pi ESG CLUB

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Achieving net zero is one of the toughest challenges of our time, a challenge that is getting tougher. This month's ESG Club looks at how institutional investors are making their portfolios more sustainable in the face of rising political headwinds.

THE SHIFTING SANDS OF ESG INVESTING

Sustainable investing faces challenges on a number of fronts, not least from some of its asset managers. *Andrew Holt* reports.

It is a critical time for environmental, social and governance (ESG) investment – with the impetus of investors addressing climate-related issues either waning or going into reverse.

After many big-hitting asset managers left the Net Zero Asset Managers group, which led to the suspension of its activities, some reports suggest many asset managers are not meeting companies on ESG matters.

This could be a slippery slope where ESG no longer remains a key priority. This follows the Glasgow Financial Alliance for Net Zero (GFANZ) – a group of various financial institutions – to be the latest industry or sector body to change its mission due to pushback on ESG issues.

The group said it will restructure and shift its focus to addressing barriers to mobilising capital, but will no longer be aligned with the Paris Agreement. In a statement, the group said: "GFANZ will transition to an independent principals group, led by chief executives and leaders from financial institutions acting to address barriers faced in mobilising capital for the transition around the world – including sovereign wealth funds, financial institutions, and market participants in countries with longer transition pathways."

Responding to this, Jeanne Martin, head of banking programme at responsible investing campaigner Share Action, said: "We cautiously welcome GFANZ's new focus on addressing barriers to mobilising capital, which is critical to achieving net-zero by 2050."

However, she added GFANZ's decision to walk back on a requirement to align with the Paris Agreement is a "dangerous one". This "could lead to its members lowering ambition even as climate change impacts like extreme weather are harming communities around the world", Martin said.

"GFANZ members have a critical role to play in mobilising capital to achieve climate goals," she added.

The International Energy Agency has warned that private finance needs to contribute \$3trn (£2.3trn) out of the \$4trn needed annually by 2030 to face down the transition challenges.

Share Action's research found that banks' incoherent climate targets are unlikely to shift enough financing away from fossil fuels towards green activities such as renewable energy at the pace and scale needed to avert the climate crisis.

"To be effective in delivering the climate action the world needs, GFANZ and its sub-alliances should reaffirm a requirement to align with the Paris Agreement," Martin added. "GFANZ should ensure its members not only mobilise capital for the real economy transition but also phase out from fossil fuels."

New low

The reappraisal or even rejection of ESG standards by some investors could already be here, at least according to the latest data. Research by Share Action shows that asset managers' support for shareholder resolutions aimed at tackling social and environmental issues crashed to a new low in 2024 with less than 2% of proposals being approved, down from more than a fifth three years earlier.

Asset managers who voted against shareholder resolutions designed to protect human rights, nature and climate included the four largest asset managers in the world: Blackrock, Fidelity, State Street Global Advisors and Vanguard.

Collectively managing \$23trn (£18.2trn) in assets, more than the GDP of the European Union, these firms, Share Action said, "have an outsized influence through the huge investments they hold in key companies" – yet collectively supported only 7% of key shareholder resolutions.

Share Action's research reveals an additional 48 shareholder resolutions could have passed had these four asset managers chosen to support them.

Claudia Gray, head of financial sector research at Share Action, said: "This is the worst result we've seen from asset managers in the six years we've been monitoring their voting performance and shows a worrying retreat from ambition when it's most needed."

And she added: "As support for shareholder resolutions hits rock bottom, our first ever analysis of votes against resolutions proposed by company management paints a similarly bleak and disappointing picture, with asset managers failing to use these votes to hold companies accountable for their social and climate impacts."

Had asset managers supported them, proposals put forward by shareholders at 190 companies could have improved conditions for low-paid workers and driven urgent climate action, noted Share Action in the report.

This could be of deep concern to asset owners who are putting their faith in asset managers to act in their best interests.

As in previous years, there is a striking gulf in performance between asset managers in the US and Europe. Supporting 81% of shareholder proposals on average, UK and European asset managers have once again demonstrated greater commitment to responsible investment than their US counterparts.

This, it should be noted, is in the context of higher corporate transparency standards set by regulators in Europe. But with a strong anti-ESG sentiment sweeping across America, the division between the US and Europe is likely to get even bigger.

INTERVIEW – EMMA DOUGLAS

"The industry can sometimes put too much weight on impact investments instead of encouraging more traditional investments to improve real-world outcomes."

The sustainable investment and stewardship lead for the body which runs the BT Pension Fund tells *Andrew Holt* about integrating sustainability into all portfolios, the unintended consequences of nature and why it's business as usual for diversity.

