issues. We expect climate change to be included but it is not defined separately." European asset owner

"New IMAs require fund managers to have regard to our ESG Policy which specifically refers to climate change." Australian asset owner

"Climate change requirements are only in IMAs with new managers. Some managers have provided excellent responses, other have been below par. We try to encourage managers to improve rather than penalising them." Australian asset owner

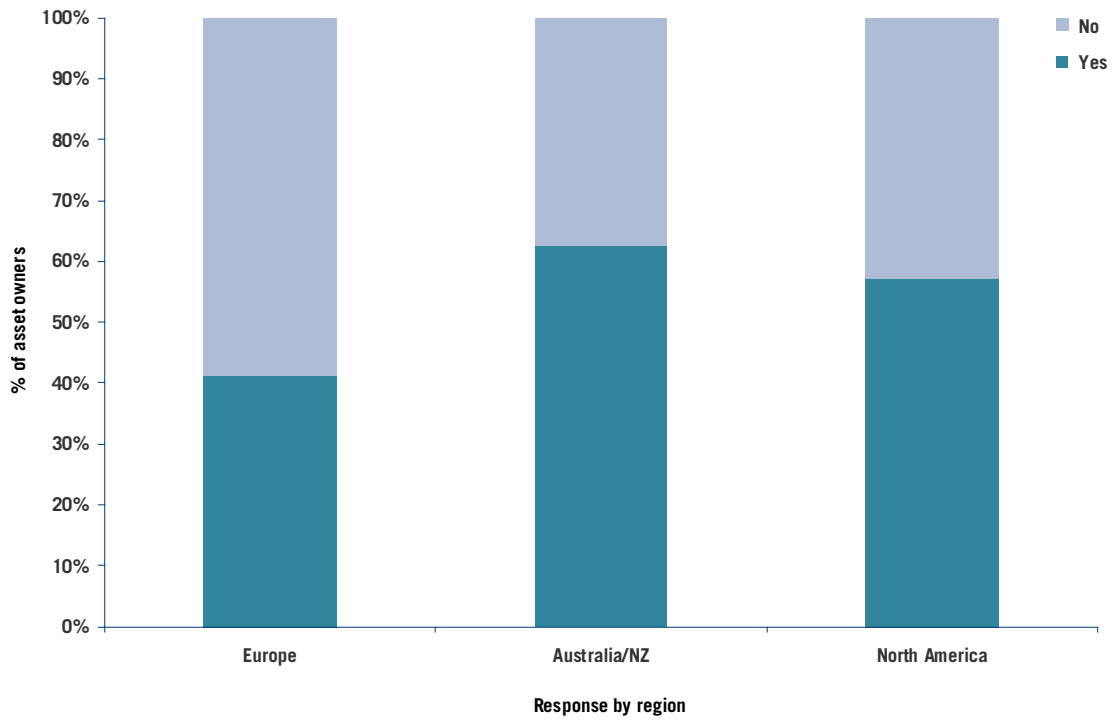
Monitoring existing managers

Whilst it is important to factor climate and other ESG issues into mandate construction at an early stage, most owners are not starting with a blank page i.e. they are attempting to retrospectively integrate climate or ESG issues into *existing* mandates and assets. Ongoing manager monitoring is therefore a critical part of the picture.

In 2011, half (53%) of the asset owner respondents monitored their existing asset managers on climate change integration. Figure 6 provides a breakdown by region for asset owners that monitor their managers on climate issues, showing that Australian funds were most active in monitoring their managers during 2011.

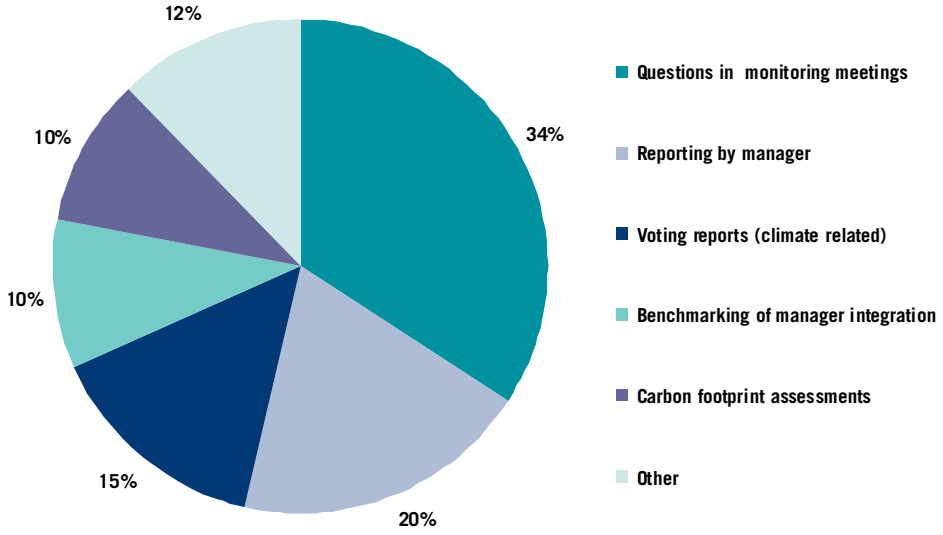
Considered as a proportion of the responding asset owners in their region, North American investors come out better – 57% of responding North American owners monitored their managers on climate change in 2011, the same level as Australian (63%) asset owners. In contrast, just over 40% of European owners monitored their managers on climate change issues during the year.

