Net Zero

A guide for financial advisers

Marketing material for professional clients only

Schroders

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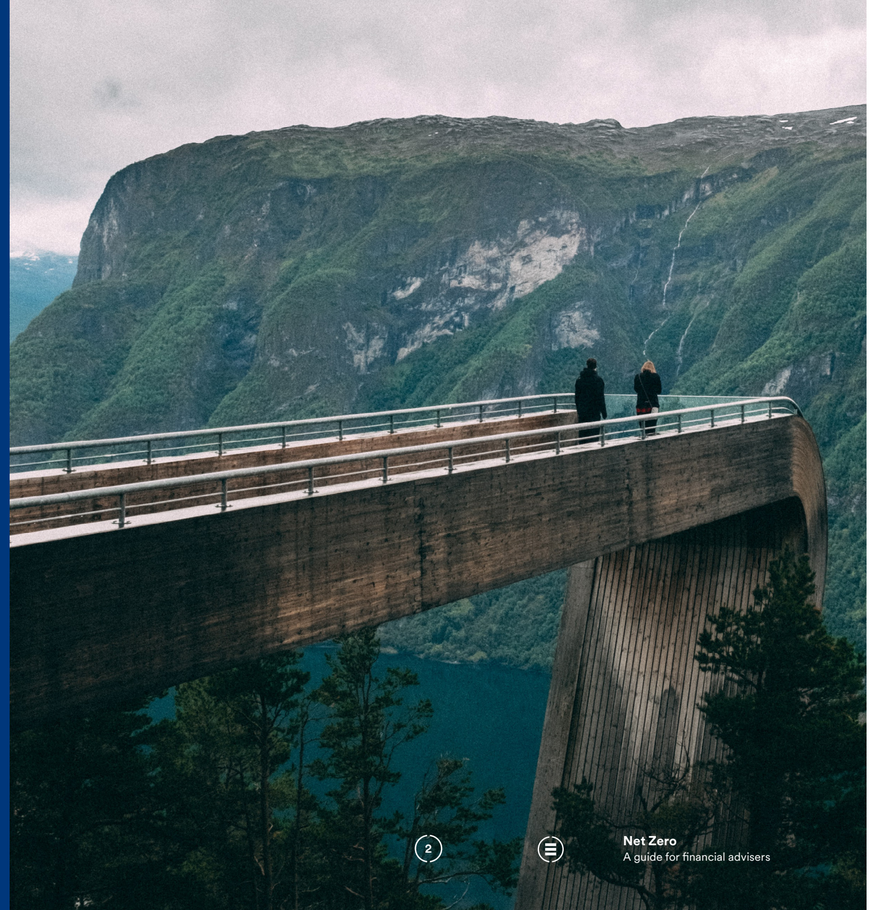


Introduction

There is incontrovertible evidence that the world is getting warmer as a result of human activity. And as extreme weather events become more frequent, the implications of what this could mean for us all are becoming ever more apparent.

It's also clear that we can't stop global warming in its tracks. Temperatures will continue to rise for some time to come no matter what mitigation actions we take. So a great deal will need to change in a short-time frame, if we are to avoid irreversible damage to our planet in the second half of this century.

Net Zero: balancing emissions and absorption

Our best chance of preventing devastating climate change is by limiting the extent of future global warming to 1.5°C Celsius above pre-industrial levels. This will require drastically reducing the amount of greenhouse gasses we emit into the atmosphere by 2050 so that they no longer exceed what can be absorbed. The term commonly used for achieving a balance between greenhouse gas emissions and absorption is 'Net Zero'.

Reaching Net Zero, or even getting close to it, is a massive undertaking. It will require the involvement and cooperation of governments, businesses and individuals on a global scale.

The main driver in managing climate change will have to be government policy. It is immensely good news to see so many governments around the world committing to a Net Zero emissions target. National governments, representing over 80% of global GDP, have now committed to lowering their emissions. Five years ago, under 10% of the world's governments, on any basis, had made similar commitments.[1]

The role investors can play

However, Net Zero cannot be achieved by governments alone. We all have an active role to play both as individuals and as investors.

