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A short guide

Race to net zero: Implementing a portfolio decarbonisation pathway

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From ambition to action

In the past five years, the emissions covered by decarbonisation pledges have risen to 70% of global emissions, according to data from the International Energy Agency. Now investors must play their part, not only by reducing their own portfolio carbon footprint but also by holding governments, issuers and asset managers accountable to those pledges, transforming ambition to action.

We understand each investor's journey will be different, with some at more advanced stages than others. Many are constrained by regulations, while others may choose to prioritise other corporate objectives. Fiduciary duties such as investment policy requirements also may influence the speed at which asset owners decarbonise their investment portfolios, as do other factors such as the level of beneficiary and client scrutiny, the organisational asset-liability profile and available resources to implement changes.

No matter the individual circumstances, net zero transition pathways must demonstrate real-world reductions in carbon emissions at the regional and ultimately global levels to meet the goals of the Paris Agreement. In the following pages, we consider the general options, advantages and challenges to implement a decarbonisation strategy.

Key takeaways

1. Once decarbonisation targets are set, investors can apply the twin pillars of climate-aware investing - reducing the existing portfolio carbon footprint and increasing exposure to climate solutions - to help them reach their environmental goals.
2. There are generally four common levers that investors can use to transition their portfolios - emissions profile, climate rating, revenue alignment and engagement. Importantly, assessing risks and opportunities with a forward-looking view is critical to make progress in decarbonising the global economy.
3. Transparency in gauging decarbonisation progress when transitioning the portfolio is crucial. While it is impossible to discuss all the different metrics available, we attempt to distil them into five common measures consistent with portfolio baselines - carbon intensity reduction, absolute emissions reduction, portfolio coverage, sectoral coverage and temperature ratings.
4. Choosing indexing, systematic or active fundamental to implement decarbonisation strategies will depend on factors such as climate ambitions, implementation budgets and risk-return objectives.
5. Careful consideration of the challenges and advantages at each stage of the decision-making process will help investors reduce the carbon footprint of the portfolio while meeting other financial and non-financial goals.

Apply techniques to decarbonise

There are two main avenues towards net zero for investors - decarbonising the aggregate investment portfolio and investing in climate solutions. In the first instance, a modular approach to decarbonise portfolios offers investors four levers to influence climate outcomes (see Figure 1). These tools can be applied on their own but are generally used together to optimise results.

Another route to mitigate the effects of global warming is to invest in climate solutions, which comprise products and services to pave the way for a smoother energy transition.

Issuers in this category focus on two goals - wider adoption of existing ways to mitigate and adapt to climate change, and innovations required to meet net zero targets. These strategies potentially offer a broader set of opportunities that directly contribute to solving climate change problems alongside attractive risk-adjusted return potential. They generally fall into five broad industry groups: transportation, power, industry, buildings and consumer.

However, these strategies also may have carbon footprint trajectories that temporary rise in the short term. For example, companies developing battery technologies may increase emissions during the initial growth stages.

Figure 1: Four levers to decarbonise portfolios

Module	Targets	Advantages	Challenges
Emissions profile	■ Declining emissions trajectory ■ Paris-alignment plan ■ Carbon intensity reduction in line with sector	■ Aligns with key climate metric - carbon emissions ■ Easily quantifiable	■ Needs contextualisation ■ High risk of estimation errors
Climate rating	■ Differentiation between issuers, e.g., achieved, aligning, high potential to align, low potential to align, and no evidence of aligning to net zero	■ Analyses credibility of climate progress ■ Assesses qualitative factors	■ Methodology inconsistencies between providers ■ Requires significant resources
Revenue alignment	■ Enabler of the net zero transition ■ Alignment to frameworks, including EU Taxonomy and SDGs ■ Reduction in revenues from high-impact sectors, e.g., thermal coal	■ Captures the 'how' of a business ■ Clear economic alignment	■ Requires additional analysis ■ High potential for data challenges
Engagement	■ Higher-impact sectors ■ Climate standards and policy to align with the Paris Agreement ■ Timebound commitment to engage	■ Pushes for measurable change from high-impact emitters ■ Guides towards best practices	■ Requires sustainability and stewardship expertise

Source: Fidelity International, July 2022.

