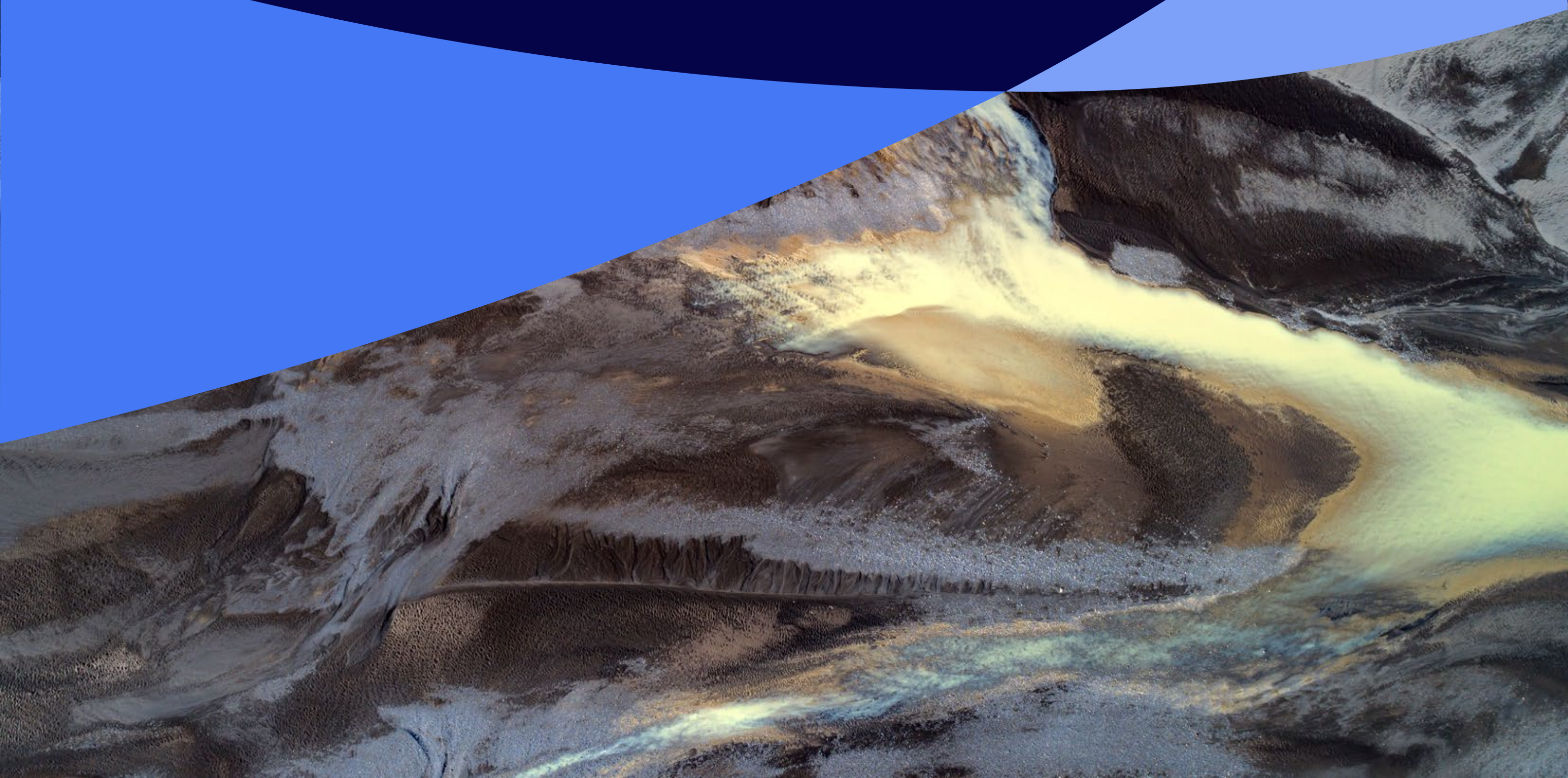
IIGCC

Net zero strategies for externally managed investments: new levers and targets



Summary

This paper outlines and explores solutions to some of the challenges investors face when trying to set climate-related goals and implement net zero strategies for externally managed investments.

Many investors, particularly asset owners, rely on external managers to interpret and implement their net zero goals and objectives. IIGCC acknowledges that the Net Zero Investment Framework and supplementary guidance can better recognise and promote the role that these investors have in setting clear expectations of external managers, creating shifts in behaviour, where possible, and promoting transparency.

