Mercer

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Mercer's advice on net-zero implementation

This paper outlines our approach to advising our clients, many of whom will have their own beliefs and strategies, specifically on net-zero target-setting and implementation.

Mercer believes it is in all investors' best interests to keep global warming to 1.5°C. To help achieve this objective, we advise that investors measure their portfolio-level carbon emissions, set net-zero-aligned targets to reduce those emissions and create a transition plan that sets out how to achieve those reductions. In setting these targets, we believe investors should consider the following:

- To achieve decarbonization, investors should aim to ensure their net-zero commitments focus not just on portfolio construction but on actions that reduce real-world emissions.
- Reducing portfolio-level carbon exposure using exclusions, divestment or portfolio construction techniques, and based solely on historical emissions, is unlikely to impact real-world carbon emissions.
- Active stewardship plays a more vital role than simply divesting. It demands a clear engagement, voting and measurement program focusing on forward-looking measures aimed at transition and net-zero commitments at a company level.
- To achieve a real-world impact on carbon emissions, we advise asset owners to work with asset managers that are stewarding the climate transition through robust engagement programs that focus on influencing companies' transition strategies.

Mercer's strategic advice

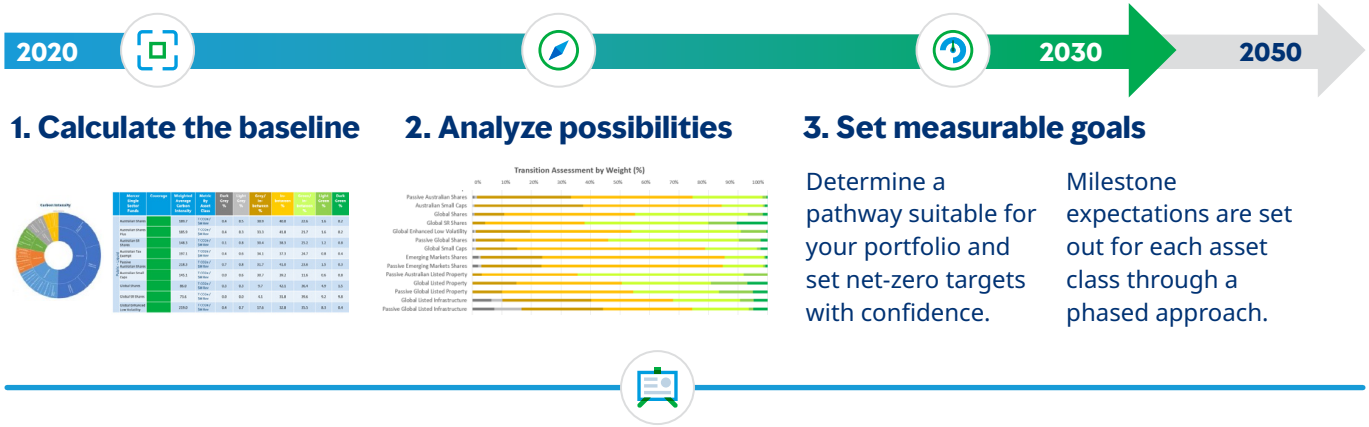
In 2020, our Sustainable Investment team launched a new framework approach to help investors who are establishing, or even just considering, net-zero targets. This framework included the Analytics for Climate Transition (ACT) tool,[1] which we created for this purpose. This framework has been applied in our advice to Mercer's own funds and those of over 50 investors in the past 18 months.[2]

ACT develops transition plans that include a step-by-step process, enabling investors to rank companies and portfolios by their capacity to support annual emissions reductions (transition capacity), prioritize active ownership of companies and allocate to transition solutions.

A multidimensional assessment draws on a range of data providers and metrics to assess portfolios across a spectrum from "gray" to "green" investments (see Figure 2); given that many companies lie somewhere in the middle, their capacity for future transition needs to be fully assessed and determined.

Through this process, investors start to identify, for example, which portfolio companies and holdings generate high carbon emissions and exhibit low transition capacity or low — even zero — carbon emissions and high transition capacity.

