

Reaching net zero

The COP26 conference in Glasgow attracted worldwide attention as leaders from across the globe made more and further-reaching commitments than ever before to try and halt the rate of global warming. For the LGPS, the need to decarbonise portfolios has become increasingly clear and many are on the path to net zero. However, many decisions still need to be made, monitored and actioned.

While the broader move in all industries should provide momentum for this change, we recognise that all our clients will continue to need support, explanations and appropriate investment solutions.

At LGIM, our overarching ambition is to help decarbonise the real economy. We are trying to lead by example, and have committed to **work in partnership** with our clients to reach **net-zero greenhouse gas emissions by 2050 or sooner** across all assets under management. Drawing on industry best practice, and to help our clients understand what we mean, we have set out below our key requirements **for a fund or investment portfolio** to be considered 'net zero aligned'. We have also committed to strengthening our standards as progress made by companies and governments worldwide accelerates.

What does this mean in practice for a portfolio?

1 Set targets

- Achieve net zero greenhouse gas emissions by 2050
- Either a reduction of **at least 50% in carbon intensity by 2030** relative to 2019 baseline¹ or portfolio **temperature alignment of 1.5°C by 2030**²
- These are two key milestones informed by the recommendations of the Intergovernmental Panel on Climate Change

2 Adopt a decarbonisation pathway

- The investment process will incorporate a **mechanism to make progress over time towards the targets set**
- Multiple approaches could be pursued (potentially in conjunction) **based on carbon emissions or temperature alignment** for the entire portfolio and/or for key sectors (such as utilities). Options include setting top-down targets for the average profile of a portfolio, or bottom-up requirements for securities to be eligible – e.g. specifying a temperature alignment threshold for issuers on fund launch³



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- LGIM will continue to develop the capability for the portfolios we manage to allocate to low-carbon investments across asset classes and, where possible under the portfolio mandate, increase the 'green' proportion allocated to low-carbon investments, while reducing the proportion invested in companies which we believe fall short of our climate standards, as set out in our [Climate Impact Pledge](#)
- **3 Engage for change**
- Engagement with investee companies to achieve real emissions reductions starting today is critical; many companies and indeed countries have recently made commitments to reduce their emissions over the coming decades but, ultimately, it is engagement with companies, and holding them to account for the pledges they make and actions they take, that will make the real difference. LGIM has a long history of corporate engagement and the activities of our [Investment Stewardship team](#), summarised in our regular [Active Ownership reports](#), demonstrate the real impact of our actions on the economy.



- As a firm, we are recognised for using our scale and the weight of our votes in advocacy and engaging with policymakers, regulators and companies on climate change
- Our engagement activities span both private and public markets – using our scale and experience in private market investment, we are able to engage directly with companies regarding the private market assets in which we invest, for example real estate and infrastructure. Our private market activities complement our longstanding Climate Impact Pledge⁴, through which we target companies associated with about 60% of greenhouse gas emissions from listed businesses⁵
- Through both direct and collaborative engagement, we will ensure that in net-zero funds **we engage with issuers responsible for more than 50% of a portfolio's associated emissions**
 - We will increase this figure further over time, in line with best practice set out in key net-zero investment frameworks⁶

In devising the standards detailed above, we have sought to incorporate elements of best practice from three investment frameworks: 1) the Net Zero Investment Framework from the Paris-Aligned Investment Initiative;⁷ 2) the UN-convened Net-Zero Asset Owners Alliance;⁸ 3) the Science-Based Targets Initiative⁹. We recognise that industry guidance is evolving fast; we will continue to build on our approach.

Net-zero challenges

There are some key challenges to consider when aligning investment funds to net zero. Less than 10% of companies today are on track for net zero¹⁰ – meaning that for many diversified investors such as the LGPS, we believe the most significant question is not whether a portfolio is net zero today, but how to devise strategies that effect long-term change in the market. This has a number of important implications:

The real economy

Net zero means that, on average at the global level, carbon-emitting 'assets' must match carbon-absorbing 'liabilities'. This does not mean that every company, sector or country will move at the same speed, and some emissions will be inevitable.

What is LGIM doing?

We are developing the analytics – such as our [Destination@Risk](#) climate modelling toolkit – to understand better which companies and countries are making progress towards net zero, and to attempt to quantify their related financial risks. We are further evolving our product range aligned with net zero and will continue to monitor and review our funds in light of the progress made in the real economy. At the same time, we will ratchet up our engagement with corporates and governments to help accelerate this progress, through programmes such as our [Climate Impact Pledge](#).

Asset classes

So far, many of the discussions around emissions have focused primarily on listed asset classes, whereas some of the most significant emissions come from sectors which tend to dominate private markets, for example the built environment. As set out in our [December 2020 net zero roadmap](#), every real estate asset we acquire has to have an asset sustainability plan, setting out how we can improve the sustainability credentials of that asset. And in private credit, we use a rigorous screening process to identify material environmental, social and governance (ESG) factors.

