BARNETT WADDINGHAM

Part of HOWDEN

DC in Focus:

Sustainable investment in 2024

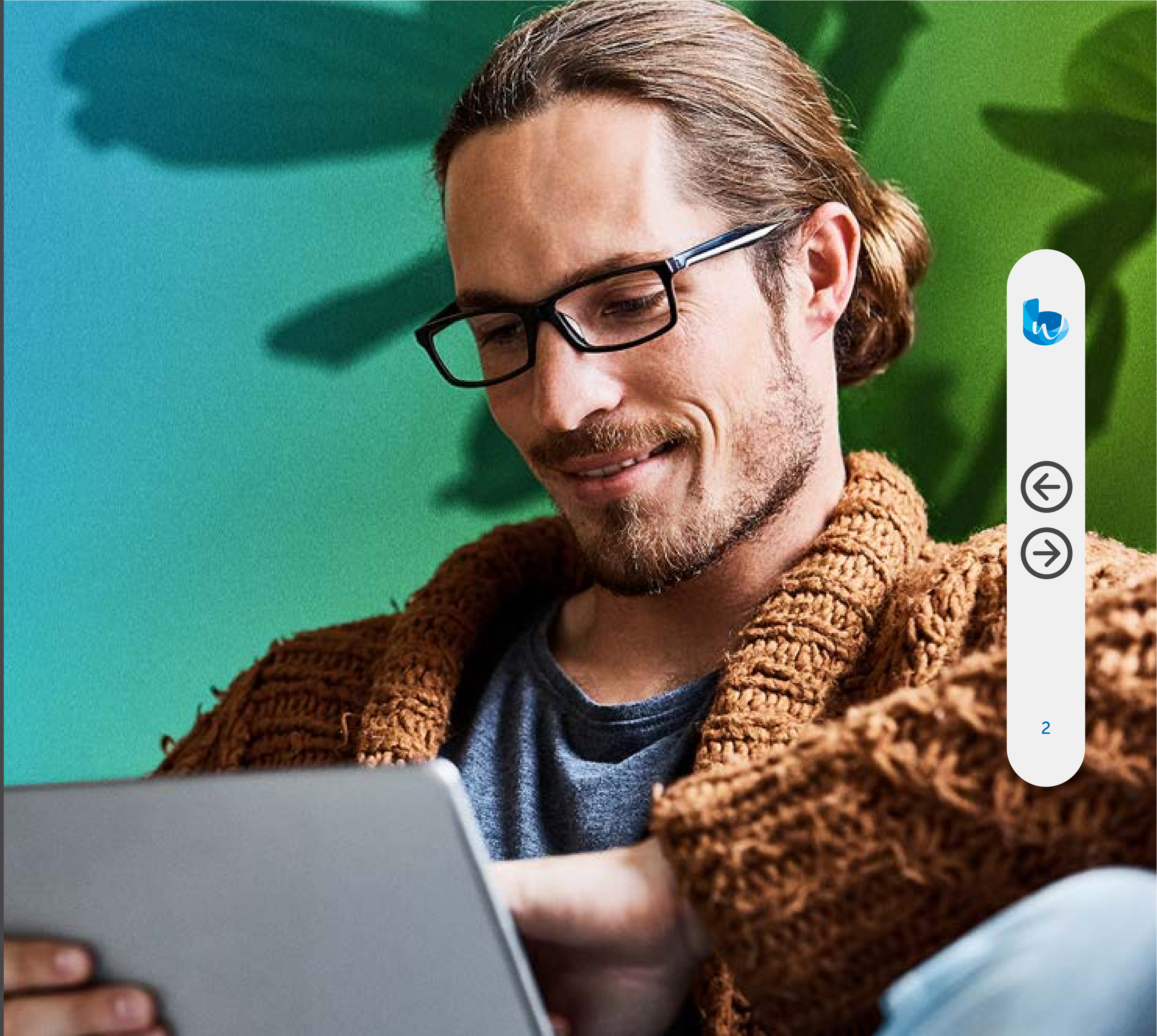
Our fourth year of reviewing the sustainability of default investment strategies offered by DC pension providers, looking back at 2024.

