

Measuring Portfolio Alignment

Consultation Report on Enhancement, Convergence & Adoption

06/09/22

What differentiates this report from previous portfolio alignment publications?



Exhaustive assessment of the landscape of portfolio alignment metrics



Use cases and case studies from net-zero alliance members



Quantitative case studies developed to highlight impact of design choices



Enhanced guidance with a forward-looking perspective

Seven use cases across two broad dimensions (*Chapter 2 of consultation report*)

The seven use case types identified have been enriched with practitioner case studies

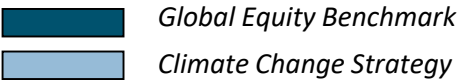
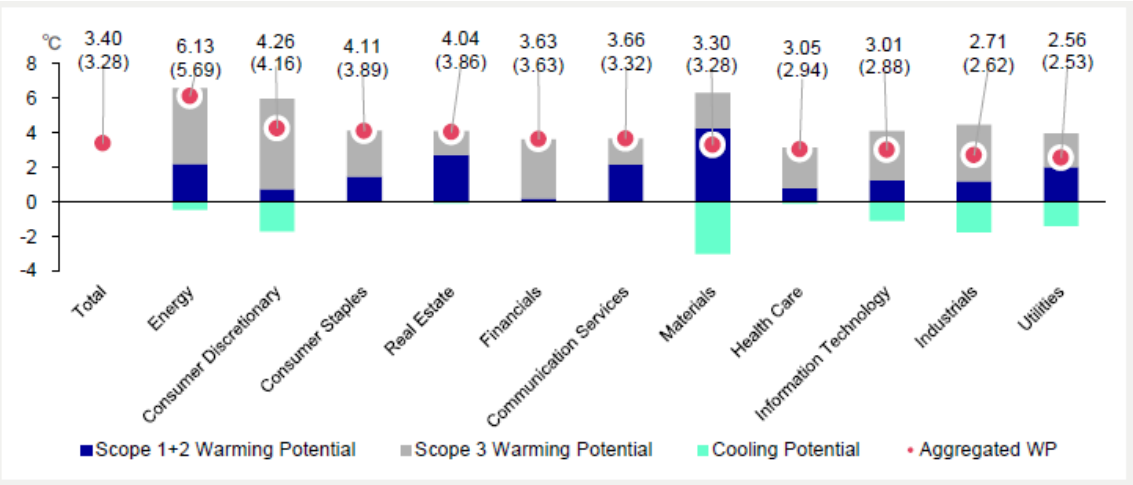
| Use Case Type | Broad Dimension | End User Type(s) | End User Type(s) Key |
|--|-----------------|-------------------|--|
| Investment research and selection | Decision-making | AM/AO/B/IC | AM = Asset Managers AO = Asset Owners B = Banks IC = Investment Consultants IU = Insurance Underwriters CBG = Central banks and governments |
| Portfolio construction | | AM/AO/IC | |
| Manager selection and monitoring | | AO/IC | |
| Disclosure of progress | Communication | AM/AO/B/IC/IU/CBG | |
| Engagement | | AM/AO/B/IC/IU | |
| Understanding the impact of internal policies and conditions | | AM/AO/B/IC/IU | |
| Supervisory activity | | CBG | |

- Seven use case types have been identified across two dimensions: **decision-making** and **communication**
- For **decision-making**, asset managers and asset owners are using portfolio alignment metrics for **investment selection** and **portfolio construction**
- For communication, the most **mature** use case is the **disclosure of progress**, with different institution types **expressing how effectively they are progressing** against net-zero goals

