Approaches to Transition Finance with the Investor Leadership Network
Baringa's Climate Change & Sustainability Trailblazers Podcast

Emily Farrimond [00:00:02] Welcome to our Climate and Sustainability Trailblazers podcast with me, Emily Farrimond. Today, I'm delighted to be joined by a number of the Investor Leadership Network or ILN members to talk about the topic of transition taxonomies. For anyone who's not aware of the ILN, they are a group of 14 open and collaborative asset managers and owners interested in addressing both sustainability challenges whilst considering the importance of long-term growth. So, without further ado, I'm delighted to be joined by Annika Brouwer from Ninety One and Astrid Hoegsted from Nordea. Thank you both for joining us. I've been looking forward to this conversation.

Astrid Hoegsted [00:00:39] Thank you.

Annika Brouwer [00:00:40] Thanks for having us.

Emily Farrimond [00:00:42] So under the ILN banner, you've just published your most recent white paper titled 'Transition and the Enabling Role of Taxonomies and Frameworks'. And we wanted to spend a little bit of time today exploring with you both the importance of transition frameworks. And if I could come to you first Annika, I would be really, really interested to hear your opinion around the role asset owners and managers have to play in decarbonisation and why this is important.

Annika Brouwer [00:01:09] So I think when you think about the two most critical levers for change, if we're talking about climate change or any sort of change in the global economy, the first is robust policy. So strong policies, laws, and the institutions that surround those. And then the second lever for change that needs to sort of turn those policies into action is finance. Asset owners and asset managers have some of the biggest pools of capital in the world. And so, I think when we're talking about the role that asset owners and asset managers play, you have to think about the quantum of capital that those institutions represent and how that capital needs to shift into, one climate solutions and, and two, effectively investing to decarbonise the problem, which is what we call transition finance. If you think about it in that context, asset owners and asset managers have an enormous role to play in driving the world towards a cleaner, greener future. I think that the two key ways in which they do that is by, sort of decisive allocation into solutions. And by solutions, we are talking about renewable energy and battery storage, new innovation and technology efficiency measures. It's the sort of asset classes of the types of companies and technologies that are reallyclassified as green, if you will. And then the second sort of area where asset owners and asset managers can play, where they can be really meaningful is in driving down the problem, which is effectively taking high emitting companies and shifting them towards a lower carbon future. But what do they need to be able to do that? That second bucket is so critical. They need information. You know, they need to know what the companies are doing, so disclosure of emissions. They need information from industry in order to understand what those companies need to be doing more of or less of to be better. Asset owners and asset managers need to have integrity in what they're doing. We have to have a very strong understanding of our role and fiduciary responsibility. And really stick to our guns when we're talking about decarbonising top emitters or high emitting companies. And then the third part and I won't go into detail of this, but really being able to do that, being able to decarbonise and transition high emitting companies. You have to be able to interrogate them. You have to be able to interrogate transition plans of companies, understand what companies can and cannot do and then invest in line with those plans.

Emily Farrimond [00:04:29] Well, you've certainly set the context nicely there and covered a lot of ground. Astrid, anything that you wanted to add?

Astrid Hoegsted [00:04:37] What I would like to reflect on here is that I think this really is a question that we also need to ask ourselves as individual asset managers and asset owners. So, I come from ten years in the impact space before I joined Nordea Asset Management. And there we really used the term almost too much, which is theory of change. And really, you know, what that is, is that we all needed to have a very clear understanding of what it was that we were doing that would drive an outcome. And I think that this is a term that we should do more to adopt within financial institutions as well. At least the idea of it, which is to say that, we are very different as asset managers and asset owners. At Nordea, we’re active asset managers, you know, we invest primarily in illicit equity, corporate bonds, sovereign debt and covered bonds. We don't have a lot of private equity. Uh, so that changes what our role is to decarbonise the wider system. I think we need to be quite clear just on communicating a little bit more firmly, maybe as well what levers that we as an institution believe that we can pull and also what kind of you can say risk we are prepared to take in association with it? You can sometimes say that if the world was on track to decarbonise, we could just do business as usual. So basically, all of us making net zero commitments and so forth would be kind of trivial because we could just do whatever we've always done, and the world would be on track. But in the similar vein, if we have a world that is completely off track, and it's not looking to decarbonise at all, then the question is really to us, how much are we willing to let our investment universe deviate from the broader investment universe? Now, what role and risk are we willing to take there in the space? So, it's just to say that it really is I think the fundamental question that we should ask ourselves.