How would you describe your role?

My focus is on sustainable investment and stewardship. I look at the sustainable investment strategy, thematic work and social issues such as DEI, as well as manager oversight of the sustainable investment approaches.

Sustainability is integrated throughout our investment approach. On the portfolio construction side, there could be work on the data front, while the manager research team might look at specific strategies. I will then work with the team and provide specific expertise, as and when is necessary, to help the investment decision making.

So you don't have a bucket for sustainable investment – it is in all of your investments?

Sustainability factors are considered in the investment process to improve risk-adjusted outcomes. Therefore, it is considered for all of the portfolio. We call it a horizontal approach, rather than a vertical and stand-alone function.

What is your approach to investing sustainably?

We set up a four-pillar approach when thinking about our net-zero ambition. So we have portfolio construction, mandates and managers, stewardship and advocacy. We also have a fifth pillar, Brightwell corporate, so our sustainability approach is aligned throughout the organisation.

We have evolved our approach from thinking about ESG risks to focusing on systemic risks and opportunities – so thinking about nature, climate and inequality. And because we encourage a more holistic approach, focusing on sustainable outcomes is linked to improved risk-adjusted investment outcomes over the long term for our clients.

When we were thinking about net zero previously, it was perhaps more about an isolated risk to the portfolio. But as time has gone by, we have realised the inter-connectedness of sustainability risks, which means they cannot be tackled in isolation.

Are any of these pillars more important than the others, or are they integrated?

They are integrated, but it is also about taking a nuanced approach. We focus on what we consider to be the most material risks and opportunities. We do materiality mapping to understand the sectors most exposed.

There is a theory behind it: water scarcity, for example, is a key risk and comes up in many portfolios.

It sounds like you have been on an evolving journey over the last few years.

Absolutely. Within the industry there is now more talk about the inter-connectedness of these risks and thinking about them together and the trade-offs. This comes back to being able to link our sustainability approach to generating the right outcomes for our clients.

Are you at the end of this developing process?

Everything is a form of continual evolvement – as it should be. Sustainability moves on quickly. New technologies are changing. We need to keep up to date, but we are happy with where we are and remain pragmatic with how we evolve.

How do these approaches sit within the overall Brightwell/BT Pension Scheme portfolio?

It is an integrated and pragmatic approach, so we do not necessarily focus on small allocations to an impact portfolio, for example.

It is thinking about what will drive real-world change. We could easily decarbonise the portfolio overnight by getting rid of the top emitters, but that is not going to have

real-world impact. We want to encourage those who might not have committed to the energy transition to do so over time.

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Could you give me an example?

We have examples within our real estate and infrastructure investments – last year we took the BT Pension Scheme members to an energy recovery facility that is in the portfolio.

The industry can sometimes put too much weight on impact investments instead of encouraging more traditional investments to improve real-world outcomes. A combination of things are needed to drive that real-world change.

So that real world change is key?

It is key. We can reduce portfolio emissions through exclusion, but that doesn't do anything to the level of emissions in the atmosphere.

What are you looking to do next with your sustainable investments?

We are always researching new developments – how managers are assessing opportunities around biodiversity. But we are focused on research and understanding portfolio risks and opportunities at this stage.

About 18 months ago you undertook a project with the Cambridge Judge Business School to look at nature-related risks. Why did you do that and what did it reveal?

That was a good starting point for our nature work. From the outset we felt we needed to understand how nature had an impact on the portfolio, which is a complicated topic. We felt that it was necessary to get a good grounding in what the risks could be.

We also wanted to understand how nature connects with climate and feeds into portfolios as well as how our managers are thinking about this.

Is this part of a wider commitment to biodiversity?

It could be. Many organisations are setting biodiversity targets, but we are not in this position. With nature we have to be mindful that there could be unintended consequences to setting nature targets.

You have committed to carbon neutrality by 2035. That is quite ambitious, but is it realistic?

It is ambitious. We have made good progress in reducing emissions across all asset classes for one of our clients who also has a net zero by 2035 ambition.

We value collaborative initiatives, particularly around systemic risks like climate change.

I would say by starting earlier, it has focused our minds and opened up longer-term opportunities. We have also said that progression might not be linear and that we are dependent on global developments.

Are the government and supranational bodies doing enough to create a framework on sustainability, net zero and climate change that investors can follow?

There is always more to do in these areas. In general, we are proponents of using industry frameworks. We are mindful that governments are working on a shorter timeframe of four-to-five years. Our clients are long-term investors, so we have that in mind.

