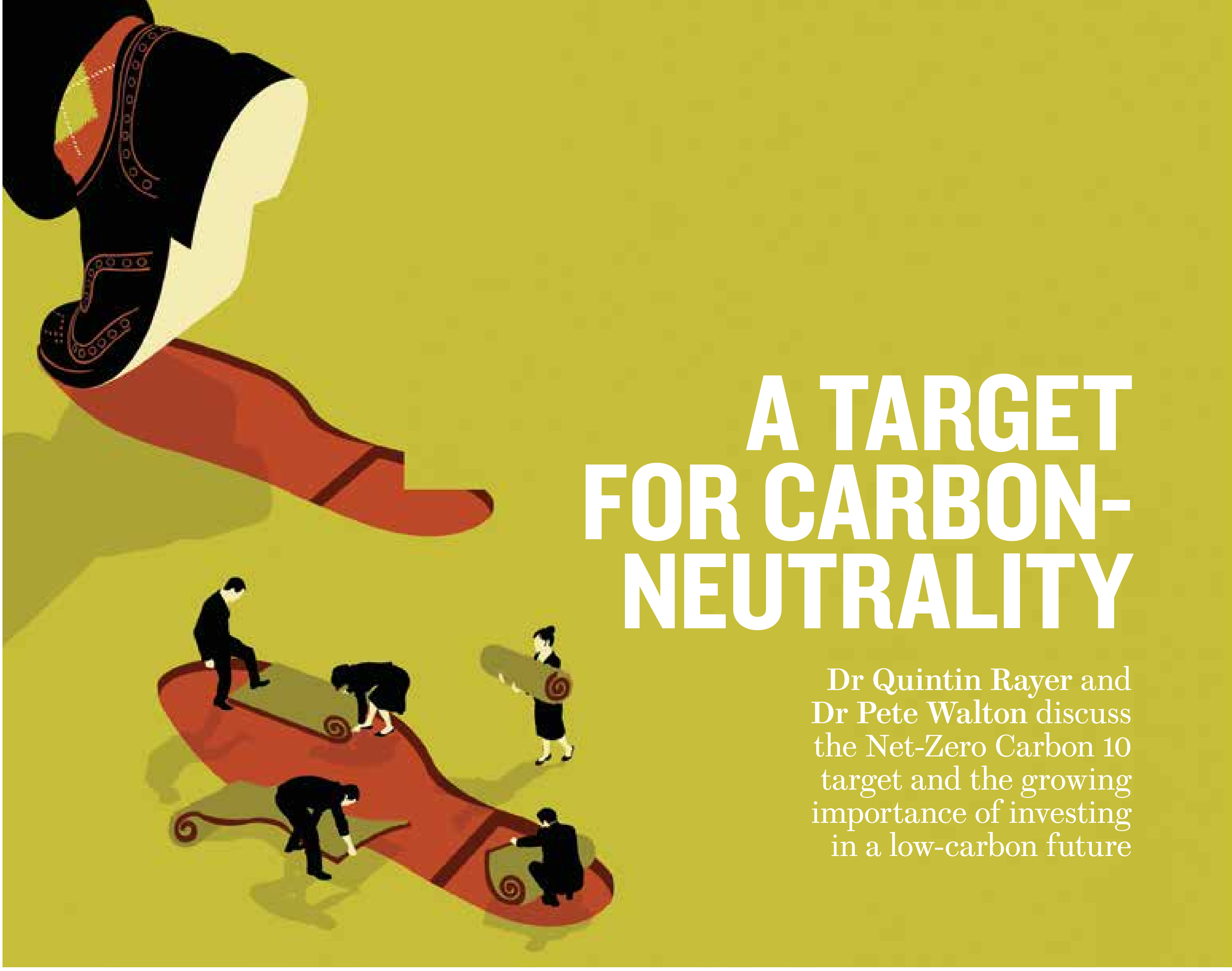

A TARGET FOR CARBON-NEUTRALITY

Dr Quintin Rayer and **Dr Pete Walton** discuss the Net-Zero Carbon 10 target and the growing importance of investing in a low-carbon future

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KEY POINTS

WHAT IS THE ISSUE?
Climate-related investment risks from global warming are increasingly being seen as part of trustees' fiduciary responsibilities, particularly when managing long-term commitments.

