

*Targeting Net Zero: Embedding  
Accountability for Portfolio  
Decarbonisation and Resilience in  
the Asset Owner – Asset Manager  
Relationship*

FAITH WARD

I. INTRODUCTION

**S**TEEP REDUCTIONS IN greenhouse gas emissions will be needed during the remainder of this decade if the hope of safeguarding a temperature rise of no more than 1.5°C by the end of the century is to remain in sight. Over 130 of the 191 parties to the Paris Agreement have committed to achieving net-zero by the middle of this century.<sup>1</sup> They are joined by companies, cities, and financial institutions across the globe.

Climate change will, due to the scale and longevity of the impacts, have profound implications for investors, particularly those with, or who support, long-term liabilities.<sup>2</sup> Action is needed to reduce and mitigate emissions, to adapt to the physical changes already underway as well as to make portfolios more resilient to minimising the potentially devastating financial impacts of climate change. Investors have critical role to play in enabling and supporting the low carbon transition, and can benefit substantially – through reducing risks in their portfolios and through accessing investment opportunities – from doing so.

Responding to these risks, delivering on fiduciary duties as well as societal expectations, is complex, and it requires action from a multitude of other actors, not

<sup>1</sup> UNFCCC, *NDC Registry* (March 2022).

<sup>2</sup> IPCC, *First to Sixth Assessment Reports* (1990–2022).

just investors. These include policymakers, regulators, other financial institutions, companies and individuals.

The key challenges for asset owners include finding enough of the right asset managers and products that align with progressive beliefs and an innovative investment strategy; and ensuring risk processes, investment time horizons and incentives structures are designed to deliver the desired outcomes. These challenges are not new or unique to portfolio decarbonisation but are the more pressing to overcome given the timelines the scientific community have made clear.<sup>3</sup> With global assets under management calculated to be in excess of US\$100 trillion,<sup>4</sup> the scale of both the challenge and the opportunity of getting accountability for portfolio decarbonisation and resilience embedded through the investment chain is essential. To be clear, it is vital that the expectation set by asset owners is that the asset managers not only consider all the risks and opportunity arising from climate risk but change their processes to take climate into account. This should result in different outcomes from investment decision making. The corollary of this is that asset owners need to support managers in changing their processes by being mindful of the parameters set, but also that they change manager monitoring to hold them to account.

This chapter aims to cover the context of the challenge, the risks and the frameworks set out to guide investors embarking on net-zero. It draws on specific case studies from the direct experience and practices of Brunel Pension Partnership Limited (Brunel). These case studies seek to illustrate how that company has gone about setting expectations, challenged, and changed processes and delivered different outcomes – ones we hope get us a lot closer to net-zero.

## A. About Brunel

Founded in 2017, the Brunel Pension Partnership is one of eight UK Local Government Pension Scheme pools and the Partnership brings together more than £35 billion of investments of ten likeminded pension funds.<sup>5</sup> Our approach to climate is strongly influenced by our clients' demands and expectations. Whilst addressing climate change is important to all our clients, they also have different risk appetites, which means we need to provide a range of products to reflect their specific ambitions.

In March 2021, Brunel committed to achieving net-zero by no later than 2050. We made the commitment through the Paris Aligned Net Zero Asset Owner Commitment,<sup>6</sup> originally developed by the Institutional Investor Group for Climate Change (IIGCC)<sup>7</sup> and now part of a global investor collaboration.

<sup>3</sup> *ibid.*

<sup>4</sup> Investment Association, *Investment Management in the UK 2020–2021* (2021).

<sup>5</sup> Avon, Buckinghamshire, Cornwall, Devon, Dorset, the Environment Agency, Gloucestershire, Oxfordshire, Somerset and Wiltshire. Brunel is authorised and regulated by the FCA as a full-service MiFID firm.

<sup>6</sup> Paris Aligned Investment Initiative, *Asset Owner Net Zero Commitment* (2021), <https://www.paris-alignedinvestment.org/>.

<sup>7</sup> See <https://www.iigcc.org/>.

Figure 1 Brunel Pension Partnership

|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |                                                                                                                                                                                                                                                             |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>Our priority is to manage our fiduciary duties to our clients. Our partnership has also made major commitments on Climate Change and Responsible Investment, in line with our shared values. In this way, <b>we aim to help our clients provide not only for their members' retirement, but for the world they will retire into.</b></p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                                             |
| <p>We believe that:</p> <ul style="list-style-type: none"> <li>Climate change presents a <b>systemic and material risk</b> to the ecological, societal and financial stability of every economy and country on the planet, and therefore will impact our clients, their beneficiaries and <b>all portfolios' holdings.</b></li> <li>Investing to support the <b>Paris goals that deliver a below 2C°</b> temperature increase is entirely consistent with <b>securing long-term financial returns</b> and is aligned with the best long-term interests of our clients.</li> <li>For society to achieve a net-zero carbon future by 2050 (or before) requires <b>systemic change in the investment industry and equipping and empowering our clients</b> (and other investors) is central to this change.</li> </ul> |                                                                                                                                                                                                                                                             |
| <p>Given our strengths and our position in the market, we therefore believe that the key objective of our climate policy is to systematically change the investment industry so that it is fit for purpose for a world where temperature rise needs to be kept to well below 2°C compared to pre-industrial levels.</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |                                                                                                                                                                                                                                                             |
| <p><b>The 5 P's of Brunel's Climate Policy</b></p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |                                                                                                                                                                                                                                                             |
| <b>Policy</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       | Encourage policy makers to establish comprehensive and robust climate change policy frameworks.                                                                                                                                                             |
| <b>Products</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     | Increase the number and range of products available to our clients and the wider investment market that deliver substantial climate change benefits and sustainable investment returns                                                                      |
| <b>Portfolios</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   | Ensure our investment portfolios are resilient under a range of climate change scenarios (both mitigation and adaptation) by adopting best practices on climate risk management and working with our managers to further improve and develop our processes. |
| <b>Positive Impact</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              | Enable investments in activities that directly support the low carbon transition and that enable effective adaptation to the unavoidable impacts of climate change.                                                                                         |
| <b>Persuasion</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   | Challenge and encourage companies and other entities in which we invest and contract with to support the transition to the low carbon economy, and to ensure that they are resilient to the unavoidable impacts of climate change.                          |

