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In focus

Part 2: Implementing a net zero plan

Once a goal to reach net zero has been set and motivations and interim targets considered, the plan must be put into action. But how to actually decarbonise your portfolio? Should all asset classes and regions decarbonise at the same speed? Does the starting point of a particular portfolio matter? We'll aim to address these questions in the second part of our Decarbonisation Guide. If you haven't seen it already, please read part 1 here.

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This guide is focused on investors aiming to prioritise investment returns, while also decarbonising their portfolio, rather than those willing to sacrifice returns to achieve more significant impact. We're going to consider three steps:

1. Project your current pathway

The first step is to understand what level of decarbonisation is expected from the portfolio, based on the actions already being taken by the companies it is invested in – and assuming companies meet the targets they have publicly set. There is already significant momentum behind the transition to net zero, and while actions aren't yet sufficient to meet the goals of the Paris Agreement, pressure from consumers, regulators and campaign groups is already leading companies to decarbonise their operations or commit to doing so in the future. Out of the 2,000 largest publicly-traded companies, 931 have set net zero targets already[1]. For private assets, the transparency around this is quite different and will depend on the investor relationship with the underlying. For, example in direct real estate holding you may track a pathway more easily than private equity fund of funds.

Figure 1: Emissions pathway by weighted average carbon intensity (MSCI ACWI)

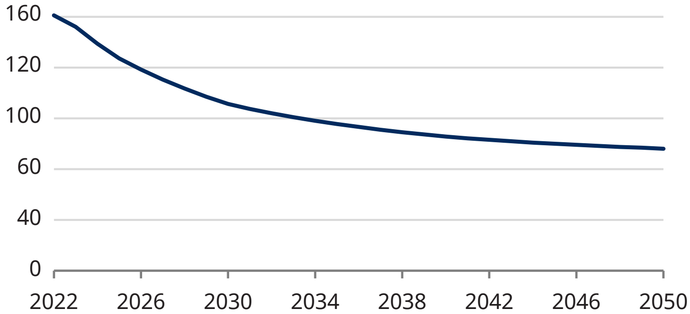

Figure 1 below shows the current decarbonisation trajectory of the MSCI All Country World Index, representing global equity markets. This indicates that the projected carbon intensity of the index (as measured by the weighted average carbon intensity, WACI) is expected to fall by 50% by 2050 if the companies achieve the targets they have already set. Although many companies have set decarbonisation targets which should reduce emissions over time, assuming these targets are met, there still remains a significant gap to reaching net zero by 2050.

This decarbonisation trajectory will only be possible if the companies set and implement robust action plans to transition their business models and decarbonise. Part 3 of our Decarbonisation Guide expands upon how investors can use multiple data points to understand the targets companies have set, the progress achieved, and actions companies are taking on transition plans and implementing climate into their organisation.

2. Influence via active ownership

The next most important step investors can take is to actively engage with companies to encourage greater ambition to decarbonise with a robust plan to achieve this. This can be done through shareholder voting, or targeted engagement with company management, for both shareholders and bond holders.

Schroders Portfolio Emissions Pathway tool. The emissions pathway is based on the most ambitious target in terms of emissions reduction for every company in the index and projected according to the timeframes and target year associated with each target. Company target information is sourced from CDP and MSCI. Note that although many companies will have more than one target, the Portfolio Emissions Pathway tool projects only one, therefore the projection may be an underestimation of the decarbonisation pathway of the portfolio.

[1] Net Zero Tracker | Welcome as at 21st June 2023

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It can also extend to other asset classes – such as developers in property investment or sovereign nations. Within private assets, where assets are held for longer and liquidity tends to me more limited, proactively engaging with stakeholders throughout the investment life cycle is key. Engagement is a very powerful way of achieving both portfolio decarbonisation (risk management) and real world decarbonisation (impact). It allows investors to focus on generating returns, without significant portfolio constraints and encourages a deeper dialogue with the company, and hence a deeper understanding of the investments being made.

Ultimately, engagements should lead to enhanced progress in the trajectory highlighted in step 1; as more companies set net zero targets, the expected carbon trajectory of the portfolio will trend closer towards zero by 2050. However, it requires investors to have a climate engagement strategy that defines which companies within portfolios should be engaged with as a priority, how they should be engaged with, how the investors will measure success and what steps will be taken if sufficient progress is not made.

