QUILTER CHEVIOT

RESPONSIBLE INVESTMENT

# Slipping through the net

## third party managers and net zero ambitions

*Across Quilter we have identified three thematic engagement priorities. This is part of our climate change theme.*

Climate Change is the defining issue of our time and we are at a pivotal moment. From shifting weather patterns that threaten food production, to rising sea levels that increase the risk of catastrophic flooding, the impacts of climate change are global in scope and unprecedented in scale. Without drastic action today, adapting to these impacts in the future will be more difficult and costly.

## SDG Alignment


> *"We are the first generation to feel the effect of climate change and the last generation who can do something about it."*
> Barack Obama, Former US President

## Introduction

The growing impacts of climate change on the global economy are increasingly unavoidable, whether it is the insurance sector reeling from unrelenting natural disaster damages[1], or the emerging fragility of our cities to harmful heatwaves[2], floods[3], and storm damage[4]. Both governments and corporations are shifting course to try to limit climate change, as the landmark Paris Agreement reaches its ten-year anniversary in 2025. We have seen the strengthening of the politicised anti-ESG movement since Donald Trump's return to office, and a corresponding rise in corporate kowtowing affecting particularly US-based asset managers. Following a number of withdrawals from both the Climate Action 100+ collaborative engagement programme and the Net Zero Asset Managers' initiative (NZAM), NZAM organisers have announced a pause and review of the initiative's fitness-for-purpose. Despite this, we consider global

1 In California, see Bloomberg and San Francisco Chronicle. In Florida, see Newsweek and Scientific American. Broad coverage of insurance sector withdrawing due to climate change-driven events, see New York Times.
2 Summer in the City: Climate Science Reveals the Impacts of Heat | Department of Energy, Asian region reels from heat and floods as WMO warns of climate change effects
3 Climate change 'most likely explanation' for torrential rain | The Guardian, In Parts of New York City, a Vexing Mix of Stormwater and Sewage Have Made Flooding the 'New Normal' - Inside Climate News
4 Fifth storm in less than a month bears down on the Philippines | Floods News | Al Jazeera

frameworks like NZAM to be critical in holding institutions to account for their actions (or, in this case, inaction). Financial services businesses have a special responsibility to protect the long-term value of clients' investments - particularly in the face of systemic threats like climate change. In line with our own expectations for asset managers, setting net zero targets in line with global efforts to decarbonise is a key priority for Quilter Cheviot in 2025.

## Engagement purpose

Quilter Cheviot (QC) is aiming to set decarbonisation targets for its financed emissions, to complement its operational emissions targets. Financed emissions are those an asset manager has financed through its investments, and typically form the majority of an asset manager's emissions impact. The first challenge is discerning what degree of alignment is feasible for our holdings given the nature of the investments – over 60% of assets under management (AuM) are in third party-managed funds. Given the significance of fund holdings in our investment universe, determining how to align these assets is critical for a meaningful net zero target.

NZAM is the most widely adopted platform for asset managers to set net zero targets for their assets. Asset managers who become NZAM signatories encourage their assets to decarbonise using engagement as the primary lever towards achieving real world emissions reductions. The goal of the initiative is for asset managers to use their influence in the market to accelerate the global transition towards net zero emissions, in line with the Paris Agreement.

Over half of the firms that manage the third-party funds QC invests in have set targets through NZAM, making this an ideal starting point for assessing how aligned (or unaligned) our fund holdings are with a net zero trajectory. We selected our top 20 firms by fund AuM-held to discuss the details of their NZAM commitments and determine to what degree the funds we invest in are linked to specific firm-level net zero commitments. These firms collectively accounted for over two-thirds of QC's third-party fund-invested AuM (68%)[5]. The exercise also would provide helpful insight into how other firms – both similar and dissimilar from QC – have approached setting net zero targets.

Where we have identified best practice, we have named the firm. Elsewhere we have anonymised the firms within the scope of this engagement as we do not feel that disclosing the names publicly would be helpful in our long-term commitment to engage constructively with the third-party managers we invest in.

The terms 'firm,' and 'third-party manager' refer to the investment house; where we use the term 'fund manager' we are referring to teams within the investment house. We have then broken down the firms into different types: asset owner, asset manager, and wealth manager to see how these compare.

This is the first phase of our engagement with third-party managers. We are also conducting engagements on third party fund alignment through the Wealth Managers on Climate group (see further detail in our forthcoming Climate Action Plan).

## Our approach

We were interested in understanding how firms approach and implement their NZAM targets, from a strategic level, down through to management of individual funds. Where firms had specified funds that were part of its NZAM target we felt it added insights to include individual fund managers in our conversations, to assess how the firm's NZAM targets affected them (or did not). For seven of the 20 firms we engaged with, individual fund managers were part of that discussion.

