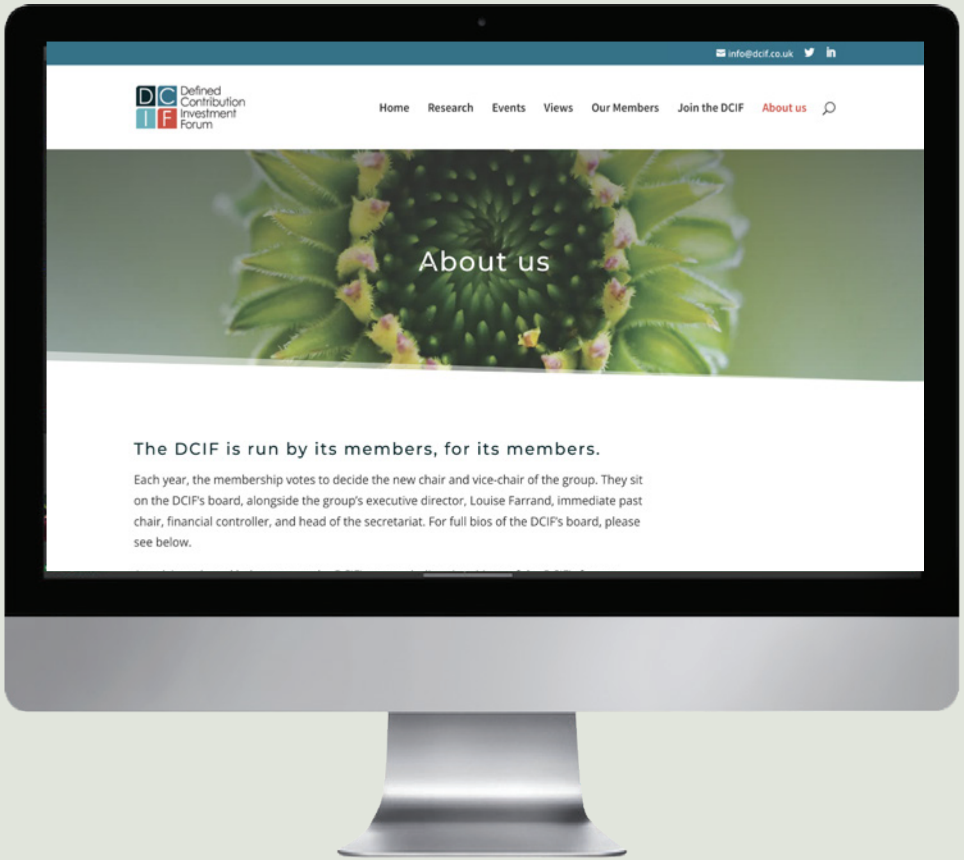
Defined Contribution Investment Forum

ESG 2.0 SERIES

The path to net zero

DCIF Defined Contribution Investment Forum



Who are we?

We're a group of asset managers who believe that a well-designed and diverse investment strategy has an important role in delivering a comfortable retirement for millions of DC savers.

A not-for-profit organisation, we commission and publish research which shines a spotlight on DC investment issues. We hope the people who determine DC pension schemes' investment strategies will use it to inform their work.

We also arrange events. From virtual roundtables to in person gatherings, they're a great way to learn more about DC investment issues and meet a like-minded community of trustees, pensions managers, investment consultants and more.

To find out more about our work and explore membership options, please visit: www.dcif.co.uk

Our members

Our members shape the DCIF's direction and steer research projects. They are:

abrdn	AXA Investment Managers	Baillie Gifford	CBRE Investment Management	Nordea Asset Management	Northern Trust
Columbia Threadneedle Investments	First Sentier Investors	J.P.Morgan	J.P.Morgan Asset Management	nuveen	PGIM Private Alternatives
Janus Henderson Investors	MFS	Mobius Life	Nareit	Phoenix Corporate Investment Services	Wellington Management

Why pension schemes should become change-makers on the path to net zero

Humanity has begun an extraordinary about-turn, from the realisation that fossil fuels were destroying the planet, to many economic actors committing to reaching net zero by 2050.

With the billions they manage on behalf of savers worldwide, pension schemes can play a key role. More than two thirds of UK pension funds have made a commitment to reach net zero; many defined contribution (DC) schemes are among them, with 2050 a target for many.

It would be easy to feel pessimistic about their chances. Many experts the DCIF interviewed for this paper are not confident that we will meet the 1.5 degree temperature threshold target set by 195 countries in the Paris Agreement of 2015.

However, from our conversations, pension schemes are taking their mission seriously. "There has been lots of noise, but the overall picture is that schemes' commitments are still there," says Vicki Bakhshi, director and climate strategist at Columbia Threadneedle Investments. "We have had a couple of high profile pullbacks – collaborative insurance initiatives have had some difficulties, but really if you look at the number of asset owners and asset managers signed up to net zero, it is still the bulk of the market."

Not everything is within DC schemes' control. As Nest's Katharina Lindmeier explains later in this paper, pension schemes can't get to net zero alone; the whole economy must transition. There are ways DC schemes can hold companies to account and punish the laggards, though.