Source: Brunel Pension Partnership.

All (100 per cent) of Brunel's mandates are outsourced to asset managers, so it is essential that we genuinely work in partnership with these managers to achieve the investment outcomes that we desire. In establishing Brunel's 17 listed markets portfolios between 2018 and 2021, our team engaged with over 200 asset managers, reviewed over 200,000 pages of tender information covering over 530 different investment strategy proposals. This chapter highlights case studies from that experience. Whilst we have similar approaches in our private markets' portfolios (infrastructure, real estate, private equity and debt), these are at an earlier stage and harder to replicate but we actively share our work and publish case studies in our annual Responsible Investment and Stewardship Outcomes report.<sup>8</sup>

## II. CLIMATE-RELATED FINANCIAL RISK AND THE ROAD TO NET-ZERO

The financial services industry's understanding of the nature of climate change has developed significantly over the last few years, with most participants regarding it as a foreseeable and materially significant financial risk. A pivotal moment was Mark Carney's speech 'Breaking the tragedy of the horizon – climate change and financial stability' at Lloyd's of London in 2015.<sup>9</sup> In his speech, Carney clearly set out why this is a matter for everyone in the financial services, as 'climate change will threaten financial resilience and longer-term prosperity'.

Helpfully, Carney also sets out the principal sources of risks to financial stability, which were further developed and enshrined in the recommendations of the Task Force for Climate-related Financial Disclosures (TCFD), initiated by Mark Carney in his role as Chair of the Financial Stability Board in 2015 and first published in 2017:<sup>10</sup>

Climate change and financial stability. There are three broad channels through which climate change can affect financial stability:

First, physical risks: the impacts today on insurance liabilities and the value of financial assets that arise from climate- and weather-related events, such as floods and storms that damage property or disrupt trade;

Second, liability risks: the impacts that could arise tomorrow if parties who have suffered loss or damage from the effects of climate change seek compensation from those they hold responsible. Such claims could come decades in the future, but have the potential to hit carbon extractors and emitters – and, if they have liability cover, their insurers – the hardest;

<sup>8</sup>Brunel, *Responsible Investment and Stewardship Outcomes Report* (2020–2022).

<sup>9</sup>M Carney, 'Breaking the Tragedy of the Horizon Climate Change and Financial Stability' (Mansion House speech, Bank of England, 2015).

<sup>10</sup>*Recommendations of the Task Force on Climate-related Financial Disclosures* (Task Force on Climate-related Financial Disclosures, 2017).

Finally, transition risks: the financial risks which could result from the process of adjustment towards a lower-carbon economy. Changes in policy, technology and physical risks could prompt a reassessment of the value of a large range of assets as costs and opportunities become apparent. The speed at which such re-pricing occurs is uncertain and could be decisive for financial stability. There have already been a few high-profile examples of jump-to-distress pricing because of shifts in environmental policy or performance.

Brunel believes that addressing climate risk is an essential component of fulfilling its fiduciary duty to its client partner funds and their beneficiaries. Brunel signed up to report to the recommendations of the TCFD in 2017, the same year that Brunel was formed as a business. This was a clear acknowledgement of the importance of not only managing climate risks but being transparent about steps taken and outcomes progressed.

Asset owners and managers are increasingly being asked to evidence that climate risk, as well other sustainable issues, are being effectively managed. The TCFD recommendations often form the basis of the climate change disclosure requirements.<sup>11</sup> The TCFD starts by requiring organisations to be clear on their climate governance and to describe the board's oversight of climate-related risks and opportunities.

Brunel took its climate beliefs and translated them into the strategic risk management of the organisation, embedding them into the terms of reference of committees managing the risk and the objectives of key personnel. For example, Brunel's Chief Executive Officer (CEO) has overall responsibility for the delivery of Brunel's climate policy and owns 'climate' as a strategic risk to the organisation. Additionally, the Chief Operating Officer is accountable for the organisation's own resilience and business continuity that might arise from the impact of physical climate risk. This principle of ensuring that the whole organisation, starting with our most senior managers, stands behind the decision to decarbonise the portfolios and strive for net-zero is essential. When appointing asset managers, Brunel seeks to identify whether there are similar levels of accountability. This can act as an indicator of the manager's own maturity in dealing with the issue. A red flag would be an asset manager identifying climate risk management being led (as opposed to being supported by) by the responsible investment and/or stewardship team without further reference to higher level of governance and accountability.

