Investing in a net zero future:

how we manage climate risk while maximising transition-related opportunity

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During his speech at COP26 on 3 November 2021, UK Chancellor of the Exchequer Rishi Sunak declared the need to "rewire the entire global financial system for Net Zero".[1] To this end, he announced the UK's intention to become the world's first 'Net Zero Aligned Financial Centre'.

The Chancellor's comments followed the publication by HM Treasury in October 2021 of *Greening Finance: A Roadmap to Sustainable Investing*[2], which sets out the UK Government's long-term ambition to green the financial system. Moving beyond promises and intentions, this would make it mandatory for firms to publish a clear, deliverable plan for how they will decarbonise and transition to Net Zero. Ultimately, the aim is to make private finance's role in addressing climate change explicit and align it directly with the UK Government's ambitious net zero commitments.

Of course, as professionals, as voters and as private citizens, we are all responsible for helping to ensure a sustainable future. However, as investors we have a duty to align that role with another, equally important responsibility: delivering strong returns for our clients. To do that, it's vital we, the Global Equities team, analyse and measure both how climate change risk can negatively affect investments and how the shift to a low-carbon economy creates valuable investment opportunities. Armed with that information, we are then able to maximise returns for clients while managing and addressing potential climate impact effectively.

Considering both relative and absolute returns

Meeting our clients' expectations is the primary lens through which our investment approach is focused. Our investment process enables us to tailor the investable universe and portfolio constraints to the specific needs of clients. As climate considerations continue to evolve, the risks and opportunities involved are becoming more meaningful across geographies and industries. As our clients seek sustainable returns, climate risk becomes an important consideration. Most clients seek outperformance relative to an industry or market-weighted index, so a lot of our frameworks are tied to relative performance and analysis. However, we acknowledge that clients also view returns from an absolute perspective. We therefore give consideration in product creation and delivery to both relative and absolute parameters.

Assessing risk: The Task Force on Climate-related Financial Disclosures (TCFD) framework

The detail behind the Chancellor's announcement makes reporting aligned with the standards set by the Task Force on Climate-related Financial Disclosures (TCFD) mandatory for businesses across the UK economy by 2025.[3]

The TCFD was created by the Financial Stability Board; its purpose is to help stakeholders better understand the financial system's exposure to climate-related risk. For investors, the TCFD framework enables more informed investment decisions by improving the transparency and consistency of climate-related reporting by companies.

The framework divides climate-related disclosures into four interlinked thematic areas that represent core elements of how organisations operate: governance, strategy, risk management and, metrics and targets.

Figure 1: TCFD framework thematic areas

These four thematic areas provide an effective framework for us to set out how we integrate the assessment and management of climate-related risk and opportunity into our investment process. The framework is applicable across sectors and jurisdictions.

[1] "COP26 Finance Day speech" by Rishi Sunak, UK Chancellor of the Exchequer, published by GOV.UK as at 3 November 2021. https://www.gov.uk/government/speeches/cop26-finance-day-speech

[2] "Greening Finance: A Roadmap to Sustainable Investing," published by HM Treasury on GOV.UK as at 18 October 2021. https://www.gov.uk/government/publications/greening-finance-a-roadmap-to-sustainable-investing

[3] "Chancellor sets out ambition for future of UK financial services," Published by HM Treasury on GOV.UK as at 9 November 2021. https://www.gov.uk/government/news/chancellor-sets-out-ambition-for-future-of-uk-financial-services

Figure 2: Timeline of climate (ESG) journey

Montreal Pledge[4]: formalising annual carbon disclosures by investors; launched on 25 September 2014

Paris Agreement[5]: 196 countries set commitments to limit global warming to well below 2° C; adopted 12 December 2015

Launch of Federated Hermes Global Equity Low Carbon strategy: Going beyond the environmental considerations in the Federated Hermes Global Equity ESG strategy to explicitly limit carbon exposure; launched April 2016

TCFD recommendations[6]: Framework for reporting climate metrics aligned to financial disclosures; published 15 June 2017

Updated International Energy Agency (IEA) World Energy Outlook 2020 scenarios[7]: Includes the new Net Zero Emissions by 2050 Scenario (NZE), building on the Sustainable Development Scenario (SDS); published 13 October 2020

Intergovernmental Panel on Climate Change (IPCC) special report on global warming[8]: An assessment of available scientific, technical and socio-economic literature relevant to global warming; published 9 August 2021

EU Taxonomy Regulation[9]: Mandates company reporting revenue and capex for green projects using sector specific criteria; entered into force 12 July 2020

Risk management

Of the four thematic areas in the TCFD framework, risk is critical from an investment perspective. It is therefore a significant focus, both in terms of our internal investment process and in our engagement and stewardship work as a business.

