ADVISORY SERIES

Broadridge®

Stranded Asset Management

Keeping up with institutions in a race to net zero

Ready for Next

Introduction

To date, 137 countries around the globe have made net zero pledges, meaning their economies will become net neutral in terms of carbon emissions. While the process of translating these pledges into laws and concrete action is at an early stage, the sheer pace of announcements has been impressive, with the US and China making their net zero pledges this year. Together with the EU, which made its net zero pledges a few years earlier, these economies account for about half of global carbon emissions. Most countries target 2050 to become carbon net neutral, which is triggering an enormous transformation in how global economies will produce goods and services over the next 30 years.

EXPECTED YEAR OF REACHING NET ZERO GREENHOUSE GAS EMISSIONS ASSOCIATED WITH INSTITUTIONAL PORTFOLIOS

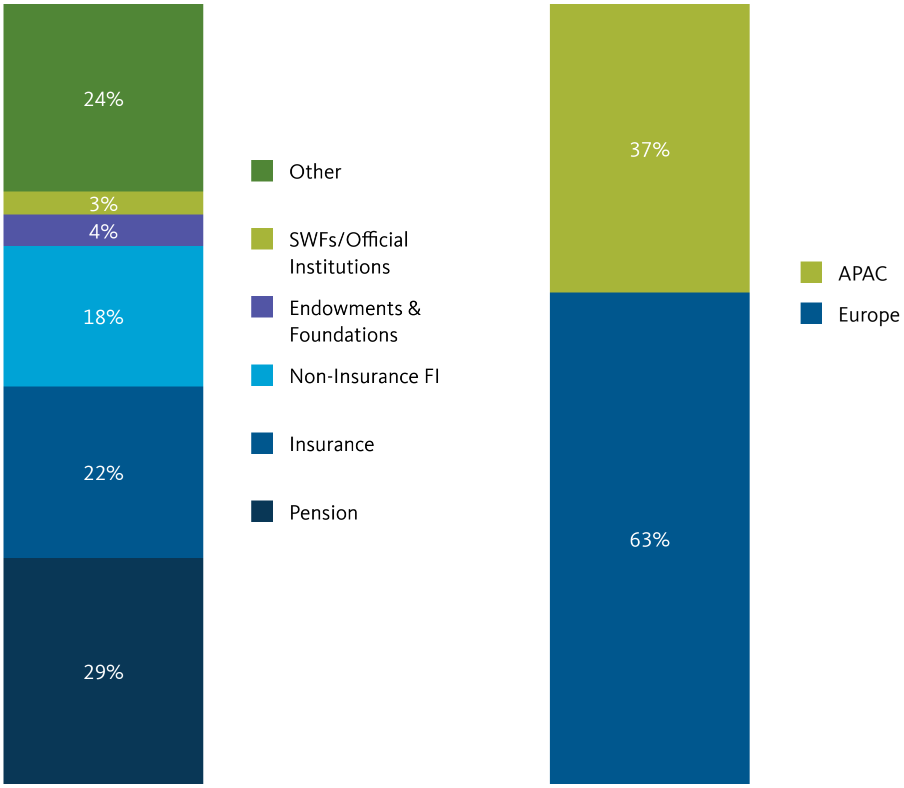
EUROPE 2042

APAC 2044

The Research

To better understand how major pension funds, insurance companies and sovereign wealth funds will adapt their investment strategies to meet net zero targets, Broadridge has undertaken a dedicated climate change investment study. The research included telephone interviews during the summer of 2021 with 200 institutional investors in Europe and Asia Pacific, together having a total of $15trn in assets under management.

Respondents' demographics



KEY FINDINGS

We found that institutions are:

I. Increasingly confident and assured in their ESG approach – especially European institutions.

II. Reacting to more than just climate regulation – and see a moral responsibility partnered with the ability to reduce risk and enhance returns.

III. Making ambitious net zero targets – in some cases, decades ahead of government commitments.

IV. Making significant changes in response to climate change across their entire businesses, not just investment – with an expectation that these changes will continue.

V. Facing challenges measuring greenhouse gases in emerging markets especially – with private assets the next problem group.

VI. Readily using low GHG (Greenhouse Gas) emission indices as a 'quick win' to lower climate risk in their portfolios – with customization common.

VII. Looking for asset managers with strong proprietary research, and clear integration of climate risk and opportunities into investment processes, along with a credible engagement approach on climate issues.

VIII. Valuing asset managers as thought partners – cited above investment consultants and other organizations as partners in furthering their approach to addressing climate change.

We conclude that asset managers must quickly invest in capabilities to deliver climate transition-aligned portfolio solutions or find their investment capabilities 'stranded' amidst an institutional investment landscape that has moved on. Adopting a continuous and agile approach to improvements in climate capabilities is key. Every firm needs a well-stocked box of 'climate solutions.' But no one firm will be THE solution. Instead, firms should carefully think about how their different capabilities can solve part of the portfolio puzzle for institutions.

