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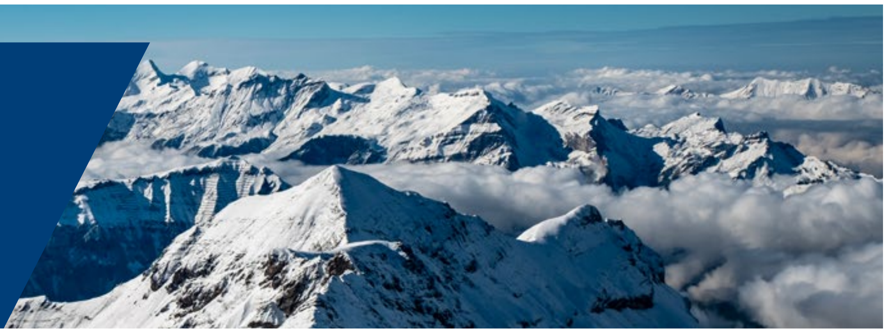
Paris alignment – our approach for investments



Summary

Climate change is one of the defining issues of our time. It can only be arrested if all stakeholders act and work together towards a common goal. ASI strongly supports the objectives of the Paris Agreement. We are committed to playing a constructive role in the decarbonisation of the global economy and serving the long-term interests of our clients. While much more needs to be done by policymakers to achieve the Paris goals, an energy transition is underway and we incorporate this into our investment decisions. We also stand ready to rapidly scale up our ambitions if and when governments raise their policy ambition. In the meantime, our calibrated approach to Paris alignment is founded on the following core principles:

- We develop innovative Paris-aligned and **net zero solutions** for clients, setting ambitious climate-related goals.
- As **responsible stewards** on behalf of our clients, we expect companies' business plans to reflect the long-term climate-related risks and opportunities they face.
- We advocate for more stringent regulatory frameworks so that **global policy** sends Paris-aligned signals to capital allocators.
- We undertake rigorous **climate-related research**, drawing on sophisticated tools and data. This allows us to assess the risks and opportunities related to climate change, integrate this into our investment processes and report on climate metrics to provide transparency to our clients.

This Paris alignment statement should be read in conjunction with our publication Climate Change – Our Approach for Investments which details how we more generally integrate climate change considerations into our investment processes.

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1. The key features of the Paris Agreement for our industry

The goal of the 2015 Paris Agreement is to "hold the increase in the global average temperature to well below 2°C above pre-industrial levels and pursue efforts to limit the temperature increase to 1.5°C".

The more ambitious objective of keeping warming to 1.5°C requires emissions to reach 'net zero' by 2050 according to the Intergovernmental Panel on Climate Change (IPCC). The 'net' in net zero means any residual emissions from hard-to-abate industries need to be removed from the atmosphere through technology or nature-based solutions.

The Paris Agreement also includes the objective of "making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development".

Financial flows are, at present, not aligned with the Paris goals. The IEA estimates that the world needs to immediately allocate around US$2 trillion a year to finance the decarbonisation of the global energy system at the speed and scale implied by the Paris Agreement. Currently, the world is allocating only around half of that.

This shortfall is largely the result of failure of global government policies and commitments to align with the stated objectives of the Paris Agreement. Most Nationally Determined Contributions (NDCs) to the agreement remain inadequate. And there are no legally binding mechanisms within the agreement forcing alignment between its objectives and policies. The upshot is that carbon prices and other signals required to incentivise Paris-aligned financial flows are currently insufficient.

2. What is 'Paris-aligned' investing?

The Paris Agreement effectively incorporates two objectives. However, the concept of a 'Paris-aligned' investment strategy has become synonymous with achieving alignment with the stronger goal of achieving net zero emissions by 2050.
In practice, that means reallocating capital from fossil-fuel-intensive activities to zero-carbon alternatives at a pace consistent with lowering global carbon emissions by 40-50% by 2030 and an average annual rate of 8% between now and 2050. It also implies a material rise in the share of portfolios financing climate solutions. Moreover, any exposure to carbon-intensive companies must focus on those with credible, ambitious climate targets.

Aberdeen Standard Investments

These principles are enshrined in the Net Zero Investment Framework designed by the Institutional Investors Group on Climate Change (IIGCC) Paris Alignment initiative, of which ASI is a member. The framework has three core pillars: shifting capital towards climate solutions; decarbonisation at the speed required to meet net zero alignment by 2050; and net zero consistent corporate stewardship. Importantly, however, the framework is flexible enough to provide investors with a range of options about how they translate the pillars into actionable investment strategies.