Figure 6 Monitoring of existing managers by asset owners



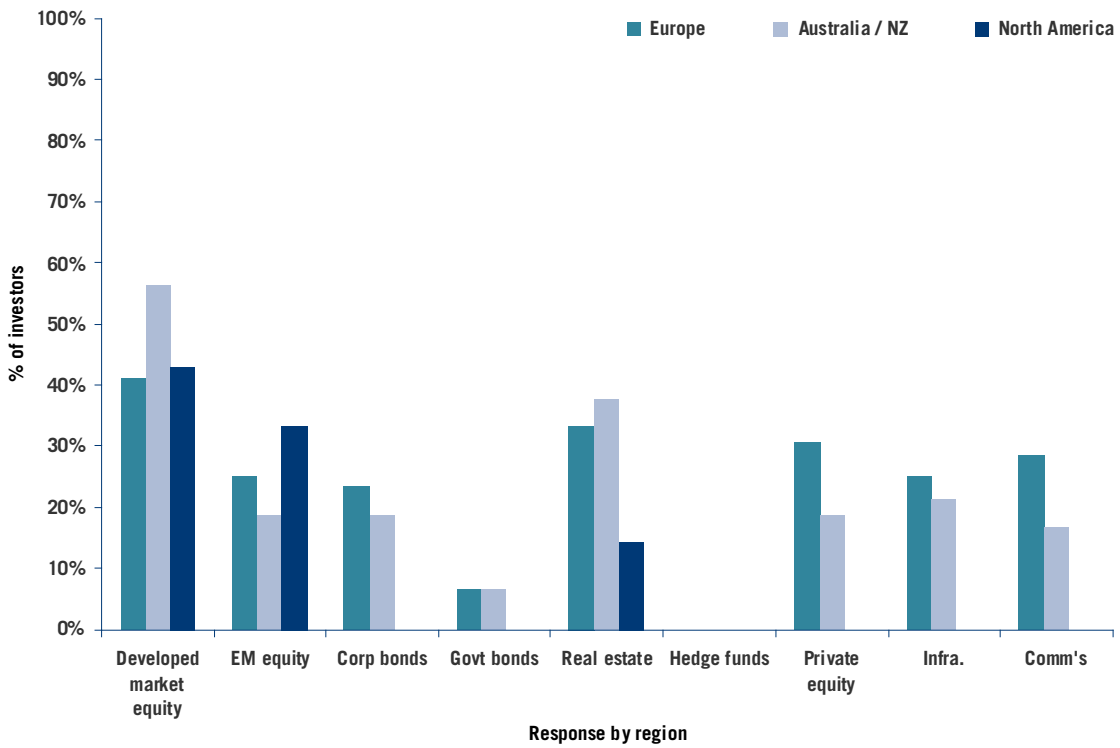
In terms of how manager monitoring is conducted, asset owners generally rely on regular monitoring meetings in which to discuss how managers are integrating climate change issues into ongoing portfolio management.

Figure 7 Asset owner monitoring of existing managers by asset class



In terms of asset classes, most activity on monitoring is still focused on listed equities and real estate. This is partly driven by asset allocation i.e. most funds have a large allocation to equities so this is to be expected, and energy use and efficiency are mainstream considerations for real estate. Private equity, infrastructure and corporate bonds are also subject to monitoring on climate issues but this is less common.

Figure 8 Asset owner monitoring of existing managers by asset class



A challenge for asset owners working with existing managers is that a manager may be limited in how much they can (or are willing to) change their investment process to include climate or other ESG factors. Working with these managers is a long-term process and should be based on a clear understanding on both sides as to what is expected (by the asset owner) and what is possible (by the manager). In the absence of clear expectations it can be difficult for a manager to improve in the eyes of their client.

It is perhaps surprising then to see that only 18% of asset owners have set clear expectations of their managers. One explanation for this apparent gap is that establishing clear expectations on climate (or other ESG) issues only comes after experience has been built up on what is possible and desirable, and is the end point in a lengthy process.

Case study 3 External manager selection and monitoring

Local Government Super

Local Government Super (LGS) is a leading Australian asset owner in the area of sustainable and responsible investment. LGS hold internal and external managed assets.

The manager selection process at LGS includes an assessment of how potential external asset managers incorporate ESG risks, of which climate change has been identified as the most important environmental risk, into their investment processes. The investment manager is asked to specify the resources available to analyse ESG risks, including personnel and their expertise, and their use of any external research services.

Upon selection, external asset managers are contractually obligated via Investment Management Agreements to consider ESG issues. Inclusion of this requirement is applicable to all new IMAs and does not extend to existing asset manager relationships.

In order to ensure adherence to ESG criteria, external asset managers are monitored. The monitoring takes place via six-monthly reporting, where the following information is requested:

- **Quantitative review of climate change and ESG risks in its portfolio.**
- **Provide case studies where climate change and ESG issues are impacting investment decisions.**
- **Advise on any changes to their approach to implementing climate and ESG in investment decision-making.**

LGS' internal investment team uses these portfolio audits to engage and enter dialogue with their managers on managing ESG and carbon risks. This is included as part of the ongoing review of the managers' overall performance.

7 Assessing and analysing carbon risk

Headline messages

- **Investors continue to conduct climate risk assessments of their portfolios using quantitative and qualitative approaches.**
- **A price for carbon is reflected in company evaluations where relevant (e.g. European Utilities) but given the low value currently attached to carbon the impact is generally immaterial.**
- **Confidence in carbon footprint data is still a limiting factor in the wider uptake of this type of analysis by investors.**

This chapter provides an overview of the processes adopted by asset managers and the internal managers of asset owners to assess their exposure to carbon risk. As mentioned in Chapter 5, public policy development around climate change is resulting in investor action with respect to risk assessment and analysis as evidenced by the response of Australian investors to the recently commenced carbon price. This is encouraging as it indicates that investors respond to policy measures.

Climate risk in due diligence and investment analysis

Survey data indicates that asset managers are more proactive than asset owners in assessing climate risk and opportunities within due diligence processes and in investment analysis. All asset managers (100%) stated that climate change issues are assessed with the majority of asset owners (80%) conducting this analysis. This reflects the difference in resources available between asset managers and asset owners.

Formal assessments are generally conducted through the measurement of a portfolio's carbon footprint (refer to Case Study 5). However, this method only captures one element of climate change, carbon emissions. Additionally, some respondents highlighted that the data's quality is in itself a barrier in assessing climate risk.

Quantification of climate impact

It is a widely held view across the investment industry that for climate change to be integrated within investment analysis, it needs to be quantified in order to feed into financial models and frameworks.

The majority of asset managers use quantitative and qualitative data together (84%). In contrast, almost half of asset owners (44%) do not consider quantitative data at all in the analysis of climate change issues. The lack of uptake amongst asset owners of quantitative data may be due to the constraints already highlighted, such as fewer in-house resources. Alternatively, as many asset owners in the survey outsource asset management to third parties, they are likely to expect this analysis to be conducted by these managers rather than themselves.

