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*DEMYSTIFYING NET ZERO*

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**DESIGNING A  
FRAMEWORK FOR  
INVESTING IN  
NET-ZERO TRANSITION  
LEADERS**

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the opportunity that accompanies it brings  
hope and means to take action today.

## FOREWORD

The climate crisis presents our greatest global challenge and the stakes are existential. After over 11,000 years of stable climatic conditions that allowed modern humans to flourish, our current fossil-intensive economic system has thrown our planet's carbon cycle out of balance. To ensure our continued progress and preserve life on Earth, we must reduce global net greenhouse-gas emissions from about 50 billion tonnes today to zero by the middle of this century.

Whilst the challenge is great, the opportunity that accompanies it brings hope and means to take action today. Responsible capitalism, underpinned by a circular economy, must replace the current linear model, that generates negative externalities through the free use and degradation of the Earth's natural resources and ecosystem services. With this shift will come a systemic transformation that impacts everything from energy and infrastructure to how we feed ourselves and travel. It is the biggest investment opportunity of our lifetime.

Climate change will impact all types of investment portfolios. At the same time, availability of data will give investors the possibility to better understand the unintended consequences of their investments, and target positive impact through their investment decisions – to do good and do well. Earlier this year, we asked our clients whether they were seeking climate action investment offerings, and the answer was a resounding yes.

Although there are a number of ways to create positive impact through investments, capital allocation and engagement are the most accessible today. Through capital allocation, investors can channel resources to companies participating in the net-zero greenhouse gas emissions transition and those providing climate-change solutions. Through engagement and voting, investors can encourage corporate management towards the sustainable transformation required for a better future for all.

Pictet's mission is to partner with our clients and provide them superior long-term investment solutions. The Pictet Group has endured and prospered for over two centuries by taking a responsible, long-term approach to business and the management of our clients' wealth. In doing so, we have always considered not only the interests of the present, but also of future generations. We believe this is the essence of responsible thinking, and the best contribution we can make towards sustainable life on our planet.

**Marc Pictet**  
Managing Partner

The physical consequences of human-induced warming have already begun to materialise, but the worst outcomes are still avoidable if we reduce net global greenhouse gas emissions to zero by 2050, in line with a 1.5°C warming scenario.

## EXECUTIVE SUMMARY

The climate science has confirmed that without deep and rapid reductions in greenhouse gas emissions, our planet will exceed 2°C of warming above pre-industrial times (1850–1900) this century.

The physical consequences of human-induced warming have already begun to materialise, but the worst outcomes are still avoidable if we reduce net global greenhouse gas emissions to zero by 2050, in line with a 1.5°C warming scenario.

Governments and corporations will play a pivotal role in directing the climate onto a 1.5°C trajectory, but as individuals, we also have scope for taking action against climate change, including through our investment portfolios.

Investors can address transition and physical risks and capitalise on an investment opportunity by investing in companies that are fully committed to a net-zero emissions future, we call these *net-zero transition leaders*.

Identifying true *net-zero transition leaders* requires a robust selection process that is driven by data. We have developed a screening process that establishes which companies have:

1. **CLIMATE RELEVANCE**, meaning influence over sufficient emissions to make their absolute reductions impactful,

2. demonstrated **INTENTIONALITY** and

3. **MEASURABILITY** baked into their target framework and disclosures

An increasing number of investment funds also target *net-zero transition leaders*. We have identified the best practices in the space in order to select those managers that are most closely aligned with the climate transition. The guidelines articulated in this paper are voluntarily stringent as we want to set a high bar when screening managers to ensure they are on a credible transition pathway.

Companies with ambitious plans towards net-zero emissions will also allocate significant resources to, and accelerate demand for, the climate solutions that will enable the transition. While this paper will focus on investing in *net-zero transition leaders*, they are a key complement to investments in companies providing the solutions that will enable and accelerate the transition. For over 20 years, Pictet has been actively investing in many of these crucial themes, which are a key component to achieving the ultimate goal of the Paris Agreement.

## OUR CLIMATE – THE CURRENT STATE

Earlier this year, the Intergovernmental Panel on Climate Change (IPCC – *see box 1*) concluded categorically that warming of the climate is well under way, that it is ‘unequivocally’ the direct result of human activity and has already produced pronounced consequences on Earth’s systems<sup>1</sup>.

The IPCC report states that ‘global warming of 1.5°C and 2°C will be exceeded during the 21st century unless deep reductions in carbon dioxide (CO<sub>2</sub>) and other greenhouse gas emissions occur in the coming decades’.

