# The Frontier Line

## Active ownership's role in decarbonisation

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# About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on around $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Our purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.


## Simone Gavin

Senior Consultant

Simone Gavin re-joined Frontier Advisors in May 2020 as a Senior Consultant and is a member of the Equities team. Simone previously worked at Lonsec for seven years where she was responsible for undertaking manager research in global and domestic equities, with lead analyst responsibilities for global equities and emerging market equities.

Prior to Lonsec, Simone spent five years at Standard & Poor's where she also undertook manager research in global and domestic equities and had lead analyst responsibilities for listed infrastructure and emerging market equities. Simone previously worked with Frontier as an analyst for two years until November 2007. Simone holds a Bachelor of Chemical Engineering (hons) and Commerce from The University of Melbourne.


## Marie Cardaci

Senior Consultant

Marie joined Frontier Advisors in 2017, having previously worked within Finance Operations at the University of Melbourne, and Taxation Services at Deloitte. During her studies, Marie also worked as a Junior Equity Analyst.

At Frontier, Marie provides consulting advice to a number of clients, and is also a member of Frontier's Responsible Investment Group and Responsible Investment team. Marie holds a Bachelor of Commerce and a Master of Finance, and is a CFA Charterholder.

# Summary

Active ownership, or 'stewardship' in some cases, is the use of influence by institutional investors to maximise overall long-term value. It is playing a major role in the decarbonisation of the real economy and this is expected to continue. Fund managers, who are often delegated the active ownership function by asset owners, are facing increasing expectations on their decarbonisation efforts.

Active ownership allows fund managers to influence company decarbonisation objectives and strategies, as well as progress towards these objectives. If decarbonising the real economy is the main objective, divestment and exclusions should play a limited role given its questionable ability to increase the cost of capital of high-emitters, and the loss of influence over companies that it causes. However, investors need to keep in mind that precisely and quantitatively measuring the value created through active ownership is almost impossible. Therefore, case studies and narratives provide an important avenue for fund managers to illustrate their value add.

Our survey and interviews with Australian and international equities fund managers showed some managers are dedicating significant resources to active ownership activities regarding decarbonisation, including setting tangible objectives and scrutinising company climate transition plans. There are many examples of how these efforts are translating into real world outcomes. Taking a collective approach has the most impact on company action, with groups such as Climate Action 100+ leading the charge, however, there is meaningful change being influenced by one-on-one company engagement too.

The 'just transition' is an area which we would like to see more focus on by fund managers, being a key element of the Paris Agreement and an integral consideration if the global economy is to transition to a low carbon world in an orderly manner.

Chart 1 summarises key signs of an effective decarbonisation-related active ownership approach. Fund managers should be assessed against these expectations and gaps must be addressed.

**Chart 1:** Signs of an effective decarbonisation-related active ownership approach

# How are fund managers using active ownership to support the decarbonisation of the real economy?

In recent years, many asset owners have set or contemplated setting net zero or decarbonisation targets. A global survey by Schroders[1] found 58% of institutional investors had committed to reaching net zero by 2050, or an emissions reduction target, and an additional 25% were exploring transition targets.

With many targets now in place, the focus (and stakeholder scrutiny) is turning to what investors can do to achieve them.

Many companies, particularly the highest emitters, are not doing enough to reduce real world emissions. In its 2022 progress report, Climate Action 100+ (CA100+) reported companies need to rapidly improve their progress on making absolute emission reductions in the real economy[2]. Active ownership will continue to play an integral role in driving these improvements, influencing change at the company, sector and economy levels.

Along with investors, regulators are increasingly aware of the power of active ownership to drive positive outcomes. For example, for the first time in its recently released draft SPG 530 Investment Governance, the Australian Prudential Regulation Authority (APRA) stated it expects regulated investors which engage in active ownership to be able to demonstrate how it contributes to creating value[3].

For many asset owners, their fund managers play a crucial role in their decarbonisation strategies as active ownership activities are delegated. Fund managers invest significant amounts in the market and therefore collectively have a high degree of potential influence on companies which can be captured through active ownership. Fund managers are key participants in the decarbonisation of the real economy and expectations regarding how they use their ownership interests have grown.

Following several years of asset owners' decarbonisation ambitions being in place, and fund managers claiming they are taking action to influence positive change, we sought to understand how fund managers help to achieve a net zero real economy via active ownership.

We surveyed and interviewed fund managers to determine what action is taken on active ownership on the topic of decarbonisation across several dimensions. We wanted to provide asset owners with insights from a mix of fund managers including those we consider currently leading active ownership approaches regarding decarbonisation, as well as those investing in the companies that need to transition. The small subset of managers surveyed are not necessarily those Frontier Advisors rates highly on responsible investment, and we emphasise we could have surveyed many more managers which lead active ownership and invest in companies that are part of decarbonisation. This analysis will help enable asset owners to benchmark their own fund managers relative to these insights and engage them where gaps can be identified. The information collected will also feed into our own ESG assessment of fund managers, and, in the spirit of 'lifting all boats', will be fed back into the fund manager industry with insights into what actions their peers are taking.

[1]Source: Schroders, "Global Sustainability Report". Survey involved 770 respondents including corporate and public pension plans, insurance companies, official institutions, endowments and foundations.

[2]Source: Climate Action 100+, "2022 Progress Update", 2023.

[3]APRA, "Prudential Practice Guide - Draft SPG 530 Investment Governance", 2022.



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# Active ownership and its evolution

## Active ownership can lead to greater long-term value

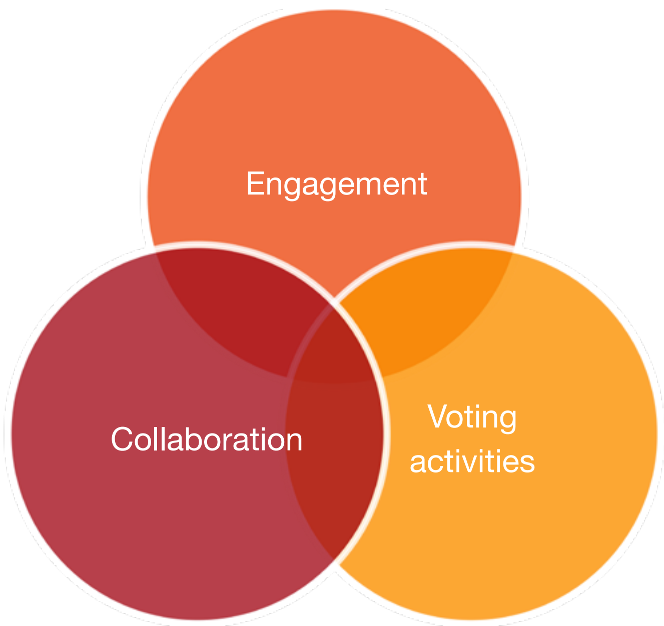
According to the Principles of Responsible Investment (PRI), active ownership is:

"the use of influence by institutional investors to maximise overall long-term value including the value of common economic, social and environmental assets, on which returns and clients' and beneficiaries' interests depend."