Figure 1. Overview of the transition plan based on Analytics for Climate Transition (ACT)



4. Implement the plan

1. Integration

- **Incorporate** analysis into strategy and portfolio decisions.
- **Monitor** market pricing.

2. Active ownership

- **Engage** with companies, including via collaborative initiatives.
- **Utilize** voting rights.

3. Investment

- **Allocate** to low-carbon/ sustainability solutions.
- **Monitor** developments and pricing.

4. Screening

- **Monitor** high-carbon exposures where there is low transition capacity.

Report and disclose

Figure 2. Single-company categorization assessing transition capacity

Manage "gray" risks

High carbon intensity, low transition capacity

Steward the "in between"

Varying carbon intensity and transition prospects

Target "green" solutions

Low carbon intensity, high transition capacity

An essential feature of our advice is to apply multiple implementation strategies to achieve real-world change at the company level, not simply divest, to achieve on-paper portfolio reductions.

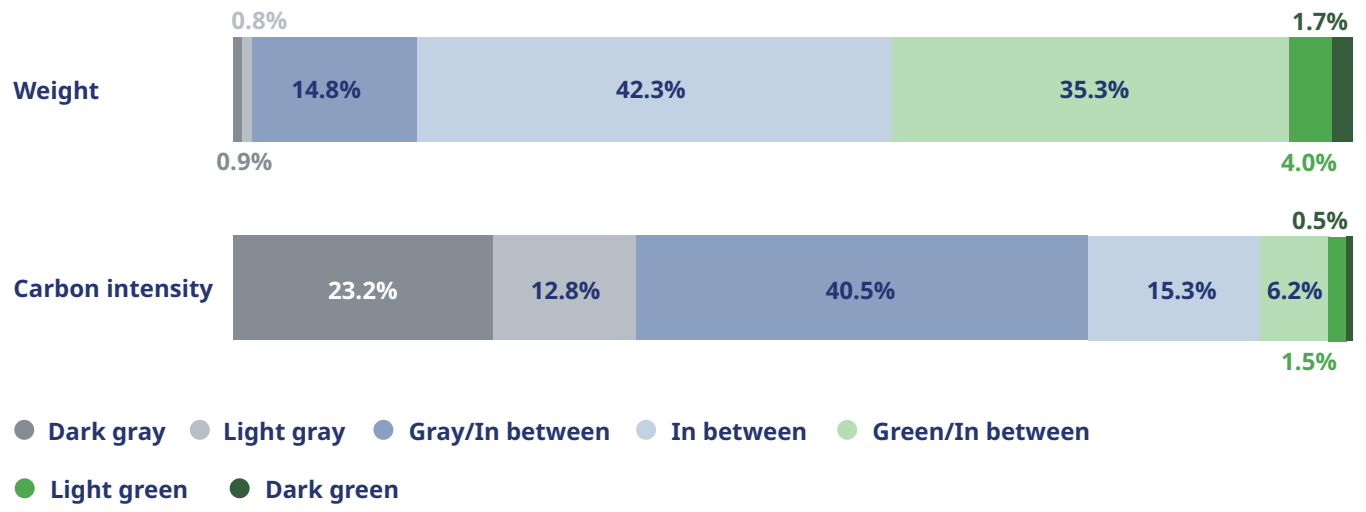
We see four main approaches for investors to implement a net-zero commitment within their portfolios:

1. **Integration (risk reduction).** Decrease allocations to high-carbon/low-transition capacity portfolio exposures where there may be stranded asset or valuation risks.
2. **Stewardship or active ownership (influencing company-level change).** Engage with investee companies to set verified science-based targets (SBTs), and implement transition-focused strategies.
3. **Investment (investing in solutions opportunities).** Increase allocation to low-carbon/sustainability-themed exposures, including transformative solutions.
4. **Screening or exclusions (setting rules).** Screen companies for fossil fuel reserves and production thresholds to inform integration and engagement activities or determine exclusions based on defined rules.

Crucially, active stewardship plays a more vital role than simply divesting.

It's also critical to adopt the right approach to assess transition capacity. ACT places portfolio companies into seven categories based on over 15 metrics (drawing from MSCI ESG and ISS ESG data, weighted with relative thresholds created by Mercer). We believe these metrics provide a more holistic, transition-focused approach to decarbonization.