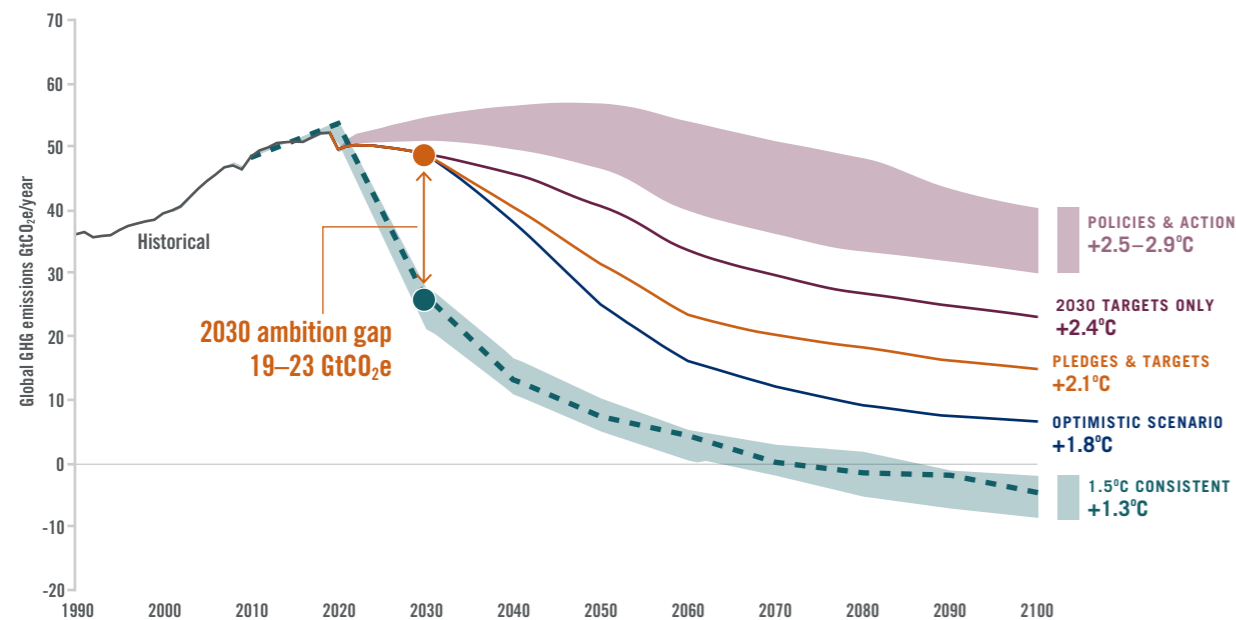
In efforts to facilitate the deep reductions in greenhouse-gas emissions required to avoid the disastrous consequences associated with exceeding 2°C of warming, since the 2015 Paris Agreement, signatory nations have submitted Nationally Defined Contributions (NDCs). These NDCs are action plans to reduce absolute emissions,

or, for developing economies, emissions intensities. According to Climate Action Tracker, global temperature increases would reach 2.7°C by the end of this century based on current policies, or around 2.1°C, if the NDCs are implemented as written in November 2021<sup>2</sup> (*see figure 1*). Even under the most optimistic scenario, in which all NDCs and net-zero targets are fulfilled, the climate is projected to warm by 1.8°C, still falling short of the Paris Agreement’s 1.5°C target.

The difference between 1.5°C and 2.7°C may seem insubstantial, yet the Earth science clearly demonstrates that a 1°C, or even a 0.5°C change in either direction will yield vastly different outcomes (*see figure 2 on pages 8–9*). This is because the climate system contains several feedback loops that might lead to exponential negative impacts from a slight increase in temperature, potentially even leading to irreversible tipping points.

**Figure 1—2100 WARMING PROJECTIONS**

Emissions and expected warming based on pledges and current policies



Global greenhouse gas emission pathways for CAT estimates of policies and action, 2030 targets only, 2030 and binding long-term targets and an optimistic pathway based on net zero targets of over 140 countries in comparison to a 1.5°C consistent pathway.

Source: Climate Action Tracker Warming Projections Global Update, November 2021

<sup>1</sup>IPCC, *Sixth Assessment Report*, 2021

<sup>2</sup>Climate Action Tracker, *Climate Action Tracker Warming Projections Global Update*, November 2021

## BOX 1 IPCC EXPLAINED

The Intergovernmental Panel on Climate Change is the global authority on climate science, periodically delivering the latest scientific data to its 195 member governments to inform the development of climate policies. It was established in 1988 by the Global Meteorological Organisation and the United Nations Environmental Programme (UNEP). Within the IPCC there are three working groups that release reports on roughly six-year cycles, which are then brought together under a final Synthesis Report.

The IPCC selects the authors from a field of experts, with other experts invited to peer-review the findings. Authors are selected to have a diversity of technical experience and represent a wide variety of geographies and backgrounds. They take into account all of the available science that has been done since the last reports. Then there is a long process of ratification, through which all of the member country governments must review the full report and summary for policy makers before its final publication. In this way, the final reports can be assured to be extremely robust and conservative in their statements.

### WORKING GROUP 1

#### PHYSICAL SCIENCE

Examines what we know about climate change to date and what can be said about its expected physical effects. Most recent report published August 2021.

### WORKING GROUP 2

#### IMPACTS AND ADAPTATION

Examines the impacts of climate change on both natural and human systems and the required adaptations. Next report due February 2022.