Portfolio Alignment Use Case Examples

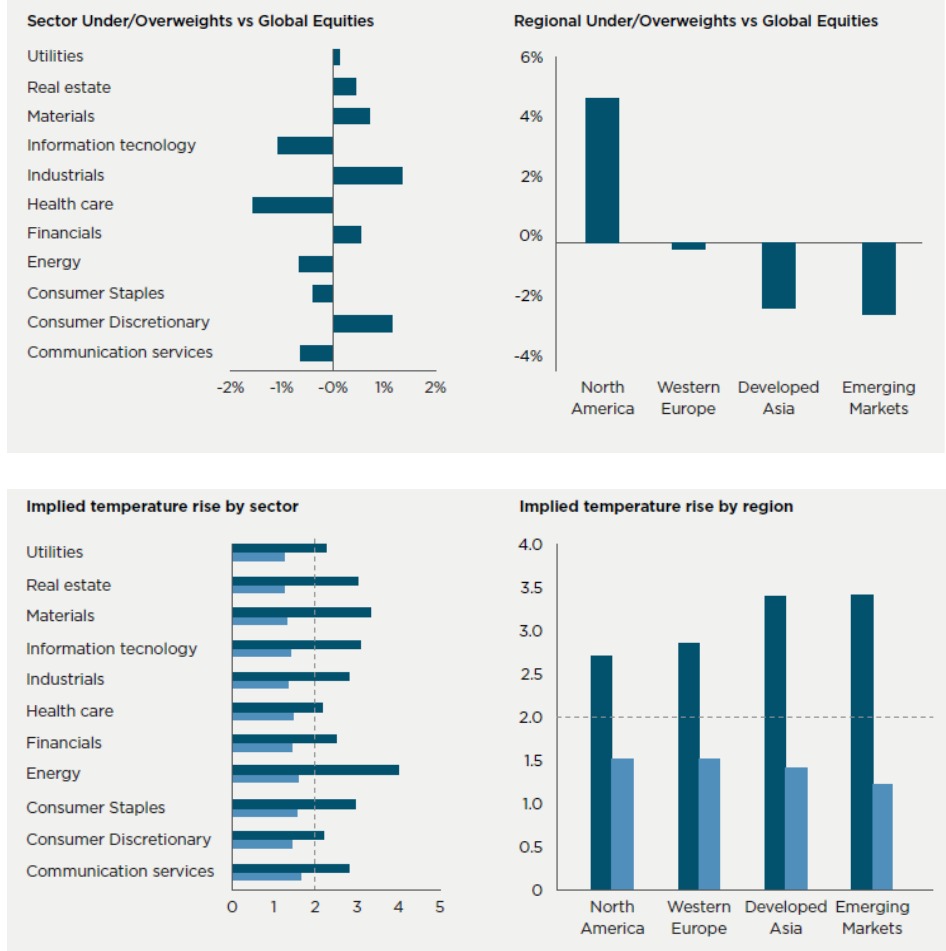
Use Case Dimension: Communication

A global asset owner disclosing the warming potential of their diversified global equity portfolio, broken out by 11 GICS sectors and emission scopes.



