Thinking Ahead Institute

Our house is on fire?! Should we do something? | setting your climate ambition

Part of a series of articles from the investing for tomorrow working group

Investing for tomorrow working group

This document has been written by members of the Thinking Ahead Group 2.0 (Tim Hodgson and Jess Gao) following the research and discussion conducted by the Thinking Ahead Institute's investing for tomorrow (IFT) working group. The authors are very grateful to the members of the working group for their input and guidance but stress that the authors alone are responsible for any errors of omission or commission in this paper.

The key objective of this working group is to produce research outputs that can usefully guide investors to establish and set a pathway to achieve their climate ambitions. Beyond this, we hope the outputs help them to become a driving force in transforming the global economy to be compatible with the 1.5C climate target.

The members of this working group are as follows:

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- Adrian Benedict (Fidelity International)
- Kate Bromley (QIC)
- James Burgess (BTPS)
- Tracy Burton (Coronation)
- Jeff Chee (Willis Towers Watson)
- Helen Christie (Univest)
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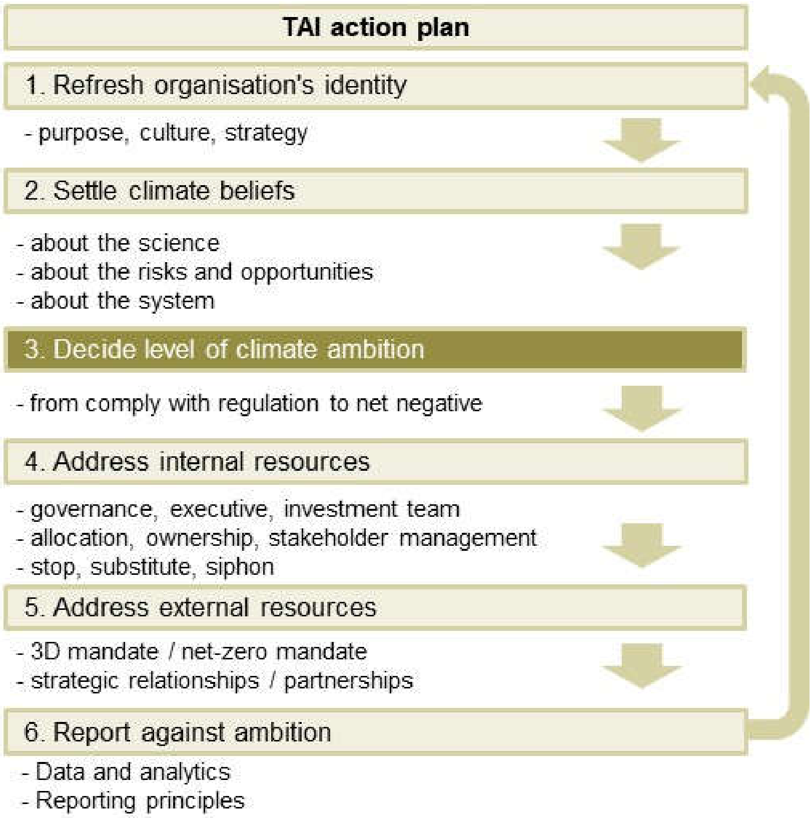
In short…



This paper explores some of the climate beliefs discussions that took place within the working group. Detailed work on climate beliefs was delegated to a sub-group, and this will be covered by a future paper. Here we explore the beliefs that were material to creating and describing different points on a spectrum of increasing climate ambition.

The climate ambition spectrum created by the working group contains a discontinuity. At lower levels of ambition, the focus is entirely on the organisation's own portfolio – but this has no impact on the real world. Higher levels of climate ambition are associated with the more difficult work of managing the portfolio AND trying to influence the real economy, and therefore influence the climate trajectory. While each organisation must choose the level of climate ambition appropriate for its own circumstances, the working group are clear in their opinion that the financial risk of climate change cannot be truly managed without changing the future climate trajectory. So while this paper seeks to dispassionately lay out the full range of climate ambitions that asset owners could adopt, the authors and the working group would like to see all investment organisations sign up to their relevant net-zero organisation – and in doing so, commit to actions that help to decarbonise the real world.

