

# Target net-zero portfolios

Addressing climate change is of paramount importance. If unmitigated, it is one of the largest threats to our planet, ecosystems and communities. It is also a threat to investment markets and shareholder value.

- **To address climate change, many investors are setting net-zero emissions targets for their portfolios.** This is a pledge to manage portfolios in a way that has zero greenhouse gas emissions by a certain date. To align with the Paris Climate Change Agreement most investor targets are to achieve 50% emissions reductions by 2030 (compared to a 2018 baseline level) and 100% by 2050.
- **Most investors will not be able to deliver net-zero portfolios in a 'business as usual' world.** Climate change is a systemic and non-diversifiable risk, this means that it is not possible to avoid the negative implications through asset selection alone. For this reason, it is essential that investors with net-zero targets have credible and consistent approaches to pushing for 'real world' decarbonisation.
- **There are two ways to pursue net-zero listed equity portfolios, 'transactions' and 'action'.** 'Transactions' is the attempt to reduce carbon emissions in an investment portfolio by selling high carbon assets and purchasing low carbon ones. Whilst this will reduce the footprint of the portfolio, it is unlikely to have an impact on the real world as the assets will be purchased by another investor and continue to emit. In contrast, 'Action' is where the investor works with their companies to incentivise them to take steps to reduce their footprint. Whilst slower, this approach decarbonises portfolios by genuinely reducing emissions and, in so doing, contributes to 'real world' decarbonisation.
- **CCLA is a signatory to the Net Zero Asset Managers initiative.** We aim to achieve net-zero listed equity portfolios no later than 2050, through 'action, not transactions'. To support this, we have set a maximum carbon footprint ceiling for our listed equity portfolios which decreases year on year in line with relevant climate scenarios. As part of our commitment to 'action', we are seeking to drive decarbonisation through dialogue with our investee companies and engagement with public policy makers.
- **Whilst it is vital to increase the pace of climate action, more ambitious Net Zero targets can reduce investors' ability to drive positive change and significantly constrain their portfolios.** For example, only 43 of 1,489 MSCI World constituents would be investible under a 2030 net-zero aligned portfolio. This would impact the ability to deliver diversification and reduce the ability to engage with companies that need to improve.
- **Work by the University of Oxford has shown that carbon offsets are 'unlikely to deliver the level of emissions reduction needed to achieve global goals'.** These can act as a disincentive for meaningful climate action and should be reserved for the small number of business activities that are essential and have no credible path to zero emissions. For this reason, we do not consider offsets to be an appropriate shortcut to accelerate net-zero portfolios.

### Context

Addressing climate change is of paramount importance. If unmitigated it is one of the largest threats to our planet, ecosystems and communities. Due to its impact, climate change is also a material threat to the functioning of investment markets and shareholder value. Because of this, investors are establishing 'net zero' emission targets for their investment portfolios. But, if they are to impact the pace of climate action, investors need to implement these in a way that goes beyond portfolio measurements and supports the delivery of real-world emissions reductions.

### What are net-zero targets?

A net-zero target is when an actor, in this case an investor, sets a target to achieve 'net-zero greenhouse gas emissions' by a specific date. The majority of net-zero targets focus on achieving 50% emissions reductions by 2030 and 100% by 2050. Whilst the pace of transition matters, as different business sectors need to decarbonise more quickly than others at a systemic level this is broadly seen as being in line with the goals of the 2015 Paris Agreement.

But what is 'net zero'? The Intergovernmental Panel on Climate Change defines net zero as being 'when anthropogenic emissions of greenhouse gases to the atmosphere are balanced by anthropogenic removals over a specified period.'

Race to Zero, the UN Framework Convention on Climate Change's emissions reduction initiative, further clarifies that 'net zero' is when, 'an actor reduces its emissions following science-based pathways, with any remaining greenhouse gas emissions attributable to that actor being fully neutralized by like-for-like removals exclusively claimed by that actor, either within the value chain or through purchase of valid offset credits'.

This is different from 'absolute zero', which requires a company to achieve their emissions target by generating no emissions (rather than offsetting), and 'climate neutrality', which has a lower threshold than 'net zero' for the credibility of any emissions offsets that are used. In contrast to net zero or absolute zero, climate neutrality is, therefore, not seen as a credible final 'end-state target' if the goal is to reduce global temperature rises.

For investors with net-zero targets, this means that portfolios need to be comprised of assets that have reduced their emissions to a minimal level and have credible, permanent, plans for negating any residual emissions that cannot be reduced to zero.

### Why set a net-zero target?

There are two reasons why investors wish to seek a net-zero emissions target. Mission-driven investors wish to use it as a tool to accelerate the world's climate action. Many other investors wish to use it as a way of containing the financial risks associated with climate change. It is widely acknowledged that, as the world decarbonises, carbon intensive assets can be placed at risk by legislation, regulation and changing consumer preferences. Therefore, a decreasing carbon footprint can be used as a proxy for managing the risks associated with exposure to these assets. However, this is contingent upon the world actually decarbonising.

