Cazenove Capital

Net Zero: our engagement with asset managers

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The Net-Zero Asset Manager ("NZAM") initiative was launched in December 2020 and bring together international asset managers committed to aligning their investment activities with the goal of net-zero emissions by 2050 or sooner. Since the launch, the economic and political landscape has shifted dramatically. Russia's invasion of Ukraine led to a surge in energy prices and prompted many countries to focus on energy security, accelerating the energy transition. At the same time, the politicisation of climate change, particularly in the US, has made "net zero" an increasingly challenging topic for investors to navigate.

Fiduciary duty: the key determinant

Where managers believe their fiduciary duty lies is the key determinant of how much, if any, of their AUM they are willing to commit to net zero. Some managers see climate risk as an investment risk and therefore believe incorporating climate risk into investment decisions is part of their fiduciary duty. Others believe that investing to achieve a targeted climate outcome is not consistent with fiduciary duty in the absence of an explicit mandate from clients.

These differing perspective have given rise to two approaches to determining committed AUM.

1) top-down, with asset managers pledging AUM to net zero for asset classes where there are formalized methodologies in place to track and measure decarbonisation

2) bottom-up, where AUM is committed based on whether net zero commitments are written into a client mandate.

The top-down approach is most commonly used by European-based managers. These managers have identified asset classes where methodologies are in place to assess associated emissions (mainly listed equities and listed corporate debt) and made an initial net zero commitment equivalent to AUM in these asset classes. We observed that managers taking this approach see climate transition as a material risk to investment, and therefore position their portfolios in this way. For example, one of the larger asset managers we engaged with committed to including all AUM in listed equities to net zero (45% of total firm AUM). They also made an initial commitment for 55% of that 45% in-scope AUM to have a science-based target (SBT) by 2030.

The most common challenges to reaching 100% of AUM by 2050 relate to the inclusion of sovereign, commodities, alternatives and real-estate asset classes into in-scope AUM, due to the lack of formalized guidance and methodologies.

Conversely, those managers taking a bottom-up approach – predominately US-based managers – may only reach net zero for 100% of AUM by 2050 through clients opting into "sustainable" mandates. Unsurprisingly, we found that these managers had a larger

To better understand how asset managers are navigating the challenges of decarbonising portfolios, we engaged with 21 managers that we invest with. Together, these organisations are responsible for £27 trillion of assets under management ("AUM"). 77% are signatories to the NZAM initiative.

We share below the key takeaways from these engagements.

1) Where a manager believes their fiduciary duty lies is the biggest factor in determining how much AUM, if any, they are willing to commit to net zero. We have seen a clear divide between managers operating in the US and Europe.

2) Educating clients is key. Managers need to be able to provide clients with the tools, data and resources to understand climate risks in order to help them make informed decisions on their investment preferences.

3) Managers need to be able to give clients products aligned with net zero in the capacity that they prefer.

4) Engaging with underlying companies is managers' preferred tool for decarbonising portfolios. We encourage managers to focus on targeting their top emitters and putting engagement policies in place with clear, time-bound targets.

discrepancy between the percentage of AUM that could be in-scope (where methodologies are in place) versus the percentage of AUM that is committed to be in-scope. Whereas managers taking a top-down approach typically committed all assets within asset classes which had a formalized methodology, those taking a bottom-up approach didn't include assets unless there were clear net zero or "sustainable" commitments written into the mandates. We found that the majority of managers who have not made an NZAM commitment are also those taking a bottom-up approach, as this methodology only allows them to commit a very small percentage of their total AUM.

The jurisdiction in which a manager operates in – and therefore the approach to climate risk taken by the regulatory bodies within that jurisdiction – plays a key role in where managers believe their fiduciary duty lies. Managers operating in the US – servicing US clients – tend to take the more conservative approach often due to fears of being caught on the wrong side of regulation or political debate. One manager that we engaged with primarily manages money for pension funds. They told us that they hadn't committed to NZAM for fear of making a commitment that may not align with pension fund trustee preferences.

Educating clients

Managers taking a bottom-up approach tend to think of their fiduciary duty in the context of climate as providing clients with knowledge around climate risk. For these managers, educating clients is therefore key.

Some managers have committed to educating clients yet have not taken into account where this additional resource/capacity will come from – these managers will be a key area of engagement focus for us. Other managers have partnered with research institutions on climate and sustainability-focused research in order to improve the knowledge and resources they can provide to clients. We welcome such initiatives and would encourage clients to take part in any courses and "teach-ins" on offer. Essentially, if the focus is on providing clients with choices – managers should:

1) Ensure they have sufficient resource, tools and buy-in from senior management to deliver clients with the requirements they need to make informed decisions on climate risk.

2) Take into account the additional capacity required to do this and encourage underlying investee companies to provide sufficient data to allow clients to make meaningful choices

Net zero methodologies

A range of methodologies are being used by managers to track and measure the decarbonisation of portfolios with managers using a combination of these approaches.