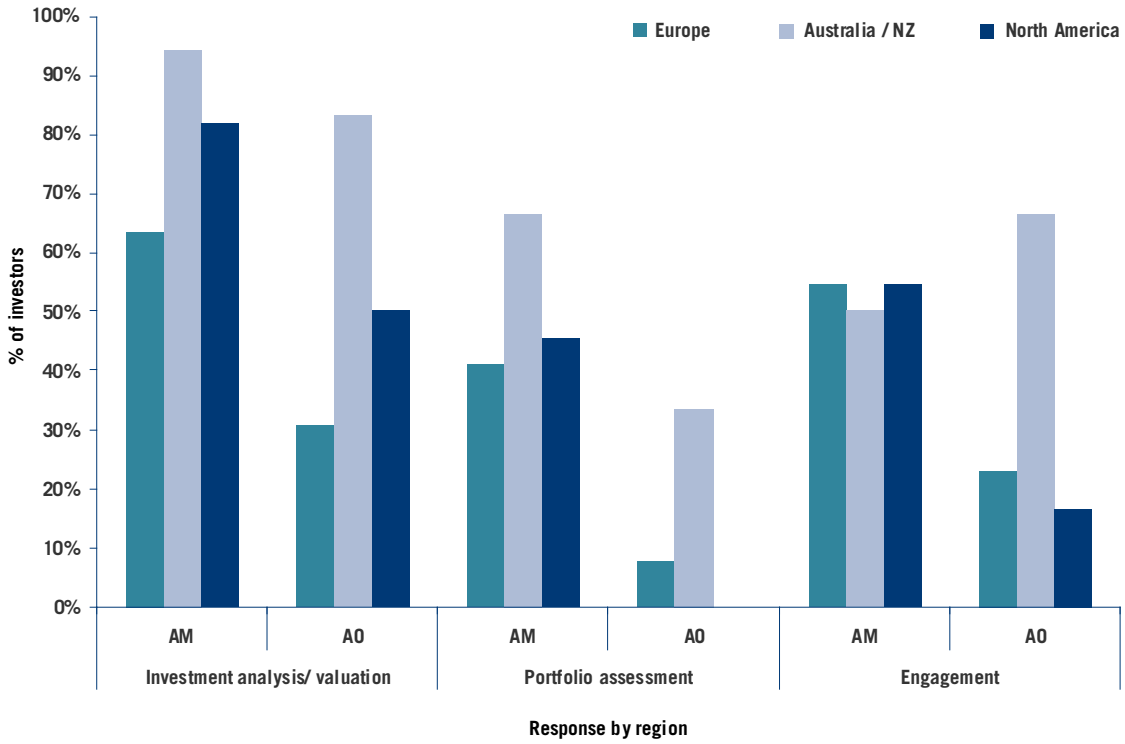
An additional barrier cited is a lack of confidence in the available data – a point which is supported by comments provided to this year's survey. This is interesting to note given that the quality of data and its reporting having strengthened in the past few years thanks in part to initiatives like the CDP. That said, nearly half of asset owners (44%) state that wider verification of climate change data would encourage its use in investment analysis. The uptake of climate change data will be explored in coming years.

Climate change data continues to be obtained from various sources with the majority of investors relying on company reported information and broker reports. The use of information from the Carbon Disclosure Project (CDP) is much more prominent amongst asset managers than asset owners. It is interesting to note of the 22 asset owners that are signatories to the CDP and have some internal asset management responsibilities, only four consider CDP data (18%). In contrast, of the 34 asset managers that are CDP signatories, 31 use CDP data representing the vast majority (91%).

The approaches used vary between the asset classes in which investment is made. Assessing climate risk for fixed assets such as real estate and infrastructure is generally focused on the potential physical impacts of climate change and/or carbon emissions as an indicator of the energy efficiency of specific assets. For listed equities, carbon emissions are used to assess potential liabilities under carbon pricing or taxation schemes which will read through into (lower) company earnings and profits.

Climate risk assessments are most commonly used in investment analysis and valuation processes for both asset managers and asset owners (refer to Figure 9). Australian investors are more active in using quantitative data than their European and North American peers across all processes. Many Australian respondents stated that the use of quantitative data has been introduced across investment processes due to the recent adoption by the Government of the Clean Energy Future policy.

Figure 9 Investment processes utilising quantitative data



Case study 4 Integration of climate change into investment analysis

Pax World Management Corp.

Pax World Management Corp. (Pax World) is a leading US manager in sustainable investments, with USD2.6 billion assets under management. The integration of sustainability issues, of which climate change is included, is a mandatory component of its core portfolio construction process. The Fund employs an internal team of six to conduct the analysis. A high rating via the evaluation of ESG issues is a minimum requirement that all prospective securities must satisfy in order to be considered within the investible universe. Only if a Portfolio Manager highly rates a particular holding would Pax World engage in an attempt to improve its ESG evaluation.

Portfolio securities undergo annual evaluations, approximately 1,200 companies. Questions that are asked within each company evaluation include but are not limited to the following:

1. Is the company a significant emitter of Greenhouse Gases (GHG), or in a sector that is a significant emitter? If so, does the company acknowledge the regulatory, litigation or other risks associated with being a high emitter, or if its product is a high emitter? What steps is the company taking to manager these risks?
2. While all companies may face adaptation risks, does the company face significant risk due to the physical impact of climate change? What steps is the company taking to acknowledge and manage these risks?
3. Has the company been asked to respond to the CDP? If so, has it responded?
4. Has the company had any GHG reporting or CDP response shareholder proposals?
5. Regardless of whether company discloses to CDP, does it report its emissions of GHGs, and climate change risks and opportunities? What is the trend in its emissions?

A detailed ESG analysis is completed for a dozen companies focused on securities within industries where climate change is intrinsically linked such as the Oil & Gas sector. The output of the detailed assessment is an environmental profile. Should the environmental profile degrade to an extent below the minimum ESG requirements, Pax World will divest from the holding.

Case Study 5 Carbon portfolio and risk assessment and analysis

Central Finance Board of the Methodist Church

The Central Finance Board of the Methodist Church (CFB) manages USD2 billion in assets of a collection of Methodist organisations in accordance with ethical and Christian values. CFB has adopted a Climate Change policy, in response to the Methodist Conference report “Hope in God’s Future”. The policy stipulates that the carbon footprint of its investment portfolios should be “relatively low and measurably declining”. In order to assess compliance to the policy, carbon footprinting is conducted with a focus on active equities within the UK.

Two service providers are used to provide the quantitative data required to measure the portfolios' carbon footprints. The two providers have differing methodologies and for this reason the combination of the data provides the CFB with the most comprehensive data that best fits its purpose. The two data sources provide similar results pointing to compliance with the Policy objective.

If the annual carbon footprint assessments were to show that the portfolio's carbon weighting had increased, a review would be conducted by the CFB. The review would determine the contributing factor(s) for the heightened level of emissions e.g. a higher allocation to a carbon intensive sector or if a particular holding is responsible. Engagement is also conducted with investee companies guided by this data.

