



Investment Insights

Sustainable

investing in DC Master Trusts

How can trustees and sponsors really know if a Master Trust provider will stay at the front of the sustainable investing curve for decades to come? We explore the importance of both providers' *commitment* to sustainable investing as well as the actions they have *already taken*.





Individuals' retirement outcomes in the UK are increasingly dependent on the actions of DC master trusts. The trend is set to continue with renewed pressure on own-trust schemes to consolidate.

The Pensions Regulator's (TPR) [recent guidance](#) on how to support members in the current economic climate stated trustees "should consider whether their scheme has sufficient scale, time and resource to govern the DC arrangements effectively". What's more, a [joint project](#) by TPR, the Department for Work and Pensions (DWP) and the Financial Conduct Authority (FCA) reviewing DC value for money assessments explicitly aims to "help drive consolidation by removing underperforming schemes from the market."

Our research

Our research covers 18 default strategies available through the leading master trust solutions.

We test each strategy against our Straw Man framework and this forms the foundation of our assessment. We rate strategies in 20+ areas to arrive at our view of the quality of each solution.

While sustainable investment is only one aspect to consider when choosing or monitoring a master trust, it is a particularly complex one. Sustainable investing is a fast-moving beast – we're discovering new concepts and ideas every day. The pace of change is exciting and reassuring to those of us who are concerned by climate change and believe that sustainable investment more generally can improve member outcomes. But how on earth can trustees or sponsors really know if a master trust provider will stay at the front of the sustainable investing curve for decades to come?

Our inaugural report on sustainable investment by DC master trusts was published last year. We explained our view that trustees and sponsors need to understand both *providers' commitment to sustainable investing as well as the actions they have taken.*

In this year's report, we explore the latest trends in how DC master trusts are addressing their Net Zero targets. While sustainable investing is not limited to climate risk, our focus here builds on our view that climate risk is the most financially material area of sustainable investing, particularly for DC schemes whose members may be invested for many decades to come.



Sustainable investing

Sustainable investing means investing for the long-term. It is inextricably linked to DC pensions given the long investment horizon many members have. A 25-year-old today could well be invested for 40 years before retirement - and with the increasing popularity of drawdown in retirement, another 30 years after that. In fact, we believe sustainable investing remains a [megatrend](#) that will define the next era of financial markets.

Net Zero commitments

In our briefing last year, we reported on the Net Zero commitments made by a selection of major DC master trusts as at 31 December 2021. There was a broad consensus –the majority targeted Net Zero by 2050, with a “halfway point” being reached by around 2030. However, a handful targeted Net Zero by 2040, with one provider targeting ‘now’.

You may not be surprised to learn there has been little change over the year, as these are not short-term objectives. However, there have been two interesting developments.

1. The one provider who had not set a target last year is now targeting net zero by 2050. However, unusually, they do not have an explicit interim target (e.g. halfway by 2030).
2. Last year, the master trust targeting ‘net zero now’ explained that it did so with the assistance of carbon offsets, with a target to make the investments themselves net zero by 2026. They have softened their stance. The latest plan for their investments is to achieve 80% emissions reductions by 2030.

We welcome this softened stance – managing climate related risks and opportunities is *one* of many considerations for pension schemes. Going ‘too fast’ could have inadvertent consequences, like greatly reducing the range and breadth of investments that can be held. While we absolutely support investors prioritising certain investments over others to manage *financial* risk and access *financial* opportunities in sustainability, we don’t think vastly narrowing your opportunity set to reach Net Zero today should be viewed as the gold standard for ‘going green’.

What's more, a key part of the green transition is helping 'brown' companies to become 'green'. This needs continued investment and focussed stewardship. With master trusts already at significant scale and growing substantially in the coming decades, they have a pivotal role to support and encourage the green transition. Their investments and stewardship have the potential to drive important change.

