Thinking Ahead Institute

A six-step action plan for net zero

Output 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 Samar Khanna) 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:

- Jyoti Banerjee (North Star Transition)
- Adrian Benedict (Fidelity International)
- Kate Bromley (QIC)
- James Burgess (BTPS)
- Tracy Burton (Coronation)
- Jeff Chee (Willis Towers Watson)
- Helen Christie (Univest)
- Tom Cullen (S&P Dow Jones Indices)
- Ed Evers (Ninety One)
- Charlotte Gibson (Ninety One)
- Philip Greenheld (QSuper)
- Arthur Grigoryants (RWC)
- James Harris (CQSM)
- Michael Jabs (Kraft Heinz Pension)
- Liisa Juntunen (QMA)
- Matt Lanstone (Capital Group)
- Ben Leale-green (S&P Dow Jones Indices)
- Alison Loat (OPTrust)
- Tom Lyons (Allspring Global Investments)
- Zak May (IFM Investors)
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- Jodie Tapscott (AllianceBernstein)
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- Nacho Valiñani (Pensions Caixa 30)
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- Sarah Wilson (Nuveen)
- Debra Woida (Willis Towers Watson
- Christine Young (Polen Capital)

In short…

Even though many investment organisations have already made a net-zero commitment, it is our belief that the implications of those commitments are not yet fully understood, and the accompanying actions have not yet all been discovered. This paper sets out the thinking behind and the structure of a six-step action plan. This plan was created by the investing for tomorrow working group to help asset owners navigate the future complexities that climate change will bring. The aim is to be as practical as possible. The working group were guided by the ethos “we do what we can with what we’ve got”.

This paper provides an overview of the entire six-step plan. The interested reader is invited to refer to six other papers in this series which unpack the steps in more detail. We provide links to this effect in each relevant section.

> The working group were guided by the ethos “we do what we can with what we’ve got”