Prioritise companies for engagement

Investors, or their investment managers on their behalf, will not be able to engage with all companies in portfolios at once. Therefore, setting out how and why certain companies should be prioritised for engagements should enable targeted and manageable interaction. A useful starting point for prioritising companies can be the data used to set the portfolio targets and track progress over time, and often the majority of carbon emissions can be attributable to a small number of companies in the strategy. Investors should review the list of target companies to assess whether it seems complete and track the degree of engagement taking place. Part 3 explains different net zero metrics for target setting and monitoring progress, which will offer different lenses to identify laggard companies that could be doing more.

Engage companies and measure progress

A climate engagement strategy should set clear expectations with companies on the changes required and how the companies will be measured to understand whether progress is being made. The party carrying out the engagement (likely the investment manager) should set clear objectives and pre-defined milestones to reach this objective. Investors can engage with their investment manager to assess whether these objective are ambitious enough. An assessment of 'momentum' could provide an additional qualitative data point to inform escalation decisions where necessary.

First stage objectives for company engagement could include committing to net zero or measuring and reporting their actual emissions data. The engagement process should then aim to push companies towards greater levels of maturity, such as setting science-based targets across Scopes 1, 2 and 3, including setting interim targets in the shorter term, having these validated, and setting out a comprehensive transition plan against which they will report progress each year. Over time, investors should increasingly then engage companies on the actual decarbonisation achieved, and whether or not companies are on track to meet their targets.

At the portfolio level, investors can track progress against engagement milestones and quantitatively track measures such as the proportion of emissions that have been engaged, the number or frequency of engagements, the types of engagement activities, and, importantly, the outcomes of engagements; for example, how many companies have now set net zero targets.

Escalate if progress is not made

An engagement strategy will not be effective unless there is a clear escalation process, outlining steps the investor can take if progress is not being made towards objectives. This must be dynamic and flexible, to reflect evolving operating environments.

There are a number of ways in which to escalate an engagement, with ranging levels of intensity. These can involve collaborative activities with third parties. Some examples are shown in Figure 2 below, although may differ between listed corporate investment and different types of private market investments.

An escalation framework should involve increasing intensity of engagement activities, with the aim of influencing companies to take the decarbonisation actions required. Ultimately, should progress against engagement objectives not be reached, full or partial divestment should be a viable option.

Figure 2: Activities available to corporate investors as part of an engagement escalation framework

3. Reallocate your portfolio

Sometimes we see investors start at the portfolio reallocation stage, as there are now benchmarks that "bake in" decarbonisation to a net zero portfolio in 2050 using a form of optimisation formula to reduce tracking error to the original index. This may achieve the desired aesthetic results of lower reported carbon emissions but may come at the expense of returns if approached mechanically. For example, you might sell a high emitting company with a great transition plan, in favour of a lower emitting company with no plans to decarbonise. This mechanical decarbonisation also doesn't contribute to real world outcomes if you are selling a company rather than encouraging a change in its behaviour. So for us, it's the final tool we turn to, but to achieve the goal of net zero in a measured and consistent way, it might be necessary.

Portfolio reallocation can be implemented in various forms:

- Adjusting asset allocation
- Changing investment manager mandate parameters
- Reallocation at security or stock level

Even within these three areas of portfolio reallocation there is a degree of detail that is worth exploring.

Adjust asset allocation

Asset allocation comes in two forms: a strategic asset allocation to meet your risk and return objectives (usually set once a year), and the tactical asset allocation to adapt your portfolio to varying market conditions (perhaps evolving monthly or in reaction to market news).

Setting your strategic asset allocation will consider your risk and return objectives, and expectations of market returns from different asset classes over the medium term. If we can achieve the same risk and return, with a lower carbon intensity by reallocation between asset classes (e.g. increasing equity in favour of bonds) or by reallocating to different regions (e.g. less emerging markets and more developed markets) then this could be a way to achieve decarbonisation. However, it always depends on the assumed correlation between these asset classes whether this can make a meaningful difference without impacting the other, perhaps overriding factor, of risk-adjusted returns.

The second form, tactical asset allocation, is less likely to be influenced by a carbon reduction target, if the primary goal is to reduce risk or take an investment opportunity. These kinds of more reactive asset allocation decisions may actually end up increasing your carbon intensity on a short-term basis. For example, a tactical move into bonds when equities look over-valued should be prioritised for risk management purposes, even if it may increase your overall carbon intensity for the short term. If the underlying portfolios have a decarbonisation plan in place, this should still take you to your end goal, even if the allocation decision is retained for some time. Understanding what is causing your carbon intensity to change is an important factor in governing your journey to net zero.

