XPS Group

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Investment Briefing

Climate strategy in DC Master Trusts

DC Master Trusts take different approaches towards climate change and there are clear leaders and laggards in different areas. Alex Quant, Head of Responsible Investment at XPS Group, explores what impact this could have on member outcomes and the commercial success of those companies. This analysis covers 16 large commercial DC Master Trusts open to new employers in the UK, covering over £200bn in assets.

In brief:

- DC Master Trusts are among the leading asset owners when it comes to development of climate strategy, supported by regulatory development in this area and the role of professional trustees. However, there are still clear leaders and laggards in different areas within the peer group.
- All but one Master Trust captured in the analysis has a Net Zero or Paris Aligned objective. Only 50% have a clear focus on transition alignment, with most targets still based on portfolio decarbonisation.
- 56% of schemes indicate a current allocation to climate solution investments, and only 25% have a strategic target to increase their allocation to solutions.
- All but one scheme refers to the importance of nature, with most positioning this as an engagement priority, and very few indicating any nature-based investments.
- Trustees overseeing the Master Trusts should engage with the provider to review the approach to sustainability and climate change to ensure it is aligned to best practice and value creation for members.
- Companies looking to select a Master Trust for their employees should carefully review the approach taken by prospective providers, as effective management of climate change will be a key factor in long-term returns.

Background

2026 is set to be the hottest year on record, and the persistent heatwaves, drought and wildfires disrupting the UK, Europe and North America are all providing clear evidence of the real-world implications of climate change. Climate Action Tracker predicts that without significant intervention, the world is on course for warming of 2.3°C above pre-industrial temperatures, missing the goals of the Paris Agreement (which aims to limit warming to below 2°C) and leading to widespread physical, societal and economic damage.

The financial consequences of this for DC members are clear: unlike DB schemes, there is no sponsor standing behind a funding shortfall. The effect of climate-related physical and transition risks flows directly through investment performance, retirement timing, sequencing, and the real-world purchasing power of members' retirement savings.

Therefore, DC Master Trusts, who are responsible for a significant and growing portion of all UK retirement savings, need to ensure climate risks are managed effectively within their portfolios, and opportunities captured, in order to deliver on their outcomes promises to members. With the focus on value, the importance of maximising long-term net returns for members is clearer than ever.

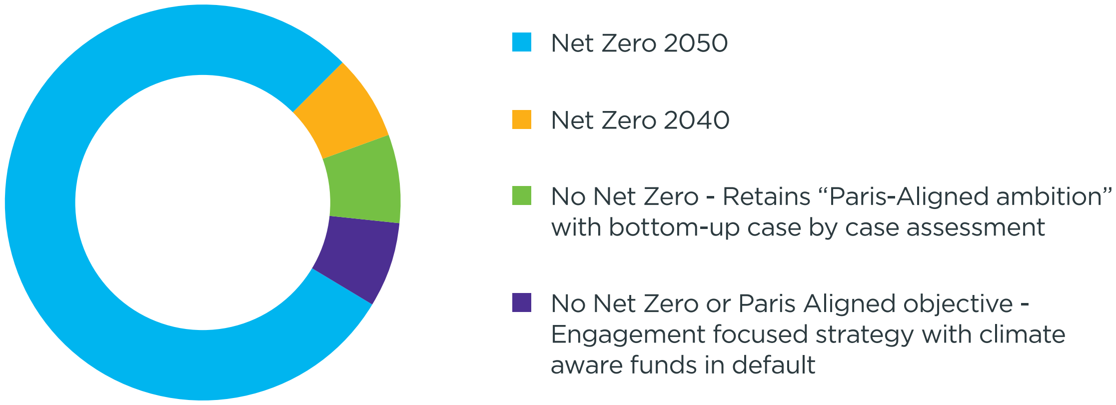
From a commercial perspective, those Master Trusts looking to scale and be the provider of choice need to demonstrate that they have a compelling proposition. Close management of climate risks and successfully finding opportunities will directly inform the long-term success of the investment strategy by which the firms are assessed.

In this briefing, we have assessed the 16 Master Trusts against three areas that we believe are increasingly important to deliver a best in class climate strategy: 1. Adopting a transition-led approach; 2. Making meaningful allocations to climate solutions; and 3. Integrating nature-related risks and opportunities.

1. Make the strategy "transition-led" not about emissions reduction

All but one of the Master Trusts under consideration have a Net Zero or Paris Aligned target. Most set this target for 2050, with one targeting Net Zero by 2040.