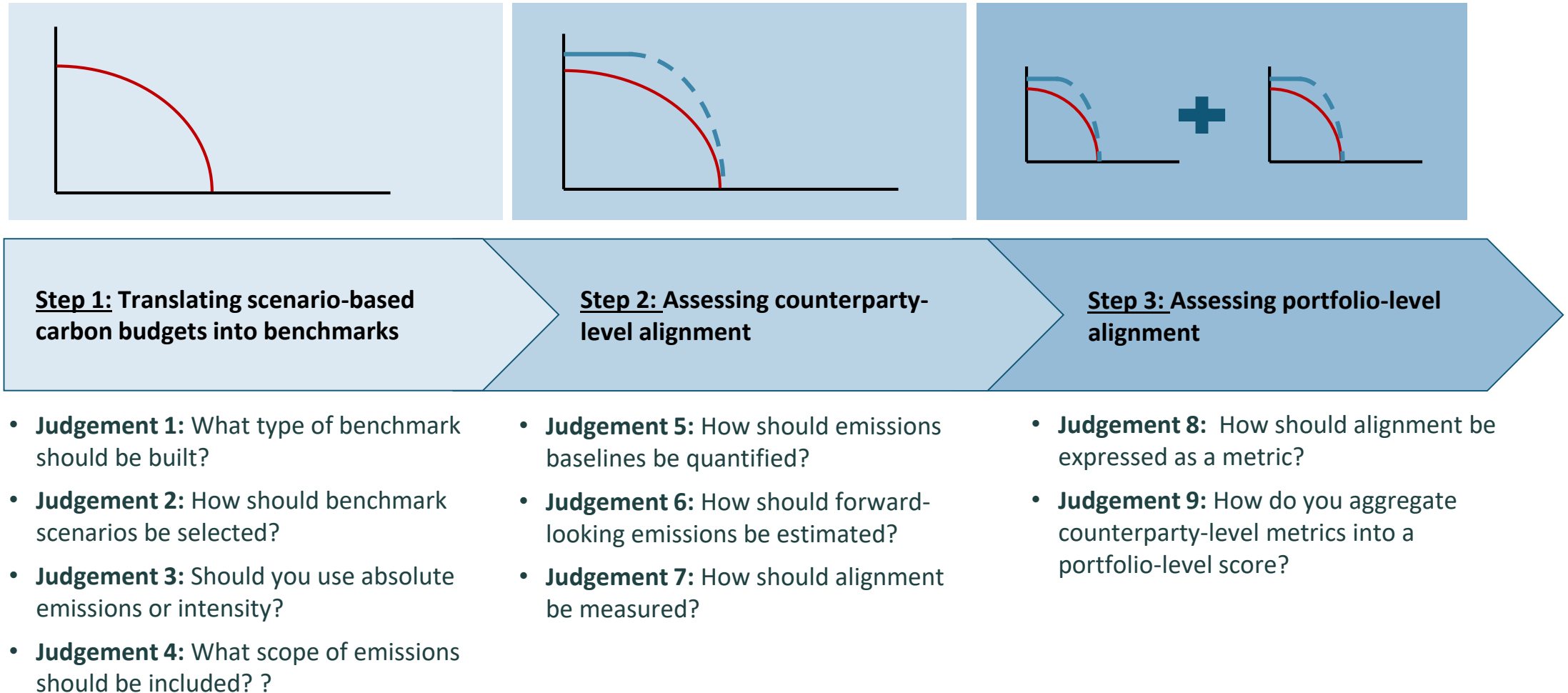
Use Case Dimension: Decision-Making

An asset manager constructing a highly diversified equity portfolio based on companies aligned with 1.5-degrees whilst maintaining regional and sectoral exposure to a global equity benchmark.

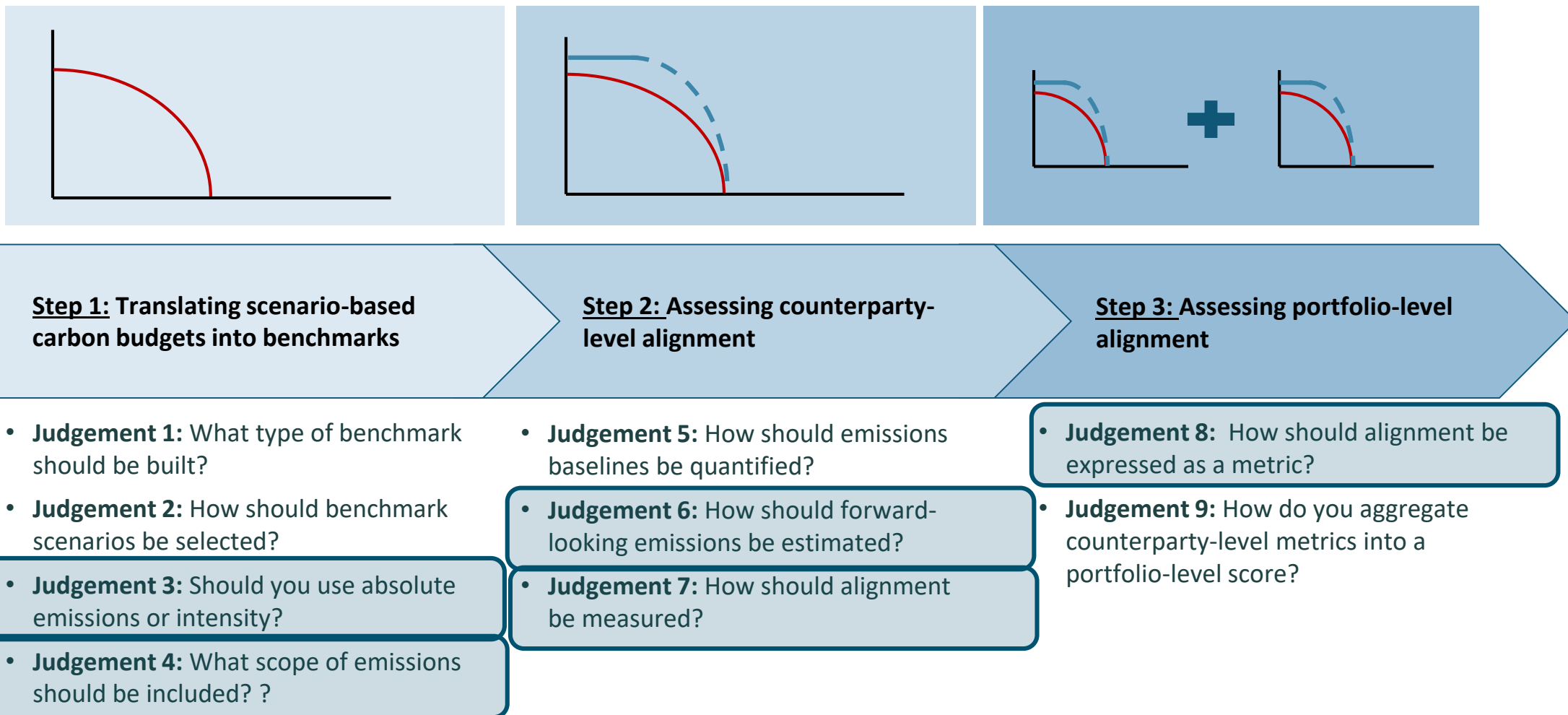


3 The Nine Key Design Judgements

“Crucial key questions to be asked when assessing the alignment of investment, lending and underwriting activities with the goals of the Paris Agreement and critical 2050 global net-zero goals”