Figure 3. Transition assessment: Example diversified portfolio



Note: Due to rounding, values may not add up to 100%.

Below are some frequently asked questions posed by investors

1. **Does Mercer believe that limiting global average temperature increases to 1.5°C is of benefit to investors?**

   Yes, very clearly.

   Mercer's climate scenarios research in our *Investing in a Time of Climate Change* papers (2015 and 2019) and our latest modeling in partnership with Ortec support the conclusion that lower warming scenarios are in long-term investors' best interests. According to scientific guidance, the aim — to increase the probability of lower warming — is 1.5°C. This translates to net-zero carbon emissions by 2050 as a target, with important milestones by 2030 and earlier.

2. **Does Mercer advise investors to align portfolios to net-zero targets?**

   We guide investors toward adopting a total-portfolio-level net-zero commitment by 2050, with interim decarbonization objectives (2030 goals) in light of the scientific evidence and market impacts. Much like performance targets, net-zero targets help to set expectations and convey progress to stakeholders.

   However, we recognize this takes time to establish and requires balance between short-term investment objectives and longer-term targets. We are advocates of "decarbonization at the right price," which recognizes the importance of taking into consideration short-term movements in price caused by a disrupted energy sector.

3. **How does Mercer advise investors to implement net-zero-aligned decarbonization?**

   Mercer's advice centers on the actions investors can take to accelerate the decarbonization of the real global economy and on understanding how net-zero commitments can be achieved while delivering on investment objectives.

   Our ACT tool was designed to help investors as part of a considered transition planning process. ACT aggregates multiple company metrics across emissions, transition and low-carbon solutions into a single company categorization assessing transition capacity. This creates a spectrum for various portfolio views to aid in risk monitoring and to prioritize engagement activities. (See Figure 2.)

4. **What role does stewardship, including engagement and voting, play in achieving net zero?**

   We believe investors should use climate stewardship (engagement/voting) as the foundation for achieving transition plans. (See Figure 1.) In achieving corporate change toward net-zero targets, Mercer believes investors will benefit from:

   a. Measuring carbon emissions exposure at both the individual strategy and overall portfolio level to identify companies/assets with 1) transition potential and 2) stranded asset risk

   b. Using engagement as the principal tool to influence underlying companies to lower their real-world carbon emissions:

      i. Engage with asset managers on areas of high stranded-asset risk, ensuring that portfolios manage short-/medium-term investment risk.

      ii. Ensure that asset managers engage with their investee companies to set science-based targets (for example, SBTs, which are verified).

   If possible, divestment should be avoided. If investors choose only to divest, the problem is merely passed on, the transition will not progress, and funding will be taken from the companies, sectors and regions that need it most.

   See the appendix for more on the Science Based Targets verification initiative as a stewardship-focused example.

5. How should investors measure progress toward net zero?

We advise investors to set baselines for emissions intensity — for example, with the Weighted Average Carbon Intensity (WACI) metric — and absolute emissions. Both should form part of the quantitative tracking of emissions reductions toward a net-zero target. Annual tracking is vital, but rolling three- and five-year trends will become more meaningful in time as short-term fluctuations are likely. (See Figure 1.)

These measures are then tracked alongside other non-emissions metrics that can drive future emissions reductions. This could include the proportion of investee companies (by asset manager) committed to SBTs or other qualitative stewardship metrics with asset managers. The percentage of investments in low-carbon solutions is also an essential contributor to the transition outcome.

It's important to monitor these quantitative metrics and qualitative measures because it helps to ensure that investors and asset managers remain focused on the goal of achieving net zero (what is monitored gets managed). However, we believe investors should emphasize measures related to real-world emissions reduction (for example, adoption rates and progress companies make on SBTs).

6. What does this mean for investor asset allocations?

Mercer's advice sets "budgeting" guidance for potential emissions reductions over different timeframes by asset class. Each has different portfolio weights and carbon intensities, with some holding greater opportunity for faster change than others. This budget guidance varies by investor depending on asset allocation and ACT results. (See Figure 3.)

