Thinking Ahead Institute

How do we get there? | a roadmap for asset owners to set and meet their climate objectives

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)
- Tom Cullen (S&P Dow Jones Indices)
- Ed Evers (Ninety One)
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- 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)
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- 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 to investment.

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 ethos will carry forward into future papers in this series which will unpack the steps in the roadmap in more detail.

The current context | net-zero momentum

In 2020, the world saw a drop in global emissions as a large proportion of countries went into a synchronised lockdown. We all saw the before-and-after photos of air pollution and clear skies. And we have seen both emissions and pollution bounce back as economies re-opened. Somewhat surprisingly, given the appropriate prioritisation of health, the momentum behind corporates and the investment industry addressing climate change did not appear to slow.

Climate change is a systemic issue. It is already affecting, and will increasingly affect, every aspect of our political, social and economic system. We therefore refer to it as a systemic ‘issue’ and not as a ‘systemic risk’, on the basis that risks may or may not happen. Climate change therefore 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 almost ubiquitous. First there was the UN-sponsored Net-Zero Asset Owner Alliance which, at the time of writing, had 58 asset owner members responsible for $9.3 trillion of assets on behalf of beneficiaries[1]. Then came the Net Zero Asset Managers Initiative (128 signatories, $43 trillion[2]), and the Net Zero Investment Consultants Initiative (12, $10 trillion[3]). 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. This question will reappear through this series of papers as the working group (like the organisations listed above) sought to be as inclusive as possible, while also pursuing the more difficult question of (influencing) the decarbonising of the real economy.

The working group context | initial beliefs

The investing for tomorrow working group is the largest working group the Thinking Ahead Institute has run to-date, suggesting that climate change is a material and current issue for the asset owner and

[1] https://www.unepfi.org/net-zero-alliance/ as of October 2021
[2] https://www.netzeroassetmanagers.org/ as of October 2021
[3] https://www.unpri.org/climate-change/leading-investment-consultants-form-global-initiative-to-push-for-net-zero/8549.article

asset manager members. We started by polling the working group members on their beliefs. The discussion of the results helped to set the tone and direction for the subsequent work.

The beliefs we tested are shown in the table below. The working group members were asked to choose which of five possible responses best matched their opinion:

1. I completely believe this (95% likely to be true)
2. I strongly believe this (75%)
3. I believe this (55%)
4. I do not believe this (30%)
5. I reject this (5% likely to be true)

We suggest that six of the seven beliefs say something meaningful about our likely future. The working group believe that current portfolios are too anchored on past returns, particularly as they expect lower-than-average returns on financial capital and higher-than-average (financial) returns on natural capital over the next 20 years. Further, they believe the investment industry is not ready for how turbulent the transition will be as the world transitions to zero-carbon energy and towards a circular economy.

Belief	Weighted strength of belief (%)*
1. The world will transition to zero-carbon energy by 2050	64.3
2. The return on financial capital over the next 20 years will be lower than its historical average	61.0
3. The (financial) return on natural capital over the next 20 years will be higher than its historical average	66.9
4. Current institutional investment portfolios are too anchored on past returns	68.7
5. The economy of 2040 will be surprisingly circular	56.3
6. A circular economy is less (financially) capital-intensive, reducing the size of the opportunity set for the investment industry	41.1
7. The investment industry is not ready for how turbulent the transition will be	66.9

Source: Thinking Ahead Institute polling March 2021, 29 responses

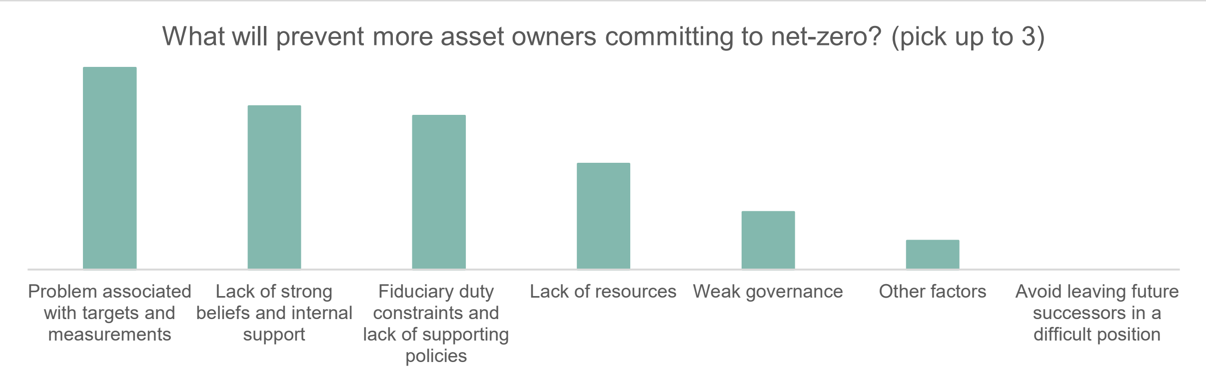
The working group's views on current and future context

In further polling, the working group suggested we would have already observed more transformational change in the investment industry if the scale and urgency of the climate problem were properly understood [+0.8[1]], and if better solutions were available [+0.8]. One such solution is more active ownership, with the working group suggesting that current engagement resources should be tripled[2].