### WORKING GROUP 3

#### MITIGATION

Assesses options for mitigating climate change through reducing greenhouse gas emissions and removing greenhouse gases from the atmosphere. Next report due March 2022.

Source: IPCC

## OUR CLIMATE – THE CURRENT STATE

Figure 2—SMALL DEGREES OF DIFFERENCE ILLUSTRATED

### 1.5°C – CONSEQUENCES<sup>3</sup>

**8**  
of world's largest cities will face substantial flooding, erosion, storm surges

**16x**  
more marine heat waves per year

Mosquito ranges expand by **6–20%**

### 2°C – CONSEQUENCES

**29**  
additional days of extreme heat per year

**36%**  
of land exposed to extreme rainfall

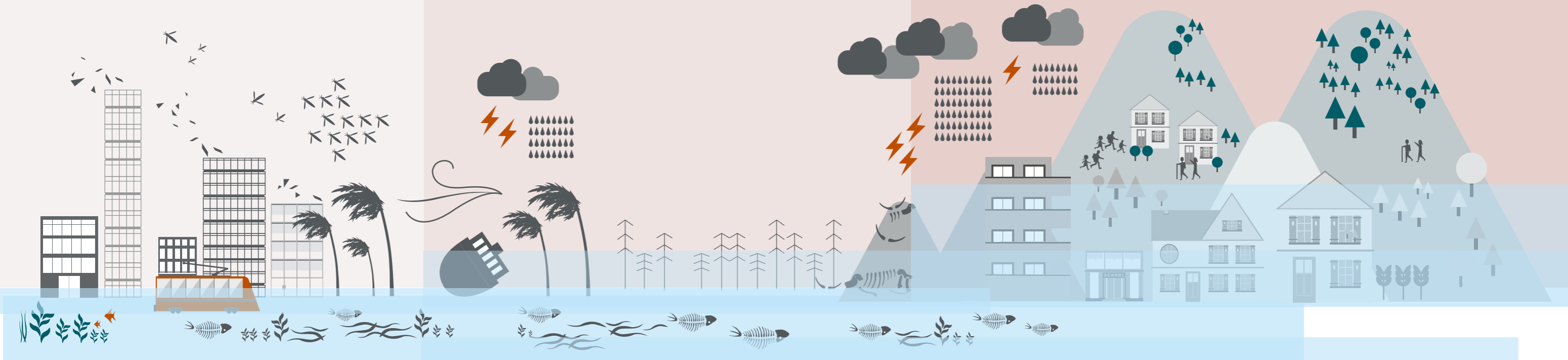
**2x or 3x**  
habitat loss for all species

### 3°C – CONSEQUENCES

**100s of millions**  
of people displaced from their homes due to sea level rise

**10 month**  
average drought length

**97%**  
area burned by wildfires in an average Mediterranean summer



Whilst the worst of these effects remain in the future, the impact of climate change is becoming increasingly palpable each year. Since the year 2000, we have had 19 of the hottest years on record, with 2020 and 2016 being joint hottest.

The US had a record 18 individual billion-dollar weather events in the first nine months of 2021, at a total cost of over USD100 bn, with the five-year average at a record USD140 bn<sup>4</sup>. Warming oceans have caused mass bleaching of coral reefs during the last decade, with 30% of global coral reefs killed during the 2014–2017 period.<sup>5</sup>

<sup>3</sup>CarbonBrief

<sup>4</sup>National Centers for Environmental Information, 2021

<sup>5</sup>NOAA Office for Coastal Management, 2021

**TIME IS RUNNING OUT.**

## THE CLIMATE OUTLOOK

The Paris Agreement established a basis for global cooperation on climate action, although, since it was signed in 2015, it has taken time for the sense of urgency to resonate through all levels of society, from governments, to corporations and financial institutions, down to individuals, voters and consumers. Today there is growing resolution to take the actions necessary to move onto a path towards a 1.5°C warming scenario, in line with the latest climate science<sup>6</sup>.

The outcome of the recently concluded COP26, the Glasgow Climate Pact, is the first ever climate deal to explicitly plan to reduce coal, the fossil fuel associated with the most greenhouse gas emissions. It also presses for more urgent emissions cuts and promises more money to help developing countries adapt to the impacts of climate change. The pledges do not go far enough to limit the temperature rise to 1.5°C yet. If fully implemented, the current 2030 NDC targets will only limit global warming to about 2.4°C. However the Pact requests that countries revisit and strengthen their targets by the end of 2022.