Our firmwide reference document *Climate change expectations for investee companies*[10] creates a clear and concise framework of six proactive measures we expect the companies we invest in to undertake. This acts as a useful blueprint both in our interactions with clients and in our own actions.

The document also sets out expectations regarding governance, scenario analysis, supply chain risk, building consensus, and metrics and targets. We also support and encourage asset-level reporting of impacts by companies.

Internally, our firmwide commitment to responsible investing and our approach to integrating ESG is explicitly laid out in our Responsible Investing Policy[11], as well as our Sustainability Risks Policy[12]. This is backed up by our commitment to the UN's six Principles for Responsible Investment[13].

As a team, we have also worked with leading groups on integrating climate considerations into our investments at the corporate, portfolio and stock level. These include the Science-based Targets initiative (SBTi)[14], the Transition Pathway Initiative (TPI)[15] and the Institutional Investors Group on Climate Change (IIGCC)[16].

[4] For more information visit https://www.unpri.org/montreal-pledge

[5] For more information visit https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement

[6] For more information visit https://www.fsb-tcfd.org/about/

[7] For more information visit https://www.iea.org/reports/world-energy-model

[8] For more information visit https://www.ipcc.ch/sr15/

[9] For more information visit https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en

[10] For more information visit https://www.hermes-investment.com/uki/wp-content/uploads/2021/05/fhi-responsibility-office-climate-change-expectations-1120.pdf

[11] For the full policy visit https://www.federatedinvestors.com/policies/responsible-investing-policy.do

[12] For the full policy visit https://www.hermes-investment.com/ukw/wp-content/uploads/2021/03/ifh-corporate-sustainability-risks-policy-03-2021.pdf

[13] For more information visit https://www.unpri.org

[14] For more information visit https://sciencebasedtargets.org

[15] For more information visit https://www.transitionpathwayinitiative.org

[16] For more information visit https://www.iigcc.org

Integration of climate considerations

The risks and opportunities from climate change can be broadly categorised as either:

- **Transition risks:** business-related risks stemming from the shift towards a decarbonised, net-zero economy
- **Physical risks:** risks arising from the impact of changes in weather and climate on economies, industries and individual businesses

Transition risk – management quality

Alongside our engagement arm, EOS at Federated Hermes (EOS), we use the TPI framework[17] to assess and score the management quality of companies in relation to transition risk, integrating this score into our voting policy.

Businesses are placed on one of five levels:

Level 0: Unaware of (or not acknowledging) climate change as a business issue

Level 1: Acknowledging climate change as a business issue

Level 2: Building capacity

Level 3: Integrated into operational decision making

Level 4: Strategic assessment

Transition risk – carbon performance

As a team, we use 2° Investing Initiative (2DII)'s Paris Agreement Capital Transition Assessment (PACTA) scenario tool to analyse the alignment of our portfolios with various climate scenarios. At the same time, we consider whether companies have set rigorous science-based targets (SBTs) for emissions reduction, and we road test these to examine whether they are achievable. Our analysis goes beyond direct Scope 1 and 2 emissions[18] created by companies to consider the Scope 3 emissions[19] contributed throughout the supply chain.

We also consider stranded asset risk, that is, the possibility of existing assets suffering from write-downs, devaluations, or conversion to liabilities due to the climate transition. And we take into account the need to ensure a just transition – one that secures the rights and livelihoods of workers as economies shift to a more sustainable model.

Some of the elements we need to consider are 'business as usual' for us as active investors: these include assessing commodity cycles, new technology trends, demand and supply of energy, changing consumer preferences, extreme weather events and policy changes. Others are specific to the evolving investment environment, such as the identification and assessment of sectors as climate-critical, hard-to-abate or transition-enabling. Our proprietary metrics and tools, including the QESG Score and the ESG Dashboard, are crucial in enabling us to measure and monitor these aspects as part of our investment decision making (see the Metrics and Targets section later in this edition of Equitorial).

