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INSTITUTE FOR SUSTAINABILITY LEADERSHIP

Investment Leaders Group

Understanding the climate performance of investment funds

Part 1: The case for universal disclosure of Paris alignment

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Contents

Executive summary

- A variety of approaches are currently used to measure and report the climate performance (as distinct from broader sustainability performance) of investment funds.
- Each has its uses (for example carbon intensity, risk, alignment with the Paris ambition), but the diversity inhibits comparison and not all measures are readily understandable by non-specialists.
- We believe that a meaningful, outcome-based number should be adopted by all investment funds to report their alignment with the Paris ambition, and that the leading candidate for this is a temperature score.
- The temperature score associates an asset – and in aggregate a fund – with a particular level of global warming measured in degrees centigrade (°C). It is readily understood by specialists and non-specialists alike, including investors, beneficiaries and the general public.
- This is Part 1 of a series. Part 2 will examine the design of temperature scores, including the underlying science, methods of emissions projection, and distribution of carbon budgets.

Introduction

Investors are increasingly turning their attention to climate change, seeking to mitigate climate risks in their portfolios, gain exposure to assets offering climate solutions, and generally have a positive impact upon the world's most serious long-term threat. Alongside their desire to protect returns, a consensus is emerging that it is in the best interests of the industry to build resilience to climate risks and stop further temperature rise.

All investment has an impact on the world but to a large extent these impacts – for example interference with the climate or degradation of nature – remain opaque to investors and their beneficiaries. Current attempts to disclose the sustainability performance of funds are patchy, non-standardised and lack rigour, resulting in confusion and scepticism among beneficiaries.

This paper explores the factors guiding the design of a sample of funds that were ranked by CDP in 2019 as having market-leading sustainability performance. The group consists of 15 funds (five European equities, five global equities and five emerging markets equities) ranked top in CDP's 2019 Climetrics Fund Awards (Table 1), using a methodology that scores funds on investee company disclosure of the management of material climate, water and deforestation issues, as well as asset manager governance of climate issues and investment policy. The awards run annually – this paper analyses the approaches used by top 2019 funds only.[1]

Fund name	Asset manager	Category
Epargne Ethique Actions	Ecofi Investissements	European equities
LBPAM ISR Actions Euro	La Banque Postale Asset Management	European equities
LBPAM Responsable Actions Europe	La Banque Postale Asset Management	European equities
LBPAM ISR Actions Environnement	La Banque Postale Asset Management	European equities
Mirova Europe Sustainable Equity Fund	Mirova	European equities
Ecofi Enjeux Futurs	Ecofi Investissements	Global equities
Jupiter Global Ecology Growth	Jupiter Asset Management	Global equities
MAM Transition Durable Actions	Meeschaert Asset Management	Global equities
Storebrand Global Solutions	Storebrand Asset Management	Global equities
Swedbank Robur Transition Global	Swedbank Robur	Global equities
Comgest Growth Emerging Markets	Comgest	Emerging markets equities
Stewart Investors Global Emerging Markets Sustainability Fund	First Sentier Investors	Emerging markets equities
Raiffeisen-Nachhaltigkeit-EmergingMarkets-Aktien	Raiffeisen Kapitalanlage-Gesellschaft m.b.H	Emerging markets equities
RBC Funds (Lux) Emerging Markets Equity Focus Fund	RBC Global Asset Management	Emerging markets equities
SPP Emerging Markets Plus Fund	SPP Fonder	Emerging markets equities

