AETOS INSIGHTS

The Role of the Asset Management Industry in Realizing a Net Zero World

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AETOS AT-A-GLANCE

Firm Overview
Aetos Alternatives Management, LP (“Aetos”) is an independent firm that, since its inception, has been a leader in providing investment advisory services and constructing fully customized hedge fund solutions for institutional clients.

Founded
2001

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INTRODUCTION

Addressing global climate change and its environmental, social, and economic impacts exists today as perhaps the single greatest long-term challenge facing our planet. Across national, scientific, and economic communities, there is widespread—although not universal—consensus that:

- Greenhouse gas emissions are an important cause of global warming
- Climate change presents an existential environmental crisis
- This crisis has enormous economic consequences in terms of global GDP
- The time remaining to meaningfully address this issue is short
- Taking the required actions is an undertaking of unprecedented global scope

To address the negative impacts of climate change, the Paris Agreement was adopted in 2015 by 194 nations and established a goal to limit global warming to “well below” 2°C—and preferably to 1.5°C—above pre-industrial levels by 2050. The Paris Agreement requires that signatory nations set out specific, increasingly ambitious actions in successive five-year increments and requires signatories to continue working to create global reporting standards. While attention has been focused on mitigating carbon emissions, the Paris Agreement also acknowledges the inevitability of negative impacts from global warming and, therefore, addresses the need for nations to develop adaptation strategies as well.

The Glasgow Financial Alliance for Net Zero (GFANZ) was created to demonstrate the commitment of the financial industry to addressing climate change. The goal of GFANZ is to achieve net zero greenhouse gas emissions by 2050. Over 450 financial entities across 45 countries representing over $130 trillion in financial assets have joined GFANZ. Asset managers represent over $57 trillion of this amount.

While the asset management industry itself is directly responsible for a relatively limited amount of carbon emissions, asset managers and asset owners are well-positioned to play an active role in achieving the global goal of net zero. Importantly, the asset management industry has the capacity to exert influence to reduce greenhouse gas emissions by directing capital and making investments that promote the transition toward a more sustainable society.

In this paper, we discuss:

- What it means to commit to net zero
- The asset management industry’s response to climate change
- Methods available to portfolio managers to track portfolio alignment

NET ZERO

Net zero refers to reaching the state where no incremental greenhouse gases are added to the atmosphere. This state is achieved once the amount of global greenhouse gases produced equals the amount that is removed from the atmosphere such that the net effect is zero additional greenhouse gases released. This is an important step towards addressing climate change.

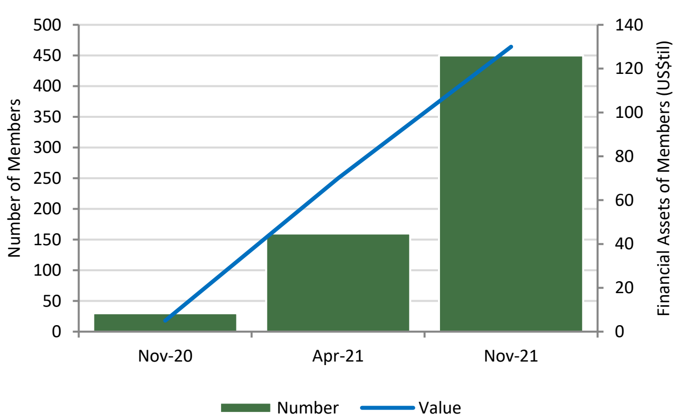
The Intergovernmental Panel on Climate Change (IPCC) published its latest report in April 2022, which states that greenhouse gas emissions must peak before 2025 at the latest and be reduced by 43% by 2030 and by 84% by 2050 (from 1990 levels). These reductions are required to limit global warming to 1.5°C in accordance with the Paris Agreement. At this level of increase, the stabilization of global temperature is predicated on achieving net zero in the early 2050s.

