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Clearing the Smoke

A Review of Asset Manager Interim Net-Zero Targets

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Summary

As of its November 2022 update, the Net Zero Asset Managers Initiative (NZAMI) had grown to 291 asset managers representing $66trn assets under management (AUM). Of those, 169 asset managers with $55trn of AUM had disclosed their initial interim targets. Asset managers have a crucial role to play in addressing climate change, using their capital allocation and stewardship tools to catalyse the de-carbonisation of the global economy. NZAMI has convened significant financial scale as its signatories formalise their commitment to this de-carbonisation through setting Net-Zero targets.

The carbon budget means the **journey** to Net-Zero is just as important as the **destination.** Thus the robustness of **interim** Net-Zero targets, which signpost that journey, are a critical component of the ultimate commitment to a Net-Zero goal. In this note we dig into the interim Net-Zero targets set by asset managers, working through the complexity and wide variation in approach, to assess whether these targets map out an effective route to NZAMI's defined destination of limiting global warming to 1.5°C.

The current framing of interim targets allow for material potential divergence from the stated goal of:

"a fair share of the -50% global reduction in CO2 identified as a requirement in the IPCC special report on global warming of 1.5°C".

In this report, we discuss four areas where this potential for divergence is present and suggest approaches to enhance their alignment to the 1.5°C target:

i. **Asset Coverage** – the 169 asset managers who disclosed their interim targets as of the November 2022 update committed just a minority - 39% on average - of their total AUM to those targets. This reflects limitations in data and agreed methodologies for calculating the emissions of certain asset classes, plus differing interpretations of whether client approval for adopting interim targets can be presumed. These are genuine challenges, but committing only a minority of assets serves to undermine the confidence in and comparability of those targets.

   We recommend that asset managers; report on and anchor targets to gross direct corporate emissions; provide a granular breakdown of uncommitted assets; outline the process for and progress in increasing the committed portion; estimate the emission-materiality of the uncommitted assets; commit to the adoption of Scope 3 targets; disclose the use of and rationale for portfolio-level offsets.

ii. **Target Construction** – there is wide variation in the target methodologies used. Some asset managers set Portfolio Alignment targets, which emphasises the engagement lever. Some asset managers set Emission Intensity targets, either relative to revenues of the portfolio companies or to the market value of the portfolio itself. Only 8 of the 65 largest asset managers[1] have set Absolute targets for emission reduction. We believe only Absolute targets necessarily correspond to the -50% emission reduction required for the 1.5°C

[1] Defined as those asset managers with more than $100bn AUM. Throughout this report, we focus on this sub-set of asset managers who have reported interim targets, to reflect the complexities faced by larger asset managers in setting those targets. This sub-set captures the vast majority – over $46trn or 96% – of the total AUM of target-setting asset managers

pathway. Denominator-distortion impacts on Intensity metrics and uncertain emissions' trajectory of less-than-aligned companies in the Portfolio Alignment approach structurally risk under-shooting the -50% emission reduction goal.

We recommend that asset managers migrate to Absolute (Financed Emissions) targets, with the baseline adjusted for net inflows or outflows. Other target approaches used in addition can serve to reinforce the Absolute target.

iii. **Portfolio Composition** – orderly transition will require the majority of today's high-carbon companies to de-carbonise their footprints while retaining their commercial presence - although there will be some increased creative destruction as clean technologies are deployed and new corporate actors emerge. Those high-carbon companies will need affordable capital and engaged shareholders to achieve transition. Thus, meeting interim targets through mass rotation from high-carbon to low-carbon assets will not deliver real-world transition - reductions in portfolio emissions need to have real-world linkage to be effective, as required by NZAMI.

That is not to say asset managers should pursue a status quo approach. Asset managers should actively recycle capital to those high-carbon companies most willing and able to transition. They should engage with urgency with those high-carbon companies who are able but less willing to transition at the required speed. And they should be willing to under-weight or divest those companies whose ability or willingness to transition is proving inadequate.

We recommend that asset managers place real-world impact at the heart of their Net-Zero targets and clearly identify progress on emissions from the underlying portfolio companies through attribution disclosure. They should consider bringing underlying emissions into their interim targets.

iv. **Target Ambition** – the -50% emission reduction goal is a *global* average. Companies in developed countries will need to de-carbonise more quickly than the global goal in order to accommodate a slower de-carbonisation from companies in emerging countries, who are facing higher underlying demand growth and have less access to capital.

We recommend that portfolios weighted to developed countries should target emission reduction beyond -50% by 2030.

NZAMI Commitment

To begin with, it is worth providing an overview of what joining NZAMI means. NZAMI signatories commit to:

"support the goal of net zero greenhouse gas (GHG) emissions by 2050, in line with global efforts to limit warming to 1.5°C…[and] to support investing aligned with net zero emissions by 2050 or sooner".

Within this commitment, asset managers agree to:

"prioritise real economy emissions reductions, consider material Scope 3 emissions, increase investment in climate solutions and create investment products in line with Net-Zero…[and] only

use offsets that involve long-term carbon removal where there are no technologically and/ or financially viable ways to eliminate emissions".

Signatories are required to:

"set interim targets for 2030, consistent with a fair share of the 50% global reduction in CO2 identified as a requirement in the IPCC special report on global warming of 1.5°C".

The asset manager has freedom to determine:

"the proportion of assets to be managed in line with the attainment of net zero emissions by 2050 or sooner".

It should aim to increase this portion over time, to 100%.