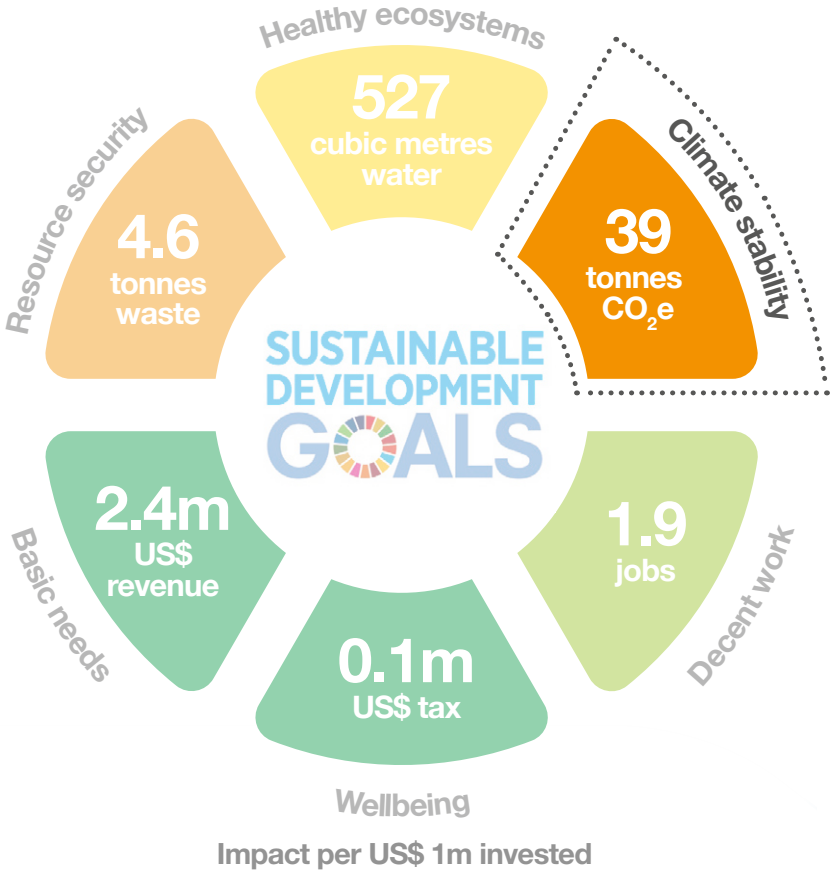
Table 1: Top climate funds across European equities, global equities and emerging markets equities according to CDP[1]

Analysis of publicly available fund factsheets, Key Investor Information Documents, annual reports, various sustainability policies and reports, and web sites revealed a multitude of fund objectives, investment strategies, measurement frameworks and disclosure arrangements in use by the funds. The diversity of approaches makes comparisons of climate performance difficult and, more importantly, does not show straightforwardly how the funds align with the Paris ambition of limiting global warming to “well below” 2°C above pre-industrial levels.

While we recognise this diversity is in part a natural consequence of tailoring funds to the needs of particular investor groups, we believe that consolidation would be beneficial in measurement frameworks and disclosure arrangement to enable performance comparability. This problem would be addressed if the industry adopted a universal measure to judge alignment of funds with the Paris ambition. A simple proposal for such a measure is included in this paper based on a ‘temperature score’ method that associates a fund with a specific level of global warming in °C.

As part of a larger programme of work exploring how to quantify the social and environmental performance of funds, this approach was proposed by the Investment Leaders Group (ILG), a group of leading institutions in the investment industry coordinated by CISL, in *In search of impact: Measuring the full value of capital* in May 2016.[2] It was later refined in the sequel to that report of January 2019 which introduced the *Sustainable Investment Framework*.[3]

The current paper builds on this previous work. It is presented in two parts: Part 1 (here) reviews the factors driving the design of funds claiming to address climate change; Part 2 examines the science behind temperature scores, and the methods guiding their design. A preferred method is illustrated using fund data provided by ILG members.



Theme	Ideal metric	Base metric
Climate stability	Alignment to future warming scenario based on consumption of global carbon budget	Total greenhouse gas (GHG) emissions (Scope 1 and 2)
	Unit: degrees Celsius (°C)	Unit: tonnes (t) carbon dioxide equivalent (CO_2e)

Figure 1: Dashboard of six impact themes and the ideal and base metrics for climate stability from the Sustainable investment Framework.[3]

The rise of sustainable investment

Sustainable investment has reached an all-time high, with assets held in what can generally be referred to as 'sustainable funds' reaching US$ 1,258 billion by the end of September 2020, up 19 per cent on the previous quarter.[4]

Despite fears that inflows to sustainable funds might be stifled by the pandemic, 2020 was a bumper year for sustainable finance generally, with 166 new fund offerings in Q3 2020 alone.[4] Inflows to sustainable funds increased by 14 per cent that quarter to US$ 80.5 billion.[4]

Sustainable funds have a variety of ambitions ranging from climate change-specific goals to broader environmental and sustainability aims.

Sustainable fund design

In order to meet their ambitions, a number of **objectives** can be observed among the sample of funds highlighted in Table 1, varying from a specific focus on climate change to broader environmental, social and sustainability goals. These are in turn supported by different **strategies** for asset selection and portfolio management, with performance assessed using different sustainability **measurement frameworks**.