Is it frustrating that the government is working on a different timescale to institutional investors?

We always want to see more ambition to move the sustainability agenda along. We are seeing good progress, generally with much wider adoption and understanding within the market. Even over the last five years there has been significant change in the awareness of climate change.

On that though, is the Net Zero Asset Managers initiative suspending operations after the withdrawal of several big asset managers a concern?

It was disappointing to see that happen. We value collaborative initiatives, particularly around systemic risks like climate change. It cannot be tackled alone. But there is now a greater appreciation of the nuances around climate change. You are balancing real-world decarbonisation versus portfolio decarbonisation.

We continue to engage with managers on this topic and want to see their climate activity continue. Whatever the forum they want to do it in, continue the work that has to be done. I don't want the ambition to be scaled down.

Does the suspension of the initiative create an uncertain future?

We haven't heard what the outcome could be. It could bounce back, maybe with some nuances and terms changed or updated, but the suspension has raised significant concerns over its future and made it public.

Do you think the same could happen with the asset owner equivalent?

We are operating in a different environment. So my expectation is that the asset owner equivalent will continue. We get a lot of value out of collaboration and sharing knowledge across asset owners.

Does the wider critical focus on ESG concern you?

We need to be mindful of the developments on a global scale. Our clients are investing for the long term and we need to do everything that is in members' best interests.

We are not working in four-year cycles, so providing our managers follow what we want them to do, we hope it is business as usual.

Are asset managers up to speed on all things sustainability, net zero and ESG?

There is a range of expertise and focus in the market. Some are leaders, others are catching up, but the majority are up to speed.

What is more debated is on the specifics and the time horizons. Things like oil and gas – at what point could they become stranded assets? That is a key question. Do you engage, divest or benefit from potential short-term profits?

What do you do in such a situation?

We want to facilitate the transition to a lower-carbon economy and a more sustainable world. We invest and don't have blanket exclusions but what we do is engage to ensure companies are aligning with a lower-carbon economy over the long term.

If that engagement is unsuccessful over time, then we could look to divest if we felt there was a detrimental impact to our risk-adjusted outcomes.

So effective stewardship is important?

It is huge. We place a lot of emphasis and value on stewardship.

How do you approach stewardship?

We work with EOS at Federated Hermes: they are our stewardship provider. We also get involved with some collaborative initiatives and engagement. For example, we have just signed up to Nature Action 100.

We engage with our managers to understand their stewardship approaches and push for alignment to the ambitions of our clients: whether that be net zero or something broader.

We will make sure they are aligning with engagement activities, which hopefully will lead to positive outcomes over the coming years.

Is the investment industry collectively doing enough on ESG-related issues?

There is always more to do in this space. We now have more understanding of the risks and opportunities, and this is developing each year. We have gone from thinking about climate to an industry, now looking more at nature and I can see social being the next focus.

One final point on diversity, has it dropped off the investment agenda?

I would say it is more discussion than it is action at the moment, but it is evolving. Particularly in Europe and the UK, I am not hearing or seeing companies dramatically change their approach as they consider it a way of improving company performance. The situation is different in the US.

EMMA DOUGLAS' CV

January 2022 – present
Sustainable investment and stewardship specialist
Brightwell

February 2020 – January 2022
Responsible investment consultant
Lane Clark & Peacock

August 2018 – February 2020
Associate investment consultant
Lane Clark & Peacock

July 2016 – August 2018
Investment analyst
Lane Clark & Peacock

August 2014 – July 2016
Actuarial analyst
Aon Hewitt

There is now a greater appreciation of the nuances around climate change.

How are institutional investors setting winning climate strategies in the face of rising uncertainty? *Mark Dunne* reports.

Our climate is trying to kill us. Floods, wildfires, droughts – they just keep coming.

The good news is we can save ourselves. The climate-changing greenhouse gases emitted from everyday activities like farming, manufacturing, traveling and heating our homes are making our planet warmer and therefore causing such extreme weather events.

Lowering these emissions so they can all be absorbed by carbon sinks, such as forests, the oceans, soil or machines, could keep global temperature rises to 1.5°C above pre-industrial levels, a safe average set by the Paris Agreement.

Many governments, including Britain's, along with institutional investors have set 2050 as a deadline to achieve just that.

The bad news is we have reached a point where progress on achieving net-zero emissions appears to be easing when it needs to accelerate. Following years of rapid growth, momentum is losing its edge in the face of political and economic issues.