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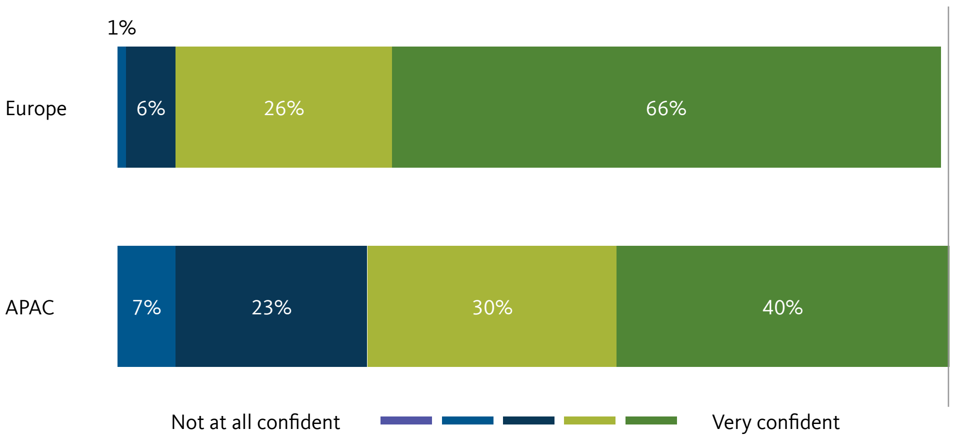
Yoon Ng, Markus Ohlig and Will Mayne lead Broadridge's Advisory practice that combines our market leading Analytics and Insights to identify and capitalize on opportunities in asset management globally.

I. Long-term confidence despite dramatic change

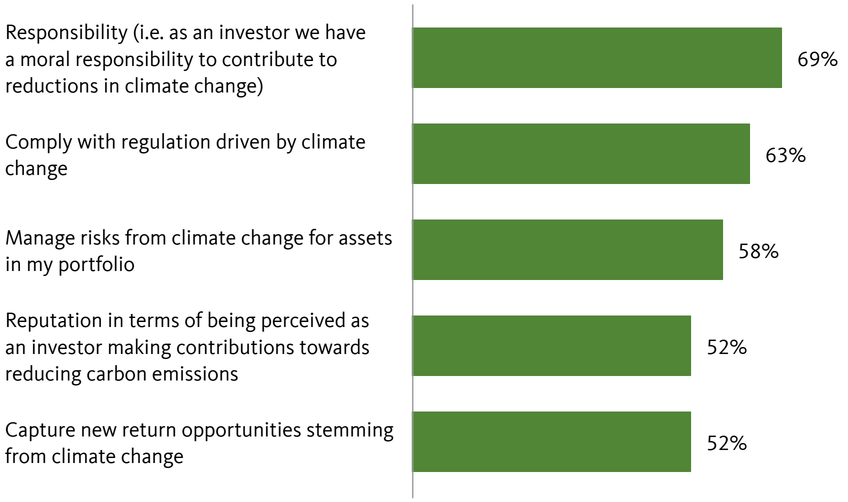
By and large, the institutional investors interviewed exhibit a high degree of confidence in their ability to make meaningful progress in developing their organization's ESG investment approach. European institutions are even more confident about their plans than their Asian counterparts. This tallies with other findings from this survey, indicating that European institutions in many instances already have a sophisticated approach to dealing with the details of incorporating climate change considerations into their investment strategy.

Investor confidence in ability to further develop their ESG approach



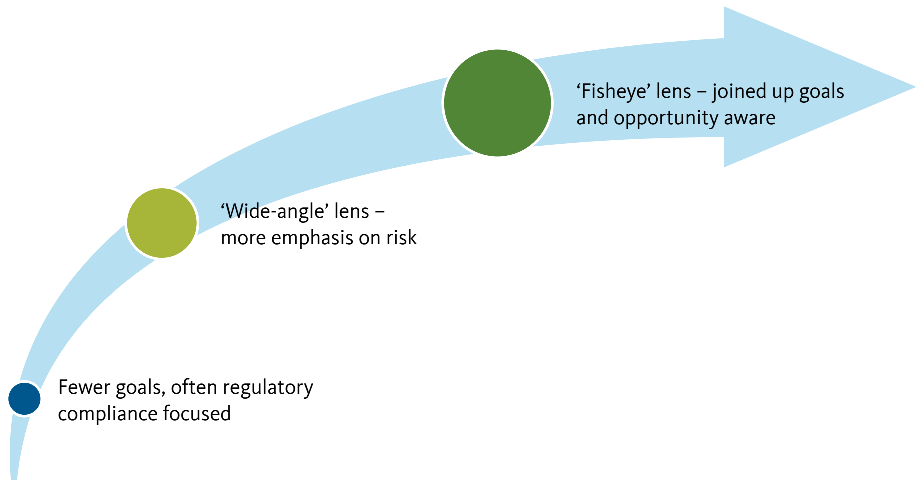
II. Regulation is only one driver – and most institutions cite three or more