Furthermore, members are required to provide transparency, including "information and analytics on net zero investing and climate risk and opportunity" to asset owner clients (with whom members must collaborate on de-carbonisation goals) and also publish an annual TCFD (Task Force on Climate-Related Financial Disclosures) report including a climate action plan.

Engagement with portfolio companies is a core feature of the commitment, requiring asset managers to:

"implement a stewardship and engagement strategy, with a clear escalation and voting policy, that is consistent with our ambition for all assets under management to achieve net zero emissions by 2050 or sooner".

The commitment also requires engaging with policy-makers and with other actors in the financial system such as credit rating agencies, auditors and proxy advisers.

It is important to reflect on the nature of the commitment being made by asset managers: de-carbonisation can only ultimately be delivered by companies themselves (who emit through the process of product creation and/or embed carbon in those products, which is emitted further along the value chain). Asset managers cannot directly deliver real-world de-carbonisation. Thus there is an element of this commitment being of **best efforts** to influence and support, rather than a **guarantee** of the outcome (at least, if an asset manager is to remain invested across the real-economy, as required).

However, the dual levers of capital allocation and stewardship are powerful. We believe that if these best efforts are made through a judicious use of both levers with the appropriate urgency, asset managers can catalyse de-carbonisation across the real economy in line with the Net-Zero goal. In other words, without directly controlling the outcome, asset managers have sufficient agency in that outcome that some expectation can be reasonably attached to their Net-Zero commitment.

We recognise that the capital allocation lever is muted for passive or indexed investment strategies. It still exists in the form of index or product creation (in particular those aimed explicitly at mobilising transition) and in educating clients on how those products align to the Net-Zero goal, as well as advocating with index providers to align existing indices to the 1.5°C goal. But the capital allocation lever is less dynamic for passive strategies, which increases their responsibility to use the stewardship lever effectively to encourage their portfolio companies onto a Net-Zero aligned transition path.

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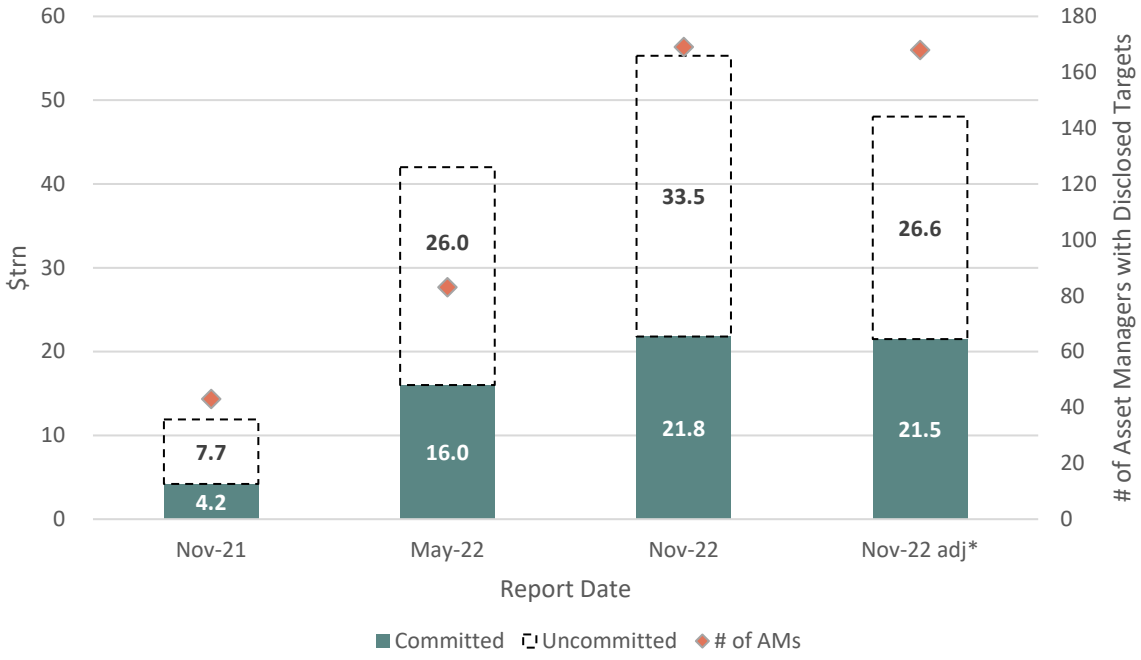
Overview of Interim Targets

Of the 169 asset managers (representing $55trn AUM) who have disclosed their interim targets, 43 ($12trn AUM) did so for the November 2021 NZAMI update, a further 40 ($30trn AUM) did so for the May 2022 update (as well as updated targets from two asset managers) and 86 ($13trn AUM) for the latest update in November 2022. However, Vanguard, with a little over $7trn AUM[2], withdrew from NZAMI in December 2022 reducing the total AUM of asset managers who have disclosed targets to $48trn.

Figure 1: Progress of NZAMI Targets



We explore four aspects of these interim targets: 1. Asset Coverage 2. Target Construction 3. Portfolio Composition and 4. Target Ambition.