Furthermore, the risk profile of thematic portfolios may be more concentrated on average. Some can have style tilts, particularly towards growth given the type of companies, increasing volatility risk. What constitutes as green activities also is increasingly under scrutiny, so applying established frameworks such as the EU Taxonomy may help reassure investors in contributing to solving the climate crisis.

Relative to traditional portfolios, risks related to managing assets with net zero ambitions may differ due to the mismatch in the time frame between organisational financial reporting periods and the long-term nature of climate change, which stretch for decades[1]. Examples include the following:

- Uncertainty of the global GHG emissions budget. For example, the rate of permafrost thawing could accelerate and release more methane into the atmosphere, reducing the current emissions budget.
- Unpredictability of how climate change affects investors' decarbonisation pathway.
- Implementation risks may rise due to market dynamics such as new regulations, public pressure to divest high emitters or geopolitical events such as Russia's invasion of Ukraine.
- Company-specific climate risks - including physical, transition and liability - could change the risk-return characteristics of investment portfolios, so periodic reviews and updates to investors' decarbonisation assumptions are necessary.

Implementation measures

How investors choose to gauge their climate-aware investing strategy depends on their initial baselines and portfolio ambitions. Unsurprisingly, a proliferation of portfolio emissions regulations, policies, guidelines and other tools have emerged globally over the past decade to help strengthen the reliability, transparency and accountability of key performance indicators (KPIs). These aim to add rigour to the efforts to mitigate climate risks and channel capital into climate solutions. However, they can be difficult to decipher.

While it is impossible to discuss all the different initiatives in this paper, we hope to distil them into common approaches that can be used on their own or combined with others to meet climate goals. The aim is to help investors interpret various metrics in a way that should also make it easier to aggregate and compare decarbonisation activities across different parts of the portfolio. (See Figure 2)

Climate-aware targets are dynamic, and the underlying data and processes supporting the decarbonisation journey should be periodically reviewed. According to the Science Based Targets initiative, for example, there are at least three instances that may trigger reviews:

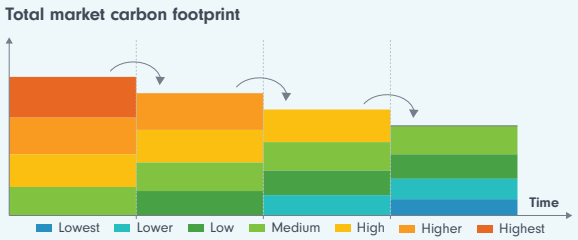
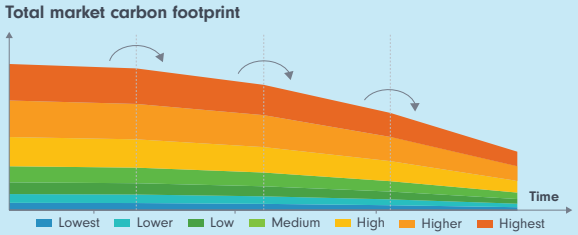
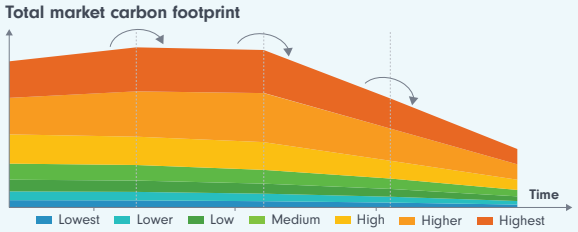
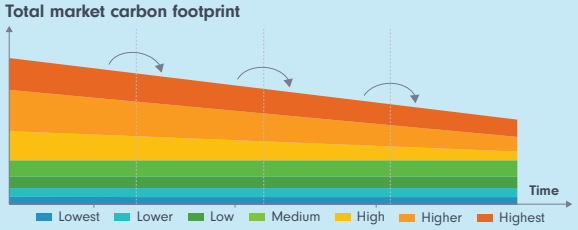
- Structural changes such as mergers and acquisitions, divestments and organisational restructurings.
- New or different data availability due to regulations, best practices or error detections.
- Operational shifts such as new product offerings.