IIGCC therefore proposes adding an additional engagement target to the Net Zero Investment Framework that captures the important client-manager engagement lever. We also explore an approach - and associated KPI - whereby external managers can be engaged, in a structured way, on attributes that indicate the extent to which they are supporting the net zero transition of a client's fund or mandate. This also aims to encourage more systemic change, beyond the fund or mandate, through the attributes demonstrated by an external manager at firm level.

Whilst it is not IIGCC's role to assess the net zero alignment of asset managers' strategies and behaviours, we recognise a gap in current net zero frameworks and implementation support mechanisms that harnesses manager selection, engagement and monitoring as a key lever for the net zero transition. Any manager selection processes should be determined by individual investors, considering both climate and non-climate factors.

The discussion below follows a number of meetings and roundtables with pension funds, endowments, family offices, managers with funds of funds and third-party fund structures, and investment consultants. Feedback to date has suggested a broad framework that creates some consistency across the industry whilst building in flexibility to account for priorities and nuances of each client and manager, which are to be discussed and agreed upon discreetly.

Further work is required to develop, refine, and test the ideas expressed in this paper. IIGCC sees value in consulting with investors that use external managers, as well as investment consultants, to draw on existing best practices for manager selection, engagement, and monitoring. We also seek feedback from managers on the attributes and successful ways of working with clients to deliver their net zero ambitions. Together, we can strengthen the approach set out in this discussion paper, develop further guidance to support implementation, and create mechanisms to facilitate engagement between the investment value chain – managers, investment consultants, and their clients.

IIGCC is seeking feedback and further engagement with members on the proposal and ideas explored in this paper. Please respond via this survey by 15 April 2024.

1.

1 Background

Investors can use the Net Zero Investment Framework as part of approaches, required of them as fiduciaries, to identify and manage material financial risks, including climate-related risks. A core premise of the Net Zero Investment Framework is that investors can manage climate-related risks and support assets in their portfolios to transition, which can in turn support the decarbonisation of the real economy, as well as investors' own portfolios.

However, of those investors that aim to reduce emissions associated with their portfolios, only half have set targets for both the net zero alignment of underlying holdings *and* engagement with those holdings[1]. There are multiple reasons for this. One commonly cited reason heard by IIGCC, particularly amongst asset owners, is that the use of external managers creates challenges around collating information relating to the net zero alignment of underlying holdings, influencing those holdings directly e.g. through stock selection, and implementing engagement and escalation strategies, since this is often outsourced to managers.

Many investors, particularly asset owners, feel that the most impactful lever they have to manage climate-related risks and transition their portfolios to protect the long-term value of their investments, relates to engaging with and influencing the strategy and behaviours of the managers they invest with. Yet this lever has not been given adequate attention in net zero target setting methodologies. This has led IIGCC to revisit manager engagement as a core lever of change.

1 Data taken from analysis of targets set by signatories to Net Zero Asset Managers and Paris Aligned Asset Owners initiatives that use the Net Zero Investment Framework as an underpinning methodology.

2 Challenges

Feedback from members indicates that the main challenges investors with externally managed investments face when trying to devise climate goals and develop and implement climate strategies are:

- **Challenge #1** They hold fewer levers of influence to support underlying holdings to transition. The transition of underlying holdings is a core lever of influence underpinning the Net Zero Investment Framework. However, many investors using external managers are not suited to perform a "look through"[2] to underlying holdings and rely on their managers for holdings-level data to influence a strategy, and/or do not undertake portfolio management techniques such as asset selection and tilting, or engagement and stewardship.

- **Challenge #2** External managers have different theories of change and can influence the transition in different ways. For example, the contribution a passive manager, who is restricted by the index, can make to a client's goals differs to that of an active manager, who has more freedom. The same is true for emerging market investors compared to investors in developed markets. This makes it difficult for clients to assess and compare managers and prioritise manager engagement efforts.

- **Challenge #3** Challenge #2 is compounded by a lack of information and data from managers on their approaches and behaviours, including on engagement strategies and outcomes and policy advocacy, as well as detailed information on the net zero alignment of holdings. Without crucial information on net zero alignment indicators such as these, at both the firm-level and fund- or mandate-level, clients are unable to assess if and how managers are meeting expectations.