Our house is on fire?!

"I want you to act as you would in a crisis. I want you to act as if our house is on fire. Because it is." Greta Thunberg at Davos, Jan 2019

The image of a house on fire engenders a greater sense of urgency that the image of the proverbial frog in a pot of gently-heating water. Is the rise in global average temperatures of around +1.2C more like the frog or the house? Despite '1.2' being a very small number in most contexts in which we consider temperature, in an earth-systems context it is a very large number and we side with Greta; our house is on fire, and we should act with urgency. For increasingly large areas of the planet this is literally true. We have had record wildfires in California, Australia, California again, Australia again, Siberia, the west coast of the USA and the Mediterranean.

Should we do something?

The second part of this paper's title, 'should we do something?', immediately pitches us into a conversation about climate (and system) beliefs. A casual scan of the world around us will quickly show there is a very wide spread of opinion out there. It is fair to say that the members of the working group are self-selected and tend to cluster down one end of the opinion spectrum (not the climate-denying end!).

In the first paper of this series[1] we reported on the working group's initial beliefs (the scale and urgency of the climate problem are not properly understood, and the transition will be turbulent) and views on the future industry context (more purposeful, more supportive legal interpretations, and net-zero pledges having a significant influence on investee companies). However, constructing a set of climate beliefs that is useful for decision making requires considerable detailed work and debate. Further, beliefs must belong to an individual organisation with its own unique context, and so a large working group representing multiple organisations is arguably not the best way to create a set of climate beliefs. As a consequence, the continued exploration of climate beliefs was passed to a small sub-group, and this work will be written up separately in a future paper.

Returning to the question 'should we do something?', the answer for an institutional investor is 'yes', but the extent of the action will vary widely. Broadly there are three options:

1. Comply with regulation
   This option could look like doing nothing, were it not for the likelihood of regulations changing. For example, large UK pension funds are now required to start reporting against TCFD guidelines, and smaller funds will be required to follow slightly later.

   Even if regulation does not change that quickly, the increasing number of court cases being brought against pension funds is likely to motivate more significant action. In Australia, the superannuation fund Rest settled litigation brought by one of its members, Mark McVeigh resulting in a commitment to greater climate action[2]. In the UK, academics have begun legal action against their pension fund, the Universities Superannuation Scheme, to (among other things) speed up the divestment from fossil fuel companies[3].

2. Climate risk management
   This option acknowledges that climate change is likely to have an impact on the valuations of at least some portfolio holdings. The action here is to anticipate this (loss-of-value) risk, and manage the composition of the portfolio accordingly. The other side of the risk management coin is the exploiting of climate opportunities. In both cases moving portfolio weights away from market weights is active management – whether done by the asset owner, or outsourced to an asset manager.

3. Align with a climate objective
   This option implies that loss-of-value risk cannot be avoided, unless we successfully limit the rise in global temperatures. The action here is to manage the portfolio in a manner that is aligned with a successful climate outcome. Later in this paper we will make a distinction

[1] *How do we get there? | a roadmap for asset owners to set and meet their climate objectives*, Thinking Ahead Institute 2021
[2] https://rest.com.au/why-rest/about-rest/news/rest-reaches-settlement-with-mark-mcveigh
[3] See, for example, the Financial Times, *UK academics begin legal action to halt proposed cuts to pensions*, November 1, 2021 (the FT operates a paywall)

between decarbonising a portfolio and acting to decarbonise the real world. Here we emphasise that climate objectives require real-world decarbonisation.

High-level beliefs

Even though the detailed climate beliefs work was delegated to a sub-group, the working group explored a number of high-level beliefs that directly affected the development of the action plan. There was no attempt to reach a settled position on the beliefs, but rather to listen to and consider diverse opinions so as to enrich the work. The high-level beliefs considered are listed here, and expanded upon further below:

- Is sustainability a relative or absolute concept?
- Should we be aiming for a net-zero economy or a net-negative economy?
- What is the role of the investment industry in securing a just transition?