Physical risk

As well as risks created by the shift to a net zero economy, it is important to consider how the physical effects of climate change can affect companies. These can include the direct impact of extreme weather events on company assets and operational sites, impact on revenue, the effect of changing commodity prices, concentration of risks and the potential impact on supply chains and relationships. This is becoming increasingly important for companies in the medium- and long-term. We approach physical risk initially using a sectoral lens, followed by a geographic lens, to identify materiality for companies.

An evolving process – focusing on decarbonisation, climate resilience and inclusive growth

Understanding around climate change is constantly evolving, so we are constantly adapting, finessing and augmenting our approach as new information becomes available. Education and access to new data is an ongoing process. Data quality has been improving and regulations are coming that will improve transparency. However, balancing the joint goals of investing for a better climate and delivering strong returns is an experimental and iterative process that requires a pragmatic approach differentiated by industry.

Using climate scenarios and sectoral decarbonisation pathways helps us assess resilience, both for sectors as a whole and for individual companies. We aim to avoid fully excluding any sector (unless a client requires this). However, it is important to use all the tools at our disposal to identify outliers and engage with them on specific issues of concern, especially laggards in a given sector.

Supporting a just transition is also important; this is a focus for the EOS team as part of their climate engagements with companies, as well as part of the Climate Action Benchmark framework (referenced later).

[17] For more information visit https://www.transitionpathwayinitiative.org

[18] Scope 1, 2 and 3 emissions as defined by the Greenhouse Gas (GHG) Protocol. For more information visit https://ghgprotocol.org

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Governance and strategy

Governance

Federated Hermes' focus on governance is both internally and externally facing. Our investment approach includes consideration of good governance at every step in the investment chain, from idea generation, through portfolio construction, to risk management and reporting.

In terms of internal governance, The Federated Hermes Pledge[20], established in 2015, compels us to be ethical, responsible, client-centric, respectful, collaborative, and transparent in everything we do. Though voluntary, it has been signed by 99% of employees at the international business of Federated Hermes. As shareholders, we vote in line with the Principles for Responsible Investment, and we publish detailed annual and semi-annual Shareholder Reports for our funds explaining our actions.

Since 2014, our Responsibility Office has acted as an independent check on the activity of our investment teams, ensuring that ESG performance is integrated into investment decisions. At the same time, our Remuneration Policy[21] is designed to directly promote responsible investing behaviour and a long-term focus which serves the best interests of our clients.

Strategy

To enhance collaboration across the business, we at Federated Hermes created an internal Climate Change Working Group. This includes staff from investment management in public and private markets as well as representatives from the engagement, strategic and investment risk and business development departments. The Group is tasked with the development of an enhanced climate change strategy, and Net Zero Statement and policy.

Externally, we are members of multiple organisations aimed at ensuring an aligned approach and enhancing pressure on investee companies to act. These include the Net Zero Asset Managers initiative[22], the Institutional Investors Group on Climate Change[23] (IIGCC) – a European organisation whose members are responsible for assets under management worth 50 trillion euros – and the global investor-led initiative Climate Action 100+[24].

At the portfolio level, and as a team, we continue to advocate for integration via a four-pronged approach. The extent of this approach depends upon the strategy and the intended outcomes.

Figure 3: AVOID – RE-WEIGHT – SUPPORT – ENGAGE

Avoid companies that are unable or unwilling to mitigate contributions to the threat of climate change

Re-weight portfolio, favouring companies that are focusing on climate change management

Support a low-carbon transition: allocate capital towards lower carbon intensive assets

Engage with companies and support efforts to limit climate change through public policy

Metrics and targets

We, as a team, use a wide and ever-growing range of data to support our investment decisions. These include:

