ESG VIEWPOINT

Five challenges for net zero investing

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At a glance

- Net zero' emissions commitments from investors have gathered huge momentum – with over $60 trillion committed by asset managers.
- Several methodologies have emerged to define what 'net zero' investing means in practice.
- Our approach is based on the Net Zero Investment Framework, which we helped to develop.
- We highlight five key challenges we have identified so far in our own implementation process.

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Overview

The Intergovernmental Panel on Climate Change gave the world a stark warning in 2018 of the dangers of failing to limit the global temperature rise from climate change to 1.5 degrees. In recent years we have seen some of the physical impacts of climate change emerge even sooner than many scientists had predicted – including deadly flooding in Europe and China, and the North American ‘heat dome’ that triggered widespread wildfires and continued record breaking temperatures.

In the run-up to November 2021’s COP26 climate negotiations, we saw momentum gather behind the ambition of ‘net zero’ greenhouse gas emissions by 2050, consistent with a 1.5 degree trajectory. Over 3000 businesses are now committed,[1] as well as the world’s major governments. The investor community has joined the push, via initiatives including the Net Zero Asset Managers Initiative – to which Columbia Threadneedle Investments is a signatory – and the Net Zero Asset Owner Alliance.

We have been working on how to fulfil our commitment, and contributing to industry knowledge on net zero investing, particularly through co-chairing the Implementation Working Group for the Net Zero Investment Framework. We have also been discussing our progress with clients, as the net zero journey needs to be a partnership between asset owners and managers. Reaching net zero is critically important, but it is not easy. Here we set out five challenges we have identified so far as we move from commitment to implementation.

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[1] UN Race to Zero campaign

Challenge 1:
Selecting a methodology

There is no single ‘net zero investing’ methodology. Several approaches have been developed by different groups. In our view, this is a healthy reflection of innovative activity on an issue that has emerged incredibly rapidly, almost from a standing start barely two years ago – but it does create the potential for confusion.

Approaches include:

- The Net Zero Investment Framework, part of the Paris Aligned Investment Initiative
- The Asset Owner Alliance Target-Setting Protocol, developed by the UN-convened Asset Owner Alliance
- The Science-based Targets Initiative, which has a methodology for financial institutions
- The EU Paris-Aligned and Transition Benchmarks
- A variety of commercial methodologies from ESG data providers
- Portfolio alignment work from the Task Force on Climate-related Financial Disclosures

Our own approach is based on the Net Zero Investment Framework, which we helped to develop. It is worth noting, though, that there are many common elements between the approaches mentioned above.

A key guiding principle for us is transparency. We have therefore been cautious, so far, of temperature alignment portfolio measures. Whilst robust in theory, temperature alignment metrics can in practice can be a ‘black box’, with multiple assumptions driving the outcome, which are not easy to unpick and understand. Our preference is for a dashboard approach, providing multiple metrics, which can better capture the inherent complexity of the net zero transition.

Challenge 2:
Avoiding perverse incentives

A concern with emissions targets of any kind is that they can encourage decisions that are aimed just at meeting the target, rather than achieving real-world emissions reductions. This risk exists both for companies and for investors.

Through our engagement we have spoken to several companies who, conscious of the intense investor focus on climate change, are wrestling with the choice of whether to invest in carbon reduction technologies for their high-emissions activities – or whether to divest them, which would immediately improve their emissions profile, but result in those emissions transferring to another owner, who might not be as ethically minded or not as transparent (for instance, by going private).

A similar dilemma could present itself to a fund manager with a portfolio-level emissions target to meet. A simple sector reallocation from, say, electric utilities to service industries could achieve the target at the push of a button. But engaging those electric utilities to cut their emissions, and achieving the portfolio target as these cuts are implemented, would have a greater positive impact on the climate.

The answer to this dilemma lies, in part, in what metrics we bring into the analysis. In line with the recommendations of the Net Zero Investment Framework, as well as looking at portfolio-level financed emissions, we are also looking to analyse 'forward-looking metrics' – in other words, assessing the performance of individual portfolio companies over time in aligning with a net zero emissions trajectory. This will enable us to understand the extent to which of our portfolio companies are net zero-aligned, and give us the confidence to continue to hold companies in higher-emissions sectors, if that makes sense from a financial point of view – as long as they are on the right pathway to reduce their impact. It will also allow us to target misaligned companies and use stewardship to encourage them to improve – with a clear message that companies which continue to be misaligned ultimately do not belong in net zero portfolios.

By combining analysis at the company level, together with the objective of cutting emissions at the portfolio level, we believe we can create a richer set of data. This will enable our fund managers to decarbonise their investments in the way that makes sense from both a financial and a climate point of view.