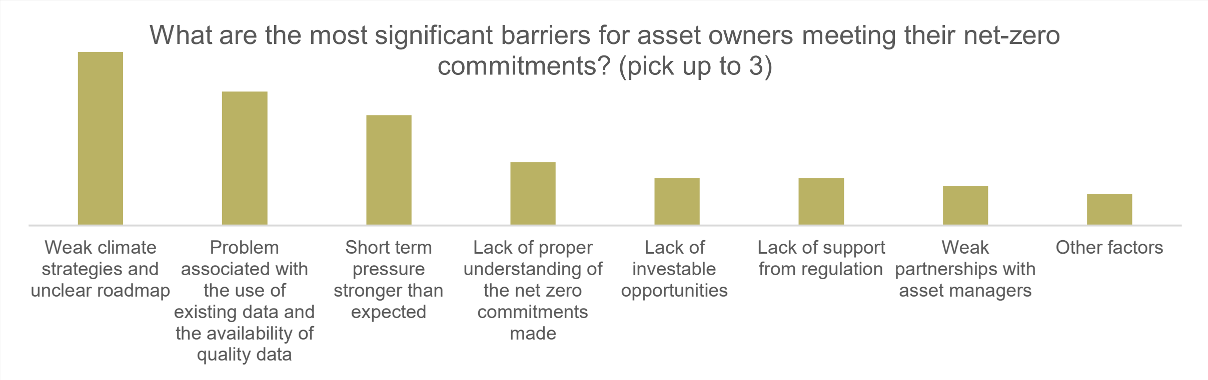
When looking to the future, the working group was more optimistic than not:

- Over the next five years, the investment industry will become more purposeful and be more multi-stakeholder orientated [+0.9]
- Fiduciary duty is likely to evolve differently in different jurisdictions as a result of regulator interventions and is likely to be defined less narrowly [+1.2]
- Asset owners [+0.8] and asset managers [+0.8] pledging to achieve net-zero will have a significant influence on investee companies
- More asset owners will move from climate-risk-focused to be climate-objective-aligned in the next five years [+1.0].

However, this is not to argue that the challenges ahead are not considerable. It is possible that we will see increased litigation from pension fund members (following McVeigh vs REST) in terms of how pension funds handle climate related risks [+0.7]. More fundamentally, net-zero commitments and managing against systemic climate change is entirely new. None of us have done anything like this before, and so we see problems associated with choosing targets, how to measure against them, and with data more generally; there are problems with weak beliefs, a lack of clear roadmap, and knowing where the constraints of fiduciary duty fall [see responses to following two questions].



[1] We asked a series of questions where the five possible responses ranged from 'strongly agree' through to 'neutral' and 'strongly disagree'. We scored the responses from +2 for 'strongly agree' to -2 for 'strongly disagree'. An aggregate score of +1.0 can then be interpreted as, on average, 100% of the respondents chose 'agree'. For this question, the aggregate score was +0.8 and can be loosely interpreted as '80% agreement'. Unless otherwise noted, these questions received 28 responses.
[2] 27 responses; none for 'same resources as present', 8 for 2x, 12 for 3x, 4 for 4x and 3 for 5x current resources.



So, where do we want to get to?

The investing for tomorrow working group inherited the prior output of two Institute working groups that ran through 2020 (+1.5C and Duty of ownership) – and some members even served on the previous working groups. Consequently, there was an existing foundation to build on – essentially the belief that limiting warming to no more than +1.5C was the correct, albeit very difficult, goal, and that owning assets carries a duty of stewardship as well as various rights. It quickly follows that the members of the IFT working group were self-selected, and highly motivated to explore what the investment industry could do to make a difference.

What does 'make a difference' mean? We need to distinguish between those areas where we have control and those where we only have influence. Institutional investors have complete control over the composition of their portfolios and so, theoretically, can completely decarbonise whenever they choose. As a forced and unrealistic example, they could hold 100% in cash if willing to risk failing to meet their return goal. This line of argument encompasses the 'divest vs engage' argument but, more importantly, gets us to the question "does a decarbonised portfolio help, if the underlying economy hasn't decarbonised?". The answer we get to is "no" – a decarbonised portfolio still carries significant financial risk if the underlying economy is still producing emissions. The IFT working group therefore set itself the goal of exploring what investment organisations can do to have real world impact. In other words, we want to change the climate trajectory (which is currently projected to far exceed 1.5C of warming) and get to a net-zero economy.

When it comes to the emissions produced by investee companies, the 2020 working groups had established that institutional investors are generally constrained to being influencers. In contrast, the managements of the investee companies can have direct impact on emissions. It follows that we should seek to have as much influence as we can. This, in turn, led to a framing of the high-level activities necessary to change the climate trajectory: stop, substitute and siphon.