- **Carbon footprinting** (available to institutional clients since 2012)
- **Science-based targets** from the SBTi (providing clearly defined pathways to emissions reduction)
- **TPI data** (showing how companies are adapting their strategies)
- Calculation of **'green' versus 'brown' revenues** (i.e., revenue from clean versus polluting sources)
- Evidence from **engagement case studies**
- **Use of proprietary QESG scores[25]** in stock selection
- Factoring **cost of carbon** into decision making
- Our proprietary **ESG Dashboard** (including data quality, relative metrics, qualitative assessment)
- Our **Portfolio Monitor** (highlights best and worst performers, compliance with international norms, exposure to controversial activities e.g., spills, litigation; exposure to high-risk areas)

When assessing the emissions intensity of individual stocks, it is important to consider performance relative to sector benchmarks as well as the underlying business models. Emissions intensity in some sectors such as steelmaking will be considerably above average, yet companies may currently have little opportunity to reduce these emissions. For a sector such as autos, emissions are currently high but declining. In contrast, others such as financials will by default be lower than average. The emissions focus, will depend on the sector and will be driven by the split in percentage contribution from scope 1 and 2 emissions, as a percentage of total emissions (see Figure 4).

[20] For the full Pledge visit https://www.hermes-investment.com/uki/our-pledge/

[21] For our full Remuneration Policy visit https://www.hermes-investment.com/uki/remuneration-policy/

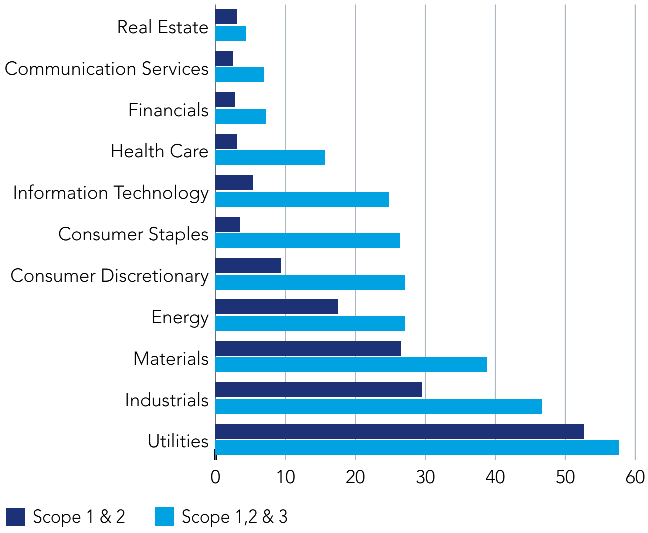
[22] For more information visit https://www.netzeroassetmanagers.org

[23] For more information visit https://www.iigcc.org

[24] For more information visit https://www.climateaction100.org

[25] Our proprietary QESG scores combine specialist ESG research from external bodies including Sustainalytics, MSCI, Bloomberg, the Carbon Disclosure Project, WRI and Trucost with fundamental insights gained through direct engagement by our stewardship team, EOS at Federated Hermes.

Figure 4: benchmark Scope 1&2, and Scope 1,2 & 3 emissions intensity by sector



Source: Federated Hermes, Trucost as at 30 November 2021.

As we have already mentioned, data is constantly improving in terms of both quality and quantity. However, information on energy mix data and indirect Scope 3 emissions throughout the supply chain continues to be scarce. This can make it difficult to set credible targets for Scope 2 and 3 emissions targets and the trajectory of company emissions can be as important as the absolute emissions.

Our net zero commitment

As a firm, we have signed up to the Net Zero Asset Managers Initiative. We will be releasing our targets for 2030 and other time periods during 2022, with net zero to be achieved by 2050 at the latest.

At the firm-level, we are using the SBTi and Trucost information to determine alignment in the first instance and plan to further refine this approach. We will engage with companies to achieve these aims, and will report on progress annually as well as reviewing these targets regularly.

A note on tracking error

As a team, we believe the climate transition represents a significant market risk/opportunity which is not currently fully represented in asset prices. Aligning portfolios with the goal of net zero is therefore expected to create dispersion in returns relative to traditional market benchmarks.

Through our proprietary risk systems, we can estimate how much of the portfolio's tracking error we are spending on an exposure to carbon leaders relative to carbon laggards, providing clients with increased transparency over the expected behaviour of their investments. Based on recent market conditions, investors who currently exclude the Energy sector from the MSCI World index, for example, can attribute around 1% tracking error to this divestment decision. Understanding how this risk evolves, and any unintended biases or exposures of these decisions, will be crucial for asset owners seeking to better align with the goal of net zero.

