Reaching net zero: Our approach

John Hoeppner
Head of US Stewardship and Sustainable Investments
LGIM America

Fighting climate change requires global greenhouse gas emissions to reach net zero. As an asset manager, we are committed to playing our part in this critical mission.

LGIM has committed to **work in partnership** with our clients to reach **net-zero greenhouse gas emissions by 2050 or sooner** across all assets under management. In addition, drawing on industry best practice, we have set out LGIM's key requirements **for a strategy or investment portfolio** to be considered net zero aligned.

Our overarching ambition is to help decarbonize the real economy. To this end, we have also committed to strengthening our standards as the progress made by companies and governments worldwide accelerates.

What does this mean in practice for a portfolio?

1 Set targets

- Net zero greenhouse gas emissions by 2050
- Either a reduction of at **least 50% in carbon intensity by 2030** relative to 2019 baseline[1] or portfolio **temperature alignment of 1.5°C by 2030**[2]
- These are two key milestones informed by the recommendations of the Intergovernmental Panel on Climate Change

2 Adopt a decarbonization pathway

- The investment process will incorporate a **mechanism to make progress over time towards the targets set**
- Multiple approaches could be pursued (potentially in conjunction) **based on carbon emissions or temperature alignment** for the entire portfolio and/or for key sectors (such as utilities). Options include setting top-down targets for the average profile of a portfolio, or bottom-up requirements for securities to be eligible – e.g. specifying a temperature alignment threshold for issuers on portfolio launch[3]

3 Engage for change

- Engagement with investee companies to achieve real economy emissions reductions is critical
- As a firm, we are recognized for using our scale and the weight of our votes in advocacy and engaging with policy makers, regulators and companies on climate change
- Our longstanding engagement program, the Climate Impact Pledge,[4] targets companies associated with about 60% of greenhouse gas emissions from listed businesses[5]

LGIM

- Through both direct and collaborative engagement, we will ensure that in net-zero portfolios **we engage with issuers responsible for more than 50% of a portfolio's associated emissions**
- We will increase this figure further over time, in line with best practice set out in key net-zero investment frameworks[6]

4 Exclude misaligned companies that are not making sufficient progress

- We will exclude companies involved in **new thermal coal and new oil sands projects***
- These represent sector-based exclusions at a strategy's launch, while other exclusions may be applied depending on the emissions profile of a company over time or as a sanction under the Climate Impact Pledge
- These exclusions will evolve in time in line commitments by corporates and policy makers

5 Grow 'green' opportunities

- We will grow the proportion of the portfolio allocated to low-carbon investments[7] where possible for the mandate
- LGIM will continue to develop the capability for the portfolios we manage to allocate to low-carbon investments across asset classes

In devising the standards detailed above, we have sought to incorporate elements of best practice from three investment frameworks: 1) the Net Zero Investment Framework from the Paris-Aligned Investment Initiative;[8] 2) the UN-convened Net-Zero Asset Owners Alliance;[9] 3) the Science-Based Targets Initiative.[10] We recognize that industry guidance is evolving fast; we will continue to build on our approach.

Net-zero challenges

There are some key challenges to consider when aligning investment strategies to net zero. Less than 10% of companies today are on track for net zero[11] – meaning that for most diversified investors, we believe the most significant question is not whether a portfolio is net zero today, but how to devise strategies that effect long-term change in the market. This has a number of important implications, which we outline below.

The real economy

Net zero means that, on average at the global level, carbon-emitting 'assets' must match carbon-absorbing 'liabilities'. This does not mean that every company, sector or country will move at the same speed, and some emissions will be inevitable.

What is LGIM doing?

We are developing the analytics – such as our Destination@ Risk climate modeling toolkit – to understand better which companies and countries are making progress towards net zero, and to attempt to quantify their related financial risks. We are further evolving our product range aligned with net zero and will continue to monitor and review our strategies in light of the progress made in the real economy. At the same time, we will ratchet up our engagement with corporates and governments to help accelerate this progress, through programs such as our Climate Impact Pledge.

Asset classes

What is the carbon footprint of a portfolio that holds no assets, just US dollars? Or inflation-linked derivatives? Whereas it is relatively easier to devise strategies around entities with attributable or reported emissions, such as companies, there is as yet no universally agreed methodology for some asset classes, such as cash, or for consistent measurement of different asset-class metrics within multi-asset portfolios .

What is LGIM doing?

We will continue to collaborate with regulators and industry peers – in initiatives like the Glasgow Financial Alliance for Net Zero – to help create more consistent, harmonized standards for net-zero investing across asset classes. The conversations are most advanced around net-zero alignment of listed equity, debt and real estate; we will seek to expand our approach as data and standardization improves in this fast-moving area.

Exclusions

The net-zero challenge is broader than merely excluding high-emitting sectors, as all companies generate some emissions – either directly through their operations (Scope 1 and 2) or through their value chain (Scope 3). Some high emitters, such as mining companies, will have an important role in developing and investing in solutions. Unilaterally divesting holdings is, therefore, not guaranteed to lead to the decarbonization of the real economy and indeed could impede necessary investment in climate solutions.

