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**A short guide**

# Race to net zero: Setting climate-aware ambitions


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## It isn't easy being green

Nations, companies, asset managers and investors are setting net zero ambitions, ushering in what we believe to be one of the most significant shifts in sustainable investing. In a 2021 survey of 800 major institutional investors and wealth managers conducted by Longitude, a Financial Times company, and sponsored by Fidelity International, more than 90% prioritise decarbonisation.

Yet just 14% have set Paris-aligned decarbonisation targets globally, with those based in Europe more advanced at 18% but falling to 8% in the Asia-Pacific region, excluding Australia. The reasons vary and include the following:

- difficulties in accessing consistent data,
- challenges in aligning sustainability goals and portfolio risk-returns targets,
- and the connection between portfolio decarbonisation and its real-world impact.

This paper aims to help investors navigate the challenges in setting climate goals and highlight some options available to address them.

## Key takeaways

1. Before embarking on a decarbonisation strategy, investors need to determine a carbon emissions baseline and define their views of climate risks and opportunities.
2. For many investors, it is not yet practical to reach net zero in every corner of the portfolio. Therefore, it is essential to prioritise strategies with the largest emissions reduction opportunities, supported by factors such as data availability, policy incentives and applicable decarbonisation frameworks.
3. Investors will also need to align decarbonisation priorities with their corporate governance framework as well as other financial and non-financial objectives.
4. Climate-aware targets should include the timeframe, scope and trajectory to reflect the organisation's ambitions in the short, medium and long term.
5. Navigating the transition pathway is a dynamic process requiring a double materiality outlook, calibrating between how quickly investors decarbonise the investment portfolio and how much they contribute to real-world emissions reduction.

## Construct the base

The climate crisis is complex and filled with long-term uncertainties. Therefore, investors motivated to align investment portfolios with the goals of the Paris Agreement may be tempted to shift their attention towards more immediate investment threats such as the energy crisis or the direction of central bank policy rates. There is no doubt macroeconomic threats may make the task more daunting. However, we believe it would be a fiduciary mistake to hold back as the world's most pressing existential risk unfolds. There will always be short-term challenges. Waiting for the right time simply pushes the can down the road.

Like any experienced pilot in a storm, investors will need to keep an eye on the horizon to successfully navigate through the turbulence. Evidence is mounting that investors have a larger role to play in tackling climate change. For example, more frequent heatwaves have devastated crops, sparked wildfires, and disrupted economies. They cannot wait for the dark clouds over the economy to pass before doing their part in mitigating the long-term effects of the climate crisis. Those who persevere will serve their stakeholders well, now and into future generations.

**Figure 1: Examples of baseline metrics**

| Question | Metric | Description |
|---|---|---|
| **What is my portfolio's exposure to carbon-intensive companies?** | Weighted Average Carbon Intensity (WACI) | Portfolio's exposure to carbon-intensive companies, usually expressed in metric tonnes CO2e per unit of currency (such as US$ million) in revenues |
| **What is my portfolio's total carbon footprint?** | Total carbon emissions | Absolute GHG emissions associated with a portfolio, usually expressed in metric tonnes of CO2e |
| **What is my portfolio's normalised carbon footprint per US$ million invested?** | Normalised carbon emissions to value invested | Total portfolio carbon emissions normalised by the market value of the portfolio, usually expressed in metric tonnes CO2e per unit of currency (such as US$ million) invested |
| **What temperature of global warming is my portfolio aligned to?** | Implied temperature rise | Estimate of a global temperature rise associated with the GHG emissions of a single entity, e.g. a company, or entities, e.g., those in a given investment portfolio, fund, or investment strategy, expressed as a numeric degree rating |

Source: TCFD, MSCI, Fidelity International, September 2022. Note: Carbon dioxide equivalents (CO2e) are used to include all greenhouse gas (GHG) emissions: carbon dioxide (CO2); methane (CH4); nitrous oxide (N2O); hydrofluorocarbons (HFCs); perfluorocarbons (PFCs); sulphur hexafluoride (SF6), and nitrogen trifluoride (NF3).