Is sustainability a relative or absolute concept?

The key argument explored in this area was that 'net-zero' changes sustainability from being a relative concept to an absolute concept. To explain, the current phase of the sustainability movement is marked by the rise in popularity of the label 'ESG', which effectively claims that there is a win-win outcome of more profit from 'doing good'. Importantly, this is not necessarily 'good' in an absolute sense, but rather is about being better than sector peers, or 'better than previously'. In other words, it is OK for a company's operations to damage the environment as long as there is an improving trend. Eventually, it is argued or hoped, the continual improvements in the way the company operates will yield no ongoing environment (or social) damage. In truth, negative environmental externalities are inevitable while we operate our current form of economic system – which Duncan Austin terms 'externality-denying capitalism'[1].

A process of continual improvement only runs into trouble if it breaches a boundary before it has completed its journey. The net-zero movement can be thought of precisely in these terms. It doesn't matter whether we emphasise time or the remaining carbon budget, net-zero either sets a deadline (sustainable by 2050) or a boundary on allowable emissions (sustainable within the carbon budget). The switch to thinking of sustainability in absolute terms changes the calculus materially. We can no longer assume that sustainability (ESG) is a win-win proposition. For example, we may need to shut down operations that are still profitable in order to stay within an absolute carbon budget. Of course, it would be far easier for the investment industry if governments create the market prices and/or policies that achieve this end for us.

Should we be aiming for a net-zero economy or a net-negative economy?

The key concept here is that the planet will continue to get hotter, irrespective of any actions we might take, or of the urgency with which we undertake them. In slightly different words, 'victory' in addressing climate change will be to limit the rise in temperature to +1.5C compared to the current level of

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[1] See *Market-Led Sustainability is a 'Fix that Fails' … Part 2*, responsible-investor.com, October 26, 2021

warming of around +1.2C. We therefore already know that in the future the wildfires will be worse, and the permafrost will melt more quickly. It follows that a net-zero economy – removing the emissions related to our economic activity – will not be enough. We need a net-zero world, with a net-negative economy that is offsetting the increased emissions from wildfires and melting permafrost.

What is the role of the investment industry in securing a just transition?

It should be noted up-front that this was a difficult exploration. A just transition is both highly desirable and potentially difficult to secure. Further, as we will explore, the role of the investment industry is not clear.

We started by stating that economies are complex adaptive systems which are always in natural transition. Some businesses are growing and hiring employees while others are dying and shedding jobs. From this we can conclude that all transitions create 'winners and losers'. In contrast to this ongoing, natural transition, we introduced the idea of a 'forced' transition which we defined as a transition that destroys existing jobs faster than the natural rate of job creation. As an example, consider the experience of the UK under ex-prime minister Margaret Thatcher.

Forced transitions imply some goals are deemed more important than the social pain (job losses) caused by the forcing. In this light, what does 'just transition' mean? It could mean (1) the judgement that the goal is more important than the social pain is wrong; or (2) that a win-win is possible (the goal can be achieved without social pain (or minimal pain)[1]). We assume the first explanation is incorrect; science provides sufficient evidence that holding temperature rise to 1.5C is the 'correct' goal, and sufficient confidence that net-zero by 2050 is a necessary pathway destination. This does not in any way suggest that inflicting social pain is good. Rather, social pain is likely, or inevitable, in pursuing the more important goal.

The second explanation is problematic. The thought experiment has argued above that even natural transitions are win-lose, and forced transitions even more so. So is the call for a just transition actually a call for redistributing the gains, to partially or fully compensate the losers? If yes, what does the investment industry make of this? The current interpretations of fiduciary duty probably make the idea of redistribution untouchable for investment. Further, even assuming we are allowed to attach some weight to impact, where does 'just' land between preserving jobs for one additional year in 'bad business model X' and increased physical risk for low-lying island nation Y? For readers wishing to explore this area further we recommend the World Benchmarking Alliance's *Just Transition Assessment 2021*[2] report.