- **Challenge #4** Even if managers provide detailed data on the net zero alignment of holdings, there is little standardisation across managers, with most using different methodologies, data sets, and definitions. Again, this makes it impractical to measure and compare progress of managers.

- **Challenge #5** Reporting practices and quality of disclosures vary across managers, particularly between managers in different jurisdictions as well as public versus private markets.

IIGCC has started to explore possible solutions to these challenges. To address challenge #1, IIGCC considers that there is a need to refocus attention on the wider range of (mainly existing) levers available to investors and better enable investors that use external managers to use their influence in the most impactful way.

The goal is to provide greater direction for investors that use external managers to prioritise engagement with asset managers on climate change, interpret how to assess the contribution different managers are making to the net zero transition, set clear expectations, and better integrate climate considerations into manager selection and monitoring.

2 "Look-through" refers to the examination of the holdings in an investor's portfolio. In the context of NZIF, this exercise is mostly based on the assessment of the net zero alignment criteria. See "Asset Class Alignment" section of The Net Zero Investment Framework: Implementation Guide (page 13)

3 Refocus: levers of influence

In practical terms, this could be achieved by adding new metrics and KPIs into the Net Zero Investment Framework, supported by additional guidance and the facilitation of greater engagement between clients, asset managers, and investment consultants.

There are a range of levers available to investors aiming to contribute to the transition to net zero, alongside a number of metrics that can help investors measure and communicate progress.

The Net Zero Investment Framework captures multiple levers available to investors, and these subsequently formed the basis of the net zero commitment statements adopted by investor signatories to Net Zero Asset Managers[3] and Paris Aligned Asset Owners[4]. Key levers include:

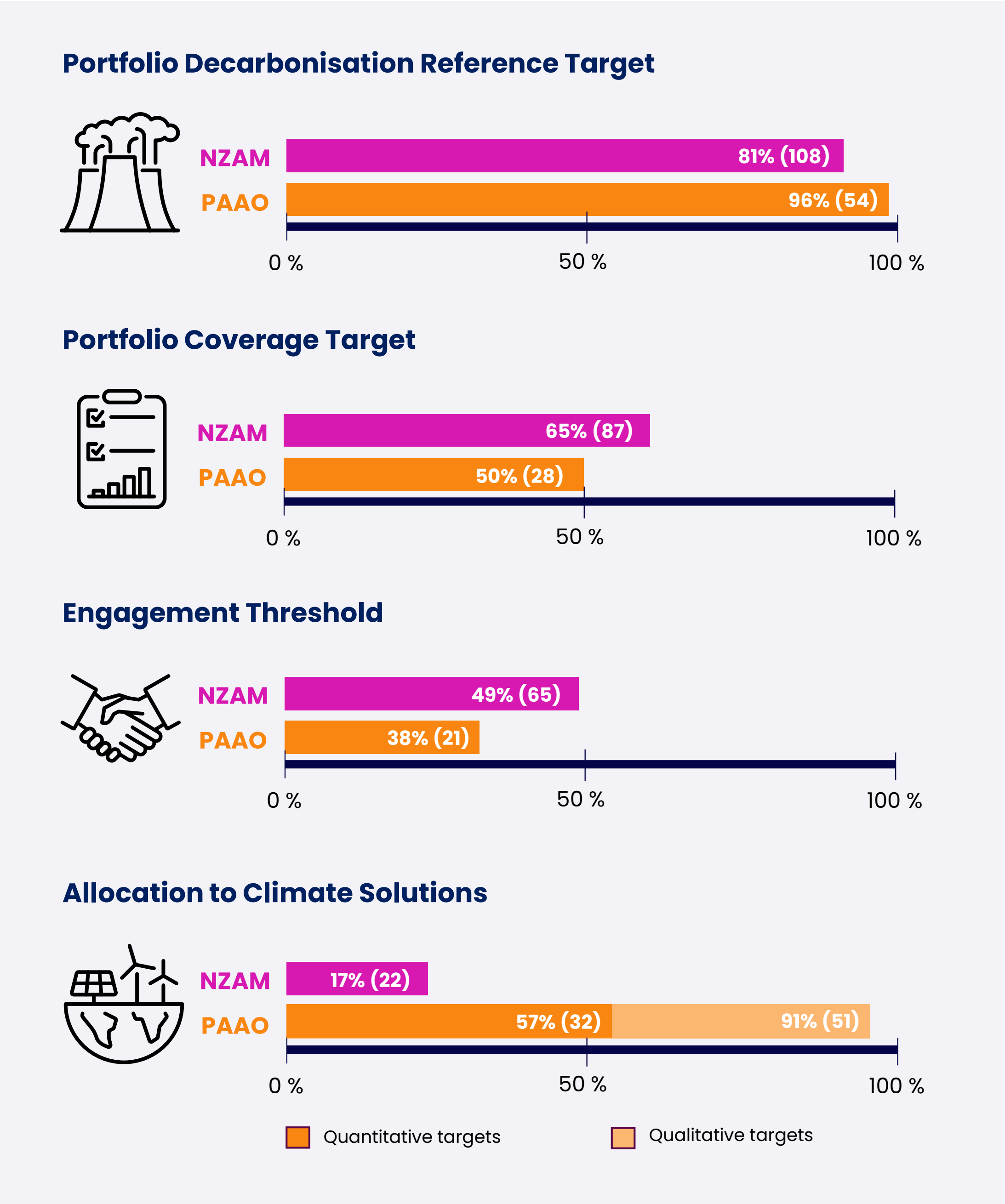
- **Lever #1** Setting objectives and targets.
- **Lever #2** Portfolio construction and management including asset allocation, "best in class" strategies, industry/sector re-allocation.
- **Lever #3** Implementing a net zero stewardship and engagement strategy, with voting policy.
- **Lever #4** Manager selection and engagement and/or educating and engaging clients.
- **Lever #5** Engaging with investment industry stakeholders including investment consultants, index providers, data vendors, and proxy advisors.
- **Lever #6** Undertaking policy advocacy.
- **Lever #7** Promoting transparency and accountability through disclosure.