Main drivers for taking into account impact of climate change on investment portfolios



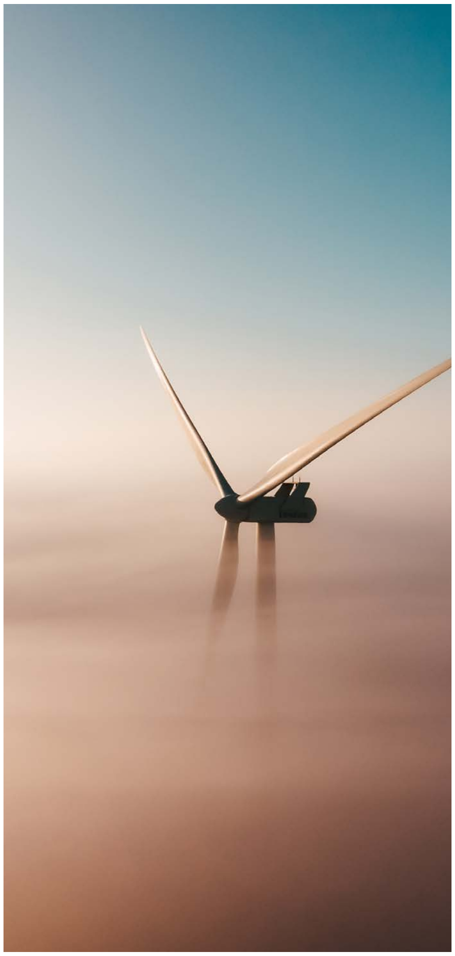
Less experienced institutions are typically focused on a smaller number of reasons for integrating climate change issues into their portfolios – meaning they are often more attentive to being compliant with regulation. This can make these institutions reliant on tracking external decisions on policy, rather than making their own decisions about what their investment thesis on climate change is. They are therefore forced to be more reactive than proactive in their design of a climate change investment approach. As experience and conviction builds, goals become more varied, with risk mitigation and finally return enhancement emerging as key objectives – with regulation acting as a guardrail rather than the guiding star. A holistic 'fisheye lens' on climate issues across multiple asset classes and themes allows more confident exploration of what opportunities are available.

A typical institutional evolution

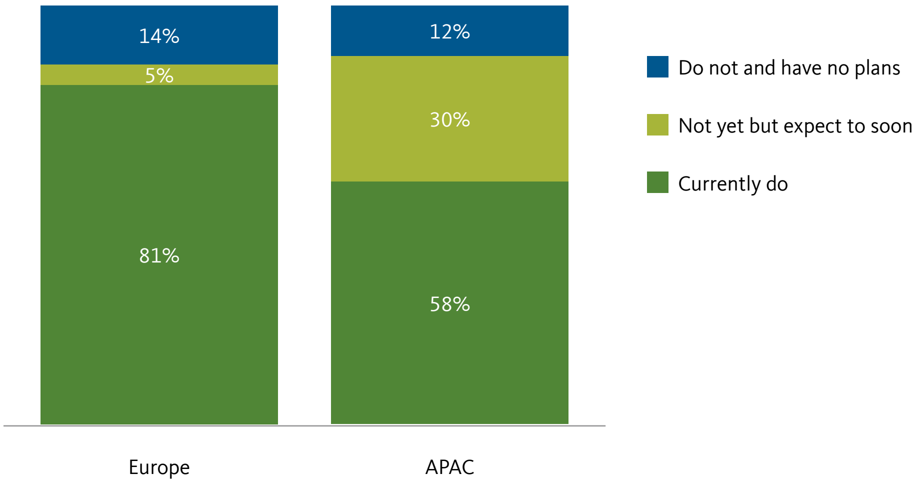


III. Net zero portfolios – faster than your government

ESG goals often vary significantly from one institutional investor to another, particularly in the areas of governance and social considerations but also on many environmental aspects, such as plastic waste and biodiversity. When it comes to climate change, investors are quickly converging on a straight path towards reducing – and eventually eliminating – the net carbon emissions associated with their investment portfolio. In Europe, 81% of institutions already incorporate climate change issues into their investment approach and while the share is lower in APAC at 58%, another 30% of Asian investors plan to do so soon. In both Europe and Asia, investors with neither current nor future plans to incorporate climate changes issues into their investment strategy are a small minority, at less than 15%.