### III. DESIGN AND DELIVERY OF CLIMATE RESILIENT INVESTMENTS

The design and delivery of net-zero investment mandates will be considerably more effective when emanating from strong climate governance. The road to a net-zero

<sup>11</sup> The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021, SI 2021/839, introduce new requirements relating to reporting in line with the TCFD recommendations.

economy is going to be complex and bumpy and there are a lot of areas where approaches are still being developed; setbacks and mistakes are inevitable, and so strong board and senior executive buy-in is essential.

Direct capital investment in solutions, engaging policy makers and changing the operations and behaviours of the companies we invest in are all part of how we will deliver real world decarbonisation needed to achieve net-zero. It is important to recognise that the outcomes of embedding accountability for decarbonisation must support real economy emission reductions. To genuinely reduce climate risk requires a net-zero economy, not net-zero portfolios. This nuance means that the task of stewarding assets through the transition is incredibly complex.

The evaluation of the investment risk in the context of climate change, including the direct physical impacts but also those arising from policy, technology and other market risks is far from straightforward. Climate change is a complex, multi-faceted, long-term issue and as such views on how it will manifest as an investment risk will vary enormously. For example, there will be multiple views on which countries, sectors and companies will be affected and to what extent and when.

This is challenging for an asset owner with these views arising not only from their own internal teams and internal research but from their asset managers as well as their data and research providers. In these circumstances it is useful to use authoritative sources to ask questions of asset managers and how they have considered this viewpoint. We use a range of tools and sources which include the IPCC and UNFCCC reports which have already been referenced extensively. To this, add the International Energy Agency's research, most particularly its *Net Zero by 2050, A Roadmap for the Global Energy Sector*,<sup>12</sup> as well extensive academic research.

The work of the London School of Economics, Grantham Research Institute on Climate Change and the Environment, is a go-to resource for Brunel. Highlights include research on policy, regulations, the 'Just Transition', as well as being the academic partner to the asset owner-led Transition Pathway Initiative (TPI). Brunel co-leads and financially supports TPI. Its application in supporting investment decisions is highlighted in case studies later in the chapter. TPI assessments are also used to guide Brunel stewardship, for example engagement and voting.<sup>13</sup>

Brunel has also utilised the Principles for Responsible Investment's research on the Inevitable Policy Response (IPR),<sup>14</sup> particularly the summary of key policy levers in training, stakeholder outreach, and as a ready list of questions to ask asset managers,

<sup>12</sup> IEA, *Net Zero by 2050, A Roadmap for the Global Energy Sector* (May 2021).

<sup>13</sup> 'Brunel Pension Partnership Ltd Stewardship Policy' (Brunel Pension Partnership, 2021).

<sup>14</sup> UNPRI and Vivid Economics, *What is the Inevitable Policy Response (IPR)* (PRI, 2021). The IPR aims to prepare institutional investors for the portfolio risks and opportunities associated with a forecast acceleration of policy responses to climate change. IPR contends that governments will be forced to act more decisively than they have thus far, leaving financial portfolios exposed to significant transition risk.

both current and prospective. These can include: How does the investment process consider such risks? What assumptions has the portfolio manager made in relation to these risks? What, if any, climate stress testing has been undertaken and did the stress testing consider these risks?

Brunel uses these resources to form its climate policy, to identify relevant climate-related investment risks which are used to engage with managers and set expectations which flow into the monitoring of asset managers.

**Table 1** IPR 2021 (IPR forecasts higher policy ambition across eight key policy levers)

|                                                                                                                                                                                                                                                                                                                                              |                                                                                                                                                                                                  |                                                                                                                                                                                                                                                                                                  |                                                                                                                                                                                                                                                                                    |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Carbon pricing</b> <ul style="list-style-type: none"> <li>• Carbon taxes</li> <li>• Emissions trading systems</li> <li>• Border carbon adjustments</li> </ul>                                                                                                                                                                             | <b>Coal phase-out</b> <ul style="list-style-type: none"> <li>• Prohibiting regulations</li> <li>• Emissions performance standards</li> <li>• Electricity market reforms</li> </ul>               | <b>100% clean power</b> <ul style="list-style-type: none"> <li>• 100% clean power targets</li> <li>• Renewables capacity auctions and other support policies</li> </ul>                                                                                                                          | <b>Zero emissions vehicles</b> <ul style="list-style-type: none"> <li>• 100% zero emission vehicles (ZEV) sale legislations</li> <li>• Manufacturer ZEV obligations</li> <li>• ZEV consumer subsidies</li> </ul>                                                                   |
| <b>Low-carbon buildings</b> <ul style="list-style-type: none"> <li>• Prohibiting regulations for fossil fuel heating systems</li> <li>• Purchase subsidies for low-carbon heating systems</li> <li>• Thermal efficiency regulations for new build and retrofit</li> <li>• Minimum energy performance standards for new appliances</li> </ul> | <b>Clean industry</b> <ul style="list-style-type: none"> <li>• Emissions performance standards for industrial plant</li> <li>• Subsidy for new or retrofit clean industrial processes</li> </ul> | <b>Low-emissions agriculture</b> <ul style="list-style-type: none"> <li>• Methane or nitrous oxide emissions tax or cap-and-trade system</li> <li>• Subsidy for low-emissions agricultural practices and technologies</li> <li>• Farmer education and technical assistance programmes</li> </ul> | <b>Forestry</b> <ul style="list-style-type: none"> <li>• Strong policy actions against deforestation, such as monitoring and penalties, supported by consumer pressure</li> <li>• Incentives for reforestation and afforestation via domestic action and carbon markets</li> </ul> |

Source: UNPRI, IPR, Vivid Economics (2021).