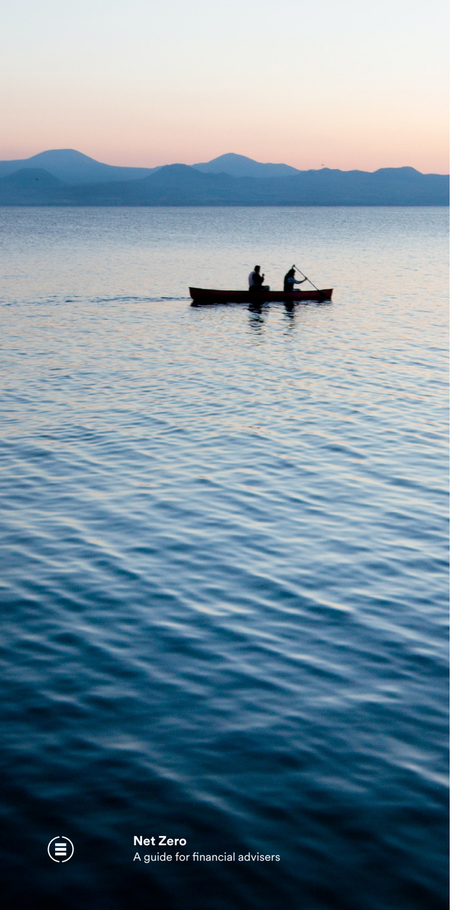
From an investment perspective, any major change in the economic and market background presents both risks and opportunities. This guide is focused on what Net Zero means for you, as a financial adviser, and for your clients, and how Schroders can work with you and support you during the transition to a more sustainable world.

"Climate change is one of the most pressing long-term issues that we face, and one that I expect to come further into focus as we look to the future. Companies have a fundamental responsibility and imperative to reduce their impact on the planet and re-orient towards a decarbonised economy.

Too often capitalism is the object of climate debate criticism, when its raw power could and should be targeted on the unifying aim of capping temperatures at 1.5°C above pre-industrial levels."

Peter Harrison, Chief Executive, Schroders

[1]Source: Net Zero Tracker 2021



The science of climate change

Why are global temperatures rising?

Global temperatures are rising primarily due to the cumulative build up in the amount of greenhouse gasses in the atmosphere over the past two centuries.

What are greenhouse gasses?

Carbon dioxide, methane, nitrous oxide, and fluorinated gases are collectively known as greenhouse gases as they can absorb heat from the sun and trap it in the atmosphere. They are emitted by both human and natural activity.

The impact that a greenhouse gas has on the climate depends on the quantity emitted, how much heat it absorbs and how long it remains in the atmosphere.

Why have greenhouse gas emissions risen?

Overall greenhouse gas emissions have risen primarily as a result of our increased use of fossil fuels as a source of energy over the past two centuries. Burning fossil fuels such as oil, coal and natural gas releases carbon dioxide. We now emit around 40 billion tonnes of carbon into the atmosphere each year. This is massively higher than the amount that we emitted prior to the advent of industrialisation.[2]

Why have greenhouse gasses built up in the atmosphere?

Emissions work in a cumulative way: the more we emit, the more is up there causing more global warming. The main (but not the only) culprit is the carbon dioxide generated from human activities. This stays up in the atmosphere pretty much forever. Greenhouse gas concentrations are at their highest levels in 2 million years and continue to rise.[3]

How much have global temperatures risen by?

The Earth is now about 1.1°C warmer than it was in the 1800s. 2015-2019 were the five warmest years on record while 2010-2019 was the warmest decade on record. Global surface temperature has increased faster since 1970 than in any other 50-year period over at least the last 2,000 years.

What are the broader impacts of global warming?

Scientific research has shown how global warming connects to a greater probability of extreme weather events. The consequences of climate change include intense droughts, water scarcity, severe fires, rising sea levels, flooding, melting polar ice, catastrophic storms, population dislocation and declining biodiversity amongst others.

What will happen if we don't take decisive action to drastically cut greenhouse gas emissions?

If we keep emitting more greenhouse gases that can't be naturally absorbed, they will keep accumulating in the atmosphere. This will warm the planet even further which means that climate change and its effects will only get worse and more frequent. At some point (and we can't predict exactly when) the emissions from our activities could tip the balance in the environment in a devastating and irreversible way.