"Limiting [global] warming to 1.5°C [by 2050] is out of reach," says Mhairi Gooch, senior responsible investment consultant at Hymans Robertson.

Gooch, who leads the firm's net-zero work, describes the target as "ambitious but plausible" back when the Paris Agreement was set 10 years ago. But today it appears progress has not moved as fast as predicted.

However, all may not be lost. "Limiting warming to below 2°C is still very much in reach," Gooch says, before adding that a temperature rise of at least 3°C is likely.

NET ZERO: HARD TARGET

Troubling times

Green is falling out of fashion. Low economic growth, wars in Europe and the Middle East boosting fossil-fuel stocks and lawmakers in the US are to blame. Indeed, with growth becoming a rarity in the developed world, governments are having to decide between meeting their sustainable goals or boosting their economies.

In Britain, not everyone is confident that hitting net-zero emissions can be achieved within the next 25 years. The Climate Change Committee, which advises the government, has warned that progress is slow.

The lack of optimism can be put down to the slow adoption of heat pumps, plans to expand London City Airport, the proposed new runway at Heathrow and awarding new oil and gas licences, of which there were more than 80 in the final quarter of 2022. If the plan is not to increase the greenhouse gases in our atmosphere, the UK appears to be on the wrong path.

There is also a backlash against attempts to create cleaner sources of energy, especially in the US. Sustainable regulation is set to become a lot looser, if not reversed under President Trump who has already quit the Paris Agreement.

In some states, the backlash has led to litigation. In November, Texas attorney general Ken Paxton sued Blackrock, State Street and Vanguard. He believes their efforts to phase out oil and gas could cause higher energy bills. Blackrock has since pulled out of a large asset management alliance aimed at achieving net zero.

Yet for the pension schemes that asset managers like Blackrock work for, mitigating the material financial risk of climate change is part of their fiduciary duty. And the financial risks are getting worse.

Extreme weather patterns have caused more than $3.6trn (£2.8trn) worth of damage since 2000 and could knock more than a fifth (22%) off GDP by the end of the century.

Research from AXA shows that investing 2% to 3% of cumulative global GDP in mitigation and adaptation measures could prevent 10% to 15% in GDP losses.

Yet investment in sustainable funds globally fell by half in 2024, compared to the previous year, despite inflows into the wider fund universe being the second highest in the past seven years thanks to a rally among US stocks.

If this continues sustainable assets under management could be worth $35trn (£28trn) in the next five years, Bloomberg Intelligence believes. This is a downward revision on the previous estimate of $40trn (£32trn).

Indeed, the era of impressive sustainable investment growth between 2016 and 2022, which saw such assets under management grow by 10% a year to $30trn (£24trn), appears to be over.

Bloomberg Intelligence predicts that litigation risk and negative sentiment will see the US' share of such assets under management drop from 30% to below 20%.

This comes despite Bloomberg Intelligence predicting that low-carbon companies will see their earnings jump by more than a quarter this year, beating the 18% expected by the benchmark.

How to achieve net zero

With so much uncertainty and with a changing geopolitical situation, how are pension schemes approaching the transition to a regenerative economy?

For Jennifer Devine, head of the Wiltshire Pension Fund, climate change is an important consideration when managing its investment portfolios. "As an open defined benefit scheme we are going to be here for 100 years, so it is something we have to think about," she says.

We are here for 100 years, so have to look beyond short-term noise.

Jennifer Devine, Wiltshire Pension Fund

Wiltshire builds its investment strategies around the various scenarios of how climate change could impact the scheme's investment returns and funding positions.

"Obviously, anything looking into the future is an approximation, and methodologies change," Devine says. "We have tried to make it as evidence based as possible, so the committee can put numbers around this big concept and make proper decisions off the back of it."

Of course, there is no one-rule-fits-all to decarbonising portfolios. Different asset classes need to be approached differently. If you want to clean up your equity holdings, you could look at the scope one and two emissions. If you are looking at property, there are the EPC ratings or you could examine the methods of construction.

Wiltshire also has a dedicated climate portfolio to tap directly into the transition, such as investing in renewable infrastructure or funding tech designed to reduce the carbon in our atmosphere. "That portfolio is trying to come at the problem from every angle," Devine says.

The Wiltshire Pension Fund has set a target of cutting 50% of its carbon emissions by 2030. "I don't know if we will hit that target on the nose," Devine says. "It is a bumpy journey; it is not going to be a smooth path.

"Massive global macro-economic events over the last five years have thrown us quite a few curve balls," Devine adds, pointing to the invasion of Ukraine and its impact on energy stocks as an example.