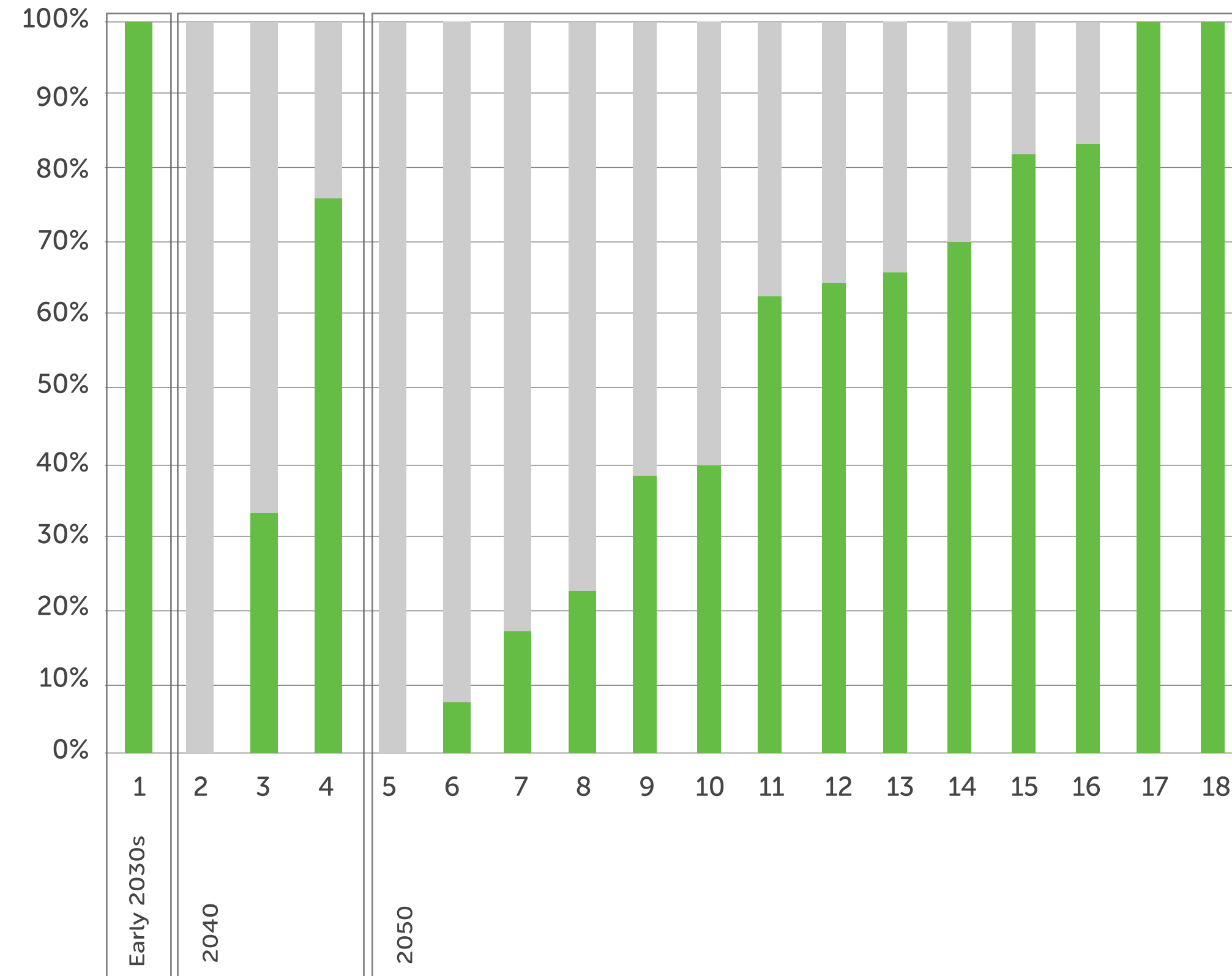
Acting on Net Zero commitments

Providers are increasingly integrating sustainability into their default strategies, though it is difficult to compare them. This challenge is reflected across the investment industry. The range of sustainable funds is evolving quickly. Investors can choose between active and passive, between tilts and exclusions, between EU Paris-aligned and Climate Transition Benchmarks, and plenty more. Companies and trustees are finding they need to rely more on their advisors than ever before to keep abreast of developments.

But are master trusts living up to their Net Zero commitments? Our analysis shows there are material differences between DC master trusts during the growth phase. The chart to the right groups master trusts according to their target date for achieving Net Zero.