[2]Source: https://ourworldindata.org/co2-emissions
[3]Source: United Nations

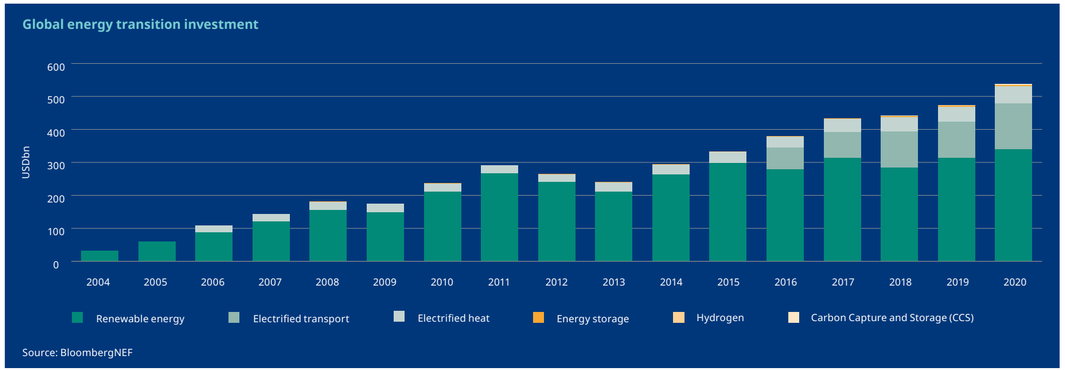
A roadmap to Net Zero by 2050

Addressing the issue of how the world produces and consumes energy, and the measures that need to be taken to limit the effects of global warming are now at the very top of the world's political agenda.

The latest report by the International Energy Agency (IEA) – Net Zero by 2050: A Roadmap for the Global Energy Sector – outlines a number of recommendations for achieving Net Zero carbon dioxide emissions by 2050. Among these is the recommendation that no new fossil fuel boilers for heating homes should be sold from 2025. The sale of new petrol and diesel-powered cars should also end by 2035, the report says. The report also says that from now, there is no place for new coal, oil or gas exploration or supplies.

The IEA's roadmap to Net Zero emissions by 2050 will require massive investments and unprecedented levels of international cooperation. The IEA calculates that global clean energy investment will need to triple to USD 4 trillion annually by 2030, which will drive the transformation of the sector. Renewables will account for almost 90% of energy generation by 2050, compared with 29% in 2020.

Some of the other recommendations in the report include further investment in the charging infrastructure for electric vehicles (EVs) to encourage their uptake. According to IEA, the number of public charging points for EVs should rise from around one million today to 40 million globally by 2030. This will require annual investment of almost $90 billion in 2030.



What Net Zero means for financial advisers and their clients

1. Regulation is coming

The UK government has committed to a 68% reduction in carbon emissions by the year 2030 and Net Zero by 2050. This is an ambitious and expensive commitment, which the government will not be able to afford alone. To hit the target they will also have to mobilise and direct private capital effectively.

The emissions reduction commitment will translate into a wave of new climate-related policy and regulation that will affect every company and business within the UK. This has wide-ranging implications both for the value of investments and what is expected of financial market participants, including advisory businesses.

Advisers are going to be an essential part of the transition to Net Zero as they play a key role as gatekeepers of private client capital.

The first change coming down the line that will affect our industry is the rolling out of mandatory reporting in line with the Task Force on Climate-related Financial Disclosures (TCFD) across companies and financial services.

The principle is that with TCFD, the market can see where most carbon is emitted and allocate capital accordingly. In March, Schroders published our first TCFD report which outlines our business' and clients' investments exposure to climate-related risks, our strategic resilience to these risks and the climate-related opportunities we are pursuing.

As sustainability is broader than climate change, the UK regulator has also unveiled plans for Sustainability Disclosure Requirements (SDR) that will effectively expand TCFD reporting to include (as yet undefined) sustainability factors.

The key part of regulation for advisers to pay attention to is SDR, which will introduce labels for sustainable investment products. This should help advisers establish which sustainable products are suitable for their clients, if the latter express such preferences. The details will be defined through a consultation process which will run over 2022. There are also ongoing plans for a UK Taxonomy (a common language to describe sustainable economic activities) more details of which will emerge over 2022.

Take a look at the UK government's net-zero roadmap at

https://www.gov.uk/government/publications/net-zero-strategy

"Advisers are going to be an essential part of the transition to Net Zero as they play a key role as gatekeepers of private client capital."

2. The need to factor environmental and climate impacts into decision making

Your investment advice, and the investment decisions that your clients make, have the potential to make a meaningful contribution to the Net Zero agenda.

As an advice business, your direct carbon emissions are likely to be relatively low. The same is likely to apply to your clients. However, within their portfolios, your clients can have exposure to many businesses that have a significant impact on the environment and, as a result, may face significant headwinds in the future.

The relationship between returns and impact has rapidly evolved as we see a fundamental shift in how companies are viewed and valued.

