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June 2022

DEFINING OUR APPROACH TO ACHIEVING NET ZERO

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As such, it is in its voice as opposed to that of BNY Mellon Investment Management.

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INTRODUCTION

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The sixth and latest report by the United Nations' Intergovernmental Panel on Climate Change (IPCC) in August 2021 warned that the world would reach 1.5 degrees Celsius of warming (the most aggressive target from the 2015 Paris Accord) by 2030 under all scenarios examined.

At the COP26 climate summit in Glasgow in November 2021, there was much talk but still a relative dearth of concrete detail over how net-zero carbon emissions would be achieved. What is clear though is that if we are to collectively hit the pledged net-zero targets, there will need to be an extraordinary and global effort, and asset managers will have a crucial role to play in the transition.

COP26 did produce at least one relatively positive aspect: it was the first time that the investment community had moved to centre stage in terms of the conversation about how we should collectively achieve net-zero carbon emissions, but the hardest work still lies ahead of us.

FACING THE STARK REALITIES OF CLIMATE CHANGE

SUMMARY OF THE IPCC SIXTH ASSESSMENT REPORT 2021

THE SCIENCE IS BECOMING UNEQUIVOCAL

- Carbon dioxide (and other greenhouse gases) causes observed planetary warming.
- Humans have released a cumulative 2.39 trillion tons of CO₂ into the atmosphere since 1850.
- Global average temperature is now 1.26 degrees Celsius higher than in 1850, and nearly half of this increase has happened since the year 2000.
- Planetary warming (air and oceans) is leading to melting ice and increasing amounts of water vapour in the atmosphere.
- Increasing global average temperatures mean rising sea levels, more intense precipitation, and more severe droughts.
- Warming will continue until CO₂ pollution stops.
- Tipping points: Increased chance for low-likelihood high-impact events.
- CO₂ removal will not solve the problem.
- A decrease in material consumption may be necessary.

We are facing some very stark realities and difficult questions. In our view, much of the existing policy around carbon emissions deviates from a clear net-zero pathway; in practical terms, we believe it requires more of the positive initiatives (encouraging investment across the entire energy-transition value chain) if we are to limit global warming to 1.5 degrees Celsius.

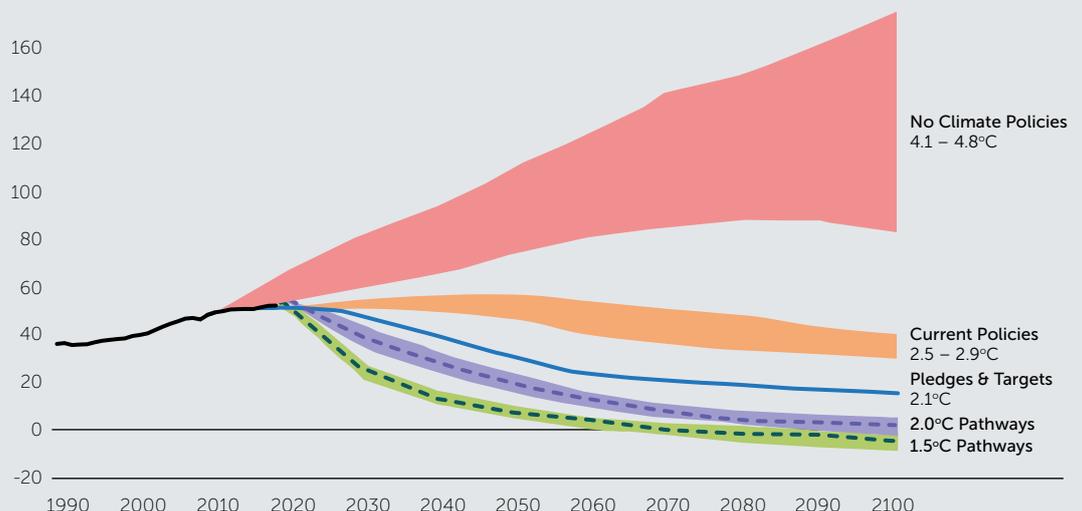
Current thinking is that if all governments hit their commitments, we will limit warming to between 1.9 and 2.1 degrees Celsius, but there is much talk and relatively little action; either we will witness one of the biggest collective misses of government targets ever and an increasing level of climate disruption, or we will experience one of the biggest waves of regulation ever seen in response to that collective failure.

For governments to hit their targets, drastic action is required, and that may prove to be politically fraught.

Thus, while the scientific case for linking human activity to climate change now seems irrefutable, the path and methodology required to achieve net-zero carbon emissions is anything but clear-cut, and full of complexity and disagreement.

Exhibit 1: Global greenhouse gas emissions and warming scenarios

Annual global greenhouse emissions – in gigatonnes of carbon dioxide equivalents



Source: Climate Action Tracker (based on national policies and pledges as of November 2021). Last updated April 2022.. OurWorldInData.org. Licenced under CC-BY by the authors Hannah Ritchie & Max Roser.