For investors allocating to a diverse range of companies across regions and sectors via different asset classes, it's important to remember where the control lies and what levers can be pulled.

Typically, a small percentage of the portfolio drives the carbon intensity. (See Figure 3.) Therefore, achieving meaningful carbon intensity reductions with relatively minimal portfolio changes is possible while delivering shorter-term investment objectives.

However, adopting this approach in a simplistic way is likely to compromise other investment considerations and unlikely to contribute to real-world change.

To be clear, **avoiding allocations to certain regions would result in reduced carbon exposure; however, this risks taking funding away from areas of the economy that need it most to transition**.

Investors need to be aware of this when balancing their objectives.

For investors, emissions reductions can be achieved through the following mechanisms:

- Strategic asset allocation (SAA) and portfolio-construction decisions
- Asset-class decisions, such as selected strategies and mandate guidelines
- Companies transitioning their business models
- Underlying infrastructure going green

For real-world emissions impacts, changes within the last two categories are most important for success.

7. What does net zero mean for manager research to support investor selection and monitoring processes?

The approach asset managers take to aligning assets or strategies to net zero varies, but we find there are two broad approaches:

a. **Focusing on a portfolio-level decarbonization pathway —** concentrating on aggregate portfolio emissions of their investee companies and committing to reducing them over time. Implementation often includes portfolio-construction techniques like tilting or exclusion without a well-structured, climate-focused engagement and voting program. In our view, while a strategy with such an approach may help investors meet their portfolio decarbonization and net-zero commitments, it is unlikely to impact real-world carbon emissions. In addition, short-term or systematic decarbonization objectives and pathways may also limit investment opportunities.

b. **Focusing on forward-looking measures aimed at transition and net-zero commitments at the company level.** By definition, this must be accompanied by a clear engagement, voting and measurement program. This is a more complex process of tracking progress, and commitments will likely include detailed internal and external (for example, SBTi) data and analysis. Where engagement is deemed to have failed, an escalation that considers the risk/return implications within the investment integration process would be expected. By focusing on engagement, asset managers (and, as a result, investors) are more likely to impact real-world carbon emissions reductions.

Mercer's view is that the second approach is more likely to achieve a 1.5°C outcome while still delivering on investment objectives. There is likely a place in investor portfolios for the first approach. However, well-considered processes will be required for this not to be seen as a blunt constraint on the opportunity set (and, therefore, to avoid ultimately leading to a lower rating from Mercer's manager research process). We recognize some investors will prefer a passively managed approach, and in this case, our view and rating process is consistent — stewardship is critical.

Asset owners have four implementation approaches to sustainable investments: 1) ESG integration, 2) stewardship, 3) solutions investments and 4) screening. For manager research, the focus is on identifying a strategy's capacity to deliver on its investment objectives, considering integration and stewardship requirements. Investment ideas addressing climate/sustainability solutions are captured in our sustainability-themed universes. The fourth approach — to adopt screens that result in exclusions — is typically driven by investors and agreed directly with asset managers on a mandate basis.

In focusing on integration and stewardship capacity, Mercer's Manager Research Team can support net-zero implementation with investors by:

1. Identifying the primary implementation approach individual strategies use to achieve net-zero commitments

2. Assessing and providing a view on the extent to which managers are stewarding a climate-transition pathway

3. Expanding the investable universe of climate-focused and sustainability-themed investment strategies

When considering hiring an asset manager that has joined the Net Zero Asset Manager (NZAM) initiative, investors should note that firms' commitments can vary significantly. Many firms have relatively modest initial commitments and are focused only on dedicated strategies. In contrast, others have ambitious firm-wide objectives with clear pathways to ensure that their commitments cover as high a proportion of their assets as possible.

For further information, please visit https://www.mercer.com/investing-sustainably or https://www.marshmclennan.com/about/esg.html, or contact our team at mercerinvestmentsolutions@mercer.com.