1. Asset Coverage

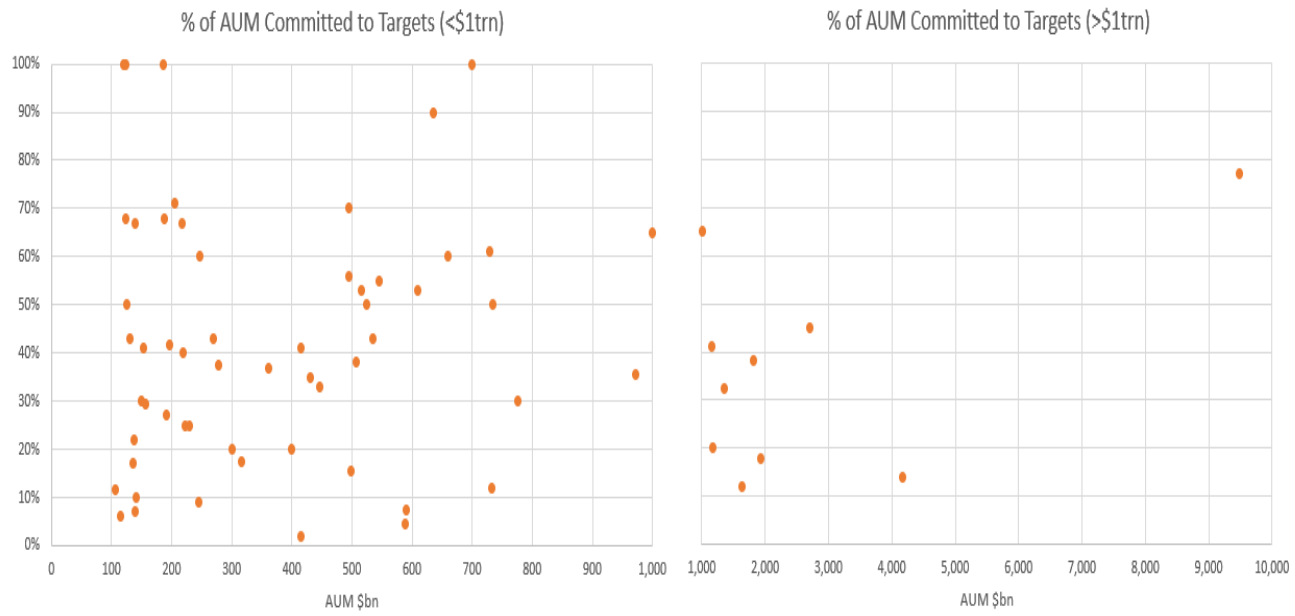
As of the November 2022 update, just less than $22trn, or 39%, of the $55trn total AUM of disclosing asset managers was committed to their interim targets, with $33trn AUM remaining uncommitted. This 39% figure was comparable to the average committed portion at the prior updates - 39% or $16trn committed out of $42trn AUM in the May 2022 update and 35% or $4trn

[2] AUM figure inferred from the May 2022 NZAMI update which showed Vanguard committing $290bn of assets to its interim target, being 4% of total AUM

committed out of $12trn AUM in the November 2021 update. We estimate the average committed portion adjusting for Vanguard's withdrawal would have been 45% at November 2022, while for our sub-set of asset managers with more than $100bn AUM (again, excluding Vanguard) the average committed portion was 44%.

There was wide dispersion around this average: 25 asset managers ($619bn average AUM) committed less than 30% of their assets to their targets, while 26 asset managers ($630bn average AUM) committed between 30% and 60% and 14 asset managers ($1,025bn average AUM) committed more than 60%.

Figure 2: Portion of Committed Assets as percent of total AUM by asset manager



There are broadly two reasons cited for assets not being committed to interim targets: data & methodological limitations and; the authority of asset managers to make commitments on behalf of investors.

- Data & Methodological constraints: calculating emissions is a relatively new concept, though most large companies in developed markets now reliably disclose emission data for Scopes 1 & 2 and increasingly for Scope 3. However, there are still emission data gaps for smaller companies or companies in emerging markets. These gaps are rapidly shrinking and so aggregating emissions across a portfolio of direct corporate (debt and equity) holdings is becoming increasingly comprehensive.

  Calculating emissions from other asset classes is not so straightforward. What emissions should be attributed to a sovereign bond - and is it a fair reflection if attributable sovereign emissions dwarf corporate emissions in a portfolio? Should emissions associated with a green bond be weighed differently to those of a non-green bond? What emissions should be attributed to currencies, interest-rate swaps, structured

products, derivatives or cash? These are thorny questions and methodologies are still being worked through.

- Client Approval: some asset managers take the view that climate change is as much an economic as a societal threat - therefore they see the adoption of Net-Zero targets as entirely consistent with their fiduciary duty to clients. However, other asset managers place responses to the climate crisis outside the financial scope of fiduciary duty – therefore they do not believe that client approval for the adoption of Net-Zero targets can be presumed unless the funds have an explicit, or reasonably implicit, commitment to the 1.5°C goal.

The resulting effect of only having a minority of assets being committed to targets undermines confidence that those targets are a fair reflection of an asset manager's alignment to a credible 1.5°C pathway. To illustrate this point: if the average asset manager achieved their goal of a -50% emission reduction by 2030 for the 39% committed assets, but emissions for the 61% uncommitted assets remained unchanged, the total portfolio emissions would have reduced by just -20% - far short of what is required for 1.5°C alignment[3].

Figure 3: Implied total emission reduction[4]

Emission Reduction by 2030

39% Committed	61% Uncommitted	Total Portfolio
-50%	-50%	**-50%**
-50%	-30%	**-38%**
-50%	-10%	**-26%**
-50%	0%	**-20%**
-50%	10%	**-13%**
-50%	30%	**-1%**

Committing only a minority of assets obscures an effective assessment of progress towards de-carbonising the global economy. Furthermore, the material *variation* in interpretation of the potential hurdles to committing assets, reflected in the wide dispersion of committed AUM, further challenges confidence in the Net-Zero targets. It hinders a comparison of progress and ambition across asset managers and leaves targets vulnerable to a suspicion of manipulation.