There are two overarching goals within a net zero target. The first goal is to bring human-caused emissions as close to zero as possible, through transitioning from heavily greenhouse gas-emitting sources of energy to more renewable sources. The second goal is greenhouse gas removal; this is particularly focused on CO2 removal and storage, bioenergy with carbon capture and storage, and removal in land-use sectors such as agriculture and forestry.

GFANZ: THE FINANCIAL INDUSTRY'S COMMITMENT

The Glasgow Financial Alliance for Net Zero ("GFANZ") is an umbrella organization for net zero commitments by the financial industry. It currently represents over 450 major financial institutions with over $130 trillion in assets, and has seen explosive growth over the recent past (*Figure 1*).

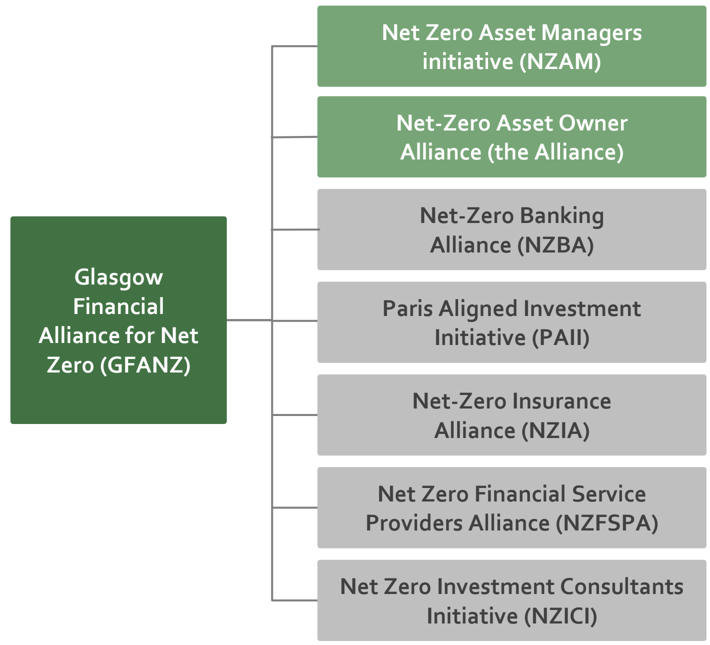
Figure 1: GFANZ Membership Growth



Source: GFANZ.

GFANZ covers every segment of the financial sector, including banks, asset managers, asset owners, insurers, consultants, and service providers (*Figure 2*). To become members of GFANZ, financial institutions join one of seven net zero initiatives serving individual financial sub-sectors. Firms that join GFANZ must "use science-based guidelines to reach net zero emissions by 2050, cover all emissions scopes…and commit to transparency in reporting and accounting."

Figure 2: GFANZ Member Organizations



Source: GFANZ. Green shading denotes organizations discussed in more detail in this research piece.

Two of the member organizations under the GFANZ umbrella which cater specifically to the asset management industry are the Net Zero Asset Managers initiative and the UN-convened Net-Zero Asset Owner Alliance (better known simply as "the Alliance"). While the overall goal of both organizations is similar, each initiative has its own governance structure and approach to supporting signatories. Investors can join more than one initiative, but certain initiatives may have a more specific focus.

Below, we explore these two asset management-focused member organizations in greater detail to help readers understand the initiatives that each group is undertaking.

Net Zero Asset Managers ("NZAM")

NZAM represents an international group of asset managers across investment disciplines. The initiative was launched in December 2020 and has more than 220 signatories as of November 2021, representing over $57 trillion in assets under management (AUM).

The initiative is managed by six regional investor networks: AIGCC in Asia, Ceres in North America, IGCC in Australia and New Zealand, IIGCC in Europe, and the global networks PRI and CDP. NZAM also collaborates with many other organizations, including other net zero initiatives. The goal is to provide asset managers access to resources that support their net zero goals, including best practices, approaches that are both robust and science-based, standardized methodologies, and improved data.