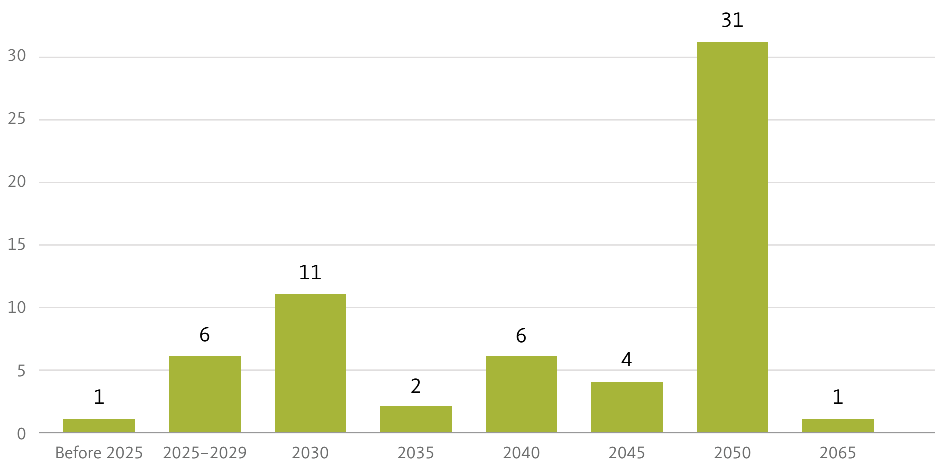
Incorporation of climate change issues into investment strategy

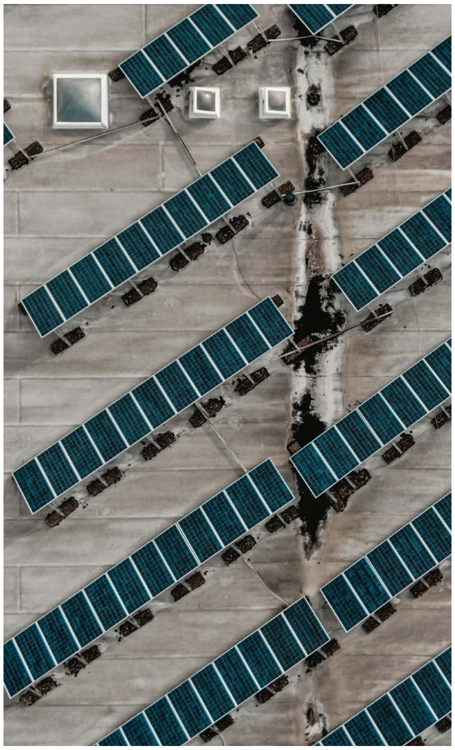


Many institutional investors have progressed further and adopted specific goals for GHG emission reductions into their portfolios. Some 75% of European institutional investors set specific objectives, including almost 40% that have set a net zero goal. The share of investors with specific GHG emission reduction goals in APAC is just short of 50% but with another 28% expecting to set an objective in the next two years, APAC is on track to quickly close the gap with Europe. Importantly, institutions with a net zero goal on average expect to achieve this in Europe and in APAC, respectively, in 2042 and 2044, almost 10 years earlier than most government pledges. For investee companies this means that they must make their business carbon neutral within the next 20 years, lest they become 'uninvestible' for a large share of the investor community, effectively resulting in a much higher cost of capital than for carbon neutral businesses.

> *"Our objective is to reduce carbon emissions across our investment portfolios by 40–50% by 2030."*
>
> FINANCIAL INSTITUTION, DENMARK

Net zero target year by number of institutions





IV. Climate change is driving a wave of transformation which will continue to evolve

Each individual institution is on a unique journey, and at a different stage of that journey, but in general there are nine theme-related adjustments taking place within institutions regarding climate change. Some are internally facing and more holistic, whereas others are investment focused and have implications for external investment partners:

1. **Getting the house in order – New governance standards and guiderails are being implemented**
    - A new team or oversight board to design and guide policy – particularly to keep compliant with fast-moving regulation.
    - New policy initiatives – generally more climate aligned/economy-transition policies, but notable strictures regarding key emitters like coal/oil, or sensitive areas like the Arctic.
    - Better breach handling as ESG breaches get increasingly viewed in the same lens as financial breaches.

2. **Playing well with others – Enhanced coordination and collaboration with other institutions**
    - Joining new public groups with other investors and external partners.
    - More coordinated climate lobbying.

3. **Loud and proud – Better communication with stakeholders**
    - Improved sustainability report (e.g. more clarity and concrete actions) and generally improved and more frequent communication with relevant stakeholders.
    - More public commitments to specific policies or alignment to select UN SDGs.

4. **Climate Portfolio Design 2.0 – Continuing to push the ESG integration bar higher**
    - Redesigned and increased investment 'budget' for climate investments.
    - Overall reduction in climate risk (e.g. reduction in portfolio carbon footprint).
    - Climate and sustainability criteria updated, enhanced and more explicitly incorporated into the overall investment strategy and underlying allocations.
    - A broadening range of instruments and asset classes e.g. working to align different parts of the portfolio in turn, say a net zero loan book.

5. **Measure it to manage it – New targets, measurements and enhanced transparency**
    - Establishing new and updated targets.
    - Refined and expanded quantitative metrics to analyse investments. Including measuring investor impact, the ongoing reduction of emissions, social value and physical risk measures.
    - More forward-looking metrics and forecasts.
    - Ensuring compliance through enhanced transparency and monitoring.