Introduction

It's fair to say that some providers' approaches are increasingly sophisticated. However, the increased politicisation of sustainability-related issues like climate change presents challenges. Providers remain under pressure to demonstrate their credentials in an increasingly complex world.

Against this backdrop, we have cut through the noise to help you better understand the factors driving how providers are approaching sustainability, plus the impact on your members. We have also set out key questions to ask your provider.

Our key findings



Beware of leaderboards: look under the bonnet and embrace complexity

Why leaderboards don't tell the full story

The increasing prominence of leaderboards ranking the climate credentials of DC pension providers offers a convenient starting point for comparison. However, climate change is an incredibly complex issue - one that cannot be reduced to simplistic rankings.

Leaderboards often fail to dig deeper into what's really going on behind the scenes. A high score doesn't necessarily mean a provider is driving meaningful change, just as a lower score doesn't always mean it's failing. We welcome this complexity because addressing sustainability is not just about optics but about delivering for members.

Reassessing net zero targets: a financial necessity

Consider net zero commitments. Of the strategies we research, fifteen have net zero by 2050 targets, with three targeting 2040 and two without a target. However, the UN has warned the chance of achieving a net zero target by 2050 is now "virtually zero[1]."

This stark reality means DC providers face trade-offs and cannot blindly reduce emissions. They must regularly reassess their net zero targets to manage unintended financial risks. For example, portfolios could become highly concentrated if there is a limited pool of investible opportunities consistent with their climate goals. A key test will be interim targets set with reference to 2030; only five years away. Providers should not be afraid to recalibrate.

This doesn't mean stepping back from climate action. Delivering for members means balancing portfolio decarbonisation with managing climate transition and physical financial risks – while also striving, where possible, to drive lower real-world emissions.

The complex interplay between climate and other areas of sustainability provides further evidence of the trade-offs facing providers. Find out more on the next page.

2050 target
15 strategies

2040 target
3 strategies

No target
2 strategies

1 Chance of limiting global warming to 1.5C is 'virtually zero' on current trends, UN warns - Carbon Brief

Why net zero
matters more than ever

Despite changing sentiment on the need to address climate change in some geographies (see next section on 'culture wars') a net zero ambition remains important.

Key takeaway

Why portfolio
decarbonisation may not be enough

Selling high-carbon assets might look good on paper, but if it simply shifts emissions elsewhere, it does little for the planet. From an investment perspective, we could lose the upside potential from helping to reshape an industry towards the low carbon and more climate-resilient economy needed. We need to ensure reducing emissions is balancing financial objectives and real-world impact.

Practical example

Systems-thinking
reveals how complexity extends well beyond climate

We recently highlighted the interconnectivity of climate, nature and economic stability in our report which focussed on testing the boundaries of ESG. With over half of global GDP dependent on nature (source: WWF), failure to recognise trade-offs and embrace the complexity between these financially material risks is a ticking time bomb.

Our analysis

Questions to ask your provider

Embracing complexity, looking beyond leaderboards, and rigorously evaluating provider approaches is critical. Here is what we recommend asking your provider:

How are you managing sustainable investment trade-offs to manage risks and access opportunities?

The response should demonstrate the complexity and how your provider sets priorities.

What steps are you taking to identify stranded asset[3] risks?

This will help you understand how the provider considers such risks in portfolio construction.

When would you disinvest from a holding on the grounds of climate related risks?

This will help you to understand the sell disciplines in place to protect members' benefits.

3 Stranded assets refer to investments that lose significant value or become liabilities due to unexpected or premature changes in the market, regulations or societal shifts. In the context of climate change, there is growing awareness that certain non-renewable energy sources will likely require phasing out.