It is increasingly being considered a normal part of fiduciary duty to clients to consider Environmental, Social and Governance (ESG) factors. Avoiding carbon-intensive industries can, for example, help to reduce investment risk while investments that harness new cleaner technologies can offer attractive return potential. Innovation provides real hope in the fight against climate change.

Active ownership is another key aspect of sustainable investing. Engaging with companies and holding them to account is critical to ensure they adapt to the changes that Net Zero brings and transition towards more sustainable, resilient business models. This can support future growth over the long term.

"Your clients' portfolios can have exposure to many businesses that have a significant impact on the environment and, as a result, may face significant headwinds in the future."

3. Demand for sustainable investments is rising

Private investors are increasingly conscious of their impact on the environment and climate and are seeking investments that have sustainability objectives.

In our 2021 Schroders UK Financial Adviser Survey, 75% of advisers reported seeing an increase in the number of clients asking for sustainable investment options over the past 12 months.

Schroders' flagship Global Investor Study, which canvasses the views of more than 20,000 private investors around the world, suggests that the most important driver of interest in sustainable funds is the environmental impact they could have. The potential for higher returns matters, but it comes further down the pecking order. Only a small percentage of people are put off investing in sustainable funds because of performance concerns.

The same study also suggests that many private investors would be open to the possibility of their entire portfolio shifting to sustainable funds (assuming the same level of risk and diversification). Again, their reason for feeling positive about such a change is less about performance and more about having a positive impact.

In general, younger investors and those with greater investment knowledge have more positive views around changing their portfolio to be sustainable only.

There are different approaches one could take to build a sustainable portfolio. One may involve screening. Another may involve targeting an outcome alongside returns such as impact or thematic investing. Yet another may involve active ownership, which is using your influence as an investor to help a company improve and become more sustainable.

"75% of advisers reported seeing an increase in the number of clients asking for sustainable investment options over the past 12 months."

4. Growing requirement to both measure and report on environmental and climate impact

Both you and your clients will wish to understand how their investments are impacting the environment both negatively and positively. Investors expect transparent reporting on sustainability objectives and concrete evidence of their contribution to tackling social and environmental issues.

Asset managers such as Schroders have many tools at their disposal in order to assess which businesses operate sustainably. Some tools involve financial metrics. Some are non-financial. Some cannot even be quantified properly, like culture. Taking sustainability factors into consideration is about broadening the toolkit and using multiple lenses to assess the impact that a business has on the environment and climate.

For our Schroder Sustainable Model Portfolios, we offer a dedicated report that shows in monetary terms the impact that client investments can have on people and planet and how these are aligned with the United Nations Sustainable Development Goals (SDGs).

Schroders uses SustainEx™ to estimate the net impact of an investment portfolio having regard to certain sustainability measures in comparison to a product's benchmark where relevant. It does this using third party data as well as Schroders own estimates and assumptions and the outcome may differ from other sustainability tools and measures.

SustainEx™

Reflecting the growing focus on sustainable investment across Schroders, we have developed SustainEx™ as a common measure of portfolio sustainability across the majority of the investments we manage.

SustainEx™ is our award-winning proprietary tool which provides investment teams with an estimate of the potential social or environmental impact that an issuer may create. It is also used to help assess the estimated sustainability of portfolios.

The central role of the costs of carbon in that analysis means that carbon risks are examined across all portfolios. In total, carbon represents around 45% of the total impacts included in the SustainEx™ model.

MOST INNOVATIVE ESG PRODUCT
ESG Investing
Winner: Awards 2021

Environmental Finance
IMPACT Awards 2020
Winner
Award for impact measurement/impact reporting

5. The need for education and information on sustainable investment

The results from the Schroders Global Investor Study highlighted that the environmental impact of sustainable funds holds the most appeal to investors. Investorsclearly care about the environment so this could be a good conversation starter with your clients. Yet our research indicates that more than half of advisers still rate their level of confidence when talking to clients about terminology, regulation and ESG integration as 'middling or below'.

Hopefully the forthcoming FCA rules on investment product labelling will help to clarify terminology and support a move towards greater consistency across the industry.

Schroders has developed an extensive range of resources that can help advisers who are looking to develop their expertise in sustainable investing and would welcome the opportunity to work together to further support both adviser and client knowledge in this area.

Questions for your solutions partner

If you partner with an investment manager to provide investment solutions for your clients, it is important to understand how they are approaching Net Zero. Here are some suggested questions to ask:

- Have you set Net Zero targets?
- Do you integrate climate-related risks into your strategies?
- What have you done to encourage the companies you own to transition to a lower emissions future?