3 The draft report seeks feedback to five enhancements proposed to the Nine Key Design Judgements

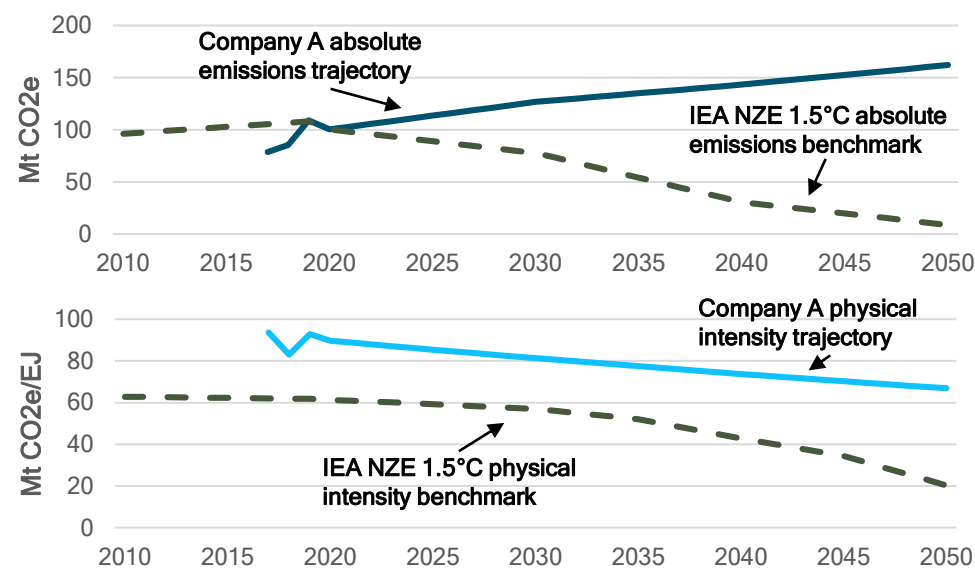


Consultation question: Should absolute emissions or physical intensities be used?

Challenge: There is a lack of guidance on the appropriate emission unit when assessing high emitting companies.

How might the challenge materialize in practice?

Company A expands oil and gas production while improving the efficiency of its emissions per barrel.



| Unit of Choice | Absolute Emissions | Physical Intensity |
|---|--------------------|--------------------|
| Percent misalignment with 1.5°C benchmark | 138% | 63% |

Physical intensities capture efficiency improvements but fail to capture the demand side to encourage decreased production of oil and gas

Our enhancement approach

- The draft report presents the challenge via **illustrative quantitative case study examples** to collect market views on the appropriate unit for measuring the alignment of high emitters.
- Best practice recommendations might be included in the final report.