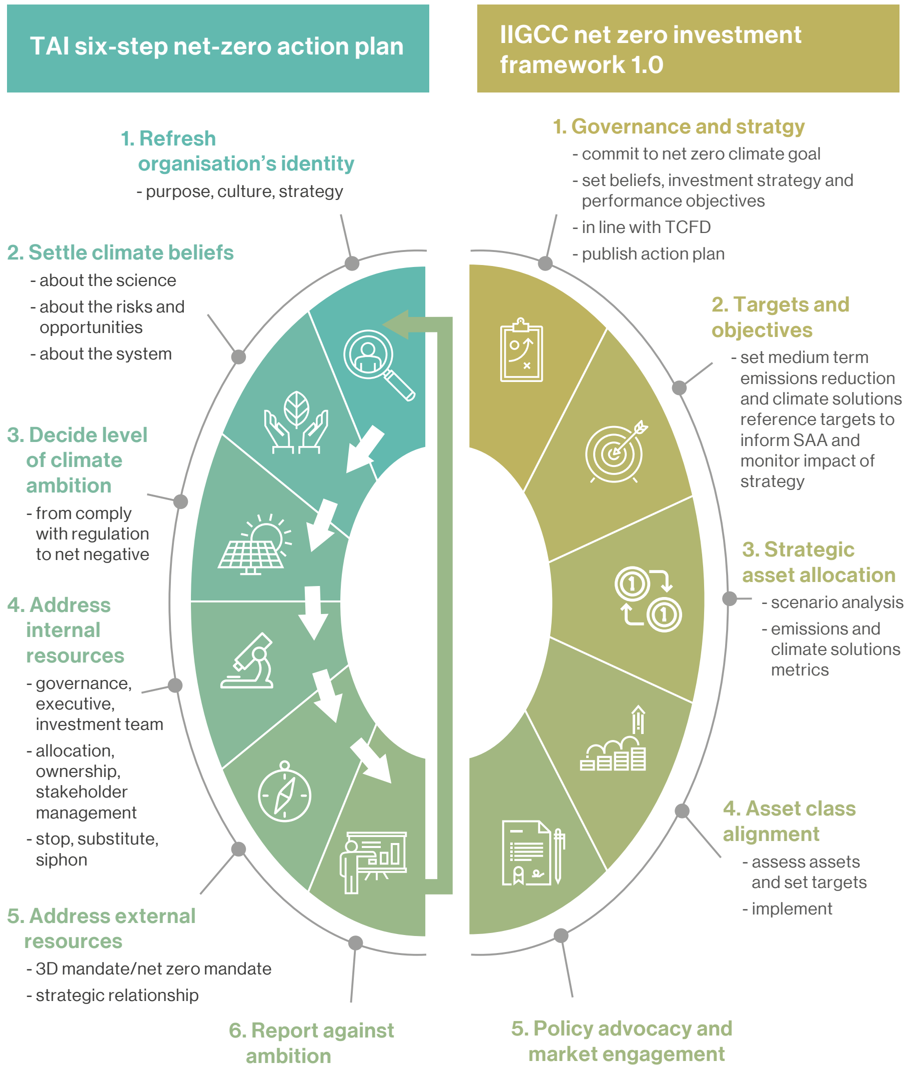
The current context | net-zero momentum

Climate change is a systemic issue rather than a 'systemic risk', on the basis that risks may or may not happen. Climate change requires us, in the financial system, to consider how we will achieve our return on capital goals in the light of the physical, transition and liability developments waiting for us in the near (and distant) future.

It should not be a surprise, therefore, that climate commitments among leading investors have become a recent feature of the investment landscape. First there was the UN-sponsored Net-Zero Asset Owner Alliance, then came the Net Zero Asset Managers Initiative, and the Net Zero Investment Consultants Initiative. Beyond the institutional investment sphere there are net-zero groups for banks and insurers, and there are further groups without 'net-zero' in their title such as the Paris Aligned Investment Initiative.

The key question at this stage is whether the net-zero commitment refers to the portfolio or to the underlying economy. The working group (like the alliances listed in the paragraph above) sought to be as inclusive as possible, while also pursuing the more difficult question of (influencing) the decarbonising of the real economy. In different words, we believe the six steps we describe here can be followed by any investment organisation, whether their ambition is to comply with regulation or to help create a zero-carbon economy. However, the actions they take in response to considering each step will differ. As *figure 1* suggests, the action plan is based on the IIGCC's net zero investment framework[1]. It should therefore be seen as one possible way to implement that framework.

Figure 1. TAI action plan and the IIGCC net zero investment framework



[1] *Please see* https://www.parisalignedinvestment.org/media/2021/03/PAII-Net-Zero-Investment-Framework_Implementation-Guide.pdf

Step 1 | Refresh organisation's identity

Step one in the action plan is to refresh the organisation's identity, and this starts with purpose and vision. A net-zero commitment effectively binds an organisation for a number of decades and so this should be consistent with the existing, or refreshed, organisational purpose and vision. That said, this step was actually left out of the scope for the working group. The Thinking Ahead Institute has done extensive prior research on purpose and culture in particular, and it was not felt necessary to revisit this work. For reference, please see the box on the right for the ten items in the Institute's organisational identity checklist.

For further detail, please refer to our paper **How do we get there? A roadmap for asset owners to set and meet their climate beliefs.**

click here

How do we get there? *describes the working group's thinking and beliefs about how the investment landscape is likeley to evolve, that lie behind the creation of the six-step plan. The plan starts from the IIGCC's net-zero investment framework, and represents one way to implement that framework.*

Organisational identity checklist

Vision

1. Purpose and value | what central purpose(s) we serve and what we see as the value that our organisation exists to create
2. Mission and vision | why we exist, and what we want to be
3. Stakeholders | what is the domain, priorities and boundaries of our reach and influence?

Culture

4. Values | what we believe in and how we will likely behave as a result
5. Culture | how does our organisation actually think and behave, how does leadership behave?
6. Talent and governance | what are the principal human and social capital resources we depend on? Board, internal team, external partners.

Strategy

7. Investment beliefs | what do we believe about the investment landscape and our edge to inform our strategy?
8. Organisational beliefs | what do we believe about our organisational context (governance, stakeholders, mission, etc) to inform our strategy including our endowments as an organisation?
9. Strategy | what is our competitive game plan? Thinking ahead, employing our beliefs, reflecting uncertainty, our innovations and initiatives, addressing business-as-usual, building capabilities, creating value.

History

10. Legacy | what is the legacy of past leaders' words and deeds and prior lived experience of the organisation that carries through into the present in artefacts and identity? What our history means for the future.

Step 2 | Settle climate beliefs

Detailed work on climate beliefs was delegated to a sub-group, and this is described in our paper Investment beliefs to change the climate trajectory. Strong and settled beliefs form the foundation for successful climate action. As the sub-group set out to create ambitious climate beliefs capable of motivating action to change to the climate trajectory, it quickly realised that the process to build the beliefs was an important component of the final result. Consequently the paper includes a focus on getting this process right. The paper then introduces the six climate beliefs that the sub-group settled on; followed by the implications and associated actions arising from these beliefs. Differentiation between asset owners can then be expressed through differing degrees of action – rather than through holding differing beliefs.

