Part Three

THE POWER OF INVESTMENT

CLIMATE FINANCE ACTION

The Power of Investment

Simply put, it's bad business to invest in companies driving climate change because it poses significant material risks to investors, including public pension funds. Yet, despite knowing that climate risk will reap huge consequences if not addressed, investors continue to avoid accounting for climate-related financial risks-- let alone trying to mitigate it.

They continue to finance companies responsible for huge carbon emissions including methane, deforestation, and other conditions spurring the climate crisis-- and shy away from applying sufficient pressure on company boards to act responsibly. But this business-as-usual investment approach is going to cost investors, workers, and countless local communities and economies...

And we now face that moment.

That is why your pension fund's decisions on the tools it can use to pressure portfolio companies are so important. These are powerful-yet-underused tools for driving real solutions to climate and economic challenges that protect a more secure retirement future. (Trustees, check out the worksheets at the end of the section for unique ways you can activate these tools.)

Four Ways A Fund Can Better Know & Limit Climate Risk

Explore practices that equip pension funds to better manage and protect itself from climate risk.

EXPLICITLY ADDRESS CLIMATE RISK AS FIDUCIARY DUTY

Most of the pension funds' practices and standards begin with its guiding policy or philosophy. Often called "Investment Beliefs" or "Investment Statement", this guiding policy is a set of core beliefs that the fund can refer to ensure their investments align with those beliefs. Explicitly naming the need to tackle climate risk as part of the board's fiduciary responsibility in this policy paves the way for actual assessment and decisions to mitigate climate change.

Three signs that climate risk is adequately covered as a part of fiduciary duty in the Investment Beliefs Policy:

1. The investment policy clearly incorporates climate economic risk factors in its investment performance. That can include increased costs of greenhouse gas emissions and operating in a high-carbon economy, air quality and workforce safety, waste and hazardous materials management, ecological impacts, biodiversity loss, and climate disaster zones and liability risk.

2. The investment policy identifies the economic opportunities in climate mitigation. These opportunities may include the evaluation of potential high-growth investments in climate mitigation, renewable energy infrastructure, and other emerging technologies such as alternative packaging.

3. The investment policy calls on the board and staff to do an analysis of a portfolio transition to low-risk assets.

CREATE AN ASSET ALLOCATION STRATEGY TO TRANSITION AWAY FROM RISK

Pension funds would greatly benefit from developing a policy that requires a risk analysis for its proactive "strategic asset allocation" reviews and decisions. "What's 'strategic asset allocation?" you may be asking. It's a complex but essential term for how your pension balances the risk and returns across all its investments when it builds the whole portfolio. **This asset allocation strategy would be clutch in a pension's ability to handle climate risk by:**

- Incorporating a climate-related risk analysis as an explicit consideration for the fund's "strategic asset allocation," performance reviews, and asset management decisions.
- Taking into account companies' "transition readiness"-- an analysis of how well-positioned a company is to move into a low-carbon economy. That's often done by assessing its involvement in energy production, carbon-efficient technology, and natural resource management (like energy, water, and waste.) This is a key to understanding just how sustainable and climate-resilient a company is.
- Pursuing economic opportunities in tackling the climate crisis by committing to a percentage of the portfolio invested in companies addressing climate mitigation and energy sector transitions.

Some pension systems develop a "Net Zero" or decarbonization plan. The key to move beyond general "Net Zero pledges" to actionable, accountability plans by setting:

Criteria and direction for external asset managers to decarbonize across all asset classes

Investment strategies pursue companies that embrace climate mitigation and transition readiness

A timeline for implementation to phase in all of its assets to be managed by firms using a Net Zero approach

The Bottom Line: All effective strategies are data-driven– to help see where the highest risk is across all assets, as well as the most impactful transition priorities– and include accountability checks baked in its timeline.

