Preparing Buy & Maintain portfolios for Net Zero

Good progress but the hard work starts now

A couple of years ago we wrote an article about preparing Buy & Maintain (B&M) portfolios for Net Zero. That used portfolio statistics from a B&M fund many of our clients hold to demonstrate the pitfalls and opportunities in making an (increasingly larger) part of their portfolio aligned with Net Zero targets.

This article reviews the progress the portfolio has made towards Net Zero and discusses how further progress can be achieved. Engagement remains key to success.

Important fund changes

While the fund objectives always considered ESG in a broad sense, the manager is now explicitly required to manage the portfolio in line with the principles of the Net Zero Investment Framework, where this does not conflict with the other objectives of the portfolio.

Quarterly reporting now includes enhanced climate metrics, including alignment, and engagement reporting to assist client review, in addition to biodiversity metrics that are interlinked with assessing climate risks.

We suggest these improvements could also be implemented by clients with segregated mandates.

Emissions monitoring — the denominator problem

We used a range of metrics in the previous article to assess the future emissions pathways. These were:

- Weighted Average Carbon Intensity (WACI) using Enterprise Value as the denominator
- WACI using debt outstanding as the denominator
- WACI using $m of revenues or $m of GDP as the denominator
- Carbon footprint per £m invested

All metrics have flaws but some are more subject to sharp market changes than others, notably Enterprise Value and £m invested, which will move due to changes in equity prices and interest rates even if emissions stay constant, and therefore were affected by the market background in 2022. While revenues could also have been affected by a weaker economy, high inflation or idiosyncratic reasons, we have used WACI with revenues as the denominator for this analysis as revenues are reported as at the end of each issuer's fiscal year, which may be part way through 2022, and changes since our last review will be easier to attribute. We intend to revisit WACI using Enterprise Value and £m in a couple of years' time when we will be better able to put the movements due to market changes in context.

That having been said, market changes will have indirect impacts. For example, the non-gilts index has a large weight of (generally high-emitting) utilities at the long end. Over 2022 the market-cap weight of these in the index decreased and the average emissions of the index fell (although GazProm being removed from the index and a number of maturing bonds issued by utilities each had a similar effect).

Clients should use a range of metrics to measure climate characteristics of the portfolio but recognise these are only point in time figures. Data will change and external factors, such as market moves, can affect the year-on-year figures, making short-term moves less relevant. We recommend clients take the time to understand the potential drivers of changes in emissions for a given metric outside of outright emissions reduction in the short term. However it is more useful for clients to focus on the long-term target and temporarily de-emphasise metrics if necessary.

Changes in WACI since the last review

The manager has obtained more granular information on the issuers in the May 2021 portfolio since our last review. Using this more complete data, the emissions of the May 21 portfolio have risen since our last paper, as shown in the graphs below. This is another example of how reported metrics will change over time. In spite of starting from this higher base, the absolute emissions of the portfolio and its WACI have fallen from the number we calculated in our last paper.

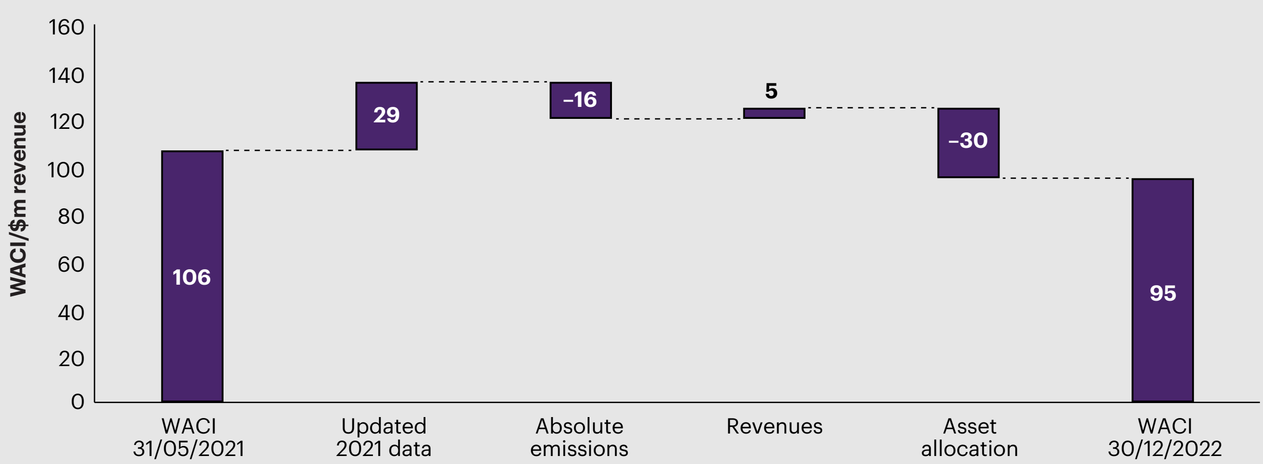
Some of this is due to a few high-emitting issuers introducing emissions targets and cutting emissions. We welcome this as a step on the path to Net Zero.