In order to realise a 1.5°C scenario, we must reach net-zero emissions (see box 2 – path to net zero) globally by 2050, with a 50% reduction in emissions (from 2010 levels) by 2030 in developed nations.<sup>7</sup>

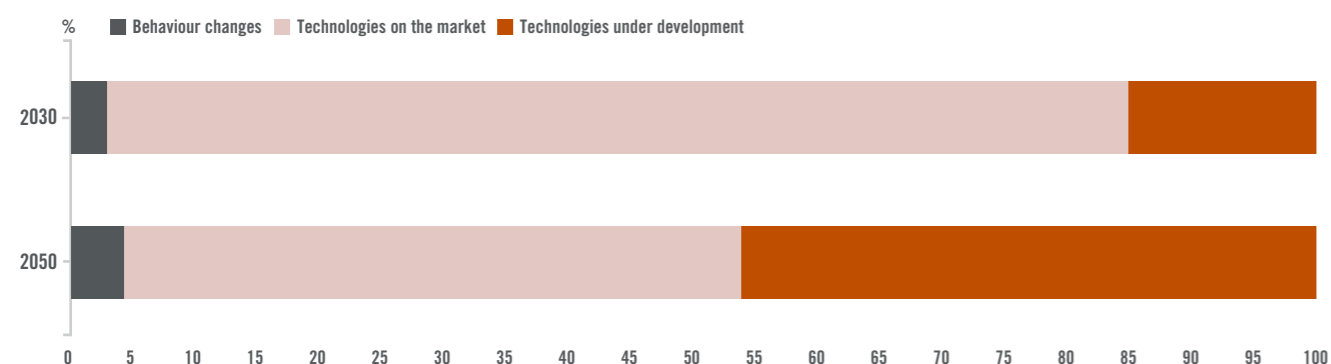
Whilst the global effort to realise a 1.5°C scenario will require existing companies and industries to rapidly transition their net greenhouse-gas emissions to zero, enabling this extensive overhaul will require novel and innovative climate solutions.

The transition to net zero is creating immense demand for decarbonisation solutions. Today, we can already achieve significant emissions reductions by scaling market-ready technologies. The International Energy Agency estimates that over 80% of the emissions reductions required by 2030 can be achieved through technologies that are available on the market today, including renewable energy, energy efficiency and electric vehicles. Because these technologies are mature, investors can access a number of listed companies that are whole or partial contributors to these climate solutions.

However, nearly half of the emissions reductions required by 2050 (and 15% of those by 2030) will come from technologies that are at the prototype or demonstration phase today (see figure 3). This means that heavy investment in innovation will be required in the transition. And this goes well beyond the clean-energy sector. During the COP26 conference, world leaders announced the Breakthrough Agenda to make clean technologies the most attractive options across power, road transport, steel, hydrogen and agriculture.<sup>8</sup>

Figure 3 — TECHNOLOGIES NOW UNDER DEVELOPMENT WILL PLAY A KEY ROLE IN REACHING NET ZERO BY 2050

Annual CO<sub>2</sub> emissions savings in the net zero pathway, 2030 and 2050, relative to 2020



Source: IEA, Annual CO<sub>2</sub> emissions savings in the net zero pathway, 2030 and 2050, relative to 2020, IEA, Paris

<sup>6</sup>IPCC, 2021

<sup>7</sup>IPCC 1.5 Degree Report, 2018.

<sup>8</sup>Race to Zero, 2021

## BOX 2 PATH TO NET ZERO

‘Achieving net-zero emissions by 2050 will require nothing short of the complete transformation of the global energy system.’

The International Energy Agency outlines a path to net zero global emissions by 2050 that includes:

- tripling of investment in renewable energy by 2030 to USD4 trillion annually
- almost half of reductions to 2050 coming from technologies currently in the early stages of development
- the complete cessation of sales of internal combustion engine cars by 2035 phasing out unabated coal and oil power by 2040
- Electric vehicle sales jumping from 3 mn in 2020 to 56 mn in 2030
- Capacity additions of wind and solar from combined 249GW in 2020 to 993GW in 2030

Source: IEA, 2021

Achieving *net zero* is comprised of two parts:

- 1) Reducing absolute emissions as much as possible +
- 2) Removing any residual emissions from the atmosphere (also known as carbon dioxide removal – CDR).

The initial emphasis of all actors should be the reduction of absolute emissions, but, since zero absolute emissions is impossible, CDR is an indispensable part of achieving *net zero*.

In its 2018 1.5 Degree Report, the IPCC stated that to limit warming to 1.5°C would require CDR in the range of 100 to 1,000 GT between now and 2100. As corporates begin to understand the challenges of absolute emission reductions, there has already been a sharp rise in the voluntary market for carbon offsets. Offsets can come in a variety of forms, including paying others not to emit or to reduce emissions, or removing them. Brief definitions:

- **Avoided emissions** are those that might have occurred but do not, e.g. building solar in the place of gas-fired power, or not cutting down a forest that might otherwise have been
- **Reduced emissions** are existing emissions that no longer occur, e.g. through energy efficiency or electrification
- **Removed emissions** are those that were emitted and later taken out of the atmosphere, e.g. through planting trees or direct-air capture

According to the [Oxford Principals for Net Zero Aligned Offsetting](#), the residual emissions to get to net zero should ideally be accomplished with removal, rather than paying for avoided or reduced emissions elsewhere.

