WHITE PAPER

How ‘core’ equity strategies can meaningfully contribute to the climate transition

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Successfully navigating carbon reduction within Your Future, Your Super

Australian equity strategies play a significant role in investors’ portfolios. ‘Core[1]’ equity strategies typically have low tracking error relative to the benchmark, so there is a common perception that they are unable to contribute to investors’ efforts to decarbonise their investment portfolios without taking on significant tracking error risk, particularly within the construct of the ASX listed equity benchmarks.

This perception is reinforced by the need for investment managers to generate performance in line with the *Your Future, Your Super* (YFYS) benchmarks. This constrains how managers can implement investment approaches to reduce carbon exposure.

We believe there are several ways in which core strategies can simultaneously satisfy YFYS requirements and have a role in decarbonisation and the transition to net zero:

- **Engagement:** Some managers - like IFM Investors - can use the size of their positions in the market to actively engage with companies directly, collaboratively and through voting rights to advocate for climate related change.
- **Allocation:** Investors can work closely with managers to develop tailored investment solutions in which core type tracking error budgets are utilised to reduce exposure to carbon intensive companies and channel capital into companies that can benefit from the energy transition.

When implemented well, we believe these approaches to portfolio decarbonisation can be consistent with strategies that also have sufficiently low active risk so as to alleviate downside risks against *Your Future, Your Super* benchmark outcomes.

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[1] In this article ‘core’ strategies refer to listed equity strategies which share the defining characteristic of having a sufficiently low tracking error as to make them a possible investment solution for the bulk of an investor’s equity allocation where that investor may have some overall risk limits, such as those stemming from the Your Future, Your Super requirements. Some examples may include low-risk Active, low-risk Quantitative, Enhanced Index, or Indexing strategies. Investors often adopt a so-called ‘core-satellite’ approach where the bulk of their funds are invested in any one or combination of low tracking error core type investments with the objective of achieving their beta, and smaller allocations in riskier strategies with the objective of achieving their alpha.

The power of engagement

Whilst some types of core equity strategies, such as indexing, are not able to fully divest from high emissions companies in their relevant benchmarks, some of them are able to advocate for change by leveraging their powerful platform for engagement. This is particularly true of IFM Investors as the sheer size of our index Australian Equities funds under management – over A$32 billion[2] - gives us the ability to actively engage with and influence companies with the aim of increasing corporate accountability and influencing decisions on climate-related issues.

We engage with companies to understand and evaluate their climate transition action plans. These include, among other things, net zero commitments, scenario analysis, emission reduction targets, and actions to decarbonise their businesses.

Engagement is particularly important to IFM as our preference is to encourage businesses to contribute positively to the transition to a net zero economy, rather than divesting or excluding due to their high emissions intensity or lack of appropriate progress.

Where we identify a company that has a transition pathway, we seek to measure and assess their progress and hold them to account with regards to the commitments they are making.

IFM's engagement in action

Our engagement with companies broadly centres around the adoption, execution and governance of a climate transition plan that is aligned with a net zero economy.

Our climate change engagement covers companies across our portfolio, with some priority given to the largest emitters. The CA100+ Net Zero Benchmark provides us with a useful guide for measuring progress.

We engage with companies both directly and collaboratively with Australian Council of Superannuation members, as well as through our involvement in the Climate Action 100+ (CA100+) initiative. Key engagement topics include setting credible emissions reduction targets; establishing robust governance structures that support climate risk management; disclosing climate change risks publicly using the Taskforce on Climate-related Financial Disclosures framework (TCFD); establishing links between targets and executive remuneration; and giving shareholders a 'say on climate', that is, a non-binding advisory vote on company activity and disclosure relating to climate change.

We also engage with banks and insurers to understand the level of funding and underwriting to fossil fuels producers, assets and projects, as well as various other stakeholders such as NGO's that propose climate related shareholder resolutions. We also participate in industry initiatives that we are members of such as the Investor Group on Climate Change (IGCC) and the Institutional Investors Group on Climate Change (IIGCC).