6. **The right tool for the job – Increased investment in technology and tools**
    - Increased digitization and automation of climate related workflows, including making climate metric integration into investment management more systematic.
    - Investing in new tools to measure the impact of climate change risk factors, track ratings and themes.

7. **Beyond ESG – An expanded investment universe**
    - Investing in low carbon/transition indices.
    - Financing the transition (e.g. green financing/loans, green bonds).
    - Investing in themes – sustainable development, biodiversity, ecological transition including clean tech, water conservation and waste management.
    - Investing in Impact.

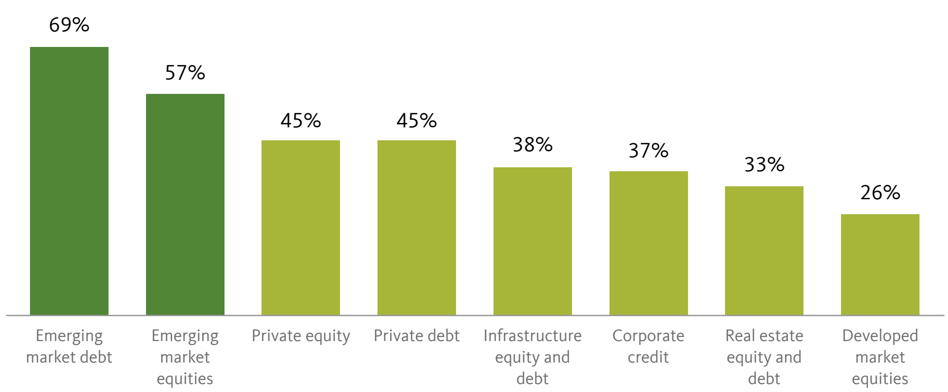
8. **Stewardship – Increased engagement and 'responsible ownership'**
    - Improved voting at shareholder meetings.
    - An eagerness to engage with corporates to change company policies and support company transparency.

9. **Going, going, gone – Divestment from coal and unaligned companies**
    - Coal especially has been hit by new exclusion policies, with some large insurers going so far as to refuse to insure new coal facilities.
    - Divestment is the final resort for any company that has resisted engagement and shows no willingness to change.

V. Emerging markets present measurement challenges

A major challenge for measurably reducing carbon emissions associated with investment portfolios is the ability to measure these emissions at the level of the individual investment. This is particularly apparent in emerging markets where corporate disclosure is often more limited, especially for corporate debt where there may not always be a publicly quoted issuer that provides at least a minimum of disclosure. A full 69% of institutional investors interviewed report challenges with measuring GHG emissions associated with emerging markets debt, 57% for emerging market equities but only 26% for developed market equities. Private market assets sit in between since investors often have direct access to management of the underlying company or asset compared with publicly quoted companies.

Challenges with measuring GHG Emissions



VI. Passive equity is a key part of the transition solution for institutions

Most European investors (87%) use either standard or customized low GHG emission benchmarks for their index portfolios. This contrasts with a large share of investors in APAC who have not yet started using low emission benchmarks – but we see this wave coming. Interestingly, around a third of European investors use customized indices, offering passive providers ripe opportunity to cater to specific needs such as the collaboration between Sweden's AP1 and LGIM to launch a new fossil-free emerging markets equity index fund in late 2020. We believe this 'personalized passive' approach will continue, as climate objectives and tracking error tolerances vary by institution.

However, low GHG emissions does not mean no emissions and for investors to achieve their net zero goals, they need to find a way of gradually reducing carbon emissions associated with their (even low GHG emission) index portfolio. APAC investors take a hands off approach to address this challenge by periodically reviewing the benchmarks, with the expectation that emissions will decline because of actions by companies in the index. European investors prefer to take a more activist route towards their passive portfolios via shareholder engagement and proxy voting – which means that at least when it comes to carbon emissions, passive investors will more often turn out to be active investors.

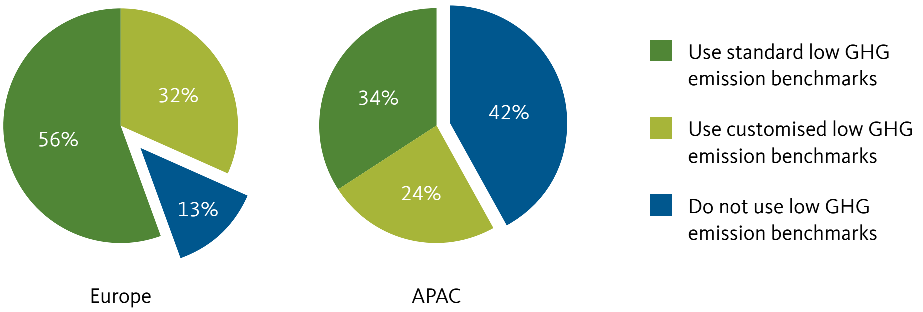
"[...] the challenge is not so much in equities, but how we incorporate climate change issues in relation to our other asset class exposures [...] We think our abilities and capabilities are very good relative to our peers and that should help us. But it's, of course, a continuing challenge as to how we actually transition our investment portfolio."