The need for pragmatism and solution providers

At Newton, we recognise that there are different methodologies and approaches to tackling net-zero carbon emissions among asset managers. However, such is the gravity of the global-warming threat that we believe a pragmatic approach is required, which can evolve as our understanding of a deeply systemic and complex issue evolves.

What is crucial is that whichever approach we choose as an asset manager, it must result in real-world decarbonisation rather than portfolio decarbonisation, as we explain in the next chapter.

As a purposeful and responsible investment manager, we believe that to play our part fully we must do two fundamental things.

- First, we need to allocate capital to ‘solution providers’ – those companies that are creating effective ways to tackle the climate crisis, and where we see increasingly significant opportunities for long-term sustainable growth.
- Second, we need to determine how we deal with our own financed emissions – those high-emitting companies that we are invested in on behalf of our clients, and which, while relatively small in number, contribute an outsized proportion of overall carbon emissions within the portfolios we manage.

We believe the right approach here is not to divest completely from these companies, but to engage with them while seeking to also allocate to companies that are doing the most to effectively create credible and effective transition plans.

Negatively affecting the cost of capital through mass divestment will not necessarily help a company change its business. Importantly, we also need to ensure that those plans are economically fair and socially inclusive, and aim towards a ‘just’ transition, because we know that tackling such a multifaceted problem will create some trade-offs, and there will be winners and losers in the transition.



India has contributed just 4% to historic global emissions in comparison to the US, which has contributed 25%. ”

Not leaving the emerging world behind

Defining the road to net zero also requires an inclusive, joined-up approach, both within companies and globally.

The Paris Climate Agreement of 2015 enshrined the intention to demand that emerging markets should aim to achieve net zero within one generation. Importantly, we believe it is unfair to expect emerging markets to do so within a mere generation when the developed world has been contributing to global warming for far longer, thus putting unfair expectations upon them.

To put this in context, India has contributed just 4% to historic global emissions in comparison to the US, which has contributed 25%.

We know that the vast majority of emissions will come from emerging markets in the future and that they will also face the biggest impact from the consequences of climate change.

Therefore, understanding the per-capita and historical context of emissions as well as the direction of travel is critical if we are to ensure that emerging markets are not left behind, because investments in these regions are likely to be increasing our portfolio carbon-intensity footprint over the near term.

OUR APPROACH: REAL-WORLD DECARBONISATION

As responsible investors and long-term advocates of the Paris Climate Agreement, we want to ensure that the transition plans of those we invest in on behalf of our clients are not just scientifically sound, but that they can be capitalised, and that there are strong leadership teams in place to deliver on long-term plans.

With this in mind, we have aligned ourselves with the Science Based Targets initiative approach, which involves a commitment to aim for an interim target of 50% of the financed emissions from the investments we make on behalf of our clients to be covered by credible transition plans by 2030, and 100% to be covered by 2040.^{1,2} This will be complemented by a suite of other measures around absolute and intensity-based emissions, alongside engagement and voting data.

As we seek to invest and engage with companies that we believe are demonstrating a genuine commitment to real-world decarbonisation, we believe it makes sense to reject the idea of a linear reduction target, as we anticipate that the path to net zero will be uneven and anything but linear.

There will inevitably be a few 'bumps in the road'. The conflict in Ukraine has shown starkly how near-term fossil-fuel consumption is likely to rise as countries scramble to wean themselves off Russian oil and gas, and the drive for energy self-sufficiency among many Western nations is likely to cause near-term spikes in the extraction of fossil fuels, which may temporarily reward some of the heaviest carbon emitters.

We are very conscious of the need to balance energy security and affordable energy pricing with exploration in low-cost, low-emission energy sources, while keeping an eye firmly on the broader systemic issue of climate change. The phrase that the stone age didn't end because of a lack of stones is very relevant.

For us, the key is to enable substitution from fossil-fuel related products through sensible government policy that creates the right economic conditions for a transition in markets.

**WE HAVE ALIGNED
OURSELVES WITH
THE SCIENCE BASED
TARGETS INITIATIVE
APPROACH:**

50%

of our financed emissions
to be covered by credible
transition plans by 2030

100%

of our financed emissions
to be covered by credible
transition plans by 2040

¹ While Newton's final target of having 100% of its financed emissions covered by credible transition plans by 2040 necessarily implies that all of its global assets under management (AUM) will be committed to net zero emissions by that point, currently 67% of its AUM (as distinct from financed emissions) are subject to the initiative.

² 'Financed emissions', global assets under management' or 'AUM' refers to the combined assets under management of Newton Investment Management Ltd and Newton Investment Management North America LLC.



Issues with a linear approach

There has been an emphasis on achieving an annual emissions reduction of about 7% per annum for the next decade if we are to stay within 1.5 degrees of warming. Our view is that such a linear approach runs the risk of oversimplifying the issue while not effectively addressing the urgent problem at the core. Indeed, we may have clients asking for such an approach, but we believe such targets could be artificially attained with relatively little effort and negligible meaningful progress towards net-zero emissions.