Three of the above levers appear to be the most widely utilised so far by investors: target setting, portfolio construction and management, and stewardship and engagement strategies.

Of the four types of metrics and targets recommended in the Net Zero Investment Framework, the portfolio decarbonisation reference target is the most commonly adopted. Fewer investors set targets on asset alignment, investment in climate solutions, and engagement of assets, as shown in Figure 1 below.

3 Net Zero Asset Managers Commitment Statement
4 Paris Aligned Asset Owner Commitment Statement

Figure 1 – NZIF targets set by NZAM and PAAO signatories



(Source: IIGCC)

For the reasons stated in section 2, it's a challenge for many investors with externally managed investments to devise a strategy that focuses on the net zero alignment of underlying assets and engagement of holdings.

Therefore, this discussion paper proposes that we elevate the status of Lever #4 and Lever #5, as they relate to manager engagement and selection, and engaging with investment consultants. Our aim is to provide greater guidance and support to IIGCC members utilising these levers.

- **Lever #4 Manager selection and engagement** and/or educating and engaging clients.
- **Lever #5 Engaging with investment industry stakeholders including investment consultants,** index providers, data vendors, and proxy advisors.

4 Manager engagement KPIs

IIGCC proposes that a future iteration of the Net Zero Investment Framework includes additional KPIs that allow investors to measure and disclose the number (#) or proportion (%) of managers that they will engage with on their climate goals and net zero strategies, representing a proportion (%) of AUM.

Example: # of external managers, representing X% of externally managed AUM, are engaged on the delivery of our climate strategy.

Rationale: Many investors, particularly asset owners, rely on external managers to interpret and implement their net zero goals and objectives. However, given the challenges outlined above, the most impactful use of resources for these investors could be to engage external managers with structured engagement processes leading to desired actions or changes in manager behaviours such that the client's net zero investment strategy is interpreted and implemented.

Whilst NZIF already recommends that mandates and performance objectives for asset managers are reflective of the clients' net zero investment strategy, and reviewed over time[5], *how* an investor engages with external managers and *what* they engage on is crucial for the efficacy of the client-manager engagement process, as explored more in section 5. We can see examples of this type of KPI utilised by some investors, with two examples shown in Box 1.

Next steps: As noted above, different theories of change, methodologies, data sources, and starting points of managers are likely to mean that there will be some variation in when, how and on what topics investors engage with their managers. The next section explores the types of topics that are likely to be central to most engagement efforts between managers and their clients on net zero. Meanwhile, IIGCC can also support investors to build processes and guidance covering engagement strategies, and manager selection and monitoring approaches for different types of funds and managers.

