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SUSTAINABLE STRATEGIES

roundtable

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DISCUSSION: SUSTAINABLE STRATEGIES

There are many roads to building a sustainable world. For some, the priority could be protecting the skies above us from the harmful gases that are altering our weather patterns. They could also be focused on preserving the natural habitats that purify our air and produce food and the ingredients needed to make medicines. Providing access to clean drinking water could also be one of the goals. *portfolio institutional* assembled a panel of insiders who own, manage and advise on such strategies to discover what sustainability means to institutional investors and how they are implementing it into their portfolios.

With sustainability meaning different things to different people, there are many ways to implement it into a portfolio.

Railpen, for instance, is a pension fund with £34bn of assets under management that integrates ESG and sustainability factors across all of its portfolios. “We think about the possible externalities, and how they could lead to negative outcomes for our members,” said David Vyravipillai, a senior investment manager in Railpen’s sustainable ownership team.

Whilst Railpen is trying to address the impact of climate change and other environmental issues, they also have a fiduciary duty to generate the best possible investment return for their members.

“We don’t explicitly state that we are going to invest sustainably, but it can be implied by the fact that we are a long-term investor.”

The Wiltshire Pension Fund also tries to embed this into all of their investments, although it does have a dedicated sustainable active equities strategy targeting environmental themes, an allocation to affordable housing, local renewable infrastructure exposure and now a Climate Opportunities fund.

For Freddie Woolfe, a global sustainable equities analyst at Jupiter Asset Management, the breadth of approaches to align members’ savings with the delivery of a more sustainable world is one of its more interesting features.

He points to the UN’s Sustainable Development Goals as an initiative that has created opportunity through setting key targets across a range of environmental and social imperatives to be achieved by 2030.

“In the discussions we have with clients, the interest is around delivery of real-world outcomes and transparency around what those real-world outcomes are,” Woolfe said. “A key aspect for us is how the delivery of those outcomes underpins and supports the robust economic sustainability of the companies we are investing in.”

Nico Aspinall, a sustainability advocate at Newton Investment Management, said the firm “thinks through the broad palette of different risks that come from the environmental, social and governance” elements in all of its products as part of its overall investment process.

“What is interesting is that the longer your time horizon, the more sustainable your portfolio has to be because we are aiming to incorporate things that might help address issues that are 15, 20 years out,” Aspinall said.

“As an asset manager, our clients have a whole range of different objectives and time horizons. So it is valuable to have a sustainable label for some of our strategies so we can move from just targeting financial returns, to adding deliberate sustainable outcomes.”

There are negative behaviours and practices that Newton keeps out of its sustainable portfolios, but sustainability is not just about risk, it's also a matter of trying to effect positive change. The firm looks for companies that understand its stakeholders and its environmental and social impacts to transition into future economies.

"So having processes in place to ensure you understand what a good chemical company or a good cement company looks like, in terms of how it is transitioning itself away from fossil fuels, is crucial, and could determine whether it is eligible for those sustainable strategies."

> **Even though there are challenges around ESG in emerging markets, it is important to invest sustainably.**
>
> Jennifer Devine, Wiltshire Pension Fund

Cadi Thomas, Isio's head of sustainable investment, said that every client she advises has different ambitions as to how much they want to push this, but the primary focus has been on climate change...perhaps overly so. "We are not saying climate change isn't important, but it's definitely dominated the discussions we have been having.

"I have often found that many people think low carbon equals good, which is, of course, not the case," she added. "This is changing slightly, moving towards more of a forward-looking focus and the identification of climate opportunities.

"We are also seeing increasing recognition of the interlinkages of climate change with social and nature issues."

Sustainable investing is a key priority at Russell Investments and has been incorporated into its investment thesis for many years, said Jihan Diolosa, its head of global ESG strategy.

"We are active owners of the assets we manage on our clients' behalf. Engagement with the underlying securities and voting are key pillars to our sustainable investing proposition.

"It is about having the right building blocks," she added. "Making sure that we have best in-class managers within our research universe to pick and build from is also a key requirement."

Nature's risks

After decades of investors being concerned about halting climate change another threat to the environment has emerged in recent years: biodiversity loss.