**Figure 2** Paris Agreement and Net-Zero

The term Paris alignment is widely used, and in general captures the wider aims and objectives of the legally binding international treaty on climate change adopted in Paris, at COP21. The term net-zero is also thrown around somewhat casually and used in many different contexts. There are many variations and interpretations, which causes confusion. In this section, we provide practical definitions of both terms to provide a context for our work. It is a high-level starting point, but the International Panel on Climate Change (IPCC) website provides a superb glossary which can be confidently used as an authoritative source.

The **Paris Agreement** under the United Nations Framework Convention on Climate Change was adopted in 2015 at COP21 and replaced previous international treaties designed to limit the release of greenhouse gases. The Paris Agreement set the ambition to achieve emissions reductions that would limit mean global temperature increases to well below 2 degrees, preferably 1.5 degrees Celsius (by 2100) above pre-industrial levels. It is understood that to limit this temperature increase by the end of the century, emissions need to be reduced to net-zero by no later than 2050. It also means that GHGs emissions beyond 2050 also need to stay at or below zero.<sup>(1)</sup>

The Paris Agreement also established the comprehensive oversight and implementation mechanisms for countries in of setting and reviewing the targets and plans proposed by countries (nationally determined contributions – NDCs) as well as commitments relating to the ‘just transition’, climate finance, adaptation and resilience.

The term ‘Paris Aligned’ by investors is used to capture these broader ambitions that seek to ensure that the transition is equitable (between and within countries and communities); that the physical risks (extreme weather events, sea level rise, drought, etc) associated with climate change amongst other matters are considered as part of the investment process.

#### **Net-Zero**

In its simplest terms Net-Zero is achieved when emissions of man-made GHGs are balanced out by removals – natural (forests, oceans, etc) and artificial (carbon storage and capture). A credible net zero strategy must address contributions to warming made by other anthropogenic greenhouse gases. Most particularly methane (CH<sub>4</sub>) and nitrous oxide (N<sub>2</sub>O) are very potent and problematic in their own right and relevant to the investors, particularly those with exposure directly or via the supply chain to agriculture, chemicals, transportation and waste treatment.

Net-Zero from an investment perspective is still evolving and Net-Zero Investment Frameworks outlined in the chapter aims to translate into tangible actions and targets.

<sup>(1)</sup> United Nations Environment Programme (2019). Emissions Gap Report 2019. UNEP, Nairobi.

## **IV. WHAT DOES IT MEAN TO BE A NET-ZERO INVESTOR?**

The setting of climate beliefs and developing climate governance supports the integration of climate risks into investment decision-making. This section provides insights into requirements, frameworks and practical actions that support investors progressing net-zero, with examples of what Brunel has done in the next section.

Translating the Paris Agreement – which was designed for world governments – into tangible definitions and requirements for businesses, cities, investors and other ‘non-state actors’ is critical if the objectives are to be achieved. To this end, the

UNFCCC's Climate Ambition Alliance launched the 'Race to Zero' campaign on 5 June 2020. The initiative, led by Chile and the UK, sought to 'bring together the leadership and support of businesses, cities, regions and investors for a healthy, resilient and carbon-free recovery that prevents future threats, creates decent jobs, and enables inclusive and sustainable growth'.<sup>15</sup>

The initiative sets out minimum criteria, or 4P's (pledge, plan, proceed and publish) that are required of initiatives to be deemed Race to Zero compliant. There are three investor initiatives that are accredited for the financial sector:<sup>16</sup>

- the Paris Aligned Investment Initiative (PAII);<sup>17</sup>
- the Net-Zero Asset Managers Initiative (NZAM);<sup>18</sup> and
- the UN-convened Net-Zero Asset Owner Alliance (NZAOA).<sup>19</sup>

A key challenge for asset owners in working with asset managers is aligning expectations, investment objectives and processes when tackling long-term challenges such as climate change. Investors do not have to be part of one of these initiatives to commit to being a net-zero investor, but what the initiatives do provide is a consistency of expectations across the investment chain.

IIGCC, who initiated the PAII, are also part of the Investor Agenda endorsing the NZAM Initiative. The coordination between the initiatives provides a supportive environment to improve alignment. The list below summarises the translation of the Race to Zero 4P's into the respective commitments for both asset owners (PAII) and asset managers (NZAM), including the overlapping shared objectives.

## A. PAII and NZAM

Shared objectives of these initiatives include:

- set 'fair-share' interim targets toward 50 per cent emissions reduction by 2030;
- consider material scope 3 emissions;
- increase investment in climate solutions;
- prioritise real economy emissions reductions;
- implement a net-zero stewardship and engagement strategy, with clear escalation and voting policy;
- limitations on use of offsets.

The NZAM commitment asks managers to:

- increase the proportion of AUM to be managed in line with net-zero;
- work with clients to achieve net zero, offering information and analytics;

<sup>15</sup> UNFCCC, *Race to Zero Climate Ambition Alliance* (UNFCCC, 2020).

<sup>16</sup> As at April 2022.

<sup>17</sup> See <https://www.parisalignedinvestment.org/>.

<sup>18</sup> See <https://www.netzeroassetmanagers.org/>.

<sup>19</sup> See <https://www.unepfi.org/net-zero-alliance/>.

- create investment products in line with net zero;
- support science-based policy on investment in coal and other fossil fuels.

Just one year after launch, NZAM has 273 signatories, with US\$61.3 trillion in AUM,<sup>20</sup> clearly illustrating the commitment of many asset managers to align with net-zero objectives.