*This is in addition to applying within these strategies our LGIM-wide coal exclusion policy.

What is LGIM doing?
Our choice of initial exclusions – new thermal coal and new oil sands* – targets some of the highest-carbon sectors of the global economy, which are structurally misaligned to the direction of travel, and to which cleaner, cheaper alternatives are increasingly available. They are also designed pragmatically, so as not to immediately and substantially reduce diversification – and increase turnover and costs – for some of the existing portfolios that are committing to net zero.

Over the next decade, as the deadline for halving carbon intensity approaches, issuers that are not making substantial progress in reducing their own emissions – regardless of their sector – are likely to find themselves at risk of exclusions from the growing share of LGIM assets managed in line with net zero. Where relevant, we may also seek to apply further exclusions – for example, sanctions under our Climate Impact Pledge, or more stringent temperature-alignment requirements.

Offsets
For net-zero-aligned portfolios, we have not committed to large-scale purchases of carbon credits to offset the emissions associated with portfolios, as our aim is to **prioritize real-world emissions reductions**.

A net-zero world
In summary, at LGIM, we are continually evolving our capability to meet these challenges, **providing climate solutions** across asset classes and investment strategies for our clients.

LGIM will continue to debate and collaborate with regulators, stakeholders and industry peers to help create more consistent, harmonized standards for net-zero investing across asset classes. We will do this through our involvement in initiatives like the Glasgow Financial Alliance for Net Zero, as well as via the key role held by our CEO, Michelle Scrimgeour, as co-chair of the COP26 Business Leaders Group.

We all have a role to play in tackling the systemic issues facing people and the planet; **both asset owners and asset managers** will play a crucial part in reaching a net-zero world.

* In addition to those exclusions set under LGIM's coal policy.

Find out more

- LGIM's Climate Impact Pledge engagement program, focused on net zero, providing credible incentives for companies to step up on sustainability: https://www.lgima.com/landg-assets/lgima/insights/esg/renewing-our-climate-impact-pledge.pdf
- Our commitment to net zero: https://www.lgima.com/media/2021/climate-impact-pledge/
- The Net Zero Asset Managers Initiative: https://www.netzeroassetmanagers.org/

[1] Relative to portfolio or reference index. For portfolios launched at later dates the 50% reduction can be pro-rated over the remaining time to 2030. Carbon intensity is to be calculated as carbon emissions divided by revenue or enterprise value including cash (EVIC). As part of our monitoring, we will seek to address any reductions in emissions intensity resulting from inflation or asset price increases.
[2] In certain portfolios (for example, actively managed portfolios) it is possible that changes of asset allocation (for example, switching from financials to utilities) may result in an increase in carbon footprint, even if the chosen securities represent the best in class from a climate performance. That is why we are proposing the use of 1.5°C temperature alignment (which means that the average expected rate of decarbonization of the portfolios in 2030 is on track for a net zero trajectory by 2050).
[3] For an illustration of such an approach, "Assuming a reference index that is aligned to a three-degree climate outcome, [we would] seek to decarbonize the portfolio by 30% in the first year, by screening out a portion of the highest emitters. The portfolio would also reduce its alignment from three to 2.5 degrees. […]. For the next decade, the portfolio manager would need both to reduce the temperature alignment of the portfolio by 0.1 degrees [each year], while simultaneously decarbonizing at a portfolio level. By 2025 the portfolio would be on track for an 80% reduction in emissions […] By 2030, the portfolio would be in full alignment with net zero, and on track for net zero by 2050, assuming the investee companies continue to deliver on their forward commitments." (Source: https://www.lgim.com/uk/en/insights/our-thinking/esg-and-long-term-themes/net-zero-a-practical-guide-for-investors/)
[4] https://www.lgim.com/uk/en/responsible-investing/climate-impact-pledge
[5] https://www.lgimblog.com/categories/esg-and-long-term-themes/climate-impact-pledge/
[6] For example, the Paris-Aligned Investment Initiative recommends "at least 70% of financed emissions in material sectors are either net zero, aligned to a net zero pathway, or the subject of direct or collective engagement and stewardship actions"
[7] Given the relative scarcity of companies disclosing line-item 'green' revenues, the extent to which, for example, an index portfolio tracking market capitalisation may be able to invest in climate solutions may be limited by tracking error constraints.
[8] https://www.parisalignedinvestment.org/media/2021/03/PAII_Net-Zero-Investment-Framework-1.0_Implementation-Guide.pdf
[9] https://www.unepfi.org/net-zero-alliance/resources/alliance-2025-target-setting-protocol/
[10] https://sciencebasedtargets.org/resources/legacy/2020/10/SBTi-Finance-Criteria-and-Recommendations-Pilot-Version.pdf
[11] Source: LGIM analysis, as at June 2021.

Contact us

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