8 Climate change investment opportunities

Headline messages

- **Asset owners continue to allocate to themed investment strategies such as clean energy, energy efficiency and sustainable timber.**
- **Evidence of growing interest amongst larger funds in low carbon passive strategies (e.g. BTPS and HESTA).**
- **Over half of investors (63% of asset managers and 62% of asset owners) invest in climate solutions. The most common asset classes for these strategies are developed market equity, private equity and infrastructure.**

Climate-related investment opportunities cover a broad range of asset classes and investment strategies. Historically most opportunities have been in listed equities or property. An increasing number of opportunities are now available in other asset classes, particularly in unlisted assets such as private equity and infrastructure. Debt funds are still uncommon however there is evidence of some investor interest in the area of "climate bonds", with some respondents highlighting such investments within their portfolios.

Creating scale in clean energy and technology markets is important, both in terms of the flow of funding into these areas and in providing a range of investment vehicles for the providers of capital. The latter is essential if institutional investors are to allocate more capital to climate solutions – asset owners in particular have varying needs in terms of risk/return characteristics and liquidity which must be met before new capital can be deployed. The following comments from respondents support this:

"For a large fund like us, finding opportunities at sufficient scale is a real challenge. We don't want to end up with hundreds asset managers managing tiny pots of money."
North American asset owner

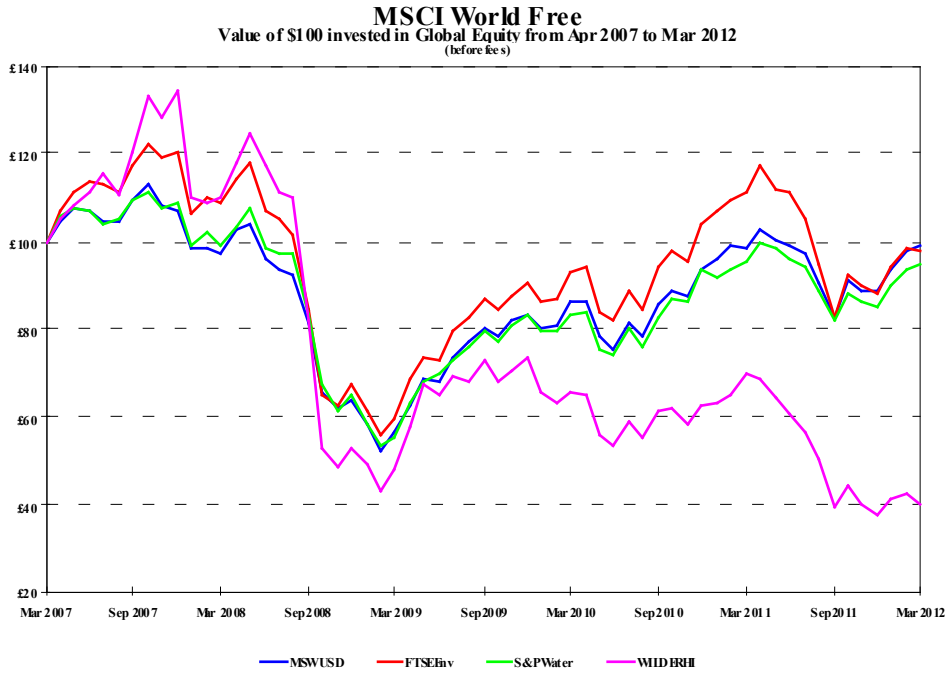
"We don't like to be more than 20% of any fund which can be restrictive and it does mean that we have to say no to interesting opportunities."
European asset owner

The current investment environment for climate change solutions is challenging for a number of reasons – low levels of economic growth in key markets (such as Europe), budget deficits leading to cuts in funding and subsidies for clean and renewable energy and reduced profit margins in the technology sector due to excess supply.[3] However, whilst these factors have led to a significant underperformance in the broad clean energy equities market since 2009, certain pockets of the sector – such as energy efficiency – continue to perform relatively well (see Figure 10).[4]

[3] Bloomberg New Energy Finance – Clean energy and policy market briefing (April 2012), Deutsche Bank, *"Investing in Climate Change 2012 – Investment Markets & Strategic Asset Allocation: Broadening and Diversifying the Approach"* (2012

[4] Energy efficiency is defined as companies that provide products and services enabling more efficient methods of energy usage and includes power network efficiency, industrial energy efficiency, buildings energy efficiency, transport energy efficiency, diversified energy efficiency, and energy storage.

Figure 10 Performance of thematic indices



Source: Created with Mercer Manager Performance Analytics (Sources: MSCI, FTSE, Standard and Poor's, and Bloomberg)

Approaches to thematic investing differ amongst North America and Europe. Europe has a considerable number of dedicated and well-known sustainability boutique firms where the firm's entire philosophy is based on sustainability investing. European managers appear to have allocated internal resources to undertake sustainability research that can be applied across various asset classes. As a result, these managers have developed a whole suite of strategies across asset classes whereas in North America, beyond the traditional SRI managers, there are only a few dedicated sustainability managers who are now in the beginning stages of developing ESG/sustainable investment strategies in other asset classes. Strategies within the US tend to be less thematic than their European counterparts, and usually include either an ethical screen or integrate ESG factors into the investment process[5]. Australian asset managers are less advanced than their European counterparts in offering climate themed investment funds products. As a result Australian funds invest through asset managers located in Europe and North America when allocating to these types of mandate.

It is therefore encouraging to see that over half (62%) of investors (63% of asset managers and 62% of asset owners) responded that they did invest in climate solutions, although the level of reporting specific allocation data varied with only 25% of asset managers and 54% of asset owners providing this information.

The reasons that this data was not reported is something that will be explored in future years. The lack of data in part reflects that not all investors are allocating assets to these types of investments. Other reasons include differences of view about what investments qualify as being low carbon solutions[6], the extent and quality of internal data management and reporting processes of investors and the extent to which investments in climate solutions are actively or passively undertaken.