Challenge 3:
Dealing with data gaps

Whilst the use of forward-looking, company-specific data points helps provide a more meaningful analysis of net zero alignment, the approach carries significant challenges in terms of data.

The good news is that nearly 160 of the world's largest corporate emitters – covering around 80% of industrial greenhouse gas emissions – have been systematically scored on their climate performance using the Climate Action 100+ benchmark.

But for other companies, data provision is patchier. We have drawn information from sources including the **Transition Pathway Initiative**, **Carbon Disclosure Project** (CDP) and **Science-based Targets Initiative**, as well as our ESG data provider MSCI. However, corporate disclosure even of simple metrics such as Scope 1 and 2 emissions is not universal, and disclosure of more sophisticated data such as Scope 3 value chain emissions is very partial and often involves estimation. We are working with peers to improve this, such as through collaborative engagement organised by the CDP targeting non-disclosers. We do expect data provision to improve, but this will take time.

The challenge is greater for some sectors than others. Many of our strategies have a heavy exposure to financial institutions, such as banks and insurers, where climate risks come not from direct emissions, but from their loan books or their exposure to insured assets. Reliable, comparable data on financed emissions is not yet available. Instead we are looking at more qualitative indicators, such as the integration of climate factors into lending decisions.

Challenge 4:
Accounting for solution providers

Many companies involved in the manufacture of emissions-savings technologies may have a significant carbon footprint of their own, as compared with some other sectors – but looking just at these direct emissions does not capture the emissions savings they create though their products.

Again, we wish to avoid disincentivising investment in these firms, as we know there is an urgent need to shift capital toward climate solutions.

We see it as vital to highlight investment in solutions as an integral part of a net zero approach. This is something we have already been doing in our Impact Reports for our Responsible and Sustainable funds, where we link company revenues to the Sustainable Development Goals, including SDG7 – Affordable and Clean Energy. The Net Zero Investment Framework recommends measuring and monitoring investment in solutions, using metrics such as alignment with the EU Taxonomy, which provides definitions of 'green' activities.

Some companies have started to report data on 'avoided emissions' – in other words, emissions that are avoided by using a company's products, as compared with other products in the market. This type of data would allow us to quantify some of the benefits these companies bring.

Challenge 5:

Expanding to all asset classes

The commitments made by investors, including ourselves, under the Net Zero Asset Managers Initiative mean transitioning all our assets under management to net zero emissions by 2050. However, whilst methodologies are becoming increasingly available for some asset classes, notably equities, credit and direct real estate, they are significantly less mature for others. We would particularly highlight:

1 Sovereign debt

The Net Zero Investment Framework sets out a broad structure for sovereign debt net zero alignment, but data sources on the alignment of government policies with net zero are not yet comprehensive, and there is not yet a systematic structure for organising investor engagement with governments. The ASCOR project (Assessing Sovereign Climate-related Opportunities and Risks) is an important initiative that is working to address these issues. This is an urgent area to make further progress, given the significance of sovereign debt in many asset owner portfolios.

2 Private equity

In principle, the same approach on net zero alignment should apply to companies in private hands as for publicly listed companies, but the lack of reported data presents a significant challenge. Guidance has recently come out from the Institutional Investors Group on Climate Change to determine how to bring this asset class up to the same standards.

3 Multi-manager funds

Converting a multi-manager strategy to a net zero pathway means collecting information and data from underlying fund managers – which, given the range of methodologies being used, may be difficult to aggregate.

Work is underway to tackle methodology gaps, but it may be that some asset classes need to adopt a net zero approach somewhat later than others.

Final thoughts

Whilst the road to net zero may seem daunting for investors, the work being done by individual investors and through collaboration is rapidly making progress. Being open about the challenges and limitations of the methodologies we use is essential in terms of communicating honestly with clients and other stakeholders, as well as identifying the areas where further work is needed.

We see many opportunities arising from the rapid growth in investor commitment. The analysis of net zero alignment will support the deeper integration of climate risks and opportunities into investment portfolios, through the use of new data sets and analytical techniques. The emphasis on engagement coming out of the methodologies so far developed will add further impetus to investor stewardship, particularly beyond the Climate Action 100+ companies already under intensive focus. And efforts to address data gaps should support better company disclosure, building on progress made by the Task Force on Climate-related Financial Disclosures.

Implementing net zero is a huge challenge. But it's also an exciting new journey for all of us. Being frank about the difficulties we encounter will add to credibility and consistency across the industry. It's critical we get this right, and fast.

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Get to know the author

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Vicki Bakhshi joined the business in 2006, focusing on climate change engagement and strategy. Prior to joining us, she worked in the UK Prime Minister's office advising on climate change. Outside of work she enjoys trail running, and spending time with her two boys.

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