What is LGIM doing?

We will continue to collaborate with regulators and industry peers – in initiatives like the [Glasgow Financial Alliance for Net Zero](#) – to help create more consistent, harmonised standards for net-zero investing across asset classes. The conversations are most advanced around net-zero alignment of listed equity, debt and real estate; we will seek to expand our approach as data and standardisation improves in this fast-moving area.

Exclusions

The net-zero challenge is broader than merely excluding high-emitting sectors; all companies generate some emissions – either directly through their operations (Scope 1 and 2) or through their value chain (Scope 3). Some high emitters, such as mining companies, will have an important role in developing and investing in solutions. Unilaterally divesting holdings is, therefore, not guaranteed to lead to the decarbonisation of the real economy and indeed could impede necessary investment in climate solutions.

What is LGIM doing?

Our choice of initial exclusions – new thermal coal and new oil sands¹¹ – targets some of the highest-carbon sectors of the global economy, which are structurally misaligned to the direction of travel, and to which cleaner, cheaper alternatives are increasingly available. They are also designed pragmatically, so as not to immediately and substantially reduce diversification – and increase turnover and costs – for some of the existing portfolios that are committing to net zero.

Over the next decade, as the deadline for halving carbon intensity approaches, issuers that are not making substantial progress in reducing their own emissions – regardless of their sector – are likely to find themselves at risk of exclusions from the growing share of LGIM assets managed in line with net zero. Where relevant, we may also seek to apply further exclusions – for example, sanctions under our Climate Impact Pledge, or more stringent temperature-alignment requirements.

Offsets

For net-zero-aligned funds, we have not committed to large-scale purchases of carbon credits to offset the emissions associated with portfolios, as our aim is to **prioritise real-world emissions reductions**.

A net-zero world

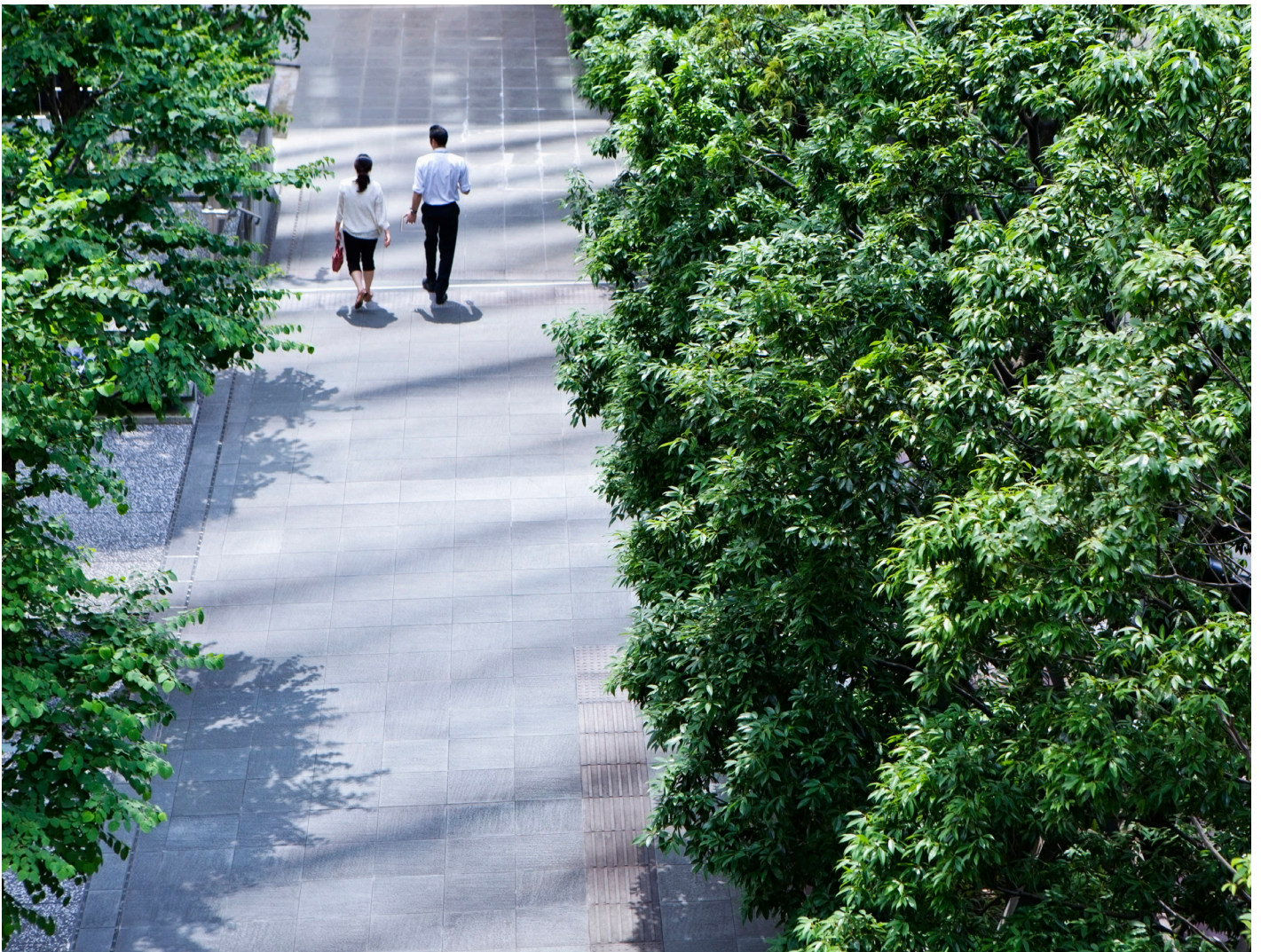
In summary, at LGIM, we are continually evolving our capability to meet these challenges, **providing climate solutions** across asset classes and investment strategies for our clients. These range from thematic funds focused on clean energy to climate-aligned credit and low-carbon index solutions.