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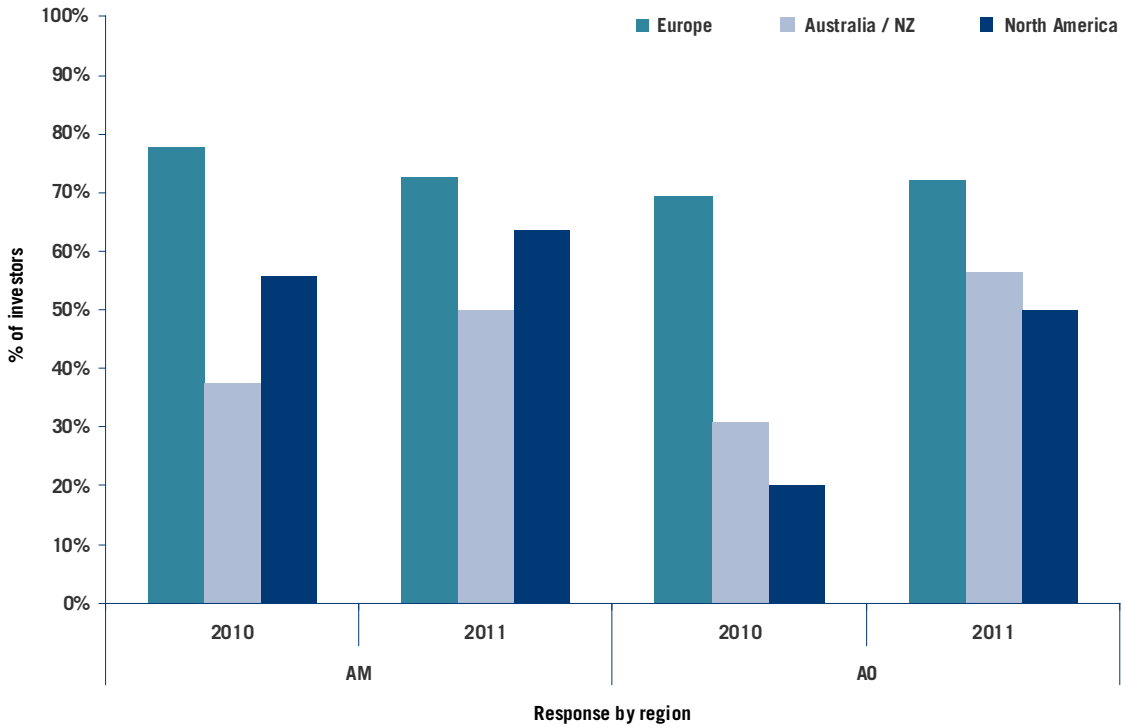
[5] Mercer, *"Differences between North American and European ESG Research"* (June 2011)

[6] Defined for the purpose of this report as solutions to climate risks and impacts including carbon markets, energy and water infrastructure, renewable energy, energy efficient assets (including real estate assets) and technologies, sustainable agriculture/forestry, and emission sequestration.

The asset classes for which investors most consistently reported their allocations to climate solutions included: developed market equity – 31% of asset managers and 36% of asset owners; private equity – 14% of asset managers and 36% asset owners; and, infrastructure – 12% asset managers and 29% asset owners. The asset classes for which few climate solutions investments were reported were fixed income, property and commodities. This level of reporting is consistent with the progress of climate related investment solutions available in the market at this time. The one area of surprise is the relatively low level of reporting on property investments. This is a market for which more investment opportunities would appear to exist than some other asset classes, mainly in the areas of energy efficient assets and energy efficiency projects.

Establishing clear reporting on investments in climate solutions is clearly an area for further exploration in future years. Improving awareness and the quality of data regarding investments in this area would appear to be an area for development by investor. The regional breakdown for the two years is shown in Figure 11.

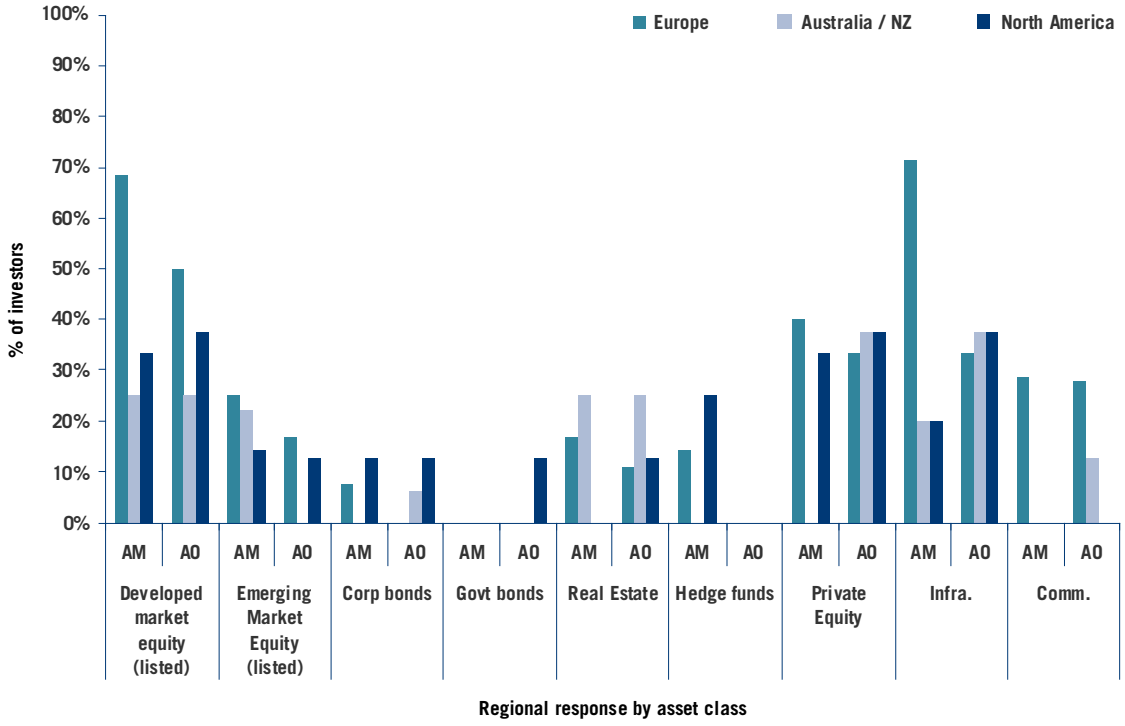
Figure 11 Investments in climate change themed funds



A shift towards passive tilts?

Some of the larger asset owners are starting to investigate how to integrate their policy on climate change into their passive assets. Climate themed indices are gaining traction in the investment market with index providers such as FTSE, Standard and Poors and UBS establishing carbon tilted indices that allow investors to decrease the carbon footprint of passive equity assets. Whilst it is early days, it is a positive sign that investors are willing to develop new products to fit their long-term objectives. As discussed in Case Study 6, these tilted indices aim to provide a form of insurance or hedge against an expected long-term increase in carbon prices whilst keeping risk-adjusted returns in line with the benchmark. This trend will be one to watch in future surveys.

Figure 12 Investment in climate change themed funds by asset class



Case study 5 Investing in "climate sensitive assets"

London Pensions Fund Authority

The London Pension Fund Authority (LPFA) is one of the largest local government pension schemes in the UK with assets of approximately USD6 billion. It has a long standing commitment to responsible investment and was a founding member of the IIGCC.