Chart 1: Overview of Master Trust Net Zero targets

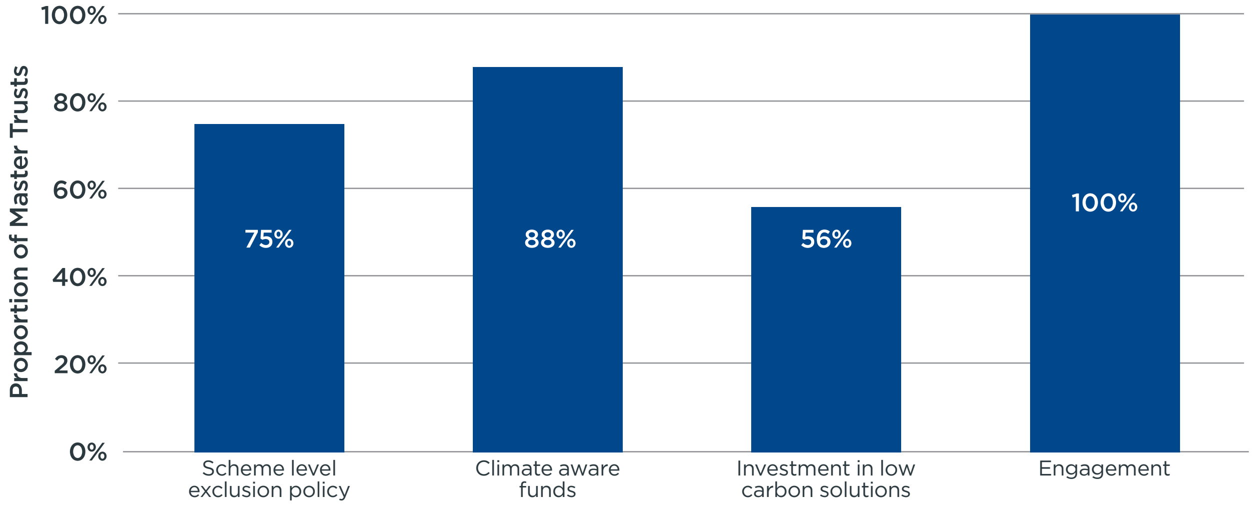


There is a change in mindset across investment markets to shift away from the focus on emissions reduction, towards a forward-looking, transition-led approach. Master Trusts are starting to reflect this but most need to do more.

- **Only 50%** indicate references to building their strategy around forward-looking considerations, resilience, or have underlying mandates which have explicit consideration on transition alignment.
- Furthermore, **only 2** Master Trusts have an overarching **target on transition alignment.**
- The rest position their headline target around portfolio carbon emissions reduction (even if within the default there are examples of funds which adopt a transition alignment methodology).

Within investments we see the following approaches taken to deliver the strategy:

Chart 2: Approaches taken to support the climate strategy



All Master Trusts articulate engagement as a key lever to delivering the climate strategy. All Master Trusts also reference the importance of systemic stewardship with policy makers or through collective initiatives.

There is good progress embedding sustainability into default strategies including climate aware funds (88% of schemes), however we would like to see more Master Trusts increase their investments into climate solutions and aim to capture opportunities to improve net outcomes for members.

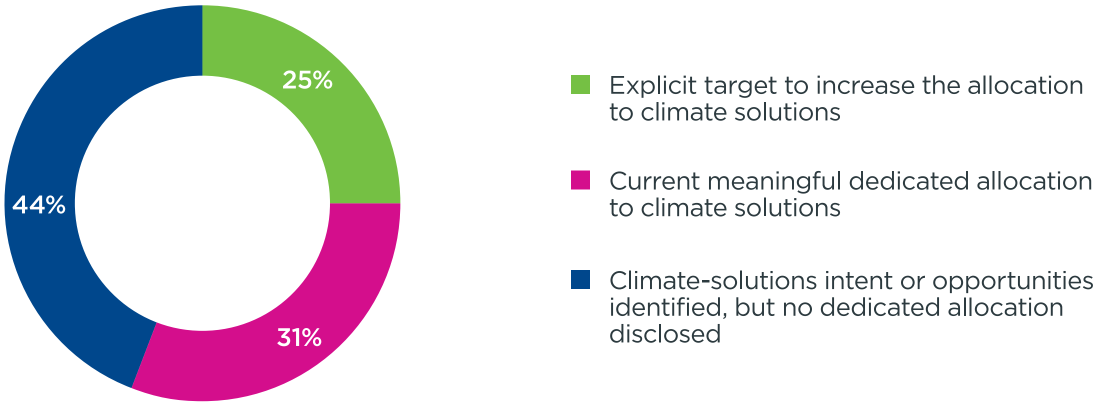
Last year we issued a report showing that sustainable passive equity funds can deliver enhanced sustainability outcomes without compromising financial objectives (minimal deviation from an unconstrained market cap index). You can read more here.