Greater transparency would help square the circle of encouraging greater confidence in Net-Zero targets while navigating the practical challenges to their adoption. In particular, asset managers should:

- provide a granular breakdown of uncommitted assets by asset class
- indicate which of those assets are uncommitted due to data & methodological reasons, client-approval reasons or both

[3] This assumes the emission materiality of committed and uncommitted assets is proportional to their AUM

[4] Total portfolio emission reduction implied by a -50% reduction in 39% of committed assets and a range of emission outcomes for the remaining 61% of uncommitted assets (assuming emissions and promotional to AUM)

- report on progress for resolving the methodological challenge for each asset class, including the anticipated timeline for inclusion and the asset manager's contribution to the collaborative resolution of those challenges
- outline the process for securing client approval, and report on the progress (including the portion of assets for which consent has been withheld) and expected timeline for completion
- indicate the approximate emission materiality of uncommitted assets – to the extent that most of the corporate emissions of a portfolio are captured in the committed assets, confidence in the interim targets increases[5].

Gross Corporate and Net Total Emissions

While emissions and emission targets are reported on a net basis, it is worth dwelling on the relevance of gross (long) corporate exposures within a portfolio. In essence, emissions are produced by corporate entities (certainly if you include Scope 3 emissions, which would cover emissions emitted by households) and thus the obligation to reduce emissions ultimately falls on corporate entities (with capital, policy, customers and suppliers all potential influencers). This suggests there is merit is distinguishing the total **gross emissions of all direct exposures to corporates** (public and private, debt or equity) within a portfolio from the broader reporting of **total net emissions** (all direct and indirect assets, according to agreed methodologies). Interim Net-Zero targets should have a clear anchor to these gross direct corporate emissions.

When thinking about **net** emissions, it is important to remember that short exposures (whether direct shorts, derivative exposures or portfolio hedges) are not inversely equivalent to long exposures. They offer no inverse engagement mechanism to mirror that of long exposures, nor is the economic effect necessarily inversely comparable[6]. So while it is necessary to consider the totality of a portfolio's net emissions as an accounting and risk measure, there is utility in isolating and disclosing the gross direct corporate exposure within that.

Offsets

Another aspect of **net** emissions worth touching on is the use of offsets. NZAMI conditions the use of offsets only "where there are no technologically and/or financially viable alternatives to eliminate emissions" and such offsets must "invest in long-term carbon removal". While the IPCC accords a role to offsets in achieving Net-Zero, it is well understood that offsets pose concerns around quality, permanence, authentication, impact-timing, additionality and capacity. Feasible direct de-carbonisation actions should always take priority over the use of offsets.

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[5] We appreciate the circularity here – it is precisely because emissions of certain assets are hard to measure or define that they are excluded. But providing a broad estimation of materiality is less onerous than providing an analytically rigorous, precise emission figure. Such estimation would help frame the materiality of uncommitted assets in the context of Net-Zero targets.

[6] To illustrate this point that short exposures don't have an inverse equivalence in a Net-Zero context to a long position, consider two portfolios: portfolio A is a long-only portfolio whose portfolio companies achieve emission reduction of -10%; Portfolio B is a matched long-short portfolio whose long portfolio companies achieve no emission reduction but whose short portfolio companies see emissions increase by 40%. Only Portfolio A is seeing a positive real-world emissions impact. Yet Portfolio B will report a higher level of net emission reduction: -20% compared to -10% for Portfolio A.

Therefore, asset managers should include in their reporting clear identification of their own use of, and rationale for, offsets at the portfolio level (including verification that the offsets are long-term, of robust quality and were absent viable alternatives, as per the NZAMI commitment). Further, they should endeavour to disclose the aggregate use of offsets by their portfolio companies – and engage with companies to provide this information where they are currently not doing so.

Scope 3 Emissions

Interim targets are largely set around Scopes 1&2 but most asset managers have acknowledged the importance of Scope 3, subject to data improving. Some have committed to implement the Paris Aligned Investment Initiative Net-Zero Investment Framework (PAII NZIF) guidelines on incorporating Scope 3 from 2023. Others are less committal, but will assess Scope 3 data quality, reliability and availability over time. While appreciating the data limitations and conceptual implications (emissions duplication), measuring Scope 3 is an important component of tying emission targets to the real-economy. Scope 3 emissions can dwarf Scope 1&2 for upstream companies in the carbon value chain. Scope 3 captures the incentive for companies to influence de-carbonisation across their value chain and reduces the incentive to outsource responsibility for their high-carbon activities. Asset managers should commit to the adoption of Scope 3 into reporting and targets over a commonly agreed timeline.

2. Target Construction

There are two main forms of interim target:

- Portfolio Alignment which set goals for the portion of companies in the portfolio that have approved Net-Zero targets and;
- Emissions Targets which set a quantitative goal for (some measure of) emissions reduction in the portfolio.

The Portfolio Alignment approach rests upon the use of the stewardship lever to influence companies to become Net-Zero aligned. The Emissions Target approach potentially allows more scope for the use of the capital allocation lever in conjunction with the stewardship lever. Some asset managers combine both target approaches. Within these two broad forms of interim target, there are different methodologies used. Each methodology has drawbacks as measures of alignment to the 1.5°C goal, which we will discuss here.