## Net-zero portfolios cannot be delivered in a business-as-usual world

Whilst investors have control over their portfolio actions and can be a significant 'force for good' in accelerating the pace of climate action, they invest in the 'real economy'. This means that if the world does not decarbonise at a sufficient rate, no matter how well intentioned or actively pursued, it will not be possible for the majority of net-zero portfolio targets to be realised.

This is recognised in the Net Zero Asset Managers Initiatives pledge, which states that 'these commitments are made in the expectation that governments will follow through on their own commitments to ensure the objectives of the Paris Agreement are met, including increasing the ambition of Nationally Determined Contributions'.

### Mandates are important

Similarly, mandates are important to ensure the alignment of asset owner and asset manager on the transition to net zero.

A [recent research paper](#) highlighted that the increasing gap between real world emissions rises (with the UN environment programme recently stating that there is currently ‘no credible pathway’ in place to limiting temperature rises to 1.5 degrees) and 1.5 degree aligned net-zero portfolio targets gives rise to concerns about short-term fiduciary duty. For example, the authors were concerned that such targets could result in investment managers disadvantaging their clients by selecting assets in a way that is aligned to an unlikely outcome. This concern can only be alleviated by asset owners explicitly including net-zero targets in their investment mandates and understanding the potential portfolio consequences of that decision in the short term.

However, despite concerns about the current pace of change – and its resultant impact, or otherwise, on portfolio composition – it is important that we continue to push for change.

### Supporting net zero

As per the stark warnings made by the recent Intergovernmental Panel on Climate Change’s report, if unmitigated, climate change will continue to lead to increased poverty in many low-income countries, erratic weather patterns and accelerated biodiversity loss.

In addition to affecting our livelihoods, we are conscious that a failure to act on climate issues will lead to market instability and poor outcomes for investors over the long term. For instance, loss of biodiversity and natural resource crises are all listed by the [World Economic Forum](#) as key global risks for companies and the functioning of the global economy.

This is the path that we are currently on. Current international policies, as measured by [Climate Action Tracker](#), are expected to only limit temperature rises to 2.7–3.4 degrees above pre-industrial levels. Despite significant progress, this is far above the desire to limit temperature rises to 1.5 degrees as set out in the 2015 Paris Climate Change Agreement and, as of 2022, we have already reached a warming level of approximately 1.2 degrees.

For this reason, we believe that accelerating the transition to net-zero emissions as soon as possible is essential. Therefore, CCLA is a signatory to the Net Zero Asset Managers initiative. We have set targets to achieve net-zero emissions in listed equity no later than 2050 and have an ambition to do so in our other directly managed asset classes. However, as our motivation is to use the target to drive climate action, we think it is essential that we implement this target in a way that actively drives change.

## Net zero through ‘action’ not ‘transactions’

Over the long term, net-zero portfolios need to be achieved through real-world emissions reductions, as this is the only way to stop the negative impact of climate change.

By this we mean that, where possible, it is important to reduce portfolio emissions by using tools, such as engagement, to encourage investee companies to lower their emissions in line with a science-based decarbonisation target (action), rather than lowering the portfolios footprint by selling our higher carbon companies and purchasing lower carbon ones (transactions).

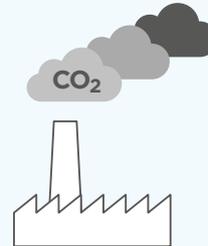
To further explain this, we believe that whilst selling high carbon and purchasing low carbon businesses would cut portfolio emissions in line with a potential net-zero target, it would have little or no climate impact. Instead, these businesses would be bought by another investor and would continue to emit at the same level. This means that whilst ‘portfolio emissions’ are lower, ‘real-world’ emissions continue to be the same and there is no positive impact in the fight against climate change.

However, through engagement, and other tools at the disposal of investors, the investor – as a part owner – can encourage the company to cut emissions. When successful, this not only reduces the portfolio’s carbon footprint it also reduces real world emissions. This is set out in the diagram on the next page.

## TRANSACTIONS vs ACTIONS

### Pre-portfolio decarbonisation

Prior to decarbonisation the portfolio has substantial emissions.

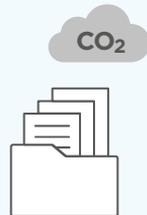


### Transactions approach

To achieve decarbonisation the investor sells a 'high carbon' holding and purchases a lower carbon-emitting company.