WHAT DOES IT MEAN FOR ME?
Trustees need to be able to identify investments consistent with a low-carbon or carbon-neutral future, both to support beneficiaries' wishes and to avoid investment in assets carrying significant 'climate risk'.

WHAT CAN I TAKE AWAY?
Targets identifying investments consistent with a low-carbon future can help practitioners support clients (including pensions and charities) with ethical or sustainable investment mandates and manage exposure to climate risk, thereby making an active contribution to fulfilling practitioners' fiduciary duties.

MANY ADVISORS AND their clients are acutely aware of global warming, with its increasing threats including extreme weather events[1,2] such as heatwaves, sea-level rise and droughts.[3,4,5] While we can invest in adaptation measures, the primary focus must be on reducing emissions of greenhouse gases, particularly carbon dioxide (CO_2). The Pensions and Lifetime Savings Association's *Statement of Investment Principles* has recommended that governance bodies should set out how they believe climate change relates to their investment strategy and how they are mitigating climate change-related risk, and should proactively seek low-carbon investment options.[6]

Despite targets in the 2015 Paris Agreement, under the United Nations Framework Convention on Climate Change, to hold increases in global average temperatures to 'well below 2°C above pre-industrial levels',[7] current warming appears to be heading for at least 3°C by 2100,[8] well ahead of the 1.5–2.0°C goal.[9,10] Emissions reductions of at least 40 per cent by 2030 are needed, with net-zero emissions necessary for global warming to stabilise.[11]

To achieve this, companies must develop genuine strategies that contribute to a carbon-neutral economy: that is, both reducing the amount of CO_2 emitted while identifying solutions to remove CO_2 already in the atmosphere.

THE NZC10 TARGET

Few sustainable fund managers currently challenge company boards on their strategy to achieve net-zero carbon emissions, mainly because they lack a systematic framework with which to begin the conversation.

The Net-Zero Carbon 10 (NZC10) target allows fund managers to better align their investment policies to the requirement for carbon-neutrality, rather than just emissions reduction. This focuses on net-zero emissions, so firms can have some CO_2 emissions, providing these are reliably offset.

The NZC10 target is defined as 10 per cent or more of portfolio assets by value being in firms that:

(i) are carbon-neutral or have net-zero carbon emissions; or
(ii) have realistic, credible strategies using currently available technologies to achieve net-zero carbon emissions by a defined target date no later than 2030; or
(iii) have a fund manager that is actively engaging with the firms to meet point (ii).[12]

NZC10 has been developed by the authors as a practical target that can be implemented by fund managers and easily understood by investors. While P1 Investment Management runs and 'polices' the target, fund managers are not charged for using it, since NZC10 forms part of a wider engagement programme. The intention is to tighten standards to raise the bar. Apart from increasing the percentage of assets required above 10 per cent, it is anticipated this will include minimum engagement requirements and improved definitions for carbon-offsetting standards. Below are some examples of how investment funds have put the target into practice. These are funds from companies with which we are engaging on this project and are, therefore, aligned with the NZC10 target. These funds should not be construed as a shortlist or recommendation for investment, and other funds that have not, as yet, aligned themselves to NZC10 may be working towards similar objectives.

JANUS HENDERSON GLOBAL SUSTAINABLE EQUITY (GLOBAL EQUITY)

The fund already meets the NZC10 standard and the manager found it galvanised its discussions with companies that had started a low-carbon journey, but had no targets to achieve neutrality by 2030. It found its engagement was positively received and felt NZC10 strengthened the quality of dialogue with companies it invests in.

Overall, the manager perceived that the target set ambitious yet achievable goals for carbon reduction to help prevent the disastrous and irreversible consequences of climate change.

LIONTRUST SUSTAINABLE FUTURE CORPORATE BOND (CORPORATE BONDS)

The holdings in this fund were already skewed away from carbon-intensive businesses, making it easier for these companies to approach carbon-neutrality. But the manager found that even the most progressive businesses would still need to scale up their ambition to achieve net-zero carbon in the next decade.