Emily Farrimond [00:06:46] Thanks, Astrid. And that's led me really nicely on to the next question, actually, around how are you holding yourselves and the companies that you're working with and investing into account around tracking their actual decarbonisation against the targets that they've set?

Annika Brouwer [00:07:04] Yeah. So, I think the answer there really is twofold. One is that, over the last few years, we're all reporting our finance emissions – that’s the emissions associated with the companies that we are invested in. And we can see that develop over time. I mean, we can also use a different metric, which is WACI, the Weighted Average Carbon Intensity, that most of us are also tracking. And I think most of us will say that it has kind of trended downward. We will see some reductions in those metrics back from 2019 and onwards. But then really the question is what's behind those emission reductions? To what extent is that because we have changed our portfolio. To what extent is that simply changes to market circumstances? You know, we had a COVID year. We had a boom year. To what extent is this then really also to do with actual emission reductions that are happening within our portfolio composition? And so, for that we run attribution analysis, which basically means that we try to identify the specific levers that are behind any figure that we have when it comes to whether or not our portfolio is decarbonising or not, but that that's one aspect. And the second one, in terms of holding ourselves and portfolio companies to account, really then is it's really related to what we think those portfolio companies are going to do in the future. But because that's what really matters to us. You know, the past is the past, but we are investing because of what we believe companies will do going forward. And so, one area of work that we have really focused on back in 2023 is to project company submissions going forward. And this sounds quite maybe like a quite simple task, but really it isn't right, because a number of parameters go into figuring out what we believe to be the most credible pathway that a company is on. And for that, we use a range of different metrics that feed into this model. And I think we will maybe get to talking about some of these as well. But these are really metrics that we can engage companies on. Right? So, if companies have validated their targets via a science-based target initiative, we know we give that more credibility. But that's also something we can engage a company on, and we can hold them accountable for. So, if they say they will have done it and they haven't, and so forth. So, we're trying to basically tie this all together, meaning that we will have the ability to assess companies in a broad universe and a range of different climate related metrics. We can feed that into an understanding or a belief in where the company is going. And we can also translate that into engagement objectives that we can use for our dialogues with companies.

Emily Farrimond [00:10:03] Fantastic. Well, thank you for sharing and outlining the approach that you're using at Nordea. I wonder if we could come to you, Anika, and just to talk a little bit more about Ninety One. I know across the ILN members, there are many different approaches used to kind of work through and track actual decarbonisation against targets. So over to you.

Annika Brouwer [00:10:25] Yeah, I think a lot of what Astrid said resonates with me personally, but also how Ninety One views, I guess, this sort of strategy of tracking. I think what you said, Astrid, about theory of change is so true, specifically when you're looking at the different financial mechanisms. So, debt versus equity, those are two different types of financial tools that require two different approaches effectively. I think the first thing, I mentioned this upfront, is about integrity. As a firm, you have to have integrity in the targets that you set. And by integrity, I mean we have to set targets that we can achieve, but definitely that have ambition baked into them. And we have to hold ourselves to account on that. And I think everyone is kind of doing that in a slightly different way. We have set a net zero target. It's about working with the top highest emitting companies in our portfolio. We do not believe in divestment or exclusion. hether we have debt or equity in those companies would determine how we effectively would track the companies, not how we would track the companies, but how we would effectively engage the companies and hold them to account. So, debt we see as more of a pull factor. You can bet conditionality into debt. Equity is more of a push because you have a voice, and you have a vote. And so, I think a key part of our strategy is that information piece. We need to have the information, publicly available information from companies. We engage companies on the information around that transition plan. So, we've developed an in-house tool called the Transition Plan Assessment Framework. I think it's been featured in one of the ILN white papers, but it's effectively 36 indicators that we track on all of our top emitting companies, covering everything from disclosure to targets setting to implementation of targets and plan and how a plan is being financed, the governance structure, etc. The reason why we look at all these indicators is because we believe that we have to look beyond just Scope one, two and three targets andScope one, two and three reductions. We need to look at how that plan is being financed. We need to look at the social injustice elements of the plan; are people being included? That is very, very important in a country like South Africa or other emerging market countries where the transition is going to be at the peril of many communities. And so, we develop that to help us have that integrity and derive that information. And then, all asset managers' biggest tool on the equity side is, of course, engagement. So, we engage companies in line with the output of that assessment. We hold them to account on the targets that they set. On a case-by-case basis, we will vote for or against management, for or against climate and transition plans based on what we believe to be achievable and what we believe to have integrity within each company.