PENSION, UK

"For private debt [...] it's hard for us to measure the emissions compared to corporate credit or liquid asset classes where there is a lot more information available and much more [sic] *third-party providers analyzing it."*

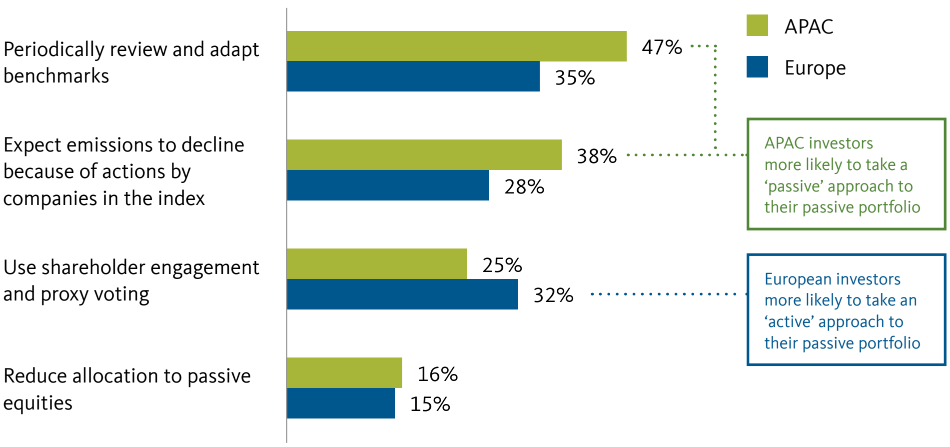
PENSION, GERMANY

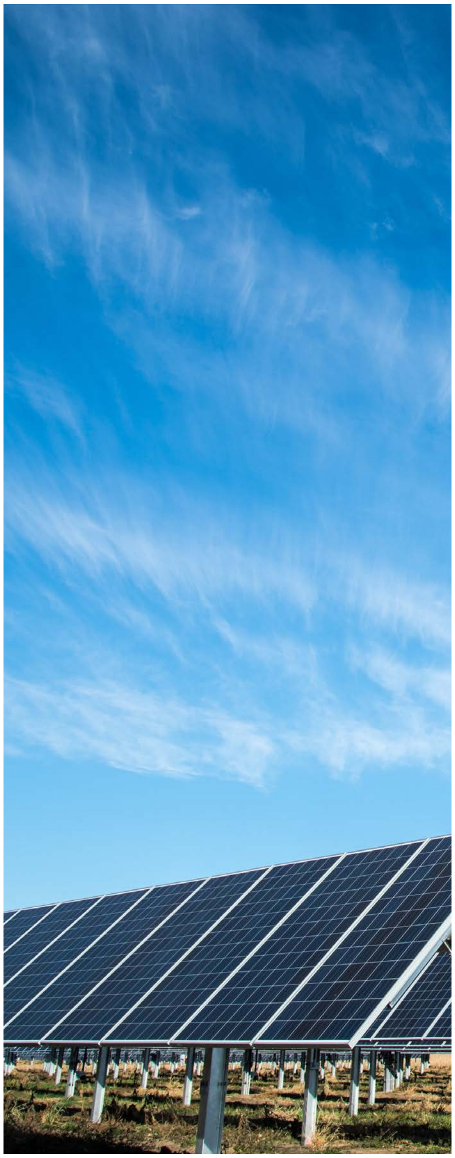
GHG emission reduction for passive investments



> *"We moved all our passive equities into a bespoke index that we helped to design. The index is designed to evolve in relation to climate risks. If we follow that index, then our equity exposure will automatically evolve with it."*
>
> **PENSION, UK**