> **"If you look at the number of asset owners and asset managers signed up to net zero, it is still the bulk of the market."**

Pension schemes can play a key role in holding companies and asset managers accountable, but they need the support of their pension provider who hold the investments on their behalf, says Alasdair Birrell, workplace investment proposition lead at Standard Life UK. "Start the journey early. So, if we really want to reach net zero by 2050, what does our net zero pathway look like? What does that mean for our strategy? Do we need real decarbonisation yearly targets? Have we got a 2030 target? What is that? Is that reducing by half? How are we getting on with that?"

Birrell adds: "You've got to be the driving force for change and start taking action for companies and asset managers to do something and actually start reducing carbon emissions and improving financial outcomes. Looking at strategies that do have clear targets, setting clear targets for your asset managers, having actual absolute carbon reduction targets, are things that you can be doing rather than just sitting there and going, 'don't worry, we'll all get there'. Rest assured, if you sit and do nothing, we are not going to get there."

While pension schemes should not be afraid of divestment as a last resort, given the need to support the transition across the real economy, it should be considered only when it's been determined that › engagement will not be effective, argues Alexandra Melhuish, sustainable investing strategist and vice president at J.P. Morgan Asset Management.

Melhuish had recently returned from a conference where she had heard pension scheme members discuss the importance of not letting the reputational risk of holding high emitting companies on their 'climate balance sheet' stop them from remaining invested.

"Melhuish adds: "As active managers, we can use our seat at the table to encourage these companies to transition. We can use our position to encourage such companies to start doing more; for example, to invest more in renewables. In many cases, these companies are also going to be the biggest drivers of the renewable transition. We need to help them on that journey, instead of just ignoring them and divesting and then they fall into someone else's hands."

In this paper, we'll explore how DC schemes can play a meaningful role in the transition, looking at the experience of some of the first movers. We'll do this by examining the stumbling blocks along the pathway to net zero and explaining how pension schemes can avoid or mitigate them. We'll also examine the experiences of some first mover DC pension schemes.

> **"In this paper, we'll examine the stumbling blocks along the way to net zero and explain how pension schemes can avoid or mitigate them."**

There are three crucial steps to achieving net zero, says Tim Gooding, a climate investment director at Baillie Gifford: "Identify your emissions. I think most asset owners have either done that or they're doing it. Next, reduce your emissions. Finally, avoid those emissions happening in the first place, although that might cause your carbon footprint to rise in the near term."

Gooding points out that reaching net zero may feel out of pension schemes' control, particularly when it comes to that all-important third step: avoiding emissions from happening in the first place.

He says: "The great risk for asset owners is that they get stuck on step two: reducing emissions. The reason they get stuck there is because that's typically low hanging fruit. If you want to reduce your emissions, a multitude of funds will offer smooth linear decarbonization, that allows you to sleep easily at night. You can buy even active funds that drop your emissions down in a smooth, linear fashion. But really, it's financial engineering and you're potentially having little to no impact in the real world."

This paper will focus on how pension schemes can create that all-important real world change. UK DC pension schemes are still relatively small players; it's easy to feel powerless. By the end of this paper, we hope you will feel empowered and inspired to act.

Key takeaways

1 Some trustees believe that net zero is not in members' financial interests. However, there are many reasons why the industry consensus is that moving towards net zero now will be best for members. It makes investment sense to act today to mitigate the risk of an abrupt climate transition in the future. Plus, members will not want to retire into a disorderly and chaotic future world, which is likely to come about if we don't act now.

2 Your pension scheme isn't too small to make a difference. Clubbing together and joining up to collective initiatives can help pension schemes to get informed in specific areas. They are then better able to ask pointed questions of their shareholdings and asset managers alike, which will make an impact.

3 Pension schemes are moving through three stages of the net zero transition: identifying, reducing and avoiding emissions. Schemes which need to identify their emissions should work with their consultants to get a clear view of their investment data and then drill down to find their high emitting shareholdings. To move from stage two of the net zero transition to stage three, DC schemes should allocate capital in two directions: towards green pioneers and also towards companies which are essential transition operators. Why the latter? Because without steel, wind turbines cannot be built. Schemes which own these types of assets should push transition operators to decarbonise.

4 Net zero reporting is complicated. There isn't a single way to measure progress, and arguably, a single methodology would mean losing important nuance. Reporting will undoubtedly develop over time; in the meantime, pension schemes should use the best available data today. New disclosure requirements mean the data will steadily improve over time.

STUMBLING BLOCK

1 Why should I make a net zero commitment in the first place when my fiduciary duty is to safeguard investors' returns?

"We're about two years into the process. Personally, I don't really understand it and I don't think most of our board understand it, either. As a trustee, I think we still challenge ourselves on: are we doing the right thing in making a decision with our investments that ticks the climate box. Is that really the right thing for the members at this stage? Will it give them the returns they need? And frankly, there's nothing I've seen, from any of our advisors, and anywhere else, that tells us that climate tilted funds, climate focused funds, are outperforming. In most cases, they're underperforming.

When we look at our funds, we've done the easy stuff, I suspect. We've restructured defaults so that, rather than being in a passive global index fund, they're in a passive, global climate tilted index fund ... It's easy to find a fund that ticks the climate box, excludes or does something around the BPs and Shells of this world and gives you the exposure that you need. So that's been a no brainer, I suppose. But was it a decision that was made lightly? Not really. I think it was a decision that I think the board probably felt they were being pushed into doing. But is it really going to end up being the right decision for our members in terms of the return?