The nexus to maximising long-term value is pertinent; active ownership is not about being an 'activist investor' (who typically seek short-term profits), rather, it aims to drive change within companies (and ultimately markets and societies), to achieve better investment outcomes. Within listed equities, active ownership includes company engagement, voting activities and collaborative activities. While we focus on equities in this paper, engagement is also conducted by managers investing in other asset classes including debt and private equity. Active ownership strategies now comprise the second most common responsible investment approach in Australia behind ESG integration, with assets under management using this approach growing the fastest relative to other approaches throughout 2021.[4]

The area of active ownership is evolving. In its Active Ownership 2.0, the PRI proposes a framework which expects a higher standard from asset owners in their active ownership activities. The three elements of the framework include: a focus on outcomes, not inputs or processes; a focus on common goals, i.e. economy-wide or society-wide scale; and collaborative action. This is a change from the more traditional approach where investors tend to focus solely on companies in which they invested, which PRI believes can undermine broader investment, economic and social goals.

**Chart 2:** Three elements of active ownership




An analysis of results from Frontier Advisors' evolved manager ESG assessment framework found that among listed equities managers, fund managers are strong on engagement and voting. However, more needs to be done on collaboration, though manager survey responses and interviews showed a gradual improvement in this area.

[4] Source: Responsible Investment Association of Australasia (RIAA), "Engage, Advocate, Collaborate: Unpacking Stewardship in Australasia in 2022", 2022. Survey of 70 investment managers, asset owners, bank/mutual/credit unions and trusts/foundations.

# Active ownership versus exclusions in the path to decarbonisation

## Active ownership is key to driving real-world emission reductions

In developing their decarbonisation strategies, investors are grappling with the decision to avoid GHG emissions in their portfolios or contribute to the decarbonisation of the real economy. The latter needs to be the priority for long-term investors; a decarbonised real economy will lead to decarbonised and more sustainable portfolios.

### Active ownership versus divestments and exclusions

A portfolio with the objective to decarbonise the real economy will likely look different to one which is focused on avoiding portfolio emissions only. The former may be initially more carbon intensive with an aim to decarbonise high-emitting exposures over time. Active ownership is a key tool investors can use to drive companies and the economy to decarbonise. There have been several high-profile cases of asset owners or managers using their 'seat at the table' to influence companies to decarbonise; we provide numerous manager examples throughout this paper. In contrast, avoiding emissions only may primarily rely on exclusions and divestments. Arguments for undertaking such an approach includes risk management (e.g. reducing stranded asset risk), managing reputational risks, and the ability to increase the cost of capital and reduce stock prices of high-emitting companies, and hence, force action to decarbonise[5]. These reasons are valid (although subject to much debate[6]) and, in some cases, divestment is deemed the only option, such as when a high-emitting company has no means to decarbonise. However, exclusions and divestments can both introduce tracking error into the portfolio, particularly in concentrated markets like Australia, and remove investors' influence on the company. Further, portfolios using this approach in the extreme will benefit less from any financial upside from the transition to a low carbon economy.

### The measurement challenge

Divesting from and excluding high-emitting companies is attractive because it is possible to measure the outcome of such decisions. On the other hand, active ownership activities cannot be precisely measured. For example, you cannot quantitatively measure the value of direct engagement, even if it does lead to the desired outcome. Although the investment outcome is not as easily measured relative to an exclusions approach, there are many examples of investors pressuring companies to decarbonise their operations. While a specific numerical value, such as investment return or emissions reduction, cannot be definitively attributed to these actions, they are undoubtedly having real world impacts which ultimately lead to a more sustainable economy, and therefore portfolios, over time.

### High-emitting companies versus other commonly excluded industries

Climate change and the transition to a low carbon economy is a systemic issue, meaning it cannot be diversified away. It differs from other commonly excluded industries such as tobacco and controversial weapons; there is no 'healthy' alternative for tobacco producers to offer, whereas high-emitting companies can potentially reduce the carbon intensity of their operations. This is likely to enhance the sustainability of their earnings in a carbon constrained world.

Investors are likely to use a combination of responsible investment approaches in their decarbonisation strategies. Overall, while a predominantly exclusionary approach may achieve the portfolio decarbonisation objective, it will likely do little to positively impact real world emission reductions. Active ownership should play a key role if decarbonising the real economy is the investor's main objective.

[5]Source: Martin Rohleder, Marco Wilkens, Jonas Zink, University of Ausberg, "The effects of mutual fund decarbonization on stock prices and carbon emissions", 2021.

[6]Standford Business, Jonathan B. Berk, Jules H. van Binsbergen, "The Impact of Impact Investing", 2021.

# Net zero investment frameworks

Several frameworks and sources are available to institutional investors to join or use as references when developing decarbonisation strategies. Such initiatives are informative for investors and provide guidance on the latest leading practice on achieving targets in investment portfolios.

Several of these initiatives point to the important role active ownership plays as well as that of fund managers from the perspective of asset owners. We outline the guidance provided by several key initiatives below.

### Paris Aligned Investment Initiative (PAII) Net Zero Investment Framework (the Framework)

Under the Framework's 'asset class alignment' element, PAII recommends an investment strategy should prioritise engagement and stewardship, particularly for existing assets, as the primary mechanism to drive alignment of assets to net zero pathways. Within listed equities portfolios, the Framework recommends prioritising engagement based on emissions intensity/exposure. An engagement strategy should be set with clear milestones and escalation, and engagement and voting should be undertaken to improve company performance against metrics in line with strategy. There are certain circumstances where selective divestment is advised, for example because of escalation following engagement.