Schroders, your partner to Net Zero

As a business and an investor, we recognise that we have a responsibility to make sure we are on the journey to Net Zero and that we are delivering investment performance for our clients over the longer term by contributing to a sustainable future.

Net Zero Asset Managers initiative

Schroders has joined 29 other global asset managers representing more than USD 9 trillion of assets in launching the Net Zero Asset Managers initiative. This leading group of asset managers commits to supporting the goal of Net Zero greenhouse gas emissions by 2050 or sooner, in line with global efforts to limit warming to 1.5°C above pre-industrial levels.

As part of this initiative, we commit to:

- Work in partnership with asset owner clients on decarbonisation goals, consistent with an ambition to reach Net Zero emissions by 2050 or sooner across all assets under management;
- Set an interim target for the proportion of assets to be managed in line with the attainment of Net Zero emissions by 2050 or sooner; and
- Review our interim target at least every five years, with a goal of ratcheting up the proportion of assets covered until 100% are included, as efforts to structurally decarbonise economies play out.

Climate Transition Action Plan

As a company we are committed to ensuring our own low-carbon transformation is closely aligned with climate science. We have laid out a trajectory of short to medium term science-based targets that will define our longer-term roadmap towards achieving the goal of Net Zero emissions by 2050 or sooner. Our Climate Transition Action Plan sets out how we plan to achieve this, spanning both the investments we manage and our operations.

We believe that in order for businesses to survive they need to adopt long-term sustainable business models. Setting ambitious targets now, will catalyse change to achieve the strongest ambition and business value in the long term.

Schroders – your sustainable solutions partner

Sustainability has been an area of focus for Schroders for more than two decades, with our ambition and capabilities in this space continuing to grow and evolve in recent years and as we look to the future. Climate change and the need to reorient the global economy towards decarbonisation is a key component of any discussion on sustainability.

As an active asset manager, investing in a broad range of asset classes around the world, we have a key role to play in encouraging companies and other stakeholders to address their own environmental impact and consider how they can reduce their emissions. This commitment to engage with investee companies on this subject is consistent with our ongoing focus on incorporating sustainability into our investment proposition.

How can we help you

Insights

We are committed to sharing the insights we gain in managing the practical challenges we encounter on our Net Zero journey with our clients so you can benefit from our experience.

Sustainable solutions

Meet your clients' sustainable outcomes by investing with a solutions provider who has set ambitious climate goals.

Education

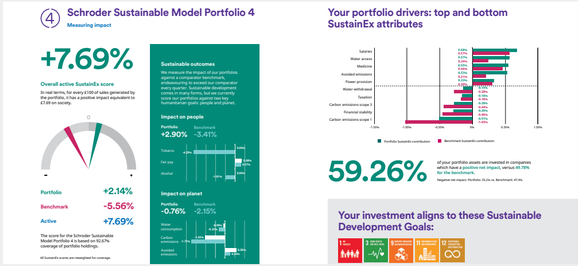
We can provide education on sustainability and Net Zero, helping you understand the regulation coming down the line and how to prepare your business and clients for this.

Impact

We provide detailed impact reporting on our Sustainable Model Portfolios using our own proprietary tool, SustainEx, which helps you and your clients see the environmental impacts (amongst others) their investments are having.

Schroders uses SustainEx™ to estimate the net impact of an investment portfolio having regard to certain sustainability measures in comparison to a product's benchmark where relevant. It does this using third party data as well as Schroders own estimates and assumptions and the outcome may differ from other sustainability tools and measures.

SustainEx impact report



Source: Schroder Sustainable Model Portfolios – Impact Report, Q1 2022.

Schroder Sustainable Model Portfolios

Six actively managed, risk mapped model portfolios

Over recent years, many forward thinking fund managers have taken on board how important sustainability is to the long-term prospects of companies. This has led to the development of funds that consider ESG factors as an integral part of their investment selection process.

The Schroder Sustainable Model Portfolios are designed to meet your clients' financial objectives, whilst ensuring their investments are promoting better long-term outcomes for people and planet.

We achieve this through a combination of investing in funds with 'best-in-class' ESG characteristics, alongside sustainable or impact funds, which look to identify companies whose products and services are meeting specific social or environmental needs.

How do we define sustainable investment styles?

We believe that sustainability covers a broad range of investment approaches and we look to invest across this spectrum. Each underlying fund has varying objectives and outcomes, which range from those focusing on financial benefit to those with a higher social focus.