Interestingly, while ten of the funds identify sustainability performance measures, not all disclose their actual performance against them. A further variable is therefore the rigour with which the funds **disclose** their sustainability performance. The four factors are depicted in Figure 2.

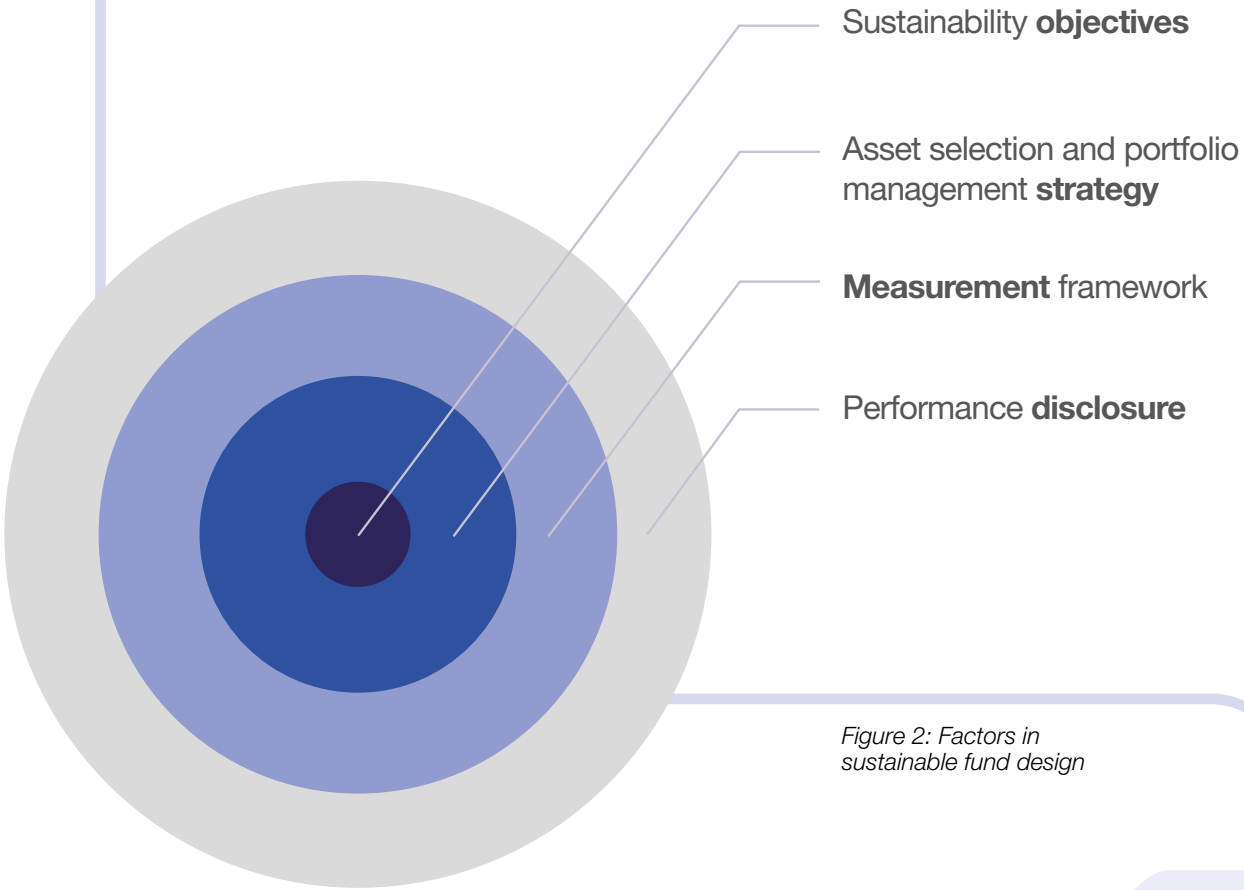


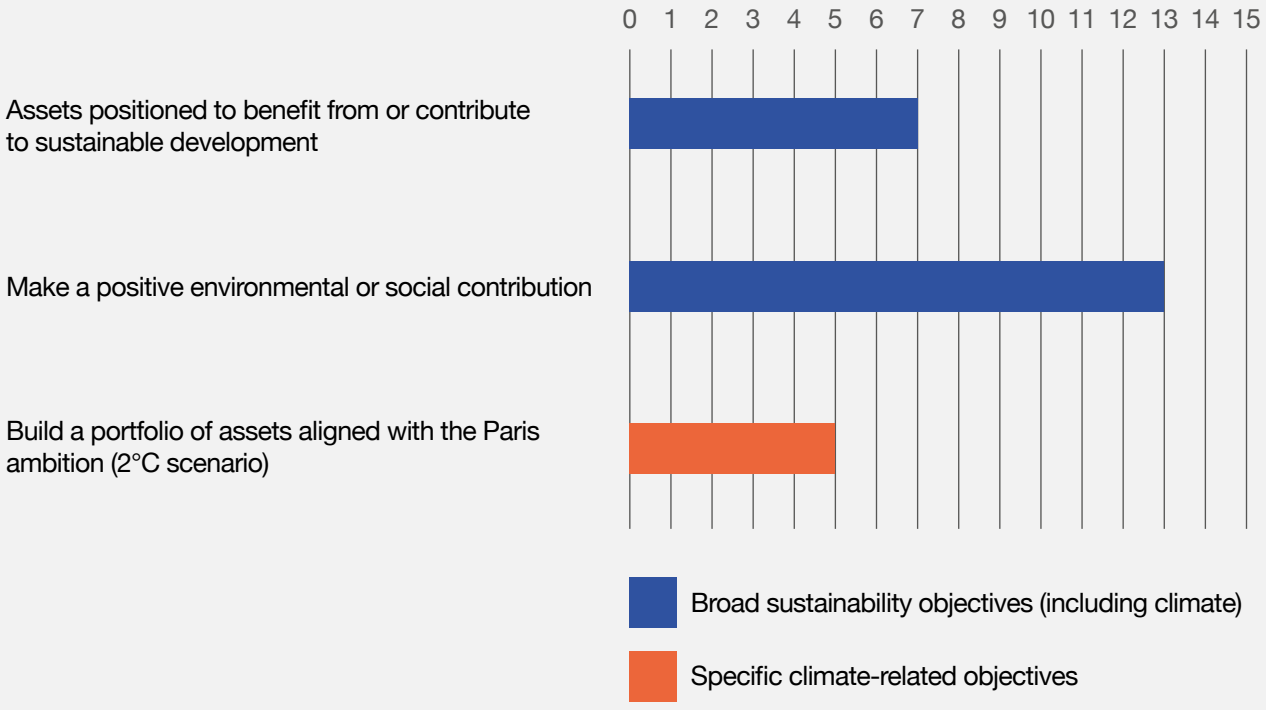
Figure 2: Factors in sustainable fund design

Sustainability objectives

Of the 15 funds reviewed, 13 included a sustainable investment objective in publicly available literature, alongside financial goals to produce long-term capital growth. Interestingly, two of the funds reviewed made no mention of sustainability objectives despite being ranked highly in CDP's 2019 Climetrics Fund Awards, although one of these did report its environmental footprint.

Seven of the funds seek exposure to the upside of investing in assets benefitting from the transition to sustainable development, for example in the electronic test and measurement instrumentation industry that grows with the use of electric vehicles, semiconductors and clean energy. Thirteen funds express the intention to make a positive environmental or social contribution, for example by investing in assets that protect ecosystems or build resilience in society. Some funds claimed multiple sustainability objectives. Five funds state narrower, climate-related objectives based around alignment of portfolios with the Paris ambition.

What objectives are stated?