### Net Zero Asset Owner Alliance (NZAOA)

The NZAOA commitment states that members will seek to reach the net zero commitment "especially through… engaging on, corporate and industry action… for a low carbon transition of economic sectors". It is the NZAOA's "conviction that engagement is an obvious and necessary component to ensure that the global economy, individual sectors and ultimately companies" decarbonise. The Target Setting Protocol mandates members to set engagement targets, all with the common outcome of increasing the percentage of companies that are aligned with the Alliance's corporate net zero expectations. The four identified forms are: corporate engagement; sector and value chain engagement; position paper contribution; and asset manager engagement. The Protocol also sets out guidance for interim engagement targets, as well as certain requests for fund managers, including the following:

- To state the benefits and limitations of their climate engagement program and stewardship activities.
- To describe what levels of influence are applied to each asset class, and how their approach supports decarbonisation objectives.
- To use systematic engagement approaches to streamline engagement efforts.

NZAOA Target Setting Protocol noted "The Alliance sees engagement as potentially the most important mechanism asset owners must contribute to a net-zero transformation … One of the most important and impactful engagement opportunities asset owners have is engaging asset managers to support greater climate action and 1.5C alignment."

### Net Zero Asset Managers Initiative

One of the commitments of the initiative is to implement a stewardship and engagement strategy, with a clear escalation and voting policy.

# Fund manager survey findings

## Decarbonisation active ownership objectives

### Risk-adjusted returns a major impetus for active ownership efforts on net zero

Setting objectives for active ownership activities helps focus resources and effort and provides reference points against which active ownership outcomes can be measured. We asked fund managers what their active ownership decarbonisation objectives were. Some common themes included:

- Overwhelmingly, fund managers engage in active ownership to enhance risk-return outcomes, by identifying and managing risks and opportunities brought by the transition to a decarbonised economy.
- Fund managers want investee companies to decarbonise and active ownership is viewed as a means to achieve this objective.
- Several fund managers pointed to the importance of having a tailored, company-by-company approach to engagement to ensure individual business strategies and industry association can be incorporated into engagement efforts.
- Several fund managers also identified engagement as an information gathering and educational opportunity.
- Proprietary frameworks are used by some managers to identify the priority companies, highest emitting or areas of most risk, to engage with. Others seek to align their engagement efforts with collective groups like the Climate Action 100+ (CA100+), and some use both to focus their engagement efforts.
  - One manager surveyed is in the process of building an engagement framework. The manager will start with its most material emitters, applying the CA100+ Net Zero Company Benchmark to those companies which are not already included in the CA100+ assessment. The framework will assist the manager in benchmarking the companies, identifying gaps, and determining specific 'asks' for each company for the year ahead.
- Over half of the managers surveyed have signed up to the Net Zero Asset Management Initiative. As part of this, there is a requirement to develop targets for the Net Zero framework including categorising companies as either aligned, aligning and not aligned to help focus where engagement should be targeted.

> "Our ultimate responsibility is to generate long-term value for clients, and we believe the initiative's (Net Zero Asset Managers Initiative "NZAMI") goals are well aligned with our active ownership approach and the expectations we have for companies held in our portfolios."
>
> – Active manager

# Actions taken to influence climate transition plans

## Active ownership is improving transition plans however, company disclosure is a challenge

Once company net zero objectives are set, it is important to see credible transition plans, including strategy and capital expenditure, aligning to these objectives. It has already been noted how challenging it is to quantify fund managers' influence on company strategy, but we hope to provide some anecdotes to demonstrate how active ownership can be effective in driving progress. The following summarises some comments from managers:

- Generally, fund managers' ability to influence is centred around active ownership, including proxy voting and engagement.
- Multiple managers noted like-minded pressures across investor groups (fund managers, asset owners) can be particularly effective.
- Fund managers stated the importance of engaging at multiple levels to have the greatest impact including with investee companies, competitor companies, companies with a role in the value chain in which investee companies operate, and influencers of companies (politicians, regulators, industry bodies).
- The frequency of engagement was also noted as important, i.e. engaging with companies over an extended period at regular intervals.
- Further, having a 'mutual dialogue' with companies where views on ESG topics that represent risks or opportunities are exchanged with a collaborative, long-term mindset (versus the traditional, adversarial style), was observed as being effective in driving positive change on climate change and climate strategy.
- Many managers use proxy voting as an important tool for influencing transition plans and as a catalyst for dialogue on related risks and opportunities.
  - One manager noted it voted almost 100% of its proxies on risks ranging from board structures, board of director elections and executive compensation to environmental and social issues.
  - Another manager added that where it voted against management, it would follow up with a call to explain its reasoning.

> "As part of our assessment of a company's transition plan, strategy and capex allocation are two of the areas that are focused on in analysis."
>
> – Active manager

- Fundamental managers particularly assess financial plans of companies including the amount of capital expenditure being allocated to transition-related projects, forecast allocations, and whether this is clear, disclosed appropriately and aligns with real world decarbonisation.
  - One manager surveyed noted it engages frequently with major emitters about their climate change strategies, and where it detects a gap between what they report and their strategy and capital expenditure, it will raise this as a concern. Any developments can also be reflected in the manager's ESG scoring.
- Company disclosure on climate change strategy and capital expenditure was noted as important to effectively assess transition plans.
  - A specialist manager noted a disclosure campaign with US companies to disclose where their assets are to enable research into geolocation data and physical risk where the focus would move to physical risk by sectors.

> "We will engage with our issuers – both individually and alongside other stakeholders in the marketplace – to encourage them to set climate net zero goals in line with the Science-Based Targets initiative (SBTi) and monitor overall alignment with sectoral decarbonisation pathways."
>
> – Active manager



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# Examples of influence

## Both direct and collective engagement has a part to play

We asked fund managers to highlight specific examples of how they have influenced companies to decarbonise their business. Table 1 includes some examples.