Selecting managers with clearly defined sustainable and impact characteristics

The Schroder Investment Solutions team led by Alex Funk uses expertise from across the Schroders Group to identify "best idea" active managers with clearly defined sustainable and impact characteristics.

We look for managers that have a repeatable investment philosophy, a sound risk management process, a strong and incentivised investment team and a record of consistent outperformance that is differentiated from the index.

Reasons why

- Targeting investors' objectives while reflecting their desire to leave a positive impact on the world
- Matching investors' risk appetites; risk mapped by Defaqto, Synaptic, Dynamic Planner and Finametrica
- Impartial selection of funds that have clear sustainability or impact objectives and are aligned with progress towards a better more sustainable world
- Free to invest in funds from across the whole market
- Actively managed in-line with an expertly constructed model
- Well diversified by asset class, geography and sector
- Delivered at a competitive cost: 0.15% Model Portfolio Service (MPS) fee
- Independently rated

Source: Defaqto as at 31 March 2022.

Schroder Sustainable Model Portfolios

Risk considerations

Capital risk: All capital invested is at risk. You may not get back some or all of your investment.
Counterparty risk: The portfolios may have contractual agreements with counterparties. If a counterparty is unable to fulfil their obligations, the sum that they owe to the portfolios may be lost in part or in whole.
Credit risk: A decline in the financial health of an issuer could cause the value of the instruments it issues, such as equities or bonds, to fall or become worthless.
Currency risk: The portfolios may lose value as a result of movements in foreign exchange rates. Derivatives risk: A derivative may not perform as expected, and may create losses greater than the cost of the derivative.
Equity risk: Equity prices fluctuate daily, based on many factors including general, economic, industry or company news. High yield bond risk: High yield bonds (normally lower rated or unrated) generally carry greater market, credit and liquidity risk. Interest rate risk: The portfolios may lose value as a direct result of interest rate changes.
Leverage risk: The portfolios use derivatives for leverage, which makes them more sensitive to certain market or interest rate movements and may cause above-average volatility and risk of loss.
Liquidity risk: In difficult market conditions, the portfolios may not be able to sell a security for full value or at all. Money market & deposits risk: A failure of a deposit institution or an issuer of a money market instrument could have a negative impact on the performance of the portfolios.
Negative yields risk: If interest rates are very low or negative, this may have a negative impact on the performance of the portfolios.

Key climate change terms

Avoided emissions
The emissions reductions that occur through the replacement of a high-carbon emitting activity with a low-carbon emitting one. These reductions cannot be reflected in a product's or an activity's carbon footprint as measured by the greenhouse gases it emits. But they help reduce economy-wide total emissions.

Carbon market (including carbon offsets)
A trading system in which countries or companies can trade carbon credits or offsets in order to comply with national limits. Those markets can be either regulated (reflecting laws requiring companies to secure credits in proportion to their emissions) or voluntary (where buyers choose to acquire credits generated by carbon reducing activities).

Carbon pricing
Assigning a cost to emitting CO2 into the atmosphere, usually in the form of a fee per tonne Wof CO2 emitted, or limiting the total emissions firms can produce and issuing emissions permits. Putting an economic cost on emissions is widely considered to be the most efficient way to encourage polluters to reduce what they release into the atmosphere.

Carbon intensity
A group, individual, company or country's carbon emissions per unit of economic activity, for example sales, GDP or power generated.

Decarbonisation
The process of reducing a company, industry or country's carbon emissions. Decarbonisation is a critical component of the world's transition to a low-carbon economy.

Net Zero emissions
When the amount of carbon emitted equals the amount of carbon being removed from the atmosphere (either through the purchase of carbon credits or carbon offsets). In this way the overall position is one of "Net Zero carbon emissions".

Science-based targets
Carbon emissions reduction targets that are consistent with what the latest climate science says is necessary to keep global warming well below 2°C above pre-industrial levels.

Scope 1 emissions
Direct emissions that come from sources owned or controlled by the emitter, such as emissions from company vehicles.

Scope 2 emissions
Indirect emissions from sources owned or controlled by the emitter, such as emissions from the electricity used in a company's office.

Scope 3 emissions
Indirect emissions from sources not owned or controlled by the emitter, but which indirectly impact the emitter's supply chain, such as emissions from a company's employees commuting to work.

Transition risk
The financial risks that could result from significant policy, legal, technology and market changes as we transition to a lower-carbon global economy and climate-resilient future.

Get in touch

If you would like further information on any of the topics in this guide or on the Schroder Sustainable Model Portfolios:

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