- **Stop**: means shutting down financially-productive but emitting assets before their natural end of life, implying a loss in capital value. This is necessary to change the climate trajectory but highly problematic for investors under a fiduciary duty. The working group judged the investment industry to be too intrinsically conflicted (ie unwilling or unable to shut down productive assets) to generate transformational change [+0.9]. Either this activity will require legislation, or we will need to come up with better ideas here as the working group progresses

- **Substitute**: means investing in assets / business models (new or scaled-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, 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 (NETs) can be nature-based solutions as well as new technologies such as carbon capture. One point worth noting is the substantial difference in future pathways between using NETs to justify the continued burning of fossil fuels, and a future where the economy is carbon-emissions-free and NETs are used to offset natural emissions from wildfires and melting permafrost.

The roadmap

Given the above context and thoughts, the IFT working group settled on a single question to guide the work: what is the framework for asset owners to establish and execute a pathway to achieve their climate ambitions? Despite the working group comprising asset owners and asset managers it was quickly agreed that the appropriate framing was to pursue this work from the perspective of an asset owner. Within this high-level framing, the working group would attempt to achieve three objectives:

1. Define the beliefs and principles to support various levels of climate ambition

2. Outline the investment activities and actions asset owners and asset managers could take to achieve stopping emissions, substituting for the stopped activities and removing emissions from the air, and

3. Define the reporting and communications frameworks needed to support the ambitions.

To avoid reinventing the wheel, we took the Institutional Investors Group on Climate Change (IIGCC) net-zero investment framework[1] as a starting point and designed a six-step process to implement it, as shown in the figure below. 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 the 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 box for the ten items in the Institute's organisational identity checklist.

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

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

1. Values | what we believe in and how we will likely behave as a result

2. Culture | how does our organisation actually think and behave, how does leadership behave?

3. Talent and governance | what are the principal human and social capital resources we depend on? Board, internal team, external partners.

Strategy

1. Investment beliefs | what do we believe about the investment landscape and our edge to inform our strategy?

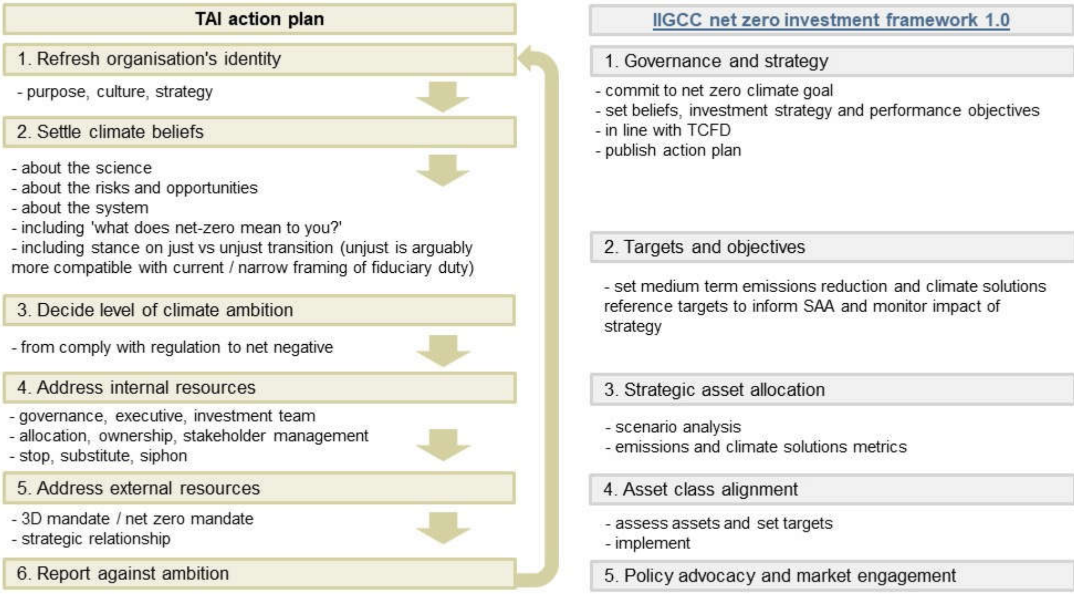
2. Organisational beliefs | what do we believe about our organisational context (governance, stakeholders, mission, etc) to inform our strategy including our endowments as an organisation?

3. 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

1. 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.

TAI action plan and the IIGCC net zero investment framework



It is our current intention to cover steps two and three, settling climate beliefs and deciding on the level of climate ambition, in the second paper of this series. In the third paper we intend to discuss how an asset owner might ‘reshuffle’ its internal resources to better pursue its desired level of climate ambition, and in the fourth, to consider external relationships with asset managers, in particular whether mandates should evolve. The fifth and final paper is planned to describe issues around data, reporting and communication. As shown in the diagram, an arrow then leads us back up to step one.

As this is new territory for all of us, we expect this to be an iterative process as we learn more and adapt.

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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