"It is a difficult place to know where to start as it is a massive issue and a lot of the information out there can be overwhelming," said Jennifer Devine, head of pensions at Wiltshire Pension Fund.

THE PANEL

Nico Aspinall
Sustainability advocate
Newton Investment Management

Jennifer Devine
Head of pensions
Wiltshire Pension Fund

Jihan Diolosa
Head of global ESG strategy
Russell Investments

Cadi Thomas
Head of sustainable investment
Isio

David Vyravipillai
Senior investment manager, sustainable ownership
Railpen

Freddie Woolfe
Global sustainable equities analyst
Jupiter Asset Management

To help, the scheme has added a framework to its responsible investment policy. "We have been educating the committee who make the decisions on why this is important and how it might impact our portfolios.

"It's a little like climate in that you need to take a dual-pronged approach, looking at the risks and opportunities," she added.

From a risk perspective, the scheme focuses on the sectors that will be heavily impacted by nature loss, namely food and agriculture. "But you need to look at the opportunities as well, which is what we are trying to do," Devine said.

Opportunities to invest directly in natural capital are not easy to find for those looking to mitigate such risks, Vyravipillai admitted. "I'm yet to come across a fund in any asset class that doesn't sacrifice short-term alpha generation in order to address biodiversity in a positive manner."

He added that Railpen is still at the beginning of its biodiversity journey. "The way we look at natural capital is mapping our biodiversity risk exposure to better understand where to spend our time. That is the first point of call.

> **We don't explicitly state that we are going to invest sustainably, but it can be implied by the fact that we are a long-term investor.**
>
> David Vyravipillai, Railpen

"We then engage with those assets to understand how they are mitigating such biodiversity risks in the near term," he added.

An easy way to protect against nature loss is to focus on deforestation or select a general environmental-based strategy. It's essential to recognise that nature-related risks and climate-related risks are interconnected. "Climate change can exacerbate the loss of natural capital by altering ecosystems and water scarcity. Organisations must therefore consider both sets of risks in their risk assessment and mitigation strategies," Diolosa said.

In the public space, she has seen a handful of nature-based solutions, but, in a sign of how young such strategies are, they have short-track records and Russell Investments has not formally ranked them, but instead are "keeping an eye on them".

The question is, can investors keep an eye on climate and biodiversity risks when looking at individual assets?

"At a high level, the two are inextricably linked," Woolfe said. "We cannot solve climate change without natural capital, and climate change impairs natural capital's ability to do that."

He then gave an example of how a Brazilian bank is tackling climate and nature loss in the Amazon through the loans it approves. "We consider that company to be a leader in addressing wrongful deforestation within the region by penalising those who are seen to be deforesting illegally, including through contractual mechanisms such as the cost of debt," Woolfe said.

"They are also looking to educate and incentivise people to use the Amazon's natural resources more sustainably so they can benefit from those resources without destroying them. Notably, there is a particular focus on helping small and micro businesses so there is an intersection with the delivery of real positive social impact from an economic inclusion aspect as well.

"What is interesting about that is you are looking at a company that has climate change and nature impacts as well as risks in its business and is looking to address them in a co-ordinated manner," he added. "I suspect that the leading companies in a range of sectors will increasingly look to incorporate both topics in a similar way."

Feed the world

Another threat to biodiversity is how we produce food. With the number of citizens on our planet projected to swell by 2 billion in the next 25 years, the pressure on the natural world looks set to increase.

"We have to try and short circuit the development curve," Aspinall said. "We need to put agricultural systems in place in the developing world that are not running off huge amounts of pollutants or tearing up virgin forests to grow their crops."

He added that this presents an opportunity for companies to scale up such technologies in the emerging world.

"The growing population means the pressure on the natural world is going to be huge," Aspinall said. "However, there is no reason why it should have to replicate the economy as it exists in the emerging markets today. We can aim to have more concentrated cities, which are supplied with water and energy that does not destroy the world around them, and are secure without triggering all sorts of chaos."

Wiltshire has been looking at forestry and agriculture through its Climate Opportunities fund. "I read some research that said there is enough land on our planet to feed everybody, but you have to stop eating meat. So it is also about changing behaviours," Devine said.

"Can you have a sustainable agriculture fund that invests in animal agriculture? I would argue not, but these things are out there, and you need to be honest in your assessment of if they are doing what you need them to do," she added.