The fund manager regarded the NZC10 initiative as a great challenge to investors and the companies it holds to concentrate on what this urgency means for their business over the next decade, observing that it will be necessary to make bigger and faster CO_2 emissions reductions than most people think.

MONTANARO BETTER WORLD (GLOBAL EQUITY)

This fund focuses on smaller companies with the potential to deliver positive impact. However, smaller companies can lag on setting and reporting non-financial targets. The manager found that just 44 per cent of fund companies reported Scope 1 and 2 emissions,[13] and very few had net-zero carbon strategies. On a positive note, this made them a good target for engagement.

The manager felt its involvement as a long-term shareholder gave it influence. By adopting the NZC10 target, it is now working with all investee companies to encourage them to set, and meet, net-zero carbon targets within a reasonable time frame.

WHEB SUSTAINABILITY (GLOBAL EQUITY)

The manager was delighted to see funds committing to this target and hopes that investors will play their role in avoiding climate breakdown. It believes the NZC10 target is a demanding test of the extent to which fund managers are serious in their efforts to tackle climate change.

Acknowledging that a great deal more work will be necessary to achieve carbon-neutrality, the fund manager will be using the target in an assertive engagement programme with investee companies over the coming year.

CONCLUSION

The participating managers show how responsible investing can help address climate change. Recent UK Committee on Climate Change recommendations for carbon-neutrality by 2050 seem ambitious,[14] but many climate scientists advise stronger action.

The managers felt the target provided an excellent framework for investee firm engagement on carbon-neutrality. Company discussions included acceleration of strategies to achieve neutrality by 2030 rather than 2050. The managers were keen to raise the target above the initial 10 per cent, which will follow the developing climate science under the guidance of P1's external ethical oversight committee.

Sustainable fund managers can demonstrate leadership on global warming in the broader investment and business communities. The NZC10 target provides a clear, systematic framework for investors for conversations with firms they hold. The adoption of this target by commercial fund managers running portfolios with assets under management from GBP160 million to GBP960 million (GBP2.2 billion in total) demonstrates that it can be practically implemented in a real-world context.

p net zero carbon

P1 Investment Management has developed the above logo, which can be used by funds that P1 believes meet the NZC10 target.

1 Jonathon Porritt, *The World in Context: Beyond the business case for sustainable development* (Cambridge Programme for Industry, 2001) **2** Nicholas Stern, *Stern Review* (London: New Economics Foundation, 2006) **3** National Academies of Sciences, Engineering and Medicine, *Attribution of Extreme Weather Events in the Context of Climate Change* (The National Academies Press, 2016) **4** Q. G. Rayer and R. J. Millar, 'Investing in Extreme Weather Conditions', *Citywire Wealth Manager* (8 February 2018), p.36 **5** Q. G. Rayer and R. J. Millar, 'Investing in the Climate', *Physics World* (August 2018), p.17 **6** Pensions and Lifetime Savings Association, *More Light, Less Heat: A framework for pension fund action on climate change* (2017) **7** United Nations Framework Convention on Climate Change, *Adoption of the Paris Agreement* (2015) **8** Climate Action Tracker, available at bit.ly/2XfHxpO (accessed 24 January 2019) **9** Intergovernmental Panel on Climate Change, *Global Warming of 1.5°C* (Switzerland, 2018) **10** Above, note 7 **11** R. J. Millar, C. Hepburn, J. Beddington and M. R. Allen, 'Principles to Guide Investment Towards a Stable Climate', *Nature Climate Change*, Vol 8, pp.2–4 **12** Above, note 9 **13** Scope 1 emissions are direct emissions that originate from sources that are owned and controlled by a company, including, for example, fuel used in company vehicles. Scope 2 emissions are indirect, resulting from energy used by a company, including electricity, steam, heating and cooling. This could include, for example, electricity purchased by a company from an external supplier. Scope 3 emissions cover all indirect emissions arising due to company activities. They include upstream and downstream value-chain emissions, and those of suppliers and customers using their products. **14** Committee on Climate Change, *Net Zero: The UK's contribution to stopping global warming* (May 2019)


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