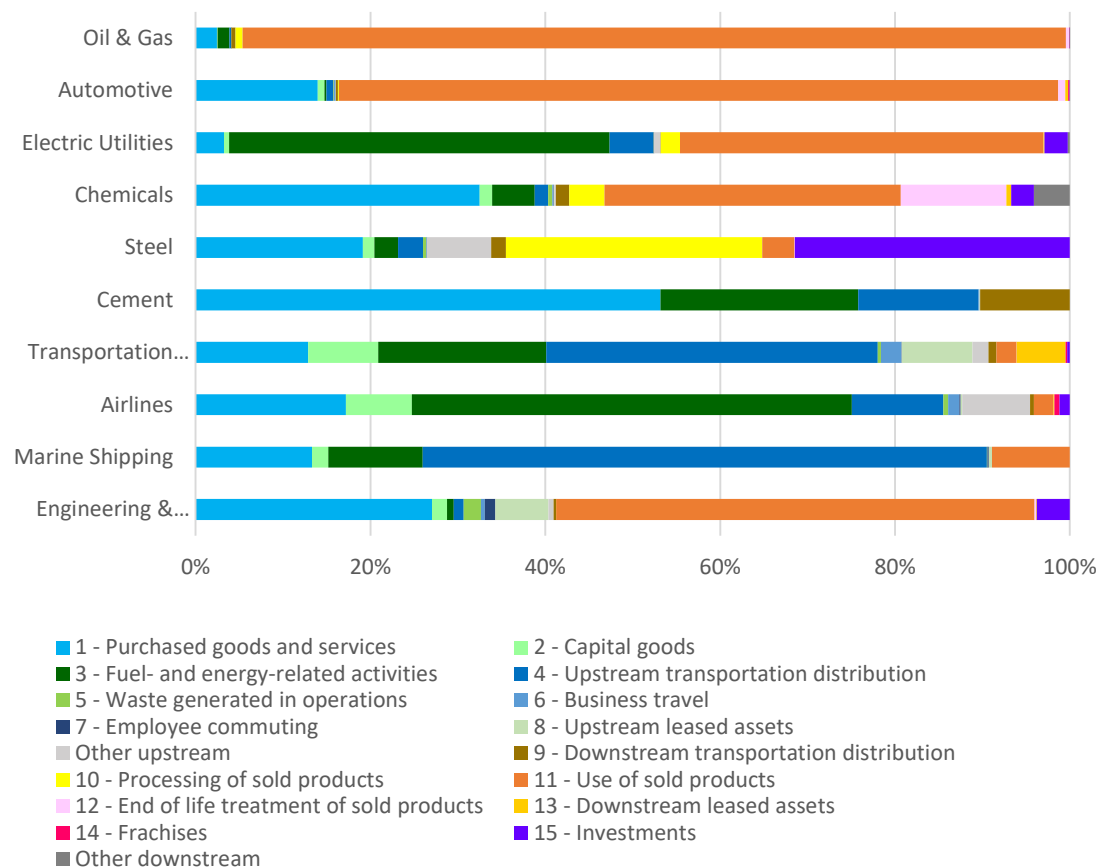
Draft report consultation questions

- *What measurement unit is most appropriate for portfolio alignment measurement of companies in the fossil fuel sector?*
- *What are the advantages and drawbacks of this measurement unit?*

3 Key enhancement: Material value chain emissions for high impact sectors (Judgement 4)

Challenge: There is a lack of guidance on the materiality of Scope 3 upstream and downstream emission categories for high impact sectors.

Scope 3 emissions by category



Enhancement and guidance

- Financial institutions should follow SBTi criteria (they are **material** if the footprint threshold of **40%** is exceeded)
- They should be included for companies where Scope 3 emissions are material both in **absolute magnitude** and in **the percentage of total emissions**
- Oil and Gas — Category 11 (use emissions)
- Automotive — Categories 1 (purchased goods & services) and 11
- Electric Utilities — Categories 3 (energy-related activities) and 11
- Chemicals — Categories 1 and 11

Draft report consultation questions

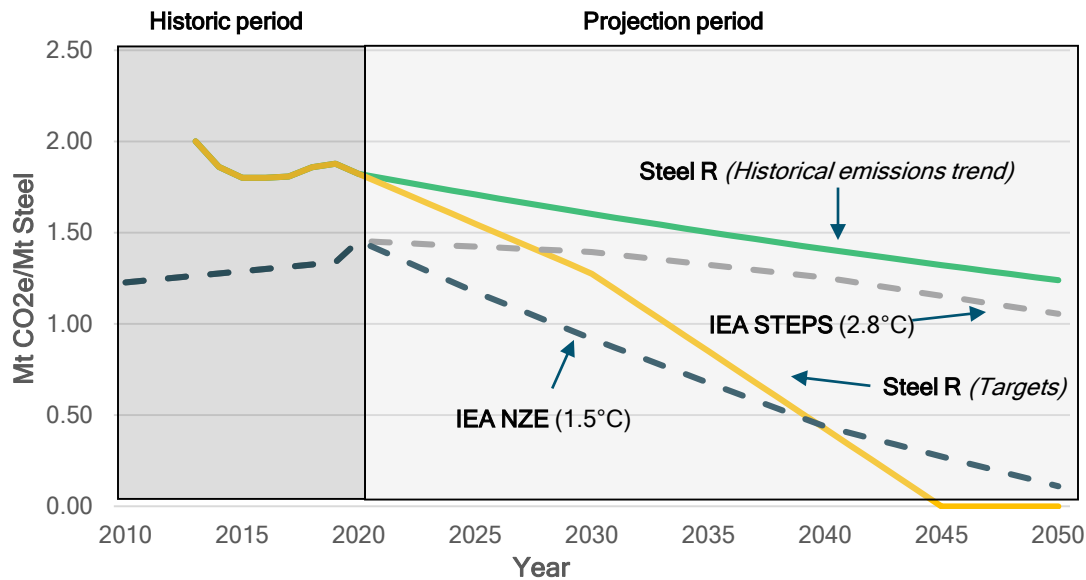
- *Is the analysis of Scope 3 emissions useful?*
- *If not, what other analysis should be included?*

Methods: Calculated based on a universe of 1300 companies that reported at least 2 categories within Scope 3 emissions. Unit: million metric tons. The values are averaged across companies within each of the sector under Bloomberg Industrial Classification Standard (BICS).