> **"The growing population means the pressure on the natural world is going to be huge.**
>
> Nico Aspinall, Newton Investment Management

Thomas said that there is a lot of innovation in the natural capital space but food has always been something of a balancing act for investors. "You will find that a lot of the US forestry managers, for example, allow hunting on their land.

"There is the argument that this controls species, but I haven't seen a natural capital solution that purely focuses on food. Natural capital solutions typically contain commercial forestry, along with maybe some agriculture and peatland restoration. However, this is an area that is evolving quickly," she added.

Divestment or engagement?

Shifting the world from an extractive to a regenerative economy is a big change. Jobs will disappear as the skills we rely on to power our lives are replaced with new ones. This could decimate communities, and even countries, unless workers are reskilled. This is part of a strategy that is designed to "leave no one behind", known as a just transition, and is something Wiltshire asks its managers to consider when investing.

"It is important to us," Devine said. "It is part of what is going to make a transition sustainable. It is not going to happen if it is not fair to everybody."

There are two ways of creating a carbon-neutral economy. One is to invest in greener alternatives to the heavy emitters. The other is greening those heavy emitters. "Just having portfolio decarbonisation may be an anti-just transition narrative," Aspinall said. "There has to be a mixture of both in your portfolio, as its important to engage with the heavy emitters about their net-zero transition plans, rather than simply excluding them.

"Essentially, where their labour is focused today, and where it might be focused in the future, is all part of that just transition," Aspinall added. The engagement versus divestment point is interesting, Thomas said.

"You always have the challenge of can you genuinely quantify the impact you have had as a manager by engaging with that company. Where do you draw the line? When do you divest? Do you ever divest?

"One of the issues trustees are debating is where do they sit on that spectrum of exclusions versus engagement," Thomas added. "We need better stewardship reporting to understand if that is making a difference. That is the big challenge."

Russell Investments would typically favour engagement over divestment. For Diolosa, setting hard divestment rules is challenging because each company is different and so is every engagement. "We often debate if we should set up divestment rules. But it is hard to do given that how to approach or solve a particular issue raised will be company specific.

"So it is difficult to set a standard framework," she added. "As most engagements need to be done on a case-by-case basis.

> **"We cannot solve climate change without natural capital, and climate change impairs natural capital's ability to do that.**
>
> Freddie Woolfe, Jupiter Asset Management

"Reporting and transparency of engagement outcomes are also important. We have developed a proprietary tool which tracks engagements over multiple channels to ensure that our clients understand the conversations we are having and the outcome of those conversations."

Regulation

Regulation is coming thick and fast in the sustainable investing space. Yet feelings regarding its effectiveness in helping to build sustainable portfolios are mixed.

"In terms of helping identify if a product is offering what it says on the tin, I would say regulation has not helped. You still need to conduct your due diligence," Diolosa said.

"You can't get away from that, but where it has been a benefit is helping investors pinpoint what could be a sustainable offering," she added. "The attention and focus on better disclosures are also welcomed."

The group then discussed if they feel that regulations are trying to make investors more effective. "What does making us more effective look like?" Woolfe asked. "Well, it is about keeping us on the straight and narrow and focusing on alignment with the delivery of real-world outcomes for people and planet rather than just managing for portfolio statistics."

"There is a lot of consultation going on, which is positive, and it feels like regulators and the investment community want to get this right.

"As the regulatory backdrop continues to evolve globally we have seen responses in the market shifting, but there is a heightened sense of authenticity which is hugely positive," Woolfe said. "And so if the regulations are in place to help clients understand what we do, why we do it and how we are aligning their savings with sustainable outcomes, that feels like things are definitely moving in the right direction."

Thomas pointed out that in the pensions space there is a lot of debate around if the Task Force on Climate-related Financial Disclosures (TCFD) adds value. "But trustees are having conversations now that they weren't having prior to TCFD," she added. "We are discussing topics such as climate tipping points and the resulting physical damage, which we wouldn't be having with all clients without this push from TCFD.

"But the issue is that you then end up with an 80-page TCFD report that aren't often read," Thomas said. "It is effective in terms of initiating conversations and everyone improving their knowledge, but not particularly in terms of communicating with members, which is half of what the regulation is meant to do."