Box 1: Examples of manager engagement KPIs set by asset owners

Brunel Pension Partnership: Persuasion target – portfolio stewardship

Engage with 100% of investment managers and general partners on measuring emissions, disclosure levels and setting targets for decarbonisation and alignment by June 2024.

Source: Brunel Pension Partnership "Climate Change Policy (2023-2030)"

LGPS Central Limited: Engagement targets for external managers

Listed equity & corporate bonds: Engagement with external managers on LGPS Central's net zero strategy and stewardship programme

- 100% in 2023

Sovereign debt & private markets: Engagement with external managers on net zero targets and data

- 100% in 2023

Source: LGPS Central Limited "Portfolio & Real-World Decarbonisation in Public and Private Markets" (October 2023)

5 See "Governance and Strategy" section of The Net Zero Investment Framework: Implementation Guide (page 9)

5 Manager net zero alignment KPIs

IIGCC understands from a number of investors who use external managers that it can be a challenge to effectively prioritise managers for engagement and identify the most important aspects of managers' net zero strategies and actions to engage on, particularly relating to stewardship and voting. This challenge is often exacerbated when investing across asset classes and jurisdictions, when starting positions, available methodologies, and levers of influence can vary significantly across managers.

This section identifies some of the most important attributes that managers aligning to net zero objectives could be expected to demonstrate. It discusses an approach that can be used by clients and investment consultants, building on existing manager selection, monitoring and engagement processes. This sets out expectations in a clear and structured way, with a view to delivering progress over time, strengthening dialogue and supporting clients to assess manager performance against their expectations. The approach is focused on helping clients assess the extent to which managers are supporting clients' climate strategies, as well as their contribution to the wider enabling environment required for the net zero transition.

By formally incorporating this style of approach into the Net Zero Investment Framework, IIGCC can help create a strong demand from investors with externally managed investments for robust action from managers, at both the level of funds or mandates *and* at firm level, whilst enhancing transparency and information flow to those clients that request it.

Examples: A 5-year target for increasing % of AUM managed by third party managers that are assessed as "aligning" or "aligned" with net zero. *Or, a 5-year target for increasing the % of AUM managed by third parties which are actively managed in line with net zero.*

Rationale: This approach could provide a structure for external managers' policies, actions, behaviours, and disclosures (together "alignment attributes") to be assessed by clients. Whilst standardisation of some of the attributes would generate greater consistency in the requests and expectations that are communicated to managers from clients, there is a need for this approach to value the various types of contributions that different managers make towards the net zero transition, as noted in section 2, as well as the different starting points and jurisdictions from which managers operate.

Therefore, there is unlikely to be a one size fits all solution that can be adopted and applied across the spectrum of managers. Clients may have to work closely with managers to determine the attributes that best capture the glidepath that they are taking towards net zero alignment and the various levers of influence that they hold in the global transition to net zero. IIGCC sees an opportunity to work closely with investment consultants to develop a robust manager engagement approach for net zero alignment, including by producing additional guidance for clients, and opportunities for collaborative engagement between asset managers, investment consultants, and their clients.

Box 2: Influence bands

In the private equity component of the Net Zero Investment Framework, IIGCC introduces the concept of "influence bands", which is relevant to the ideas expressed in this discussion paper.

Influence bands are a means of recognising the varying levels of influence that different types of investors in private equity have and reflecting this variation in the recommended portfolio coverage and engagement targets.

Within private equity, General Partners (GPs) are generally the only actors engaging with portfolio companies (PCs) and have differing levels of influence, depending on the investment type and amount of equity and governance they hold. Limited Partners (LPs) will also have varying levels of influence depending on how and when they invest. Figure 2 below illustrates the six influence bands, grouped into two categories of direct and indirect influence.

To account for these dynamics, both the private equity portfolio coverage target and private equity engagement threshold targets use influence bands to establish objectives that are ambitious yet reflective of the practical circumstances that each investment type faces (see Figures 5 and 6, page 15). The guidance also sets out tailored engagement actions that are designed around the influence levers available, given the band's dynamics (see Figure 7, page 19).

The discussion in this paper takes inspiration from the private equity guidance and aims to replicate some of the practical solutions for engagement between LPs, GPs, and PCs, a method for assessing the alignment of funds and their managers, and important engagement actions.