Following our engagements, we assessed firms' responses against our climate alignment criteria, and assigned scores accordingly. The criteria were deliberately weighted towards rewarding the Strategy and Engagement components of firms' NZAM commitments. We were interested in understanding:

1. how thoroughly a firm interrogated alignment feasibility before setting targets;
2. whether they had a clear strategy for achieving their targets; and
3. how integrated this target was in the management of individual funds QC is invested in.

5 Holdings data as at 2/12/2024.

## Outcomes

**Translating firm-level to fund-level**

Several themes came out of our discussions. The first and perhaps most salient: the most common approach to net zero alignment made discerning fund-level alignment very challenging. Most firms we spoke with had chosen to align their committed assets by asset class rather than by fund. Where a firm's commitment applied to all of its listed equities, for instance, it would mean that only the proportion of the fund made up of listed equities (say, 45%) would be considered committed to aligning. This approach makes it impossible for those invested in third-party funds to neatly categorise their investments as either committed to net zero or not.

### Tale of two tracks: comparison of fund-level vs. asset class alignment

Firms tend to structure their net zero commitments within their assets in two ways: by asset class or by fund. The more common approach among the firms we met with was asset class-alignment within a sub-set of its universe (usually segregated mandates, or those with sustainability mandates; or the assets of a parent company asset owner). Many firms chose this approach for its ease – its targets focus on ring-fenced portions of its universe and only apply to those asset classes with well-established alignment methodologies. This approach also neatly avoids the fraught issue of appropriate exercise of firms' fiduciary duty: by only choosing to align portfolios which are either owned by the firm or those with explicit mandates in place.

Although straight-forward in these ways, this approach complicates how these targets apply to clients' investments. Because only portions of individual funds or portfolios are included, it is a more complex, nuanced answer to the question 'Are my investments included in the firm's net zero target?'

The less common approach is to set 'whole-of-portfolio' targets, where entire funds (all assets) are included in the firm's targets. Although both methods require fund managers' support in delivering the targets, when entire portfolios are included in a firm's targets firms typically expend more effort obtaining explicit agreement from fund managers. Despite this, this approach has the obvious benefits of simplicity. This extends to firms' ability to clearly report progress against their targets – whole-of-fund targets present more clearly.

**Flexible complexity**

Another factor complicating fund categorisation is the open structure of NZAM commitments. NZAM was purposefully designed to be "methodology neutral" to allow signatories flexibility and ensure their ability to make meaningful commitments. Although this succeeded in encouraging asset managers into the initiative, it impedes comparing commitments between signatories because each asset manager defines alignment differently. The permitted methodologies – broadly categorised below – provide the foundation structure for firms to define alignment, but ultimately allow for a considerable amount of variety in the scope and implementation. This makes even comparisons between commitments within the same methodology challenging.

Consider a comparison among firms using the Science Based Targets Initiative (SBTi) approach[6]. Half of the firms we spoke to use this methodology, which offers three options for setting targets: Sector Decarbonisation Targets, Science Based Targets portfolio coverage, or Temperature Rating. Three of the ten firms chose to use Temperature Rating, while seven used Science Based Targets portfolio coverage. To compare within these target options may appear straight-forward, as the structure is the same: aligning the committed assets to a set temperature score by a set time (2030, for the near-term target). The targets in isolation appear to set Firm 18 as the best performer – its assets are aligning to a more ambitious temperature, 1.5°C in the same timeframe as the other firms' targets are over 2.0°C. However, this changes when we scrutinise the detailed parameters of the target: Firm 18's targets do not include Scope 3 emissions, unlike Firms 20 and 19, making that 1.5°C alignment much less comprehensive than the more modest temperature targets set by Firms 20 and 19. Which target is more progressive in this instance? Perhaps we look at the size of the firm's commitment. This is presented as a percentage of a firm's assets under management (AuM). We can view this as an indication of how dedicated a firm is to achieving net zero; however, it also inevitably reflects the limitations of some investments – not all asset classes have alignment methodologies available – and other ancillary factors, such as investment geography, investment style, and even client base.

6 Note: this refers to version 1.0 of this guidance (SBTi Criteria and Recommendations for Financial Institutions: Pilot Version, April 2021)

| Firm | Target | Assets in scope | Emissions included | AuM committed |
|---|---|---|---|---|
| Firm 20 | 2.5°C by 2030 | Listed Equity<br>Corporate Bonds | Scope 1,2 and 3 | 91% |
| Firm 19 | 2.2°C by 2030 | Listed Equity<br>Corporate Bonds | Scope 1,2 and 3 | 60% |
| Firm 18 | 1.5°C by 2030 | Listed Equity<br>Corporate Bonds | Scope 1 and 2* | 38% |

* Scope 3 emissions only included for holdings in Energy or Financial sectors.

For the sake of completeness, we can look at those firms using the Net Zero Investment Framework (NZIF) to set targets. Twelve of our twenty firms used NZIF at least to some degree in their targets. All were keen to highlight the benefits of the framework – a ready-made, industry-accepted framework designed for flexibility was a much easier ‘sell’ to corporate authorities than the prospect of building a bespoke process, where this was often outside of firms’ existing knowledge.