Portfolio Alignment:

A simple form of Portfolio Alignment sets a future target for the portion of portfolio assets that will have adopted a Net-Zero strategy, approved by an organisation such as the Science-Based Targets initiative (SBTi). Alternatively, asset managers may use the graduated approach set out by the PAII NZIF. This approach categorises companies as: already Achieving Net-Zero; already Aligned to a Net-Zero pathway; in the process of Aligning to a Net-Zero pathway; Committed to aligning to a Net-Zero pathway or; Not Aligned. The target would set milestones for a minimum percent of AUM in or above a qualifying category – usually at least Aligning – with the intention of being at 100% Achieving or Aligned by 2040.

The asset manager may also set an engagement threshold, either instead of or as an overlay to the Portfolio Alignment target. For instance, the target may set a minimum portion of the portfolio to be Aligning or subject to engagement. (A further Portfolio Alignment approach is the Temperature Score method, but as only one large asset manager uses this as their primary target method, we do not dwell on it here).

Asset managers have considerable latitude to tailor their Portfolio Alignment targets. As a result, one Portfolio Alignment target rarely looks like another, which makes comparability difficult.

Moreover, the Portfolio Alignment approach makes it difficult to assess the emission trajectory of the portfolio. We can infer that the portion of the portfolio that is categorised as Aligned is on track to deliver – or potentially go beyond - its allocated share of the -50% reduction goal. By definition, all assets that are below Aligned are on track to deliver something less than their allocated share of the -50% emission reduction and assessing the reduction trajectory of these assets would be guesswork.

Intuitively, the target for Aligned assets by 2030 would need to be fairly high – say, above 75% - to have a reasonable chance of the whole portfolio achieving its -50% fair share**.** That is because the scope for underperformance to the -50% emission reduction trajectory is likely to be greater than the scope for outperformance - the potential emission reduction scenarios will not be normally-distributed around -50%, but rather have a longer underperformance tail. Therefore, there would need to be a higher number (portion) of companies outperforming to generate sufficient excess emission reduction to offset the underperforming companies. For example, if the average aligned company delivered a -60% emission reduction by 2030 and the average of all other companies at Aligning through to Not Aligned delivered a -20% reduction, then 75% of the portfolio would need to be Aligned to deliver a -50% average reduction. Few Portfolio Alignment targets currently meet this threshold.

The point here is not that Portfolio Alignment approaches are invalid or that asset managers following this approach should only invest in Aligning companies. Rather it is that the targets have a structural capacity to deliver something less than the -50% emission reduction goal.

16 of the 65 asset managers with over $100bn AUM use Portfolio Alignment as their primary interim target. Using Portfolio Alignment seems to allow for a higher portion of assets to be committed to the target – the average for these 16 managers is 67% of total AUM committed to the interim target.

Emissions Target

There are three main categories of emissions targets:

- Revenue-based Intensity or Weighted Average Carbon Intensity – this measure sums the Issuer's Emissions (in tons) relative to the Issuer's Revenues (for example, in $m) of each portfolio company/issuer, weighted by the value of the holding in that portfolio company/issuer as a percentage of the total portfolio value (the Portfolio Weight)

$$Weighted\ Average\ Carbon\ Intensity = \sum_{i=1}^{n} Portfolio\ Weight\ x\ \frac{Issuer's\ Emissions_i}{Issuer's\ Sales_i}$$

- Absolute or Total Financed Emissions - this measure sums the Issuer's Emissions (in tons) of each portfolio company/issuer attributed to the portfolio holding (Invested Capital, in $m) in proportion of the total capital[7] (Issuer's EVIC) of the company/issuer

$$Total\ Financed\ Emissions = \sum_{i=1}^{n} Issuer's\ Emissions_i\ x\ \frac{Invested\ Capital_i}{Issuer's\ EVIC_i}$$

- Investment-based Intensity or Total Carbon Intensity (or Economic Emission Intensity) – this measure normalises the Total Financed Emissions figure, dividing it by the Total Portfolio Value

$$Total\ Carbon\ Intensity = \frac{Total\ Financed\ Emissions}{Total\ Portfolio\ Value}$$

Of the 48 asset managers with >$100bn AUM whose primary interim target is emissions-based, 22 use Revenue-based Intensity targets, 8 use Absolute emissions targets and 15 use Investment-based Intensity, while the remaining 3 use Intensity but it is unclear which type.

Intensity-based metrics are inherently flawed. Aligning to a 1.5°C pathway mandates a reduction in **absolute emissions**, not in **relative emissions**. Therefore, Intensity-based emission targets aim at the wrong goal. Intensity measures introduce the potential for denominator distortion – changes in the reported Intensity metric resulting not from the emissions of the company but from their revenues or their share price. Furthermore, this distorting impact is not random - it has a directional bias over time, as revenues and asset values generally trend upwards in the long-term. That means an Intensity target could be met with a smaller real emission reduction than its numerically-identical Absolute target.

To illustrate this, we show how each emission metric is impacted by changes in revenues & market capitalisation. Consider two portfolios, A & B, which invest in a single company Z. Across two reporting periods (Y0 & Y1), Company Z sees revenues increase by 10%, its share price increase by 13% (such that its EVIC increases by 10% with debt remaining unchanged) and its **emissions increase by 5%**:

Figure 4: Profile of Company Z in Y0 and Y1

	Company Z		
	Y0	Y1	Change
Revenues ($m)	2,000	2,200	10%
Gross Debt ($m)	200	200	0%
Market Capitalisation ($m)	800	900	13%
Enterprise Value ($m)	1,000	1,100	10%
Emissions (t)	100,000	105,000	5%

Portfolio A owns a mixture of equity ($15m in Y0) and debt ($10m) in Company Z, while Portfolio B only owns equity ($25m in Y0) in Company Z. Both Portfolios have $25m total exposure to Company Z in Y0.