By becoming a signatory of NZAM, asset managers make a series of commitments with respect to their investment portfolios, which include the following:

- Provide clients with information and analytics on net zero investing and climate risk and opportunity
- Implement a stewardship and engagement strategy with a clear escalation and voting policy
- Engage with other participants within the broad investment industry, including rating agencies, auditors, exchanges, consultants and data and service providers to ensure they are providing data and information relevant to allow investors to assess and monitor the net zero status of their investments
- Assess and engage in relevant direct and indirect policy advocacy from a net zero lens
- Disclose annual climate action plans and methodologies employed to measure progress

Additionally, signatories may elect to designate all or just a portion of their assets to be managed in a net zero compliant manner and, with respect to these assets, managers make certain commitments regarding the investments they hold, outlined below:

- Set interim targets for 2030, consistent with a fair share of the 50% global reduction in CO2 identified as a requirement in the IPCC special report on global warming of 1.5°C
- Measure and report on their portfolios' carbon impact by identifying: (i) direct emissions from resources owned or controlled (scope 1); (ii) indirect emissions from the generation of purchased energy (scope 2) and where material (iii) all other emissions that occur in the value chain, including both upstream and downstream emissions (scope 3)
- Use offsets/invest in long-term carbon removal, particularly where there are no technologically or financially viable alternatives to reduce/eliminate emissions

Finally, signatories commit to publish TCFD disclosures, including an annual climate action plan, and submit them to the Investor Agenda via its partner organizations for review. This ensures that the approach applied is based on a robust methodology, consistent with the UN Race to Zero criteria, and action is being taken in line with their commitments.

The key benefit of NZAM is that it provides a framework for signatories to follow. This allows firms to clearly align themselves with net zero goals that can be replicated across an investor's entire portfolio. However, a notable challenge of the current standards is that the relatively lax minimum requirements can allow "low-commitment" managers to remain signatories. Managers only need to initially commit to aligning a portion of their portfolio with net zero goals.

Our analysis of an initial group of signatories that joined NZAM in December 2020 shows that 35% of the AUM they are responsible for are being managed in line with net zero. Not surprisingly, smaller asset managers and those specializing in sustainable investment were initially able to disclose a higher percentage of AUM in line with net zero goals. This development will be important to monitor through regular diligence as the industry and initiatives evolve.

Net-Zero Asset Owner Alliance ("the Alliance")

The Alliance was started in 2019 by a group of pension funds and insurance companies. It is convened by the United Nations Environment Programme Finance Initiative and the UN-backed Principles for Responsible Investment (PRI).

As of November 2021, there are currently sixty-one institutional investors that represent over $10 trillion in AUM in the Alliance. The group places heavy emphasis on quantitative targets that are set every five years, with the most recent targets highlighted in their 2025 Alliance Target Setting Protocol. The commitments are similar to NZAM's in that the whole portfolio is targeted and clear guidelines are given on engagement and the types of companies with which to engage.

For example, members of the Alliance are asked to engage with 20 companies in their portfolio, with a focus on those that contribute the most emissions. Similarly, members of the Alliance are asked to set emissions reduction targets for the most material sectors and seek to improve the carbon efficiency of their overall portfolios. As markets develop, this group will continue to establish and refine sector and asset-class specific methodologies for measuring emissions reduction within portfolios.

NET ZERO-ALIGNED PORTFOLIOS IN PRACTICE

To better understand the impact of businesses in signatories' portfolios, GFANZ encourages companies to report specific targets and metrics that allow external stakeholders to track progress in reducing emissions. Monitoring and analyzing such information provide asset managers with a valuable tool to measure their own net zero compliance.

Until recently, the primary ways asset managers and owners have sought to influence how companies manage climate risks and to assess their commitment to net zero alignment have been through engaging with companies and/or divesting from certain sectors. The

GFANZ framework seeks to expand on this, requiring signatory asset managers to apply science-based approaches to setting goals and tracking emissions.

Below are three emerging methods used to calculate a portfolio's alignment with net zero, each with its own advantages and drawbacks. These methods are still evolving and encountering difficulties in getting consistent and comparable data from companies relating to emissions, particularly as there are multiple potential paths to achieve net zero and multiple—relatively long—time horizons.