Culture wars: staying the course

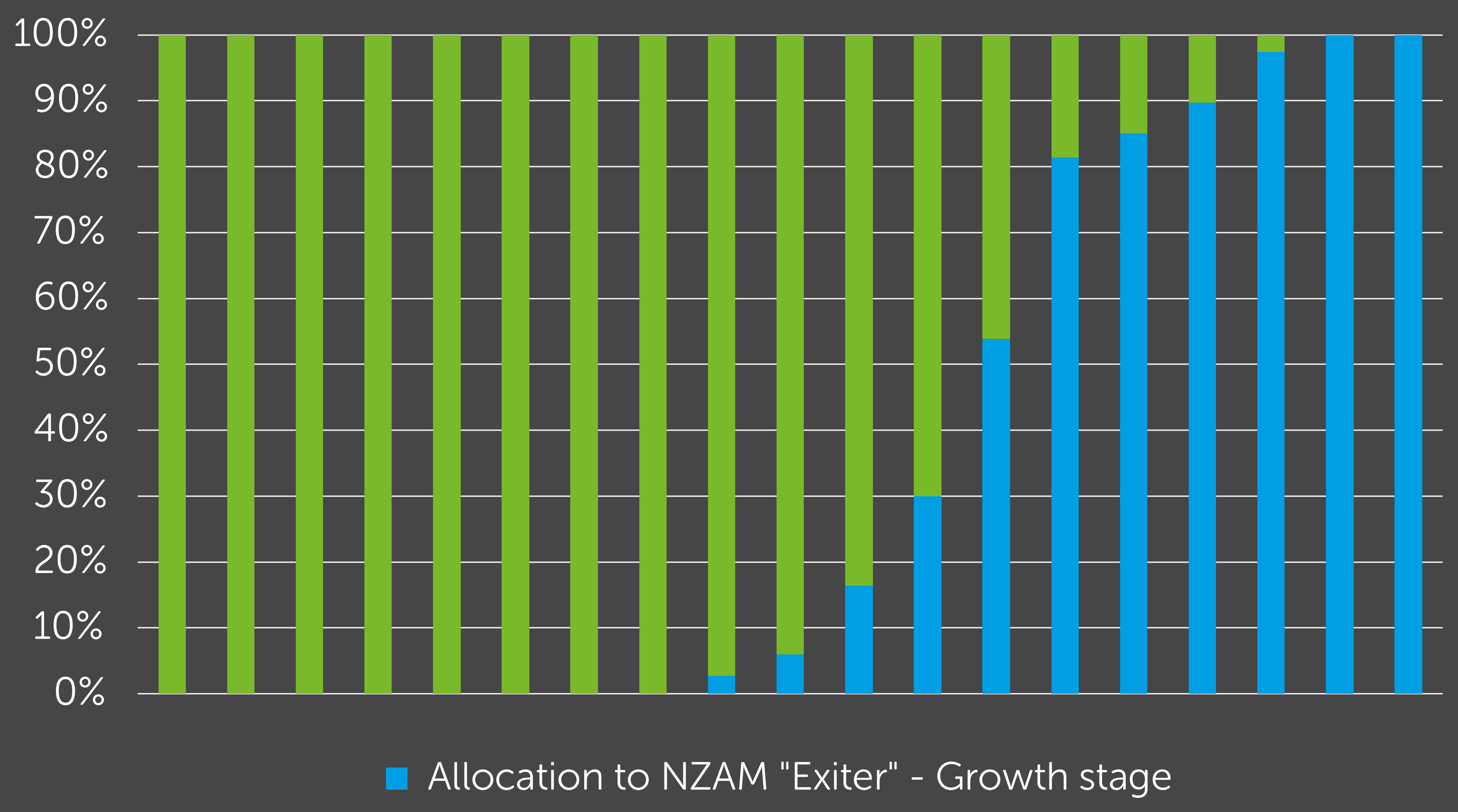
The market is changing rapidly

BlackRock, Vanguard, State Street and Northern Trust have all recently left the Net Zero Asset Managers (NZAM) initiative and Climate Action 100+ (CA100+). Together, they manage a staggering $25 trillion USD of assets – that was roughly a quarter of global GDP in 2024.

These exits are part of a broader trend, with 71 investors leaving CA100+ since June 2023. This exodus comes off the back of growing anti-sustainability sentiment, particularly in the US, exemplified by accusations that asset managers are overstepping their fiduciary duties, which has even led to legal action by 11 US states.

Many managers have justified their exits by citing their ability to manage climate risks independently and continue to invest in a manner that supports stewardship and sustainable investing.