Since 2006 the LPFA has steadily built up a portfolio of 'environmental' and 'social' assets including renewable energy, clean technology, sustainable timber and water, waste and social infrastructure. These investments now account for around 8% of the fund's total assets and are spread across listed equities, private equity, infrastructure and commodities.

The LPFA's most recent investment in this area is an allocation to the Foresight Environmental Fund (FEF). The FEF is a private equity vehicle that invests in unquoted companies involved in recycling and waste to energy with a focus on the London region.

The LPFA selects its environmental and social investments on the same basis as any other i.e. to provide diversification across asset classes, managers and markets/ geographies and taking account of the risk/return profile.

A noteworthy point is that the LPFA does not have an explicit strategy to tackle climate change. Instead the Board of the LPFA has a general belief that attention to environmental, social and corporate governance issues is a prudent approach to the long-term management of its assets. Indeed, it states in its responsible investment beliefs that: *"ESG issues can create attractive investment opportunities across asset classes and investment styles".*

Case study 6 Passive investment in Low Carbon Assets

HESTA

HESTA, the Australian super fund asset owner that is responsible for USD18.5 billion in assets, incorporates climate change in its passive portfolio via an investment in a carbon-tilted index fund. During 2011, HESTA seeded, with an initial investment of USD100 million a Low Carbon Equities strategy managed by Industry Funds Management (IFM). The aim of this strategy is to track the return of the underlying S&P/ASX 200 Index but with a carbon footprint that is 50% lower than the Index. All constituents of the underlying index are retained however these are weighted in accordance to their relative carbon emissions with carbon intensive stocks being underweighted relative to the benchmark. The carbon footprint of constituents is calculated by MSCI ESG Research using company disclosed data.

HESTA has also seeded the Highland Good Steward Global Bond fund, a global bond fund that is managed by PIMCO, who recently signed up to the PRI. PIMCO use company specific ESG signals, provided by Highland Good Steward, to identify changes in the ESG risk of companies. Highland Good Steward also use the HERMES EOS to engage with companies on their behalf. Whilst this fund has a broader focus on ESG issues, climate change is one the Fund's engagement themes.

9 Asset Classes

Headline messages

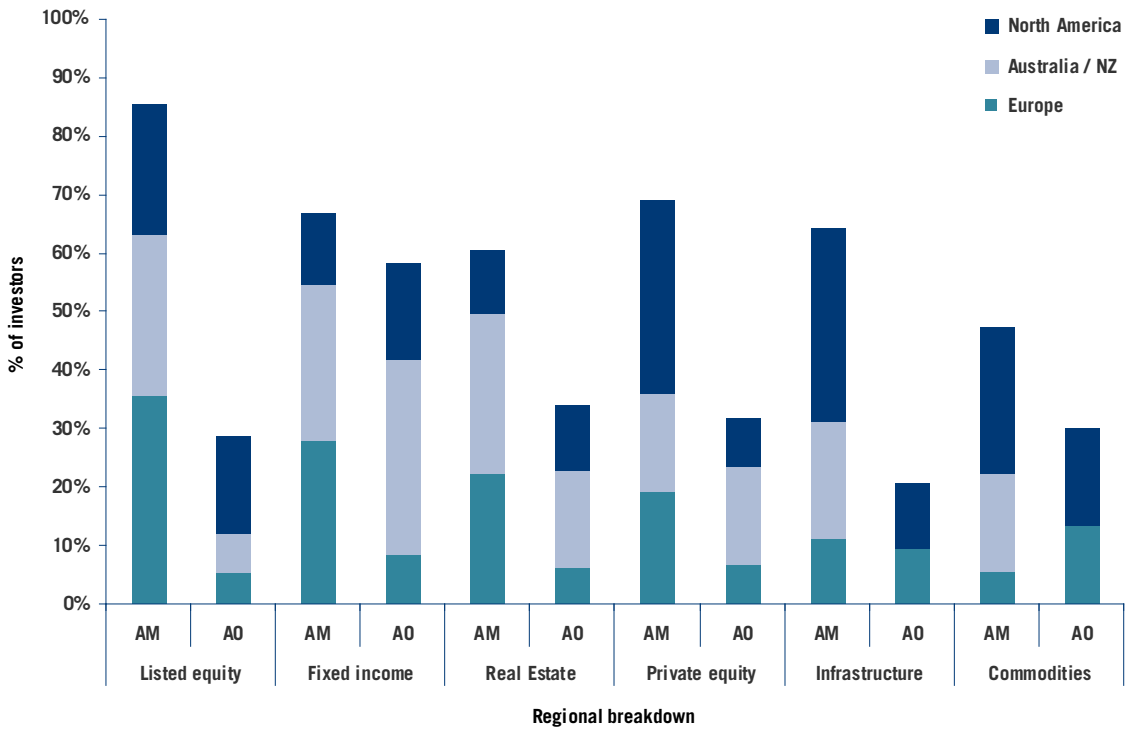
- **Equities continue to receive most investor attention in terms of monitoring climate risk. However other asset classes are subject to climate related monitoring and assessment – for example real estate, infrastructure and fixed income (see case studies).**
- **A minority of investors are avoiding or divesting from assets due to climate concerns.**

This chapter focuses on the integration of climate change issues into the investment processes of mainstream funds across all asset classes.

Monitoring of climate change issues

Asset managers are consistently more proactive than the internal managers of asset owners in assessing climate risks in individual asset classes. The variation between the investor types is demonstrated in Figure 13. This result is not surprising given that all asset managers state that climate change issues are of relevance, to varying degrees, across the organisation's investment portfolio.

Figure 13 Monitoring of climate change issues across asset classes



Listed equity remains the main asset class where investors consider and monitor climate risk – a further reflection of the historic focus on equities and the size of investor allocations to this asset class. Monitoring the climate risk of real estate investments is also popular due to the clear link between energy efficiency and operating costs, and therefore returns.

Most asset owner respondents outsource the management of non-equity and real estate assets. According to survey responses, asset owners who manage listed equity internally do not generally monitor climate change issues, with only one quarter doing so. This may be a reflection of asset owners' internal management responsibilities being focused on passive equity whilst active equity continues to be outsourced.

Case study 7 Integration of climate considerations in large and small asset management firms

This case study highlights the approach to "ESG integration" of two asset management firms that completed this year's survey. The goal of ESG integration is to systematically include ESG factors in investment analysis and engagement processes. It is increasingly the strategy adopted by investors who are trying to include a broader range of risk factors into investment decision-making. One of the managers selected (BlackRock) is very large, the other (Generation) is a small, boutique firm. Our aim is to showcase how firms at different ends of the size spectrum are proactively addressing ESG issues, which include climate risk and related issues.