The portfolio has grown materially since the last review and changes in asset allocation, including diversifying allocations to high emitters at the long end, have been the most significant contributors to the fall in WACI. However, we expect the fund to grow less explosively in future so future falls in WACI are more likely to come from falls in absolute emissions.

Changes in revenues have slightly increased the WACI number, as discussed above.

Buy & Maintain managers should be striving to be able to provide this level of granularity to clients, particularly as institutional investors are coming under increased scrutiny to demonstrate their progress towards Net Zero.

Figure 1: **Change in WACI since 5/2021**



Source: AXA Investment Managers

Changes in the projected pathway, assuming the portfolio is unchanged

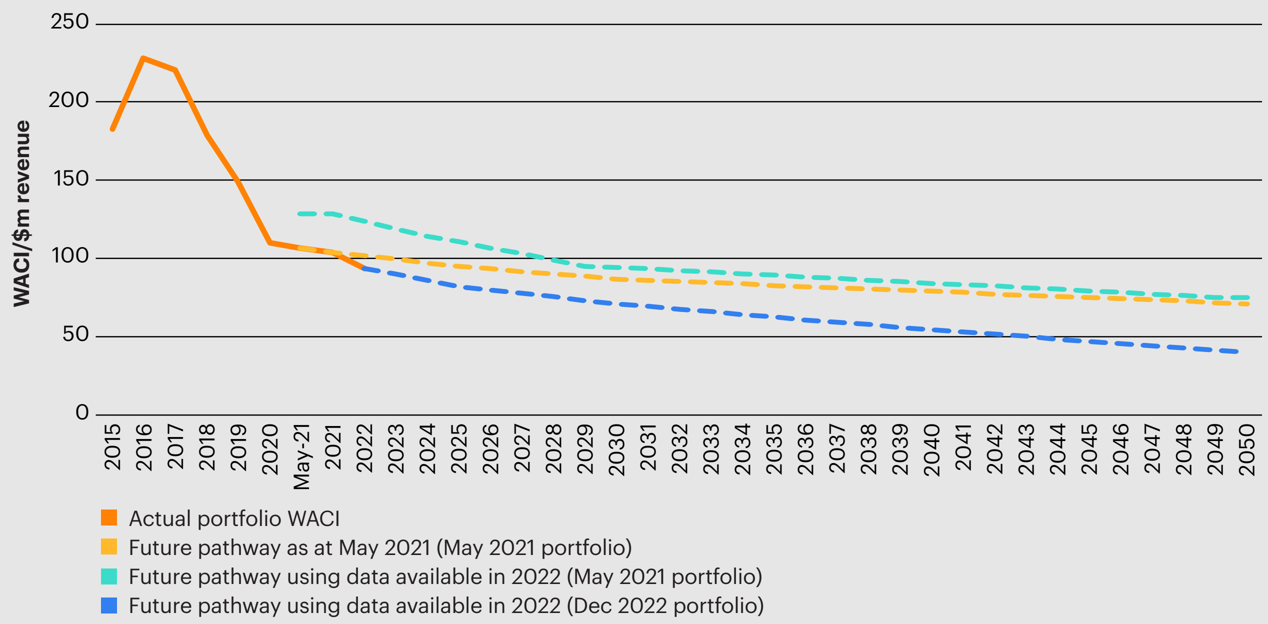
The change in emissions today is one thing, but the future pathway is more important to judge whether the portfolio is on target for Net Zero.

The projected emissions of the December 2022 portfolio are lower than May 2021's (using data available then and data available now) and are expected to continue to fall more steeply throughout the life of the portfolio. Caveat: this calculation assumes that companies and sovereigns in the portfolio meet their stated emissions targets (as sourced from MSCI or SBTi). The fund manager will be monitoring this, adjusting projections and engaging with issuers as necessary in future.