The other advantage of our broad-based engagement with companies is that it increases our knowledge and understanding of the climate risks and opportunities that currently exist, as well as new developments within the market. This helps us to stay informed and better assess how companies are progressing in their climate transition journeys.

CASE STUDY

Climate Action 100+

IFM is a supporting investor of the Climate Action (CA) 100+ initiative, the world's largest-ever investor engagement initiative on climate change. Over 2021, we supported engagement with four of the fourteen Australian target companies and we have increased this to six companies in 2022.

In 2021, Climate Action 100+ investor signatories continued to push for harder, faster climate action from focus companies and secured numerous commitments around setting net zero targets, improving climate lobbying disclosure and developing decarbonisation strategies. Two of the companies IFM supports engagement on made significant commitments in 2021:

- **BlueScope,** announced a commitment to net zero emissions by 2050 and an initial capital allocation of US$50m over five years to support mid- and long-term climate ambitions, while exploring renewable hydrogen and options for low-emissions steelmaking.
- **Rio Tinto,** the world's second-largest metals and mining corporation, has more than tripled its medium-term 2030 target, setting a new target to reduce absolute Scope 1 and 2 emissions by 50% by 2030.

Source: 2021 Year in Review: A Progress Update (Climate Action 100+) and IFM Investors

[2] As at 30 April 2022

FIGURE 01 IFM'S FY21 ENGAGEMENT AND VOTING SUMMARY

FY21 Australian Listed Equities Engagement & Voting Summary

We believe actively engaging with companies and exercising our voting rights are critical to advancing responsible investment considerations across the broader corporate and financial sectors and that they help to enhance long-term investment value and returns.

228 company meetings

1416 resolutions

9% of votes were against management

- Director elections **32%**
- Executive Remuneration **28%**
- Remuneration Reports **34%**
- Other* **6%**

*'Other' includes resolutions regarding shareholder proposals relating to cultural heritage, industry associations, board spills, indemnification of board directors and related party transactions.

Source: IFM Investors

Exercising our voting rights

Actively exercising our voting rights is also critical to encouraging decarbonisation. We vote on all companies we invest in, with our voting being informed by our engagement with companies as well as internal and externally sourced research.

We have a climate engagement and escalation approach that guides us to vote against certain resolutions, such as director re-elections or remuneration reports, if we feel that a company is not progressing its transition initiatives at a pace that we are satisfied with, or if we feel that there is insufficient recognition of the climate risks facing a firm.

We assess climate change-related shareholder resolutions on a case-by-case basis, with consideration given to the strategic-level recognition of climate risk; maturity of plans in place to manage climate-related risks and opportunities; existence of long-term targets and goals; climate change disclosure and adoption of TCFD recommendations; climate-related lobbying activity; and the overall environment in which the company is operating.

We believe that if companies are managing these issues well, then they are effectively managing their climate-related risks and opportunities. In cases where we are not convinced that a company is responding appropriately, we would generally support a resolution if it promoted positive change.

The exercise of our voting rights is a key pillar of our active ownership approach in all our equity strategies. It is also a core element of how we can help shape companies' climate change behaviour.

Targeted use of tracking error budgets

Another way in which core strategies can contribute to decarbonisation is through targeted use of their modest tracking error budgets. This enables portfolios to be designed so that they have sufficiently low active risk to be suitable for an investor's core allocation, whilst also having the ability to materially lower measures of carbon intensity.

Lowering the carbon intensity of such a portfolio is done in two ways:

- underweight positions in high carbon intensity sectors and companies with the aim of reducing the portfolio's direct carbon exposure
- overweight positions in clean economy companies that have low/no carbon exposure and are positively contributing to the net zero transition.

These underweight and overweight positions are also designed together to take account of stock volatilities and correlations, enabling the minimisation of the overall portfolio tracking error for a given level of carbon reduction.

CASE STUDY

BHP gives investors a 'Say on Climate'

In 2021, BHP released its updated Climate Action Plan which included Scope 3 reduction targets on direct supplier emissions and the emissions from the shipping of its products. Following the release of the Plan, BHP also announced that it would include an advisory "Say on Climate' resolution at the 2021 AGM, making it the first Australian company to do so.