Our strategies are run against traditional market benchmarks rather than ESG or carbon-constrained benchmarks. This is our current favoured approach due to the backward-looking, rigid approach required to construct alternative benchmarks; third-party benchmarks do not currently allow for forward-looking engagement insights to be embedded in their construction. We do, however manage and report against custom benchmarks as agreed with clients, and our systems support analysis to describe the triple impact from a performance, sustainability and a risk viewpoint.

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Addressing the emissions targets challenge

We believe that companies who better manage their exposure to physical and transition risks will outperform their peers over the long-term. Achieving the goal of net zero is therefore a necessary component of our fiduciary duty to maximise returns. Our portfolios will be positively tilted towards companies which are better at managing the material environmental risk in their business. Our expectation is that through this climate focus, our portfolios will maintain a lower carbon exposure than the benchmark.

As a team, we will urge the companies in which we invest to set out plans towards achieving net zero, and encourage greater transparency on other environmental risks where relevant. As well as measuring current positioning for simplicity and transparency, we will evaluate the forward-looking alignment of companies in terms of implied temperature rise. We will continue to deepen our research and data-led approach in this area.

However, we acknowledge that companies and sectors will decarbonise at different rates. Indeed, there may be companies which cannot align with net zero. This raises questions: for example, if a company diverges from the net-zero aligned decarbonisation path for its sector, how far, and for how long, can we tolerate this? Similarly, should we prioritise percentage reduction, or are absolute levels of emissions more important? The engagement outcomes generated, catalysing real-world impact through emission reductions, are a primary imperative.

We recognise that both issues and scenarios will evolve over time. Experimentation and iteration are to be expected and indeed to be welcomed. We will incorporate enhancements on an ongoing basis, for example rules on capex plans for companies. To this end, we have consulted with data providers and clients to learn from and facilitate emerging best practise in this area.

Addressing net zero is complex, and involves the broader but intertwined issues of resource sustainability and protection of the natural environment. However, we must not shy away from the issue: it is vital to act now to accelerate the transition by keeping a sharp focus on achieving emissions reductions aligned with net zero. Collaboration with all stakeholders, including clients, companies and regulators, will be essential to success.

Annex 1 – Core Elements of a Net Zero Transition Plan

Consistent with the Climate Action 100+ Benchmarking Disclosure Framework and Net Zero Investment Framework, the table outlines key components of a Net Zero transition plan and the most important data points.

Net Zero Transition Plan Component	Critical data points (simplified)
Ambition*	• A clear ambition to achieve Net Zero emissions across all relevant scopes of greenhouse gas (GHG) emissions
Short-, Medium- and Long-Term Targets*	• Targets stated on a short-, medium- and long-term basis covering scope 1-3 (as relevant) and consistent with the pathway required to achieving Net Zero by 2050 and halving emissions by 2030
Target delivery strategy (decarbonisation approach) *	• A clear explanation of the decarbonisation levers that will be used to deliver the targets with limited use of carbon offsetting
Capital allocation planning*	• A methodology for demonstrating that capital expenditure is consistent with Net Zero including, as relevant, phase out of fossil fuel use and production
Climate Governance & lobbying	• Alignment of remuneration with the plan • Confirmation of alignment of public policy activities with the plan
Just Transition	• Evaluation and management of the impact of the transition on workforces and communities
Disclosures, Financial Statements and Audit Report	• Commitment to and delivery of TCFD Reporting • Integration of climate risk in the development of the financial statement • Consideration of climate risk in the audit report
Emissions reporting*	• Clear reporting of emissions and on progress towards targets

* Items are identified as 'core' within the Net Zero Investment Framework

As defined by the Net Zero Investment Framework: https://www.parisalignedinvestment.org/media/2021/03/PAII-Net-Zero-Investment-Framework_Implementation-Guide.pdf

Additional references:

Climate Financial Risk Forum Guide 2021 - Case Studies (fca.org.uk)

PAT_Measuring_Portfolio_Alignment_Technical_Considerations.pdf (tcfdhub.org)

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