Supplement — The science backing Mercer's advice on climate change

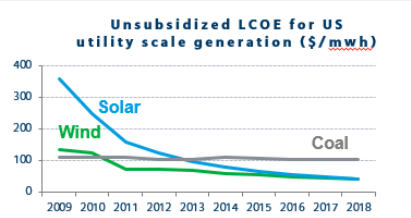
Mercer's more than 10 years of investor-focused research on climate change — including the *Investing in a Time of Climate Change* report series (2011–2019) and Analytics for Climate Transition (ACT, 2020) — has driven our global investment advice:

Climate change poses a systemic risk, and investors should consider the potential financial impacts of both the associated transition to a low-carbon economy and the physical impacts of different climate outcomes.[3]

The latest scientific research from the Intergovernmental Panel on Climate Change,[4] also supported by the International Energy Agency,[5] guides Mercer's advice to investors on physical damage and loss implications of higher warming scenarios and the drivers for transition and decarbonization.

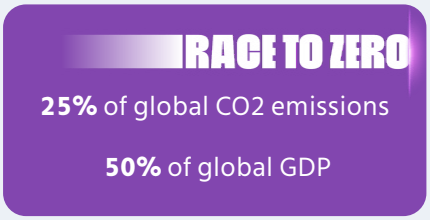
Transition to a low-carbon economy is already happening

Technology and price disruption in energy is already evident



Markets are increasingly recognizing in pricing[6]

Climate policy ambition is growing in quantity and quality

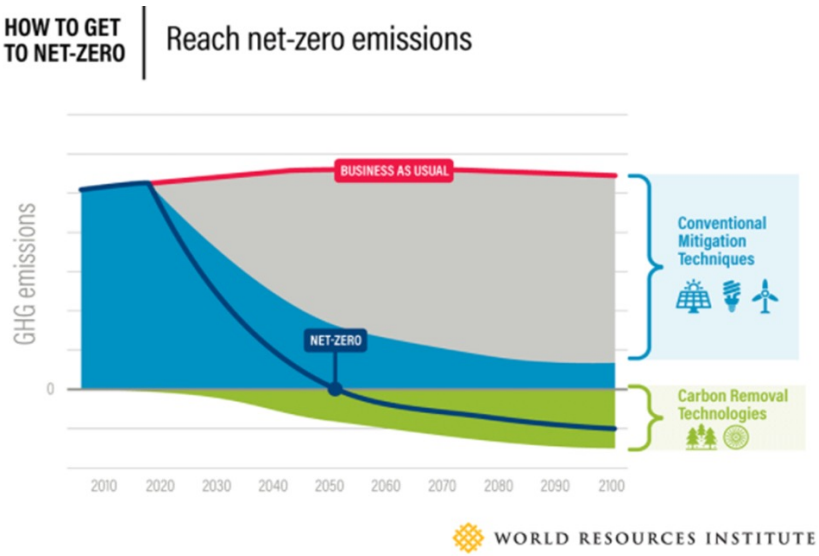


The recommended guidance is for decarbonization to follow the principles summarized below.

What we DON'T mean by decarbonization ...	... and what Mercer DOES mean by decarbonization
Immediate ...	A **multi-year plan** to significally reduce emissions in the portfolio
... divestment from only fossil fuel energy ...	An **integration- and engagement-based approach** that is climate aware
... only in equities ...	A **total-portfolio view**, including real assets (property and infrastructure)
... regardless of price ...	**"Decarbonization at the right price"** to build flexibility into the strategic plan
... without factoring in future transition capacity ...	Analyzing **emissions plus transition capacity** and green revenue exposures
... with disregard for broader investment principles	**Traditional investment and ESG factors must still be considered**

The most recent development is net-zero commitments, which go further by setting a quantum for the decarbonization to align with science-based reductions required to achieve the long-term-best-interests scenario.

For an approximately 50%–67% chance of achieving a 1.5°C scenario, the scientific conclusion is that a 45% emissions reduction is required from 2010 levels to 2030, and the net-zero target year is ~2050.[7] This sets a goal to work back from and establish trajectories to navigate decarbonization.



Source: WRI, available at www.wri.org/blog/2019/09/what-does-net-zero-emissions-mean-6-common-questions-answered.