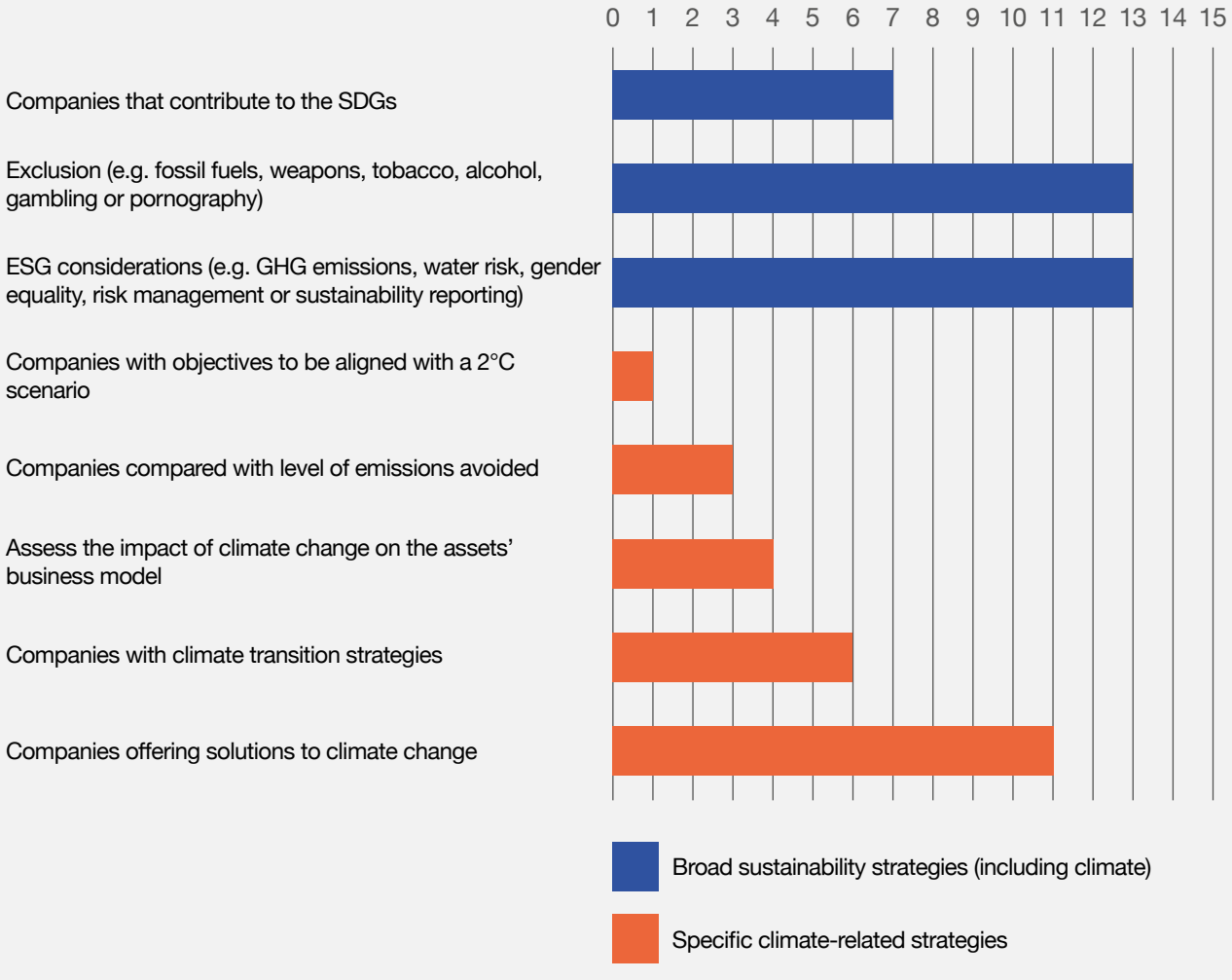


Asset selection and portfolio management strategy

Managers use different strategies to select and manage assets in their portfolios. Nearly all the funds assessed used basic screening and exclusion policies (13 funds) such as the exclusion of companies with more than five per cent of revenues from fossil fuels, weapons, tobacco, alcohol, gambling or pornography. The integration of environmental, social and governance (ESG) factors was also common (13 funds), for example the assessment of whether companies measure and set improvement targets for emissions, water risk, gender equality or risk reporting processes. Seven funds pursue thematic strategies based on selecting assets contributing to global sustainability goals such as the United Nations Sustainable Development Goals (SDGs). An example of the latter is a fund that invests in water preservation and treatment companies to further SDGs 6 and 14.

A number of funds employ strategies that directly address climate change, such as investing in companies with plans to transition to a low carbon, sustainable economy (six funds), using scenario analysis to assess the impact of climate change on investee company financial performance (four funds), and selecting assets that offer products and services to mitigate climate change (11 funds). Despite five funds having an objective to build a portfolio aligned with the Paris ambition, only one selected assets based on their alignment with a 2°C scenario. It should be noted that most funds use a combination of strategies to deliver their climate ambitions.

What strategies are pursued?