On the surface, firms utilising NZIF have set more easily comparable targets (see table below). However, we find again that under further scrutiny, the flexibility of the NZIF approach allows for nuanced differences in these targets.

| Firm | Target | Assets in scope | Alignment criteria |
|---|---|---|---|
| Firm 9 | 50% reduction in carbon intensity by 2030 | Direct equities<br>Corporate bonds<br>Sovereign bonds | + Consideration of use of offsets<br>+ Commitment to financing climate solutions<br>+ Transparency factor |
| Firm 12 | 50% reduction in carbon intensity by 2030 | Direct equities<br>Corporate bonds | * Replaced Emissions performance NZIF criterion with in-house ‘Targets aligned’ criterion<br>- Removed capex alignment<br>- Removed Just Transition criterion<br>* Changed lobbying (#7) and TCFD (#10) to apply only to Climate Action 100+ (CA100+) companies[7] |

Both firms are using the same core criteria but have adapted it differently – Firm 9 appears to have included additional criteria in its application of the NZIF framework, while Firm 12 has questionably altered key criteria[8] as well as removing several criteria altogether from its NZIF-adapted framework.

How then do we meaningfully rank or categorise these commitments, given the layers of detail behind even a simple-looking target? The answer – with a magnifying lens in hand. The structure of NZAM commitments means that no two commitments can be compared without detailed and thorough interrogation of the context around a firm’s targets. This finding has driven the creation of our in-house climate alignment criteria, which we will use to better gauge the integrity of firm-level net zero targets. These criteria will form the foundation of our own climate targets. Further details of this will be included in our forthcoming Climate Action Plan, to be published in early 2025.

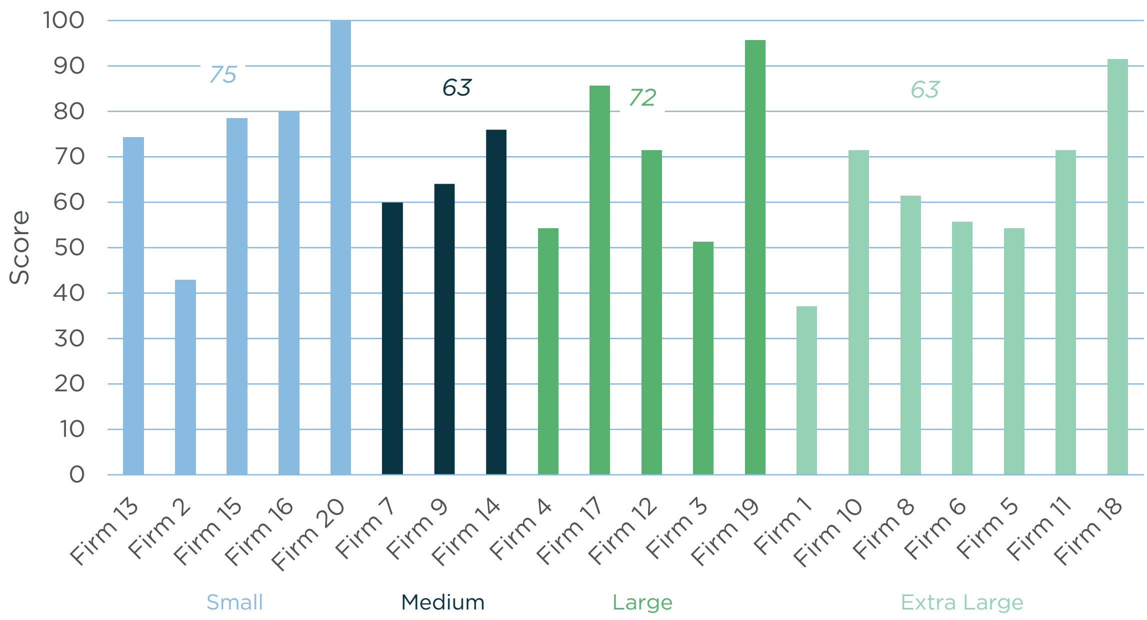
## Analysis

When comparing scores across the firms we assessed, there were a number of trends which emerged. Some of these were to be expected – for instance, smaller firms typically committed more assets to their NZAM targets than larger firms – while others leave more room for interpretation. We have summarised these below with accompanying figures, where relevant.

7 This refers to the companies targeted by the Climate Action 100+ initiative. CA100+ evaluates over 100 focus companies against its own ‘climate benchmark’.

8 The firm defines its replacement criterion as: “Company targets are driving its emissions intensity consistent with a 1.5°C industry trajectory.” This removes the direct reference from the NZIF standard criterion 3 to assessing *current emissions intensity performance*. The firm claims that “No reliable data [is] yet identified” to support the inclusion of NZIF standard criterion 3, an ambiguous statement given its assessment includes criterion 4, disclosure of company emissions. The wording of the revised criterion could suggest the firm will be more permissive of limited progress in companies lowering their emissions, focusing instead on whether the firm has targets in place – rather than whether it is progressing them. Alternatively, the firm’s criterion may have included the phrasing with a 1.5°C industry trajectory to reflect its focus on sector-relevant performance in its company alignment assessments.