All of this detail is set out in our paper **Investment beliefs to change the climate trajectory.**

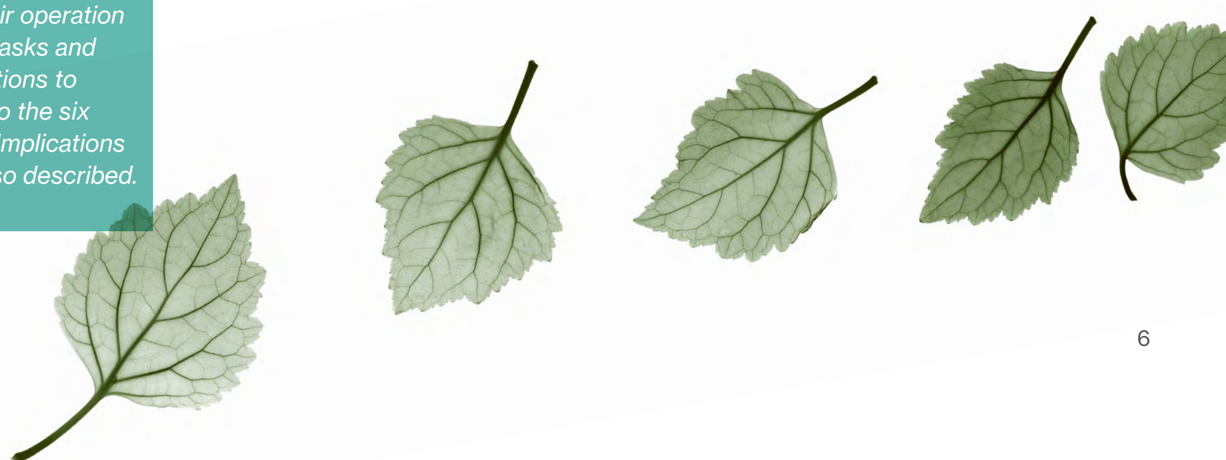
click here

Investment believes to change the climate trajectory

describes the process followed by the climate beliefs sub-group and their operation as a superteam. It asks and answers five questions to lead the reader into the six ambitious beliefs. Implications and actions are also described.

The headlines of the six climate beliefs the sub-group created are as follows (see the following page for an explanation of the 'stop, substitute, siphon' framework):

1. **We believe climate change is an emergency and we are part of the economic system that must address this** (we must act)
2. **We have all the evidence we need to act** (we will act now)
3. **Acting ambitiously now will incur costs, but these will be materially less than those arising from a late transition or no transition at all** (acting now, while costly, will be cheaper)
4. **We believe the only way to change the climate trajectory is to adopt the stop, substitute and siphon framework** (we will invest differently)
5. **We will invest to create the future we all need which requires establishing new investment conventions** (we will think differently)
6. **We will actively participate in the collective action required to address climate change** (we must collaborate)



TAI's stop, substitute, siphon framework

In the various discussions within the investing for tomorrow working group about what actually needs to happen to create a net-zero world, three high-level activities were identified as necessary – stop, substitute and siphon.

Stop: means shutting down financially-productive but emitting assets before their natural end of life, implying a likely loss in capital value. The likely loss in capital value can be considered an insurance premium that we are willing to pay in order to protect the rest of our portfolio. If emissions are allowed to continue, the rise in global temperatures is likely to exceed 3C, at which point portfolio values are likely to be significantly and permanently impaired.

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.