Significant variation in manager exposure following NZAM exits



The chart above shows the exposure of different providers to managers who have exited NZAM during the growth stage of their investment strategy. A number have significant exposure (shown by the blue bars), but there is a wide range (with the green bars showing exposure to managers who did not leave NZAM). Investors must understand how their provider is actively engaging with managers.

Our analysis

Impact matters more than activity

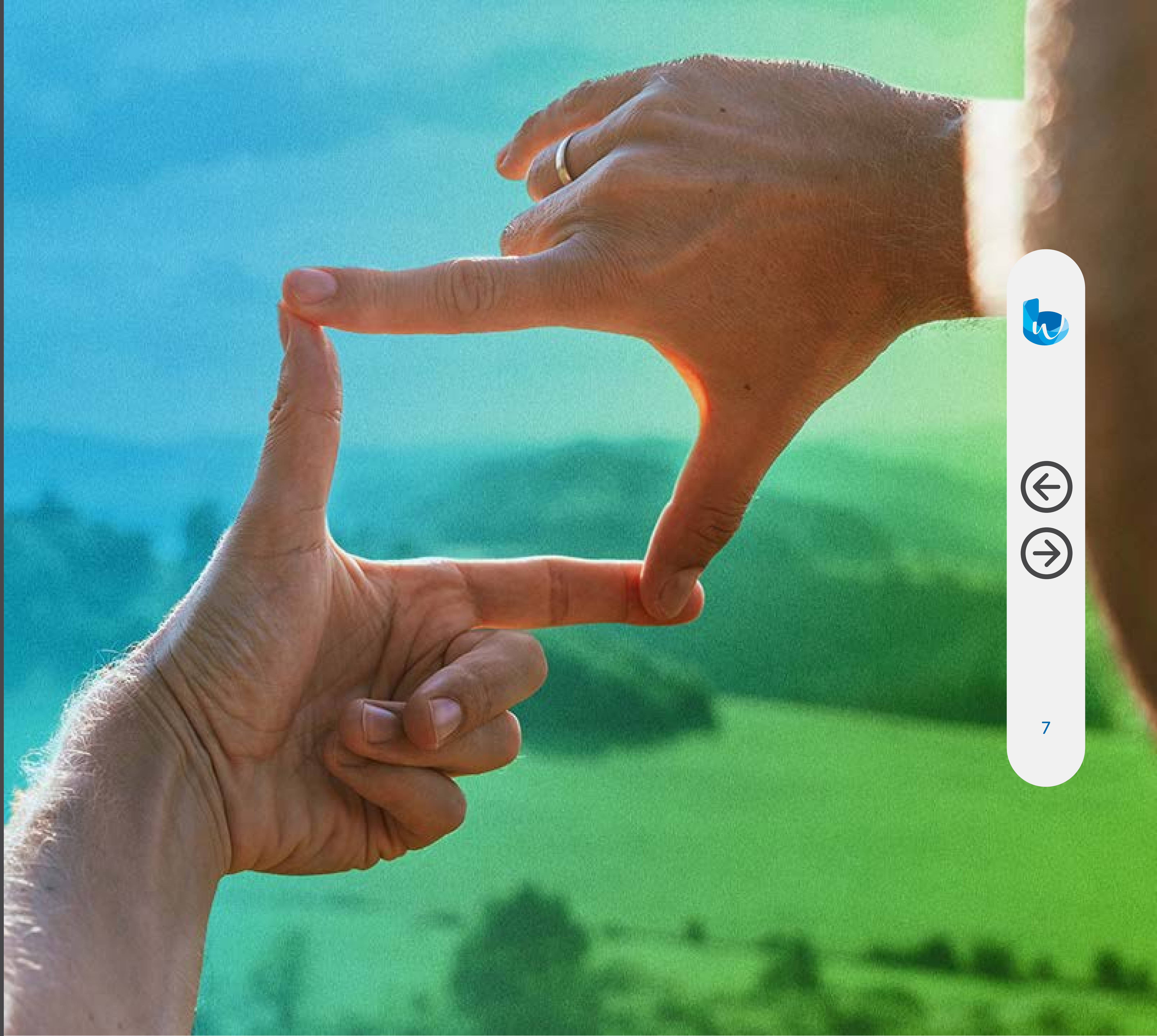
For example, tracking the number of engagements or votes can be useful, but true success is measured by the quality of change. Persuading a manager to back a pivotal vote that secures a critical outcome can be far more impactful than thousands of surface-level engagements.