Critically, the demand for Paris-aligned investment solutions is growing rapidly. For example, the UN Net Zero Asset Owner Alliance consists of investors with combined assets of more than US$5 trillion (and growing). Each of these investors has committed to net zero portfolios by 2050 as well as verifiable intermediate targets, albeit some stipulate caveats related to the evolution of global policy.

3. Why does Paris alignment matter to ASI?

Paris alignment matters to ASI for three main reasons:

1. **Acting responsibly** - We have signed the 'pledge for Paris' and believe we have a responsibility to play a constructive role in financing the low-carbon energy transition. We seek to achieve this though our capital allocation decisions and stewardship activities.
2. **Successful investing** - We cannot achieve strong investment returns without incorporating the likely risks and opportunities associated with the energy transition as well as climate change itself, into our decision making.
3. **Meeting client needs** - An increasing number of asset owners have set objectives to align their portfolios with the most ambitious goals of the Paris Agreement. We aim to provide solutions that allow us to capture this opportunity and support the transition to a low-carbon future.

4. What are the challenges to Paris-aligned investing?

Paris-aligned investing is not straightforward. Among the most important challenges are that:

1) There are many different pathways to achieve the Paris climate objectives

The Paris Agreement does not specify an annual pathway for emissions. Indeed, there is a wide range of potential country and sector allocations, policy choices and technology options compatible with the goals of the Agreement. There is also considerable uncertainty about which low-carbon technologies will be most viable. The upshot is that there are myriad potential firm-level capital spending plans and, thus, portfolios that are plausibly aligned with the Paris Agreement. This makes it difficult to have one consistent approach that can be compared across investors.

2) Global climate policies are not Paris-aligned

At present, global government policies, including credible future plans, are not consistent with the objectives of the Paris Agreement. In a world where global government policy does not become 'Paris aligned' it is unrealistic to expect realised aggregate capital deployment to become aligned either, though there may be some sectors and regions for which alignment is more plausible. That in turn will limit the ability of investors to make full, Paris-aligned, changes in their own capital allocation without likely affecting financial returns in the longer term. However, a significant energy transition is in prospect, even without global Paris Alignment. And critically, such a transition is not fully priced into assets according to our internal research. As such, the energy transition we are expecting will generate significant investment opportunities.

3) It is hard to recognise which companies have credible, Paris-aligned transition strategies

Although net zero corporate pledges are on a rising trajectory, it is difficult to assess their credibility. For example, credible targets need to include all upstream and downstream emissions (Scopes 1, 2 and 3) and focus on real decarbonisation action rather than offsetting. Long-term ambitions also need to be broken down into transparent short-term and medium-term goals and capex spending plans so companies can be held accountable during the transition.

Including companies with credible decarbonisation objectives in a Paris-aligned portfolio is critical for real-world decarbonisation impact. We need energy, transport, steel and cement providers to transition rather than fail. However, in the early stages of their transition, these companies are still likely to be highly carbon intensive, which creates a conflict. It would be counter-productive if crude attempts at Paris alignment resulted in divestment from credible transition leaders or companies being nationalised. This would only make the problem worse. Transition companies need investor capital to finance decarbonisation. It is important to focus on real world impact rather than simply portfolio reporting.

4) Asset managers and owners can have different priorities and responsibilities

Asset owners have freedom, subject to their fiduciary and regulatory obligations, to set their own long-term investment objectives. That means they can choose to set a Paris alignment goal for their portfolios. Asset managers, however, have fiduciary obligations to their clients, based on pre-agreed objectives and mandates. It is not possible for asset managers to change these mandates to include net-zero objectives without their client's consent, unless such a change was required to fulfil their fiduciary obligations.

The nature of any commitment by asset managers is therefore different. It needs to differentiate between solutions designed for clients with specific net-zero aligned objectives and those whose objectives are limited to incorporating the likely risks and opportunities arising from the different dimensions of climate change.

5) Paris aligned approaches are hard to compare across investors

We believe that large differences in investment objectives and strategies mean that Paris alignment cannot be defined in the same way for every investor. For example, it is challenging to compare Paris alignment across investors using a single temperature alignment score - this masks the complexities outlined. Standards in the industry need to evolve to improve comparability.

ASI's approach to Paris alignment in our investments

It is not within the gift of investors to completely overcome all of these challenges. For example, investors cannot dictate global policy decisions. However, there are steps they can take to mitigate them. They can use their influence to lobby governments for stronger action. They can make capital available to the companies that need or want to transition. They can also ensure that announced transition plans are transparent and credible. And they can partner with asset owners to make Paris-aligned investing more viable. All of this requires a calibrated approach, driven by rigorous research and a deep understanding of the implications of different climate scenarios on the investment landscape.