We found that the most commonly-used approach is the Paris Aligned Investment Initiative Net Zero Investment Framework (NZIF), where managers set portfolio decarbonization targets on carbon intensity reduction. This was followed by the Science Based Target Initiative (SBTi) for Financial Institutions, where managers' targets are based on the percentage of investee companies that have set science-based targets (SBTs).

Due to the lack of standardisation in methodologies used across the industry, we strongly encourage managers to disclose justification for the chosen methodology to allow for better transparency with clients.

Challenges with making a net zero commitment

A common deterrent to making a net zero commitment is the binary decision managers believe they must make when committing to NZAM – to align or not to align, rather than seeing it as a ratcheting up of ambition over the next few decades.

Many managers have expressed a view that only active managers are able to make this commitment, suggesting that net zero commitments can only be embedded into an active fund or an index fund that track companies that decarbonize over time. Passive fund houses described the challenge of taking accountability for transitioning funds where a majority of the investee companies haven't made a net zero target. In these instances, managers emphasized that in order to make a commitment, governments need to encourage underlying companies to act.

Many of our US-based managers referred to the difficulty of making a net zero commitment in the current political environment, expressing concerns over being accused of greenwashing or taking a certain political view. In Europe, where the political backdrop is relatively more unified, managers did not share these concerns. To navigate these differing environments, one US-based manager takes advantage of having separate US and international entities: the latter have committed to NZAM, but the US entities have not.

Of the 33% of managers who have not made an NZAM commitment, very few have surveyed their client base to understand what percentage of their client base would be in favour of them implementing net zero target. If managers want to ensure they are making decisions that reflect both the financial and non-financial preferences of their clients – but do not want to go as far as making a net zero commitment – managers should:

1) Survey their client base to understand both interest and demand for net zero aligned portfolios.

2) Where there is interest, we encourage managers to focus on education of clients on net zero.

3) Where they is demand, managers should ensure they are providing net zero products that satisfy those preferences.

Data challenges and innovative solutions

Some managers expressed concerns around data reporting issues. One manager told us that only 20% of their underlying companies report on emissions. Many managers pointed to inconsistent and unreliable data as a reason not to make a commitment. Others referenced a lack of understanding as to what methodologies and data metrics to use, the challenge around using carbon metrics alone as a measure of success, and the inconsistencies in forward-looking metrics.

Below are some innovative solutions managers have taken to overcome these obstacles:

1) Engagement with investee companies on management strategy to see whether this is consistent with a sustainable business model and with their own net zero commitment.

2) An indicator that generates a quantitative net-zero alignment status for each company based on over 30 metrics from ESG data providers.

3) An analytics platform which includes a carbon attribution tool, allowing PMs to see where the increased carbon intensity of a portfolio is coming from, as well as potential changes that can be made in order to help reach alignment to 1.5C.

It is encouraging to see that some managers, including those that have not made a net zero commitment, have started to invest in extensive infrastructure to support PMs with decarbonizing client portfolios.

Engagement as a key priority

A majority of managers do not have a firm-wide coal phase out policy, and instead have in place fossil fuel revenue thresholds for sustainable mandates. Those that have decided against a firm-wide coal phase out policy tend to cite the belief that divestment is ineffectual relative to other courses of action such as engagement. Those managers that have decided to use engagement have benchmarked their largest emitters - using data from the Climate 100+ Benchmark, for example – to see where engagement is required. Once that is done, they put in place formal engagement frameworks with laggard companies to ensure action is taken. If the focus is on engagement, managers should:

1) Isolate the top 20 emitters (at least) in their underlying funds and create a priority list with key timelines in place for reaching established KPIs. Managers may consider disclosing this list publicly to allow for better transparency with clients.

2) Aim to strike a balance between engagement and divestment as they transition their portfolios.

Challenging areas

Commodities

As part of our engagements, we spoke with a large commodity ETF provider in the UK. This manager expressed the challenges with measuring the carbon footprint of futures-based commodities, and in particular decarbonizing their gold commodities. Currently, the company is working on a carbon-neutral gold product. As gold is typically either used in jewelry or is stored for value, the company defines their carbon measurement in terms of the carbon used in the production of gold. The company is taking efforts to reduce the carbon footprint in the value chain through engaging with its partners to implement carbon reduction practices in the production process.

Sovereigns

A key concern for bond fund managers has been around committing sovereign bond funds as part of in-scope AUM due to the lack of formalized methodology and guidance in place for this asset class. Specifically, managers have expressed challenges with determining how they should engage effectively with sovereigns on net zero. They have also challenged where the line is between where the role of the asset manager begins and ends when it comes to lobbying governments.

Final note

Our engagements have emphasized the need for industry initiatives like NZAM to drive change through building momentum and signaling to underlying companies. Whilst industry initiatives such as NZAM are not perfect – and the financial sector does not have the primary responsibility to act on climate change – pulling out of commitments due to frustrations around the initiative is not the answer in our view. A focus on both educating clients and engagement with underlying investee companies should be a key priority for managers as we transition portfolios to a net zero future – ensuring we incorporate a key investment risk into our portfolios and align accordingly with government priorities.

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