"We set ourselves quite an ambitious target initially, and whether we will hit that or not, I don't know, but we have been making progress in the right direction."

For Gooch, a credible net-zero strategy has to be thinking about the real-world effect of the decisions investors make. Selling high-emitting companies is just shifting the problem around.

"Our core message this year at Hymans is about investing in reducing emissions, not reduced emissions," Gooch says. "Everything is about transition. We have to transition all parts of all sectors, industries and economies. That includes emerging markets and fossil fuels. They all need to transition and quite quickly."

Craig Campbell, UK head of responsible investment at Aon, agrees that divesting is simply passing the problem on to somebody else. "It is much better, albeit difficult to measure, to use your role as an active steward of capital to engage better behaviour towards decarbonisation."

It's good to talk

Deciding where to invest is not the only lever asset owners can pull to make their portfolios carbon neutral. "Engagement is absolutely essential, and you have to constantly raise the bar on this," Gooch says.

And the engagement side of portfolio management always needs to be improved. “There is obviously a lot of backlash on ESG, in the US in particular,” Gooch says. “That is where we just have to go stronger as asset owners, on our beliefs as these are important topics.

“They are financially relevant. They underpin our economies and financial system. They should not be an afterthought,” she adds.

German sports car-maker Porsche is one corporate where investors have much to discuss with management. The company is believed to be set to continue making petrol-powered cars for longer than planned due to demand for one of its electric models collapsing by as much as 50% in the first nine months of 2024.

Then there is BP. There are fears the oil and gas giant could move away from renewable energy as falling profits have left its share price depressed and some of its shareholders are demanding change.

This comes as a coalition of global pension schemes and insurers collectively managing $1.5trn (£1.2trn) worth of assets has called on their peers to improve how they interact with their portfolio companies to fight the financial impacts of climate change.

The Asset Owner Statement on Climate Stewardship, which counts the stewards of some of the largest pots of retirement savings in Britain as members, wants asset owners to ensure that their asset managers meet their net-zero expectations.

“Time is running out in the lead up to 2030,” Leanne Clements, head of responsible investment for People’s Partnership, said in a statement.

“Asset owners and asset managers must work together in partnership to drive meaningful change – not only in the companies in which we invest, but in the underlying economic, social and environmental systems upon which our members depend,” she adds.

And asset managers are failing to use their votes to hold companies accountable for their social and climate impacts. Their support for shareholder resolutions aimed at tackling social and environmental issues slumped to a new low in 2024, according to responsible investing campaigner Share Action.

Only four out of 279, or 1.4%, of the shareholder proposals assessed by the campaigner received majority backing, down from 21% in 2021.

The Wiltshire Pension Fund holds the asset managers who are not delivering their sustainable goals to account, and publicly in various reports. “We are not secret about what we are doing,” Devine says.

For Campbell, this is important. “You are relying on asset managers to invest money on your behalf in line with your goals,” he says. “It is absolutely crucial to ensure that managers are engaging with companies to decarbonise them in line with your goals.”

A credible net-zero strategy has to be thinking about the real-world effect of decisions.

Mhairi Gooch, Hymans Robertson

A sound stewardship strategy offers many benefits, Devine says. “Engagement can help not only reflect what the beneficiaries want, but you can also use it to set an example in the industry as well.”

But engagement can only take your portfolios so far and for Campbell this could mean you achieve “near zero”. “Before the endpoint you will have to invest in a carbon-offsetting strategy, because there will be some emissions in the portfolio that will just be too hard to abate,” he says.

Meet the new boss

One area where engagement may not help is with the new president of the United States, who wasted little time pulling out of the Paris Agreement, so does his election make net zero by 2050 more less likely? “Over the last five years, we have weathered some significant events,” Devine says. “We saw our returns chart plummet and come back up again during Covid and have seen wobbles around the conflict in Ukraine. Although we want to understand how our investment managers are dealing with those issues, it doesn’t impact our strategy.

“We are here for 100 years, so have to look beyond short-term noise,” she adds. “We still believe, and the modelling shows us, that net zero by 2050 is the right outcome financially for our pension fund. So we won’t change our strategy off the back of short-term political noise.”

Trump has created more uncertainty, but longer term there is potential for sharp shifts in policy once he departs. “While we are not on track today, there is a significant level of expectation that policy will shift in the future to help bring us into that position,” Gooch says. “So for pension schemes, building a net-zero strategy should be about navigating this transition that is already underway has plenty of momentum and that we will likely see further shifts in the future.”

We need them. If they don’t come our climate will continue to try killing us and the generations that follow.