More formally, we have developed a business-wide approach to support the goals of the Paris Agreement based on five principles:

1. **Public policy advocacy** – Government policies are key to achieving Paris goals. Investors can play a part in this process by expressing their support for more policy ambition. They can also assist with the design of efficient policies that will help drive net zero consistent capital flows. ASI publicly joins with other investors in supporting the need for stronger climate policies.
2. **Rigorous climate scenario analysis** – We have developed unique climate scenario analysis capabilities. We have created bespoke scenarios that reflect our research-driven views on likely climate policy and technology pathways across regions and industries. This includes a range of 'Paris aligned' scenarios we use to assess the financial impact of Paris-aligned pathways on our funds. Our approach includes an assessment of resilience to different scenarios, as well as an assignment of probabilities to different outcomes. At present, this implies that the world is likely to fall short of the ambition to limit temperature increases to below 2 degrees by the end of the century. However, we will review and update our assessment on an annual basis and incorporate all relevant risks and opportunities into our investment process – from strategic asset allocation to individual stock research, portfolio construction and engagement.
3. **Responsible Stewardship** – We engage strongly with corporates and encourage them to set ambitious transition and adaptation goals consistent with the risks and opportunities most relevant to their business, as well as their own climate values. The probability of global policies becoming Paris-aligned is high enough that we expect businesses to assess their resilience to such outcomes and adapt their strategies accordingly. In addition, for many companies, the business cost of net zero alignment is negligible. We therefore expect these companies to transition regardless of the regulatory environment in which they operate.

   More generally, we have clear climate change stewardship expectations. For transitioning companies, we demand to see improvement against transparent, measurable criteria. We are also active members of Climate Action 100+ and engage with some of the world's largest emitters using the CA100+ net zero benchmark. If a company makes only limited progress relative to expectations, we consider reducing or eliminating exposures. We believe that active engagement on Paris alignment is critical for real-world decarbonisation. Companies seeking to be transition leaders need to take an ambitious and proactive approach to decarbonisation.

   That said, our approach to climate stewardship is highly calibrated, reflecting the challenges set out earlier in the statement. In particular, the policy environments, availability of low-carbon technology options and social considerations are all taken into account. That means our expectations of utility companies will be greater than for industrial companies, and expectations of companies operating mostly in developed countries higher than for emerging economies.
4. **ASI net zero real estate commitment** – As signatories of the UK Better Building Partnership's Climate Change Commitment, we have developed a framework to achieve net zero emissions across all our real estate funds by 2050. This includes the operational and embodied carbon of our existing buildings and new acquisitions as well as the energy consumed by our tenants.
5. **Reporting: tracking carbon and climate solutions** – We are tracking the carbon footprint of our portfolios (where data is sufficiently available) and are developing an approach for measuring our exposure to climate solutions. This helps us understand where risks and opportunities are concentrated and enables monitoring decarbonisation progress. It also provides transparency for decision making – to clients, internal analysts and investment decision-makers.

"Supporting the goals of the Paris Agreement requires a calibrated approach, driven by rigorous research and a deep understanding of the implications of different climate scenarios on the investment landscape."

For clients who have set specific climate-related goals to align their investments with the Paris Agreement, we can go even further than our wider business approach. We have developed (and continue to develop) solutions to help achieve these objectives, with a focus on real-world decarbonisation, including:

1. **Climate-aligned funds and benchmarks** – For clients who want their investments to have a positive impact on the energy transition, we offer and develop climate-related products across a range of asset classes. These invest in low-carbon climate solutions and energy transition leaders, with decarbonisation progress tracked over time. We are also working on the development of climate-tilted benchmarks. Investors can have an important real world impact by tilting away from carbon-intensive industries - particularly from companies with inadequate transition plans- towards climate solutions. This helps realign the cost of capital in favour of companies investing in initiatives to mitigate climate change.
2. **Net zero investing solutions** – Clients who have set net zero targets can achieve these by moving to funds that tilt away from carbon-intensive activities towards transition-leaders and climate solutions and overlay this with a net zero stewardship approach. This needs to be tracked against a Paris-aligned emissions pathway so decarbonisation happens at the required rate. For strategic clients wishing to adopt net-zero objectives, we are working to enable this shift in their portfolios and to develop clear metrics and targets to measure progress over time. This includes integrating climate objectives into the strategic asset allocation work we do for clients as well as stewardship, aligned benchmarks and integration of climate risk into investment decisions. Real-world decarbonisation impact is key. If companies have sufficiently ambitious and credible decarbonisation targets, we want to be able to support them, rather than divest to meet annual carbon-reduction targets.