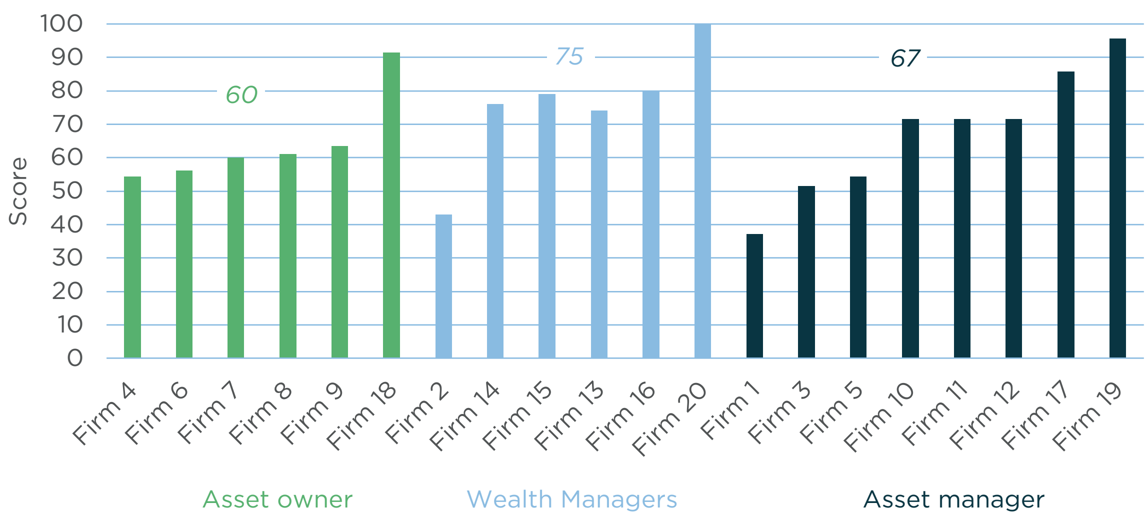
**Size[9] was not a limitation on scoring well in our matrix.** Of the top five firms, two were classified as Small, two were Large, and one was Extra-Large.




Firm NZAM alignment score. Firms grouped by size class. Average score for each firm size class in italics above.

**Firm 'type' showed differences among asset owners and asset managers.** We were interested in understanding whether firm 'type' played a role in how firms scored. We defined several 'types' including asset managers linked to asset owner parent companies ('Asset Owner', including insurance and bank parent companies), smaller boutique firms (grouped as 'Wealth Managers'), and general asset managers typically involved in institutional mandates ('Asset Manager').

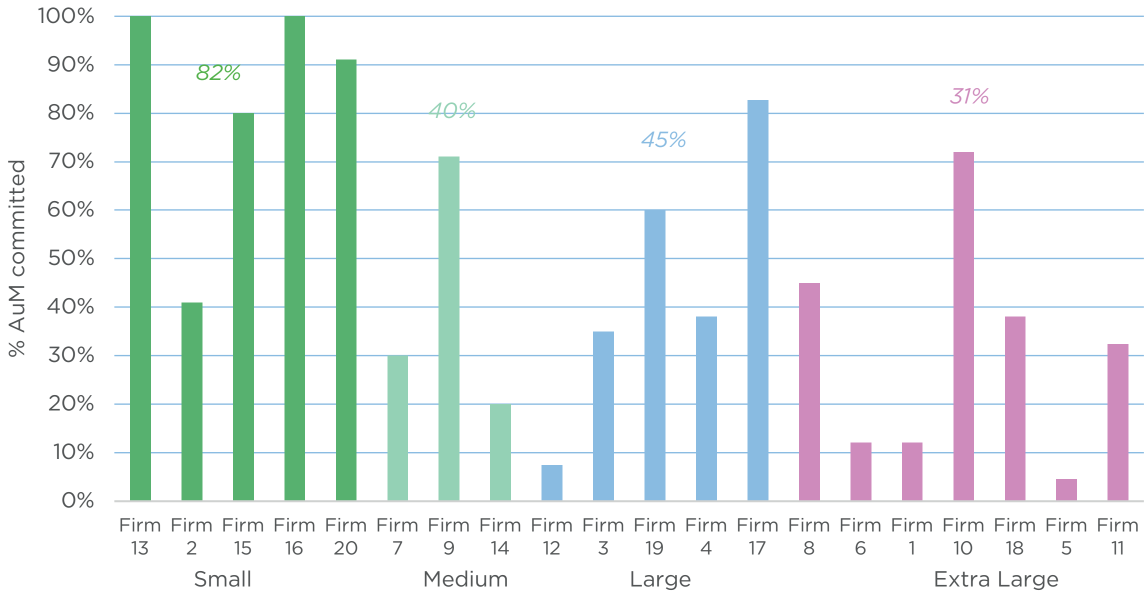
Firms with asset owner parent companies (in either banks or insurance) scored lower on average, which may in part reflect the restrictions of managing owned assets (e.g. lower risk thresholds) or the slight variation in approach for asset owners setting targets through the Net Zero Asset Owner Alliance (NZAOA). Within the Asset Owner category, those firms with bank parent companies scored the lowest (58 on average), while insurance-backed asset managers did considerably better (68 on average; driven largely by superior performance in the Engagement criteria). Within the smaller firms, the Wealth Managers' category outperformed the other two considerably (75 to the others' 60 and 67 on average). Unsurprisingly, the boutique firms within this category scored the highest on average (85), likely a reflection of these firms' ability to concentrate on restricted subsets of investments, and more readily adopt a unified 'whole of firm' approach to setting climate targets.