**Table 1:** How fund managers influence companies decarbonise their business

| Passive/active | Company | Sector | Direct/collective | Action |
|---|---|---|---|---|
| Active | Rolls Royce | Consumer discretionary | Collective | Focus on company's efforts to reduce air travel-related climate impacts with a focus on sustainable aviation fuels and alternative propulsion technologies. Engagement group was more positive on the company's small modular nuclear reactor business, however, given the regulatory headwinds for alternative fuels likely to be in place for some time. The small modular reactors will be manufactured in a central facility to reduce time to energy production and higher costs associated with traditional reactor construction. |
| Active | Nestle | Consumer staples | Direct | Discussion with CFO regarding the company's climate impacts, regenerative agriculture investments and methane risks related to its dairy products. Also conducted in-depth discussions with the company and its peers regarding action on scope 3 emission impacts. This gave the manager comfort the company and its peers are taking it seriously and have coordinated action. |
| Active | APA | Utilities | Direct | Actively engaged with the gas infrastructure company that was planning to buy a seemingly overpriced electricity asset in the US, which the manager deemed value-destroying. |
| Active | BlueScope Steel | Materials | Direct | Engagement to encourage commitments on emissions intensity reduction for steel production. The company showed a steady improvement in its climate change approach including appointing a responsible chief executive, publishing a climate change plan and setting capex commitments for hydrogen trials. |

| Passive/active | Company | Sector | Direct/collective | Action |
|---|---|---|---|---|
| Active | ENN Energy Holdings | Utilities | Direct | Set seven clear climate risk-related objectives for engagement with the Chinese company. The company has since made significant improvements on their disclosure and setting mid-term emission reduction targets. |
| Active | Sasol | Energy | Both | Co-led a collaborative engagement on its transition plan, as well as engaging bi-laterally to accelerate ESG-focused capex and bring forward the company's proposed energy transition. This resulted in the company presenting a reasonably well-received climate transition plan to the market, as well as progress on the capex planning. |
| Passive | AGL | Utilities | Collective | The company called a vote to demerge its 'clean' and 'brown' assets. A large shareholder publicly opposed the demerger. The manager held multiple meetings with representatives from both sides to understand each perspective. The vote was withdrawn; however, the manager formally communicated its expectations on how decisions should be made about the existing assets and operations of the company. |
| Passive | ConocoPhillips | Energy | Direct | Engaged in constructive dialogue with the company regarding its approach to managing GHG emissions, including Scope 3 and methane emissions. The company subsequently formally joined the Oil and Gas Methane Partnership 2.0, committed to report methane emissions, and set a methane emissions intensity target. |
| Active | ExxonMobil | Energy | Direct | Engaged with the company on its decarbonisation strategy (and other ESG risks) to inform the manager's investment thesis and voting decisions on shareholder proposals. The engagement informed the manager's decision to vote a certain way on a shareholder proposal requesting greater disclosure on scenario analysis. |



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# Escalation policies and divestment

## Divestment is broadly considered a last resort

While active ownership is the preferred approach to reduce real world emissions, it is sometimes the case that fund managers are unsuccessful in influencing change, at least initially. In such cases, fund managers may put in place an escalation policy or process to determine the next steps.

- Most managers surveyed agreed divestment is either a last resort, or not a viable option (such as for passive funds) when active ownership objectives are not met by companies. Managers cited wanting to be 'part of the solution' and not 'shift the responsibility to other investors' via divestment.
- Some managers have a standard escalation policy for circumstances where engagement is unsuccessful.
  - A passive manager surveyed stated as part of its escalation process, it considers voting against directors as one of the most impactful tools it uses. While it does not currently do so, it also named the nomination of directors as a tool which it may deploy in future, noting this action requires much more effort.
  - The stages of an escalation strategy provided by one of the managers surveyed is depicted on Chart 3. The manager has not reached the divestment stage for several years.

**Chart 3:** Stages of an escalation strategy for divestment


- Rather than a standard escalation policy applied to all companies, some managers noted they take a more flexible, company-by-company approach to determining the required actions when active ownership efforts are not successful. Case-by-case was key to many statements and there was no-one-size-fits-all approach.
  - Following its success in agitating for an investee oil and gas explorer to return capital to investors, a manager surveyed exited its position in the stock given the company's plans to invest further in exploration, which the manager assessed as value-destroying in a decarbonising economy.
  - Another manager noted it divested an Australian industrials company as it believed transition risks had not been sufficiently priced into the stock. The manager assessed that due to the company's reliance on the coal industry, its stock price had significant downside risk. Following its engagement with the company, the manager believed the company was not aggressive enough in restructuring its business.
  - Other managers noted materiality of the issue to the business might impact confidence in management and lead to adjustments to valuation models or ESG ratings, and ultimately portfolio weight.

> "As a near-permanent holders of capital, it is our responsibility as fiduciaries to consider elements that may impact long-term value creation."
>
> – Passive manager



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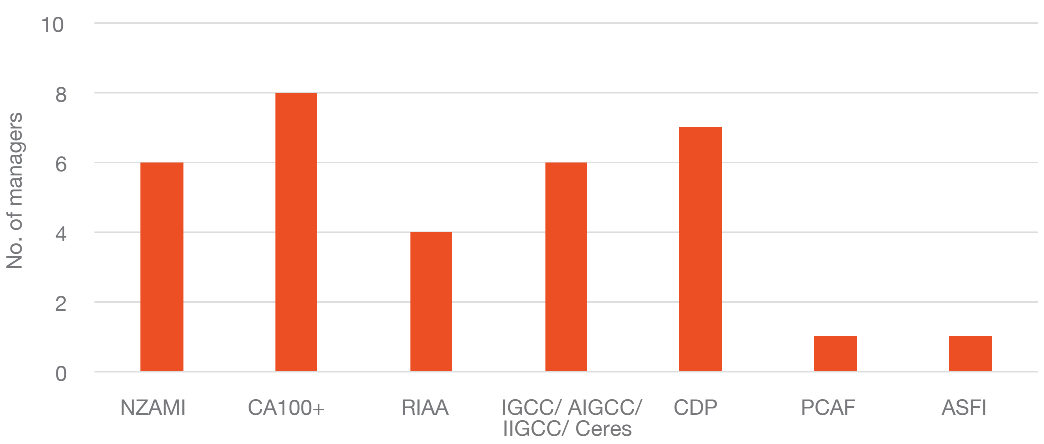
# Collaborative efforts

## Most managers use a mix of direct engagement and collective action

For the most part, managers believe direct engagements, supporting aligned organisations and collaborative engagements all have a role in stewardship. While all engage to create shareholder value, managers have different investment approaches, style and time horizons, so may be seeking different outcomes in engagement. Collaboration appears to have come a long way over the past few years through collective groups where like-minded investors are able to gain a louder voice and influence companies. Therefore, most of the managers surveyed noted a mixed approach to active ownership.

