Thinking Ahead Institute

3D net-zero mandates

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 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.

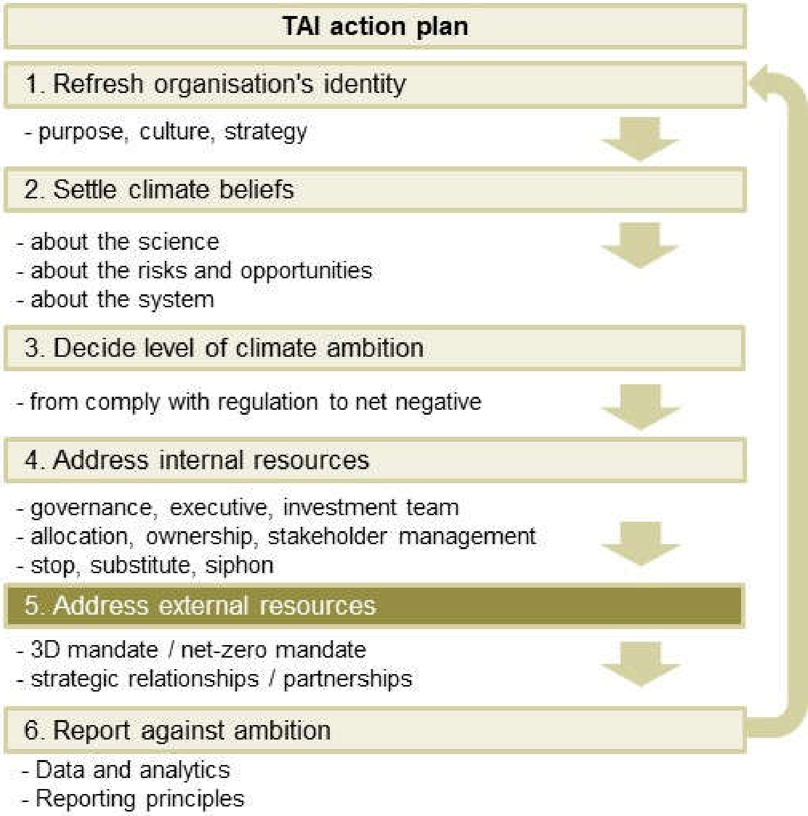
The key objective of this working group is to produce research outputs that can usefully guide investors to establish and set a pathway to achieve their climate ambitions. Beyond this, we hope the outputs help them to become a driving force in transforming the global economy to be compatible with the 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)
- Herschel Pant (AXA IM)
- Jeroen Rijk (PGB Pensioendiensten)
- Elena Shatrova (Santander AM)
- Leo Taglieri (Barclays Pension)
- Lucy Thomas (NSW Treasury Corporation)
- Adrian Trollor (NSW Treasury Corporation)
- Nacho Valinani (Pensions Caixa 30)
- Jaco van der Walt (RBC Global Asset Management)
- Sarah Wilson (Nuveen)
- Debra Woida (Willis Towers Watson)

In short…

In this paper we argue that net-zero commitments pitch us straight into the world of 3D investing (risk, return and impact). We review how the working group believes this will affect our organisations and industry, and then describe 3D net-zero mandates which comprise return and decarbonisation goals and limits to risk. We distinguish between 'lite' mandates that target the decarbonisation of the portfolio, and 'full-on' mandates that target real-world decarbonisation. We suggest that Paris-aligned benchmarks can be considered a 'super-lite' 3D net-zero mandate.



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). We describe our shared history as being one of 2D investing, where we talked of managing risk and return. We believe our shared future will be one of 3D investing, where we manage risk, return and impact. As risk and return are generally combined into a single objective function of maximising risk-adjusted return, this means we will need to figure out how to manage against two objective functions. We might, eventually, progress to maximising risk-and-impact-adjusted return but that lies in the future. The challenge now is meeting two, unintegrated objective functions, 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 is not legally possible, then we should not attempt further progress. 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.

So, what changes?

Arguably the first thing we need to do is significantly increase our training budgets (for both asset owners and asset managers) in order bring our organisations up to the necessary level of knowledge

[1] https://www.thinkingaheadinstitute.org/research-papers/with-great-power-comes-great-responsibility/

and skill on climate and sustainability [working group polling score +1.1, where a score of +1 can be interpreted as 100% of respondents 'agree'[1]]. Partly as a result of this training, but also through hiring and retention policies, investment organisations will reshape their workforces. The majority view within the working group was that asset owners will maintain their level of headcount but upgrade the quality, but a sizable opinion was that headcount would be increased. For asset managers, the dominant view was that headcount would increase (with most growth in climate / sustainability / engagement areas), and the minor view was a stable headcount but a rotation of resources to expand climate and sustainability efforts [please see appendix for polling details]. The final observation regarding internal resources is that the boards of investment organisations will be strengthened by adding climate / sustainability experts [+0.7].