I'm still not convinced currently that it is the right thing, but there's such a wave of regulatory pressure pushing trustees and boards that you just have to do this, because otherwise you become an outlier."

Anonymous trustee

Let's address this often-cited barrier to reaching net zero upfront. This trustee is concerned that members' investment returns are being sacrificed of combatting climate change. But surely members' returns should come first? Is members' investment returns being sacrificed in the name of combatting climate change. Surely members' returns should come before wider concerns like climate change? It's an issue that trustees understandably often return to.

The trustee quoted at the start of this section is unusual in having an older DC scheme membership. He believes they are unlikely to see a financial benefit from pursuing net zero, and he may well be right. It is far easier to argue the case for net zero when scheme members are younger and will be materially affected by the world's failure to reach it.

Over the long term, the argument for investing for net zero becomes straightforward. While climate strategies may underperform the benchmark over the short term, over the long term, investing in companies which have high exposure to fossil fuels is likely to prove problematic.

Let's look at the short term arguments for investing today in a way that propels us towards net zero.

Avoid a 'Minsky moment'

Julius Pursaill, who is a strategic adviser to Natwest Cushon, a DC master trust, offered one powerful counter to this trustee's argument, in a DCIF podcast which we recorded in 2023. ›

› Pursaill told us: "[Hyman] Minsky was an economist who talked about how bubbles burst and lead to a collapse in asset values. Our trustees – and Cushon – are absolutely convinced that we will see a series of 'Minsky moments', where you see asset values collapsing as a result of the impact of both physical and transition risks. And therefore, it's not so much a risk that your climate assets are going to fail to deliver you an adequate return. Actually, [climate assets are] where you want to be invested to ride out this series of Minsky moments."

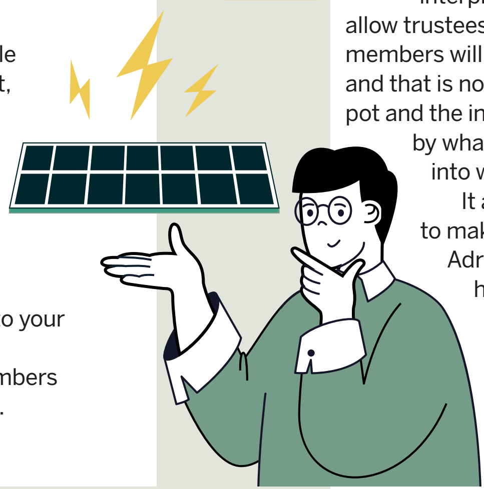
Some assets will suffer imminently in the transition – or are already underperforming

Even in the short term, some assets are likely to perform poorly in the transition to net zero. All the pension schemes we spoke to for this report have divested from thermal coal, for instance. Valeria Dinershteyn, director of sustainable investment and client engagement, EMEA, at Northern Trust, points out: "As with every type of asset, it is important to think about the place of thermal coal investments in your portfolio on a more diversified investment case basis. One needs to think how investing sustainably folds into your overall investment process."

If we don't act now, we risk members retiring into a chaotic future world.

There's a powerful existential argument for making net zero a priority now. If we don't get to net zero, the future world may be disorderly, with natural disasters becoming more common and food shortages and mass climate-related migration challenging the world order.

> **"As with every type of asset, it is important to think about the place of thermal coal investments in your portfolio on a more diversified investment case basis."**



As Pursaill says: "It always seems perverse that trustees might find themselves driven to invest, by their interpretation of fiduciary duty, in an investment strategy which delivers an extra thousand pounds for members in retirement, but at the same time is contributing to, or failing to address, the collapse of the society into which those members seek to retire. What value is an extra thousand pounds of retirement if your members are retiring into a society which doesn't have a functioning healthcare system, social care, education or legal system?

"It seems to me that a broad interpretation of fiduciary duty ought to allow trustees to consider the standard of living members will experience in their retirement, and that is not just driven by the size of their pot and the income it can produce. It is driven by what that pot can buy in the society into which they want to retire."

It also makes investment sense to make net zero a priority today. As Adrienn Sarandi, Janus Henderson's head of ESG strategy and development puts it: "The longer we wait [to transition], the more abrupt and violent the moves will have to be, and the more financial risk this is going to pose for us."

Trustee takeaways

- Some trustees believe that they are breaching their fiduciary duty if they invest in a way which prioritises net zero. Several of the DCIF's members urge trustees to read the Financial Markets Law Committee's paper on fiduciary duty and climate change, which was published in February 2024.

- Siobhan Cleary, Baillie Gifford's deputy head of ESG, summarises: "It clarified that as fiduciaries, trustees absolutely have a responsibility to consider sustainability factors (such as climate change) where they believe that these may impact financial risk or return. And that is not necessarily at individual asset level but in the totality of the scheme that they are managing.

- "That may involve, for example, thinking about what are the negative impacts or externalities that one holding within a portfolio may have on the ability of the rest of the portfolio to generate long term returns. So, it's a way of thinking more systemically and over longer time horizons. I think the paper goes as far as to say trustees may consider whether they should sacrifice shorter term returns because of the risk they introduce to the longer term health of returns in the portfolio."

- The guidance can be found here.

STUMBLING BLOCK

2 My scheme is too small to make a difference

As a small pension scheme, it's easy to feel voiceless when it comes to holding shareholdings and asset managers alike to account on the net zero journey. However, small schemes should not feel discouraged. There are plenty of ways they can punch above their weight.