Alignment has been further advanced by the development of the Net-Zero Investment Framework (NZIF), codeveloped by both asset owners and asset manager as part of the PAII. To clarify the alphabet soup of initiatives, the PAII and NZAM are commitments to what organisations are signing up to. The NZIF, first published in March 2021, provides a common set of recommended actions, metrics and methodologies through which investors can maximise their contribution to achieving global net zero global emissions by 2050 or sooner.<sup>21</sup>

Figure 3 Net-Zero Investment Framework



Source: IIGCC (2021).

<sup>20</sup> As at 31 May 2022.

<sup>21</sup> PAII, 'Net Zero Investment Framework Implementation Guide' (Paris Aligned Investment Initiative, March 2021).

The NZIF methodology recognises that different legal structures and applications in different jurisdictions will require flexibility in implementation. The first edition of the framework sets out the steps for investors in relation to strategic asset allocation, setting high-level and portfolio specific targets; stewardship and specific guidance on listed equities, corporate bonds, real estate and sovereign debt.

The framework also signposts to resources that have been evaluated by investors and can support implementation. The NZIF continues to develop asset class implementation methodologies, eg private equity, infrastructure, together with guidance on key issues such as use of offsets, derivatives and benchmarks.

Asking managers to use the framework and – even better – to formally commit to NZAM, will break down many of the barriers identified in the introduction, as the frameworks help to align the outcomes, the expectations and even the mechanisms that can be used to analyse and discuss individual assets. The contribution NZIF has made to aligning asset owners with their asset managers in delivering portfolio decarbonisation cannot be underestimated.

## V. BRUNEL CASE STUDIES

Our Climate Policy was published in 2020. The heart of the Policy is the belief that we need to use our position in the investment chain to be a stimulus for system-wide change. Brunel can exercise power in many parts of the financial system, with policymakers and with companies although, due to our size, this is generally most productive when done in collaboration with peers. More significantly, we have considerable power through the selection, appointment, monitoring and ultimately retention of asset managers.

Brunel made it very clear in its climate policy what it expected of its asset managers and was also clear that it would, if alignment did not seem evident, terminate mandates. Whilst we have not used specific climate-linked incentive structures in asset manager fees structures as we believe building it into how managers are appointed, assessed and retained, acts as an incentive in itself.

Brunel's 2020 Climate Policy contains the following text:<sup>22</sup>

We will rigorously, assertively and continuously challenge our investment managers on their analysis and assessment of change-related risks in their investment practices and processes. We will expect them to continually improve these practices and processes, and will explicitly consider these improvements in our monitoring, management, selection, appointment and reappointment of our investment managers.

### A. Brunel Position on Divestment is Key to Manager Accountability

Brunel supports divestment from specific fossil fuel and other carbon-intense companies, if these companies are considered to present material investment risks to our

<sup>22</sup> 'Brunel Climate Policy' (Brunel Pension Partnership, 2020).

portfolios. An example might be companies who face the risk of having a significant number of ‘stranded assets’. These decisions are based on analysis by our investment managers. We expect managers to take these decisions independently (ie based on their assessment of the risks and opportunities presented by companies). That said, there is an increasing availability of data and analysis that can aid the asset managers’ decisions and also equip the asset owner to challenge the assumptions made by the manager. The use of frameworks such as NZIF by both asset manager and owners will aid harmonisation of approaches to divestment and engagement.

We chose not to use exclusion lists with our active managers. Instead, we require them to analyse the companies and other entities they invest in, and to justify their investments in any companies who have higher greenhouse gas emissions. We do not issue exclusion lists because, in our view, what is most needed is change in the way investment managers work. Simply enforcing exclusions, or requiring divestment from specific stocks or sectors, will not compel investment managers to develop their capacity on climate change or to drive change in the companies they hold. In a world of exclusion lists, climate change inevitably becomes a technical operational matter, not an investment priority.

Driving changes in company behaviour is a complex process and is much more nuanced than what is often reduced to an ‘engagement versus divestment’ debate. What Brunel is seeking to do is embed the accountability for what is held – or indeed not held – in our portfolios with those who are employed to select those assets. To ensure that we are accountable for the outcomes of these processes, we not only publish all our holdings but also a comprehensive carbon metrics report that demonstrates the outcomes, such as exposure to fossil fuels and future fossil fuel emissions, for these portfolios. That said, we also recognise that we may want to selectively exclude certain stocks or activities, particularly in the context of passive or quantitative products, and will review these options as part of the climate stocktake process that begins in 2022. Brunel has published a statement outlining its approach to engagement versus divestment,<sup>23</sup> which explores the issue more deeply.

## **B. Manager Selection**

Brunel’s policy is to embed climate into all its mandates. We do have some specialist products – sustainable equities, for example – where the requirements are more specific, but in the main there are very few differences in our approach. We do acknowledge that managers focusing on smaller companies and emerging markets will have constraints on data availability and we do take these constraints into account. However, all managers in the context of their mandate have the same expectations shaped around our policy which is to limit warming arising from emissions,

<sup>23</sup>Brunel Pension Partnership (2021), <https://www.brunelpensionpartnership.org/climate-change/our-approach-to-engagement-and-divestment/>.

and to positively invest in climate solutions and companies that are aligned and more resilient than their peers.

New mandates provide an exciting opportunity to test market participants and put them through their paces in relation to climate risk and opportunity. Brunel had the advantage of building all its portfolios since 2018, in a time where the investment management industry has been more aware of climate risk. That said, there remains a wide disparity in managers' technical understanding and the maturity of their approaches, even within the same asset class.