Firm NZAM alignment score. Firms grouped by type. Average score for each type in italics above.

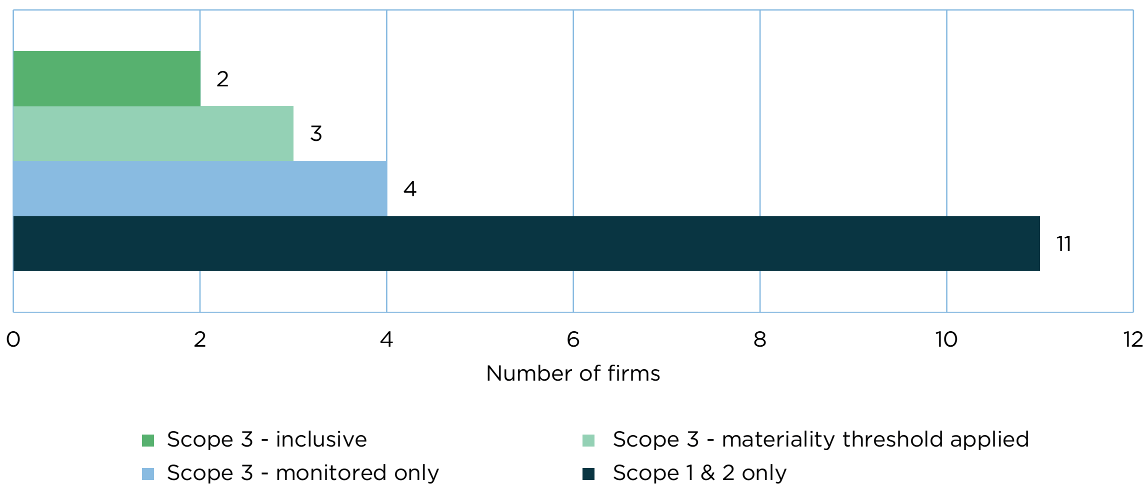
9 Firm size was categorised as follows: Small = <$100bn AuM; Medium = <$500bn AuM; Large = <$1trn AuM; Extra-Large = >$1trn AuM.

**Smaller firms made larger commitments.** This is often a reflection of boutique firms' more limited investment universes (e.g. they do not tend to invest in harder-to-align assets such as index trackers) and particular investment theses (e.g. extensive exclusions screen out heavy-emitting sectors). Nonetheless, we still had notable exceptions to this, where larger asset managers were comfortable committing sizeable portions of their AuM in their NZAM commitments.



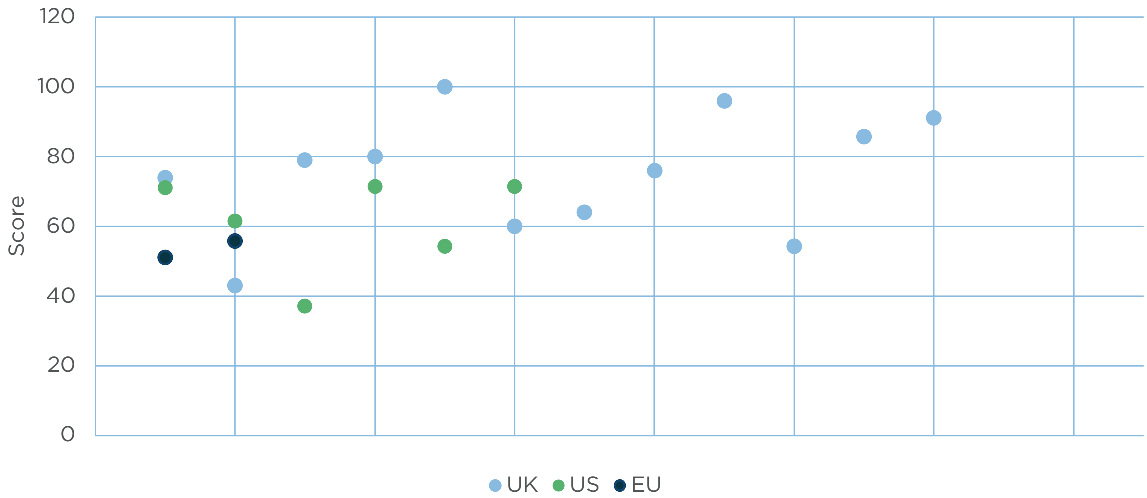

Firms' committed AuM, as a percentage of total AuM. Grouped by firm size. Average for firm size in italics.