[7] Total capital is defined as the enterprise value including cash or EVIC, being the notional value of gross debt plus the market capitalisation

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Figure 5: Impact of revenue and share price increases on emission calculation methods

	Portfolio A				Portfolio B		
	Y0	Y1	Change		Y0	Y1	Change
Equity ($m) - Market Value	15	17		**Equity ($m) - Market Value**	25	28	
Debt ($m) - Notional Value	10	10		**Debt ($m) - Notional Value**	0	0	
Portfolio Weight	100%	100%		Portfolio Weight	100%	100%	
Emissions(t)	100,000	105,000	5%	Emissions (t)	100,000	105,000	5%
Sales ($m)	2,000	2,200	10%	Sales ($m)	2,000	2,200	10%
WACI (t/$m)	**50**	**48**	**-5%**	**WACI (t/$m)**	**50**	**48**	**-5%**
Emissions (t)	100,000	105,000	5%	Emissions (t)	100,000	105,000	5%
Invested Capital ($m)	25	27	8%	Invested Capital ($m)	25	28	13%
EVIC ($m)	1,000	1,100	10%	EVIC ($m)	1,000	1,100	10%
Attribution	2.5%	2.4%	-2%	Attribution	2.5%	2.6%	2%
Financed Emissions (t)	2,500	2,565	3%	**Financed Emissions (t)**	2,500	2,685	7%
Portfolio Value ($m)	25	27	8%	Portfolio Value ($m)	25	28	13%
Total Carbon Intensity (t/$m)	100	95	-5%	**Total Carbon Intensity (t/$m)**	100	95	-5%

As we can see, the Absolute (or Financed Emissions) metric fairly captures the **increase** in emissions of Company Z. The impact is not identical across the two portfolios, because the attribution method causes some of Company Z's emissions to move from debt to equity as a result of the increase in market capitalisation (share price). Thus debt-heavy Portfolio A sees emissions increase by a little less than 5% and equity-only Portfolio B sees emissions increase by a little more than 5%.

However, both the Revenue-based Intensity (WACI) and the Investment-based Intensity (Total Carbon Intensity) metrics show a **decline** in their emission metric. This is because the real emissions increase of Company Z is masked by the increase in their revenues and share price respectively. In this illustration, both Intensity metrics completely mis-represent the trajectory of emissions in the portfolio.

There are three arguments used to support the preference of Intensity targets over Absolute targets: Intensity smooths year-on-year emission volatility; it allows for easier comparability and; focusing on Absolute emissions punishes growth. Taking each in turn:

- **Volatility** – it is not clear whether, at a portfolio level, Absolute emissions are indeed consistently noisier than Intensity metrics, but more importantly the point of emission targets is not volatility management. Volatility of emissions is not the problem – the absolute level of emissions is the problem and reducing absolute emissions is the goal. Preferring an Intensity metric in order to reduce volatility is to confuse the point of the targets.
- **Comparability** – targets are individual, mapping the journey for the asset manager itself to reach its defined end goal of emission reduction, using the most appropriate metrics. If all asset managers reported Absolute emissions, it would be a straightforward exercise to compare targets and progress across asset managers by normalising for AUM. But an asset manager should not alter the true form of its target simply to anticipate the need for comparability. Targets should be set in the form of Absolute emission reduction because that is the goal. Disclosure should then be supplemented to enable comparison. Defining targets in the comparable form is a misconstruction of the real goal.

- **Growth** – Intensity metrics adjust for two drivers of growth: increases in **price** (of goods, in revenues or of asset prices, in portfolio value) and; increases in **volume** (the amount of goods sold, in revenues or net inflow/outflows, in portfolio value). Intensity metrics do not distinguish between these two drivers. It seems intuitive to understand why price increases alone are false indicator of emission progress – for example, a doubling in oil price does not make oil producers, ceterus paribus, half as GHG-emitting! Price has no informational relevance to emissions. Therefore, adjusting the emission metric for price impacts is a clear distortion. When looking out to 2030, this distortion impact could add up – an average price inflation of 2% pa in revenues from 2020 to 2030 (on stable output) would result in a -50% Intensity reduction target being met with only a **-39% reduction in Absolute emissions.**

    The impact of volume growth is a little trickier to address. A company that is increasing sales volumes would also expect the production of emissions to grow comparably (ignoring effects like scale efficiencies). Thus the argument is that focusing on Absolute metrics discourages investing in growing companies, even where those companies may be doing more to address their emissions.

    For example, imagine two companies, Company A and Company B. Company A reduces its emission intensity by -5% and increases its sales volumes by 10%, while Company B sees no change in emission intensity or in sales volumes. Company A's absolute emissions will have risen by 5% and therefore have a negative impact on the portfolio emissions, while Company B's absolute emissions remain unchanged (neutral impact for the portfolio). Yet Company A is intuitively preferable both financially (it is growing) and environmentally (it looks to be taking some active action to reduce emissions).

    However, achieving Net-Zero is not a contingent goal, subject to such benign conditions as sufficiently restrained growth. At both a global economy level and the individual company level, the higher the economic or output growth, the harder the grower will have to work to ensure they remain on track for Net-Zero over the long term.