Appoint a manager who will manage your scheme's assets to make a difference: Lindsay Nickerson, institutional sales director of Nordea Asset Management, summarises: "Managers do the voting, they have the voice, pick one that uses it."

Club together: As the NOW: Pensions case study illustrates, pension schemes can divide and conquer. "Collective initiatives, like Climate Action 100+ help pool those smaller schemes to make sure they have an influence," points out Sasha Miller, managing director, responsible investing strategy at Nuveen.

Many have similar shareholders; by getting together and splitting a list of companies, pension schemes can immerse themselves in some shareholdings and get prepared to ask awkward questions. Which leads us to our second point…

Get informed: When he was instrumental in ousting Aviva's then-chief executive, Andrew Moss, in 2012, Philip Meadowcroft proved that even a single shareholder can have a big impact. What did Meadowcroft do? He assembled information and came to Aviva's AGM prepared with damning information and accompanying killer questions – which schemes can do, whatever their size.

1

Appoint a manager who will manage your scheme's assets to make a difference

2

Club together and pension schemes can divide and conquer

3

Get informed and ask the right questions

Schemes can apply the same technique when grilling their asset managers, as Columbia Threadneedle's Vicki Bakhshi explains. "I think sometimes smaller asset owners underestimate the power they have and the impact that having client questions has on their managers. It pushes managers who maybe aren't at that stage in their net zero strategy. It really does make a difference getting multiple client questions on a topic, you can be absolutely sure they will be spending more time on an issue as a result."

Avoid generalities: Bakshi adds:. "What I wouldn't ask is general questions like: do you have a policy, can you disclose…' The more general policy questions are easily batted off with, 'Please see our carbon emissions report, please see our TCFD report'. I would ask the question: 'Please give us a list of your top three contributors to carbon emissions, your view on their transition strategy and what engagement you've had with them?'"

Kate Turner, First Sentier Investors' global head of responsible investment, adds: "The First Sentier MUFG Sustainable Investment Institute published a paper last year where we interviewed executives from 100 companies, small and large, about: when has engagement in the past from investors led you to change your behaviour? What were the success factors and what made you less likely to change your behaviour? Overwhelmingly, the sweet spot was when you had an investor that knows the topic and the company really well and can clearly articulate the benefits of action or the risks of inaction."

Keith Guthrie
Head of sustainability
NOW Pensions

How NOW: Pensions is punching above its weight on engagement

Sustainability at NOW: Pensions has been a key business focus for the last seven years. Keith Guthrie took up his role as head of sustainability for NOW: Pensions in the autumn of 2023. Prior to that, he was chief investment officer and deputy chief investment officer respectively at Cardano, the asset manager for NOW: Pensions.

Guthrie says: "It's been a wonderful journey for me, because I really feel like this is the area where I can make the most impact."

In a 2021 strategic review, the NOW: Pensions trustee board articulated their objectives: to achieve financial returns for members and to have a real-world impact. They established three, interlinked priorities: climate change, the living wage and gender diversity.

The trustee board decided that to make a real-world impact, they needed to make a net zero commitment. Accordingly, the scheme aims to achieve net zero by 2050, with a 50% reduction by 2030. They decided to allocate at least 50% of the scheme's assets to strategies with a responsible investment objective. Revisiting this in 2023, they increased that target to 75%.

With its young and diverse scheme membership, NOW: Pensions believes net zero is in its savers' financial interests. As Guthrie points out: "They are on the sharp end of many of the social and environmental impacts that are going to happen because of the risks we face with climate change and biodiversity loss."

Punching above its weight

In 2023, NOW: Pensions decided to take the equity default fund portfolio in-house, managed by Cardano. This gave them stronger alignment with their commitments. Plus, the stewardship approach is more consistent with the trustee board's beliefs. The scheme also had mixed experiences with external asset managers. "In one case, we found that while the strategy was decarbonising the portfolio, the asset manager was not really engaging with companies or voting in the way that the trustees wanted them to," says Guthrie.

The external asset manager responded by giving NOW: Pensions the ability to vote as they wanted to. However, Guthrie and his team worried that if NOW: Pensions voted differently to the asset manager, and that was not consistent with the engagement from the asset manager, it would give companies a mixed message and was unlikely to drive the real world change necessary.

While NOW: Pensions is a large master trust by UK DC standards, with over £4bn in assets under management, it is not yet up there with the biggest pension schemes in the world – a fact of which Guthrie is very aware. Nonetheless, the scheme's stewardship team have found ways to punch above their weight when it comes to engagement.

Collaboration is the first tool in their arsenal. The scheme has joined initiatives like the Climate Action 100+ and the Principles of Responsible Investment (PRI)'s Spring, which focuses on reversing biodiversity loss and deforestation.

Collaborating with like-minded investors means they can divide and conquer when it comes to engaging with the stocks in their portfolios, says Guthrie. "There are 150 or so stocks that are most impactful on nature or climate. We can allow other investors in the collaborations to take the lead on some of the stocks where we may play a supporting role, and we'll take the lead on others."

Investors can then devote resources to investigating specific stocks in some detail, says Guthrie. For example, Cardano has invested in satellite intelligence on deforestation. After they gathered detailed information on the locations where deforestation is happening, they needed to be able to link that information to companies operating in the area – "which is the really hard part," says Guthrie. "We have been able to do that in the cases of Unilever and Nestle."

