# Aligning a fund to the Paris Agreement

M&G Investments

## Seeking to mitigate climate change through investment

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November 2022

## Key points

- Rising greenhouse gas emissions from human activities are driving global warming and the associated climate risks
- The Paris Agreement is an international treaty aimed at reducing emissions and halting global warming
- At M&G, we take a company-specific, outcome-focused approach to 'Paris Aligning' select equity funds, ie aligning those funds to the Paris Agreement, by looking for companies to invest in that are either taking steps to reduce their own emissions, or providing solutions for others to do so

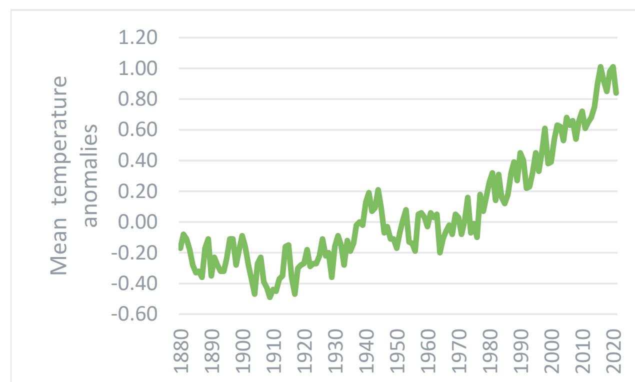
The value of a fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise and you may get back less than you originally invested.

## Setting the scene

According to the Intergovernmental Panel on Climate Change (IPCC), the United Nations' official body on climate change, human activities have already caused approximately 1°C of global warming above pre-industrial levels, and this is set to continue over the coming decades if immediate action isn't taken.[1] Rising temperatures increase the likelihood of a host of climate risks, such as more frequent and extreme heatwaves, heavy precipitation, droughts, tropical cyclones and reductions in Arctic sea ice.

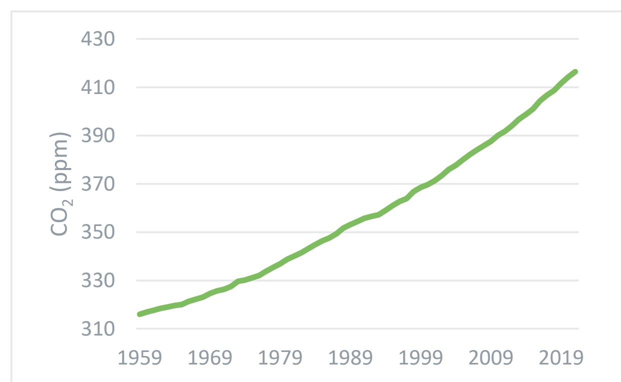
The concentration of greenhouse gases (GHGs) in the earth's atmosphere is directly linked to global temperatures, and both measures have been rising steadily since the industrial revolution. The most abundant greenhouse gas is carbon dioxide ($CO_2$), comprising approximately two thirds of GHGs.[2] Encouragingly, the IPCC concluded that reaching net zero $CO_2$ emissions would halt global warming over a multi-decade timescale, although a net-negative emissions approach may then be required to prevent any further warming over the longer term, considering the cumulative GHGs which are already present in the atmosphere.

Figure 1: Rising global temperatures




Global mean land-ocean temperature deviations, relative to corresponding 1951-1980 temperature mean.
Source: NASA, GISTEMP Global Land-Ocean Temperature Index, September 2022.

Figure 2: Atmospheric carbon dioxide




The carbon dioxide data on Mauna Loa constitute the longest record of direct measurements of CO2 in the atmosphere.
Source: Mauna Loa Observatory $CO_2$ records, September 2022.

[1] https://www.ipcc.ch/report/sixth-assessment-report-working-group-i/

[2] Climate Watch, the World Resources Institute (2022).

## What is the Paris Agreement?

Announced in 2015 at the COP21 climate change conference in Paris, the Paris Agreement is a legally binding international treaty aimed at reducing global warming. Today, 193 countries or regions have signed the agreement and committed to the following:

- Limiting the increase in global temperatures to well below 2°C above pre-industrial levels
- Aiming to keep the average global temperature increase below 1.5°C, as this would reduce the risks and impact of climate change
- Recognising that global emissions must peak as soon as possible, but that this will take longer for developing countries
- Undertaking rapid reductions thereafter in accordance with the best available science, to achieve a balance between emissions and removals in the second half of the century

Signatories must report their carbon emissions annually. They must also submit Nationally Determined Contributions (NDCs), outlining the country's emission reduction commitments and the action it is taking. NDCs must be updated every five years, with each submission showing greater ambition than the last (in the form of additional action or more aggressive emission reduction targets). However, the NDCs themselves are not legally binding, so there is no mechanism for enforcing the promises within. In practice, the enforcement and efficacy of the NDCs will come down to peer pressure, and 'naming and shaming' bad behaviour.