Green bars show the proportion of assets in the growth phase invested in funds with explicit targets for reducing emissions as at 31 December 2022. The **blue dots** show 2021 data, highlighting the change over the year.

Allocation to active and tilted-passive assets



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There are some striking observations. As we saw in our report last year, master trusts with earlier target dates for Net Zero are not always investing more in funds with climate targets than master trusts with later target dates. However, it is clear that many have made significant changes over the year – with some large increases in the proportion of assets in the growth phase that have emission reduction targets.

These changes reflect the growing awareness of trustees about the importance of climate change, but also the availability of new funds. Trustees will need to work hard to keep up as the market evolves in the coming years. In fact, regulations now require trustees to meet certain standards in their governance and reporting around climate-related investment matters.

Along with plenty of work behind the scenes, trustees are required to prepare a so-called 'TCFD report' every year. Reading through these reports has been an interesting exercise. While so much progress has been made, it's clear that trustees face challenges in getting good quality data, carrying out and interpreting complex climate scenario analysis from the member's perspective, and of course presenting it all clearly and concisely. Given the approaches taken vary considerably and the commercially sensitive documents may not paint the whole picture, comparing different master trusts is no easy task. The data we collect helps us to dig deeper and give our clients helpful and insightful guidance.

Net Zero

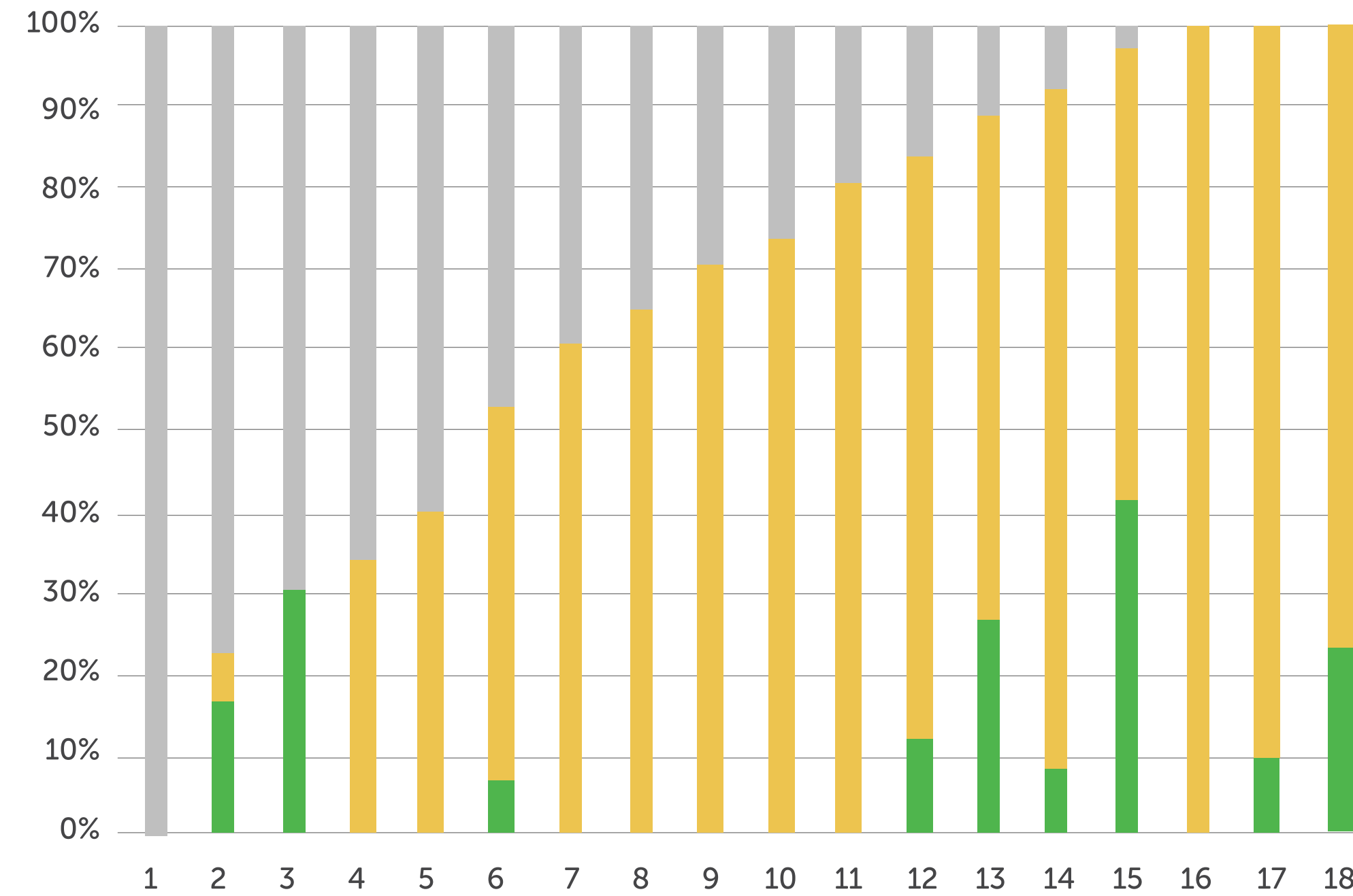
Beyond Net Zero...