In engagement conversations with companies, information is power. Guthrie continues: "Once you have the information, all of a sudden you are in a position where you can say: 'Listen, in your supply chain, there's deforestation happening.' When we first raised these issues a few years ago, the companies weren't even aware of it. And they were really interested in having the conversation, because suddenly, it became much more real to them."

NOW: Pensions has also engaged with Sainsbury's to encourage them to pay the living wage. The supermarket was receptive, reports Guthrie, and their decision to pay workers the living wage for several years in a row has now prompted competitors to review their own pay decisions, showing that impact can have broader reverberations, beyond just the company with which a scheme directly engages.

Guthrie concludes: "So, it has never felt like little old us › can't have effective conversations if you approach them with the right mindset and tools."

While engagement is a powerful tool, there are others in the arsenal. Cardano will vote against directors and co-file shareholder resolutions where engagements are not making the necessary progress.

Cardano is also now much more willing to divest from companies with which they have struggled to engage, and which represent material financial risks because they don't have a credible transition plan. This marks a shift from its previous strategy, which had fewer exclusions.

Guthrie explains: "There are some companies that are not at all interested in changing. We focus on companies that are willing to adapt, and therefore much more able to engage with us and progress on the transition pathway."

Advice for other schemes

Choose asset managers who can demonstrate alignment with your trustee board's beliefs, advises Guthrie. "I'm from South Africa, and we have an expression that a leopard doesn't change its spots. Make sure at the beginning with your choice of asset manager that they are aligned with what you believe is important on stewardship."

A key differentiator for asset managers is how they approach stewardship. Really investigate that, advises Guthrie. When appointing an asset manager, investigate how they have escalated issues with their shareholdings and voted in previous shareholder resolutions. After appointing them, continue to hold your managers to account, he says.

Climate change is a good place to start on ESG. But once you start, you realise the interconnectedness of the issues, says Guthrie. "Try to think holistically. Biodiversity and social issues are very interlinked to climate change"

Pensions insomnia: what's keeping Guthrie awake at night?

The borderline between where to engage and where to exclude stocks preoccupies Guthrie. At the moment, NOW: Pensions excludes around 15% of the equity market. He says: "A point of debate is about how stringent we are vis a vis adapting or not adapting. We don't exclude all oil and gas companies; that said, we do exclude a lot, because many do not have what we believe to be credible transition plans or commitments. Many have backtracked on their commitments."

However, Guthrie is keen to stress that he believes some oil and gas companies have a place in the future. "I think when it comes to things like carbon capture, in the future, oil and gas companies have a lot of engineering skills, as well as the storage sites that we might need for it. I would love to see much more engagement from them on this."

Guthrie's engagement/divestment concerns pale by comparison to his worries about systemic risk, though. "This is why stewardship is so important. You can only tackle systemic risk by convincing companies and governments to try and change and be in line with 1.5 degrees. In the long term, avoiding a 3.0 degree scenario is the most important thing we can do in our members financial interests.

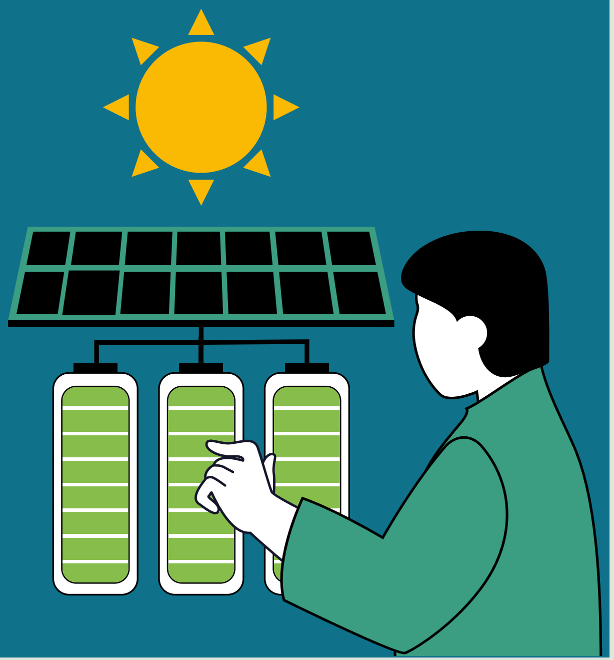
"The second thing you can do is invest in the solutions. We invest part of our portfolio in green bonds that's investing in solutions, and a portion of our equities are invested in positive impact companies. And so, we can say those are companies that are making a positive impact. I think we could still go further, so that's the part of our journey that we're developing."

While Guthrie worries about whether we'll collectively make it to net zero by 2050, he tries to stay optimistic. "There's a great quote from Bill Gates: 'We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next 10. Don't let yourself be lulled into inaction.' I am really hoping that that is true of our efforts to tackle climate change."

"A point of debate is about how stringent we are vis a vis adapting or not adapting. We don't exclude all oil and gas companies; that said, we do exclude a lot, because many do not have what we believe to be credible transition plans or commitments. Many have backtracked on their commitments."

STUMBLING BLOCK

3 How can I move from step two of the transition to step three?



The three stages of the net zero transition: recapped

1

Identify your emissions. Most asset owners have either done that or they are in the process doing it.

2

Reduce your emissions.