Additionally, climate-aware investing helps to manage the following:

- Fiduciary duties (climate transition, physical and liability risks).
- Government regulations such as IORP II Directive, Solvency II and EIOPA Insurance Distribution Directive.
- Reputational risk as a result of scrutiny from the public, media outlets, consumers and non-governmental organisations.
- Beneficiary expectations.

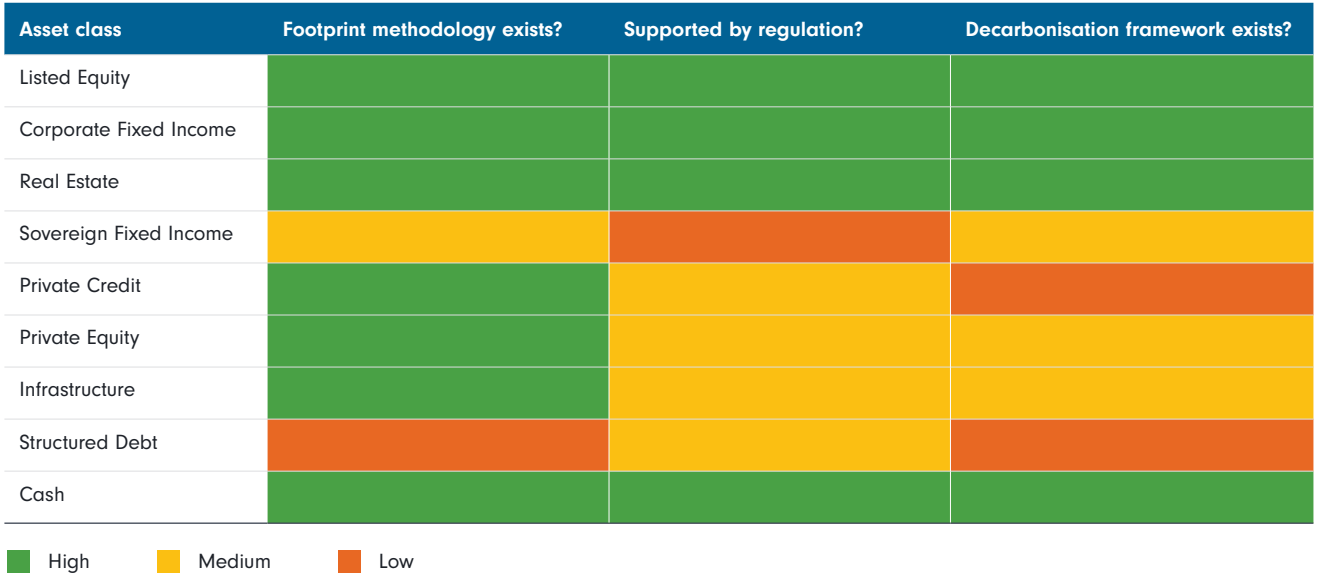
Before embarking on a decarbonisation pathway, however, investors need to establish where they stand. The starting point should include the current portfolio carbon footprint expressed in Scopes 1 and 2, and if possible, material Scope 3 emissions in high-impact sectors such as oil & gas, aviation and automotive.[1] As with financial metrics, we believe more than one carbon metric is often needed to understand a portfolio's emissions exposure. Certain metrics may be more suited to certain mandates. For example, when measuring the carbon footprint of a multi-asset strategy, weighted average carbon intensity may be more accurate than total carbon emissions because the former is applicable cross-asset, reduces double-counting risk and is not affected by the portfolio size. Which carbon metrics investors choose to report will depend on the questions they need to answer for stakeholders (see Figure 1).