Diolosa said there are many smaller asset owners who are still digesting TCFD and now are talking about the Taskforce on Nature-related Financial Disclosures [TNFD]. "There is a significant amount of strain on smaller schemes as there is a lot more that they need to educate themselves on and the world is moving on quite quickly.

"There are a lot of new frameworks coming through," she added. "TNFD has just been finalised, separately the DWP's taskforce on social factors has just released a draft guide for consultation. Against that backdrop the UK's FCA has just finalised the Sustainability Disclosure Requirements which will likely have implications for the categorisation of solutions that investors are currently invested in. It is a lot to digest."

Vyravipillai hopes to one day see a homogenisation of all these reporting standards. "That could be by the end of this decade. So in the grand scheme of reporting, that is still a positive step in the right direction."

He added that it is the same with TNFD. "We have already spoken about the overlap between biodiversity and climate and hopefully this leads to a combined TNFD and TCFD report in the future. That will ease the burden on asset owners, asset managers and corporates.

"We are heading towards a singularity of reporting standards with the formation of the ISSB," Vyravipillai added. "Regulation can be incredibly positive if all market players participate."

Transparency is crucial to helping members understand what is happening on their behalf. The Wiltshire Pension Fund produces mini magazines and one-page colourful factsheets to keep its members informed with what they are doing. "That is what you need, not 80-page reports," Devine said.

Aspinall focused on regulation being biased towards disclosure. "As an industry we must kill thousands of trees to print stuff nobody reads.

"TCFD is a framework to help schemes go through risk and strategic assessments. That has become a mandatory docu-

ment of the outputs of that process, but it doesn't necessarily guarantee a pension scheme has gone through a good process.

"In 2022, pension schemes had to go through it for the first time and it was such a rush," Aspinall added. "I'm sure that initially, they were more focused on simply producing the document and less focused on going through that risk and strategic assessment, but I'm sure they are having conversations that they have never had before as a result.

"So there is a bias in our disclosure regimes around the world to produce mountains of paper, which is ultimately meant to reflect on the process, but cannot give you that insight because the disclosures are not aligned to it."

Diolosa said the focus [on regulation] has shifted from disclosure to understanding. "I find with the large schemes I'm working with, the conversation has changed and is now focused on action."

> **"Climate change can exacerbate the loss of natural capital by altering ecosystems and water scarcity.**
>
> Jihan Diolosa, Russell Investments

Vyravipillai added: "Ultimately, my job is to understand security fundamentals and not just provide ESG disclosures on the basis of our investment decision."

Thomas believes that the industry gets bogged down in the data. "The carbon footprint of an investment strategy is going to jump up and down because a market moves or a strategy changes.

"We get bogged down in justifying what the changes are, rather than just thinking about the bigger picture, which is: we have until 2030 to meet a decarbonisation target, what are we going to do strategically to get there?

"We don't look at the annual volatile numbers for returns, so I don't know why we do it on ESG metrics. That is interesting," she added.

"One of the key challenges is the metrics that tend to be reported on are inherently backward looking, but sustainable investing is fundamentally a forward-looking process," Woolfe said.

"We are looking to understand what will drive future cashflows and so some of these data points need to be company specific. Trying to aggregate and generalise is challenging and risks missing some of the more investment-relevant aspects."

Woolfe agrees that scepticism is required on how companies are going to achieve net zero – is their plan credible and will the next management team go back on those targets?

"Those are some of the key questions for assessing the credibility of a transition plan and its likelihood of delivery. A dataset on its own is not going to get you the answers that will help you invest most effectively as a sustainable investor, because it is about making an assessment of what you believe will happen in the future, which needs to include company-specifics and qualitative assessments," Woolfe said.

Emerging markets

The emerging world is becoming the new economic powerhouse fuelled by favourable demographics and an abundance of natural resources. Yet these nations are also home to high levels of inequality and pollution. So how can investors gain exposure to such growth while keeping their portfolios sustainable?

A lack of disclosure is one of the prime challenges in the emerging world, according to Aspinall. Lower listing requirements is one such issue. "If you want sustainability based on disclosure to define your portfolio, then you are probably going to have to exclude a lot of emerging-market companies."