The reasons for the fall are:

- Reductions in WACI over the last 18m, as mentioned on the previous page
- Better pathways for some issuers. For example, a large utility company has moved from no emissions reduction target to a 66% emissions reduction target by 2050. With a high WACI this has a material impact on the current portfolio pathway, even with a relatively small portfolio weight, demonstrating the benefits of investor engagement with issuers and the handicaps of blanket exclusions. Other holdings have made similar commitments.

Figure 2: **Portfolio emissions if today's portfolio is static**



Source: AXA Investment Managers as at 31/12/22

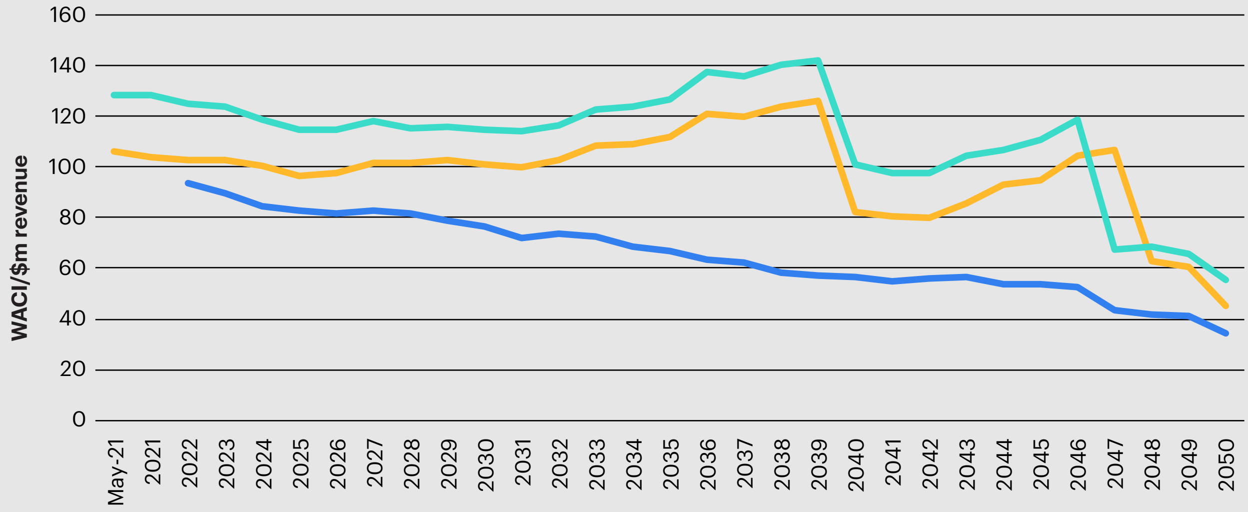
Changes in the projected pathway, taking into account the run-off characteristics of the portfolio

The previous emissions analysis, while more detailed than most managers are able to provide at the moment, is fairly standard in scope and all that is relevant for a high-turnover portfolio. However, this portfolio is Buy & Maintain and pays all maturities and coupon cashflows to clients rather than reinvesting them. Therefore it is both possible and relevant to consider how its emissions might change as the portfolio runs off over time.

Today's run-off emissions pathway is also lower and much less 'lumpy' at the longer end than it was in 2021. This is because of:

- Emissions reduction and improved targets
- Portfolio inflows making it possible to diversify high-emitting issuers or those with no reduction pathway.

Figure 3: **Portfolio emissions as the portfolio runs off**



Runoff pathway as at May 2021 (May 2021 portfolio)
Runoff pathway using data available in 2022 (May 2021 portfolio)
Runoff pathway using data available in 2022 (Dec 2022 portfolio)

Source: AXA Investment Managers as at 31/12/22

Other indicators of the path to Net Zero

We recommend clients use a balanced scorecard that does not look solely at emissions. 39% of the fund portfolio now has SBTi targets, compared to 23% in May 2021, and 68% of the portfolio is aligned or aligning to a Net Zero pathway. That having been said, the allocation to green bonds is only 2%. We do not feel this is a weakness, given the proportion of the portfolio that is aligning to Net Zero.

The manager has begun to include biodiversity in their reporting, although the Taskforce on Nature-related Financial Disclosures (TNFD) is not yet fully defined so some metrics may change. Nevertheless all best in class managers should be forward thinking in this area. Portfolio coverage for this is 63% and shows land use is by far the greatest pressure on biodiversity.