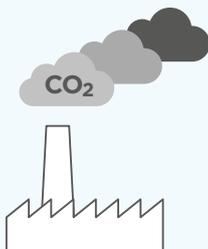
### Portfolio emissions outcome

As a result of the sale and purchase transaction, the investment portfolio's carbon footprint shrinks.



### 'Real world' emissions outcome

However, as the company has been purchased by another investor the company's emissions - and negative impact - remain the same.



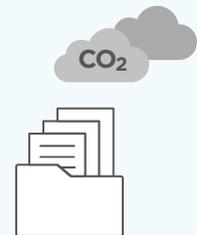
### Action approach

To achieve decarbonisation the investor engages with the company with the aim of pushing it to take new actions to reduce emissions.

### Portfolio emissions outcome

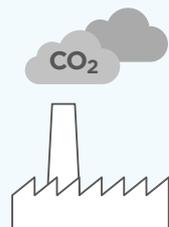
As a result of the engagement the company implements a new emissions reduction initiative and the portfolio's carbon footprint shrinks in line with this change.

Given the gradual nature of this process this is likely to be a smaller initial reduction in the portfolio's footprint.



### 'Real world' emissions outcome

However, as the company has reduced its climate impact 'real world' emissions have also fallen.



**This means that the investor's approach to net zero has encouraged action that has a positive climate impact.**

In addition to engaging with companies, investors are able to take other 'actions' to increase the pace of climate action. This includes lobbying public policy makers to increase the ambition of climate regulation and allocating new capital to projects – such as the introduction of new renewable energy capacity – that will have a positive climate impact.

## Is offsetting the answer?

Appropriate carbon offsetting will be an essential component of achieving net-zero emissions globally. However, offsets can be a disincentive for action, misused and ineffective. In addition, despite their importance, there is no recognised global approach to offsetting emissions.

For this reason, the Smith School of Enterprise and the Environment has developed the Oxford Offsetting Principles. Recognising that current approaches to offsetting are 'unlikely to deliver the level of emissions reduction needed to achieve global goals' the principles set out four main elements for credible net-zero aligned-offsetting. These are:

1. Prioritise reduction of your own emissions first, ensure the environmental integrity of offsets you use and disclose how those offsets operate.
2. Shift offsetting towards options that directly remove carbon from the atmosphere.
3. Shift offsetting towards long-lived storage, which removes carbon from the atmosphere permanently or almost permanently.
4. Support development of a market for net-zero-aligned offsets.

For investors, this broadly means that:

- the focus should be on promoting decarbonisation, rather than offsetting
- any offsets used should be focused on negating essential activities that are currently impossible to decarbonise at scale
- they should actively remove carbon from the environment rather than counting activities that just 'avoid' the generation of emissions.

Offsetting should not be used as a short cut for achieving or accelerating portfolio net-zero targets.

## CCLA's net-zero targets

We have set net-zero targets for all our listed equity portfolios, which we aim to achieve through the 'action' rather than the 'transaction' route.

To fit with this approach, we have chosen to set our decarbonisation targets through a decreasing maximum carbon footprint based upon the MSCI World Index. This approach ensures that we are not taking significant short-term regulatory risk, by driving radical 'buy and sell' decisions today, controls our aggregate 'carbon exposure' to a level below the market average, and allows us the freedom to invest in companies and use our active ownership expertise to drive change.

As set out in the chart below, the decreasing ceiling of emissions is initially based on the 2018 emissions of the MSCI World Index and decreases year on year at a rate informed by the Intergovernmental Panel on Climate Change Special Report on Global Warming 1.5 Degrees Celsius and the work of the UN Environment Programme.

We are aware that the science of setting climate targets that focus on real world emissions reductions is a complex and evolving area. With this in mind, we continually monitor the best available science and methodology for setting these targets. We expect that over time, our targets will evolve and improve to reflect the developing field.

## Portfolio performance

All our listed equity portfolios (and the listed equity components of our multi-asset funds) are managed in a way that is less carbon intensive than the MSCI World Index and are below our maximum carbon ceiling.

The below graph shows CCLA listed equities across all our funds, which are well below the target.