Engagement is critical to improving the standard of corporate disclosures in the emerging world but can we in the West criticise their environmental and social practices?

"We can't sit here and tell them how to do things," Devine said. "Our own emissions can be low, but that is because we have outsourced our manufacturing. You can't have net zero for some, it has to be for everybody.

"So even though there are challenges around ESG in emerging markets, it is important to invest sustainably," she added. "That is something that we try to do. It would be easy to just sell high-emitting stocks to make our decarbonisation curve look better, but that is not the right approach."

Aspinall believes that a partnership approach to these problems could help the emerging world to emerge more sustainably. "You have to be in that opportunity space as a critical friend, but making sure that we are not removing capital on the basis of our western ideals," he said.

> **"I have often found that many people think low carbon equals good, which is, of course, not the case.**
>
> Cadi Thomas, Isio

Engaging with countries is different to engaging with companies, but this should not be a barrier to investing. "As providers of equity and debt, if you are clear about what you are trying to achieve, and they are clear about what they are trying to achieve, then we can have a good conversation," Aspinall said.

However, he added that there are cultural differences between the West and some emerging nations to overcome, such as a high level of family ownership in some emerging-market companies. "That is a different conversation."

Woolfe says that regional nuances, for example corporate governance idiosyncrasies, demonstrate that a local market under-

standing is needed when investing there. "If you are looking to invest in companies that are leading the sustainable transition, you need to understand where they started from.

"Having blanket expectations across the world means you risk missing investment opportunities in companies that are demonstrating local leadership and delivering clear and tangible real-world outcomes."

Diolosa added that when investing in emerging markets, you need to look at the trajectory that individual companies are on. "There are a lot of attractive opportunities in emerging markets.

"It depends on the country. But what we have found in the last five years is that companies are more receptive to having those conversations because they appreciate that the wider international audience want that further engagement," she said.

Things to come

This discussion took place as we were closing in on the end of 2023, so what are the panellists expecting from sustainable investing in the years ahead?

For Devine, Railpen are ahead of their time in that they don't have dedicated sustainable strategies; it is in every investment they make.

This is a mindset Wiltshire are moving towards. An example came when they were re-designing their website and had a page called 'responsible investment'. "I thought: are the rest of our investments irresponsible?" Devine said. That page is now called 'Investment'.

"It will become more like that," she added. "It is going to become a lot more integrated. It will have to be."

Vyravipillai agrees that in a few years' time we won't have ESG as a separate consideration to security fundamentals. "That is what makes me excited," he said. "ESG investment professionals will be just investment professionals. The SFDR has formalised the importance of double materiality and the CSRD extends this.

"Securities should not only offer investors sustainable financial returns, but also an environmental and social return."

Aspinall chooses to focus on the "patchwork quilt" that is regulation, believing that it will get worse before it gets better. "I suspect the UK's sustainability disclosure requirement is close. If you look at Europe, every country has a slightly different interpretation of SFDR requirements."

He then points to the US, where the SEC can issue disclosure guidance, but each state can do the same, as California did in late 2023. And then there is Asia, where the standard of corporate disclosure could be higher.

"It will take time for us to work through that complexity," Aspinall said. "That is probably going to be a big feature in 2024. But hopefully, further down the track, regulators will talk to each other on these matters and start harmonising their standards."

Woolfe closes the discussion by concluding: "If corporate behaviour continues to develop in a way that means more companies operate more sustainably, our investment opportunity set should also expand. Societal and regulatory expectations and requirements are clearly evolving, even if some of the pathways are sometimes complex, to encourage companies along this route as well and increasingly penalise those that don't meet those expectations. So we're excited about the continued opportunities to support our clients' financial outcomes by aligning their investments with those companies leading the transition to a more sustainable world."

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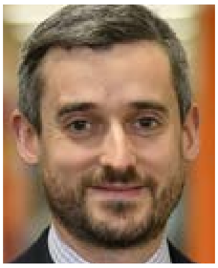

Freddie Woolfe is an investment analyst for the Jupiter Global Sustainable Equities strategy.

BIODIVERSITY: AN INVESTMENT IMPERATIVE TODAY

Freddie Woolfe discusses the importance of considering biodiversity in analysing companies.