Figure 2: Five ways to gauge decarbonisation pathways

Method	Description	Example	Advantages	Challenges
Carbon intensity reduction	Reduce the amount of emission (usually calculated as metric tonnes of CO2e) per economic output unit such as GDP within a specific time frame from baseline	Lower weighted average portfolio carbon intensity for Scopes 1 and 2 emissions (and where appropriate, Scope 3 emissions) by 20% in the next decade from a 2019 baseline	■ Comparisons possible between issuers, sectors and regions to determine relative environmental metrics ■ Considers economic growth trajectories along with climate goals, and easier to adjust with changing circumstances along the net zero pathway	■ May be more difficult to incorporate with other organisational objectives such as liability matching ■ More difficult to understand the underlying carbon characteristics or measure of investor responsibility
Absolute emissions reduction	Targets actual carbon emissions reduction within a specific time frame from a baseline.	Reduce portfolio carbon footprint by 2.5% per year for Scope 1 and 2 emissions and 1.25% for Scope 3 emissions across entire portfolio from a 2019 baseline	■ Clarity around magnitude and time frame required to align with organisational, regulatory and global climate frameworks ■ Useful for investors with specific carbon budget	■ May be more difficult to incorporate with other organisational objectives such as liability matching ■ Data cannot be easily compared across issuers, sectors and regions
Portfolio coverage*	Decarbonisation goals are applied at the more granular portfolio level	Increase equity climate solutions to 5% of the aggregate portfolio in the next five years	■ Conducive to meeting specific organisational goals such as contributing towards certain UN Sustainable Development Goals (SDGs) ■ Higher scope for tailoring capital flows, for example towards clean fuel innovations	■ May be challenging to aggregate and compare data across different investment portfolios ■ Assessing the specific carbon footprint and the potential to meet emissions KPIs may be more complicated
Sectoral/ regional coverage	Similar to portfolio coverage, but targets are expressed from a sector or regional lens	Engage with companies in the materials industry to commit to a 'net zero by 2050' pathway within the next five years	■ Potential to target high-emitting industries or specific regions such as emerging markets more precisely to accelerate real-world decarbonisation	■ Requires enough companies within sectors and regions to work together to decarbonise at scale
Temperature rating	Emission reduction targets implied temperature rise (ITR) aligned to the Paris Agreement	Cut portfolio ITR to 2.2°C by 2035 from a 2022 baseline	■ Clearer alignment to the Paris Agreement across the entire portfolio ■ Modelling programmes allow for integration of climate scenario analysis with other tools (e.g., strategic asset allocation) to chart ITR trajectory	■ Higher risk of overpaying for low emitters to meet decarbonisation targets ■ Potentially missing out on opportunities such as climate solutions that contribute to real-world emission reductions

Source: Fidelity International, Science Based Targets Initiative (SBTi), Principles for Responsible Investment (PRI), MSCI, September 2022. *The Science Based Targets initiative (SBTi) has adopted an asset class-specific approach to enable robust and meaningful targets.

Figure 3: Routes to decarbonise investment mandates, by typical sector emissions profile

Action	Description	Example	Hypothetical decarbonisation path
Exclusion/ Divestment	Apply exclusionary screen on sectors or companies based on pre-determined criteria, or divest after an unsuccessful engagement period	Excluding companies involved in Arctic oil & gas exploration and tar sands. Periodically divesting high-emitting utility companies that show no progress in reducing the percentage of revenues from fossil fuels	
Best-in-class	Overweight companies with higher climate credentials vs. peers, based on Paris-alignment criteria, climate solutions revenues or other climate metrics	Gradually increasing the weighting to companies aligned to SDG 13 (Climate Action)	
Momentum	Emphasis is on companies with a future trajectory to add value, such as those reducing emissions from a high-base or those likely to continue reducing emissions in the future	Target high-impact companies with robust decarbonisation plans and execution strategies with attractive risk-return profiles	
Tilting	Often used in systematic or customised indexing, this approach adjusts the carbon footprint of a portfolio against a benchmark, which can be traditional or PABs/CTBs*	Reduce the carbon footprint of high-impact emitters by 50% and increase exposure to low-impact companies in the next 10 years vs. benchmark while limiting tracking error within specified range	