## The measure of portfolio emissions

Establishing a baseline for the carbon footprint will require the consolidation of various data for each portfolio and benchmark investee. The purpose is to identify the baselines according to asset classes, ideally compared to their respective benchmarks, to help prioritise which strategies to decarbonise. Emissions data are not available across the board, with some asset classes such as listed equity more reliable than others. The viability of the data depends on factors such as whether a carbon footprint methodology exists, whether regulation is supportive and whether a framework for decarbonising the asset class is available. (See Figure 2)

In this paper, we provide a broad-brushed view of data reliability. However, as with other aspects of ESG, the reality may be far more complex. For example, in some cases, investors in private markets such as private equity and private credit may have access to more reliable data than those available to their listed equivalents. The reasons vary, but hinges on the nature of the relationship between issuer and investor, as well as the potentially bigger holdings and longer holding periods that allow for more influence. Larger asset managers, for example, may be in a more advantageous position to gain ESG insight when investing in private assets.

**Figure 2: Feasibility of obtaining portfolio emissions data, by asset class**




Source: Fidelity International, September 2022. Note: Footprint methodology refers to the availability of a generally accepted process for measuring Scope 1, 2 and material Scope 3 emissions. In terms of data reliability, regulation generally aims to improve the reliability, comparability and verifiability. Decarbonisation framework helps identify and manage transition risks and opportunities within sectors and asset classes.

The data usually come from different sources that may not be comparable, so it's important to understand the nuances of what they represent. Information is then used in evaluation models to allocate the respective ownership share of emissions and to calculate the absolute portfolio carbon exposure, expressed in carbon dioxide equivalents ($CO_2e$). This information can serve as a basis for other metrics required.

Some large institutional investors may have the internal capacity to measure their portfolio carbon footprint by independently sourcing their data. Most investors, however, will not likely have the capability to source, standardise and calculate emissions data at the portfolio level and must rely on third-party providers. Among them are asset management companies, specialist consultants and ratings companies or their subsidiaries.

## Determine the ambition level

Just as investors differ in their views on the right risk-return profile for their investment portfolios, decarbonisation ambitions also vary significantly. The commitment level depends on factors such as regulatory constraints, resources available and other organisational priorities. According to McKinsey, there are three levels of sustainability ambitions[2], which we have adapted to address the climate crisis as illustrated in Figure 3.

Investors at all commitment levels should encompass the concept of double materiality as they reflect on their pathway to align to the Paris Agreement. This concept stipulates that portfolio management activities can influence climate matters, and the climate crisis influences portfolio risk-return characteristics. In other words, decarbonising the portfolio is not enough if it does not result in an additive reduction in carbon emissions in the real economy. A meaningful set of ambitions will balance elements of both.

**Figure 3: Three levels of ambition for decarbonising portfolios**


Source: McKinsey, Fidelity International, September 2022.