BlackRock

BlackRock is one of the largest asset management firms in the world, with over USD3 trillion in assets under management. Whilst it manages money in Responsible Investment (RI) products such as dedicated renewable energy and cleantech funds BlackRock focuses its RI resources on the integration of ESG factors and considerations into mainstream investment processes and decision-making. Company engagement is an important tool for encouraging ESG improvements.

BlackRock has RI resources in North America, Europe and Asia/Pacific. Each team works with its local asset managers to build ESG issues into investment processes. Given its size and reach, a one-size-fits-all approach to integration and engagement is inappropriate – direct and regular engagement with company management is commonplace in Europe but is relatively new for Asian companies.

Engagement targets are identified through different means. Third party ESG data is used to highlight companies that are lagging best practice for some portfolios. In other instances, sector-specific issues are used as the prompt – for example, natural resources companies will be subject to discussions on resource scarcity and carbon risk.

To date BlackRock has found that the comprehensive provision of ESG information provides a good general indicator of management quality. Testing is also underway to see whether ESG assessments provide a sufficient signal of forward-looking company risk or potential alpha in both quantitative active and fundamentally managed portfolios.

Generation

Generation has less than 0.1% of the assets of BlackRock, however, the boutique manager has established itself as one of only a handful of asset managers that places sustainability issues at the heart of its investment strategy and outlook.

Generation's main strategy is its Global Equity Strategy. This strategy considers sustainability issues – such as climate risk and opportunity – alongside financial factors rather than as a separate part of the research process.

Its analysts conduct in-depth research on companies that are eligible for its equity strategy – the resulting "focus list presentations" assess all material sustainability and traditional factors for each company. ESG data from varied sources, including the Carbon Disclosure Project, are used as part of this analysis and provide useful flags on the level and quality of company disclosure on climate and other ESG risks. Ironically, while its global equity strategy does have exposure to issues such as energy efficiency and reducing energy demand, Generation has few investments in renewables or cleantech companies because in many cases they do not meet the thresholds on business and management quality.

Case study 8 Climate change and real estate

Stockland

Stockland is one of Australia's largest diversified property companies; owning, developing and managing a portfolio of office, retail, industrial, residential and retirement living properties worth approximately USD13 billion.

In 2011 Stockland made an investment in strengthening its understanding of climate risks and developed an organisation-wide climate adaptation strategy, building its 'Climate Action Plan' which has been in place since 2009.

The climate adaptation strategy examines primary climate effects such as: temperature, precipitation and sea level rise, as well as secondary climate effects such as: bushfires, flooding and drought, cyclones, wind and relative humidity – in regions/corridors where Stockland has a presence.

Stockland's adaptation strategy starts at the pre-investment/acquisition phase with an assessment of mitigation and adaptation criteria, including an asset's energy use and efficiency and exposure to physical risks such as fire and sea level changes/ flooding. In addition each asset is assessed on "adaptive capacity" i.e. whether it can be modified to be made more efficient and resilient to potential risks.

The strategy allows Stockland to prioritise the exposure of its assets, minimise increased operation and maintenance costs, make informed decisions on future assets, reduce liability and insurance premiums by ensuring assets are appropriately climate prepared, increasing occupant and customer comfort levels, avoiding early retirement of assets within its portfolio and compliments its carbon mitigation efforts.

Stockland believes that its approach to sustainability, and climate in particular, is an important differentiator for it in a market that is sensitive to the impacts of a changing climate. Further, its focus on mitigation measures – like energy efficiency upgrades – provides immediate savings that help to reduce its management expenses and support profits.

Case study 9 Climate change and fixed income

Amundi

Amundi is the largest asset management firm in France, with approximately USD800 billion under management. It has been a responsible investment leader in its home market for many years since launching one of the first SRI funds in France in 1989.

Currently Amundi has SRI assets of USD70 billion, most of which are in corporate fixed income funds. These funds broadly consider ESG issues rather than taking a thematic approach. However, climate risk is assessed for each issuer on a sector basis through Amundi's SRI research process.

Amundi's SRI research process quantifies over 40 criteria across a range of ESG issues all of which are weighted based on the contribution to risk in each sector. One of the five environmental factors is "emissions and energy use" and, depending on the sector, can account for up to 30% of a company's ESG risk. Issuers are assigned a rating from A to G which then determines whether their debt can be included in the SRI universe and, ultimately in the SRI portfolios. Amundi applies the following three portfolio-level SRI investment principles:

1. The portfolio's aggregate ESG score must be no lower than a C rating.
2. The portfolio's aggregate ESG score must be equal to or higher than the aggregate rating of its universe of benchmark.
3. If an individual issuer is rated E or below it is excluded.

The same process is applied to equity as well as fixed income, covering the MSCI World and the Barclays Euro Aggregate indices.

Case study 10 Climate change and infrastructure

AMP Capital

AMP Capital is a global investment house with over USD126 billion in funds under management across a range of asset classes including infrastructure, property, equities and fixed income. AMP Capital has been investing in the infrastructure asset class since the late 1980s and is recognised as a global leader in sustainability consideration across both its mainstream and specialist funds.

Climate change risks are considered throughout the entire lifecycle of the investment process of AMP Capital's infrastructure portfolio, from identification of new investment opportunities to the active management of assets.

When originating new investment opportunities in cleantech, renewable energy and other thematic investments, AMP Capital applies focus to government policy, regional directives, regulatory environments and legislative trends.

During asset management activities, climate change is monitored via:

- ESG audits and asset management plans, which include consideration of mitigation and adaptation strategies, and the availability of government subsidies and incentives to accelerate implementation.
- Influence through Board positions on underlying investee companies, which allows for climate change to be considered in the context of both daily operations and the longer term strategic direction of the investment.
- Bi-annual valuation reports, incorporating likely impacts of climate change related legislation on long term cashflow and investment profitability.
- Insurance provisions and contract renewal, in which the boundary and scope of service provision relating to climate change, where possible, is explicitly addressed.

Case study 11 Climate change and private equity

F&C Asset Management

F&C Investments (F&C), the UK asset manager with USD158 billion in assets under management established the F&C Climate Opportunity Partners private equity fund of funds in 2011. The range of opportunities for investing in climate change through private equity has been growing rapidly however the combination of climate policy risk and technology risk can be daunting for investors without the capability to assess these fully. A fund of funds structure offers a lower-risk way to access this growth area.