Source: Fidelity International, MSCI, September 2022. For illustration purposes only. Note: High emitters generally refer to harder-to-abate sectors such coal-based utilities, and low emitters generally refer to sectors such as software and services companies. However, within specific sectors, there can be relatively low emitters such as a coal-based utility that has transitioned to renewables. Likewise, there may be relatively high emitters among low-emitting sectors.
*Paris-Aligned Benchmarks (PABs) and Climate Transition Benchmarks (CTBs)

Greening portfolios

Data and framework availability, regulatory support and organisational constraints dictate that investors often do not have the resources to implement a decarbonisation strategy for the aggregate portfolio all at once. Therefore, they need to prioritise investment mandates deemed to be the most achievable to decarbonise. In Figure 3, we consider several options. Of all asset classes, listed equities - particularly in developed economies - are perhaps the starting point to decarbonise for most organisations due to several factors:

- Relative availability, comparability and reliability of data.
- More established investment best practices.
- Regulatory and corporate support frameworks.

However, listed equities account for less than a quarter of total emissions, according to estimates by the Climate Accountability Institute. The global fixed income market also offers investors attractive decarbonisation opportunities. It is larger in terms of total outstanding debt in 2021 at US$123.5 trillion compared to the global equity market capitalisation of US$105.8 trillion[2] with annual issuance that also dwarfs that of equities.

Furthermore, managing a climate-aware portfolio cannot be limited to public markets. Standards must be just as rigorous when investing in private markets. Otherwise, issuers and asset owners can sidestep public scrutiny by shifting into the private sphere - undermining long-term sustainability goals along the way.

Comparing passive, systematic and active fundamental strategies

Choosing the right implementation approach to advance climate ambitions is the next key component of the decarbonisation pathway. We believe every decision is an active one, whether investors use indexing, systematic (rules-based) or active fundamental strategies. Even when tracking an index, investors must decide whether to use a Paris-Aligned Benchmark (PAB), a Climate Transition Benchmark (CTB) or a bespoke benchmark among other options. These decisions involve trade-offs between non-financial goals such as the pace of decarbonising the portfolio and the financial goals, including risk appetite, tracking error and volatility limits.

How investors transition their climate-aware investing portfolio depends on the nature of the decarbonisation pathway, along with other factors such as the organisational governance structure, implementation budgets and investment horizon. In Figure 4, we compare three common types of implementation strategies against specific outcomes in a simplified infographic.

One of the difficulties when indexing, for example, is how to divest an issuer if engagement fails within a certain time period; in general, neither the asset manager nor the asset owner has direct control over the construction of most indices. One solution is to underweight, and some asset managers are exploring ways to use shorting to influence corporate behaviours.

On the other hand, active fundamental strategies require closer monitoring of asset managers to ensure alignment to investors' climate goals, relative to indexing and systematic approaches. However, regulatory changes combined with technological advances potentially are making that task easier and more granular.

For example, reporting to clients increasingly includes data on the extent to which a portfolio contributes to mitigating and adapting to climate change under the EU Taxonomy framework. Other reporting mechanisms may be aligned to the UN Sustainable Development Goals (SDGs). The evolution of data transparency should provide more clarification, consistency and comparability over time.