What can providers do?

This trend has inevitably raised significant questions about what providers can do in response. Reassuringly, there are plenty of options, before we even consider portfolio construction. These include:

- Setting clear expectations for managers.
- Regularly monitoring and feeding back to managers.
- Taking more control of voting, for instance adopting 'voting choice' in the default strategy or opting for an expression of wish approach with regular oversight of the underlying manager.
- Taking an active role in direct-to-company and collaborative initiatives.
- Reviewing manager selection decisions and reflecting sustainability considerations in mandates.
- Considering sustainability as part of wider reviews of operating models (e.g. the use of segregated accounts).

Horizon scanning



What are providers doing?

Encouragingly, many providers are asserting their role as stewards of capital, making it clear that fund managers must step up – a recent investor coalition is calling on managers to develop and evidence robust stewardship strategies.

This level of clarity is essential, now more than ever given the cautious approach seen in the US. Political leadership may shift, but the reality of climate change remains, and pension schemes have a unique opportunity to chart a steady course in the face of these challenges.

A DC provider voting with their feet

Building nature into engagement strategies

In terms of portfolio construction, our research reveals a clear and accelerating trend among providers to embed carbon emission reductions into their default strategies. As shown in the graphs to the right, this shift has gained significant momentum over the past four years, demonstrating tangible progress in aligning portfolios with global targets and The Paris Agreement.

Questions to ask your provider

How have recent exits from climate collaboration initiatives impacted your stewardship activity?
The response will help you assess your provider's concerns about recent news.

What is your escalation strategy for when managers don't act in line with your interests?
The response will help you assess your provider's commitment to sustainability and willingness to act.