1. **Calculate the percentage of the portfolio that is net zero aligned.** At a high level, this is the most basic method. A key positive for this approach is the ease of implementation. However, one flaw is that it does not actually track what the companies are doing to get to net zero—just that they have committed. Managers using this approach must also engage with companies to make sure they are on track for net zero.[1]
2. **Measure divergence from benchmarks.** Normative benchmarks (emissions pathways that describe what must be done to achieve a given warming target) are constructed from forward-looking, science-based climate scenarios; the emissions of invested companies are compared against them. Investors can attempt to measure deviations using emissions data. For example, over the next 10 years, global emissions will need to decrease at an annual rate of 7.6% to achieve an approximate 45% decrease in CO_2 emissions by 2030 (an intermediate goal of the Paris Agreement required for the world to be on track to achieve net zero by 2050). Managers can then calculate the rate of decline in emissions in the portfolio to determine if it is in line with net zero expectations. One key concern regarding this approach is determining whether the rate of emissions is decelerating due to emissions reductions of the underlying companies or change in composition of the portfolio over time.
3. **Calculate the Implied Temperature Rise (ITR) of the portfolio.** ITR extends the benchmark divergence approach by translating each company's benchmark alignment into a measure of the consequences in the form of a temperature score, which describes the most likely global warming outcome if the global economy were to exhibit the same level of emissions as the company in question. For example, a score of 2.5°C assigned to a given company indicates that it is exceeding its benchmark and that if everyone exceeded their benchmark by a similar proportion, the world would end up with about 2.5°C of warming by the end of the century. One of the main issues with this strategy is that, while very ambitious, the current data and reporting available makes it difficult to arrive at a single number that is accurate. It is just as difficult to agree on what assumptions to use when determining the trajectory of emissions. For example, the IPCC's assessment of pathways to net zero incorporates over 900 different scenarios.

CONCLUDING THOUGHTS

An important and immediate benefit of having net zero targets is that it lays the groundwork to build a scalable framework for collecting emissions information and analyzing this data, which, even if applied to a portion of the portfolio in the immediate term, could subsequently be replicated for the rest of a signatory's assets under management. This foot-in-the-door approach could later be leveraged to incentivize managers to further accelerate their portfolios' alignment with net zero principles (e.g., recognizing the highest achievers among NZAM signatories).

Active managers are particularly well positioned to pursue net zero in their portfolios, given that they are not constrained to own each company in a specific (non-ESG) index. This is especially true for hedge funds, which can short stocks and are otherwise benchmark-agnostic. This flexibility has allowed managers to incorporate a range of ESG factors to mitigate investment risk (e.g., avoiding investments in coal companies) and, to generate alpha (e.g., investments in energy transition themes).

A growing subset of these managers also have engaged with companies on a range of ESG concerns, including climate change. The promise of the net zero initiative is to move beyond these steps as companies provide more data to track emissions in order to develop a comprehensive picture of their portfolios, set emissions reduction goals, and accurately monitor progress towards those goals. Armed with this data, managers who become net zero signatories can make better investment decisions and have more meaningful engagements with companies in their universe.

[1] A recent Morgan Stanley analysis of the companies in the S&P 500 and STOXX 600 estimates that roughly 20% of S&P 500 companies and 37% of companies in the STOXX 600 currently have some form of net zero target. Additionally, of the companies that have announced targets or committed to doing so, fewer than half have specifically stated targets of less than 2°C in line with the Paris Agreement. Within corporate credit, Morgan Stanley estimates that only 30% of the IG index and 12% of the HY index have a net zero pledge ("Net Zero Aligned Investing: How Potential Approaches Match Up Across Asset Classes" published June 28, 2021).