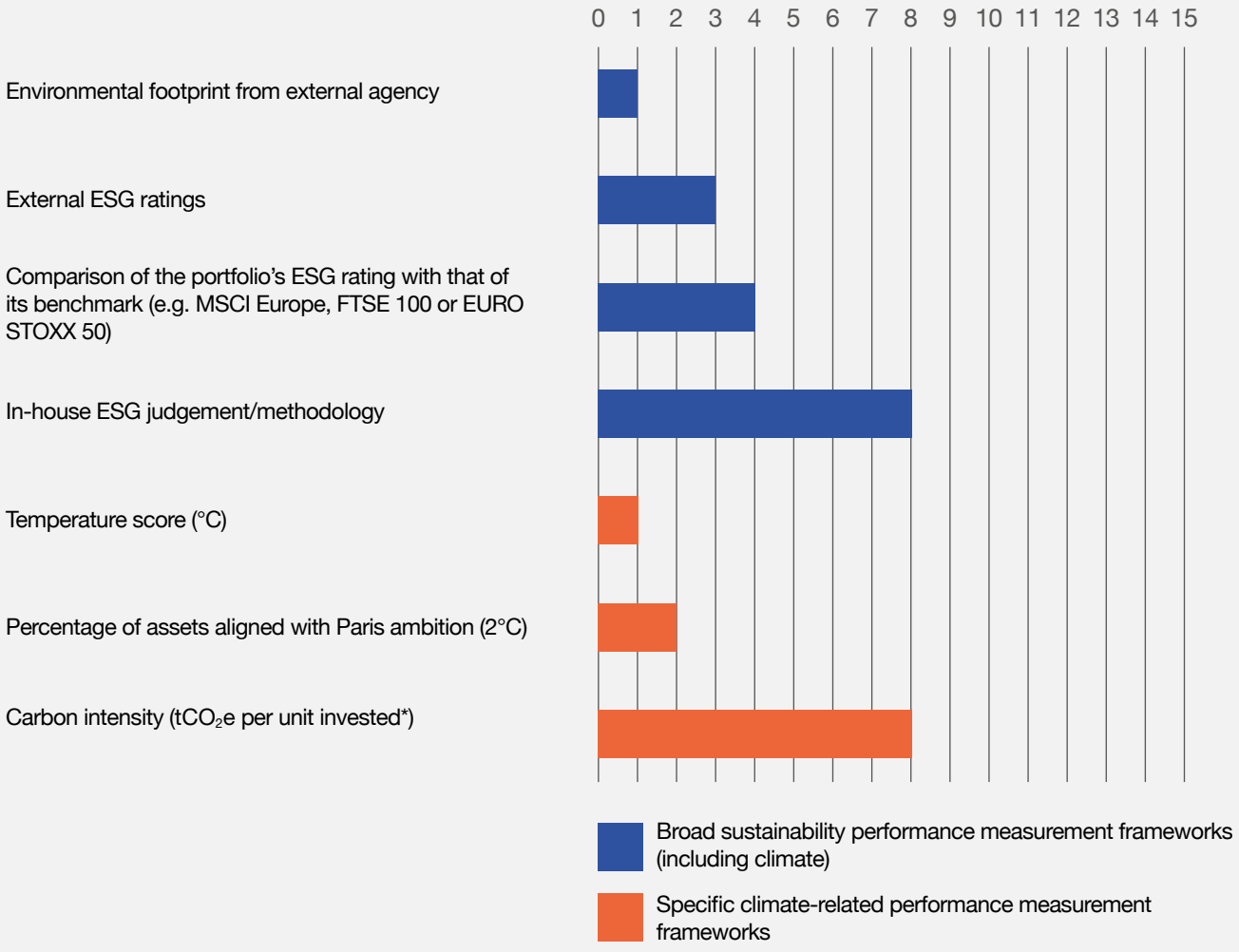


Measurement framework

Eight funds measure their sustainability performance using in-house methodologies while others use external ESG ratings such as ISS-Ethix and Sustainalytics (three funds) or methodologies such as Trucost's estimate of the costs of pollution, natural resources, ecosystems deterioration, waste and climate change (one fund). Four funds measure relative sustainability performance by comparing portfolio ESG ratings with a benchmark.

Of the 15 funds assessed, eight specifically measure their climate performance. Six measure carbon intensity (scope 1 and 2 carbon dioxide equivalent emissions in tonnes (tCO_2e) per million asset turnover), one measures portfolio carbon emissions (scope 1 and 2 tCO_2e per million invested) and one measures the level of emissions avoided through investment (tCO_2e per million of company value).

How is performance measured?



* Funds use a variety of methods to report carbon intensity including sales, turnover, enterprise value and amount invested.