For example, by increasing exposure to energy companies seeking increased exposure to the clean energy sector, one might see an approximate average increase of 9% in carbon intensity on a weighted MSCI basis, while simply divesting from emerging markets could produce a 5% reduction in carbon intensity,³ but, as we discussed earlier, emerging markets are where the most urgent need and biggest funding gap to achieving a successful energy transition lies.

We see other complications with the linear approach, which stem from the way in which emissions are classified. For example, the lack of consistent Scope 3 disclosures makes it difficult to implement a 7% reduction meaningfully, and the reality is that it remains highly unlikely that global carbon emissions will drop over the next several years, which for us, makes the 7% reduction issue a non-starter.

We believe the more important question is *how* one is achieving an *actual* physical carbon reduction within a portfolio of financed emissions; decarbonisation needs to take place in the real economy, rather than via a more superficial portfolio decarbonisation that can easily be obtained by investing more heavily into capital-light business models rather than engaging to help difficult sectors with their transition.

That is not to say that reduction targets are a pointless tool. We may still rely on some carbon-intensity measures to provide a supporting framework of data for our portfolio assessments, but it is crucial to understand the context and realities of carbon-intensity data and how it can change.

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³ Data derived from stress tests on the weighted average carbon intensity (Scope 1+2 emissions/sales) of the MSCI ACWI index. MSCI ACWI, Newton, 29 March 2022.

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Our focus must also be on investing in affordable and scalable substitutions for oil, rather than simply forcing down the supply of oil, which risks raising prices further and harming near-term climate transition peaks. ”



Engagement not divestment

As active investors, our approach is centred on engagement with the heavy emitters within our portfolios to help change their practices. For most asset managers, the heavy emitters tend to be focused among a small number of securities, but we must commit to working with them even if they may not be able to pass the interim emission-target plans.

Our focus must also be on investing in affordable and scalable substitutions for oil, rather than simply forcing down the supply of oil, which risks raising prices further and harming near-term climate transition peaks.

Because climate change is a systemic risk, it is also crucial to understand that asset managers alone cannot solve the issue. We depend on the right regulation and technology being put in place, and asset managers becoming better aligned. Industry bodies and trade associations must be onside too, and we must involve ourselves with advocacy efforts – not just engage with our investments alone.

Advocating for change and a holistic approach

We must be brave; first movers may fear that competitors will not follow suit, but companies have to play their part in lobbying governments for the policies required to achieve our targets, and where industry is unwilling, government regulation must step in.

From an investment perspective, we know the current environment is one of significant uncertainty for net-zero efforts, with economies still recovering from pandemic lockdowns, the continuing Russia/Ukraine conflict, and capital discipline by heavy emitters providing a good short-to-medium term environment for carbon-intensive securities, albeit with a long-term overhang from potential regulation.

Our advocacy efforts must call for government and industry regulation with genuine ‘teeth’, as voluntary efforts alone are unlikely to be enough to create the level playing field to deal with the complexities of issues such as carbon taxes, border taxes or offsetting green premiums. For us, this is the crucial mechanism by which net zero will be achieved; we believe that voluntary action from consumers and asset owners will struggle to realise the desired outcomes on their own.

At an asset-manager level, we still get a sense that the thorny issues are being broadly dealt with within responsible investment and environmental, social and governance (ESG) team silos, but it needs a more holistic approach across companies, harnessing the risk function and the critical role that investment teams need to play.

To create that internal ecosystem to deliver on our net-zero pledges, it requires a standardised and multi-disciplinary approach with ESG teams, analysts, portfolio managers, and senior management all pulling together.

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CONCLUSION

We are facing some very stark realities. Fossil-fuel substitution with cleaner counterparts needs to happen more quickly. Energy security and affordability have to be balanced with climate considerations. Crucially, government regulation must be strengthened to correct the market failure to price emissions, which will create the right market considerations to incentivise the transition. These are imperatives.

- In the near term, we know that the Russia/Ukraine conflict will continue to create headwinds on the path to net-zero. We view it as a short-term 'speed bump' to the energy transition in that we will see a near-term increased reliance on coal and gas, but over the longer term we see it as an accelerant of the energy transition as a number of countries seek to bring forward their clean-energy transition plans.
- While there is a huge amount of jargon used by asset managers, broader business and governments seeking to quantify how to achieve net zero, at a fundamental level climate change represents a series of risks and opportunities for all businesses that must be managed. Burying heads in the sand and using the past as an indicator of the future will not only cause serious damage to our planet, but also result in permanent destruction of capital and the missing out on the opportunities as new industries emerge.
- We know there are a concentrated number of stocks that produce most of our financed emissions. We will continue to work closely with them even if they do not achieve initial target-emission reductions. We must also act as advocates to influence the wider system, which includes government and trade bodies, to ensure that the right regulatory framework is put in place.
- If we are to succeed in our aim of becoming a truly effective net-zero organisation, we will need to harness our active engagement approach and a truly company-wide buy-in to ensure that all our financed emissions have credible transition plans. By setting interim targets towards our end goal, we will be accountable to our clients, via transparent and timely reporting, to mark our progress along the way.



Your capital may be at risk. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested.

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