When we look outside the individual organisation, we should expect to see the investment industry significantly grow the extent to which it engages with the public sector [+0.9], and a net-zero commitment becoming a pre-requisite for winning new business [+1.1]. In addition, and the idea we will take forward in the remainder of this paper, there will be significant growth in the number of 3D mandates [+0.8].

3D net-zero mandate

In an earlier paper, *Our house is on fire?!*[2], we introduced a spectrum of climate ambition which contained a discontinuity. 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.

Total portfolio thinking

As already noted in this paper, we refer the interested reader to explore our paper *With great power comes great responsibility* which describes the 3D framework and 3D mandates in big-picture sustainability terms. In our current context we have removed total portfolio thinking from our description of 3D net-zero mandates, NOT because we attach any lesser value to it but because we have chosen to leave the responsibility for it with the asset owner. In fact, we believe total portfolio thinking is especially valuable in the pursuit of a climate ambition. A total portfolio approach ensures that future climate solutions which may not fit typical asset class buckets do not 'slip between the cracks'. It also completely integrates the top down and the bottom up, and it delivers the best and most aligned 'spend' of the carbon budget, partly because it is a real-time process (as opposed to less frequent 'calendar-time' decisions).

As its name suggests, total portfolio thinking is only applicable to whole-fund mandates which, outside delegation to an OCIO / fiduciary manager, tend to be very rare. For this reason we leave responsibility for total portfolio thinking with the asset owner.

For more on this please see our papers, *Total Portfolio Approach* and *It's about time*.

[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] *Our house is on fire?! Should we do something? | setting your climate ambition*, Thinking Ahead Institute, 2021

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 partner
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	✓	✓	

We now describe the components of a 3D mandate. 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. Each of the components we elaborate on below play an equally important role in the construction of 3D mandates.

1. **3D (net-zero) goals**

   The mandate specifies the return and decarbonisation goals and the risk tolerance, to guide portfolio construction and strategy. For broader sustainability mandates the decarbonisation goal would be replaced by impact goals that specified positive and measurable social and environmental impacts.

2. **Strategic partnership**

   The mandate would specify whether or not a strategic partnership was being created. A strategic partnership typically involves the flow of intellectual property from the manager to the asset owner in areas outside the direct mandate. This is most usually in the form of investment strategy ideas, and reverse enquiry new mandate ideas. The value to the asset manager accrues in the form of strengthened client relationships and direct access to the asset owner's evolving thinking.

3. **Core sustainability strategies**

   The mandate would specify that ESG is fully integrated within all investment decisions, adding insight to support value creation, over both the short-term and the long-term. In addition the expectations for active ownership and engagement to be undertaken by the asset manager, again to support value creation over multiple horizons, would also be specified.

4. **Impact strategies**

The mandate would specify any expectations for targeting and achieving real-world decarbonisation outcomes. The mandate may specify minimum and/or maximum limits for portfolio and stewardship positions. These targeted positions would be based on some combination of systems thinking, universal investor strategies and TAI's stop, substitute, siphon framework.

5. **System-level engagement**

   The mandate would specify any expectations for addressing the systematic risk elements in the portfolio relating to climate change. For broader sustainability 3D mandates this section could also include systemic risks relating to financial stability and social stability. We believe practice in this area will develop and so we do not attempt to define the actions that might be undertaken here, but do note that they could include expectations for the asset manager's involvement in industry collaborations, and in efforts to lobby the public sector.

6. **Score-card monitoring**

   The mandate should specify that reporting from the asset manager to asset owner will be in score-card format, comprising multiple metrics of both hard and soft measures. The score-card should convey (i) portfolio efficiency (in terms of meeting both the return and decarbonisation goals with an efficient use of risk), (ii) portfolio robustness (balanced exposure to risk factors / different scenarios), (iii) implementation skill (liquidity, simplicity, flexibility, cost) and (iv) climate (net-zero) impact. TCFD reporting will be increasingly required / mandatory.

7. **Other mandate details**

   The mandate will specify all other necessary details including items such as fees; service level agreements; collaboration terms; termination terms; and possibly expectations for asset manager governance and culture.