Actions to reduce GHG emissions associated with passive investments



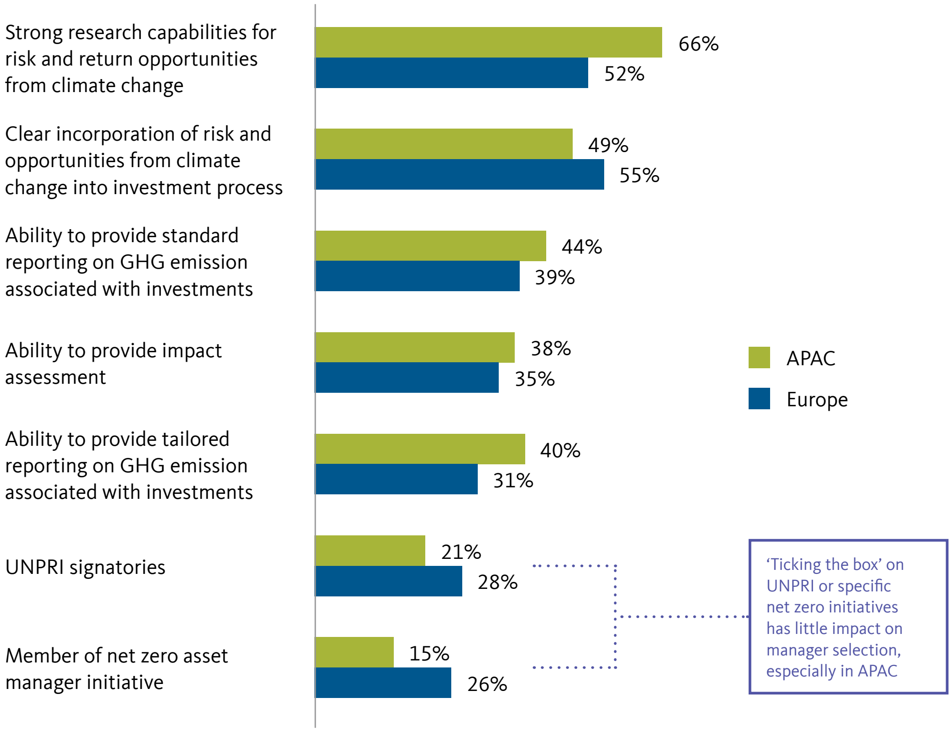


VII. Decarbonizing portfolios: Long live active management

The challenge of decarbonizing investment portfolios provides another 'raison d'être' for fundamental, active management at a time when allocations to passive and factor-based index strategies continue to gain market share. When institutions were asked about their key requirements for third-party asset managers to help them reduce portfolio GHG emissions, two key aspects of active management came out top: strong research capabilities to identify risk and return opportunities from climate change combined with a robust and clearly articulated approach to incorporate these into the investment process. GHG emission and impact reporting related aspects was the second set of priorities, whereas being a signatory of UN PRI or membership of the net zero asset manager initiative received little attention, most notably in APAC.

The role of active management takes on an added importance given recent MSCI estimates, where 16% of companies in the ACWI index are aligned with a 2 degree warming scenario as of late 2020 and only 5% are aligned with the 1.5 degree warming scenario targeted by the Paris Agreement. This leaves passive strategies with a portfolio construction challenge as they will be limited to a small universe of stocks while active strategies will often take a broader view, for example by trying to identify 'brown' companies that will make significant progress towards reducing their businesses' GHG emissions.

Requirements for third-party asset managers



"We ask fund managers to quantify (climate change) risks for us. We expect managers to clearly report on those risks and to actively manage those risks – particularly stranded assets."

FINANCIAL INSTITUTION, AUSTRALIA

CHINA: MIND THE GREEN GAP

Chinese ESG fund assets have more than tripled in 2020 to reach US$26.4bn, with clean energy accounting for 70% of total AUM. China's ambition to curb carbon emissions will be a key growth driver, as aligning investment themes to the government's agenda is a critical success factor. While lack of credible data is a challenge, market leaders are exploring AI analytics and natural language processing to build more robust ESG data reporting and ratings systems. Global managers can look to partnerships and sub-advisory opportunities with the wealth management subsidiaries of banks for growth opportunities beyond funds. However, global managers looking to replicate their ESG success in China need to note that performance is the dominant driver for adoption, unlike the more multi-faceted and nuanced drivers seen in Europe and the US.

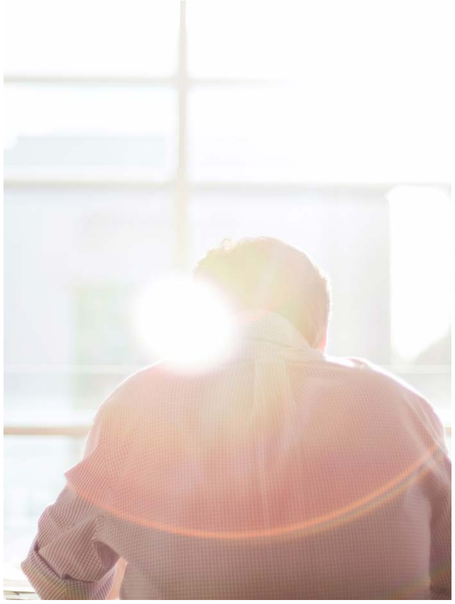
"At present, there is no sound management system or quantified standard for climate change-related risks. If the country has relevant guidance documents, we will follow the national policy."

ASSET MANAGER, CHINA

"The biggest challenge is finding the right balance between being green and being profitable. Having a good living environment is the common pursuit of human beings; everyone should try their best to create such an environment. However, the essence of finance is profit. If we blindly pursue 'net zero emissions' and cannot produce a return on investments, that is not what we want either."