**Many firms are still reticent to include Scope 3 emissions in targets.** This is likely due in part to the age of some targets (i.e. the earliest NZAM targets were set in 2021); industry view of Scope 3 emissions – both the reliability of the data and its relevance – has markedly shifted in recent years. Some firms, however, expressed a clear disdain for Scope 3 emissions. For some, this reluctance was linked to concerns about data quality and availability – a valid concern for some asset classes, certainly. More troublingly, however, were firms who argued Scope 3 emissions are beyond their scope of climate responsibility. We acknowledge there are complexities to including Scope 3 emissions in decarbonisation targets – including some degree of inevitable double-counting, and the need to shift away from using estimates-based emissions calculations in Greenhouse Gas (GHG) accounting. Given the mounting evidence that global efforts to limit global warming to 1.5°C are, at present, insufficient, consideration of Scope 3 emissions is ever more critical. Firms wilfully ignoring these emissions – which, in many cases, are the *vast majority* of an issuer's carbon impact – is a profoundly irresponsible view.




Scope of emissions included in targets. 'Scope 3 – inclusive' means a firm's Scope 3 financed emissions are included in its targets. 'Scope 3 – monitored only' means the firm monitors its Scope 3 financed emissions, especially for engagement purposes, but does not include it in its targets. 'Scope 3 – materiality threshold applied' is where firms include Scope 3 emissions where one of two conditions are met: either they breach the 'materiality threshold' set by the Science Based Targets Initiative (SBTi), i.e., where an asset's Scope 3 emissions account for over 40% of its total; or they are included as a 'material sector', as identified by the firm (in some cases, this aligns with the 'material sectors' set in the NZIF criteria).

**Mind the growing gap: US-based firms scored slightly worse than UK/EU firms.** American firms scored lower overall than the UK firms we engaged with, indeed 18% lower (average score of US firms 61, UK firms 74). The lower-scoring US firms tended to have relatively poor targets, with corresponding weakness in accompanying engagement framework. That said, three of the US firms were included in the top half of overall rankings, indicating there remain firms with relatively robust climate targets despite the challenging geopolitical context in the US.




Comparison of alignment score and domicile of firms. Total samples – UK (12), EU (2), and US (6).

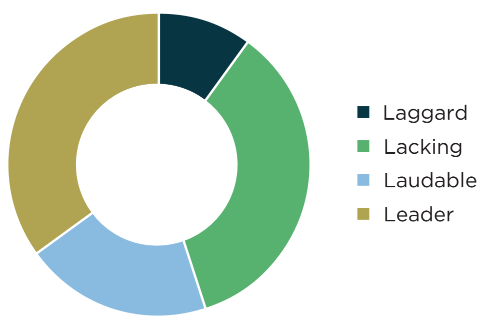
We used the scoring from our alignment criteria to categorise all firms into four categories: Laggard, Lacking, Laudable and Leader.

**Laggard** is defined as any firm scoring less than 50 (out of total 100). These firms were notable for their reticence in their climate approach. They were uninterested in or unable to evidence any engagement strategy linked to climate targets, and often expressed deep scepticism towards otherwise commonly accepted elements of climate stewardship (e.g. efficacy of collaboration, relevance of Scope 3 emissions).

**Lacking** included firms where their climate strategy was insufficient in at least one of the three criterion themes (Targets, Strategy, Engagement). Firms in this category often took a simplistic, template approach, without adapting this overly to their investments. In many cases, this category included firms with narrow targets (i.e. assets committed were only 'low hanging' fruit, such as funds with sustainability objectives already in place) or lacked clear engagement frameworks (e.g. no engagement targets prioritisation in place, or unclear ownership of stewardship activities). In many cases, firms in this category structured their climate approach so that it was easily rescinded or removed, rather than truly integrated into its investment and stewardship workstreams.

**Laudable** firms differentiated themselves from the 'Lacking' category by embedding a more advanced strategy– including governance around NZAM targets, and forward-planning (i.e. demonstrable plans in place to increase target coverage over time). These firms had climate stewardship strategies in place but may have lacked in one element (for instance, had clear engagement targets and processes, but these did not extend to inclusion of a climate-specific voting policy).