## The implications for investors

### Real-world costs

Climate change and the push for decarbonisation efforts can affect company finances in many ways. Weather changes can damage physical assets, disrupt supply chains or force expensive changes in process. Negative publicity could reduce customer demand. Similarly, adhering to new regulations and requirements for transparency can create additional costs.

### Alignment with increasing regulation and subsidies

The Paris Agreement talks of 'increasing ambition', which may conceivably translate into new regulations around emissions. There could be new subsidies available for companies making positive changes, or increased costs for high emitters. Businesses will need to align their strategies with these developments.

### The need for measurement

It is difficult to manage what you cannot measure. This is why the consistent, accurate measurement of emissions is so important. Companies improving the scale and scope of their emissions disclosures should be rewarded.

### Long-term goals, short-term stewards

Trends such as global warming and the need to decarbonise will play out over the coming decades, requiring decisions that will have long-lasting impacts to be made today. Companies and investors must also balance the short-term expectations of shareholders with their long-term strategies.

## The different options for Paris Alignment

As the Paris Agreement was primarily designed for governments and industries, investment funds may take many different approaches in their attempts to align with the goals of the agreement.

One option is to adopt a portfolio-level framework. Fund managers must measure portfolio-wide emissions and track their progress over time, usually adhering to predetermined annual reductions. For example, the EU Paris Aligned Benchmarks require a 7% annual reduction in emissions intensity.

Alternatively, fund managers can take a company-specific approach. This involves choosing individual companies for the contributions they make towards the Paris Agreement. For example, they may provide solutions for reducing emissions through their products and services, or they may have implemented strict targets for decarbonising their operations.

## Our approach

At M&G, we believe the most effective way to align a fund with the goals of the Paris Agreement is by taking a company-specific approach, where we consider the real-world climate impacts of investee companies, and the actions they are taking, rather than solely focusing on portfolio-level metrics. In particular, we look for companies taking positive climate action, either to reduce their own emissions or by providing solutions for others to do so. These companies should also have good sustainability credentials, and not cause any significant harm through their activities.

### Real world outcomes, not just metrics

Climate change is a real world phenomenon, existing outside the parameters of an investment fund. As such,

when investing we focus on the real world impact of every investee company, and the positive action it is taking, rather than focusing solely on portfolio-wide metrics. While we believe these offer an important insight into the climate impact of investee companies, and they do form part of our investment process, prioritising metrics above all else can be counter-intuitive.

For example, a fund manager could simply hold a portfolio of traditionally low-emitting companies, such as software developers. While the fund would appear to align with the Paris Agreement on paper, it wouldn't necessarily contribute towards the absolute emission reductions necessary to limit global temperature increases. The same level of carbon emissions would still exist, they would simply be outside of the fund.

### A company-specific approach

Rather than a portfolio-wide approach, we focus on individual companies in the fund. We consider the amount of emissions they produce, their plans for reducing emissions, their progress against these targets, and where relevant, the amount of emissions they help others to avoid through their climate solutions. This way, we can more effectively determine how a company is contributing towards the goals of the Paris Agreement, how to best engage with the company, and how it might benefit from the decarbonisation trend that we expect to persist for decades.

Importantly, most companies looking to cut emissions will not experience a consistent, linear reduction year in and year out. Instead, there will be jumps as the company makes changes, such as switching to renewable energy or rolling out a new, more efficient process. With a portfolio-level framework, if the timing is wrong, the company could be cut from the fund before its good work comes into effect. Furthermore, a small number of companies may generate the majority of portfolio emissions, especially if they operate in an emissions-intensive industry such as manufacturing. A focus on portfolio-wide metrics above all else may tempt the fund manager to simply reduce their stake in these companies, improving the high-level metrics but making no real-world impact.

### Active engagement

Engagement is an integral part of our investment process. By engaging with investee companies, we can encourage positive changes, such as improving emissions disclosures or setting Science Based Targets for emission reductions. We could also encourage companies to link executive pay to climate-related metrics. And if a company's progress falls behind its targets, we can use engagement to understand why and encourage further action.

### Carbon intensity

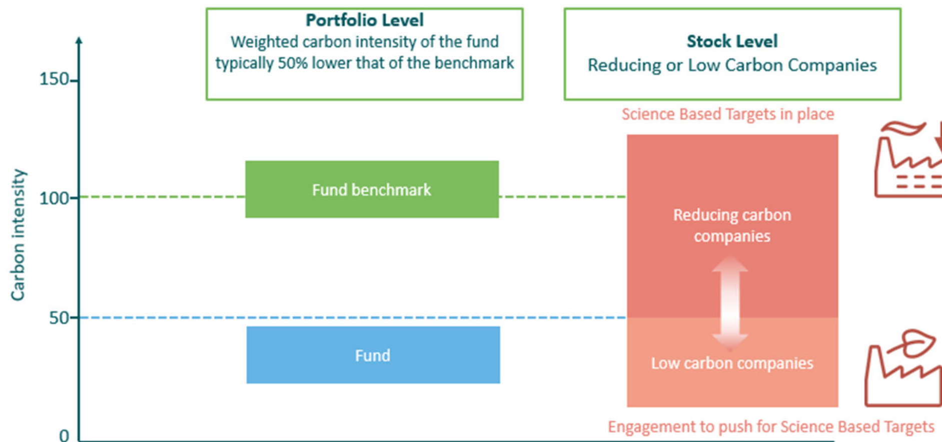
While we believe real-world outcomes are the most important element of a Paris-Aligned investment strategy, in practice we also consider portfolio metrics. We use carbon intensity as a framework for assessing company eligibility and measuring our funds' climate impact. Carbon intensity is the amount of carbon emissions per million US dollars of sales.