3 Key enhancement: How should forward-looking emissions be estimated and what is the appropriate time frame? (*Judgements 6 & 7*)

Challenge: There is a lack of guidance on how to conduct and incorporate a **credibility assessment** on emission reduction targets as well as the **appropriate time horizon** for measuring alignment.

How does the challenge materialize in practice?



| Emissions projection method for Steel R | Steel R ITR |
|---|-------------|
| Using emission reduction targets | 1.9°C |
| Using the historical emissions trend | 3.0°C |



The final alignment score can vary materially based on the emissions projection method.

Enhancement and guidance

- Calculate alignment based on backward (i.e., historical emissions) and forward-looking data (i.e., transition plans)
- Perform a **credibility assessment** of the company's targets, paying attention to both short and long-term targets
- **Appropriate time frame:** focus on measuring alignment over short- or medium-term time horizons (e.g., up to 2030), supplementing with alignment metrics calculated over longer-term time horizons (e.g., 2050)

Draft report consultation questions

- *Do you agree with the illustrative credibility assessment framework?*
- *Are there any further credibility indicators that should be included?*
- *What is your preferred approach for projecting the emissions of real economy companies with no stated emission reduction targets?*

3 The illustrative credibility framework synthesizing guidance from ACT, TPI, CA100+, SBTi and others

| Credibility Indicators | | Weighting used in the calculation of future GHG emission trajectory | Target Weighting (w-value) |
|--|--|---|----------------------------|
| Simple Assessment | Detailed Assessment | | |
| The company does not have published emission reduction targets | | 100% based on historical emissions trends | 0% |
| The company has a long-term emissions reduction target that is not 3rd party verified | | 25% on emission reduction targets 75% on historical emissions trends | 25% |
| The company has ambitious but not 3 rd party verified short- and long-term targets | <ul style="list-style-type: none"> • Short- and long-term targets exist but are not validated by a 3rd party • Some executive oversight/incentives are linked to the target | 50% on emission reduction targets 50% on historical emissions trends | 50% |
| The company has 3 rd party validated short- and long-term targets, supported by a transition plan | <ul style="list-style-type: none"> • The reduction target has been validated by a 3rd party (e.g., SBTi) and includes both short- and long-term components • A transition plan has been disclosed • Low carbon CAPEX plans are dedicated to activities required to meet the reduction target • Historical trends in production/capacity indicate progress towards alignment (where applicable by sector) | 75% on emission reduction targets 25% on historical emissions trends | 75% |
| The company has validated short- and long-term targets, supported by a clear funding channel and a transition plan that lays out the pathway to achieving these. The company also has successfully met past targets. | <ul style="list-style-type: none"> • Executive oversight/incentives are linked to the target • A transition plan has been disclosed • Low carbon CAPEX plans are aligned with the set reduction target • Planned production forecasts and accompanying business strategies are aligned with the set reduction targets • Company has a successful history of meeting past 1.5 degrees C-aligned and third-party verified emissions reduction targets • An enabling policy environment is in place | 100% based on emission reduction targets | 100% |