To summarise this difficult exploration: transition win-wins are unlikely, compensating losers is problematic from a fiduciary duty perspective; and judging between competing claims for justice is not the natural remit for the investment industry. However, to return to this section's opening, a just transition is a highly-desirable outcome. So, what can we in the investment industry do? We invoke the principle of 'do what we can, with what we've got'. First, we can re-organise ourselves to switch our focus to new primary investment, and create new jobs at the fastest rate we can. And, second, we can

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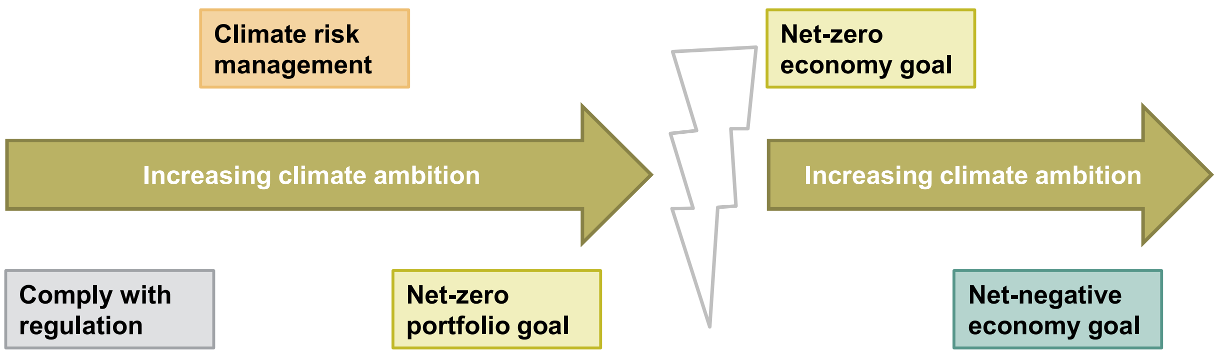
[1] This is a thought experiment and we ask the reader to stick with us for now. In reality environmental issues and social issues are deeply intertwined.
[2] https://assets.worldbenchmarkingalliance.org/app/uploads/2021/10/2021_Just_Transition_Assessment_FINAL.pdf

increase our ownership resources and engage more actively with investee companies on the net-zero agenda.

As noted above, the working group did not seek to reach a consensus or a settlement on the above beliefs. However, simply by engaging with the arguments the output of the working group was enriched. A simple demonstration of this claim is that the working group easily agreed to expand the core three options outlined further above to five distinct positions on the spectrum of climate ambition – which we show below.

The spectrum of climate ambition



In moving from left to right, the spectrum of climate ambition represents an increasing level of ambition, which is supported by differing sets of climate beliefs. The spectrum starts with the 'comply with regulation' and 'climate risk management' options outlined above, and then introduces a net-zero portfolio goal as a more ambitious version of climate risk management. The lightning bolt in the diagram signifies a discontinuity in the spectrum. On the left-hand side, the focus is entirely on the portfolio. On the right-hand side, the focus shifts to include the economy. This construct aims to make it very clear that it is possible to decarbonise a portfolio (left side) without having any positive impact on the economy, and therefore on the climate trajectory. If an investment organisation has a level of ambition to play its part in influencing the climate trajectory, then it is placing itself on the right side of the diagram. Here the choice is between a net-zero economy goal and a higher level of ambition to assist the creation of a net-negative economy (see beliefs discussion above).

As a quick aside, there was a degree of interest within the working group as to the general level of understanding of what net-zero commitments imply. Is the majority opinion more aligned with decarbonising the portfolio, or the more ambitious decarbonising of the economy? The nature of aligning with a climate objective clearly implies the latter, and this is reflected within the details of the various net-zero movements. The working group believe that all investment organisations should join their relevant net-zero movement and therefore world towards, at minimum, a net-zero economy goal.