## GOVERNMENTS

Governments of 135 countries responsible for almost 90% of current global greenhouse-gas emissions have already committed to achieving *net zero* in the coming decades, including the recent addition of India, which made a commitment at COP26.<sup>9</sup> Of these, a number of large emitters have enshrined these targets into law,

including the EU, the UK and Canada. Additionally, governments representing more than 50% of methane emissions have committed to reducing methane by 30% by 2030. It is now crucial that these commitments get translated into concrete policy to ensure that these targets are met.

### BOX 3

## COPS UP TO GLASGOW – A PRIMER

There has been deservedly much press coverage of the recent climate gathering in Glasgow at COP26. Although the awareness around these events has been spreading, for many, the first time they would have heard of a COP was at COP21 in Paris in 2015. So what exactly is a COP and how did we get to where we are today?

COP stands for Conference of the Parties and is the supreme decision making forum on climate for the UN Framework Convention on Climate Change, a treaty signed in 1994 by 197 signatories (196 nations plus the EU) with the aim of preventing ‘dangerous’ anthropogenic climate change. Since then, the signatories have been meeting to gradually ratchet up coordinated global action on climate change. Major milestones:

- COP3 1997 – Kyoto Protocol – A mandate for developed countries to reduce their emissions by 5% from 1990 levels by the 2008–2012 period. However, the Kyoto Protocol didn’t include major emitters China and India from the beginning and was never ratified by the United States, so didn’t cover a large portion of global greenhouse gases.
- COP18 2012 – Doha Amendment – In the final year of the Kyoto commitment period, the signatories agreed to extend the Kyoto Protocol to 2020 and reaffirmed that they would create a comprehensive climate treaty that includes developing countries by 2015, in what would become the Paris Agreement.

– COP21 2015 – Paris Agreement – The Paris Agreement was the first comprehensive agreement to address climate change including all nations, both developed and developing, with the aim of keeping global warming to well below 2°C from pre-industrial levels, aiming for 1.5°C. Unlike the Kyoto Protocol, the Paris Agreement didn’t have binding top-down targets, but delegated to countries to build their own action plans (the Nationally Determined Contributions, NDCs), with a mechanism for monitoring and reporting. It also requires countries to resubmit new climate action plans every five years. It is for this reason that COP26 – being the fifth since the Paris Agreement – was so crucial.

– COP26 2021 – Glasgow Climate Pact – The recently concluded climate conference in Glasgow saw a step change in commitment to addressing climate change across the globe. Nations agreed to submit more aggressive NDCs ahead of next year’s COP and a leaders’ summit in 2023. A commitment to ‘phase down’ coal (watered down from the original ‘phase out’ by India and China) was also made. The Paris Rulebook, setting out guidelines for how the Paris Agreement is implemented was finalised. COP26 also saw countries representing 85% of the world’s forests commit to ending deforestation.

**Governments of 135 countries responsible for almost 90% of current global greenhouse-gas emissions have already committed to achieving net zero in the coming decades.**

<sup>9</sup>Net Zero Tracker



## Despite a clear trend and strengthening momentum, most companies have yet to set net-zero targets.

### CORPORATIONS

Nearly one third of the world's largest 2,000 listed companies have now made net-zero commitments<sup>10</sup>. The Science Based Targets initiative (SBTi) announced a coalition of over 1,000 companies, representing more than USD23 trillion in market capitalisation, would commit to science-based targets in line with 1.5°C of warming. However, despite a clear trend and strengthening momentum, most companies have yet to set net-zero targets and the majority that have still lack detailed, science-based plans for achieving them. With many corporate net-zero commitments, there is a risk of overreliance on offsets that skirt the need to make deep reductions in absolute emissions. The SBTi recently released its Net Zero Standard, which requires most companies to achieve 90–95% emissions reductions by 2050 and to remove the residuals.<sup>11</sup>

### FINANCIAL INSTITUTIONS

As credit providers, financial institutions can determine which projects get funded and at what cost and, as capital allocators, their activities have an impact on climate-change outcomes. They can both foster positive and mitigate negative impact in a significant way, given the volume of global assets such institutions control.

The last few years have seen a series of coordinated financial-sector initiatives aimed at facilitating the climate transition, aligning USD trillions in assets with the objective. The **Net Zero Asset Managers initiative** has 220 signatories with USD57 trillion in combined assets under management. The **Net Zero Asset Owners Alliance**, of namely pension and insurance funds, has 61 signatories with USD10 trillion in assets. The **Net Zero Banking Alliance** has 95 signatories representing USD66 trillion in banking assets, or over 40% of global banking assets. These and other global organisations, compose the **Glasgow Financial Alliance for Net Zero**, a group of over 450 financial firms responsible for assets of roughly USD130 trillion, which aims to create a pan-financial sector commitment to aligning assets with *net zero*.<sup>12</sup>

Investors are also increasingly pressuring companies to commit to meaningful climate plans. For example, 220 financial institutions **recently sent a letter** to 1,600 of the top greenhouse gas emitters to submit science-based emissions-reduction plans.