State Examples:

- California Teachers' Net Zero plan
- New York City Net Zero plan across three of its five funds
- New Mexico's investment plan for renewable energy

ADOPT MONITORING AND TOOLS TO ACCURATELY KNOW YOUR CLIMATE RISK

To make smart and timely investment decisions, each pension fund needs accurate and reliable information. Expanding climate risk monitoring and analysis tools strengthens a pension fund's ability to accurately assess risk, see indicators of its investments' long-term value, understand companies' transition readiness, and inform strategic decisions.

Three steps your pension can take:

Incorporate more Environmental, Social, and Governance (ESG) and climate measurement tools within the pension's resources. That can include company-level transition readiness scores that go beyond headline analytics or company self-reporting. (And if your pension doesn't even account for the headline analytics, push for that as a modest baseline.)

Set stronger portfolio monitoring practices that include environmental key performance indicators and climate scenario analyses of emissions in the companies it reviews.

Make sure the "portfolio risk review" has criteria for material environmental, social, and governance factors.

Pension system examples: Los Angeles County Employees Retirement Association; and the New York State Teachers' Retirement System, using MSCI.

SET STANDARDS AND EXPECTATIONS FOR EXTERNAL MANAGERS

Just as discussed in the “Shareholder Power” section of the toolkit, the standards your pension uses to hire and evaluate its asset managers are critical to whether your investment goals and strategies are put into practice. And this is another reason for your pension to have a strong Due Diligence policy.

When it comes to investment, a solid policy would set criteria, hiring practices, and evaluation prompts that ensure managers are using a capital allocation strategy to invest in companies outside of high-impact sectors and transitioning to lower-risk investments, along the timeline and goals set. (Check out the Shareholder Power section for more concrete policy language and examples to include.)

To give it weight, Due Diligence should be included in the Investment Policy and shared with all consultants, fund managers, asset managers, and other parties responsible for investment decision-making for your pension fund.

State Example:

Minnesota State Board of Investments’ due diligence inclusion in its Investment Policy- “(e) The SBI shall engage investment or fund managers to manage assets under its control who credibly agree to apply its ESG integration policy to investment decision-making, investment analysis and portfolio construction.

An investment or fund manager so engaged shall report to the SBI, no less frequently than annually, on how it has integrated each category of opportunity/risk factors described in subsection (b) into their investment analyses, decision-making and portfolio construction. The SBI shall make each such report publicly available on its website no more than 30 days after receipt.”

WORKSHEETS

WORKSHEET: Assessing & Advocating for Climate-Solutions Investing

BENCHMARKS TO ASSESS YOUR CURRENT ASSET ALLOCATION STRATEGY

The adage of “SMART” goals can be helpful to strength-test your asset allocation strategy. **Does it:**

- Have specific goals and outcomes for how much climate risk is acceptable.
- Are the outcomes for a transition away from high-risk to lower-risk investments measurable? Do you have the practices and monitoring tools in place to accurately measure?
- Has there been industry and peer-based research on best practices of setting a transition strategy and progress points to ensure its ambitious-yet-achievable?
- Does the strategy clearly define why transitions from high-risk to low-risk companies- or to climate-friendly economies- is relevant to fiduciary risk??
- Is there a concrete timeline for when the portfolio will meet specific benchmarks?

HOW TO FIND OUT

You can learn the answers to the questions above through:

- Investment policy documents on your pension website
- Investment risk analysis reports and briefings
- Listening in on or following minutes of board and investment committee meetings
- Asking a trustee on the board that represents your group
- Asking for a meeting with the pension staff

Hesitant to ask? Remember, as a trustee representing public employees or a direct beneficiary yourself, you have a unique role in urging more transparency in the pension fund processes and performance!

Based on answers to the questions above and guidance in this section, fill in ideas for concrete improvements in your investment policies:

FINDING THE RIGHT TIME TO ENGAGE

Investment policies and asset allocation strategies are typically designed or revised every 3-5 years. So be sure to check in with your pension system site to see when the strategy was last updated and/ or ask a staff member or trustee when the board is going to revisit these core policies and strategies.

WORKSHEET FOR TRUSTEES: Steps to Strengthen Investment Policy Decisions (Page 1 of 2)

As a trustee, you have a unique role to raise the need to properly manage climate risk in the pension fund's portfolio. In fact, this falls within your fiduciary responsibility to ensure that the fund's decisions and actions are in the best financial interest of beneficiaries.