#### *i. Tender Questionnaires*

Brunel uses questionnaires as part of the initial tender process for its listed markets portfolios. Climate risk questions have been used in all of them at one point or another. One example is our multi-asset credit (MAC) manager search in 2021. There was clear client demand to find MAC managers who would need to have capability to support our climate policy and commitment to net-zero. The word capability is used specifically, as our market research suggested there was little evidence of current provision for such strategies in the market at the time.

Brunel often used both an Expression of Interest questionnaire (EOI, first stage screen) and Invitation to Tender (ITT, second stage); ESG questions, including climate, would be in both.

The ITT climate questions, in combination with those relating to stewardship and engagement, represented over half the score relating to quality and service. We would recommend ensuring sufficient weight is applied to these areas, in order to send the message to asset managers that climate policy alignment and accountability are genuinely important.

The questions explored not only the managers' current approach but also how they expected it to evolve considering Brunel's climate requirements. The focus on the future was vital as climate integration into this asset class was not well developed and the interest and capacity to be innovative – recognising the fast-moving nature of climate research, tools and available data – is essential. Manager selection is a resource-intensive process and one Brunel does not seek to do more than necessary. We believe long-term asset manager relationships increase alignment and increased probability of better long-term performance.

Brunel's approach to tender evaluation across all searches is for several members of the team to score each answer. To assist in consistency the lead portfolio manager will provide guidance as to what makes for a good answer. What stood out in this process was that the best answers (ie the investment managers who scored the highest) were those which clearly demonstrated some of the challenges with integration and where the managers were very honest about what they did and did not do, and where they faced specific challenges (eg the challenges of conducting climate risk assessments of some credit types such as asset backed securities and other derivative based instruments due to the lack of data and methodologies).

Figure 4 Brunel's Multi-Asset Credit Invitation

**Extract – Climate questions**

- a) How do you think about climate change in the context of ESG?
- b) What climate change integration already exists within your proposed strategy;
- c) What is currently in the process of being implemented (with anticipated completion timescales) and;
- d) What are your more ambitious long-term goals.

Please note that your answers to the questions above should be specific to your proposal for this mandate, not fixed income in general.

Please provide an overview of your approach to Climate Change analysis for the Multi Asset Credit portfolio, with reference to the following:

- How and why do you integrate Climate Change factors into the Multi Asset Credit investment process? To what extent does Climate Change data impact investment decisions for this portfolio?
- If you have developed proprietary Climate Change ratings, please explain how these are created and monitored.
- How do you overcome the challenge of limited carbon data in the Multi Asset Credit universe?
- If you utilise any third-party Climate Change data, please specify the data providers and how this data is incorporated.
- What Climate Change parameters do you impose on this portfolio and why?

Please provide an example or report you will be able to provide.

Source: Brunel Pension Partnership.

The questionnaires also explored the managers' approach to engagement. Engaging with the underlying assets to positively impact operations and behaviours in the real economy is what will deliver the real world decarbonisation needed to achieve net-zero. This is a core area of manager monitoring. Carbon footprinting alongside asset level net-zero alignment are key metrics in manager monitoring.

All the managers selected committed to a set of actions, to be delivered over time, that will support aligning the portfolio with net-zero. The evidence emerging from early manager monitoring is very positive with increased resources allocated to climate analysis and numerous examples of where the analysis has had a direct impact on the portfolio construction, reducing climate risk with no impact on return expectations.

## *ii. Using Carbon Footprinting Data to Support Selection of Asset Managers*

In 2019, we were searching for investment managers for a global equity strategy. Essentially this involved finding a blend of asset managers whose approaches were different, eg highly concentrated with a focus in high growth, to a strategy that held a much larger number of holdings focusing on value (stocks which trade at a significant discount to their intrinsic value), allowing us to balance risk through using a mix of styles.

Figure 5 illustrates the carbon intensity for each of the short-listed managers grouped by the investment characteristics of their approach. The carbon intensity, but



### C. Manager Appointment

Brunel includes the requirement to adhere to our Climate Policy, provide climate data (eg carbon footprint) and regular stewardship reporting in our investment management agreements (IMAs) for segregated mandates. Even in pooled vehicles we seek to get side letters agreed that enhance our expectation of managers. However, what we need to support our approach to climate change is evolving rapidly and there is a risk of the requirements in an IMA becoming quickly obsolete. In assets or geographies where climate risk is less developed, asset managers can also be wary of legally committing to requirements that are broadly defined (as we know they will need to evolve) and therefore difficult to capture in formal legal negotiations. This can lead to protracted and resource intensive conversations.

To solve the problem of ensuring that Brunel's expectations are clear but do not require detailed explanation, Brunel developed a principles-based approach documented in the Brunel Asset Management Accord.<sup>25</sup> The Accord is intended to help clarify understanding and shape expectations in the implementation of the investment mandate that Brunel has awarded. It is not intended to create legal obligations on either party; in all matters of contract the investment management agreement takes precedence. However, the Accord captures the spirit of the relationship and a partnership approach that Brunel is seeking to establish. It is a two-way commitment, with Brunel committing to being long term and to acting to support the manager, particularly in periods of under-performance.

Its purpose is to focus on establishing 'long-term investment' relationships and therefore touches on matters much broader than those specifically relating to climate change. However, given the need to evolve investment approaches to deal with the long-term nature of climate risk, it is a key component of the toolkit. Extracts that are particularly relevant to dealing with climate risk are presented below.