Four-year trend: climate targets embedded in default strategies

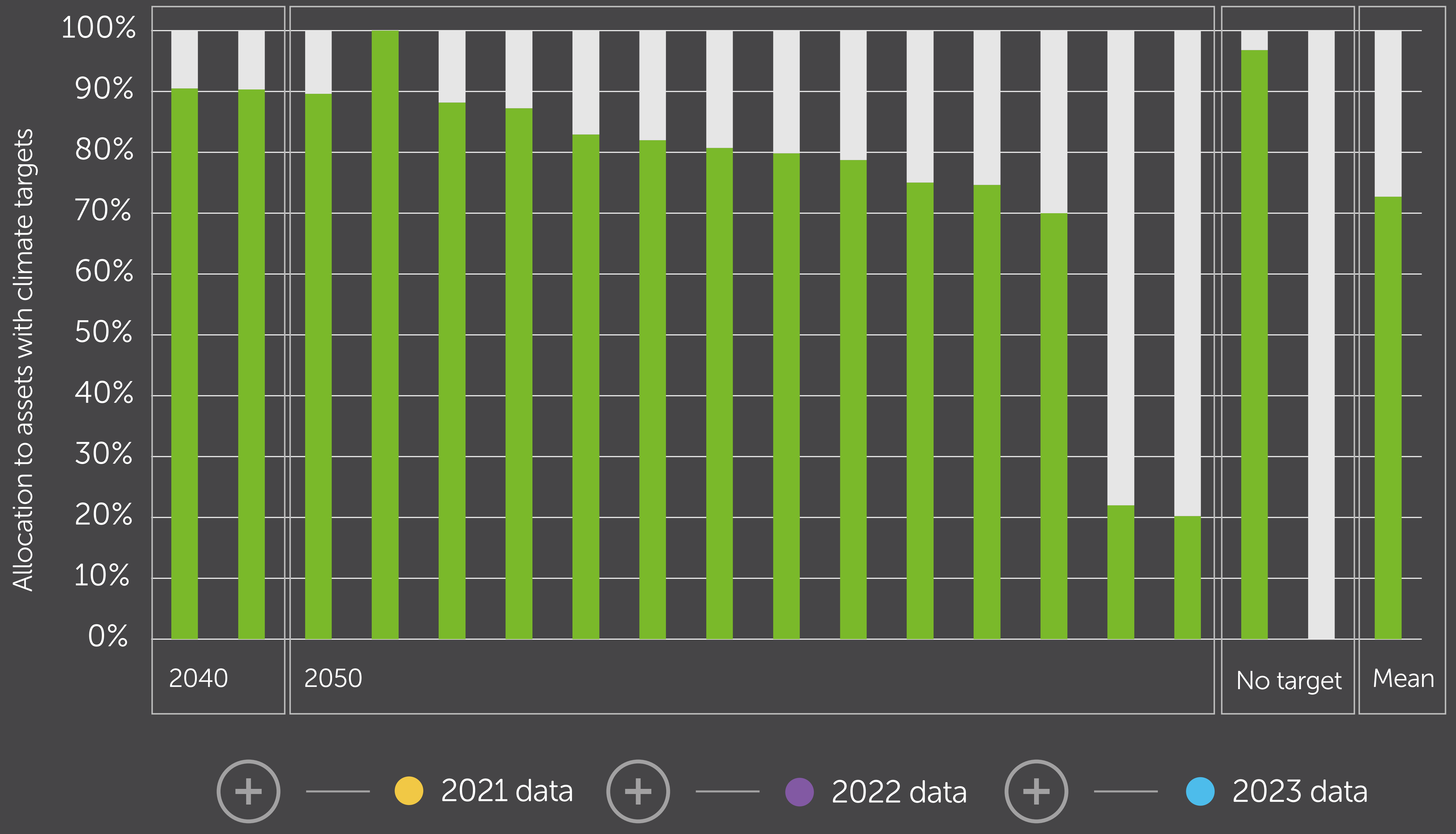
Growth stage | At retirement stage

Growth stage average improvement

+34% Since 2021

+16% Since 2022

+10% Since 2023



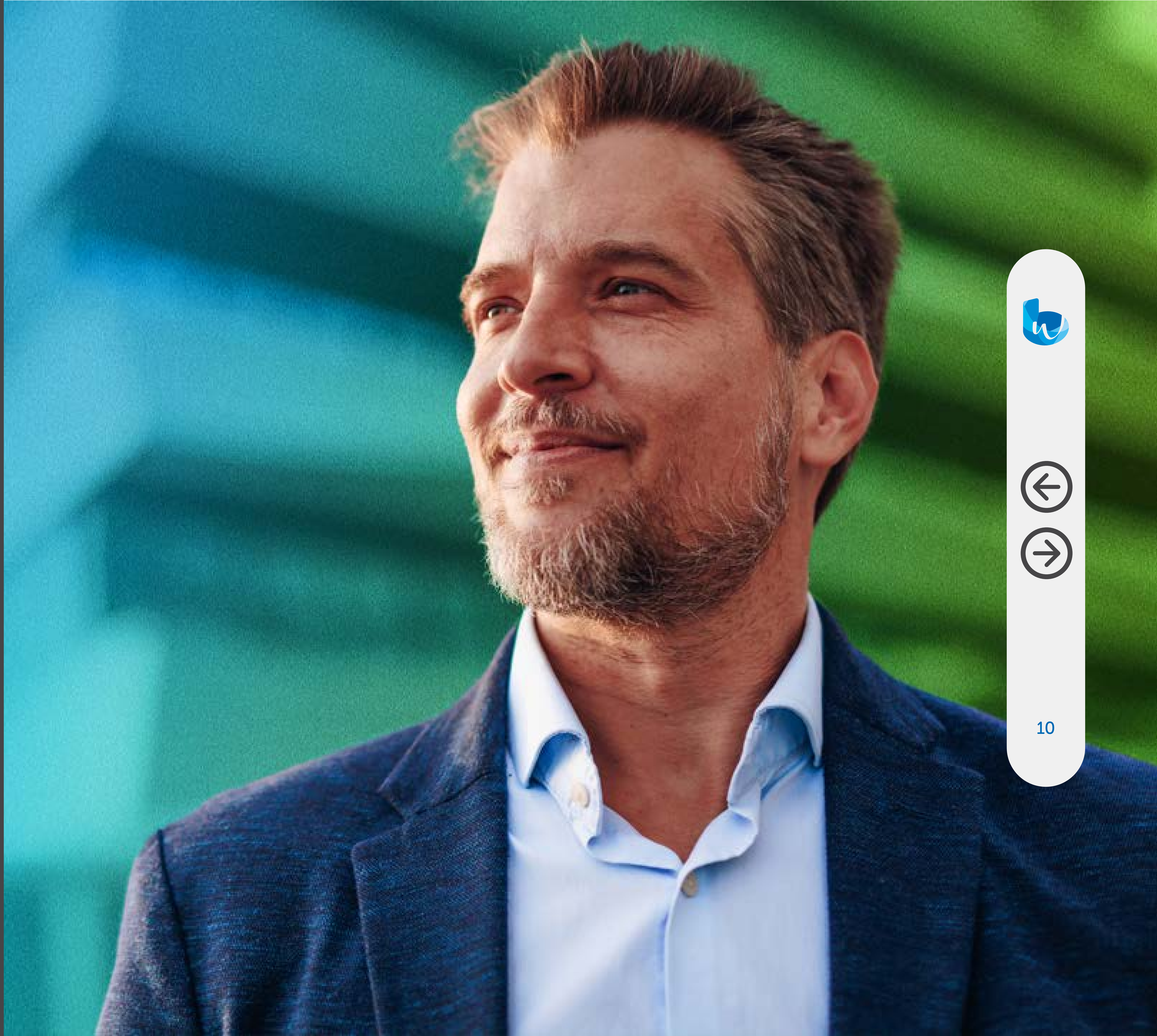
Is scale needed to drive sophistication?