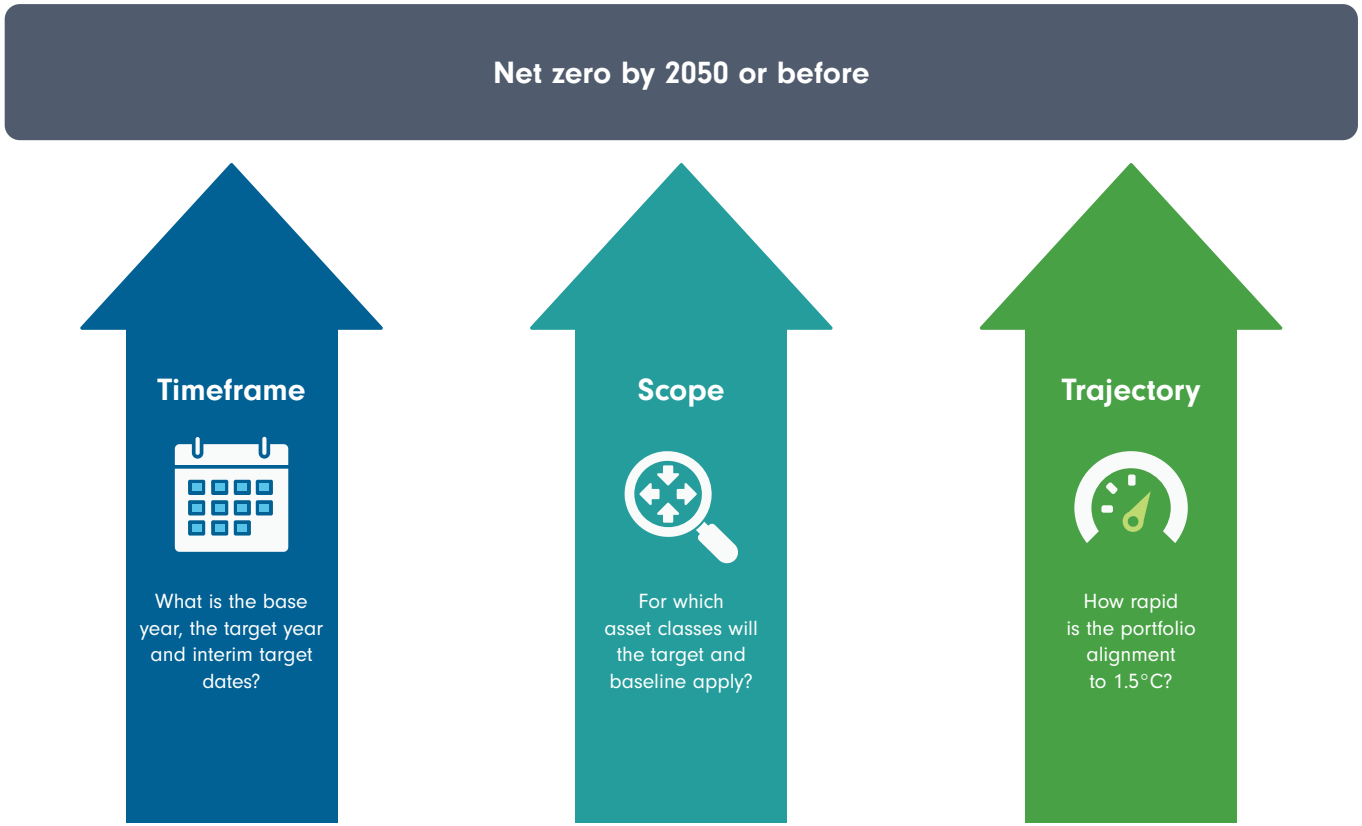
## Harmonise climate views with risk-return objectives

Once investors clarify their level of commitment, one way of mapping the net zero pathway is to adjust the strategic asset allocation (SAA) to reflect climate views, supported by rigorous stress testing to estimate the potential repercussions on portfolio risk-adjusted return characteristics.

However, many investors may not have the resources or the ability to forecast the long-term effects of the climate crisis on risk-return assumptions to adjust their strategic asset allocation with confidence. Therefore, a more practical approach may be maintaining their standard SAA expectations and introducing climate sleeves at a bottom-up level within portfolio allocations. The aim is to improve climate performance while pursuing similar risk-return objectives.

To enhance accountability, investors also may need to align their organisation's governance structure before setting climate-aware targets for parts of the portfolio deemed most achievable to decarbonise, such as listed equities, corporate bonds, or real estate. Each target should have a defined timeframe, scope and trajectory. (See Figure 4)

**Figure 4: Elements of investor climate ambitions**




Source: Fidelity International, September 2022.

## In practice: Target setting

A long-term strategy to transition investment portfolios should accompany shorter-term tactics to reach that goal in a way that contributes to reducing emissions in the real economy. Considerations such as which framework, methodology and reference benchmark upon which to base targets (see examples in Figure 5) will influence which levers to apply during implementation and outcomes in the all-important reporting stage. Finally, interim targets help to keep investors on track in their net zero glidepath. The Institutional Investors Group on Climate Change (IIGCC) recommends that investors set interim targets at intervals of 10 years or less at the aggregate portfolio level and five years or less at the asset class level.[3] These should include one or more of the following components:

- A reduction of the portfolio carbon footprint.
- An increase in Paris-aligned investment solutions.
- Engagement with portfolio companies to improve the environmental standards of portfolio companies and with policymakers to influence regulation.
- Selective divestments where engagement shows no potential for net zero alignment.