Overall, we believe this portfolio is well constructed to provide secure cashflows and also well constructed to assist in a client's transition to Net Zero.

Best in class managers should be able to analyse the portfolio's emissions pathway and demonstrate it is on the path to Net Zero. They should also be engaging with all issuers to ensure targets are met and reporting regularly on that engagement, including on issuers where escalation has been or will be necessary.

Engage, engage, engage

All this is very reassuring and we are pleased many issuers in the portfolio have set ambitious emissions targets in the last couple of years. However, setting targets is easy — achieving them will be difficult and managers should be reviewing progress continuously and escalating engagement as necessary.

Many managers are still not able to produce mandate-level engagement reports routinely, although most should by the end of this year. This is a minimum standard of ours and managers that fail to do so will be at risk of being downgraded. We encourage clients to ask for this reporting, to evidence that managers are engaging with issuers of all types, as required by the regulator, and to cross-check engagement activity and outcomes across all their portfolios. Managers have been able to report many engagement 'successes' in the last few years as issuers set targets. We expect a higher proportion of engagement 'failures' in future, as those targets are missed and it is important managers are reporting on these.

We feel such engagement and escalation will become as important to the successful management of a low-turnover B&M portfolio as best in class credit analysis, and managers should see engagement as a source of risk reduction and, where relevant, alpha generation. We are not sure all B&M managers yet appreciate this.

Next steps

We suggest clients review managers' regular reporting for their B&M portfolios and:

- Check TCFD and emissions reporting of the current and future portfolio is providing the necessary information.
- Check engagement reporting covers issuers of all types, not just corporates with listed equity, and includes details of issuers that are lagging on ESG commitments or failing to meet milestones. The manager should have a clear escalation policy for those failing to meet milestones.
- Check managers are thinking about biodiversity (the partner issue to climate) and are making plans to include TNFD reporting in their future reporting, as we suspect this will be a regulatory requirement in time.
- Engage with managers who are unable to do the above and have no clear route to achieving this.

Disclaimer

WTW has prepared this material for general information purposes only and it should not be considered a substitute for specific professional advice. In particular, its contents are not intended by WTW to be construed as the provision of investment, legal, accounting, tax or other professional advice or recommendations of any kind, or to form the basis of any decision to do or to refrain from doing anything. As such, this material should not be relied upon for investment or other financial decisions and no such decisions should be taken based on its contents without seeking specific advice.

We incorporate sustainable investment considerations, including sustainability risks, into our investment research, due diligence and manager assessments. We believe that sustainability risks and wider sustainability considerations can influence investment outcomes from a risk and return perspective. Where sustainability risks and other sustainability considerations are most likely to influence investment risk and return, we encourage and expect fund managers to have a demonstrable process in place that identifies and assesses material sustainability risks and the impact on their investment strategy and end portfolio.

This material is based on information available to WTW at the date of this material and takes no account of developments after that date. In preparing this material we have relied upon data supplied to us or our affiliates by third parties. Whilst reasonable care has been taken to gauge the reliability of this data, we provide no guarantee as to the accuracy or completeness of this data and WTW and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any errors, omissions or misrepresentations by any third party in respect of such data.

This material may incorporate information and data made available by certain third parties, including (but not limited to): Bloomberg L.P.; CRSP; MSCI; FactSet; FTSE; FTSE NAREIT; FTSE RAFI; Hedge Fund Research Inc.; ICE Benchmark Administration (LIBOR); JP Morgan; Markit Group Limited; Russell; and, Standard & Poor's Financial Services LLC (each a "Third Party"). Details of the disclaimers and/or attribution relating to each relevant Third Party can be found at this link.

This material may not be reproduced or distributed to any other party, whether in whole or in part, without WTW's prior written permission, except as may be required by law. In the absence of our express written agreement to the contrary, WTW and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any consequences howsoever arising from any use of or reliance on this material or any of its contents.

About WTW

At WTW (NASDAQ: WTW), we provide data-driven, insight-led solutions in the areas of people, risk and capital. Leveraging the global view and local expertise of our colleagues serving 140 countries and markets, we help you sharpen your strategy, enhance organisational resilience, motivate your workforce and maximise performance. Working shoulder to shoulder with you, we uncover opportunities for sustainable success — and provide perspective that moves you. Learn more at wtwco.com.

wtwco.com/social-media

wtw-HP-2023-0713

wtwco.com