(2) Brunel takes a long-term view of its fiduciary duties and expects the Manager to act as if it were a fiduciary investing for the long term when operating this mandate

(8) Brunel demands high standards of transparency from the companies and organisations it works with, so likewise places a high priority on being transparent itself and providing high standards of reporting and communication. Brunel will expect the Managers' reporting to facilitate its ability to deliver this commitment.

(14) Brunel are prepared to be innovative and demonstrate thought leadership in collective investment, within the requirement of prudence and joint fiduciary duty. Brunel welcomes open dialogue to explore ways to meet both its own and our clients' evolving investment needs. The Manager will keep Brunel informed of the evolution of its business and its investment process so that Brunel can ensure the mandate remains fit for purpose.

<sup>25</sup> 'Brunel Asset Management Accord' (Brunel Pension Partnership, 2018).

The Brunel Asset Management Accord has been well received by asset managers and has been signed by managers with whom we have a direct relationship across both public and private markets.

#### D. Manager Monitoring, Working in Partnership

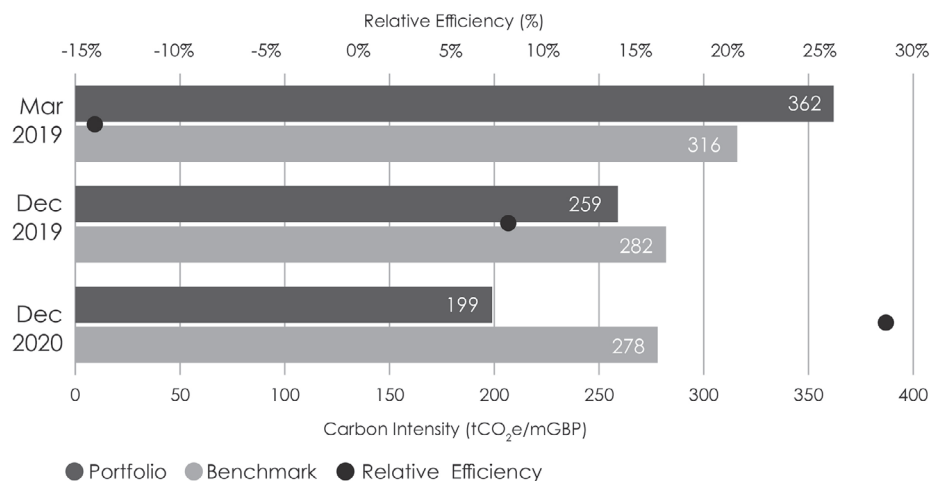
As outlined above, the Accord sets out clearly the commitment to the integration of ESG risk, the need to collaborate and to innovate. The Accord recognises that investment processes will need to evolve if they are to remain fit for purpose. We view this evolution as eminently preferable to needing to design new mandates and undertake the lengthy, costly and time-consuming exercise of retendering and transition. By extension, therefore, given the multidecadal challenge of climate change, ongoing manager monitoring is going to be the most important part of the investment process.

In the spirit of the Accord, Brunel prioritises its time in working in partnership with our managers, seeking to be pragmatic, patient and collegiate in resolving issues. The example below is just one of many examples and the work will always continue, especially in the context of achieving net-zero. We believe this style of working with our managers will be critical if we are to succeed.

Over a period of 18 months, starting in January 2020, we worked closely with Invesco, one of our UK managers, in order to decarbonise our UK Active Equity Portfolio. Invesco uses an approach called quantitative investing, also known as systematic investing. This approach uses proprietary modelling and data analysis to deliver the investment objectives. The solution to looking at the climate risk, therefore, had to follow the same quantitative approach, rather than using tools such as engagement with the companies.

Over the 18 months we experimented using different parameters and there was a lot of back and forth and sharing research and outcomes. Working together, we developed a bespoke low-carbon solution through integrating carbon data into the existing multi-factor strategy. Along with Invesco, we identified several project objectives, including: stable and predictable carbon emission reductions over time; minimal impact on expected investment performance; and the ability to quantify the low-carbon impact on portfolio risk and return. Exposures to quality, momentum and value factors were maintained, which was important because they represent the targeted factors of the strategy.

The outcome from this work has been a significant reduction in the carbon intensity of the Brunel UK Active Portfolio. When it was first measured in March 2019 it was 362 tCO<sub>2</sub>e/mGBP, but, by December 2020, had reduced to 199 tCO<sub>2</sub>e/mGBP – a reduction in intensity of 45 per cent over the 21-month time period.

**Figure 6** Carbon Intensity of Brunel's UK Active Equity Portfolio (March 2019–December 2020)

Brunel requires its managers to observe our climate policy and undertake carbon footprinting, at least annually. Analysis of the holdings, supported by the footprint and other data, is used in regular manager monitoring meetings. In addition to manager monitoring, climate change is embedded into product governance, risk and reporting. For example, carbon metrics such as emissions intensity and fossil fuel exposure are included in quarterly and annual client reports and investment risk reports.

Another important aspect was the work in 2021 to develop and launch the Paris Aligned Benchmarks series with FTSE-Russell. These benchmarks enabled us to provide net-zero index products and will support our next steps in setting out climate policy and work with asset managers.