Companies with a carbon intensity at least 50% lower than the fund's benchmark are eligible for inclusion. These are considered to be 'low-carbon companies'. Those with a carbon intensity above 50% of the benchmark must have set or committed to setting Science Based Targets for emission reductions, and are considered to be 'reducing-carbon companies'. We also aim to maintain a Weighted Average Carbon Intensity (WACI) at least 50% lower than that of the benchmark. WACI is the carbon intensity of every holding, weighted to its proportion in the fund (see Figure 3).

### Companies doing no harm

In our Paris-Aligned strategies, we look for companies demonstrating good sustainability or ESG credentials. As part of this, we also exclude certain companies from our investible universe, as we consider them to be in breach of the 'Do no significant harm' principle. These include companies which are flagged as violating the UN's Global Compact, a global framework for businesses to adopt sustainable and socially responsible policies. We also exclude companies from a number of sectors, including those involved in fossil fuel extraction and controversial weapons.

Figure 3: Fund approach to Weighted Average Carbon Intensity




## Company emissions disclosures are essential

The analysis of company emissions is an integral aspect of our approach to Paris Alignment. Companies tend to report emissions data for the previous year in their annual sustainability reports. This data helps us to measure the climate impact of companies and how this changes over time.

Investors can drive positive change in this area by encouraging investee companies to disclose their emissions if they are not already doing so, or to increase the scope of their disclosures. For example, by encouraging them to report their 'Scope 3' emissions.[3] These are indirect emissions from the activities of a company, but which occur from sources it does not own or control, such as those from suppliers and customers. Scope 3 emissions often make up the largest portion of a company's overall carbon footprint. Where companies are also providing climate solutions, investors can also encourage the publication of data on the levels of emissions saved/avoided.

There are standardised, international frameworks to help companies disclose their emissions, such as those from the Carbon Disclosure Project (CDP). However, the issue of consistency remains a challenge for investors looking to make meaningful comparisons. Some companies will be more thorough than others in their disclosures, searching deeper into their supply chains to gather data. Similarly, the same business activity could appear in the Scope 1 emissions (direct emissions from sources the company controls) for one company, but Scope 3 for another. And if a company provides climate solutions, these must also be considered. This is why we believe it is important to carefully analyse the business' activities, and take a holistic view of its approach to reducing emissions, rather than simply measuring annual changes in data.

## Science Based Targets

Science Based Targets form an essential component of our Paris-Aligned investment strategies. Emission reduction targets are considered 'science based' if they are in line with the levels required to meet the goals of the Paris Agreement (limiting the average global temperature increase to 1.5°C above pre-industrial temperatures).

All companies with a carbon intensity greater than 50% of the fund's benchmark must have adopted Science Based Targets, although we encourage all companies to set them, regardless of the amount or intensity of their emissions. Currently, our target is for at least 90% of fund holdings to have set Science Based Targets. Eventually, our intention is for at least 90% of the absolute direct portfolio emissions to be covered by Science Based Targets.

### The Science Based Targets initiative (SBTi)

When engaging with investee companies, we encourage them to set science based targets with the Science Based Targets Initiative (SBTi). This is a joint initiative of CDP, the United Nations Global Compact (UNGC), the World Resources Institute (WRI) and WWF.

Target setting is a five-step process:

[3] Scope 1 emissions are direct emissions from sources the company controls; Scope 2 emissions are emissions purchased or acquired by the company.

1 **Commit** – a company submits a letter establishing its intent to set a Science Based Target
2 **Develop** – the company works on an emission reduction target that is in line with the SBTi's criteria
3 **Submit** – the company presents the target to the SBTi for official validation
4 **Communicate** – the company communicates its target and informs its stakeholders
5 **Disclose** – the company reports emissions and progress against targets on an annual basis

## Playing our part

Global warming is one of the biggest challenges faced by society, and the need for immediate emission reductions has never been more apparent. As investors, we can play a part by investing in companies that are actively contributing towards the goals of the Paris Agreement, either by taking steps to cut emissions themselves, and ideally setting Science Based Targets for emission reductions, or by providing solutions for other companies to reduce their emissions. Finally, we can ensure that we review their progress over time, holding them accountable and encouraging them to take more positive action wherever possible.

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