We often get asked whether we prefer exclusions or tilts to manage sustainability risks and opportunities. The range of approaches in the industry means this is not the straightforward question we would like it to be.

Tilts and exclusions are often used to characterise passive (or index-tracking) funds. These funds require managers to invest in line with an index, which is created using prescribed rules. These rules can include tilts and/or exclusions to achieve specific objectives, such as improving ESG scores or limiting exposure to emissions. More often, active fund managers can invest in the companies they believe are most appealing at any given time, meaning the concept of 'tilting' is less meaningful. This means we can't look at just one or the other to understand the extent to which a master trust's fund managers *can* consider sustainability. However, it is worth noting that actively managed funds may not view sustainable investment a key pillar of their investment process.

Both tilted-passive and actively managed funds can be used to manage financial risks and access financial opportunities involved with sustainable investing. The chart to the right shows the total held in both tilted-passive and actively managed funds.

Allocation to active and tilted-passive assets



[Click for further insight](#)

Green bars show the proportion of the growth phase in actively managed funds as at 31 December 2022. **Yellow bars** show the proportion in tilted-passive funds. The **blue dots** show 2021 totals, highlighting the change over the year.



Once again, it is interesting to see the emerging trends over the year, such as master trusts increasing their allocations to tilted-passive funds.

The master trusts using these investment styles arguably have more potential to benefit from trends in sustainable investment. However, there is no guarantee. Our research teams set ratings for both active and passive funds that give our view on how well they are managed and their sustainability, helping us to advise clients. It is critical that investors understand any additional investment risks involved with investing in these funds too – for example, we have seen examples where funds end up with unintended biases towards certain sectors in order to meet climate goals.

What else are we seeing?

Last year, we highlighted private markets as an area master trusts could use from a sustainable investment standpoint. While progress is still slow – and the jury's out on whether the turmoil in 2022 will help or hinder the slow and steady progress of DC schemes into private markets – it's clear that master trusts are looking at plenty more beside.

We have seen examples of funds incorporating UN Sustainable Development Goals ("SDGs"), biodiversity metrics, impact funds (for equities and bonds), green bonds, green real estate, forward-looking climate metrics, and social factors.

A number of fund managers have also started giving investors choice around how votes are carried out on their behalf. This is a stepping-stone to master trusts being able to take much greater control over stewardship. However, voting is only one part of a coherent approach to stewardship. Stewardship should start with focused engagements with companies. Tools such as voting, industry collaboration and divestment are all important escalation strategies. Master trusts will need to consider all of this to live up to the potential for real world impact offered by their growing scale.

In conclusion, just as pension trustees are being encouraged by DWP to set "stewardship priorities" and report on these annually, anyone choosing or monitoring a DC master trust should consider what sustainable investing means to them. While evidence of forward thinking is fantastic, it's vital anyone who uses a master trust is confident these new ideas are right for their members. After all, your members' livelihoods are at stake. With strong working relationships across all the major DC master trusts, we can help you understand the detail and make choices that are right for you and your members.



Please contact our [Sustainable Investment Team](#) if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:



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