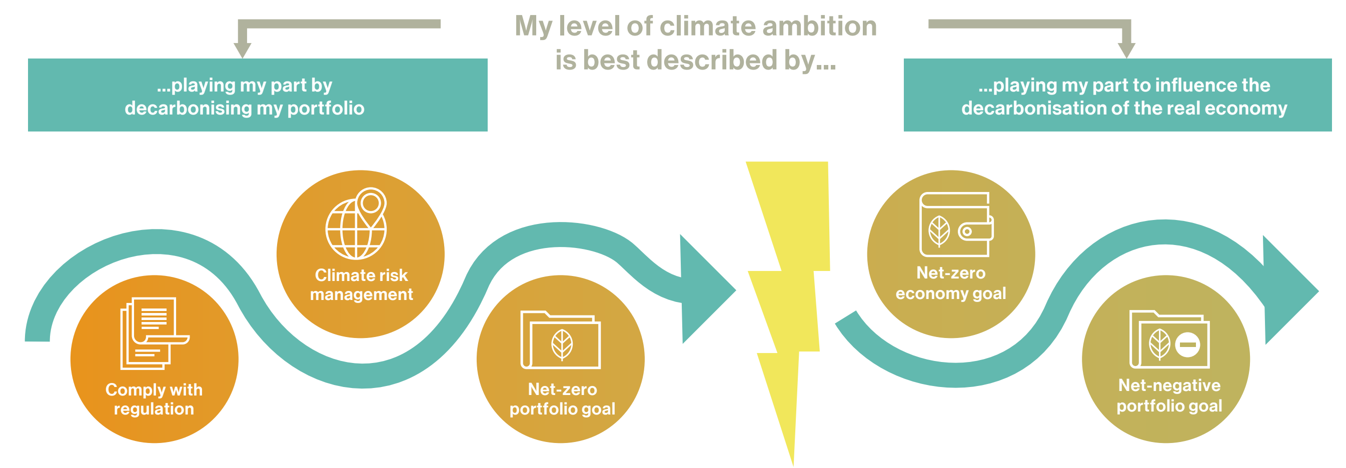
> "We believe the only way to change the climate trajectory is to adopt the stop, substitute and siphon framework (we will invest differently)

Step 3 | Decide level of climate ambition

When it comes to setting a level of climate ambition, an institutional investor must choose a position somewhere between complying with regulation and aggressively pursuing a de-carbonised real-world economy. The working group chose to distinguish between five levels of increasing climate ambition. At the left-hand, minimum, end of the climate ambition spectrum, is complying with regulation (which either is, or is likely to become, more onerous). At the right-hand end, the most ambitious position is defined as running an investment portfolio so as to assist the creation of a net-negative-emissions economy. The spectrum contains a discontinuity. To the left of the discontinuity, the focus is all about decarbonising the portfolio while to the right, the ultimate goal becomes a decarbonised economy. This is illustrated in the figure below.

> 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, January 2019*

Figure 2. Levels of increasing climate ambition



More importantly, we note that a public net-zero commitment automatically places the investment organisation to the right of the discontinuity.

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).

For further detail, please refer to our paper
Our house is on fire?! Should we do something? | setting your climate ambition.

click here

Our house is on fire?! *describes the different points on a spectrum of increasing climate ambition. However, the group believe the financial risk of climate change cannot be truly managed without changing the future climate trajectory - implying decarbonising the real world is a necessary objective.*

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Step 4 | Address internal resources

This paper, indeed this series of papers, is written from the perspective of the asset owner. It is the decisions of asset owners in respect of how to deal with climate change that will have the biggest impact on the actions of other organisations in the investment chain.

Our paper covering this step, **We've decided to address climate change | getting our own house in order,** *presents 32 ideas for actions that asset owners can take to implement their climate ambition.*

The first 16 actions relate to decarbonising an organisation's own portfolio, but also form a foundation for the second set of 16 actions which target changing the climate trajectory. We do not see these ideas as a complete list. For example, we do not include more 'indirect' actions like knowledge sharing and/or setting a good example through policies and actions regarding an organisation's own emissions.

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Getting our house in order

offers 32 actions to implement the identified level of climate ambition. Half relate to decarbonising the portfolio and the other half to changing the climate trajectory.

The practicality of some of the actions can be debated. The intention here is to provide clarity on what needs to be done if we truly wish to see net-zero emissions in future. We also note that these actions are specifically targeted at climate change. There is growing awareness that climate issues are unlikely to be adequately addressed without simultaneously addressing other issues such as biodiversity loss, inequality and the circular economy.

We've chosen our level of ambition | what's next?

A list of 32 actions can appear somewhat daunting. We therefore provide some framing to make the list easier to access. First, we take as a given that the executive team at every asset owner is already fully and gainfully employed. In the short term, therefore, resources must be considered as a constraint and, hence, this is a prioritisation exercise and, potentially, an invitation to stop doing some other things. Over the longer term, resources can be added, and this will allow a greater number of actions to be adopted. In case it serves as a useful data point, we polled the working group members on what "the asset owner response to net-zero commitments, in terms of internal resources, will be (NB not 'should be')" – 37% believed there would be an increase in headcount (at asset owners) to reflect the additional work, 44% believed headcount would be static but the quality of personnel would be upgraded, and 19% believed there would be no material response.