As policy leaders around the world gather this month in Dubai to address the challenges of combating climate change, the related impacts on biodiversity cannot be overshadowed, in our view. We all require natural resources for our lives and livelihoods, and we are currently using those critical resources at an alarming rate.

Earth Overshoot Day, the day when humanity's demand for ecological resources and services in a given year exceeds what the planet can regenerate in that time, has been consistently moving earlier in the calendar. In 1971, that date sat at Christmas Day; this year it was 2nd August. As of 2023, it is estimated that we would need 1.7 Earths to provide the annual resource requirements of humanity.[1]

The rapid need to address biodiversity loss is one we have been discussing for some time. Not least because we all rely on natural resources for vital human needs, but also due to the inextricable link between the preservation of natural capital and combatting climate change. As a result, we believe that companies which are able to reduce their adverse environmental impact are likely to generate more attractive financial returns over the long-term.

While biodiversity considerations have formed part of our investment process since inception, recent regulatory and policy convergence is driving a greater impetus from governments and companies too. Like carbon, we anticipate that biodiversity impacts will increasingly become costs to business as the regulatory framework develops to penalise unsustainable use of and impacts on natural capital. For example, the EU's Deforestation Regulation envisages maximum fines of at least 4% of EU turnover for violation.

The launch of the final recommendations of the Taskforce for Nature Related Disclosures (TNFD) at the end of September is another major catalyst for change; we think this formalisation of reporting standards will become as important for biodiversity impacts as the Taskforce for Climate-Related Financial Disclosures (TCFD) has been for climate.

How investors can consider biodiversity risks

We see investment opportunities in companies that can provide solutions to biodiversity loss as well as those that actively seek to minimise their impacts.

1) https://www.overshootday.org/newsroom/past-earth-overshoot-days/

It is important to consider companies' own operations as well as further detail around supply chains. We have developed an investment-led approach to assessing biodiversity impacts and dependencies, using company location data and geospatial data on natural capital risks.

This allows us to be more precise about where biodiversity impacts might exist, and the potential materiality of operational and financial risks on a much more specific basis. We have identified three key areas for engagement: deforestation, water use and plastic reduction.

Deforestation

Forests are some of the world's most biodiverse areas, operating as the 'lungs of the planet' through their ability to capture and store carbon from the atmosphere. This critical ecological role means it is important for companies to address deforestation risks in their operations and supply chains. For example, a consumer goods company is likely exposed through its packaging and commodities supply chains. We look to understand how the company will set and achieve its target of being deforestation free, focussing on procurement and supply of key resources such as deforestation-free palm oil, paper and board, tea, soy and cocoa.

We have discussed with a Brazilian bank how it works with other banks to identify wrongful deforestation in the Amazon and penalise it through higher borrowing costs, while providing cheaper financing to small businesses that use rainforest resources sustainably.

Water

Water's vital importance inevitably leads to tensions in almost every aspect of its use. The semi-conductor industry produces components which are used for the digitalisation and electrification of many industries; however, the process of making them requires large volumes of ultra-pure water.

Access to water is a key consideration for the economic and environmental sustainability of semi-conductor companies, so developing efficiencies around water use is crucial for semi-conductor businesses. We look for significant water recycling rates and conservation programmes, allowing a company to continue to operate in drought periods when peers have struggled.

Plastic reduction

Plastic is ubiquitous in our everyday lives for good reason – it is cheaper, lighter and more versatile than most other alternatives. However, it is also highly pollutive. While all businesses are impacted, companies in the sectors which use a lot of packaging are likely to be highly exposed.

While reducing reliance on plastics is a challenge, we look for companies with ambitious goals to transition away from virgin plastics and expand their use of recycled plastic, reusable packaging or alternative materials.

Opportunities

The measurement and management of biodiversity loss and impact remains in its infancy. The adoption of incoming frameworks should dramatically improve the assessment and understanding of risks that have been poorly disclosed to date.

Companies that do not adapt their operating models to reduce their reliance on vital resources will likely be increasingly at risk. However, this also presents opportunities for those companies already leading the transition to a more sustainable world.