Appendix

Company net-zero commitments

The Science Based Targets initiative (SBTi)[8] drives ambitious climate action in the private sector by enabling companies to set emissions reduction targets and have them externally verified. The SBTi formed in 2015 as a partnership between key NGOs — CDP, WWF and WRI — and the UN Global Compact.

According to the latest SBTi Progress Report, over 2,200 companies have committed to SBTs in many sectors and regions, with evidence showing that these companies are delivering emissions reductions. According to the progress report, companies with SBTs in place reduced their annual emissions by 29% between 2015 and 2020. Furthermore, the typical SBTi company has reduced its Scope 1 and 2 emissions at a linear rate of 8.8% per year since setting targets. Within listed equities, SBTi organizations currently only represent 20% of total global companies (by market cap). Consequently, there is significant scope for stewardship initiatives by asset managers to drive adoption of SBTs, which should translate into the real emissions reductions needed for a net-zero economy.

2,253
overall number of companies

1,171
commitments

1,082
approved targets

US$38 trillion
in market capitalization

as of December 31, 2021

Investor net-zero commitments

An investor-based net-zero pledge typically involves committing a proportion of assets to the requirements outlined in, or broadly consistent with, industry-based initiatives such as the Net Zero Asset Owner Alliance (NZAOA) or the Net Zero Asset Managers (NZAM) initiative.

As an example, asset managers and investors who commit assets to NZAM "support the goal of net-zero greenhouse gas (GHG) emissions by 2050, in line with global efforts to limit warming to 1.5°C" and "commit to support investing aligned with net-zero emissions by 2050 or sooner."

Credible net-zero-aligned decarbonization curves should have three things in common:[9]

- Target 2050 or sooner
- Set interim milestones along the pathway that are no more than five years apart — for example, 2025, 2030, etc. — where progress is reviewed and targets are revised as necessary
- Prioritize genuine decarbonization over carbon offsets and carbon credits

Signing up to the NZAM initiative involves commitments, including:

- Setting interim 2030 carbon reduction targets consistent with a fair share of the 50% global reduction in CO2 identified as a requirement in the IPCC special report, *Global Warming of 1.5°C*
- Accounting for portfolio Scope 1 and 2 emissions and, to the extent possible, material portfolio Scope 3 emissions
- Implementing a stewardship and engagement strategy, with a clear escalation and voting policy
- Engaging with actors key to the investment system
- Prioritizing the achievement of real-economy emissions reductions

Notes

[1] Mercer. *From Gray to Green: Your Path to Portfolio Transition*, November 2020, available at https://www.mercer.com/our-thinking/wealth/investing-in-a-time-of-transition.html.

[2] As of October 26, 2022.

[3] Mercer. "Mercer Investment Beliefs," available at https://www.mercer.com/our-thinking/wealth/mercer-investments-beliefs.html.

[4] Mercer. "Zero Places to Hide," available at https://www.mercer.com/our-thinking/wealth/zero-places-to-hide.html. See also the Intergovernmental Panel on Climate Change site for the latest reports, available at https://www.ipcc.ch/.

[5] IEA. *Net Zero by 2050: A Roadmap for the Global Energy Sector,* May 2021, available at https://www.iea.org/reports/net-zero-by-2050.

[6] Mercer. *Aiming for a Net-Zero Target*, 2021, available at https://www.mercer.com/content/dam/mercer/attachments/global/gl-2021-aiming-for-a-net-zero-target-investing-in-a-time-of-transition.pdf.

[7] See IPCC. *Global Warming of 1.5^0 C: Special Report*, 2018, available at https://www.ipcc.ch/sr15/. See also WRI. "8 Things You Need to Know About the IPCC 1.5^{0}C Report," October 7, 2018. And IPCC. "Summary for Policymakers" in *Climate Change 2021: The Physical Science Basis* (contribution of Working Group I to the *Sixth Assessment Report of the Intergovernmental Panel on Climate Change*).

[8] The Science Based Targets initiative (SBTi), available at https://sciencebasedtargets.org/.

[9] Mercer. "Net Zero or Fake Zero?," *Critical Thinking, Critical Issues*, August 2021 podcast, 23 min., available at https://www.mercer.com/our-thinking/wealth/podcast-critical-thinking-critical-issues.html.

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