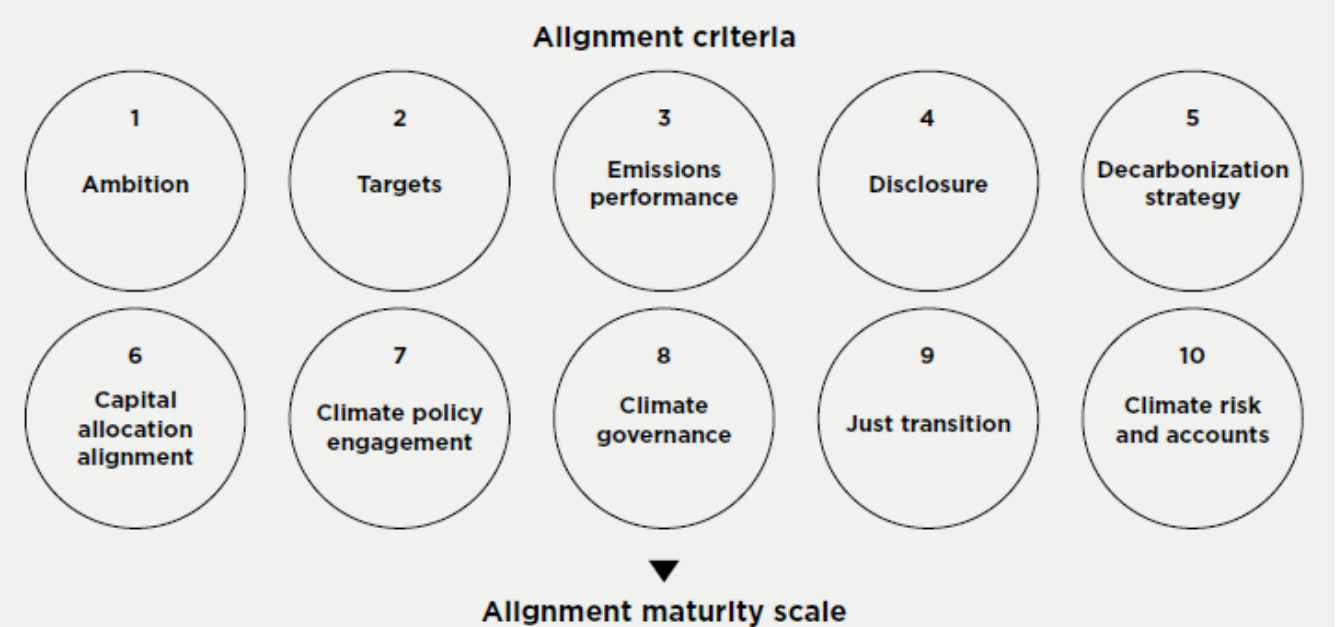
3 Key enhancement: What are the metrics for expressing alignment? (*Judgement 8*)

Challenge: Practitioners lack guidance on the portfolio alignment metric to choose when considering different use cases.

| Portfolio alignment metric type | Binary target measurement | Benchmark divergence | Implied Temperature Rise (ITR) | Maturity alignment scale |
|---------------------------------|--|---|---|---|
| Example metric output | Yes | 75% | 2.8°C | Aligning |
| Metric description | Measure the alignment of a portfolio with a given climate outcome based on the percent of investments or companies in that portfolio with 3rd party verified net-zero targets | Assess alignment at the company-level by comparing the carbon budget over or undershoot of a company to the allocated benchmark emission budget. | Translate the carbon budget over or undershoot of a company into a likely global warming outcome , assuming that the global economy over or undershoots by the same level as the company | Assign companies on a scale of net-zero alignment based on a qualitative and quantitative assessment factors |
| Fundamental purpose | Communication, decision-making | | | |
| Use cases | <i>Disclosure of progress, engagement, investment research & selection, portfolio construction, manager selection, monitoring of internal policies (e.g., on fossil fuel restrictions), supervisory activities</i> | | | |

Example of maturity scale portfolio alignment metrics

The Net Zero Investment Framework outlines five maturity buckets that allow portfolio companies to progress.



| Net zero | Aligned | Aligning | Committed to aligning | Not aligned |
|---|--|--|---|---|
| <ul style="list-style-type: none">Companies that have current emissions intensity performance at, or close to, net zero emissions with an investment plan or business model to continue that goal over time | <ul style="list-style-type: none">Meeting criteria 1-6 (or 2, 3 and 4 for lower impact companies).Adequate performance over time in relation to criterion 3, in line with targets set | <ul style="list-style-type: none">Have set a short or medium-term target (criteria 2)Disclosure of Scope 1, 2 and (material) 3 emissions data (criteria 4)A plan relating to how the company will achieve these targets (partial criteria 5) | <ul style="list-style-type: none">A company that has complied with criteria 1 by setting a clear goal to achieve net zero emissions by 2050 | <ul style="list-style-type: none">All other companies |

