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LGPS Investment Current Topics

Q3 2024

1. Science Based Targets initiative (“SBTi”) - April 2024 announcement to consider use of carbon credits
2. Middle East Note
3. UK Budget

Cambridgeshire Pension Fund

November 2024

A business of Marsh McLennan

Science Based Targets initiative ("SBTi")

April 2024 announcement to consider use of carbon credits

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Science Based Targets initiative (SBTi)

Why have they been in the news?

- The SBTi was launched in 2015 and is a collaboration between CDP, the UN Global Compact, the World Resources Institute (WRI) and the Worldwide Fund for Nature (WWF). Funded by prominent institutions and foundations like Amazon and the We Mean Business Coalition, it operates as a UK charity.
- The SBTi aims to support corporate climate decarbonisation plans and targets, in-line with climate science. Investors use the SBTI's data to assess portfolio alignment with science-based climate targets. In June 2024, over 5,500 companies had science based targets validated by the SBTi.[1]
- However, companies are not currently able to use carbon credits to offset any scope 3 emissions (which capture all indirect emissions that occur across the value chain of the reporting company).
- The SBTi announced in April 2024[2] that they are considering allowing reductions for certain Scope 3 emissions via carbon credits. If finalised, this decision would represent a significant shift from previous standards.

SCIENCE BASED TARGETS

DRIVING AMBITIOUS CORPORATE CLIMATE ACTION

Carbon Credits[3]

- *A carbon credit represents the reduction, removal or prevented release of greenhouse gases by natural or technological processes. Businesses and individuals can purchase credits on the voluntary carbon market and may use them to offset their own emissions.*
- *Projects generating carbon credits can fund initiatives that protect ecosystems and enhance biodiversity, but they may also negatively impact the environment and indigenous communities.*
- *Ensuring that credits accurately reflect genuine carbon reductions is complex, as it can be challenging to prove that emissions would have been emitted otherwise and to ensure the permanence of carbon storage.*

[3] https://researchbriefings.files.parliament.uk/documents/POST-PN-0713/POST-PN-0713.pdf2

The SBTi has announced they are considering allowing companies to use carbon credits to offset scope 3 emissions. No change has been made to the current SBTi standards, but a discussion paper with a draft proposal is expected to be released in July 2024.

[1] https://sciencebasedtargets.org/news/sbti-marks-5500-companies-with-validated-targets-announces-next-steps-in-transformation
[2] https://sciencebasedtargets.org/news/statement-from-the-sbti-board-of-trustees-on-use-of-environmental-attribute-certificates-including-but-not-limited-to-voluntary-carbon-markets-for-abatement-purposes-limited-to-scope-3

Science Based Target initiative

Implications of the potential change & opposition

- The SBTi's current rules do not allow for carbon offsets and this has, among other reasons, potentially limited the growth of the carbon offset market. A change in the SBTi's positioning could have major implications for the carbon credit market, which could now **exceed $1 trillion by 2050**.[4]
- The SBTi had been very public in its previous view that companies should not be using carbon credits to offset emissions, so this potential change marks a **key milestone for the carbon credit/offset market**.
- The opposition to the potential change, in particular from its own staff (as noted below), has raised questions about the **governance structures within the SBTi**.
- The CEO of the SBTi, Luiz Amaral, announced on 2 July 2024 that he will be stepping down from his role, citing personal reasons[5].

Opposition

- The SBTi's announcement came under criticism from a number of parties, including an **open letter from some members of its staff[6]** against the potential change, and **public criticism from WWF[7]** (a founding partner of the SBTi).
- WWF publicly stated that carbon credit offsets **"cannot be a substitute"** for decarbonisation.
- The SBTi's own staff in their letter noted that nobody on the SBTi's independent technical council was informed or consulted in this major policy shift.

[4] https://about.bnef.com/blog/mega-boost-for-carbon-offsets-market-seen-from-sbti-easing/
[5] https://www.businessgreen.com/news/4330850/science-targets-initiative-ceo-resigns-citing-personal-reasons
[6] https://future.portfolio-adviser.com/sbti-decision-to-allow-carbon-offsets-in-tackling-scope-3-emissions/
[7] https://wwf.panda.org/wwf_news/?11115466/WWF-statement-on-Scope-3-emissions

Carbon Credits

What does this mean for investors?