- Important climate-related collaborative groups included CA100+, IIGCC, Ceres and CDP as well as broader forums where investors might find like-minded views on issues. CA100+ was by far the most cited organisation when it comes to effective collaboration, with eight of the ten surveyed managers being signatories.
- Engagement through various industry groups was also seen as an important education piece in building out knowledge as well as expanding reach and influence beyond what is owned in portfolios and advocating collectively for stronger sustainable outcomes and stronger ESG practices.
- Notably, some managers believe direct engagement with companies has the greatest impact and collaborative action was more useful for educating policy makers and company management.
  - One manager had a particularly strong view that its direct engagement with companies, one-on-one or with a small group of investors, had the greatest impact, and reported receiving feedback from company senior management this was the case from their perspective as well. However, the manager acknowledged the influence a large sum of capital can have when engaging as a group of investors.
  - Another fundamental manager does not engage in collective action. It believes its investment style focuses on independent research and its engagement approach follows from that.
- The collective pressure from different investors is seen to be bringing positive change through groups like CA100+ and the IGCC. According to one manager, massive capital allocators like sovereign wealth funds, as well as industry superannuation funds, are adding major collective pressure to companies in requiring strong ESG and carbon credentials in their business and capital expenditure.

**Chart 4:** Collaborative memberships of fund managers surveyed



> “We do not believe that there is one ‘most influential’ approach to stewardship and engagement, as our approach to every company is nuanced and tailored to address specific concerns raised by our investment team.”
>
> – Active manager

# Monitoring and measuring success in stewardship activities

## Approaches to measurement are inconsistent and attribution is challenging

We asked fund managers how they monitor and measure success from their engagement specific to decarbonisation. It is clear there is no one-size-fits-all methodology to a net zero approach and climate-related risks and opportunities can be nuanced across and within industries. Some common themes included:

- Attribution of individual fund manager efforts in influencing a company are extremely difficult to quantify particularly when the manager is not a significant shareholder.
  - One manager noted it was impossible to highlight causality and effect from its own engagement.
  - A global equities manager recorded 47% ‘positive’ outcomes of their engagement where there had been change but noted it was much less and harder to quantify if they had single-handedly influenced change.
- Many managers have now developed tools to monitor and track the progress of companies as well as engagement. In addition, managers are now more transparent with their engagement reporting on stewardship focus and outcomes.
- Tracking progress against engagement objectives through CA100+ priorities and the net zero alignment with short- and medium-term emissions reduction targets were noted by several managers.
- There are challenges with many aspects of monitoring, tracking and prioritising focus as there is currently very limited standardisation or consistency in approach to measurement. Therefore, managers are reporting against their own ESG engagement plans and using several metrics to measure emissions. Disclosure of Scope 1, 2 and 3 emissions were noted as well as progress towards net zero targets including reporting the Weighted Average Carbon Intensity (WACI). Other ambitions were to align portfolios with the decarbonisation goals of the Paris Agreement.
- Clear objectives being set and recorded, and success measured against these objectives in an appropriate time frame was key. As decarbonisation is a long-term goal, ‘check ins’ and ‘touchpoints’ with companies in terms of short and medium-term targets were imperative. One manager noted that like the setting of objectives, it’s important to measure individual company progress against its own industry and objectives, as well as portfolio-level progress.
- Measuring a manager’s net zero progress is also an annual requirement via the PRI reporting, which all managers approached have signed up to.
- Another statistic provided by an Australian equities manager was over 60% of ASX200 companies have set net zero goals by 2050 but the manager also questioned whether these were credible or achievable in reality.

> “Part of the tracking of what companies are doing is to look at goals and challenge companies on their achievability.”
>
> – Active Australian equity manager



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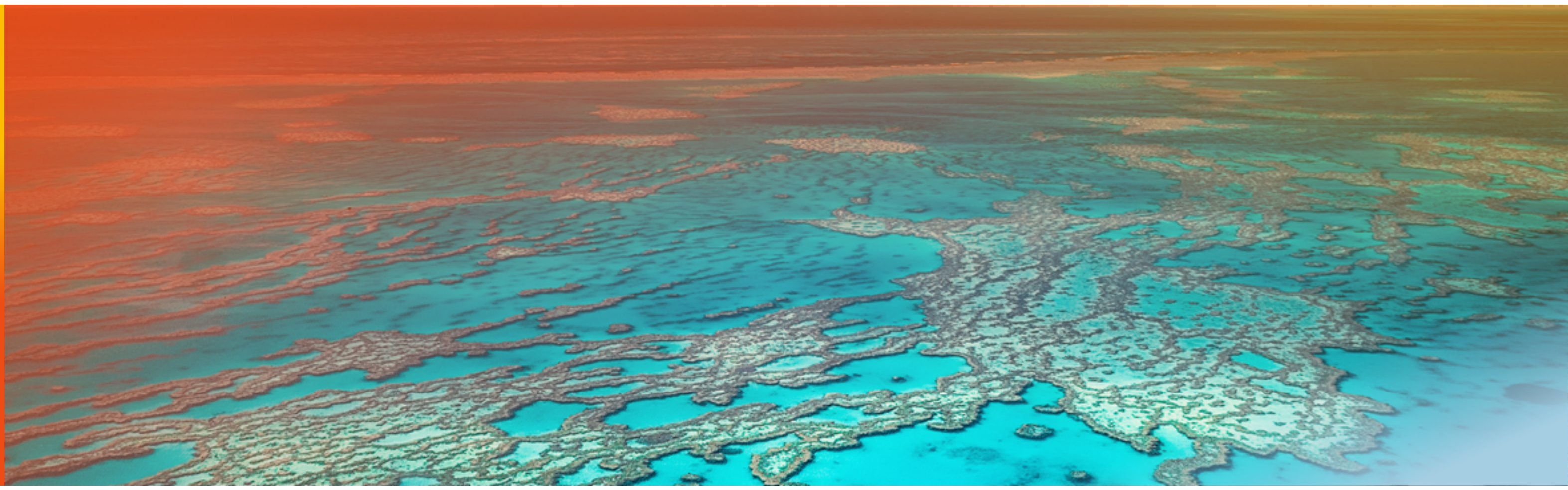
# Barriers to decarbonisation

## The current war-induced energy crisis is a key barrier, along with historical climate change inertia in Australia

It clearly won't be a linear journey in managing climate change and decarbonisation will endure bumps along the road, with the clearest example of the energy crisis in Europe following the Ukraine conflict which led to a strong run in energy stocks. Broadly, the barriers raised by fund managers can be categorised as those related to decarbonisation, and those challenges which impede positive active ownership outcomes.