Figure 2 – Table of influence bands in the Private Equity component of the Net Zero Investment Framework

Asset classes	Band	Criteria	Influence level
Direct • GP buyout fund • GP growth fund • GP continuation fund	**1a**	> 50% of board voting seat appointments (usually the majority shareholder)	Strong (with PCs)
	1b	≤ 50% of board voting seat appointments (usually a significant minority shareholder	Moderate (with PCs)
	1c	No board votes	Limited (with PCs)
Indirect • LP investments in buyout, growth or continuation funds • LP co-investment • GP fund of funds • LP-led secondaries	**2a**	Big ticket investors* and/or first close investors	Strong (with GPs)
	2b	Investment made during fundraise not included in 2a; co-investment	Moderate (with GPs)
	2c	Investment made through secondaries market	Limited (with GPs)

*Substantial capital commitments to a fund (typically 5 to 10% of the fund size).

Alignment attributes

Below is a list of alignment attributes that many investors are already engaging their external managers on and are likely to form the basis of a manager engagement strategy.

The alignment attributes are differentiated into "firm level" and "fund or mandate level". Fund or mandate level attributes are key to ensuring that clients' climate goals and preferred strategy are reflected by the fund or mandate. Clients with segregated mandates will have greater influence compared to clients invested in pooled vehicles. Techniques and tools for investors in pooled vehicles ought to be a key focus for further work on this approach.

Firm level attributes aim to encourage consistency between the management of a client's funds towards its net zero objectives and the wider actions and behaviours of the manager. Firm level attributes, therefore, aim to ensure that managers are contributing to a positive enabling environment for the transition to net zero and not undertaking activities that may undermine the climate goals or performance of the clients' investments, in the short- or longer- term.

Firm level attributes could also be important for clients to engage with managers of passive and index strategies. In the case of these strategies, where underlying holdings are necessarily at the discretion of the manager, managers can demonstrate that they are dedicated to using other avenues to support the net zero transition.

The list below is non-exhaustive and designed for illustrative purposes only. Each attribute would require further guidance to support both interpretation and implementation. For some attributes, there are existing bodies of resources and materials that can be signposted to. The overall set of criteria aims to bring together different techniques and good practice in a single framework that can be adopted across the industry, by investors using external managers. A list of existing resources is provided in Annex I.

Firm level attributes

- An increasing proportion of AUM to be managed in line with net zero (as per NZAM targets)
- A long-term 2050 decarbonisation goal for all AUM consistent with achieving the global net zero goal
- Implementation of a robust Transition Plan / Investor Climate Action Plan
- Corporate stewardship practices consistent with the global net zero goal
- Policy advocacy in line with the global net zero goal

Fund level

- Disclosure of financed emissions and/or net zero alignment of underlying assets and/or climate solutions allocation
- Short- and medium-term targets most applicable to the fund's strategy, such as
  - Portfolio coverage targets
  - Climate solutions targets
  - GHG emissions associated with the fund (e.g. financed emissions, WACI)
- Adequate performance against short- and medium-term targets
- Fund is within scope of the manager's Transition Plan
- Fund has a strategy to contribute to the net zero transition
- Fund is designated as Article 8 or 9 (or equivalent in non-EU jurisdictions)

For some attributes, information and data is likely to be readily available or easily provided by managers. Some can be tracked by reasonably well established metrics, such as those relating to targets and emissions. However, some attributes would require more extensive data, information collection and qualitative analysis, the outcomes of which may not be easily attributable or verifiable. Examples include those relating to corporate stewardship practices and policy advocacy. Despite these challenges, the importance of such attributes is widely recognised as a means to support real world decarbonisation.

Deploying these attributes as part of a net zero alignment assessment may support clients to engage with managers and set clear expectations to be delivered in a timebound manager, in a similar way that IIGCC promotes timebound engagement between investors and public equity holdings[6]. Managers can also evidence the progress they are making towards greater net zero alignment over time.

Figure 2 provides an illustrative example of how an investor using external managers might structure a net zero alignment assessment for the purposes of prioritising managers for engagement, engaging managers on the clients' net zero goals and objectives and measuring progress over time. Clients can select the most relevant attributes applicable to specific managers, and those attributes could even be identified in collaboration with the manager itself. This provides the necessary flexibility required to capture different starting points, levers of influence, and jurisdictional contexts from which managers operate. Annex II provides a second example with some proposed alignment attributes.