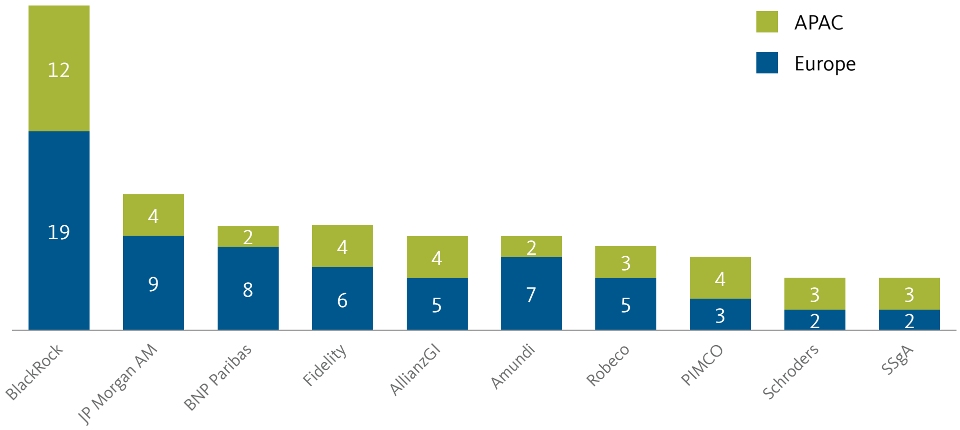
INSURER, CHINA

VIII. Institutions value asset managers as thought partners – with large managers mentioned most frequently



Institutions value asset managers as thought partners – cited above investment consultants and other organizations as the key partners in furthering their investment approach to addressing climate change. When it comes to engaging with specific asset managers to help investors reduce their portfolios' carbon footprint, the competitive field is still wide open. BlackRock (excluding iShares) is the only asset manager that genuinely stands out across all survey interviewees for capabilities to identify risk and return opportunities emanating from climate change and to make and manage climate change-related impact investments. Major European asset managers lead by reputation in Europe while US managers dominate among institutional respondents in APAC.

Asset manager association with climate change expertise (number of mentions)



ESG REQUIREMENTS ARE BECOMING AN INTEGRAL PART OF INVESTMENT GUIDELINES

European institutions are almost unanimous in making ESG requirements an integral part of investment guidelines for asset managers and, importantly, handle breaches in the same manner as breaches of more traditional financial guidelines. As these guidelines are becoming more specific and stringent over time, asset managers will have to invest into monitoring, managing and reporting breaches of ESG guidelines with the same stringency as financial breaches. In many instances, this will require significant changes in company culture, organizational process and client service as well as IT systems. Institutional investors in APAC are still at an early stage when it comes to ESG guidelines but are clearly following in the footsteps of their European counterparts.

"We are very serious about ESG breaches."

FINANCIAL INSTITUTION, UNITED KINGDOM

"We have huge penalties for ESG breaches."

PENSION, NORWAY

"We [...] make sure the managers perform due diligence on investments and are following the guidelines. If, and when, a breach is suspected or discovered in our investigations, strict actions are taken, and the situation is dealt with accordingly."

ASSET MANAGER, SWITZERLAND

"We treat all aspects and subsets equally, all breaches financial, ESG or any other are handled in the same manner."

INSURANCE, JAPAN

CONCLUSION

The trends towards incorporating ESG requirements into their investment approach is already well under way amongst institutional investors globally. However, climate change and the need to decarbonize portfolios stands out as the area that will have the most profound and fastest impact on how institutional investors manage their investment portfolios and, consequently, on how they work with external managers. Stringent requirements for asset managers to make GHG emission reduction a core part of their investment approach across virtually all asset classes, monitor and report on progress and identify and handle breaches will transform a key aspect of their business. Like any major structural change impacting an industry, some asset managers will proactively capitalize on this trend to build a long-term competitive advantage. Conversely, managers that do not invest sufficient organizational and financial resources to respond to this trend, or do so slowly, will be left behind and potentially see their business model imperiled.

To avoid being 'stranded' asset managers need to consider the following:

- Asset managers need to evolve at a pace that exceeds the significant rate of change in the market to avoid being left behind. Adopting a continuous and agile approach to improvements in climate capabilities is key. Institutional requirements and desired outcomes will continuously evolve with regulation and changing internal policies. Frontline distribution teams need to be encouraged to channel client insights into a cross-team forum that listens, and more importantly can prioritise resources to make progress.

- Every firm needs a well-stocked box of 'climate solutions.' No one firm will be THE solution. Instead, firms should carefully think about how their different capabilities can solve part of the portfolio puzzle for institutions. Some solutions will be at product level, whereas others will be unique research, data and technology used in partnership with institutions. Products with inherent climate intentionality like low carbon portfolios, Thematic and Impact will become more important. But so too will transparent 'core' portfolios with high climate 'look through' and sophisticated forward-looking metrics for carbon footprint and physical risks from climate change. ESG Integrated is sometimes seen as a dirty term, considered ESG 1.0 along with exclusions. But investments in higher quality research and sophisticated climate investment processes will be rewarded with support from more experienced institutions.

- A well-resourced stewardship approach coordinated at the firm level with a proven track record of material engagement will be a key differentiator for firms that are successful. To punch above their weight, asset managers need to be in the right clubs: collaboration is a big part of the climate change investment movement. Successful managers will need to be on the inside of movements like the Net Zero Asset Managers Initiatives, not on the outside looking in.

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