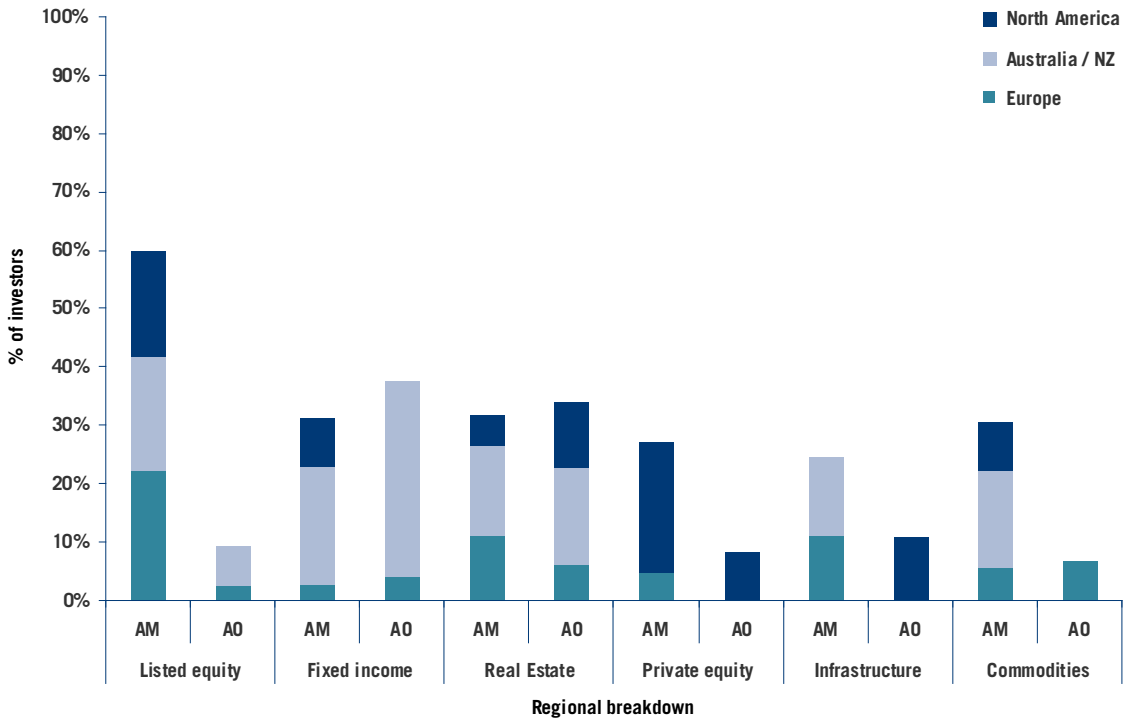
The fund, managed by the Private Equity Funds team, aims to invest in a portfolio of 12-15 underlying funds and selected co-investments offering investors exposure to nine climate change investment themes. It is currently EUR30 million in size and has a target net IRR of 20%. The fund's nine themes are: Alternative Energy, Energy Efficiency, Sustainable Mobility, Waste, Advanced Materials, Forestry & Agriculture, Water, Acclimatisation and Supporting Services. The themes were developed by F&C's Governance & Sustainable Investment (GSI) Team, which is also responsible for monitoring global policy trends, and advising on how potential investee funds fit within these themes.

F&C will invest at least 70% of the fund in private equity funds with the remaining 30% available for direct co-investment in renewable energy project-focused funds. Eligible funds are assessed by the GSI team on their approach to managing ESG risks and issues in general, and climate change risks in particular. The results of this due diligence are used when presenting the formal investment case for each underlying fund.

Climate risk reduction and divestments

The survey, focused on the investment activities undertaken during 2011, asked respondents whether they had divested (or avoided investing) due to climate risk concerns, with few respondents having done so. Divestment or avoiding investing is one step that investors can take in considering climate change within investment practices. A higher proportion of investors choose other approaches in limiting climate risk in their portfolios such as corporate engagement.

Figure 14 Climate risk as consideration for divestment or non-investment



Appendix: list of respondents

Asset owners

AustralianSuper
BT Financial Group
BT Pension Scheme
CalPERS
CalSTRS
Catholic Super
Cbus
Central Finance Board of the Methodist Church
Christian Super
Church of England Pensions Board
Commonwealth Superannuation Corporation
Connecticut Retirement Plans and Trust Funds CRPTF
Environment Agency Pension Fund
ESSSUPER
Evangelical Lutheran Church in America Board of Pensions
Fourth Swedish National Pension Fund
Greater Gwent Torfaen Pension Fund
Greater Manchester Pension Fund
HESTA
HOSTPLUS
Islington Council Pension Fund
Local Government Super
London Pensions Fund Authority
Maryland State Retirement and Pension System
Merseyside Pension Fund
New York State Common Retirement Fund
NGS Super
Ontario Municipal Employees Retirement System
PGGM Investments
PKA
REI Super
Second Swedish National Pension Fund
South Yorkshire Pensions Authority
State Super
StatewideSuper
The Church Commissioners for England
The General Board of Pension and Health Benefits of The United Methodist Church
The Joseph Rowntree Charitable Trust
UniSuper
USS
VicSuper Pty Ltd
West Yorkshire Pension Fund

Asset managers

Addenda Capital Inc
AMP Capital Investors
Amundi Asset Management
APG Asset Management
Arkx Investment Management
Australian Ethical Investment Limited
Aviva Investors
AWJ Capital Partners LLC
BlackRock
BT Investment Management
Calvert Investment Management
Celeste Funds Management Limited
Clearbridge Advisors
Colonial First State Global Asset Management
Deutsche Asset Management
DEXUS Property Group
Eureka Funds Management
F&C Asset Management
Five Oceans Asset Management
Generation Investment Management
Grosvenor Fund Management
Henderson Global Investors
Hermes Fund Managers
Hunter Hall Investment Management Limited
Impax Asset Management
Insight Investment Management
Kleinwort Benson Investors
Legal and General Investment Management
Low Carbon Investors
Mercer Global Investments Europe Limited
Mirvac
Nanuk Asset Management Pty Ltd
Osmosis Investment Management LLP
Pax World Management LLC
Platina Partners
Prudential Investment Management
PRUPIM
Robeco
Russell Investments
Schroders Investment Management
Scottish Widows Investment Partnership
Smith Breeden Associates
Solaris Investment Management Ltd
State Street Global Advisors
Stockland
Temporis Capital
TerraVerde Capital Management LLC
The Cooperative Asset Management
The GPT Group
Victorian Funds Management Corporation
Water Asset Management

IIGCC
Institutional Investors Group on Climate Change

Investor Network on CLIMATE RISK

Investor Group on Climate Change

MERCER

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