Marketing material
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In focus

Part 1: Setting a net zero plan

Welcome to our client guide to decarbonisation. This three-part guide aims to help asset owners set and manage an effective net zero investment strategy.

In this, Part 1, we cover the necessary decisions and steps to be taken when designing the right strategy for your organisation. Part 2 explains how to put this into practice and the investment levers available, and Part 3 explores the options around measuring and keeping track of progress.

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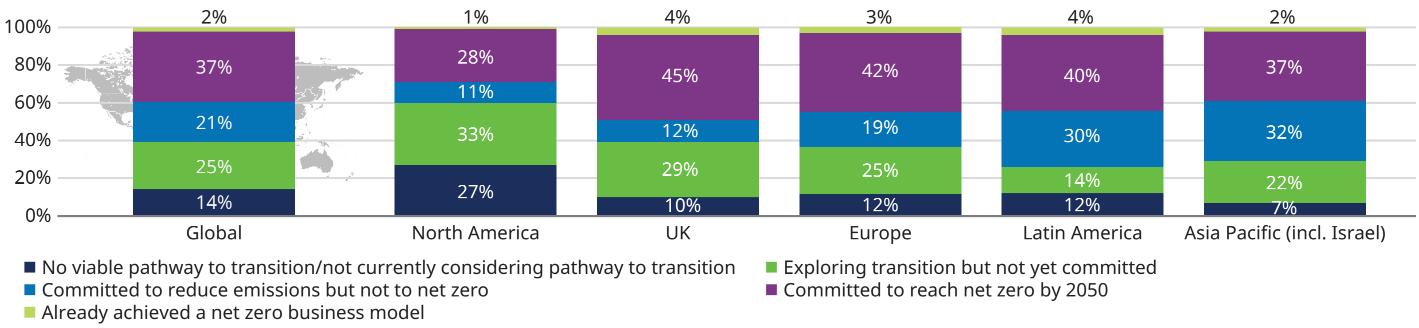
Why net zero?

Climate science shows that in order to avert the worst impacts of climate change, the increase in global temperatures needs to be limited to 1.5°C above pre-industrial levels. We have a clear international framework in the Paris Agreement, signed by 196 countries, to keep global temperature rises well below 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5°C. This will require emissions to be reduced by 45% by 2030 from 2010 levels and reach net zero by 2050.[1] To get there, we need huge structural shifts in societies and economies from the ways we generate power to the ways we produce and consume goods and services. Policies such as carbon prices and taxes, as well as those that incentivise further electrification and greener infrastructure, will be needed to galvanise these shifts. This transformative change will be a source of both value creation and destruction across industries, companies and investment portfolios.

For asset owners, setting a net zero target serves multiple functions. It can be a way of assessing and managing risks relating to the low carbon transition. Aligning to a net zero pathway may reduce the risk that portfolio values are disrupted by economic shifts that have a disproportionately negative effect on more carbon-intensive investments. At the same time, it can be a way to accelerate positive change in the world by channelling capital to sustainable and durable businesses. Depending on the starting point and end goal, the longer an investor waits to start decarbonising, the faster and more dramatic it may have to be.

There is already huge momentum behind net zero target setting. Asset owners (covering assets of c$13.9 trillion[2]), asset managers (covering assets of over $66 trillion[3]) including Schroders (see our [Climate Transition Action Plan (CTAP)](#)) and other organisations, are establishing commitments. For example, in our institutional investor survey of 2022, almost 40% of the 770 organisations surveyed had made a commitment to net zero or had already transitioned their business model.

Figure 1: Where are you on your path to net zero?



Data may not sum to 100% due to rounding.
Source: Schroders Institutional Investor Study 2022.

[1] https://www.un.org/en/climatechange/net-zero-coalition.

[2] The second progress report of the Net-Zero Asset Owner Alliance. Advancing delivery on decarbonisation targets. – United Nations Environment – Finance Initiative (unepfi.org) and Signatories – Paris Aligned Investment Initiative.

[3] NZAM update – November 2022 initial target disclosure – The Net Zero Asset Managers initiative.