## VI. DISCUSSION

It is vital that the expectation set by asset owners is that the asset managers are not only considering all the risks and opportunity arising from climate risk but changing their processes to take it into account. This should result in different outcomes from investment decision making. Although Brunel's mandates are all relatively new, and engaging managers is an ongoing and evolving activity, we believe we have different portfolios as an outcome from the interventions and many managers are using the principles of work with us in other product areas. Whilst we recognise weighted average carbon intensity is only one metric for gauging changes in portfolio outcomes, it does provide supporting evidence for the outcomes from our approach.

**Table 2** Brunel Pension Partnership Weighted Average Carbon Intensity for a Sample of Brunel's Portfolios<sup>26</sup>

| Portfolio                                                         | Reduction % | Carbon Intensity (£m invested) |               |
|-------------------------------------------------------------------|-------------|--------------------------------|---------------|
|                                                                   |             | 2021 Portfolio                 | 2019 Baseline |
| Active Portfolios                                                 |             |                                |               |
| Brunel UK Active Portfolio                                        | 25.90%      | 209.0                          | 282           |
| Brunel Global High Alpha Portfolio                                | 50.41%      | 149.3                          | 301           |
| Brunel Emerging Markets Portfolio                                 | 32.86%      | 382.7                          | 570           |
| Brunel Active Low Volatility                                      | 35.72%      | 214.7                          | 334           |
| Brunel Global Sustainable Portfolio                               | 15.47%      | 282.3                          | 334           |
| Brunel Climate Transition Benchmark UK Equity Index               | 18.39%      | 229.3                          | 281           |
| Brunel Paris Aligned World Developed Equity Index                 | 43.41%      | 171.5                          | 303           |
| Brunel Climate Transition Benchmark Developed Market Equity Index | 22.48%      | 234.9                          | 303           |

Source: Brunel Pension Partnership (2022).

Note: Carbon intensity is a weighted average carbon (equivalent) intensity per million pounds invested. The baseline was the investable universe (performance benchmark) for each product as at 31 December 2019, although many were launched in 2020 and 2021.

Brunel does not have all the answers to embedding manager accountability to achieve net-zero, but we have made a good start. We shared a selection of case studies that aim to share tools and techniques that have enabled progress and are evidenced in portfolio outcomes.

The key component has been to build strong relationship-based partnerships with asset managers, moving away from a more traditional transactional approach. A practical example of the shift in behaviour we want to see would involve asset managers moving from doing what has been asked (ie following, to the letter, the investment agreement), to thinking about the outcome that is being sought, asking whether there are better ways of achieving that goal and, if needed, proposing adjustments to the investment agreement that would enable that to be achieved, eg widening risk tolerances. This would be reciprocated with us – Brunel – acknowledging that contribution as part of our ongoing assessment and retention of the manager. This shift feels essential to deal with the challenges, such as climate change, that investment industry faces in the 2020s.

## VII. CONCLUSION

Becoming Paris-aligned and hitting the net-zero target is the challenge of our generation, especially as the remaining years of this decade are going to be some of the

<sup>26</sup> 'Responsible Investment and Stewardship Outcomes Report' (Brunel Pension Partnership, 2022).

most critical in human history. For investors, particularly asset owners, who carry the responsibility of managing assets on behalf of others, the challenge is incredibly complex. There are still a lot of unknowns and we still need to make judgements on incomplete information, but we know enough to start taking action and as new information arises, we review and adapt those actions.

Drawing on the experience of Brunel we would summarise our critical components of achieving asset manager accountability as:

- senior level commitment and robust governance on your own climate policy, objectives and outcomes;
- being clear on how those policy objectives translate to expectations on asset managers and actively monitor the managers against them;
- not being overly prescriptive on how those outcomes are to be achieved. The manager will know their process best and therefore is best placed to adapt it. They are also therefore accountable for the outcomes;
- welcoming a variety of approaches to managing climate risks and targeting net-zero, as this will help avoid creating other risks, eg factor and concentration risks;
- prioritising those portfolios which present the highest risk and take time to work out the optimal solution. Brunel's portfolio projects have generally taken between 12–18 months to implement;
- being supportive and being prepared to back managers who experiment with changes designed to meet your needs – they will not all work, but failure is an essential component of innovation;
- regularly reviewing and agreeing amendments where necessary. It is expected that portfolios will need to evolve over time;
- ensuring good flow of communication, with climate risk issues integrated into the regular touchpoints;
- ensuring that your other climate policy objectives (policy advocacy, corporate engagement, etc) are consistent and support the expectations on asset managers and the portfolio outcomes.

Our starting point was recognising that that the finance system itself is not fit for purpose in dealing with climate change and placing improving the financial system at the centre of our policy and at the heart of our approach. Our approach recognises that addressing systemic risk needs all those in the system to work together, and that addressing climate change requires a change of mindset and a willingness to push at the boundaries of the conventional wisdom that has shaped the investment industry for generations.

We have learned that to embed accountability to achieve decarbonisation and build resilience into investment strategies, we need to be explicit and persistent in setting the expectations of asset managers and ensuring that climate change is built into each and every process to convey the seriousness of the pursuit. The commitment to do so must therefore come from the top and flow down to everyone in the organisation.

The best innovations come from teamwork, and the challenges of integrating new research into investment processes, in light of the scientific evidence of climate change, will best be done working collaboratively across the industry. There is now a huge amount of guidance and support – possibly too much in some areas and not enough in others – but as an industry we have made huge strides and continue to do so. Sharing our experiences with others is crucial to enable all of us to learn from both successes and failures, and Brunel will continue to do so as part of its mission to work towards a world worth living in.