APPENDIX 1: KEY TERMS

- **Intergovernmental Panel on Climate Change (IPCC):** This was created in 1988 and currently has 195 member countries. The IPCC provides policymakers with scientific assessments on climate change, implications of climate change, future risks, and how to mitigate the effects. There are three working groups and a task force.
    a. Working Group I: deals with the physical science of climate change
    b. Working Group II: deals with the impacts of climate change, adaption, and our vulnerability
    c. Working Group III: deals with how to mitigate climate change
    d. Task Force: aims to develop a way to calculate and report greenhouse gas emissions and removal

- **Paris Agreement:** This was adopted in 2015 at COP 21 by 195 signatories (194 countries and the European Union), with the goal to limit global warming to below 2°C, and preferably to 1.5°C, above pre-industrial levels (i.e., 1850-1900). The Paris Agreement works in five-year increments so that every five years, signatory countries must submit increasingly ambitious climate actions. Countries are working together to create a global standard for how companies and countries around the world report on climate issues.

- **Scope 1 Emissions:** Scope 1 emissions cover direct emissions from resources that are owned or controlled by the company. For example, company vehicles would fall into this category.

- **Scope 2 Emissions:** Scope 2 emissions cover indirect emissions from the generation of purchased energy. Examples include purchased electricity, steam, heating and cooling consumed by the company.

- **Scope 3 Emissions:** Scope 3 emissions include all other indirect emissions that occur in a company's value chain, including both upstream and downstream emissions. For asset managers, this tends to primarily be the emissions financed by invested companies.

- **Task Force on Climate-Related Financial Disclosures (TCFD):** This was established by the Financial Stability Board to develop recommendations for more effective climate-related disclosures that would promote more informed investments, credit, and insurance underwriting decisions. TCFD's goal is to enable stakeholders to better understand the concentration of carbon-related assets in the financial sector and the financial system's exposure to climate-related risks. TCFD makes high-level recommendations for disclosure but does not mandate specific standards or metrics; in practice, companies can report using metrics defined by existing standards that are aligned with TCFD (e.g., GRI, CDP, SASB).

APPENDIX 2: GFANZ MEMBER ORGANIZATIONS

- **Net Zero Asset Managers (NZAM):** The Net Zero Asset Managers initiative is an international group of asset managers committed to supporting the goal of net zero greenhouse gas emissions by 2050. It aims to provide asset managers access to best practices, to approaches that are both robust and science-based, to standardized methodologies, and to improved data.

- **Net-Zero Banking Alliance:** The Net-Zero Banking Alliance works to reinforce, accelerate, and support the implementation of decarbonization strategies, providing an internationally coherent framework and guidelines in which to operate, supported by peer learning from pioneering banks.

- **Paris Aligned Investment Initiative:** The Paris Aligned Investment Initiative (PAII) is a collaborative investor-led global forum enabling investors to align their portfolios and activities to the goals of the Paris Agreement.

- **Net-Zero Insurance Alliance:** This organization brings together insurers and reinsurers who are committed to individually transitioning their underwriting portfolios to net zero greenhouse gas emissions by 2050.

- **Net Zero Financial Service Providers Alliance:** The NZFSPA brings together investment advisors, rating agencies, auditors, exchanges, index providers, ESG research and data providers, and proxy research providers. Members have committed to aligning all relevant services and products to achieving net zero greenhouse gas emissions by 2050, or sooner, and will develop a target-setting framework for how the services and products they offer will transform over time to support the transition to a net zero global economy.

- **Net Zero Investment Consultants Initiative:** The Net Zero Investment Consultants Initiative sets out nine actions that investment consultants will take to support the goal of global net zero greenhouse gas emissions by 2050 or sooner, in the context of legal and fiduciary duties and specific client mandates. The first action is integrating advice on net zero alignment into investment consulting services.

- **Net-Zero Asset Owner Alliance (the Alliance):** The Alliance is an international group of institutional investors delivering on a commitment to transition their investment portfolios to net zero greenhouse gas emissions by 2050.

APPENDIX 3: NZAM MEMBER ORGANIZATIONS

Asia Investment Group on Climate Change (AIGCC): This is an Asia-based body focused on raising awareness and encouraging action among Asia's asset owners and financial institutions. AIGCC provides investors with a forum to share best practices and collaborate on investment opportunities associated with climate change and low carbon investing.