Schroders

Designing an effective net zero strategy

Many investors set net zero commitments before they know how these will be implemented. Using this five step framework, we explain how to design and implement an effective net zero strategy.

1	2	3	4	5
Agree motivation and priorities	**Set time horizon and targets**	**Agree investment implementation approach**	**Agree what is going to be measured and how you will track progress**	**Document the plan in your Investment Policy Statement**
Managing climate risk vs. real world impact (i.e. double materiality) Client priorities vs. mission and returns	Target year Baseline year Interim targets	Avoid/divest Active ownership Positive climate solutions	Coverage Measurement methodology Active ownership targets Climate solution targets	e.g. 'The portfolio should align to a 2050 net zero pathway whilst consistent with the risk and return objectives'

(1) Agree motivation and priorities

The motivation for your organisation's net zero goal will be an important determinant of the most appropriate investment strategy.

- Are you primarily aiming to manage climate risks to your investments?
- Or is the impact of your investments on the environment and society also a priority?
- How important are the reputational risks of inaction?

Being clear on the reason, or reasons, for the goal in the first place, will help you to communicate your needs and expectations clearly to your investment manager or advisers.

- 'Materiality' or 'inward materiality' is the effect of climate change on a company's finances and activities. A focus on this is a focus on risk management
- 'Outward materiality' measures the effect of finance and corporate activities on climate change, the wider environment and society. This is considering the impact of your investments
- 'Double materiality' incorporates both - managing climate risks on your investments and the impact your investments may have on the earth

Investors may have various motivations and priorities for their investment strategies. On the one hand, impact investors may wish to prioritise real world outcomes while seeking financial returns, while other investors may prioritise risk-adjusted returns regardless of impact. Decarbonisation strategies can be optimised to support sustainability and climate objectives. If implemented carefully, decarbonisation strategies can also support or enhance risk-adjusted returns, managing the risks that a changing climate will have on the economy, consistent with fiduciary duty.

In addition, investors may need to limit the tracking error of their portfolios against an index or maintain sufficient liquidity to meet regulatory requirements. They may be subject to capital charges or have an income requirement. The appropriate pace of decarbonisation will be influenced by these variables. Climate-aligned products or investor specific solutions can be designed to reflect investor priorities.

(2) Set time horizon and targets

An asset owner will need to specify the time frame they are looking at to reach their overall net zero target. 2050 is the most common for those that have set financed emission targets, consistent with the majority of governments and companies. If the world is decarbonising at the same speed as the asset owner's trajectory (or quicker), the organisation could meet their targets without any action. But if the world fails to keep pace, asset owners will have to adjust their portfolios more actively if they want to address the shortfall. There will be some regions where targets are set at a later date to be consistent with local policies (such as 2060 in China). It may be tempting to set an ambitious target to demonstrate your commitment to the cause, but this may impact the ability of a portfolio to meet all other investment objectives.

The organisation will need to choose a baseline year to anchor all targets – many have chosen 2019 as the year before the COVID pandemic, given the temporary drop in global emissions during this time, but getting historic data from this year can sometimes be challenging. Targets over multiple timeframes help to set out the journey to the end goal and can include more than one measure. For example, Schroders have a net zero absolute emissions target by 2050 or sooner, but to support our journey to achieving this end goal, we have targets for portfolio alignment in 2030 and 2040. Interim targets over short and medium time horizons will demonstrate early action (for example 2025 and 2030 targets) and further interim targets can be incorporated as progress is achieved.

It is important to adopt a dynamic approach to target setting. The world will not be decarbonising in a linear or uniform manner, and so any strategy will have to be cognisant of its starting position and other portfolio goals, and be prepared to adapt to new information; for example, changes to the political and market environment, climate science and advances in technology.