Levels of climate ambition

To make the spectrum and the different levels of climate ambition more tangible, we provide here a brief statement for each. These are written in the form of statements an investment organisation might make if adopting that level of climate ambition.

- Comply with regulation
  Our primary goal is to deliver attractive risk-adjusted investment returns. Our organisation has no strong belief about addressing climate change. We will be guided by, and comply with, requirements set by regulators.

- Climate risk management
  Our organisation acknowledges that climate change is a material, direct and current financial risk to our portfolio across all asset classes and is an important concern of our members. We will actively manage climate-related financial and transition impact on our portfolio.

- Net-zero portfolio goal
  Our organisation commits to transition our investment portfolios to net-zero emissions by 2050 or sooner with interim target of [XYZ] by 2030 or sooner.

- Net-zero economy goal
  A net-zero portfolio in a net-positive world does not serve the interests of our beneficiaries. Our organisation commits to support the global climate ambition of net-zero emissions no later than 2050 to reach the 1.5C goal. We will use our investments to both produce risk-adjusted returns and enable the de-carbonisation of the real economy.

- Net-negative portfolio goal
  The natural release of GHG emissions means we need a net-negative economy by 2050 to support a net-zero world. Our organisation believes we can best achieve our risk-adjusted return goal and impact goal through an investment portfolio that removes GHG emissions from the atmosphere by 2050 (ie is net-negative).

From climate commitment to actions

The aim of this paper has been to highlight the importance of climate beliefs in setting an organisation's level of climate ambition, and to document the different levels of ambition that can be adopted. From this decision we will proceed to taking action, and this will be the focus of the next paper in the series in which we will consider actions asset owners can take to implement their climate ambition. We will introduce the 'stop, substitute, siphon' framework to describe the activities that are necessary to change the climate trajectory (to the right of the lightning bolt in this paper's framing). To whet appetites:

- **Stop**: means shutting down financially-productive but emitting assets before their natural end of life, implying a likely loss in capital value. This likely loss in capital value can be thought of as an insurance premium that we are willing to pay in order to protect the rest of the portfolio. We use 'stop' to convey an appropriate sense of urgency but, in reality, this will be a process of 'stopping' that starts with 'greening the brown' but must eventually reach 'green'.

- **Substitute**: means investing in assets / business models (new or scale up) that substitute for the emitting activities that must stop. Examples of substitutes include renewable electricity and batteries instead of fossil fuels, building with wood rather than concrete and steel where possible (and with climate-neutral cement and steel where not possible), natural shading and ventilation instead of air conditioning etc.

- **Siphon**: means investing in negative emissions technologies now if we wish to see impact at scale in 20 years' time. These negative emissions technologies can be nature-based solutions as well as new technologies such as carbon capture.

In addition to exploring these further, we will also consider actions that asset owners can take on the left side of the lightning bolt.

Limitations of reliance

Limitations of reliance – Thinking Ahead Group 2.0

This document has been written by members of the Thinking Ahead Group 2.0. Their role is to identify and develop new investment thinking and opportunities not naturally covered under mainstream research. They seek to encourage new ways of seeing the investment environment in ways that add value to our clients.
The contents of individual documents are therefore more likely to be the opinions of the respective authors rather than representing the formal view of the firm.

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About the Thinking Ahead Institute

Mobilising capital for a sustainable future.

Since establishment in 2015, over 60 investment organisations have collaborated to bring this vision to light through designing fit-for-purpose investment strategies; better organisational effectiveness and strengthened stakeholder legitimacy.

Led by Tim Hodgson, Roger Urwin and Marisa Hall, our global not-for-profit research and innovation hub connects our members from around the investment world to harnesses the power of collective thought leadership and bring these ideas to life. Our members influence the research agenda and participate in working groups and events and have access to proprietary tools and a unique research library.

Join the Thinking Ahead Institute

We seek collaboration with like-minded organisations to achieve our vision, so for more information about us please contact:

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