IFM representatives met with the company regarding the announcement of the Plan, ahead of the "Say on Climate" resolution. We provided positive feedback to the company for setting these targets, and we also communicated our preference for an annual "Say on Climate" vote as opposed to their proposed 3-year voting cycle. While there has been progress, we do anticipate BHP continuing to address the challenge of Scope 3 emissions in particular as a result of their iron ore operations.

We voted in favour of the resolution which received 84% support at the Australian AGM.

In 2020, we published an analysis of the potential to lower carbon exposure across global and Australian markets using tracking error budgets within a systematic, low active risk approach[3]. The results of this analysis are presented in Figure 2 which shows estimates of the degree to which a portfolio's carbon intensity can be lowered for each level of tracking error. This analysis suggests that it is possible to obtain a meaningful reduction in carbon exposure by actively using modest tracking error budgets, particularly in global portfolios.

When implementing this approach, the structure of the overall market is important as it impacts the ease with which a lower carbon level can be achieved in a portfolio. If high intensity stocks are concentrated in just a few sectors – as is the case in Australia – a portfolio is likely to require incrementally higher tracking error (i.e. larger company and/or sector tilts) to achieve a given level of carbon reduction.

This helps explain why a given level of carbon reduction can be achieved with lower tracking error in the global equity market (as measured by MSCI World ex Australia Index) compared to Australia (S&P/ASX100 Index). None the less, it is possible to achieve material carbon reduction in the Australian market for a modest tracking error cost.

Interestingly, whilst the Australian share market's concentration makes the management of tracking error risk a bit harder, it may actually result in more targeted engagement as there are a smaller number of major emitters that need to implement significant emissions reduction plans.

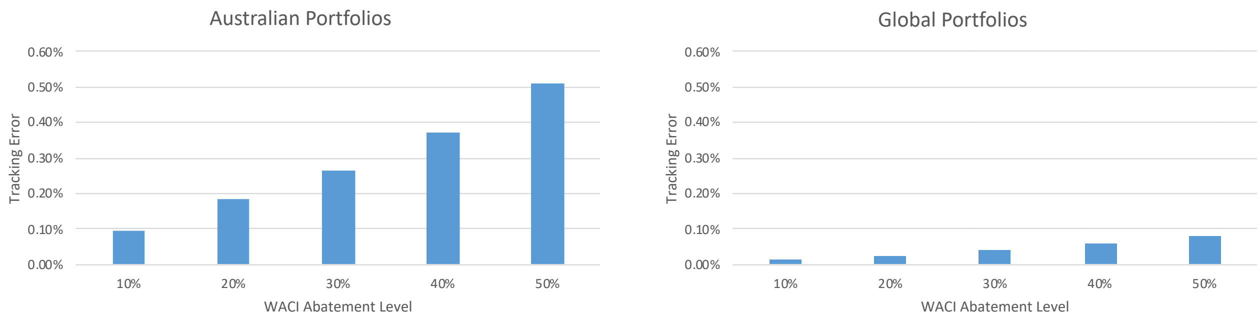
Meeting the challenge

The need to decarbonise portfolios within the requirements of the *Your Future, Your Super* benchmark framework presents a clear challenge for investors that hold low tracking error, core Australian equities exposure. Taking a strict index approach does nothing to assist with the transition to net zero, whilst straying too far from the benchmark risks YFYS underperformance.

We believe a solution lies in the use of systematic low active risk strategies that employ a combination of active corporate engagement and targeted use of modest tracking error budgets to achieve a meaningful reduction in carbon exposure.

Our experience managing low carbon portfolios for the past 10 years suggests that it is possible to successfully implement these systematic low active risk, carbon exposure lowering strategies in pooled and separately managed investment vehicle structures that also meet the *Your Super, Your Future* requirements.

FIGURE 02 CARBON REDUCTION LEVELS AND TRACKING ERROR



Source: IFM Investors, June 2020

[3] A full account of this analysis and the underlying assumptions are presented a previous IFM white paper titled "Low carbon portfolios" (Dec 2020) which may be available on request.

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