Figure 3 – Illustrative example of structuring manager alignment attributes into a framework for assessing manager performance against a clients' expectations and supporting engagement priorities

	Manager net zero alignment attributes	Not aligned	Committed to aligning	Aligning	Aligned
Firm level (Systemic change)	Attribute 1				
	Attribute 2				
	Attribute 3			Full or partial	
Fund or mandate level (Tactical change)	Attribute 4				Full or partial
	Attribute 5				
	Attribute 6			Full or partial	
	Attribute 7				

6 Net Zero Stewardship Toolkit (IIGCC, 2022)

6 Next steps

For this approach to have the desired impact, further work would be required to determine ambitious attributes that reflect both specific shifts that are needed to align funds and investment portfolios with net zero, as well as systemic shifts that are needed to create a net zero aligned enabling environment over the medium-to long-term. In combination with the existing types of targets, levers and approaches outlined in the Net Zero Investment Framework, an approach such as that outlined here - if designed and implemented thoughtfully - could create incentives to make progress towards net zero alignment and support enhanced dialogues across the investment chain.

The new KPIs, manager attributes, and overall method should be further developed in collaboration with asset owners, managers with externally managed investments, and investment consultants, and tested and validated by asset managers. This will help to ensure a high chance of incentivising positive actions and outcomes across a wide range of managers, investment styles, and jurisdictions.

As noted above, asset owners and other investors utilising this approach will require a suite of additional guidance and tools to support with the interpretation of the attributes for different types of managers. For example, more work needs to be undertaken to determine what is required for corporate engagement and policy advocacy to be considered consistent with the global net zero goal. It also needs to be considered in the context of the practical steps that can be taken to prioritise managers for engagement, undertake engagement and communicate expectations, and incorporate this method into existing manager selection and monitoring processes.

7 Feedback

IIGCC is seeking feedback and further engagement with members on the proposal and ideas explored in this paper. Please respond via this survey by 15 April 2024 to provide answers to the five questions listed below or general feedback.

1. Do you agree that new approaches are required to support investors to act on climate change in a way that recognises the unique challenges and opportunities of those with externally managed investments?
2. Are you supportive of the additional proposed "manager engagement" target type? Why?
3. Are you supportive of an approach to assess and engage on alignment attributes of external managers? Why?
4. What type of guidance or support is most needed to support investors with externally managed investments to set and implement ambitious climate goals?
5. How do you think IIGCC should work with investment consultants to refine and implement new approaches?

Appendix I

IIGCC recognises that for an approach such as the one discussed in this paper to be effective, a body of additional guidance, tools, and resources would need to be collated from existing sources where possible and created where there are gaps.

The list below provides some relevant existing resources may be helpful investors using external managers:

- Net Zero Asset Managers - signatory disclosures
- A Guide of Sustainable Investment Guides for Asset Owners (Investment Consultant Sustainability Working Group)
- Net zero stewardship questionnaire (IIGCC, 2023)
- Serving Asset Owner Clients through Climate Stewardship: A call to action to the asset management industry (Asset Owner Alliance, Feb 2024) and Elevating Asset Manager Net-Zero Engagement Strategies (Nov 2023)

Appendix II

Figure 4 provides a second example of a set of manager attributes across fund or mandate and firm level that could provide a robust and ambitious basis on which to engage a manager and assess ability to deliver against the client's net zero goals and objectives over time.

Figure 4 - Example of manager alignment framework for assessing manager performance and supporting engagement priorities against a clients' potential expectations

	Manager net zero alignment attributes	Not aligned	Committed to aligning	Aligning	Aligned
Firm level Systemic change	A long term 2050 goal consistent with global net zero				
	Implementation of a transition plan			Full or partial	
	Corporate stewardship practices consistent with the global net zero goal			Full or partial	
	Policy advocacy consistent with the global net zero goal			Full or partial	
Fund or mandate level Tactical change	Short- or medium-term targets and annual disclosures • Portfolio coverage *and/or* • Climate solutions				
	Short- or medium-term financed emissions targets and annual disclosures*				
	Implementation of a fund level strategy for net zero transition				
	Fund is designated as article 8 or 9 (or equivalent)			Full or partial	

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