Additionally, central banks are creating a more prominent role for climate change in assessing financial stability and macroeconomic modelling. The Federal Reserve **announced** the creation of a Supervision Climate Committee in early 2021, whilst the European Central Bank **released** its own climate action plan over the summer of the same year. In total, 33 central banks representing 70% of global GDP have committed to issuing guidance on mitigating climate-related financial risks.

<sup>10</sup>Net Zero Tracker

<sup>11</sup>Science Based Targets The Net-Zero Standard

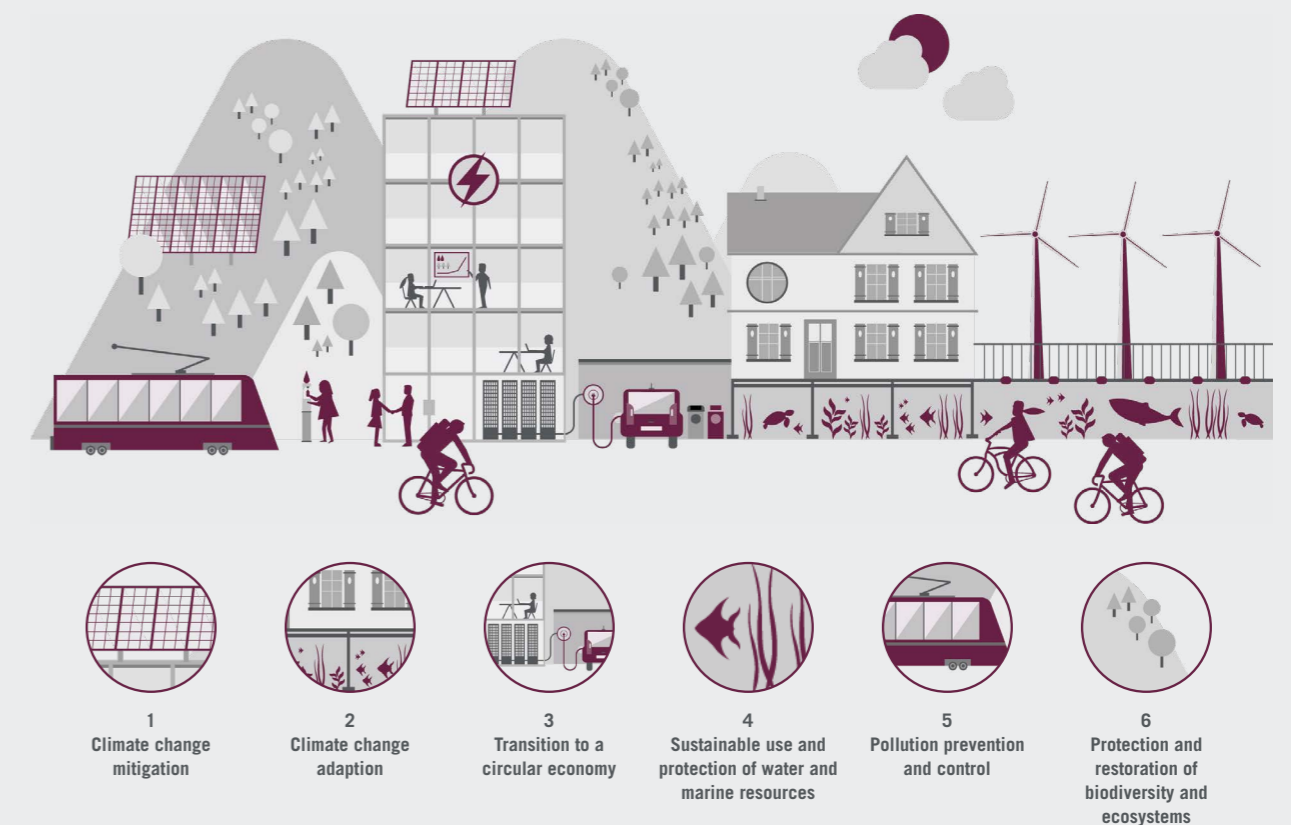
<sup>12</sup>Glasgow Financial Alliance for Net Zero, 2021

### BOX 4

## EU TAXONOMY REGULATION

In order to meet the EU's climate and energy targets for 2030 and reach the objectives of the European Green Deal, it is vital to direct investments towards sustainable projects and activities. To facilitate this, a common language and a clear definition of what is 'sustainable' is needed. This is why the action plan on financing sustainable growth called for the creation of a common classification system for sustainable economic activities, or an 'EU taxonomy'.

The **EU Taxonomy Regulation** indicated six environmental objectives (*see figure below*) and planned to identify lists of environmentally sustainable activities, by defining technical screening criteria through 'delegated acts'. A first delegated act on sustainable activities for climate change adaptation and mitigation objectives was formally adopted in June 2021. A second delegated act for the remaining objectives will be published in 2022.