Some of the main risks and opportunities of allowing the use of carbon credits to close the Scope 3 emissions gap are presented below:

OPPORTUNITIES/PROS	RISKS/CONS
• **Immediate Emission Reductions:** Companies face challenges in reducing Scope 3 emissions. High-quality carbon credits enable companies to reduce their emissions quickly while they develop long-term emission reduction strategies, encouraging more companies to set climate targets. • **Support for Sustainable Projects:** Buying carbon credits supports projects that reduce or capture greenhouse gases, such as reforestation, renewable energy projects, and methane capture initiatives. • **Encourages Innovation:** The demand for carbon credits can drive technological innovation in carbon capture. • **Economic Benefits:** This decision would boost the demand for carbon credits, and these projects can stimulate local economies and create jobs, particularly in developing regions. • **Biodiversity Preservation**: High-quality carbon credits have the potential to help preserve biodiversity.	• **Delayed Action:** Risk of companies not prioritising reducing their own emissions over the use of offsets. • **Greenwashing:** There is a risk that companies may use carbon credits as a form of greenwashing, giving the appearance of sustainability without making substantial changes to their operations. • **Quality of Credits:** Not all carbon credits are created equal. There is a risk that some credits may not represent real, additional, verifiable, and permanent emission reductions. • **Verification Challenges:** Ensuring that projects genuinely reduce emissions and are not subject to double-counting or fraudulent claims is a significant challenge. • **Potential for environmental/ social harm**: Some offsetting projects have been found to be detrimental from other environmental or social perspectives (e.g. undermining natural species diversification/ negative impacts on indigenous peoples).

We believe investors should continue to **prioritise decarbonisation** over offsetting.