3

Avoid those emissions happening in the first place.

Let's return to the three stages of the net zero transition (set out on the left). Pete Cox, who is Northern Trust's head of ESG product, explains: "You can't really set targets until you have a clear and aggregate view of your current scheme investment data and are able to drill down to see where your potential risky high emitters are."

Most schemes will have identified their emissions already, but if your pension scheme is working on this, there are plenty of consultants and service providers who can help, says Cox. "Or you can try to do a lot of it yourselves but that is the more complex option," he adds. "There are a lot of guides and industry disclosure frameworks – including the UN PRI, the TCFD, the ISSB, they all offer tools and materials to educate and guide investors to follow best practice. There is a lot of support through significant investor collaboration too, such as through the Net Zero Asset Owners' Alliance."

If Baillie Gifford's Tim Gooding is right and asset owners tend to get stuck when trying to move from step two to step three, what do they need to change in order to make progress?

"Embrace a carbon budget," suggests Gooding. Having some companies with embedded carbon in your portfolio can be essential, because those companies are often part of the solution. "You need companies that make steel, for example, because without steel, there are no wind turbines."

To reach stage three, schemes should allocate capital in two different directions, says Gooding. First, towards the companies which are already pioneers in the transition: electric car manufacturers and battery producers, for example. Second, towards companies which are transition operators.

The importance of these dual investment objectives is echoed by Mark Austin, who is trustee chair of the Northern Trust UK pension plan. Austin likens it to "driving between two lines".

Gooding concludes: "We need to scale up capital directed towards these solution providers, if we're going to hit net zero. Asset owners are agents of change."

Finding and investing in unappreciated transition operators is Alexandra Christiansen's full-time job. Christiansen, who is a portfolio manager at Nordea Asset Management, runs Nordea's Global Climate Engagement Fund. She explains: "A lot of these sectors that are a perceived risk in the energy transition were being excluded from investors' universes, sold off by people who were trying to look good on paper. You know: 'let's just divest out of these sectors that look bad in terms of emissions and environmental footprint.' It was really interesting, because we could see plenty of opportunities in those parts of the market that were being excluded, that were still relevant in the low carbon future. In fact, they might be critical in enabling us to get to net zero. Otherwise, a company might offer great growth prospects and profitability that was being misunderstood.

"We go into these parts of the market and pick opportunities that we think are ›

› misunderstood in terms of that low carbon future and probably mispriced. We buy them at a cheaper valuation than what they're worth. And then we engage with the companies to change their perception in the market. Let's show the wider investment community that actually they are relevant in the low carbon future, and they're worth a lot more."

Studying the nuances of the transition is also a focus at abrdn, says Kate McGrath, who is an ESG investment manager – fixed income. She explains: "I work on the Climate Transition Bond fund, and the whole focus of that fund is on what are the things that create decarbonisation momentum, rather than looking at emissions today and just excluding the highest emitters, which has no impact on real world emissions at all."

An active approach is needed to integrate climate change, especially in fixed income, argues Nick Gaskell, a senior sustainability analyst at abrdn. "Where more passive approaches to integrating climate change are taken, you will typically see a massive overweight in banks, especially in fixed income indices. In equity indices, there will be a massive overweight to tech, whereas the Climate Transition Bond fund is overweighting what we feel are the most credible and aligned utility companies, industrial companies, materials companies, that are at the coalface of the transition.

"From a risk-adjusted perspective, these are sectors where we believe climate risk is more material than it is for other sectors where the indices that tend to just focus on decarbonisation will overweight. So, it's, in our opinion, a much more thoughtful, active mindset around integrating climate change. We do feel that that's the direction of travel that needs more attention across the industry."

"If all you're doing as an investor is tilting your portfolio out of heavy emitting sectors into less heavy emitting sectors, selling out of these opportunities that look bad on paper, that's all you've done. You've just changed it on paper. Because in practice, these industries are necessary. We're going to need steel in the future. So, you haven't changed anything in the real world. Whereas, if you buy that steel company and then you push them to actually decarbonize, and over your investment horizon, you participate in that decarbonisation, you've had a positive real world impact. You've made a difference, and you've banked real emission reductions in the economy. And I think that's a really important nuance to understand."

Alexandra Christiansen

Trustee takeaways

- **To get to net zero, schemes should invest in companies which are trailblazers – but also in companies which are transition operators, without whom reaching net zero would be impossible.**
- **Look for managers who are making change from the inside, pushing companies to decarbonise and holding them accountable.**

CASE STUDY

Katharina Lindmeier
Senior responsible investment manager
Nest

How Nest is tackling the stumbling blocks on its road to net zero

As the UK's largest master trust, all eyes are on Nest when it comes to all aspects of its decision making, and the path it takes to reach net zero is no exception. It's a responsibility the scheme has always taken seriously.

Nest's ambition is to reach net zero by 2050, says Katharina Lindmeier, the pension scheme's senior responsible investment manager. As well as its net zero ambition, Nest has also set decarbonisation targets. The scheme is aiming for a 30% reduction in scope one and two financed emissions for its public equities and fixed income portfolios by 2025, from a baseline set in 2019. Lindmeier explains: "We didn't explicitly include scope three, because of how unreliable the data was, but we are tracking that and performing quite well."