**Figure 5: Examples of net zero target-setting by asset class**

| Asset class targets and measurements | | | |
|---|---|---|---|
| **Asset Class** | **Sovereign Bonds** | **Listed Equity/Corporate Fixed Income** | **Real Estate** |
| **Targets / objectives** | ■ Increase average climate performance / AUM (maximum extent possible), exceeding the average benchmark score<br>■ Increase allocation to green or SDG climate bonds, if possible | ■ Set portfolio coverage target for % in AUM in net zero, aligned, or aligning assets<br>■ Set target for increase % climate solutions revenues / AUM<br>■ Set engagement goal for coverage of assets aligned or under active engagement at >70% of financed emissions from material sectors | |
| **Asset alignment and climate solutions assessment criteria** | ■ Past and future expected territorial production emissions performance / capita or / GDP against net zero pathway<br>■ Past and future performance on key sectors (energy use and exposure of the economy to fossil fuels)<br>■ Other national and international policy positions<br>■ Allocation to verified green or SDG climate bonds | ■ A long term 2050 goal consistent with global net zero<br>■ Short- & medium-term emissions reduction targets<br>■ Current emissions intensity performance (Scope 1, 2, and material Scope 3).<br>■ Disclosure of Scope 1, 2 and material Scope 3 emissions<br>■ A quantified plan to deliver targets<br>■ Capital allocation alignment<br>■ Revenues from EU mitigation taxonomy activities | ■ Current alignment of building carbon emissions and energy use in line with regional / building type net zero pathway<br>■ Future expected alignment based on plan for retrofit, demand management and renewable energy use |

Source: The Institutional Investors Group on Climate Change (IIGCC), March 2021.

## Striking a balance between the portfolio and real-world decarbonisation

The effects of climate change are not distributed evenly, with certain issuers, sectors and regions worse off if no or inadequate action is taken. Others with the solutions to mitigate or adapt to a changing environment will prevail. Investors have a fiduciary duty to determine the implications for their portfolio and map an appropriate decarbonisation pathway, starting with parts of the investment portfolio most feasible to transition.

Applying a double materiality concept, targets should aim to reduce emissions for the real economy as well as for the portfolio. Otherwise, unintended consequences may undermine investor goals. For example, a narrow focus on reducing a portfolio's carbon footprint can result in divestments of high emitters, reducing the organisation's carbon footprint but shifting the responsibilities of decarbonisation to others. Hypothetically, this potentially may result in a net increase rather than a decrease in global emissions if those assets end up in the hands of those who are not environmentally responsible. Crucially, reducing a portfolio carbon footprint too quickly - without considering the real-world impact - can also negatively impact investment risk-return and diversification potential.

Climate ambitions also must be based on reallocation decisions and data that are forward looking, with transparency both on the success and any shortcomings in reaching the set goals. To optimise risks and opportunities, additional resources should be channelled towards defining, implementing and refining the investment decision process to protect the environment. Investors face significant challenges when striking a balance between climate-aware investing and meeting other financial and non-financial objectives. The alternative, however, is not a viable option.