Figure 4: Common allocation strategies vs. portfolio decarbonisation outcomes

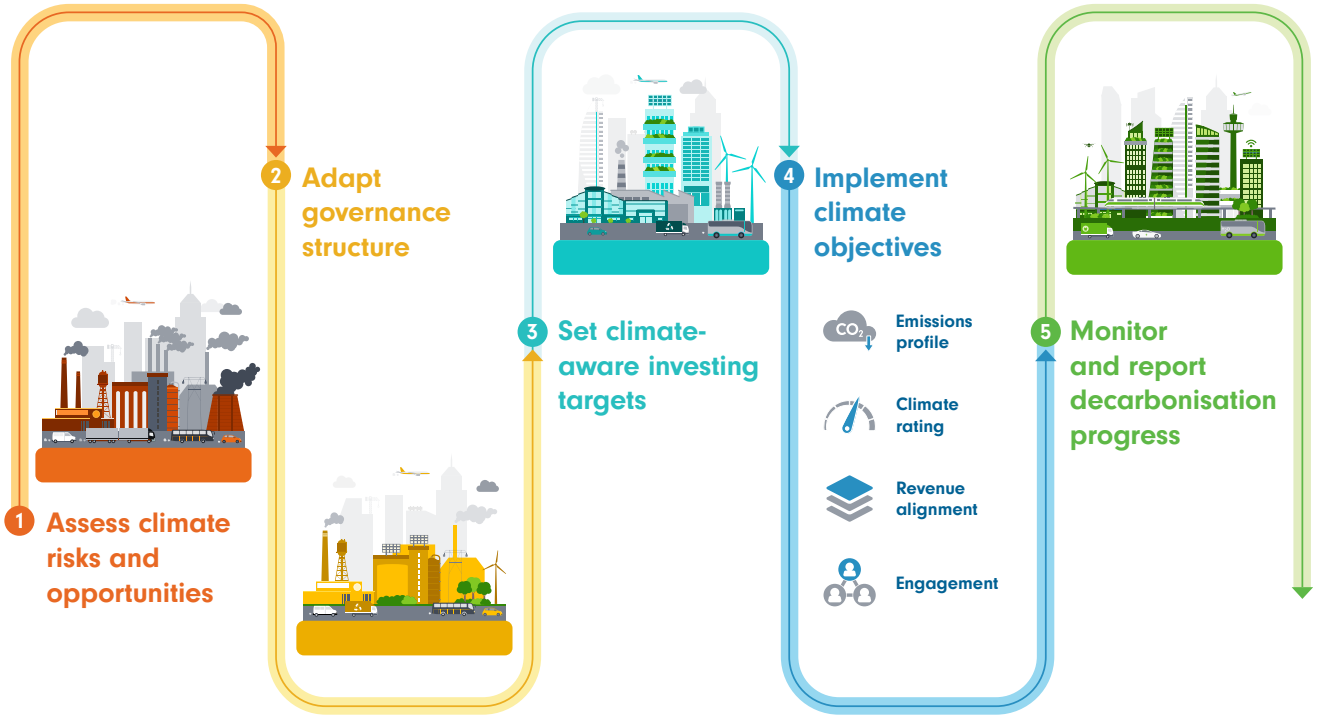
Source: Fidelity International, September 2022. *Ability to customise climate solutions refers to a range of options to help institutions tailor investments aimed at mitigating or adapting to climate change. They can work with index providers to customise their indices or set 'customised' investment guidelines, for example, for active climate solutions strategies.

Generational investing

Climate events are increasing in terms of number, magnitude and intensity, with clear repercussions on the global economy. Investors cannot wait to act. While the tools to do so are expected to evolve as gaps are addressed, as demonstrated in this guide, there is already enough available to enable a cogent decarbonisation pathway without compromising other organisational goals. Those with the resources to align their entire investment portfolio should do so. If they cannot, then define which portion of the portfolio can be decarbonised and map out a clear, timebound transition strategy.

Undoubtedly this is one of the most difficult tasks facing investors, though it is also one of the most crucial endeavours to leave beneficiaries, clients, employees and future generations with financial security that is grounded in a sustainable economy. Traditionally, sustainability has been viewed as separate from an organisation's financial security, with many investors reluctant to introduce and implement portfolio decarbonisation targets because of concerns that they may negatively affect returns. We disagree. We believe financial security relies on the wellbeing of the ecosystem. Therefore, tackling climate change should not be considered an 'add-on' but a necessary component of financial security. And just like the net zero transition itself, the longer the wait - the higher the cost and the more volatility to be expected. As well as being the right thing to do for the planet, climate-aware investing is a critical alignment of long-term fiduciary interests.

This guide is part of a series titled "Race to net zero" and addresses the implementation stage, accompanied by "Race to net zero: Setting climate-aware ambitions". In the coming months, we will be adding other modules on topics such as the implications by asset class when implementing climate objectives, and monitoring and reporting decarbonisation progress.



Source: Fidelity International, September 2022.

[1] Patrick Bolton, Marcin Kacperczyk and Frédéric Samana, "Net-zero carbon portfolio alignment", Financial Analysts Journal, March 29, 2022.

[2] "Capital Markets Fact Book, 2021", SIFMA, July 2021.

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