In short, no – scale alone does not guarantee sophistication. However, it can amplify impact. Larger providers can wield significant influence by directing capital away from underperforming managers, and they are in a unique position to push for stronger stewardship and set higher standards for responsible investment.

Having said that, sophistication can be achieved by smaller providers if they use their powers effectively. These providers may have less scale, but they can focus resources to provide deep influence, prioritising the most financially material issues.

Alongside the collaborative initiatives discussed above, we have seen great examples of providers and managers using their collective scale to improve outcomes, for example to influence policy through the recent blueprint to mobilise pension capital for net zero.

The Pension Schemes Bill has set the direction of travel on scale requirements, but the jury is still out on whether scale is essential to integrate sustainability on portfolio construction – after all, the largest schemes have not always paved the way on this front to date.



Are smaller schemes leading the way on portfolio construction?

To date, we have seen Smart Pensions invest in a biodiversity equity strategy that funds projects aiming to positively impact biodiversity, whilst also delivering competitive returns for members. We have also seen Cushon invest in private markets, including infrastructure projects to support their decarbonisation journey. Both Cushon (circa £3bn AUM) and Smart (circa £6bn AUM) are relatively small when compared with competitors (by total assets).

One area we expect to receive increasing attention is policy lobbying. Again, scale can ensure a voice is heard, but collaboration can empower smaller schemes.

For example, the recent Mansion House Accord states very clearly that action by the 17 signatories to increase their allocation to private markets and UK assets is contingent on supporting action by the Government. With the Government looking to the pensions industry more and more to support their own objective, this sophisticated approach to lobbying and negotiation on behalf of members will remain critical.

Questions to ask your provider

- **Positive investor outcomes**
- **Sustainable investment approach**
- **Government policy lobbying**

What can you do?

Backed by science, the risks and opportunities associated with sustainable investment will continue to climb up the agenda for investors around the world. Set against culture wars and growing politicisation of sustainability, DC pension providers are under more pressure than ever to demonstrate how their approach is delivering value for members.

The bad news: there are no quick fixes and easy answers. The good news: there is a lot providers can do – however big they are – and many are acting.

If you're an employer or a trustee, be sure to challenge your provider on their approach. If you're a provider, be sure to keep member outcomes front-and-centre as the political backdrop evolves.

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