How Nest is achieving its ambitions

Nest does not manage money in house, so Lindmeier and her colleagues have been working with the scheme's fund managers to align the scheme's net zero objectives with its mandates. Lindmeier says: "A big part of what we've been working on is engaging with managers and setting objectives for them. There is a very big difference between what an active equity manager can do and what a passive manager can do."

Nest has also been allocating more to climate solutions, increasing its allocation to private markets and investing £1.3bn in renewable infrastructure equity and debt to date. Lindmeier explains: "We wouldn't necessarily go into something purely for climate reasons, but we do find that there are broader benefits. Private markets add diversification and areas like infrastructure can be used to hedge inflation. We've also recently conducted a search for timberland, again in part because of its diversification benefits."

Thematic equities are another new area which tick both the diversification and climate boxes. Lindmeier explains why Nest made an allocation: "We had almost 50% in one developed market fund. At our size, that means about £20 billion in one fund. So, we wanted to diversify that exposure and develop an actively managed portfolio to complement our passive exposure, with a particular focus on some key themes. They include climate transition and adaptation, nature, and also social themes."

Divestment is also a tool that Nest is prepared to use. The scheme has exclusions in areas like tobacco and excludes companies which violate the UN Global Compact. Nest has also divested from areas such as thermal coal and Arctic drilling. "These are the first that are going to be decommissioned in the transition to net zero, so there is the highest risk there," explains Lindmeier.

The stumbling blocks Nest faces

For any pension scheme, bumps along the road to net zero are likely. For Nest, hitting the 2025 target was primarily achieved through asset allocation decisions, such as moving into climate aware funds, rather than real world decarbonisation, reflects Lindmeier.

Achieving a 50% reduction by 2030 is going to be more challenging. Lindmeier explains: "As an asset owner, we have very low direct emissions, so our carbon footprint is almost entirely based on what we invest in. Therefore, we are very dependent on what investment managers and companies do. While we think that reaching net zero by 2050 is in the best interests of our members, the entire economy needs to shift to net zero to achieve that."

She adds: "Now that a lot of the low hanging fruit have been ›

> **"While we think that reaching net zero by 2050 is in the best interests of our members, the entire economy needs to shift to net zero to achieve that."**

plucked, to achieve that target, it means that our underlying assets need to decarbonise, or we're going to be forced, potentially, to restrict quite a lot of what we invest in. I think that's going to be really challenging, and it's why we've been cautious in setting an ambition, rather than making a commitment."

Right now, Nest is not seeing the real world decarbonisation which is needed to achieve net zero materialising, says Lindmeier. "What's going to become more important is opportunities to influence companies and policymakers to head in that direction, given the evidence is clear that a net zero world is going to be in the long term interests of our members because of the physical risks. We don't want it to be a knee-jerk transition. But at a global level, we are not heading in the right direction."

Lindmeier and her colleagues are also seeing some companies backtracking on their net zero commitments. "In the last two years, momentum has stalled, and in some cases, potentially reversed. We're in a slightly difficult position as an industry: where do we go from here? We don't necessarily want to divest; it isn't going to change anything. But realistically, how many more levers do we have if we've already voted against shareholder resolutions? Companies are just not listening to us."

In response, Nest has been ramping up its stewardship and engagement efforts, as well as reviewing its in house policies.

Lindmeier is also sympathetic to the unexpected supply chain struggles many companies have faced as a result of Russia's invasion of Ukraine. Reluctance to follow the net zero path and backtracking on commitments has been most pronounced in the energy, oil and gas sectors, she says. "We're seeing a lot of companies in the fossil fuel industry saying: 'We only had something in the region of a seven percent squeeze in supply and look how big an impact that had on gas bills.' Therefore, they argue, we need to keep production at the same level rather than scaling it down."

However, to do so would put oil and gas companies behind where they need to be on the path to net zero, Nest argues. If they keep their production stable until 2030, it will mean a much deeper decline to 2050. However, the temptation could be to delay. "Today's board members are possibly not going to be around to deal with that problem," points out Lindmeier.

While Nest will divest in some circumstances (as detailed above), this is generally a last resort, says Lindmeier. "We make exclusions where we have engaged and haven't had the results that we wanted to achieve, and we consider the company to be a laggard. We would first engage, then use a vote against them, then file a shareholder resolution – for example, we recently did this at Shell – and try and be quite public about it so other shareholders take note, because collective action is important."

Nest is also considering a slightly softer sanction, says Lindmeier. As a large master trust, it receives significant assets in the form of member contributions every month, which are then invested. The scheme is considering mechanisms where it freezes investments into companies which are not behaving in line with net zero expectations. Nest would continue to hold its existing investments, though, meaning it would retain voting rights and an all-important seat at the table.

What's clear from our conversation with Lindmeier though is that no single actor can reach net zero alone. To ensure an orderly transition, others must join Nest around the table.

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STUMBLING BLOCK

4 Net zero reporting is complicated

One key challenge for net zero implementation is that there isn't a single way to measure it – and opinions differ on whether this is something we should aspire to. Columbia Threadneedle Investments' Vicki Bakshi says: "I think the net zero investment framework – that's what we've chosen – has a lot of pickup and credence, but there are other approaches out there and even within those methodologies, there are a lot of decisions that individual managers need to make about how they are implemented and what data points they are going to use."

The lack of a single methodology makes it challenging for asset owners like pension schemes to compare progress between asset managers – and to report their own progress.