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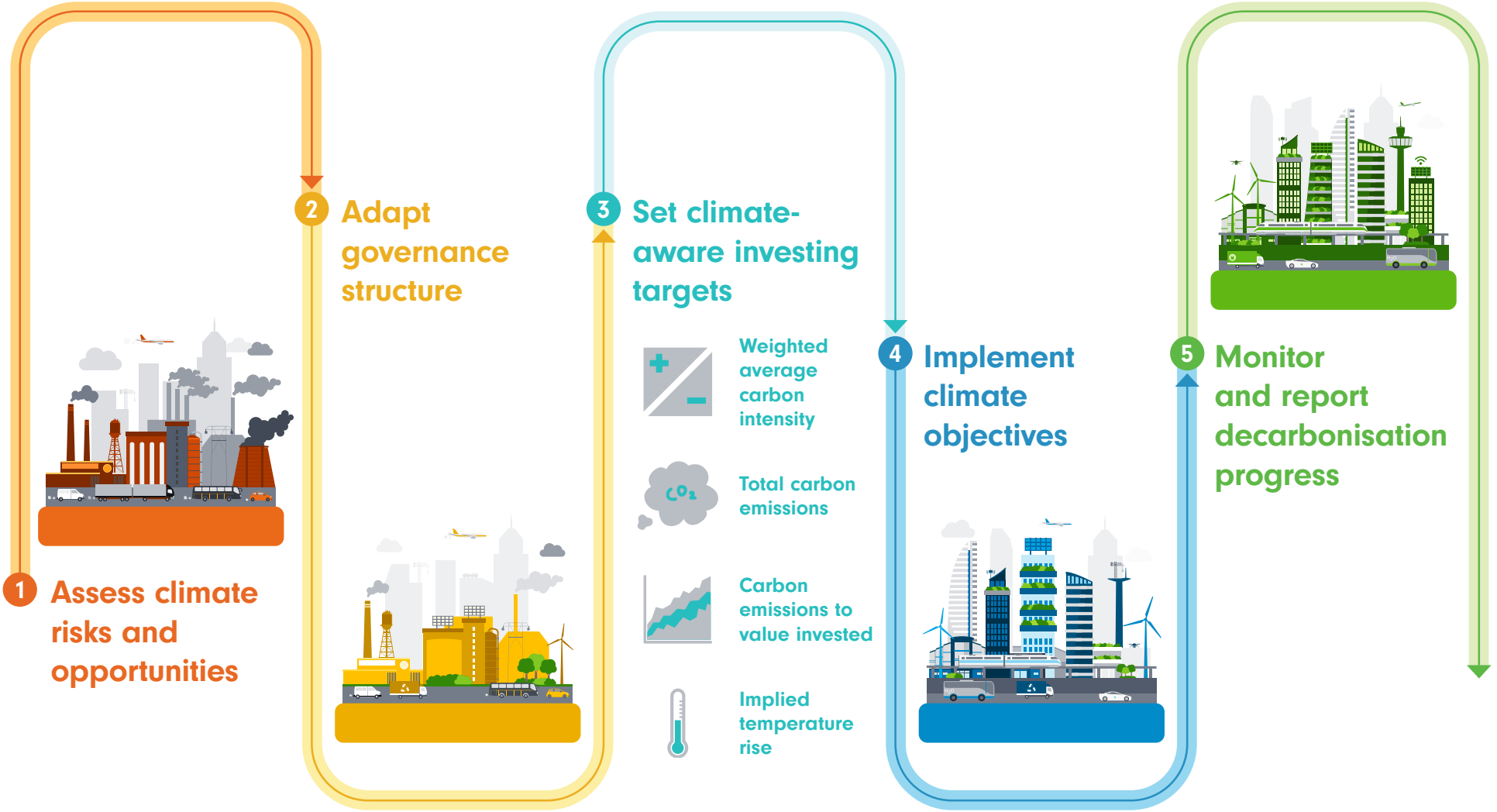
[1] "Scope 1 and 2 Inventory Guidance", US Environmental Protection Agency, 2021.

[2] Lucy Pérez, Vivian Hunt, Hamid Samandari, Robin Nuttall, and Donatela Bellone. "How to make ESG real", McKinsey Quarterly, August 2022. The three levels of ambition for climate-aware investing applies the same concept as the hierarchy for ESG in the McKinsey Quarterly.

[3] "Net Zero Investment Framework Implementation Guide", The Institutional Investors Group on Climate Change, April 13, 2021.

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




Source: Fidelity International, September 2022.

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