Source: European Commission

## CLIMATE AND INVESTMENT PORTFOLIOS

### CLIMATE-RELATED INVESTMENT RISK

Climate change will have a material impact on asset prices. The Taskforce on Climate-Related Financial Disclosures (TCFD) identifies two types of material financial risk – transition risk and physical risk.

Physical risks relate to those associated with higher severity and incidence of extreme weather events, or more gradual changes in climate. Transition risks are associated with the process of mitigating climate change and transitioning to a low carbon economy, more specifically, one aligned with the Paris Agreement.

Physical risks relate to a company's physical assets or operations that are vulnerable to any adverse consequences of climate change. Climate change has direct physical impacts that are either severe or chronic. The former are harder to estimate due to their intermittency, and arise from the higher frequency and/or severity of extreme weather events<sup>13</sup>. The latter include losses due to heat impacting labour productivity, or from changing agricultural yields, as examples. Whilst the most dramatic of physical effects lie in the future, we are already seeing the materialisation of physical risks today (see box 5 – real manifestations of physical risk).

Transition risks are particularly pertinent for high-emitting sectors, such as energy; agriculture, forestry and land use; and industry (see figure 4 on page 20). Transition risks play out over a shorter horizon than physical risks. It can also manifest earlier as stranded asset risk, which relates to a decline in the valuation of an asset as it becomes less viable in a particular emissions trajectory. Perhaps the clearest example of stranded assets lies in the fossil-fuel reserves that cannot be combusted within the Paris Agreement framework, yet today account for considerable balance-sheet assets among oil and gas companies. According to a recent article in *Nature*, to be consistent with a 1.5°C scenario, 60% of current oil and natural gas reserves must remain unextracted<sup>14</sup>, meaning they are at risk of becoming stranded assets. Like that of mortgage derivatives in 2008, we can expect such a revaluation to occur as a non-linear event. Studies suggest that the market is already demanding higher compensation to hold brown versus green assets<sup>15</sup>.

### BOX 5

## REAL MANIFESTATIONS OF PHYSICAL RISK

In 2018, California wildfires drove the state's largest utility, PG&E, to bankruptcy and made it an emblem of the very material impact that climate change can have on corporations and financial markets. The company was left with USD30 bn in liabilities, after the fires killed 85 people and destroyed over 30,000 buildings. The wildfires, while caused by the company's **inadequate management and infrastructure**, were exacerbated by rising temperatures and drought.

Severe flooding in Thailand in 2011 caused large-scale disruption to manufacturing processes of car parts suppliers, as well as computer hardware suppliers. This led to **a shortage of key parts for major international companies** with significant supply chain exposure to Thailand – from car manufacturers to computer makers.

<sup>13</sup>Financial Stability Board 2020

<sup>14</sup>Nature, 2021

<sup>15</sup>The Review of Financial Studies, 2021

## CLIMATE INVESTMENT OPPORTUNITIES

Whilst it is imperative that investors understand the financial risks posed by the climate transition, Pictet has always believed that facilitating the green economic transition represents a significant investment opportunity. In fact, since 2000 – long before the Paris Agreement was signed – we have pioneered thematic strategies that direct capital towards companies providing solutions to some of the world's greatest environmental challenges.

Today, companies operating in the field of cleaner infrastructure and resources, carbon-reducing technologies and equipment, clean power generation and distribution and energy efficiency are all pockets of the economy developing solutions to help the system transition.

### BOX 6

## CLIMATE INVESTMENT OPPORTUNITY EXAMPLES

### RENEWABLE ENERGY

The costs of renewable energy generation, such as wind and solar, have dropped steeply over the years and are now increasingly competitive with traditional energy sources coming from fossil fuels (e.g. coal, oil and gas). In addition to economic competitiveness, global governments are also taking major steps to support the renewables industry through their net-zero commitments. As such, renewable energy is expected to play a key role in the clean energy transition by replacing fossil fuels.

### ENERGY EFFICIENCY

On the demand-side of the energy transition, energy efficiency-focused businesses reduce energy demand in transportation (including sub-themes such as electrification of transport and smart mobility), or improve energy efficiency in industry and buildings, thereby contributing to a decoupling from economic growth.

### Green Buildings

Buildings account for 29% of global energy consumption by end use. They represent a significant potential for energy savings. The real estate sector's focus on energy efficiency and green buildings has accelerated in recent years, a trend that is expected to continue. This sub-theme includes multiple areas such as building materials and insulation, efficient lighting, data centres, HVAC & Heat pumps and building energy management.

### Efficient Manufacturing

Improvements in industrial manufacturing processes such as prototyping software and simulation produces savings in energy and resource use, while allowing companies to optimise the design and lifespans of their products.

### Smart Mobility

Smart mobility and electric mobility are driven by powerful forces such as increasing cost competitiveness (compared to combustion engine transport), stronger health awareness regarding air particle pollution, and thus increasingly stringent regulations globally. As such, we believe the future of transport is going through a transformational change towards electrification and greater autonomy.