Second, we suggest that it is useful to use different lenses to view the climate change problem in more manageable pieces.

We use three lenses:

- Function lens: the functions within an asset owner, comprising governance, an executive and investment.
- Action lens: the actions an asset owner undertakes comprise allocation (or portfolio construction), ownership (engagement), and stakeholder management.
- Activities lens: there are three high-level activities that are necessary to create a net-zero world – stop, substitute and siphon (see above).

There are suggestions for improvements in each of these.

Step 5 | Address external resources

In this step, we move from an asset owner's internal focus to looking at their external relationships in the context of the net-zero transition. A fuller treatment would include a consideration of possible strategic partnerships with select asset managers, and expansion of private markets activities (including possible public-private partnerships). However, the working group concentrated on the issue of 3D investing (risk, return and impact), and the management of 3D net-zero mandates comprising return and decarbonisation goals, and limits to risk, into an uncertain future.

Net-zero commitments require 3D investing

For a few years now, the idea of 3D investing has been gently circulating round the Thinking Ahead Institute (TAI). Our historic 2D investing involved a single objective function of maximising risk-adjusted return. Under 3D investing the challenge becomes meeting two, unintegrated objective functions (we add maximising impact), and developing processes that allow us to deliver on that.

TAI's first formalisation of these thoughts was in the context of big-picture sustainability, as explored within the 2020 duty of ownership working group. We refer the interested reader to the paper that describes the output of that working group, **With great power comes great responsibility**[1]. That paper opens with a consideration of the fiduciary model on the basis that, if managing against two objective functions was deemed to be not legally possible, then 3D investing would not be appropriate in that context. It is therefore interesting, to us at least, that net-zero commitments (smaller-picture sustainability) take us straight past this step. The requirement to manage risk-adjusted return remains, but the commitment introduces the new requirement to also manage greenhouse gas emissions (one aspect of 'impact'). We are now unambiguously in the world of 3D investing.

> "We are now unambiguously in the world of 3D investing

[1] *Please see* **With great power comes great responsibility,** *Thinking Ahead Institute, 2021*

3D net-zero mandate

In step 3, we introduced a spectrum of climate ambition. On the left-hand side the action was about decarbonising one's own portfolio, while on the right-hand side the action was about decarbonising the real economy. These are fundamentally different activities. It therefore follows that 3D mandates that target real-world decarbonisation should look different to those that only seek to decarbonise the portfolio. We use the terms 'lite' and 'full-on' to distinguish between the 3D mandates. Please see the comparison table below.

The components of the mandates are described in our paper **3D net-zero mandates.** *Organisations which want to build a robust, sustainable and effective 3D investing mandate will need to examine these components in detail and see how they can best incorporate these factors into their climate strategies.*

Comparison table	Lite	Full-on	Comment
1. 3D goals	✓	✓	Lite: portfolio decarbonisation; Full-on: real-world decarbonisation
2. Strategic Partnership	✓	✓	Not all asset managers will be considered a strategic
3. Core sustainability strategies	✓	✓	
4. Impact strategies		✓	The target is real-world decarbonisation
5. System-level engagement		✓	
6. Score-card monitoring	✓	✓	
7. Other mandate details	✓	✓	

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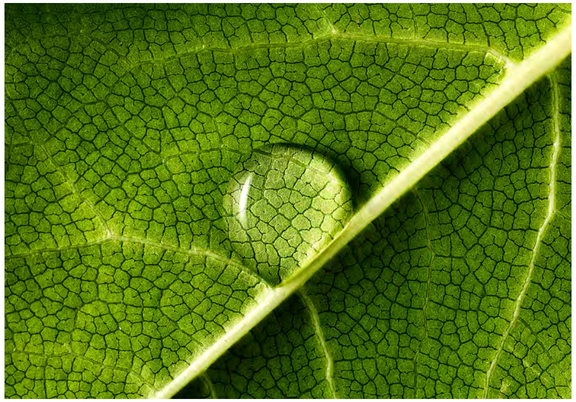
3D net-zero mandates

describes the outline structure of mandates with explicit risk, return and impact (net-zero) goals. It distinguishes between 'lite' and 'full-on' 3D mandates and suggests that Paris-aligned benchmarks qualify as 'super-lite' 3D mandates.

Step 6 | Report against ambition



The sixth step in the action plan is to measure and report progress against climate ambition. A climate report is a way to communicate with, and manage the expectations of, stakeholders, and an aid to better future decision-making.