Emily Farrimond [00:13:46] Brilliant. Thank you for that. And just to then dive a little bit deeper into the specifics of transition finance framework. So, we've seen a proliferation of industry standards and frameworks specifically around transition finance and helping you to inform the credibility of transition plans. What advice would you offer to those struggling to navigate this proliferation?

Annika Brouwer [00:14:14] I wish I was starting this journey now, and I didn't have to wade through the many frameworks that I have to wade through in the last two-and-a-bit years. But in many ways, I think having started this journey earlier than many others, you learn quickly what works for you and what doesn't work for you. The ILN white paper, I think, has a really good summary of a lot of what is useful to many asset owners and asset managers who are looking for similar outcomes that we are looking for. So, you can look through resources like the white paper. There's also a G funds transition andtransition finance guidance that has a sort of long list of all the different types of taxonomies and guidelines available in the market. I don't necessarily think that provides clarity on what would be useful for each individual asset manager and asset owner. I think what it does is, it lays out the landscape of what's available. I always think the best thing you can do is start with your end point in mind. What do you want to achieve? Do you want a green portfolio? Do you want real world decarbonisation? Are you in EM, DM or both? Because every one of those answers will determine a different strategy and different use case for the range of taxonomies and tools that exist. And I know that doesn't answer your question, Emily, but I think the sort of overarching message is that you should be clear on the strategy and what you want to achieve before you go down this route. We've had to ask ourselves the question many times. Are we wanting to simply maintain or are we wanting to invest for decarbonisation? And not many asset owners and asset managers want to change their portfolios or develop new strategies or tilt their existing portfolios. An asset manager or asset owner needs to ask themselves those questions. Are they willing to really go the extra mile effectively?

Emily Farrimond [00:16:34] So I think what I heard from you there, please let me know if this is correct, is make sure you're clear on their strategy. Start with the end in mind and then engage with the frameworks. And you're going to have to kind of roll around in them and just work through what works for your business.

Annika Brouwer [00:16:52] Yeah, absolutely.

Emily Farrimond [00:16:53] Great. Thank you, Astrid. Anything else from you in terms of advice you'd give to others around navigating the transition finance framework landscape?

Astrid Hoegsted [00:17:04] Yeah. I just wholeheartedly agree that we need to work backwards from the end in mind. I think that the challenge, at least, that we have faced is that there are multiple possible ends to work backwards from, especially if you ask across the organisation. What we have found is that we both have specific portfolios that are focused on delivering decarbonisation via engagement. We also have a range of portfolios that are more interested, you could say, in the kind of risk aspect,to make sure that they're mitigating against climate risk. And then we have a kind of entity, organisationally wide incentive to make sure that we can dobroad diagnostics across all of our portfolios. And that can also inform our engagement strategy. The thing that has helped us in the end has been the large amount of work to identify the specific data points across the right data landscape that we believe that we need to have in our centralised system, that we can then use as building blocks to develop a whole bunch of different tools and frameworks on top of. And that database, pulling from the science-based targets Transition Pathway initiative, Climate Action 100, CDP and other providers that are delivering different types of proprietary information, can be packaged and repackaged in different ways, but only if you have them in there and you have a way of maintaining them consistently as well. So, I guess my advice would just be to say I would really just concur with Annika. The starting point is to really map out the most important use case, organisationally that we have for this type of data and these type of assessments, and then try to work backwards from that in terms of what is that we need centralised, and I guess you can kind of say tailored solutions that might work for individual portfolios that at least have been our experience. Now we have all this data, we are also finding new use cases. We're like, oh, we could actually be doing that, we could be doing this, or we could be using this data point over here, which is of course useful. But at the same time, you might have ended up with a slightly different result if we had started with a clearer understanding exactly all of our key use cases.

Emily Farrimond [00:19:41] And it sounds like, Astrid, what you're advocating for that is the use of a smorgasbord of transition finance frameworks, not having quite a narrow view that you're going to select one and use that consistently.

Astrid Hoegsted [00:19:55] I would say that what I'm advocating for really, is to understand the raw data that you want to make informed decisions on. Because that's what we need. We need to identify the actual underlying data that we want in our systems. And then we can package into different frameworks. But we need the data first, right? We need the actual data that is the basis for everything. We can really spend a lot of resources on one specific provider. Or we can spend a lot of resources drawing from different providers. And then you'll have to find a way of consolidating that, prioritising it and so forth. So, there's a lot of management simply when it comes to the data inputs that we need. But really that's just to say that that is really at the core of everything. We don't just want to buy from our providerssomething that says that a company has an implied temperature rise of 2.1 degrees, because we can't really use that for anything. We need to understand the underlying data. We want to send the targets that go into emissions additional information log, quantitatively in terms of their strategic plan and so forth. But that's all data in the end, solid data that we need in our systems. And the big piece of work then is just to build up that data in-house.