Terry Alleyne is one trustee who hopes data and reporting will become simpler. He says: "The further we go down this path, the more educated we become. Ten years down the line, I assume we'll understand what the data is telling us and what good and bad numbers look like for each fund, in terms of their carbon emissions and things like that.

"It's a bit like when petrol cars were first made; at some point, someone said, 'We should do a measurement which is miles per gallon.' And then people ask: 'What's efficient in terms of miles per gallon?' I always grew up thinking if I got a car which did thirty miles to the gallon, it was a good, efficient car. But when the price of petrol goes up, you become more astute to that in terms of your buying criteria. I assume that, some years down the line, we will have a set of data for each scheme which you can quickly look at and go, 'That's good.' Or: 'That's bad.'"

> **"I think the fund managers and providers are getting more and more pressure to produce data and output on their funds and their climate reporting. So, we are producing a lot of paper - not printing it though! But you sit in the meetings and you think, well, what does this mean? Does this mean it's good or bad? Does this number mean we're making progress?"**
>
> **Terry Alleyne, trustee of the Citibank UK Pension Scheme**

However, a single methodology would have significant limitations, Bakshi argues. "It is much easier to tell a divestment story – it is more complex to tell a transition story. The only way to do that credibly is to identify which the most significant companies are in terms of emissions, tell the story, and show how the trustees and managers have done their due diligence. How they understand where the company is at, they've looked at the company strategy, they've engaged with the company ideally, they have been thoughtful in voting – and what conclusion they have come to. That is a much more nuanced set of reporting, and it will be open to challenge." She adds: "If [a pension scheme] can set out the process by which they have done that, particularly the ›

"There are more and more disclosure requirements globally that enforce the [reporting] need on the issuer, the publisher of that early scope 3 data. The trend is upwards. There are good estimation models in place – I work with data providers who are following that 'best efforts' approach. Most of the legislators and global frameworks are saying: use the best available data today, even if it isn't perfect. It is better than putting off the start of the journey."

› conversations and engagement they have had and the engagement outcomes, that is the more meaningful story."

Finding and reporting on scope three emissions data – emissions which are not produced by a company directly but are created elsewhere in the company's value chain – is one particularly thorny area for pension schemes. Olly King, who is a sustainable investing product specialist at Fusion, Data Solutions at J.P. Morgan, observes: "It is a hard nut to crack, because the information is woolly and also you don't necessarily control what happens in terms of scope three – you are looking at supply chain analysis upstream and value chain analysis downstream. Which ones are you going to attack?" However, new data and ways of doing things, like multi-level supply chain analysis, are making monitoring more complete for asset managers, he says.

Northern Trust's Peter Cox is also optimistic that matters are improving. Cox explains: "There are more and more disclosure requirements globally that enforce the [reporting] need on the issuer, the publisher of that early scope 3 data. The trend is upwards. There are good estimation models in place – I work with data providers who are following that 'best efforts' approach. Most of the legislators and global frameworks are saying: use the best available data today, even if it isn't perfect. It is better than putting off the start of the journey."

Trustee takeaways

By guest contributor Vicki Bakshi, director and climate strategist, Columbia Threadneedle Investments

■ An objective of TCFD reporting is not just to give the raw carbon footprint numbers, but to say: 'Which companies are the biggest contributors to your carbon footprint and what are they doing about it? Where are they on their transition journey?' That is where you can have a meaningful discussion. Picking apart whether a carbon footprint has risen or dropped is not really telling you useful information.

■ For instance: we need solutions providers, the companies which produce the copper cabling, batteries, and other tools we need for the energy transition. But those are often industrial companies and by their nature they have a high carbon footprint. I think that was underrecognized in some of the industry methodologies. Some, like the net zero investment framework are now picking that up and talking about a way of more thoughtfully embedding the positive benefits of investing in solutions providers, even though they tend to have a high carbon footprint.

■ It is tempting to think 'high footprint bad, low footprint good', but really, if you look at what's in the net zero investment framework, what we need to be looking at is the transition story. That is much more complex and harder to capture with data, but that is what the net zero investment framework is trying to do, and that's what some of the data points we're covering are trying to do.

■ When speaking to your managers and looking at your shareholdings, don't just look at their carbon footprint today. Ask: have these firms got a transition plan and is it credible? It is a harder question to answer – but it is the right question."

Closing thoughts
Will we get to net zero by 2050?

Defined Contribution Investment Forum

2050 is just over 25 years away, but most people we interviewed were optimistic about the pensions industry's net zero trajectory. Nuveen's Sasha Miller says: "I think one of the things I'm heartened by is I don't see any resistance to meeting net zero commitments; actually, the opposite, from an asset owner, client, asset manager perspective, which is great. They're getting closer to their milestones, where they may have set a 2030 interim target, and they're executing it. And therefore, they are expecting managers like ourselves to execute. So, I think things are progressing overall."

However, as Katharina Lindmeier points out earlier in the paper, pension schemes cannot get to net zero alone. "At a global level, we are not heading in the right direction," she says. Geopolitical conflicts and economic headwinds have caused some companies to quietly backtrack on their net zero commitments. Pushing net zero further down the track risks a hastier and more disorderly transition in the years to come. Therefore, pension schemes and the wider industry must not rest as we collectively move towards net zero.

We hope this paper has given DC schemes some tangible ideas of how to overcome the stumbling blocks in their paths.