You can flag that not taking into account climate risk puts all three elements of the duty in jeopardy:

- **Duty of Care:** Fiduciaries must exercise reasonable care to prevent undue risks from harming beneficiary portfolios, such as the systemic risk of climate change.
- **Duty of Loyalty:** Fiduciaries may not ignore the concerns of their beneficiaries.
- **Duty of Impartiality:** Fiduciaries may not favor one group of beneficiaries, such as those receiving current retirement payouts, over those who may just be entering the workforce, and whose retirement nest eggs could be severely impaired by long-term climate change

Spaces where you can help advance stronger climate risk-managed investment practices:

- During board or committee meetings or in spaces to offer feedback on reports, you can –
  - Call out the damage & risk of an investment policy that doesn't adequately cover climate risk.
  - Raise questions and push for quality standards.
  - Share other pension funds' model examples to shape the fund's policies and capacity to address climate risk.
- If there is an assessment, push to assess the quality metrics and information the board is using to account for risk. If there aren't explicit, or inadequate, assessments of climate risk in investments, raise the need for it as part of the board's fiduciary responsibility.

WORKSHEET FOR TRUSTEES: Steps to Strengthen Investment Policy Decisions (Page 2 of 2)

Specific questions you can raise:

- **Are climate risks defined in the Investment Policy Statement (IPS)?** This helps push the policy to clearly define the climate risks that are relevant to the investment portfolio. These risks may include physical risks (such as extreme weather events or sea level rise), transition risks (such as policy changes or technological developments), or missing out on adaptation opportunities.

- **How is climate risk assessed and measured by the board?** Raises the conversation to explore what climate data, scenario analysis, or other tools are needed to evaluate the potential impacts of climate change on investments.

- **How does climate risk fit into the overall investment strategy?** Spotlights ways climate risk factors can be used in asset allocation decisions or as a screening tool when selecting investments and can cover

- **What are our expectations for investments on climate risk management?** Covers setting portfolio-level goals for greenhouse gas emissions reductions, requiring climate risk reporting, or engagement with companies. What work has been done to date in this area?

- **What language could be added to the IPS to strengthen climate risk oversight and management?** This could include a section on climate risk management, or specific language that outlines your expectations for companies and investments in terms of climate risk– setting up the pe sion system for stronger Due Diligence policies with its asset managers.

- **How often does the IPS undergo review?** Encourages your board to review and refresh annually, to ensure that it remains relevant and up-to-date with the latest climate risk information and leading practices.

And remember that you don't have to go at it alone. Check out our tips and resources on mapping and reaching out to your fellow trustees to find allies and supporters as you step into action.

Beneficiaries, there are opportunities for you to get involved as well! Check out the "Organizing to Build Power" section of this toolkit to get guidance and hands-on tools to chart out your engagement strategy.

THE POWER OF INVESTMENT

Key Takeaways:

- Accounting climate risk as a key responsibility in the Investment Policy Statement sets up your fund with the decision-making agency and tools it needs to really tackle climate change.
- "Asset allocation strategy" is a wonky but essential term and an excellent opportunity to tackle climate risk. This is the place where a fund can establish criteria, direction, and timeline to move investments away from companies loading your fund with high climate risk-- and embrace financial opportunities in climate solutions.
- Ensuring your fund sets clear standards for whom it hires to manage investments-- as well as solid data it uses to monitor longterm portfolio performance-- is essential for your fund's capability to tackle climate risk.

Thank you for exploring The Power of Investment, Part Three of **Investing in Our Future: A Guide for Climate-Conscious Pension Strategies**.

What to do Next:

CONTINUE LEARNING:
Part Four: Organizing to Build Power

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Climate Finance Action (CFA) is a women-led, 501(C)3 non-profit organization equipping stakeholders and decision-makers to leverage the transformative power of publicly-held capital for real-world climate solutions to ensure a just transition to an inclusive economy in favor of people and the planet.