Emily Farrimond [00:21:27] Fantastic. Thank you for clarifying that, Astrid. Something that is, I think, a topic of much debate in the industry is around whether financing the transition actually supports with alpha generation. I'd just be keen to hear both of your perspectives about how investment in transition finance and utilising transition taxonomies can support with that alpha generation. Astrid, if you wanted to kick us off.

Astrid Hoegsted [00:22:01] My hope is that the long arc of history will bend towards decarbonisation. Let's say it like that. We definitely have an understanding or an anticipation, and on our side, there are some untapped opportunities to explore. And really, that has to do with trying to identify those companies that may not yet be clear transition stories, but we believe that they can be and particularly those would be companies where we know that what they are delivering is something that there's going to be a lot of use for also in a transitioned world. Right? So, we know we need steel. We know we need cement, we know we needchemicals of a different nature. But we just want to try to, so we don't want to shy away, basically is what I'm saying from companies or sectors. But we want to try to identify the things within them you can see. And then whether or not that generates alphaover time, you know, we would certainly hope so.

Annika Brouwer [00:23:03] I absolutely agree with Astrid. We have identified over the last two years that companies that have robust transition plans are more future proofed physical and transition risk associated with climate change than those without. And that transition plan may be in various stages of maturity. You know, some companies have 168-page reports on their transition time, with five years of data behind them. And others are just setting targets and figuring out the financing and figuring out what that company looks like in 2035. But as an investor, as a shareholder, the confidence that you get from having that company in your portfolio and that company being one that isn't looking at the future and thinking about the risk of a changing world to the value of that company is more valuable in the long term than one that doesn't. And so, I think you have to see value in alpha generation, but there's also will this company have a place in a 2035 or 2050 world? Is the product something that we need? As Astrid said, you can't shy away from steel, cement, , agricultural inputs. These are all high emitting high polluting industries today that have no choice other than to be low emitting, low polluting industries tomorrow. And we need to be backing the companies that see themselves as those low carbon pioneers. And that's where the alpha generation ultimately will come in. In, COP28, we launched a strategy called the Emerging Market Transition Debt Strategy. And effectively, the whole strategy is designed around identifying companies in emerging markets, that require debt financing and debt capital to scale up their decarbonisation plans. That is a commercial strategy. We believe that that strategy will generate alpha in line with our clients,, in line with our fiduciary duty, in line with what our client's needs will be. I think that when you start seeing those bright spots, I'm talking about emerging markets specifically but at the same can be said for developed markets, those bright spots are the companies that are looking at climate change as both a risk and an opportunity. And that's where effectively the alpha generation will start that flywheel will start spinning, we hope.

Emily Farrimond [00:25:52] Right. Good. And it sounds like you're making a bet that that will start to, to flow through into alpha generation. I guess a further question for you then is what you are thinking of in terms of timescales of when you're expecting to see that.

Annika Brouwer [00:26:07] That's also very market dependent, because these are both public and private companies that we're talking about. The short-term market fluctuations make it very, very difficult to predict specifically when you're looking at decarbonisation. We've seen green investments fluctuate hugely over the last three years. Who knows what that's going to look like over the next three years. But in the long-term game and you know, we play a very long-term game when you're talking about pension funds,when you're talking about sovereign wealth funds, they are investing for the long term. And so, we're looking at long term investment horizons.

Emily Farrimond [00:26:50] Yeah. Understood. And I think as we start to see increasingly short-term impacts of climate change and changing weather patterns, that can only, I guess, be a more medium-term outcome in all likelihood, as those risks start to become realised, unfortunately. Thank you to Annika and Astrid. We're really grateful you've taken the time out of busy and important roles to share your perspectives. Personally, I've really enjoyed our conversation and I'm sure our listeners will too. I'm sorry to say we've run out of time today, but it's been an immense pleasure having you on the podcast. It's been really insightful and I'm sure will resonate. Now,if you enjoyed the podcast, please do like and share and also look out for further installments of the Climate and Sustainability Trailblazers. We've got some really exciting guests in the pipeline who will bring their unique perspectives on the markets they work in, and if you have any feedback, please do let us know. Thank you.