**Leader** category included firms with clear, cohesive climate strategies and progressive targets in place, often with 'stretch' components (e.g. including harder-to-align assets, such as sovereigns, or geographies, such as emerging markets) or where a firm has forged ahead of existing best practice (examples include proactively developing new alignment tools, promoting transparency in increasingly detailed disclosures, focusing engagement on assets typically excluded from climate alignment scope).




Categorisation of firms. Laggard (2), Lacking (7), Laudable (4) and Leader (7).

## Best in class

These criteria have informed our view of what best practice looks like for a firm-level net zero target made through the NZAM framework. It should be noted that whilst we have called out best practice examples, this does not necessarily translate into an overall positive rating for the firm.

**Comprehensive targets**

Targets should include as broad a range of asset classes as is reasonably practical. Where possible, firms should 'stretch' their targets to include asset classes where alignment methodologies are still emerging and where the firm has some exposure to these assets. Best practice is to include Scope 3 emissions in targets (at minimum, for material sectors).

**BlackRock** stands out from among its peers for its inclusion of sovereign assets in its targets. This sits well within the firm's strengths – namely, market share and therefore exceptional access to sovereign asset owners. In this, the firm has set a great example of leading the industry by utilising a firm's specific strengths.

**Schroders** and **Veritas** have included Scope 3 emissions in their targets, a marked difference from many of their peers. **Federated Hermes** and **Wellington** have included Scope 3 emissions where they are material. Although many firms promise to 'consider' Scope 3 emissions, particularly in engagements, these firms' targets are addressing company-level climate impact much more comprehensively than Scope 1 and 2-related targets.

**Veritas** and **Stewart** have included their emerging markets-based funds in their targets, despite the challenges in aligning these assets. Both have indicated the importance of including these companies in the 'journey' towards net zero and are undertaking extensive engagement with these assets to ensure these companies are not left behind in the forthcoming economic transition.

**Appropriate alignment metrics**

Chosen alignment metrics should ideally balance between backward-looking (i.e. based on past performance) and forward-looking (i.e. estimated trajectory) to discern how progressive a company's targets are. Offering a choice of multiple alignment metrics often facilitates broader alignment across a firm's assets and is indicative of commitment to expand coverage of targets.

**Columbia Threadneedle** applies two layers of alignment to its committed funds: the NZIF-based criteria, and portfolio-specific decarbonisation trajectories. This allows tracking of both year-on-year emissions reductions and visibility of the longer-term trend of alignment of its assets.

**Wellington** offers two different alignment metrics for its funds – Weighted Average Carbon Intensity (WACI) or SBTi alignment. The firm chose to offer this option after extensive engagement with its fund managers, as it avoids limiting the inclusion of asset types which cannot be measured against certain metrics. Taking this approach meant the firm was able to demonstrably increase the range of funds it could commit in its targets.

**Legal & General (LGIM)** similarly offers its fund managers two alignment options – temperature alignment or WACI. This ensures funds' relative alignment is being measured in a way which is appropriate to the asset type mix of the fund. Taking measures like this expands the range of funds the firm can commit to its target.

**Balanced methodology**

Chosen alignment methodology should seek to balance rigour and industry adoption of third-party frameworks. If amending a third-party approach, any changes should be clearly justified. If using bespoke / proprietary method, this should include some degree of assurance or review from a trusted climate authority (e.g. academic, Carbon Trust).

**Artemis** applies a NZIF-adapted climate alignment framework, which it ensured went through appropriate stress-testing by an external third-party prior to being rolled out across the firm. This is an apt example of firms taking reasonable additional steps to ensure the workability and robustness of their climate alignment approach.

**Federated Hermes** developed its own proprietary temperature alignment metric, which was reviewed by several external, credible authorities[10] (in this case the University of Exeter's Global Systems Institute and Chronos Sustainability consultants).

**LGIM** also uses its own proprietary temperature alignment metric. However, it routinely benchmarks its own metric outputs and methodology against other similar metrics available in the broader industry (e.g. MSCI's Implied Temperature Rise ITR, WWF-CDP Temperature rating). This allows the firm to use its preferred metric while still providing a measure of transparency in its approach and facilitating comparisons across different firms' metrics.

**Useful tools**

Firms should evidence that they have tools (systems) and resources (staff) in place to upskill those responsible within the firm for implementing its net zero strategy. A range of climate-related data and metrics should be easily accessible by investment and stewardship teams (not just the single metric being used in targets).

**BlackRock** has developed innovative new tools to address data gaps around the environmental impacts of fixed income assets. Its Positive Externality / Negative Externality (PEXT/NEXT) tool allows fund managers to evaluate the environmental impacts often ignored or excluded from assessments of company impacts. Creating tools and building fit-for-purpose solutions to overcome challenges is crucial to global net zero efforts: innovation will play an important role, and asset managers are encouraged to use their resources to develop new tools in support of this.

**Wellington** has developed its Net Zero Portfolio tool, which allows fund managers access to climate metrics and visuals. Importantly, the platform also allows users to model specific changes in the portfolio on climate metrics, enhancing fund managers' ability to gauge materiality of individual assets and explore the effects of different changes to the portfolio's climate impact.