(3) Set implementation approach

Where climate objectives are set as part of an investment strategy, such as net zero, investors will need to decide how they intend to achieve this goal. There are a number of levers available to investors to decarbonise portfolios, but each requires careful consideration as to the impact on portfolio decarbonisation and on the investment universe. For example, exclusion is a way to raise the cost of capital for more carbon-intensive entities, but the impact may be limited if capital is instead raised by other sources. Engaging companies, even if they have higher emissions, to encourage them to set net zero transition plans and take steps to decarbonise is another way to influence real world emissions reductions and avoid restricting the investment universe when starting a decarbonisation programme. For investors with diversified portfolios, the reality will likely be a combination of approaches; for example engaging companies with high emissions to transition, with a robust escalation strategy which ultimately leads to divestment and exclusion for failure to act. Over time, exclusions may play an increasing role in high emitting sectors where there is a danger of stranded assets as the economy transitions.

(4) Agree what is going to be measured

Net zero strategies can come in many forms. However, we believe that most boil down to a few key aspects:

- **Measure:** An important step is agreeing on the metrics to measure, track and report progress against. In some cases, this may depend on data availability and may even require estimates to be used. Each portfolio decarbonisation metric will play a different role and will depend on the targets set and investment priorities. To understand current exposures, financed emissions provide the absolute carbon emissions associated with the portfolio, while intensity-based measures, such as weighted average carbon intensity (WACI), help to normalise for company size and production, enabling comparison between companies and portfolios. Target-based or aspirational measures, such as temperature alignment are important to provide an indication of portfolio trajectory, based on projected emissions or whether companies have set targets. We cover this in greater detail in Part 3. Asset owners, or the investment managers servicing them, will need to keep track of progress using a variety of different measures – it is unlikely that one metric will show the whole picture.
- **Target:** Now you have your metric and timeframe, how should your target be calculated? This usually depends on the measure you have chosen. For financed emissions and emissions intensity, this could be a percentage reduction over a given time, such as 5% year on year. The appropriate degree of percentage reduction will be influenced by the starting point and other investment policy stipulations such as emission levels relative to an index. For temperature alignment and similar methodologies, the target can be set at a specific temperature, such as aligned to 1.5°C. More detail on alignment and measurement is detailed in Part 3 of this guide.
- **Emissions coverage:** While most asset owners acknowledge that Scope 3 emissions are important in the long term, they are not yet widely reported. This is why most have opted to use Scope 1 and 2 financed emissions for interim targets, with the objective of incorporating Scope 3 financed emissions once the data becomes more reliable. As the Taskforce for Climate Related Financial Disclosure (TCFD) encourages inclusion of Scope 3 portfolio emissions in its reporting framework, this data is expected to improve over time. Whether and how to incorporate carbon offsets is also a point of industry debate. Target-setting bodies such as the SBTi do not currently allow offsets to be used to meet interim portfolio decarbonisation goals. Allowing interim offsets could take focus away from actions to decarbonise. However, there is recognition that they may be considered viable at 2050 for a small amount of the residual emissions.
- **Asset class coverage:** Net zero target setting lends itself more to certain asset classes. This is often due to the intrinsic nature of the asset class, or due to data availability challenges. Where an asset owner has set a net zero target, most have focused on their listed equity and credit portfolios, where there are well-established methodologies and better data availability. Standards to measure emissions and set targets on other asset classes, such as private equity and debt, and real estate, are diverse; largely depending on the relationship between investor and investee, e.g. the ability to measure and access data is greater for direct real estate holdings vs a private equity fund of funds investment. Accounting for the emissions of asset classes such as sovereigns, securitisations and derivative-based strategies are more challenging, with measurement methodologies less developed.

- **Supplementary targets and policies:** An asset owner's net zero targets alone are unlikely to be sufficient to capture all the climate objectives they seek to cover. For strategies with emphasis on engaging for transition, investors should include engagement targets with clearly defined outcomes; for example, covering a percentage of portfolio emissions, or percentage of companies with science-based targets. Where the climate strategy seeks to invest in climate solutions such as low-carbon technologies, alternative measures and targets may support this aim. For example, setting a target for a percentage of their portfolio to be invested in climate solutions, or a measure of decarbonisation contribution such as avoided emissions (more details can be found in our joint paper with the Singaporean Sovereign Wealth Fund here). In addition, there may be steps that investors want to take to help deliver a "Just Transition" (more information here) – for example engaging with companies to consider social consequences in their net zero transition plans. Supplementary targets and policies are a way to address this and are an important part of an overall climate strategy.