2. Set a strategic target for allocating to climate solutions

Successfully managing climate risks requires thinking beyond your portfolio characteristics (e.g. carbon footprint) and towards the real-world impact your investments are having (good and bad). Investing into climate solutions is an effective way to address climate change to manage the systemic risks in your portfolio, and to access the opportunities associated with the climate transition. By climate solutions, we refer to direct investments in mitigation or adaptation solutions, such as renewable energy assets, grid infrastructure, batteries, carbon capture, and technologies to support decarbonisation of hard to abate sectors. Within these areas, we see opportunities for value creation that could be helpful in supporting and enhancing net returns for members.

56% of schemes clearly indicated a current allocation to climate solutions, but **only 25% have set an explicit target to increase their allocation to solutions.**

Chart 3: Master Trust approaches towards climate solutions



There is a link here to the role of private markets in DC default strategies, and also to the role of UK investments, which are both hot topics in DC.

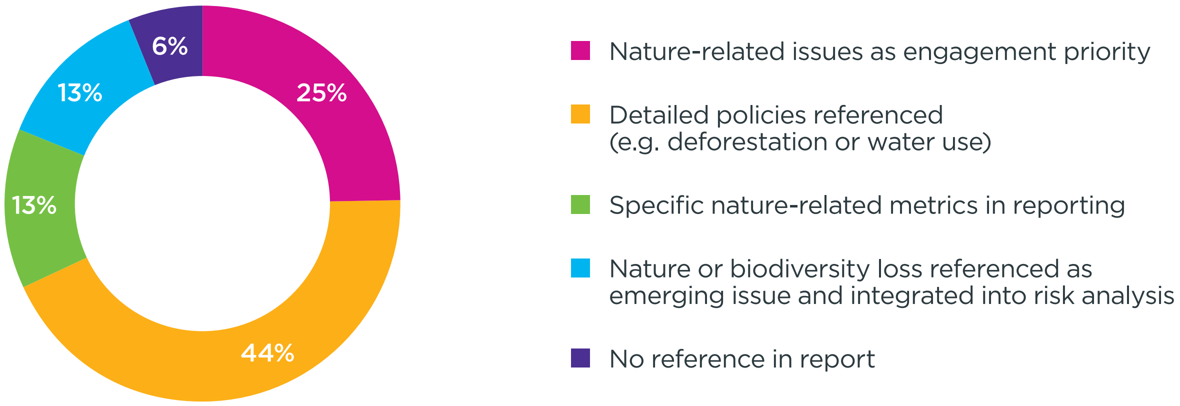
One potential opportunity for Master Trusts to meet strategic targets is through the use of private markets, where many investments such as renewable energy infrastructure or natural capital sit. Of the 16 DC Master Trusts covered under our analysis, 13 have signed up to the Mansion House Accord and committed to making at least a 10% allocation to private markets within the default strategy.

Investing in private markets can help Master Trusts implement transition-led investment strategies, and providers should consider any new allocations to private markets with a specific sustainability focus.

3. Progress made recognising the importance of nature, but needs to be converted into tangible outcomes

All but one Master Trust has some **reference to nature** in their climate reporting, but the degree of integration into the climate strategy varies. The chart below sets out the proportion of Master Trusts recognising nature and biodiversity loss as a key risk issue, proactively incorporating those issues into their stewardship priorities, and those going further to measure and report on their exposures.

Chart 4: Master Trust progress on nature-related issues



This is encouraging, but we would like to see providers do more to develop and implement a **holistic climate and nature strategy,** given the intrinsic link between the two issues and wider universe of investment opportunities that could enhance outcomes for members.

Summary and conclusion

UK DC Master Trusts are among the leading asset owners when it comes to development of climate strategy, however there are still clear leaders and laggards in different areas within the peer group. While Net Zero commitments are now commonplace, the next stage of development will be defined by how effectively Master Trusts translate these ambitions into investment decisions, stewardship activity and capital allocation.

Master Trust Trustees and the provider should proactively review their strategies to ensure they are aligned to best practice, to manage the real-world financial consequences of climate change on their investment portfolios. We've seen examples of strong collaboration between Trustee and provider leading to effective development of the climate strategy.

Companies looking to select a Master Trust for their employees should carefully review the approach taken by prospective providers, as effective management of climate change will be a key factor in long-term returns and growth of pension pots and there may be potential to establish alignment with existing corporate policies.

Trustees of single employer trusts can learn a lot from the policies and solutions that the leaders in the Master Trust market are adopting. In the most part these solutions are available to all schemes and so size shouldn't be a barrier to maximising long-term net returns for members.

The real-world effects of climate change are clear, as are the expectations from the market and members. Master Trusts that fail to review and enhance their climate strategy will soon feel the heat.

Find out more

For further information, please get in touch with **Alex Quant** or **George Cooper** or speak to your usual XPS Group contact.

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