The detailed paper *discusses broad principles that lay the foundation of a well-constructed reporting framework, proposes a straw-model reporting template, examines the current state of climate data and analytics, and highlight areas for future development. We believe this provides the necessary tools and insights to build a reporting framework best suited to an organisation's own context and needs.*

Here, we briefly outline the Institute's principles for climate reporting and our proposed E-CART framework.

Communication principles

Our eight guiding principles for investors wanting to report their climate impact are[1] :

1. The purpose of the impact report should be stated clearly
2. The milestones or interim targets should be clearly defined (level and timescale)
3. The actions taken to achieve targets should be documented (the investor's contribution)
4. The metrics/evidence reported should allow simple assessment of progress, or not, towards targets (the investee company's impact)
5. The complexity of climate requires multiple, complimentary metrics to be shown
6. Be transparent about any limitations/challenges inherent in what is being reported upon
7. The impact dashboard is incomplete without a supporting narrative
8. Be open to evolving the dashboard over time

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Reporting and communication

explores reporting and communication frameworks to help asset owners measure progress against climate ambition. This is essential both for good stakeholder management and to better inform future decision making.

[1] *Please see* **Climate dashboard reporting,** *Thinking Ahead Institute, 2021*

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The E-CART framework

We propose an E-CART[1] climate reporting template comprised of five climate categories which we believe effectively summarise an organisation's climate actions and intentions.

Engagement	These metrics capture actions within the direct control of the asset owner and can be grouped into three categories: (1) signalling that impact matters (eg number of public statements made over the year, number of staff in collaborative initiatives etc), (2) engagement to influence an investee company's actions (eg investment staff sitting on boards of [X%] of investee companies, number of letters written, number of resolutions tabled at AGMs etc), and (3) growing new or undersupplied capital markets (eg X% of portfolio providing primary capital, $Y m of primary investment in zero/low carbon energy over 12m etc).
Carbon footprint	These metrics convey total portfolio carbon emissions and/or carbon emissions intensity eg scope 1, 2 and 3 emissions[2], carbon emissions/US$ invested, weighted average carbon intensity. They have the benefits of simplicity and relevance (absolute emissions must fall) but are backward looking.
Alignment	These metrics provide information on the level of alignment of portfolio companies against plausible pathways to achieve stated climate objectives eg implied temperature rise, % of Paris-aligned assets, science-based emissions reduction targets. They have the benefit of being forward looking but the disadvantage of being reliant on assumptions about the unknown.
Real world impact	These metrics provide evidence to demonstrate contribution to emission reductions in the real economy eg % revenues from low/zero carbon energy, estimated % revenues aligned to EU taxonomy, estimated greenhouse gas emissions mitigated etc. They are usefully actionable but suffer from narrow coverage.
Transition risk	These metrics show potential financial sensitivity to risks and opportunities associated with a transition to a 1.5C world eg Climate Value-at-Risk, Earnings-at-risk. They generally provide broad coverage but are not so actionable.

[1] *This framework excludes a potential sixth category of physical risk. For some organisations, such as insurers and banks, this would be essential to include.*
From an investment perspective we are assuming that physical risks are best picked up through risk to earnings, and are therefore captured by the other categories.

[2] *Scope 1: All direct emissions from sources owned or controlled by company*

Scope 2: Indirect emissions from company's purchased electricity, heat and energy

Scope 3: All other indirect emissions from activities of company from sources they don't control

The end is just the beginning

Having introduced the six steps of our net-zero action plan, we note that the plan is meant to be iterative. Organisations should continue their climate journey by reverting to step one and working their way through each step again, employing the information they gained from their previous action plan. This will help them build pathways more aligned to their climate goals and will enable them to elevate their climate ambition. The climate action plan will continuously evolve as the investment industry transforms in response to sustainability demands and the race to net-zero. We appreciate there is a lot of work implied by our six-step plan but the climate is going to change anyway. So the choice is really between being pro-active or being re-active with respect to addressing climate change. We are not sure which path will involve less work, but we are confident that being proactive gives your organisation a better chance of success.

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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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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About the Thinking Ahead Institute

The Thinking Ahead Institute seeks to bring together the world's major investment organisations to be at the forefront of improving the industry for the benefit of the end saver. Arising out of Willis Towers Watson's Thinking Ahead Group, formed in 2002 by Tim Hodgson and Roger Urwin, the Institute was established in January 2015 as a global not-for-profit group comprising asset owners, investment managers and service providers. Currently it has over 40 members with combined responsibility for over US$12 trillion.

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