Through their investment research and active ownership efforts, particularly in engaging with companies and advocacy efforts, fund managers are in a good position to comment on what is impeding global decarbonisation. It was interesting to hear from domestic managers that Australia's decarbonisation efforts are lagging because there is no clear government policy, while different issues were noted by the international equity managers. Some of the comments included:

- An Australian-based manager noted the current energy crisis as a key barrier.
  - Positively, while governments may be temporarily leaning on fossil fuels, private capital flows are still supporting decarbonisation. The manager is optimistic that investor pressure will help support government policy and vice versa in diversifying the energy mix into renewables.
- A global equities manager has an Australian equity strategy and noted Australian-based asset owners are lagging global peers in making climate commitments and the amount of capital expenditure focused on reducing carbon emissions is relatively low.
- The historical, long-term climate change inertia and absence of a clear government policy, support and carbon tax in Australia was noted.
  - An Australian equities manager reported companies will find it difficult to balance fiduciary duties to shareholders and expectations of society. Further, there still appears to be certain trade-offs for companies and as such, we are likely to see slow progress towards net zero.
  - Another Australian equity manager noted a lack of clarity on the policy levers required to achieve national emissions targets in Australia as a barrier.
- Similarly, the lack of consensus on decarbonisation pathways and target-setting methodologies being incomplete for certain sectors, such as fossil fuel sectors, is considered a barrier. The Science Based Targets Initiative's guidance on the oil and gas sector will be important once it is released.
- Poor governance and oversight of the key issues at company board level was noted by a global equity manager as a challenge to making progress, acknowledging the importance of appropriate sustainability governance at the board level to make progress in areas such as net zero. The manager added that accountability mechanisms at the company management level are important to ensure progress and should be linked to climate strategy and remuneration[7] as it is an effective tool in focusing efforts and driving outcomes.
- Innovation was another barrier in the path to decarbonisation to transition carbon-intensive industries to a carbon-neutral world and these new technologies while offering many possibilities are currently underdeveloped. The manager added that as these technologies develop, associated growing pains will need to be assessed case-by-case.



[7]See Frontier's research, "ESG-aligned incentives for further insights on corporate ESG-aligned incentives.

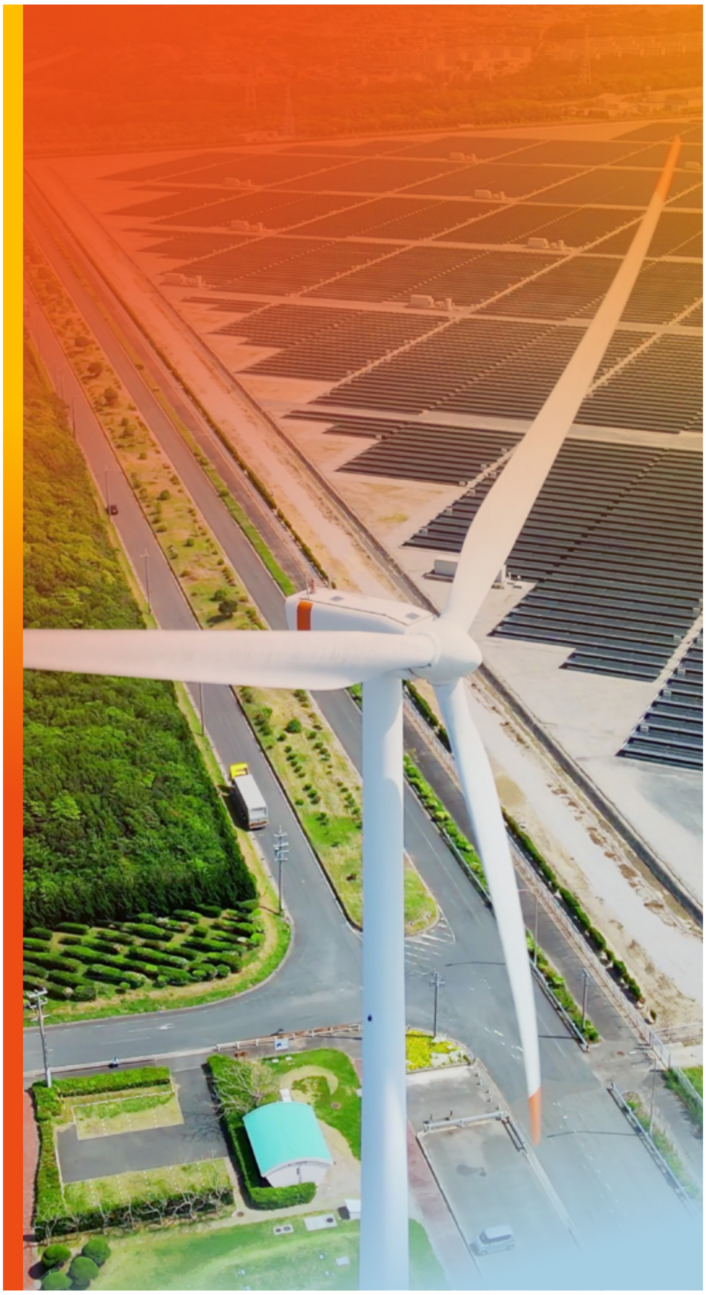
# Barriers to active ownership

## Active ownership is hindered by ESG data shortcomings, resourcing constraints and shareholding size

The challenges that managers face are important considerations when assessing active ownership efforts. While some, such as inconsistent climate disclosure, will likely improve over time, others, such as small shareholdings, will inevitably limit the influence some fund managers can have. The barriers to effective active ownership which were raised by the surveyed funds managers included:

- Global equity managers noted shortcomings of ESG data, including its quality and the variation between providers. Further, the lack of a unified approach to climate disclosure was also noted by several managers and the lack of standardisation is clearly a barrier for managers and investors in monitoring and measuring progress.
- An interesting point was that engagement with issuers in emerging markets and frontier markets is challenging, and the effectiveness of engagement in such regions is less than in developed markets. Another manager noted several countries such as China and India do not have robust engagement culture at this time. This is to be expected as with most new frontiers but does not reduce the importance of active ownership across all regions.
- Several managers raised concerns around some unintended consequences by some investors' active ownership efforts.
  - For example, one manager believes ESG trade-offs within each value chain needed to be better appreciated by some investors, such as the necessity of some high-emitting companies to the energy transition.
  - A passive manager pointed to unproductive investor dialogue focused on divestment of company assets, which in its opinion, hinders responsible decommissioning of assets (including just transition considerations) and therefore the effective transition to a lower carbon economy. The manager addresses this barrier by working constructively with companies, and not being adversarial or divesting stocks and hence losing affiliation as a shareholder.
- Small shareholding size or partly privately-owned ownership structures were also listed as barriers, with collective action suggested as a solution here to increase the likelihood of positive outcomes.
- Limited internal resourcing can also be a challenge given the time-consuming nature of engaging with companies.
- Finally, client mandates may restrict the action managers can take, for example if there is no mandate to advocate or engage with companies, particularly in the case of passive fund managers.

> "Lack of a unified approach to climate data disclosure makes benchmarking and progress difficult."
>
> – Passive manager



# What should asset owners expect of asset managers?

## Signs of an effective active ownership strategy on decarbonisation

Table 2 exhibits our views on what asset owners may expect from their fund managers' active ownership efforts regarding decarbonisation. We emphasise the approach taken should be fit-for-purpose. We would not expect a small fund manager to be able to achieve the same amount of effort as a very large fund manager with ample resources. Therefore, we have not been prescriptive but rather aim to highlight some practices which we consider leading currently.

**Table 2:** What asset owners may expect from their fund managers' active ownership efforts regarding decarbonisation

| | Good practice | Gaps to address |
|---|---|---|
| **Setting objectives** | Fund managers' objectives with regard to decarbonisation-related active ownership should be linked to the objectives of the strategy/portfolio (i.e. fit for purpose) and value adding. In our view, the stronger managers included those with a systematic way of setting objectives (such as via a framework) and those which set company-level (or at least industry-level) objectives. Prioritising engagement efforts, such as the highest-emitting companies makes sense given the resource-intensity of such activities. Finally, the achievement of objectives in active ownership may be incorporated into fund manager remuneration structures to encourage alignment. | Managers with vague objectives, such as "for our portfolio companies to decarbonise", will likely have less focused active ownership activities, and therefore, likely be less effective. Engaging for engagement's sake (evidenced by an over-emphasis on number of engagements for example) is also less likely to lead to the desired change versus an active ownership strategy centred on outcomes. |
| **Means of influencing climate transition plans** | Managers to keep up to date with relevant guidelines on how to assess the quality and credibility of transition plans, such as those recently provided by the United Nations[8] or the CA100+ Net Zero Company Benchmark. Where managers detect a gap, we would expect this to be the focus of active ownership activities. However, such efforts cannot be expected to drive material changes over night; fund managers should instead work with companies on an ongoing, and potentially long-term, basis. | We expect the active ownership efforts regarding climate transition plans should go beyond that of improving disclosure. While this is an important element in assessing transition plans, stewardship efforts should look beyond this to strategy setting and capex decisions. Further, there was a noted lack of discussion on the 'just transition' in managers' descriptions of their efforts in influencing climate transition plans. This is a key consideration in decarbonisation and should not be ignored by managers. |
| **Escalation policies and divestment** | While we do not expect managers to have a formal escalation policy which is applied to all companies, we expect managers to be thinking about what actions should be taken if active ownership efforts are not successful. A company-by-company approach is acceptable and can mean a more nuanced approach is taken to escalation, however, a standard approach across all stocks is also acceptable. We agree with most fund managers surveyed that divestment, where possible, should only be used as a last resort. | Managers using divestment excessively may be a symptom of reducing portfolio emissions rather than an intention to influence real world emission reductions. While this can be challenging to assess, we encourage asset owners to seek clear reasoning for such actions, such as that all active ownership approaches had been unsuccessful up to that point. |

[8]Source: High-Level Expert Group on the Net Zero Emissions Commitments of Non-State Entities, "Integrity Matters: Net Zero Commitments by Businesses, Financial Institutions, Cities and Regions", November 2022.

| | | |
|---|---|---|
| **Collective efforts** | Frontier strongly believes in the power of collective action particularly for decarbonisation given its systemic nature. Investors raising a consistent voice and demands is more likely to lead to optimal outcomes. Managers' participation in collective activities should reinforce progress on decarbonisation relative to acting in isolation. Managers should be signatories/members of collective groups which align with their active ownership objectives. Like with its engagement and proxy voting efforts, managers should monitor the effectiveness of collective activities. | Managers who do not engage in collective activities should be assessed with caution. While the active ownership approach should be fit-for-purpose, managers should provide a suitable and evidence-based rationale for this position. |
| **Measuring and monitoring success** | Similar to setting objectives, the way progress is measured and monitored will also vary by manager. The materiality of, and ability to effectively manage, the issues being engaged and voted on will vary and should guide the allocation of active ownership efforts and resourcing; it is essential that managers are continuously assessing whether these efforts are effective. Managers should assess company progress sceptically. Further, we prefer managers which acknowledge the limitations of what they can achieve single-handedly. Finally, engagement activity should be reported to investors, including progress against set objectives. | Managers claiming to have single-handedly driven a certain outcome at a company should be considered with caution, especially if the degree of influence of the manager is likely to be limited. Rather, managers are able to agitate for change, and only in certain circumstances can one manager attribute their own efforts to a certain outcome. |

# The final word


Active ownership is evidently having a meaningful impact on the economy's transition to a low carbon future, and momentum is only building for this to continue. Our engagement with managers provided various examples of how active ownership has influenced companies to accelerate progress in a way that likely would not have been achieved otherwise. While there are very public, high-profile examples of investor activism and ability to influence, more often it is about managers building relationships with companies and through frequent contact, seeking to influence decisions.