While carbon intensity is the most common measure of climate performance in the sample, a standardised method of calculation is not apparent. For example, four funds rely on scope 1 and 2 emissions from assets, while two funds use this in addition to suppliers' direct emissions as the basis for carbon intensity calculations. The monetary currency used to compute carbon intensities also varies, hindering comparison.

Twelve of the funds compare their emissions performance against an industry benchmark, for example the MSCI Europe, FTSE 100 or EURO STOXX 50 indices. While relative performance can help position a fund on a spectrum of good to poor practice, it is absolute performance that counts with climate change. Are emissions in line with the downward trend of emissions captured by the Paris ambition? If not, by how much are they out?

Only three of the funds reviewed seek to demonstrate their alignment with the Paris ambition. Two measure their performance in terms of the percentage of assets aligned with a 2°C global warming scenario, while one expresses its emissions performance as a temperature score.

Performance disclosure

The three funds seeking Paris alignment disclose their performance publicly in the manner described above. However, while ten funds highlight some form of measurement framework (such as emissions intensity, external ESG ratings or in-house judgement methodology), only eight actually disclose their performance. Likewise, the criteria used to assess asset sustainability (for example in-house ESG methodologies) are often not disclosed.

Among the eight funds that do disclose broad sustainability performance, this is generally done voluntarily and separately from financial performance reporting. The low level of disclosure – even where funds claim to calculate performance – suggests that the reporting of sustainability, including climate change, is considered discretionary rather than a means of building public trust in the investment industry.

A universal measure of alignment with the Paris ambition

The Paris Agreement turned five years old in December 2020. It made clear that global warming should be limited to 2°C above pre-industrial levels, with a preference for 1.5°C to avoid catastrophic consequences to life on Earth.[5] It noted that the finance industry – and private investment in particular – should ensure that capital flows are consistent with this aim.[6]

In 2020 the UN reported that the world is not on track to meet the Paris ambition.[7] While financial markets are increasingly alive to the issue, the contribution of investment funds to meeting the ambition remains opaque at present. Even among the top-ranked funds reviewed in this paper, the absence of a clear, consistent measure of climate performance militates against investment beneficiaries and the general public understanding where we stand.

While year-on-year corporate disclosure of carbon emissions is improving, it is alarming that just under half of the assets in the MSCI World Index fail to report something as basic as carbon footprint (the figure is far lower across many broader global indices). Where climate performance is disclosed by a fund – as is the case with eight of the funds reviewed in this paper– a variety of distinct methods are employed (carbon intensity, percentage of assets aligned with the Paris Agreement or a temperature score).

We believe this process should now be standardised, and propose that among the basket of measures reported by investment managers an explicit measure of alignment with the Paris ambition is included: the temperature score. Why this metric? In brief it offers a meaningful, outcome-based number in degrees centigrade (°C) that reveals instantly how a fund aligns with the Paris ambition – keeping global mean temperature rise under 2°C between now and 2050. Clarity, simplicity and ready interpretation are core strengths of a measure designed for non-specialist investors, and the temperature score has them all.

No measure of performance sits alone, and climate is no exception. Investment managers may wish to report carbon intensity figures, for example, to distinguish their products from industry norms; similarly, reporting the proportion of an asset's revenue derived from 'green solutions' may be material to investors, as might an assessment of exposure to climate risks. Nonetheless, we believe the temperature score is the obvious candidate to act as a universal measure of climate performance for the industry, and should be adopted as a basic reporting requirement across all funds, not only ones with specific climate claims.

Part 2 of this series examines the design of temperature scores, including the underlying science, methods of emissions projection and distribution of carbon budgets. By analysing the different components of a temperature score, we explain the main reasons why the methodologies in the market today yield different results, and make some suggestions for convergence.

An updated picture of the relationship between greenhouse gas (GHG) emissions temperature rise is offered using the latest scientific information from the Intergovernmental Panel on Climate Change (IPCC). We then explore how to project an asset's future emissions over a defined period, say to 2050, based on different assumptions; and how different approaches to allocating the global carbon budget (for example by sector and region) yield different temperature results based on the same underlying assets.

In order to converge on a universal metric for the finance industry we believe familiarity with this methodological landscape is critical. The report aims to breed this familiarity. It offers a decision-making framework, helping financial institutions to distinguish the correct approach based on their various assumptions and concludes with a simple, potentially standard disclosure method for general use by the investment industry.

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