    Further, in our example, Company A's efforts to improve its emission intensity should lead to accelerated reductions on a forward looking basis (assuming its above-market volume growth is not sustained indefinitely). So over time, the emissions trajectory of Company A should be more beneficial to the portfolio from both emission-target and financial perspectives than Company B.

    Furthermore, supplementary disclosure – for instance comparing the revenue-growth of the portfolio relative to that of a benchmark – can be used to shed light on near-term factors pertinent to the emissions outcome such as growth.

This is not to say that Intensity metrics have no utility. They can help explain why a company's emissions are what they are – the impact of the company's size, the carbon-intensity inherent in its sector or the efficiency with which the company manages its carbon-intensive activities relative to peers. Intensity metrics allow for comparison of emission-efficiency against peers and is a useful input into investment and stewardship decisions. It can help asset owners decide which funds are most aligned with their own Net-Zero goals. But it is less useful as a metric to assess an asset

manager's alignment to the 1.5°C pathway, which is the point of setting interim targets. Emissions Intensity is the wrong basis for interim targets – and thus could lead to the wrong outcome[8].

We recommend that asset managers migrate to using Absolute targets as their primary approach. Supplementing an Absolute target with other target types, including Portfolio Coverage approaches – as some asset managers already do – can serve to reinforce the Absolute target and elevate the engagement lever in delivering their Net-Zero goals.

3. Portfolio Composition

It is becoming increasingly appreciated that portfolio de-carbonisation needs to correlate to real-world impact if it is to contribute to addressing the global climate challenge. Wholesale divestment from high-carbon assets does not address the climate problem, it avoids it. A more orderly transition is likely to be achieved by a meaningful portion of existing high-carbon companies transitioning to a no/low-carbon footprint, rather than by being replaced by new, clean companies (though creative destruction will be an increased feature of such a deeply systemic transition). Thus, an important component of an asset manager's progress on its Net-Zero targets should be actual emissions reduction by the portfolio companies themselves, as distinct from reductions that result from changes to the portfolio composition (such as shifting from high-carbon to low-carbon sectors).

This should not constrain asset managers from exercising their investment discretion and expertise, across and within sectors, according to their fund strategies and mandates. Over-allocating capital to companies most willing and able to transition, over-allocating engagement resources to those able but less willing and under-allocating capital and engagement resources to companies unwilling or unable can be an effective approach to catalysing transition. Furthermore, the capital allocation lever – over-weighting, under-weighting or full divestment – adds necessary heft to engagement.

Asset managers should be transparent on how they are achieving their emission targets. In particular, asset managers should enable the underlying emission change attributable to the portfolio companies themselves to be easily identifiable. There are three factors that impact change in portfolio emissions:

- portfolio composition;
- net fund inflows/outflows[9] and;
- underlying change in emissions from portfolio companies.

Each of these impacts are measurable. The underlying change in emissions can be calculated by comparing the emissions for the *current* portfolio in the *current* period to the emissions of the *current* portfolio at the *prior* reporting period (steady-state emissions). Net flows are routinely disclosed and thus the perimeter impact on portfolio emissions can be estimated. The impact of changes in composition can be estimated by comparing the *current* emissions of the *current*

[8] We recognise that the Absolute (Financed Emissions) metric is also an imperfect measure because of the attribution noise. But this noise has a much smaller distorting impact than with Intensity, as our example illustrated - a 2% variance vs a 10% variance for Intensity. Further this noise under the Absolute metric is essentially zero-sum, a transfer between shareholders and bondholders – across all investors in a company, the effect cancels out. That is not the case for Intensity distortion effects.

[9] Not to be confused with change in AUM, as this also reflects changes in asset prices, which have no influence on emissions

portfolio to the *current* emissions of the *prior* portfolio. This disclosure of the underlying emissions reduction is conceptually similar to like-for-like reporting of, for instance, company revenues - where the year-over-year change is adjusted for things like FX impact and perimeter change (acquisitions, opening of new stores etc) to capture the underlying change in revenues.

To illustrate this approach, consider asset managers A and B, each of which has Absolute or Financed Emissions of 1mt in the prior year. Asset manager A's emissions increase by 20% as a result of net inflows and increasing their exposure to high-carbon companies with ambitious, credible transition plans. Meaningful progress is made by asset manager A's portfolio companies on emission reduction (-10%). Asset manager B meanwhile has delivered a -10% reduction in emissions, but entirely from compositional changes (selling out of high-carbon sectors), while underlying company emissions actually increased by 5%.

Figure 6: Example of portfolio emission attribution

Asset Manager A

	Emissions tons	Change tons	%
Prior Year	1,000,000		
Perimeter		*200,000*	*20%*
Composition		*100,000*	*10%*
Underlying		*-100,000*	***-10%***
Total Change		***200,000***	***20%***
Current	1,200,000		

Asset Manager B

	Emissions tons	Change tons	%
Prior Year	1,000,000		
Perimeter		*0*	*0%*
Composition		*-150,000*	*-15%*
Underlying		*50,000*	***5%***
Total Change		***-100,000***	***-10%***
Current	900,000		

If only the total change in emissions is reported, then asset manager B could be assumed to be making "better" progress towards its emission targets than asset manager A. However, if both asset managers provide the attribution for the change in emissions, it becomes clear that asset manager B's progress is certainly not "better" in quality (though it is "more"). Indeed only asset manager A has seen actual portfolio company de-carbonisation and appears to be more actively engaging with transition.