Paris-aligned benchmark – a super-lite 3D net-zero mandate

In closing this paper, we note that the working group also discussed Paris-aligned benchmarks. We have chosen to label these a 'super-lite' 3D net-zero mandate. A Paris-aligned benchmark gives an asset owner a governance-friendly (ie minimal demand on governance resources), off-the-shelf way to decarbonise their portfolio. It is debatable whether these benchmarks qualify for having 3D goals. They absolutely manage a decarbonisation path and do so in a risk-managed manner. However, return is not managed and is simply a residual of the decarbonisation methodology.

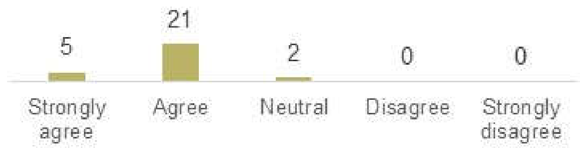
As for the other components of a 3D net-zero mandate, we note that there is potential for a strategic partnership, in this instance with the index provider. While we can imagine that the index provider would be open to selective strategic relationships, we also believe that the users of Paris-aligned benchmarks might be the smaller asset owners and so possibly less attractive. In terms of core sustainability strategies, decarbonisation is explicitly integrated. In summary, therefore, Paris-aligned benchmarks are a viable and easily implementable 'super-lite' 3D net-zero mandate.

Next step?

This paper has described step five of the action plan we have been working through. The sixth and final step, reporting on progress against our carbon ambition, will be explored in the next paper in this series.

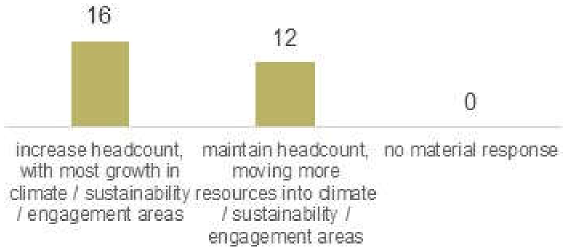
Appendix – polling results

The budget for climate / sustainability training (for both AOs and AMs) should be significantly increased
[28 votes | score +1.1]

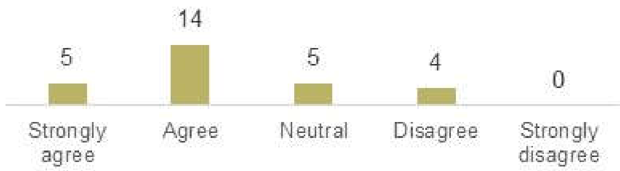


The asset owner response to net-zero commitments, in terms of internal resources, will be (NB not 'should be')
[27 votes]

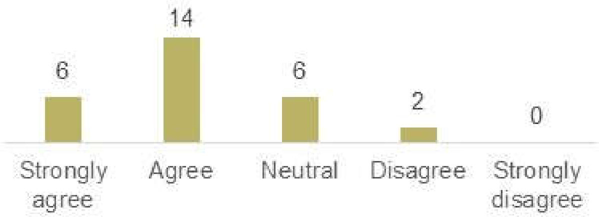
The asset owner response to net-zero commitments, in terms of internal resources, will be (NB not 'should be')
[28 votes]



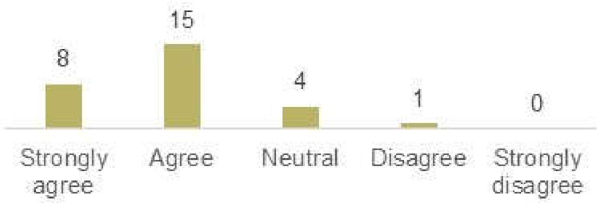
On average over the next five years, the boards of investment organisations (AO and AM) will be strengthened by adding climate / sustainability experts
[28 votes | score +0.7]



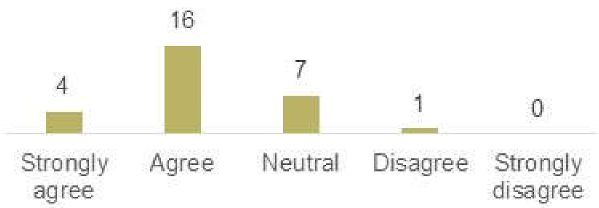
Over the next five years, there will be significant growth in the extent of public sector engagement by the investment industry
[28 votes | score +0.9]



In five years' time, a net-zero commitment will be a pre-requisite for winning new business
[28 votes | score +1.1]



Over the next five years, there will be significant growth in the number of 3D mandates
[28 votes | score +0.8]



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.
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Contact details

Tim Hodgson
+44 1737 284822
tim.hodgson@willistowerswatson.com

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:

Paul Deane-Williams
+44 1737 274397
paul.deane-williams@willistowerswatson.com