CDP (formerly the Carbon Disclosure Project): This is a global non-profit that provides disclosure system for environmental reporting. The data is used by investors, companies, and governments to manage their environmental impacts.

Ceres: This is a US-based organization for North American investors, companies, and nonprofits to advance sustainable investment practices, engage with corporate leaders, and advocate for key policy and regulatory solutions to accelerate the transition to a net zero emissions economy.

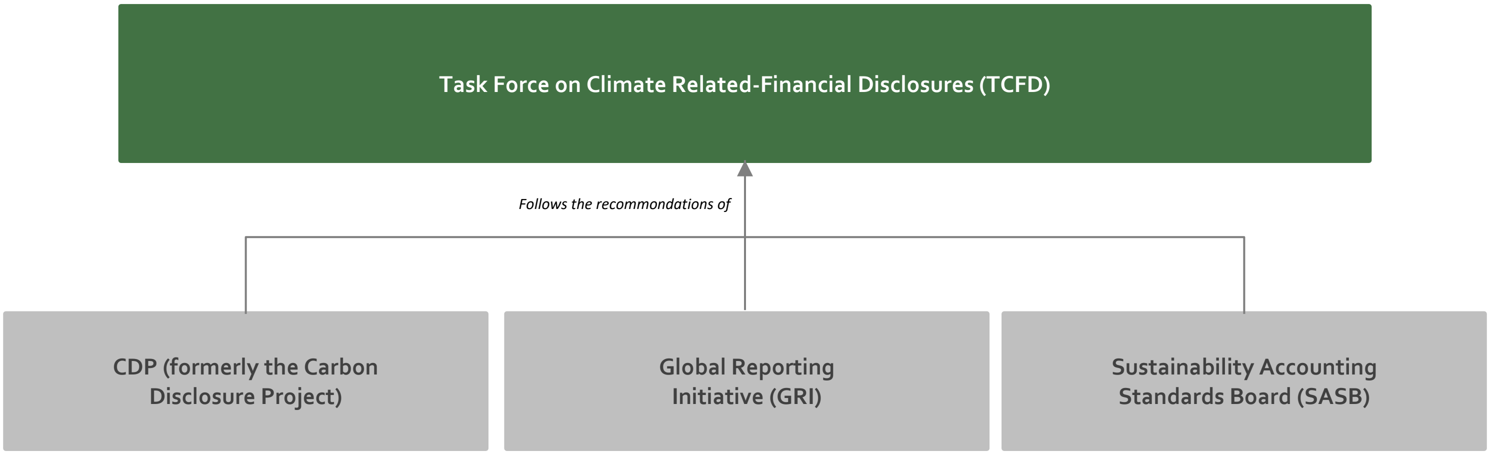
Institutional Investors Group on Climate Change (IIGCC): This is the European body for investor collaboration on climate change. There are over 360 investor members, representing €50 trillion+ in assets. The group works with investors and policymakers to define best investment practices required to address climate change, in alignment with the goals of the Paris Agreement.

Investor Group on Climate Change (IGCC): This is an organization of Australian and New Zealand investors focused on the impact of climate change on investments.

Principles for Responsible Investment (PRI): This is an UN-supported network of investors that are working to promote sustainable investment through the incorporation of environmental, social, and governance factors in investment and ownership decisions.

APPENDIX 4: REPORTING FRAMEWORKS AND STANDARDS

There are many organizations that are focused on developing frameworks and standards for managing climate risk; several standard-setting organizations build on the recommendations by the TCFD, which has developed a high-level framework to help companies disclosed climate-related risks and opportunities.



Source: TCFD.

- **CDP (formerly the Carbon Disclosure Project**): This is a global non-profit that provides a disclosure system for environmental reporting. The data is used by investors, companies, and governments to manage their environmental impacts.

- **Global Reporting Initiative (GRI):** The Global Reporting Initiative is an independent organization that sets standards for sustainability reporting on economic, environmental, and social impacts.

- **Sustainability Accounting Standards Board (SASB):** SASB Standards identify the subset of environmental, social, and governance issues most relevant to financial performance in each of 77 industries.

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