Disclosing such attribution would provide transparency on **how** an asset manager is delivering changes in portfolio emissions and how much they are contributing to real-world de-carbonisation. This transparency creates some incentive for the asset manager to put real-world de-carbonisation at the core of their target strategy. Further, asset managers should consider bringing the concept of underlying emissions into their targets by setting a minimum contribution from underlying emissions to the total target (say, -40% of the -50% goal).

4. Target Ambition

NZAMI notes that the interpretation of "a 'fair share' of CO2 emissions reduction" is subjective and influenced by factors including: a portfolio already having "achieved significant emissions reductions" which could justify a "shallower trajectory" in emission reductions in future and; the "sectoral or regional exposure". In aggregate, this interpretive licence could contribute to undershooting the goal of a -50% reduction in CO2 emissions. There are two important points to bear in mind when framing what a fair share requires

- The -50% emission reduction is a global **average** – it is well understood that some companies and sectors will be able to de-carbonise faster than this average, while others will be slower.

This dynamic also exists for countries – developed countries should be able to de-carbonise more quickly than emerging countries, with the latter generally having higher underlying demand growth to contend with and less access to (sufficient) transition capital. If developed countries only deliver a -50% reduction by 2030, global emissions will probably fall short of the -50% target. The rate of developed-country de-carbonisation needs to exceed the -50% global average to accommodate slower de-carbonisation in emerging countries. An asset manager's interim target should reflect their geographic mix, with portfolios weighted to developed countries requiring a fair share ambition that goes beyond a -50% reduction.

- The inherent uncertainties in climate modelling – the core IEA NZE scenario embeds just a 50-50 chance of keeping global warming below 1.5°C – combined with the growing presence of tipping points mean that it is prudent to build in some buffer in interim target setting, to increase confidence that they will actually align with the 1.5°C goal.

35 of the 48 asset managers with AUM above $100bn that set Emission Targets have set those targets at a -50% reduction by 2030. However, there are some examples of increased ambition:

- 6 of those 48 asset managers have set their 2030 interim targets at more than -50% emission reduction, ranging from -54% to -75% (-61% average).
- 12 of the 65 asset managers (including those with Portfolio Coverage targets) have set their initial interim targets for 2025 (or sooner) - with an average target reduction of -29% - which builds in a helpful near-term milestone, pointing to a prioritisation of immediate action to reduce consumption of the carbon budget prior to 2030.

Conclusion

Interim Net-Zero targets as currently structured are not yet securely anchored on the NZAMI goal of a -50% reduction in emissions by 2030. There are a number of ways in which targets could be met without delivering their fair share emission reduction: uncommitted assets' emissions being on an unaligned trajectory; Intensity metrics diverging from Absolute emissions; emission reduction achieved through rotation out of high-carbon exposures; insufficient regional ambition.

Interim Net-Zero targets are hugely complex to calibrate, posing thorny questions around what to measure (even while data is still being created), requiring sophisticated monitoring infrastructure and raising challenges over integration into existing investment approaches and fund mandates. It is why NZAMI is essential as a convenor of collaboration, because the transition to Net-Zero will not happen through unilateral, un-coordinated actions. Asset managers do not lend their reputations to these commitments lightly. This is reflected in the tentative nature of these first steps in setting interim targets, with asset managers needing to be confident they can deliver what they are committing to.

But the conundrum for setting Net-Zero targets is representative of the climate challenge as a whole – notwithstanding the complexity, time is running out. An iterative approach to target calibration through incremental changes will take too long. This is why it is crucial that progress is accelerated to create interim Net-Zero targets that are consonant with a fair share of a -50% reduction in emissions by 2030.

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We believe NZAMI signatories should be clear that initial targets are a work-in-progress, acknowledge the short-comings of most current target structures against the defined goal, and drive coalescence around a common target standard that robustly underpins capping global temperatures at 1.5°C. Confidence in asset managers' Net-Zero alignment will be improved by greater standardisation in target structure, together with increased transparency on how targets will be delivered and on the progress in overcoming constraints to target ambition. We believe the following recommendations will reinforce robust target setting and will engender the transparency necessary to assess real progress.

Asset managers should:

- Report and set targets for both gross direct corporate emissions and net total emissions;
- Provide a breakdown of uncommitted assets, including: the basis for exclusion (data, methodology, client-approval); progress and expected timeline for inclusion and; emission-materiality;
- Report and set targets on Absolute emissions (with the EV-impact on apportioning disclosed);
- Disclose the use of and rationale for portfolio-level offsets and aim to disclose aggregate company-level offsets over time;
- Commit to the adoption of Scope 3 emissions targets and disclosure on a commonly-agreed timeline;
- Place real-world impact at the heart of Net-Zero targets;
- Attribute year-on-year emission changes to: perimeter effect (net flows); compositional impact; underlying portfolio company de-carbonisation (like-for-like) ;
- Calibrate targets to reflect the regional mix of the portfolio, recognising that ambition for portfolios oriented to the developed-world should go beyond the global average requirement of a -50% emission reduction by 2030;
- Advocate for the development of a common approach to target setting and reporting.

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About ShareAction

ShareAction is an NGO working globally to define the highest standards for responsible investment and drive change until these standards are adopted worldwide. We mobilise investors to take action to improve labour standards, tackle climate change and address pressing global health issues. Over 16

years, ShareAction has used its powerful toolkit of research, corporate campaigns, policy advocacy

and public mobilisation to drive responsibility into the heart of mainstream investment. Our vision is a world where the financial system serves our planet and its people. Visit shareaction.org or follow us on Twitter and Instagram @ShareAction to find out more.

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