HYMANS ROBERTSON

Levers of change

The role of capital allocation

As an LGPS fund, you have two levers at your disposal to determine the success of your net-zero investment strategy. These are **capital allocation** and **stewardship**. In this article, we explore how capital allocation can aid our collective transition to a low-carbon economy. We also show how a model portfolio can act as a handy reference point to guide your asset-allocation decisions. And in our next article, we'll be switching the spotlight to the role of stewardship.

Taking advantage of investment opportunities

The efficient allocation of capital to key assets that support the low-carbon transition is a crucial feature of an effective and robust net-zero investment strategy. Capital can be allocated to accelerate change and solve challenges associated with the low-carbon transition, as well as to take advantage of opportunities like climate solutions across the investment universe. However, in practice, decarbonisation will not happen as rapidly as is required to reverse the adverse impacts on the planet.

As a result, we'll see increasing demand for climate adaptation solutions. These help society adapt to the effects of climate change rather than focusing on reducing emissions, offering both investment opportunity and positive impact.

Capital allocation includes a wide range of considerations from asset class allocation to manager selection and mandate-specific selections. For some specific investment opportunities, certain asset classes provide access to these investment opportunities, which is something to consider when exploring different investment opportunities across the climate solutions space. Mandate-specific decisions for an asset owner's net zero investment strategy can include ESG tilts towards companies that align with net zero objectives. Equally, exclusions from certain types of companies that are not aligned or compliant with net-zero ambitions can also be applied to mandate decisions.

When thinking about capital allocation and the types of assets that can accelerate the transition, we can split these into two broad groups:

Emissions reducers

Investment opportunities centred around emissions reductions. Asset owners can increase allocations to more efficient companies within sectors.

Emissions removers

Investment opportunities centred around emissions removals. Asset owners can increase allocations to assets that remove or avoid emissions in a measurable and robust way.

Using capital allocations to build a strategy

Being able to prioritise your actions is key. As is being clear on where your role in the transition sits based on your Fund's objectives, funding position, stakeholder views and pooling opportunities.

To help frame the approach, we might want to look at the trade-off between 'ease' of investment and the relative 'importance' of different assets in the transition.

- When assessing the 'ease' of investment, we consider factors like the time involved in building out a mandate and the range of suitable options available in the market. For example, investing in natural capital assets may take time for a committee to get comfortable with. As might understanding the nuances of different offerings in the market. Timescales to then deploy assets into the investment would also be a key consideration.
- When assessing the 'importance' of investment, we balance the carbon emissions reduction potential with the asset's ability to influence real world change. The assets that move the dial (we mentioned these in our first article of this series) are energy transition assets like renewable infrastructure and other enablers as well as natural capital like timberland, which is a 'remover'.

Model portfolios – mapping out your path to net zero

Model portfolios can provide an illustration of how strategy and mandate changes could put your net-zero journey on a better path. For a robust net-zero investment strategy, it's still crucial that the approach displayed by a model portfolio is used as a guide and point of reference. It should prioritise actions and drive positive investment decision-making for the future over the long term, rather than simply providing a static well-rounded investable portfolio for today. Model portfolios are a particularly useful tool for LGPS funds when considering pre-2050 net-zero target dates, as these can highlight the extent to which a current investment strategy needs to be adapted and the feasibility of this.

A model portfolio can help show how mandate changes through capital allocation into climate solutions supports a portfolio's journey to net zero and emissions reductions. By allocating to climate solutions, an LGPS fund can take progressive steps to accelerate the journey towards net zero.

Conclusion

Capital allocation is a key lever for change that asset owners can use to support net-zero ambitions and the low-carbon transition. It's important to be aware of the different investable opportunities available and how capital allocation decisions will impact your own net-zero strategy as well as the real world. If you'd like to understand more about investment opportunities across the climate solutions space, model portfolios and how we can help, please get in touch.

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