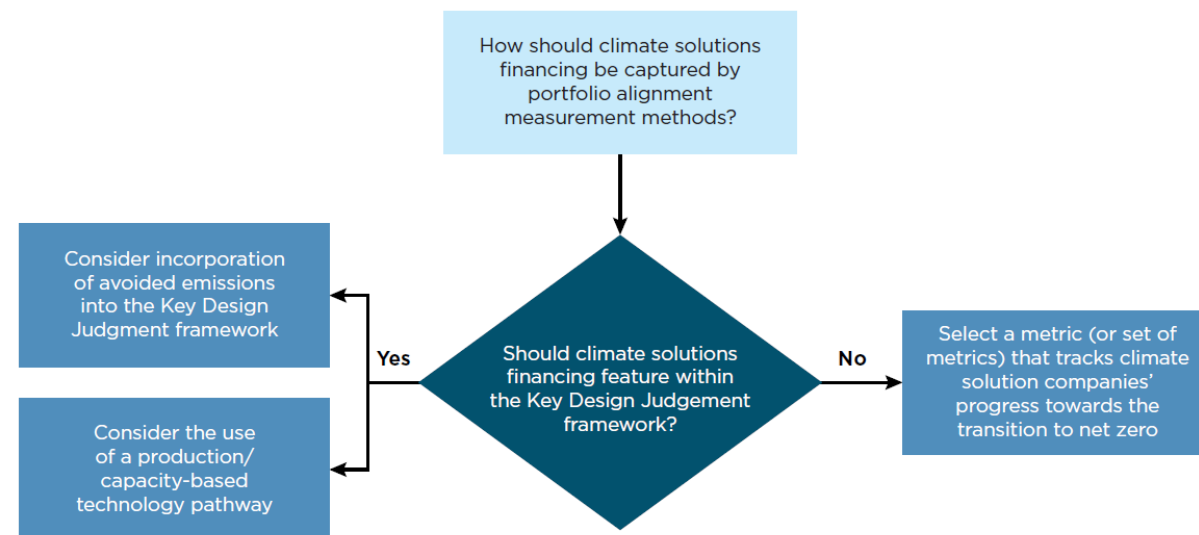
3 Starting the Journey: Portfolio Alignment Measurement for Climate Solutions

Challenge: Climate solutions are not easily reflected in portfolio alignment metrics and their inclusion is technically difficult.

Perspectives on measuring the alignment of climate solutions

- Our **approach to the challenge** has been to identify and **engage with institutions** that have experience with **the evaluation of climate solutions**.
- We have **collated perspectives** from some of these institutions to **provide insight for** the Portfolio Alignment Measurement report.
- These **case studies** should be considered as a **starting point that reflects the current thinking** of financial institutions on this topic.
- The **enhancement of the climate solutions section** might be a **focus area for a future report on** Portfolio Alignment Measurement.

Case studies capturing potential approaches to measuring climate solutions



We would like to thank our Workstream members and look forward to your input!

GFANZ Implementation Pillar on Measuring Portfolio Alignment

Allianz
Bank of America
BlackRock
Bloomberg
Cambridge Associates
CDP (Advisor)
Deutsche Bank
EY
Fulcrum Asset Management
Generation IM (Workstream Chair)
HSBC
Institutional Investors Group on Climate Change (IGCC)
Lombard Odier

McKinsey (Advisor)
Mirova
Mitsubishi UFJ Financial Group, Inc.
MSCI
Ninety One
Rocky Mountain Institute (Advisor)
Shinhan Financial
Singapore Exchange Group
S&P Global
UBS
UNEP-FI (Advisor)
Wells Fargo
WTW

Our online consultation survey is open until 12th September. We are looking forward to hearing from you!!

<https://selfserve.decipherinc.com/survey/selfserve/591/220764?list=3#?>

Appendix

2 Adoption: A deep dive into barriers to adoption and how we address each barrier in the report

| Barrier category | Barrier(s) to adoption | How we address this barrier(s) in the report |
|-----------------------------------|--|---|
| Methodological and implementation | <ul style="list-style-type: none"> Uncertainty about underlying model assumptions & complexities | <ul style="list-style-type: none"> Section 3 contains enhancements to Judgements to drive convergence on best practices Section 4 contains a call to action to drive greater metric provider transparency |
| Methodological | <ul style="list-style-type: none"> Lack of guidance about which emissions unit is the most suitable for the fossil fuel sector Lack of guidance on the materiality of Scope 3 emissions by sector and category Lack of guidance for assessing the credibility of companies stated emission reduction targets. Lack of guidance for selecting a time horizon that will appropriately capture the alignment of companies | <ul style="list-style-type: none"> Guidance provided in relevant Judgement-specific subsections for Judgement 3, 4, 6, 7, and 8 |
| Implementation | <ul style="list-style-type: none"> The impact of climate solutions financing is not reflected in portfolio alignment benchmarks Lack of agreement on the appropriate use cases for different alignment metrics | <ul style="list-style-type: none"> Practitioner case studies featured in Section 3 |
| | <ul style="list-style-type: none"> Lack of portfolio alignment metrics that are applicable to all asset classes limit full portfolio coverage | <ul style="list-style-type: none"> The 2023 workplan will address this challenge |