Middle East Note

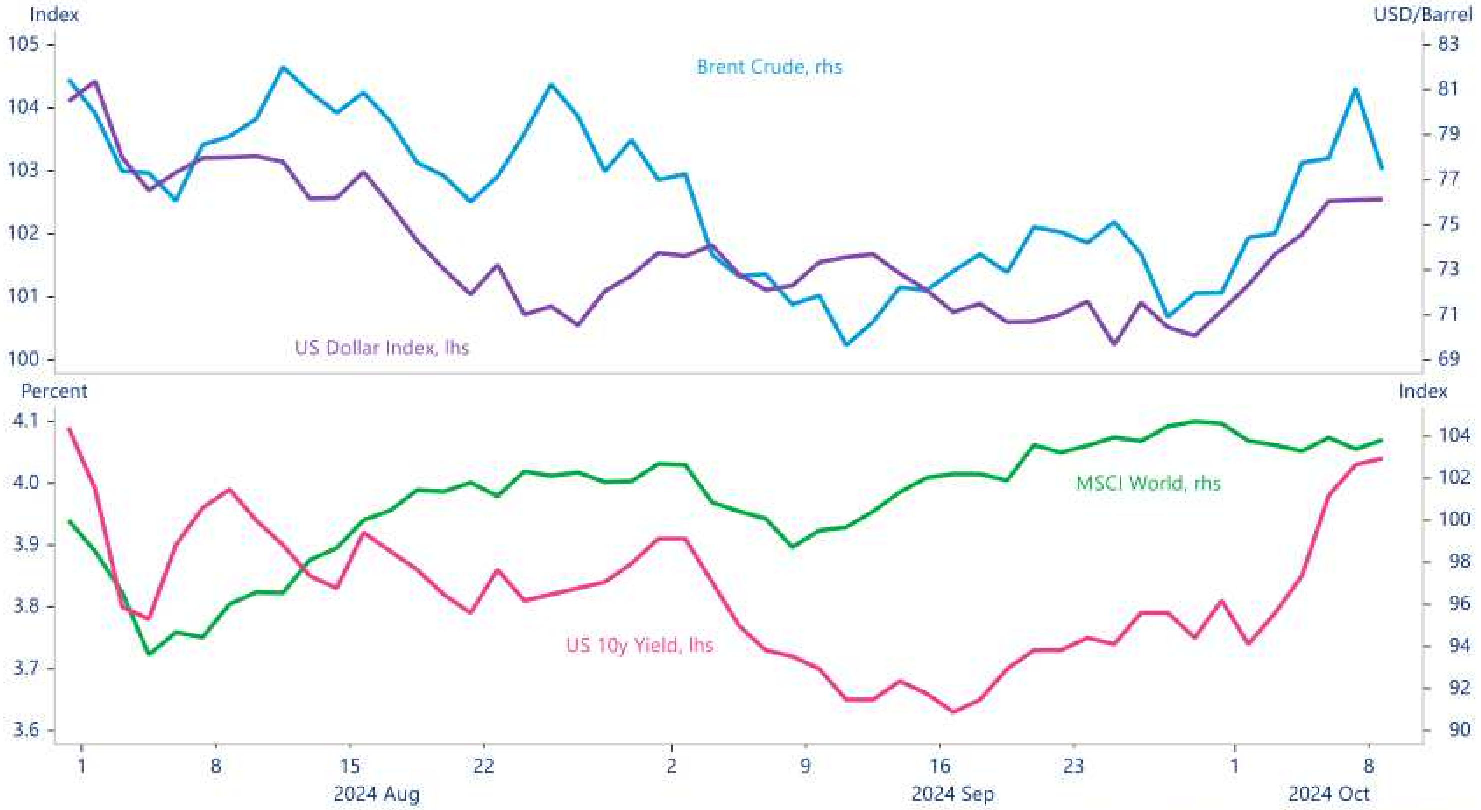
2

Recent Market Developments in light of the Middle East Tensions

written on 11 October 2024

- Over recent days and weeks the conflict in the Middle East has seen a series of escalations. The region has long been one of the world's biggest geopolitical fault lines – where tectonic plates of power, religion and resources collide. In mid-September the conflict in the region escalated with a series of retaliatory attacks involving Israel, Lebanon and Syria.
- Financial market reaction to the events so far has been largely confined to the oil market, which has rallied by over 5% since 17 September, albeit from the lowest levels of 2024. The US dollar has also risen modestly while bond yields and equities have largely focused on macroeconomic data such as the recent strong US labour market report and the Fed's 0.5% interest rate cut.

Figure 1: Market Impact



Source: Intercontinental Exchange (ICE), U.S. Department of Treasury, MSCI, Macrobond, Mercer as of 09/10/2024

Mercer View & Outlook

Mercer View

Our initial take on events centres on the heightened risks of a broader conflict, potentially hitting oil output and thus prices. Geopolitical events are difficult to forecast and although initial market reactions can be volatile, they often dissipate. Please see our paper Peering through the fog from 2022 where we analysed the market impact of prior geopolitical events.

Any major Israeli strike on Iranian energy assets could potentially lead to a spike higher in oil prices. However, the oil market has significant excess capacity, and we would expect countries with excess capacity, such as Saudi Arabia, to increase output if Iranian output falls. However, a much bigger rise in energy prices and therefore inflation cannot be ruled out if hostilities pull in other energy producers or shipping lanes are targeted.

Mercer Outlook

The crisis in the Middle East is happening at the same time as the upcoming US election. A second Trump term could potentially lead to volatility especially if markets focus on the likelihood of large tariffs on US trade partners, which we think would be negative for equities, inflationary and positive for the US dollar. Financial markets do not appear to be pricing this, with equities at all-time highs in many markets and Chinese equity markets up c. 40% since mid-September (albeit driven by more local factors including long-awaited stimulus measures). Harris is not proposing broad new tariffs on trade partners hence may potentially lead to a more limited impact on markets.

From a dynamic asset allocation (DAA) perspective (i.e. short to medium term), we have had a broadly positive view on global equities since October 2023 as interest rates have started falling and economies have largely avoided recession. Global equities have risen by over 30% since then to all-time highs[1] . In light of the increased potential risk and uncertainties we have reduced that view to a more neutral position.

Specifically, within our DAA views, we have reduced our overweight conviction to Emerging Market Equities, Real Estate Investment Trusts (REITs) and Japanese Equities, although retain a small overweight relative to developed market equities in each. This has taken conviction in equities to neutral and we have re-allocated it back into defensive fixed income assets, where yields have risen. We have also slightly reduced our overweight to frontier market debt (FMD) following very strong performance year to date but still see it as an interesting opportunity. We will set out of broader views in our upcoming annual outlook paper in November.

[1] *Source: MSCI, Mercer calculations as at 30 September 2024.*

UK Client Perspective

As we alluded to in our 2022 paper *Peering through the fog*:

Positioning portfolios for the unfolding of geopolitical events whilst they are already developing **requires an ability to see into the future**. History shows us that any sell-offs driven by geopolitics can be so short-lived that even high governance investors may struggle to time them.

Attempting to position for geopolitical events is more often than not likely to lead to an overall reduction in risk assets. **Inflection points are easy to miss and the opportunity cost could be enormous in the long term.**

From a client perspective, gilt yields have recently risen further than in the US, driven by global as well as local factors. We continue to support the calls to action made in our recent UK Budget Briefing Note where in isolation we expect the Budget to slow the UK economy and put some downward pressure on yields. Dollar strength versus sterling is still something we would recommend clients consider but remain aware of the tail risk hedge that dollar exposure gives for UK investors.

UK Budget

3

30th October

A summary of the key investment and pension issues stemming from the upcoming UK Budget, scheduled for release on 30 October 2024, will be presented for discussion at the November Investment Committee Meeting.

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