- Across the fund managers we engaged with on this topic, it is clear a lot of thought and effort is going into decarbonisation of the real economy. Those we would consider leading in this space are:
  - Setting tangible, measurable objectives for their active ownership activities on decarbonisation, centred around enhancing risk-adjusted returns.
  - Proactively measuring progress against these objectives, while being realistic about the influence that any single manager can have on active ownership outcomes, and hence, performance (investment, environmental, or other).
  - Using active ownership to influence climate transition plans of companies, moving beyond disclosure requirements to influencing strategy setting and capital expenditure.
  - Employing an escalation process which is fit-for-purpose, either at the individual company level or a plan which is applied consistently across all stocks. Divestment should be considered with caution and seen as a last resort.
  - Open to, if not rely heavily on, collaborating with peers and other industry participants to strengthen the voice of investors, and if not, have a suitable rationale for taking this position.
- A notable omission in many responses and discussions with managers was the 'just transition'; this is an integral element of the Paris Agreement and cannot be ignored by fund managers.
- Managers noted several barriers to both global decarbonisation progress and active ownership, such as the Ukraine war-induced energy crisis and a lack of ESG data. Some barriers can and should be overcome, while others will require government and regulators' support before they can be addressed by fund managers.
- Asset owners should engage with their fund managers to understand their activity on decarbonisation and discuss how any gaps in their progress can be addressed. We provide a guide on what we can now expect from fund managers, considering their individual resources, objectives, and circumstances. Having access to portfolio carbon data across managers can be invaluable to help investors understand where climate risks and opportunities are within the portfolio, and address these when discussing active ownership priorities with managers.

We will continue to engage with fund managers on this topic and will formally incorporate net zero considerations into our ESG assessment of managers.

### Want to learn more?

Contact a member of the Frontier Advisors Responsible Investment Group, our sector research teams, or your client team for a discussion on your portfolio decarbonisation objectives and your fund managers' progress on decarbonisation.

## Appendix 1: Methodology

Given the ownership rights which come with listed equities exposures, we focused on listed equities fund managers only, in both Australian and international markets.

We surveyed ten fund managers. The managers we selected are a combination of those we consider strong on active ownership, or those which tend to invest in stocks/industries which are more challenging to transition. Frontier Advisors rates products by each of the ten managers. Of the ten managers:

- four were surveyed in relation to their Australian equities capabilities
- five had international capabilities only and one was surveyed across both Australian and international capabilities
- four managers had not set formal net zero portfolio targets
- six are signatories to the Net Zero Asset Manager Initiative
- five of the managers are either specialist ESG managers or have a dedicated sustainable product.

We also held meetings with five of the managers to discuss their survey responses in detail, in addition to our ongoing ESG-related discussions with the managers.

## Appendix 2: Glossary

**Net zero** is an objective whereby a given entity (such as a country, a company or investment portfolio) is no longer additive to global greenhouse gas emissions arising from human activity, e.g. carbon dioxide. The term is intrinsically linked to the 2015 Paris Agreement ambition of limiting global temperature increase to a maximum of 1.5°C above pre-industrial levels by the end of the century. A 2018 special report by the Intergovernmental Panel on Climate Change (IPCC) concluded the global economy would need to reach 'net zero' by 2050 for the 1.5°C ambition to be achievable. A net zero-aligned investment strategy should include both decarbonisation of the portfolio in a way that is consistent with achieving real economy emissions reductions, and increased investment in 'climate solutions' needed to meet the IPCC's 2050 net zero milestone.

**Just transition** is the effective and equitable management of the positive and negative social and employment implications of climate action across the whole economy. An example of just transition is the successful reskilling and relocation to a low-carbon industry of redundant workers from a coal-fueled power plant which has closed due to climate policy. A just transition is expected to facilitate faster transition to a low-carbon economy while also mitigating social exclusion and increased inequality.

**Real economy** is the part of an economy which produces goods and services. It is distinct from the financial sector which is concerned with buying and selling on financial markets. The sustainability of both the real economy and the finance sector are intrinsically linked with each being reliant on the other.

**Active ownership/stewardship** is the use of influence by institutional investors to maximise overall long-term value including the value of common economic, social, and environmental assets, on which returns, and clients' and beneficiaries' interests depend. Stewardship can be implemented through a variety of investor stewardship tools including engagement with current or potential investees or issuers; voting at shareholder meetings; filing of shareholder resolutions/proposals; direct roles on investee boards and board committees; and where necessary, litigation.

## Appendix 3: Collaborative organisations

**The Taskforce for Climate-Related Financial Disclosures (TCFD)** was established in 2016 by the Financial Stability Board. In 2017, the TCFD published its recommendations on voluntary and consistent climate-related financial disclosures that were deemed useful to investors, lenders and insurance underwriters in understanding a given financial entity's climate change risks and opportunities.

The **Investor Group on Climate Change (IGCC), The Institutional Investors Group on Climate Change (IIGCC), Asia Investor Group on Climate Change (AIGCC) and Ceres** are collaborations of Australian and New Zealand, European, Asia and US institutional investors, respectively, focused on the impact of climate change on investments.

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, supported by IGCC, IIGCC, AIGCC, and Ceres.

**Climate Action 100+ (CA100+**) is an investor-led initiative to ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change.

The **Net Zero Asset Managers initiative (NZAMI**) is an international group of asset managers committed to supporting the goal of net zero greenhouse gas emissions by 2050 or sooner, in line with global efforts to limit warming to 1.5 degrees Celsius; and to supporting investing aligned with net zero emissions by 2050 or sooner.

The **Responsible Investment Association Australasia (RIAA)** champions responsible investing and a sustainable financial system in Australia and New Zealand.

**CDP** is a not-for-profit charity that runs the global disclosure system for investors, companies, cities, states and regions to manage their environmental impacts.

**Partnership for Carbon Accounting Financials (PCAF)** is a global partnership of financial institutions that work together to develop and implement a harmonised approach to assess and disclose the greenhouse gas (GHG) emissions associated with their loans and investments.

The **Australian Sustainable Finance Institute (ASFI**) is committed to realigning the finance sector to create a sustainable and resilient financial system by directing capital to support greater social, environmental and economic outcomes.

The **UN-convened Net Zero Asset Owner Alliance (NZAOA)** is a member-led initiative of institutional investors committed to transitioning their investment portfolios to net-zero GHG emissions by 2050 – consistent with a maximum temperature rise of 1.5°C.

The **Science Based Targets initiative (SBTi)** drives ambitious climate action in the private sector by enabling organisations to set science-based emissions reduction targets.

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Frontier is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.




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