## How are we driving action?

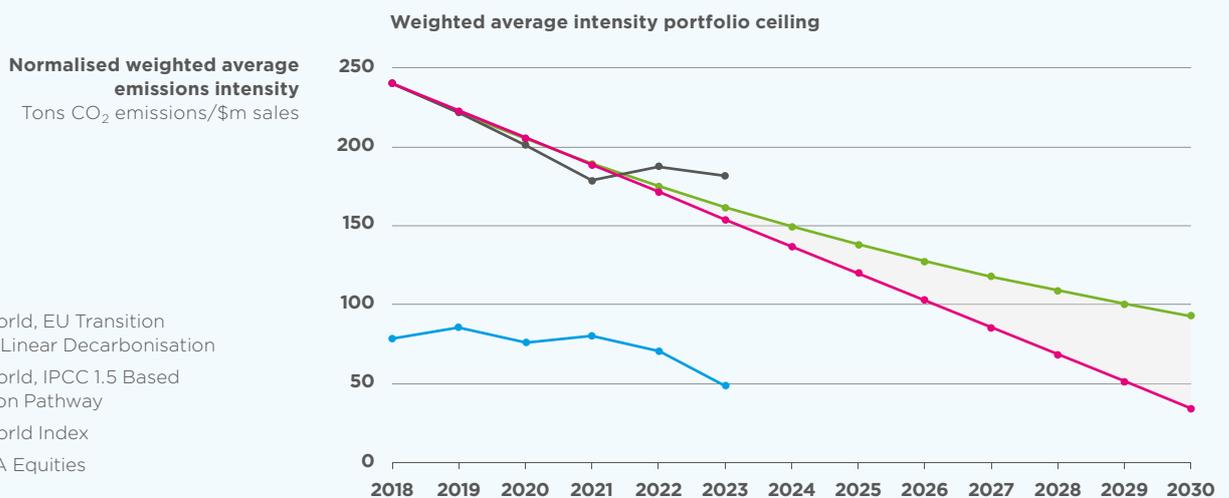
Our approach to driving climate action in our listed equity portfolios is based on two approaches:

1. **Pushing for better regulation and legislation.** Progressive legislation is essential in efforts to transition to a low-carbon economy. If legislation can be strengthened it will have the impact of increasing all companies' climate action, not just those in a portfolio. To this end, we are members of the Institutional Investors Group on Climate Change and support other initiatives that advocate for appropriate climate related public policy. This includes the UK and Canadian governments' Powering Past Coal Alliance.

2. **Corporate engagement.** Investors can be highly influential in encouraging companies to take steps to reduce their own environmental impacts. We have a very long track record of engaging companies about climate change and, in 2012, we were instrumental in bringing the investment industry together on this topic through Climate Action 100+'s forerunner 'Aiming for A'. Today, the primary focus of our climate stewardship program targets the most carbon-intensive businesses in our portfolios, such as electrical utilities. Our engagement also extends to banks, many of whom continue to finance fossil fuel extraction, production and refining.

In addition, in our multi-asset funds we seek to allocate capital to assets that have a beneficial climate impact. The OECD estimates that approximately \$6.9 trillion is needed in investment every year through to 2030 to meet climate and development objectives. That said, purchasing assets that already exist on the secondary market has little positive real-world impact. Where we can, we prefer to identify and invest in assets on the primary market.

### NET-ZERO TARGET SETTING



Source: IPCC, MSCI and CCLA, 31 December 2022.

### Climate engagement in action

One, current, example of our climate engagement is with Bank of America where we co-filed a shareholder resolution developed by As You Sow, a non-governmental organisation, for the 2023 annual general meeting. Through the resolution we are asking Bank of America to issue a report disclosing a transition plan that describes how it intends to align its financing activities with its 2030 sectoral greenhouse gas emissions reduction targets. This should include the specific measures and policies to be implemented, reductions to be achieved by such measures and policies, and timelines for implementation and associated emission reductions.

### Minimum standards

There are, however, some assets that we will not invest in as we believe that they are significantly behind the transition to a low carbon economy and engagement is unlikely to deliver change in the timeframe required. To this end, we do not invest directly in any companies that focus on extracting, producing or refining coal, oil sands, oil or gas (as defined by a revenue threshold).

### Why not sooner than 2050?

CCLA aims to achieve net-zero emissions in all listed equity portfolios by 2050. This target reflects the requirement to achieve net zero through real world action. Achieving net-zero portfolios this way is inherently slower than through 'transactions', however we believe that it is the only way to use the power of investments to genuinely be a force for good.

According to data from MSCI, only 43 of the 1,489 constituents of the MSCI World Index (which comprises the largest businesses in the developed markets) have set 2030 net-zero targets. Whilst several of these companies are held by CCLA, limiting our investment universe to these businesses (as would be required should we aim for 2030 net-zero portfolios) would significantly constrain our ability to build diversified portfolios and, from a sustainability perspective, limit our ability to engage with the companies that most need investor support to improve.

### Summary

Despite significant rhetoric the world is not where it needs to be on addressing climate change. This is bad for people, planet and portfolios. Net-zero targets are essential in accelerating the change that we need to see, but if they are to make a difference, must be delivered in a way that decreases 'real world' – rather than just portfolio – emissions. This takes time, but is the best way that investors can contribute to the fight against climate change.

More 'ambitious' targets can speed up portfolio decarbonisation but, by reducing the ability for investors to engage with the companies that need it most, reduce the ability to drive positive change.

## WANT TO KNOW MORE?

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# CCLA

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