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The value of active minds – independent thinking: *A key feature of Jupiter's investment approach is that we eschew the adoption of a house view, instead preferring to allow our specialist fund managers to formulate their own opinions on their asset class. As a result, it should be noted that any views expressed – including on matters relating to environmental, social and governance considerations – are those of the author(s), and may differ from views held by other Jupiter investment professionals.*

Nico Aspinall is a sustainability advocate at Newton Investment Management.

OUR SUSTAINABLE FOCUS FOR 2024

It is time to invest in real-world decarbonisation

Addressing greenhouse-gas emissions is an urgent and critical task. Investment is needed to accelerate the shift towards a 'greener' world to protect our economy, society and environment from climate change, and we need to do it at pace. That means investors investing in the companies that are already part of the future energy and technology mix, as well as those that are part of the current mix, but earnestly planning to be a part of the future one. It also means investing in the regions where the vast majority of future emissions will originate – emerging markets.

There are two contrasting ways in which investment managers can support this progress towards a genuinely carbon-neutral economy.

The first is through portfolio decarbonisation – investing only in companies with the lightest emissions at the expense of those with the heaviest, i.e. avoiding companies with operations in regions with higher emissions in their grids (i.e. South Africa). The second is via real-world decarbonisation, meaning investing in companies with robust transition plans ahead of those without plans or with weak alignment behind them. Real-world decarbonisation focuses on a company's pathway of emissions, and the likelihood of it achieving reductions consistent with a 1.5-degree path to net zero by 2050.

We have been through a phase where net zero-committed asset owners have had little choice but to go down the route of portfolio decarbonisation. We think this has been unhelpful for the transition itself, but, increasingly, better reporting and clarity from companies across many sectors is making real-world decarbonisation a plausible alternative.

The problems with portfolio decarbonisation

Our issue with portfolio decarbonisation concerns what it actually achieves. Reducing the disclosed emissions of portfolios does not mean the global economy uses fewer fossils to generate energy or transport goods; these emissions and the connected climate risks simply fall outside the purview of the asset owner.

It results in a portfolio which excludes energy-intensive sectors of the economy, countries with limited access to renewable energy, and countries with weaker disclosure requirements for emissions. In other words, it introduces unintentional sectoral and regional biases, which would lead to the exclusion of large companies making energy-intensive products which enable future energy efficiency (like batteries).

Asset owners who desire to reduce the carbon intensity of portfolios face pressure from their underlying investors to deal with climate risks, but we would caution against a focus solely on portfolio emissions rather than the wider environment of their investments.

We believe that the portfolio decarbonisation approach, which excludes heavier emitters despite many having credible plans to achieve net zero, does little to help solve the existential threats posed by climate change. Weighting portfolios towards sectors with lower energy needs will not reduce exposure to energy price or supply volatility in a disorderly transition, because supply chains still need energy.

> **“Achieving net zero via ‘real-world’ decarbonisation means investing in the companies we believe are best placed to deliver on their pledges and commitments to turn into low-emissions businesses, regardless of current emission levels.**

A market solely invested through portfolio decarbonisation is still exposed to a world ratcheting up climate risk, it just has no shareholder power to mitigate those risks. We believe the one-dimensional approach of portfolio decarbonisation needs augmenting.

The benefits of real-world decarbonisation

Achieving net zero via ‘real-world’ decarbonisation means investing in the companies we believe are best placed to deliver on their pledges and commitments to turn into low-emissions businesses, regardless of current emission levels. We have witnessed a surge in companies committing to achieving net-zero emissions, enhanced reporting on progress and alignment with science-based targets to reduce emissions.[1] That means the universe of companies with improving plans is now large enough to make real-world decarbonisation portfolios possible.

We believe these companies will be more resilient to transition risks because ‘plan beats no plan’; it is easier to accelerate your decarbonisation plans in response to energy-price volatility than to form plans on the hop.

Real-world decarbonisation also supports the ‘just transition’ – the need to move and retrain the labour force to participate in the low-carbon economy. Companies within heavy-emitting sectors with robust approaches to the transition will necessarily be considering evolving their workforces.

The main takeaway from last November’s COP28 conference must be that the time for execution is now. This is why we, and other active investors with a net zero mandate must carefully consider the credibility of company transition plans, and support those we believe are better equipped to achieve net zero, rather than blindly disinvesting from the real world.

1) https://sciencebasedtargets.org/reports/sbti-monitoring-report-2022