The number of decisions needed to set a net zero strategy can seem daunting, and many asset owners have turned to industry initiatives and frameworks, such as the Net Zero Asset Owners alliance (NZAOA), Science-based Target initiative (SBTi) and Paris-aligned Investors Initiative (PAII). These provide helpful guidance and structure for target-setting, but can have nuanced differences as well as areas of focus. For those trying to navigate this alphabet soup, we provide more information here.

Whether an asset owner would like to sign up to a particular framework or initiative will depend on many factors; for example, the popularity of the framework in their operating regions or whether the guidance suits investment strategies. The key factor is that these choices will affect how net zero targets are implemented during the investment process as well as engagement strategy. No one framework is mandatory to follow, therefore asset owners should consider which option will best meet their objectives carefully, or consider whether they could design their own approach in partnership with their investment managers which may provide greater flexibility in implementation.

(5) Investment policies to support net zero targets

It is vital that the asset owner's intentions and strategy are reflected in the formal investment policy, as this is the key document that will drive investment manager behaviour. Policies should reflect elements (1) to (4) above, including the objectives and priorities, the desired strategy for portfolio decarbonisation, and should seek to support measurement against the net zero targets set. Examples of investment policy extracts are set out below.

Example 1: Net Zero Aligned

The organisation has set a target to achieve net zero greenhouse gas emissions across Scopes 1–3 by 2050, while remaining consistent with risk and return objectives. The organisation believes that managing climate risk will be beneficial for risk adjusted returns over the coming years. It is recognised that the strategy will evolve over time and will be reviewed at least annually. The organisation expects its investment managers to measure progress against the following objectives:

- Equities:
  - Aligned with 1.5°C by 2040 as measured by the CDP-WWF temperature rise methodology
  - Interim target of 2.2°C by 2030 as measured by the CDP-WWF temperature rise methodology
  - Scope 1 + 2 carbon emissions lower than MSCI ACWI
  - Include Scope 3 when data is available
  - Engage with underlying companies to set a science-based net zero target by 2050 or sooner and track progress
- Other asset classes:
  - Aligned to net zero by 2050
  - Incorporate targets as data improves
- Third party funds:
  - Where funds are managed externally, engage with fund managers to set a science-based target for net zero by 2050 or sooner and track progress

Example 2: Net Zero Active

The organisation has set a target to achieve net zero greenhouse gas emissions across Scopes 1-3 by 2050, and bring its investment portfolios as close as possible to the trajectory set by the Paris Agreement to limit global warming to +1.5°C by 2030. The organisation is committed to exit from fossil fuels by 2030 for coal and non-conventional fossil fuels, and by 2040 for oil. Its decarbonisation strategy focuses on three core pillars: the reduction of the carbon footprint of its investments (covering listed equity, corporate bonds and real estate), increased financing of the transition, and engagement with highest emitters. The organisation is focused on being a responsible investor, by contributing to the necessary acceleration of transitions, while maximising returns. It is recognised that the strategy will evolve over time. The organisation expects its investment managers to measure progress against the following objectives:

- Equities, corporate bonds and real estate assets:
  - Carbon footprint reduction of 25% by 2025, from 2020 base year (Scopes 1–3)
  - Get as close as possible to 1. 5°C alignment by 2030 as measured by a third party methodology
  - Minimum allocation to climate solutions of 15% total invested assets by 2025
  - Engagement strategy for the 20 companies with the highest carbon emissions
- Third party funds:
  - Where funds are managed externally, the fund house is expected to implement a coal and non-conventional fossil fuel phase out by 2030 and ending new financing to new oil & gas projects

Conclusion

Setting a decarbonisation strategy to reach net zero requires many related decisions which have consequences on how your portfolio is subsequently managed. No one framework is perfect for all investors, and a degree of flexibility in a decarbonisation strategy will be required to help meet all other investment objectives. Supplementary targets are a good way of capturing climate-related objectives that don't necessary relate to the decarbonisation of a portfolio.

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Important Information