While we are emphasising firms where they have tools already in place, we equally encourage firms which may be working towards developing the capacity and skills to effectively manage its climate strategy. **Allianz** is introducing internal training programmes to upskill its fund managers in direct stewardship activities, to ensure the firm's engagement targets are actively be driven by the fund managers.

10 By 'credible,' we mean institutions with demonstrable expertise and specialism in climate. This would not include 'Big 4' accounting firms.

**Net zero aligned activities**

Firms' activities should align with their targets and support their net zero strategy more broadly. These should include climate-related voting expectations (or 'red line engagement triggers'), annual climate risk analyses (e.g. TCFD), and climate action plans (to include other climate impacts, e.g. operational emissions).

**Schroders**, **LGIM**, **M&G**, **HSBC**, **Federated Hermes**, **Stewart**, **Wellington**, and **Veritas** all have published Climate Action Plans (or equivalent) addressing how the firm addresses the climate impacts of its investments and activities. **BlackRock**, **Allianz**, and **Royal London** have issued public statements indicating the firm's support of the ambitions of the Paris Agreement, but these lack further detail on implementation of this goal within the firm.

**Veritas** has set clear climate voting expectations with its Red Line voting policy. This document is communicated publicly in advance of proxy season, and establishes the firm's voting 'red lines,' where the firm will vote against management in instances where assets fail to meet the published expectations.

**LGIM** also has Red Line voting policies included in its Climate Impact Pledge, which outlines sector-level expectations on climate and rationale for these. The firm occasionally pre-declares some of its voting decisions, with detailed rationale for why a given asset is in violation of its Red Lines on its Voting Intentions blog. The firm will place a 'vote sanction' in cases where a violation is not corrected prior to close of voting.

**Integrated strategy**

Firms' targets and net zero strategy should be integrated beyond a single function of the business - i.e. even if only stewardship team are executing the firm's net zero strategy, fund managers can evidence awareness of targets (where they apply to their duties). Executives must fully 'own' the implementation of the net zero strategy, meaning they are responsible for progress (or lack thereof), and it is included in discretionary performance-based remuneration.

**Artemis** was able to demonstrate strong coordination between fund managers and its stewardship team, particularly in driving progress on its climate engagements. Fund managers proactively lead all engagements linked to the firm's NZAM targets, including linking with multiple fund teams where there is shared ownership of a target company.

**Federated Hermes** also evidenced effective integration of climate transition risk into the investment processes of its aligned funds. Even where funds have no specific climate objective, the firm's environmental, social and governance (ESG) evaluation processes are well-embedded in the fund manager's work. For instance, wherever a new holding is under consideration it is scored for transition-related risk and financial risks (each weighted appropriately to reflect sector-specific risks).

**Schroders** has included its climate targets in its executive remuneration policies. This reflects the longer-term commitment included in these climate targets, and the need to embed these in the incentives offered to those leading asset management institutions.

## Lessons learned

Setting climate targets for investments is no simple feat. It is challenging to balance setting a rigorous strategy with communicating the details and nuances of targets clearly. We have outlined specific examples of what we consider best practice in detail here. Beyond this, several general principles apply to our expectations of firms' climate-related targets.

**Transparency above all else** We appreciate the complexity inherent to setting climate-related targets. It is understood that all firms making commitments are operating under different constraints, whether structural or more cultural / political. Regardless of the scope of a firm's commitment, however, we encourage all to prioritise transparency in disclosures – be up front about which asset classes are excluded; what current data coverage looks like for relevant climate metrics; and what has influenced the firm's chosen methodology. We found all too often this information was either very challenging to ferret out from firms' disclosures, or it was actually absent.

**Engagement is the key** Engagement can start now, and can take many forms, adapted to a firm's resources and abilities. There is a reason this is the crux of the NZAM commitment firms make when becoming a signatory: it is something that all asset managers can do now, even if firms are unable to determine and set targets. Reporting on engagements is a critical element of stewardship – and it is important that firms' engagement disclosures are outcomes-focused, demonstrating where its efforts have contributed to material improvements and changes. Clear, impact-focused reporting plays a significant role in promoting the use of effective stewardship practices across the industry.

**Be a part of the conversation** Evidence that your firm is proactively working on this today, and not simply delaying until peers demonstrate a way forward. All asset managers are operating under constraints. Commit where it is possible to and take other measures in the harder-to-align areas. Where setting explicit targets is not possible, scale proactive engagement activities to compensate.

There will be mis-steps along the way, but it is critical that we act, full in the knowledge that not all paths taken will be successful. We are looking for partners who are active participants of industry working groups and collaborative efforts to solve some of the problems in aligning investments to a lower-carbon future. We are more likely to achieve this with more voices in the room.

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**Investors should remember that the value of investments, and the income from them, can go down as well as up and that past performance is no guarantee of future returns. You may not recover what you invest.**