Choose the right managers and mandates

You need to work with the right partners to help you decarbonise your investments, based on your investment beliefs and priorities. The managers responsible for asset allocation or security selection should be able to deliver against your decarbonisation objectives. This is where we believe the debate around passive vs active investing should also be considered.

There are passive approaches to decarbonisation. The European Commission has designed the EU Climate Transition Benchmark (CTB) and the EU Paris Aligned Benchmark (PAB), and there are indices that track these methodologies for mechanically reducing emissions year-on-year between now and 2050, as well as many other methodologies. The challenge we have with mechanical methodologies is that it is difficult to determine the impact on investment returns. Some of these indices don't take into account any forward-looking metrics or judgement on the credibility of a company's transition plan. We believe this is where an active manager has the edge. This is particularly true if the portfolio is likely to invest in positive climate solutions, which may have a higher carbon intensity today as the necessary infrastructure is developed and built. These could be excellent investment opportunities that would be missed by a more mechanical approach.

So if you have chosen an active approach, you need to be confident your chosen manager has decarbonisation at the forefront of their minds alongside their objective of generating strong risk-adjusted returns, and that the mandate facilitates

decarbonisation in the most appropriate way. For example, should a manager's benchmark be changed? This will really depend on the style of the manager and their belief in, or commitment to, decarbonisation. If you employ a core manager who is aware of the benchmark and the portfolio's risk relative to the benchmark, there may need to be a change in benchmark to achieve the desired level of decarbonisation. However, if you employ a manager who is more concentrated with less restrictions vs the benchmark, you may not need to change it and the manager may see an active approach to decarbonisation as a way to add value.

At this point, you might also consider whether you want all parts of your portfolio to decarbonise at the same speed, and whether it is right to set the same baseline date for all of them. For example, some regions may have a stronger tailwind from regulatory reform (e.g. Europe) vs areas that may be naturally decarbonising a little more slowly (e.g. emerging markets). Setting the same constraints for both may lead to more portfolio reallocation in emerging markets that may hurt long term performance. Also, some investment strategies that see carbon emissions as a risk may already have taken action to reduce their carbon emissions markedly relative to their benchmark (i.e. relative to their investible universe). They may have already implemented the "easy wins" that allow a portfolio to exclude some climate laggards without jeopardising their ability to generate alpha. While this might be good risk management and provide lower reported emissions for investors today, it does pose a challenge when considering a decarbonisation strategy – particularly as many of the frameworks suggest setting a base year and decarbonising relative to your portfolio emission at that date, rather than relative to the market benchmark. Asking this manager to decarbonise to the same degree as a manager who has not yet taken any action could penalise or overly constrain the manager that decarbonised earlier. If you have a manager that has a strategy which is already 50% lower emissions than its benchmark, requesting them to decarbonise by a further 50% by 2030 could lead to a markedly reduced universe, and potentially worse investment outcomes. This is where we feel that a bespoke approach works well, both for managers selecting stocks and investors designing mandates. Not every mandate should be asked to reduce emissions in a linear fashion if they have already made great strides in this direction. Trying to force decarbonisation too quickly may lead to poorer outcomes than allowing a portfolio to decarbonise in step with, or a little faster, than the broader universe. Be ambitious, but not too ambitious that it comes at a cost.

Implement stock level changes

If you've identified that you have the right asset allocation and managers with the right mandates, then you are likely to delegate the stock selection to those managers. The manager then has to choose how to reallocate the portfolio to implement the decarbonisation needed.

Suppose there are annual carbon reduction targets to achieve and a manager is faced with the decision on how to reduce carbon emissions, they could exclude the highest emitters (in absolute terms or by sector), they could down-weight the higher emitters or they could take a bespoke approach. It is our view that a bespoke approach is generally the most appropriate – and may include a combination of exclusion, and down-weighting, but not necessarily for the stocks the more mechanical approach would target. Active managers should take into account a forward-looking view, and are likely to reduce rather than exclude stocks if there is still scope to engage for change. The one exception to this might be where engagement isn't working and change looks extremely unlikely.

Conclusion

In summary, we believe managing a portfolio along a decarbonisation pathway should not be mechanical, and should use all the tools available – with a particular focus on engagement before exclusion. However, that engagement must be targeted, well documented and tracked to ensure the portfolio is on the right trajectory, and portfolio reallocation may be needed in addition to ensure the decarbonisation goals are met. Partnering with the right manager, with an appropriately designed mandate is paramount to achieving the right balance of strong risk-adjusted returns with the appropriate level of decarbonisation, adjusted to allow for the starting point of the portfolio.

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