LGIM will continue to debate and collaborate with regulators, stakeholders and industry peers to help create more consistent, harmonised standards for net-zero investing across asset classes. We will do this through our involvement in initiatives like the Glasgow Financial Alliance for Net Zero, as well as via the key role held by our CEO, Michelle Scrimgeour, as co-chair of the COP26 Business Leaders Group.

LGIM, the LGPS and other asset owners and managers all have a role to play in tackling the systemic issues facing people and the planet, and will play a crucial part in reaching a net-zero world.

Find out more

- Legal & General Group's [journey to net zero](#)
- More details on our [climate modelling solutions](#) in the context of net zero
- The [potential for hydrogen](#) in the net zero economy
- LGIM's [Climate Impact Pledge](#) engagement programme, focused on net zero, providing credible incentives for companies to step up on sustainability
- Our [net zero roadmap](#) for the real estate portfolio
- The [Net Zero Asset Managers Initiative](#)
- Our [five-step TCFD checklist](#) for trustees



¹ Relative to fund or reference index. For funds launched at later dates the 50% reduction can be pro-rated over the remaining time to 2030. Carbon intensity is to be calculated as carbon emissions divided by revenue or enterprise value including cash (EVIC). As part of our monitoring, we will seek to address any reductions in emissions intensity resulting from inflation or asset price increases.

² In certain funds (for example, actively managed funds) it is possible that changes of asset allocation (for example, switching from financials to utilities) may result in an increase in carbon footprint, even if the chosen securities represent the best in class from a climate performance. That is why we are proposing the use of 1.5°C temperature alignment (which means that the average expected rate of decarbonisation of the fund in 2030 is on track for a net zero trajectory by 2050).

³ For an illustration of such an approach, "Assuming a reference index that is aligned to a three-degree climate outcome, [we would] seek to decarbonise the portfolio by 30% in the first year, by screening out a portion of the highest emitters. The portfolio would also reduce its alignment from three to 2.5 degrees. [...] For the next decade, the fund manager would need both to reduce the temperature alignment of the portfolio by 0.1 degrees [each year], while simultaneously decarbonising at a portfolio level. By 2025 the fund would be on track for an 80% reduction in emissions [...] By 2030, the portfolio would be in full alignment with net zero, and on track for net zero by 2050, assuming the investee companies continue to deliver on their forward commitments." (Source: <https://www.lgim.com/uk/en/insights/our-thinking/esg-and-long-term-themes/net-zero-a-practical-guide-for-investors/>)

⁴ <https://www.lgim.com/uk/en/responsible-investing/climate-impact-pledge>

⁵ <https://www.lgimblog.com/categories/esg-and-long-term-themes/climate-impact-pledge/>

⁶ For example, the Paris-Aligned Investment Initiative recommends "at least 70% of financed emissions in material sectors are either net zero, aligned to a net zero pathway, or the subject of direct or collective engagement and stewardship actions"

⁷ https://www.parisalignedinvestment.org/media/2021/03/PAII_Net-Zero-Investment-Framework-1.0_Implementation-Guide.pdf

⁸ <https://www.unepfi.org/net-zero-alliance/resources/alliance-2025-target-setting-protocol/>

⁹ <https://sciencebasedtargets.org/resources/legacy/2020/10/SBTi-Finance-Criteria-and-Recommendations-Pilot-Version.pdf>

¹⁰ Source: LGIM analysis, as at June 2021.

¹¹ In addition to those exclusions set under LGIM's [coal policy](#)

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative



Key risks

Past performance is not a guide to future performance. The value of an investment and any income taken from it is not guaranteed and can go down as well as up; you may not get back the amount you originally invested.

Reference to a particular security is on a historical basis and does not mean that the security is currently held or will be held within an LGIM portfolio. The above information does not constitute a recommendation to buy or sell any security.

Important information

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