### ENABLING TECHNOLOGIES

This theme consists of technologies such as battery storage, smart grids and power management semiconductors, which are critical accompaniments in the transition to a low-carbon economy. For example, large-scale batteries are increasingly becoming a competitive solution towards smoothing out the intermittent electricity generation profile of renewable energy and will also experience large growth alongside renewables buildout.

### ENABLING INFRASTRUCTURE

Similar to Enabling Technologies, this theme consists of networks and smart grids, which are also crucial in providing energy networks and supporting the low-carbon transition.

These are just some examples of how to access the clean-energy transition, but so much more will need to be done to move from our current trajectory onto a path that is consistent with avoiding the calamitous effects of a 3°C (or worse) outcome.



## ACCESSING THE NET-ZERO TRANSITION LEADERS OPPORTUNITY: A FRAMEWORK

Reducing greenhouse gas emissions to net zero by the middle of this century requires leadership from today's established corporations and industries in decreasing the emissions associated with their own operations and supply chains (net-zero transition), and innovating and scaling the low-carbon solutions that will enable these transitions (climate solutions).

The two are closely related as companies that want to reduce emissions will require the procurement of decarbonisation solutions, from renewable electricity to lithium-ion batteries, from energy-efficiency technologies to sustainably produced ingredients. In the process of transitioning, previously high-emitting companies may also pivot their business models to delivering climate solutions, e.g. switching from producing internal-combustion-engine to electric vehicles.

## DEFINING NET-ZERO TRANSITION LEADERS FROM AN INVESTMENT PERSPECTIVE

Transition leaders are companies with robust commitments and plans to meaningfully reduce greenhouse gas emissions (see box 7 overleaf – for breakdown of emissions types). To identify these transition leaders, we identified four steps:

### 1) SUITABILITY

Verify that companies do no significant harm

### 2) CLIMATE RELEVANCE

Companies must influence sufficient emissions for their absolute reductions to be impactful

### 3) INTENTIONALITY

Companies need to be intentional in their strategy

### 4) MEASURABILITY

Companies must include measurable KPIs into their target framework and approach

## KEY CONSIDERATIONS

### SUITABILITY

Any credible screening starts with ESG-integrated financial analysis, including considerations about any physical and transition risks and ensuring that companies 'do no significant harm', for example that companies are not associated with any severe controversies, nor participate in any 'high risk activities'<sup>16</sup>.

### CLIMATE RELEVANCE

The sectors and companies that emit the most greenhouse gases into the atmosphere today have the potential to make the largest climate impact. To screen for sufficient climate relevance, we also consider how much of the indirect emissions a company can reasonably influence (for example, the financial sector has high indirect 'financed emissions' in its portfolios, but it has a limited ability to prevent those emissions). At the company level, we consider that a company is 'relevant' from a climate impact perspective when it emits more than 2mn tonnes of CO<sub>2</sub> emissions per year.

## INTENTIONALITY

### Ambitious targets

With greenhouse gas emissions targets being set across both the public and private sectors, it is essential to recognise that defining a target is not enough. The target must be science-based, in alignment with a 1.5°C warming scenario and must also be implemented in both policies and procedures. Companies that set ambitious greenhouse gas reduction objectives today will gain a competitive advantage in the years to come. Energy efficiency gains will lead to cost savings; credible targets will bolster company reputations; and ambitious goals will spur innovation and transformational change, which can also unlock new growth opportunities.

### Climate governance

Companies demonstrate commitment to these targets by adopting the climate governance processes and disclosure practices required for aggressive climate-change mitigation, thereby increasing the likelihood of achieving any targets.

Sound climate governance encompasses a comprehensive approach to managing climate-change-related risks and reducing greenhouse gas emissions. This is indicative of an organisation-wide commitment to seriously combatting climate change and determines to what degree climate governance mechanisms are institutionalised, including:

- executive- and board-level oversight on climate
- incentive-alignment mechanisms around climate (remuneration or some other tangible impact)
- engagement with value chains
- a strategy that takes climate change into account across the entire organisation
- a process to identify and assess and manage climate risks and opportunities
- incorporation of climate-related scenario analysis in assessing climate-related risks and opportunities
- detailed disclosures in-line with TCFD

These criteria are aligned with the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD).

<sup>16</sup>Details about Pictet Wealth Management's Responsible Investing Policy can be found here.

### Walking the walk – initiating a track record

Transition leaders align their actions with their commitments. Future plans to reduce emissions are essential, but what measures a company has already taken can be indicative of how committed it is to its future transition plans. In order to include companies that are early in their transition journeys today, we monitor the Scope 1, 2 and 3 emissions intensity reduction in the past three years (rolling).

### MEASURABILITY

Measurability, or the investor's ability to track a company's progress against targets, is critical because great plans (intentionality) do not always translate into real progress. However, in practice, measurement is complex, particularly given the nature of climate change and the number of dependencies involved. Compared to positive impact investing in other areas, measuring for positive climate impact cannot be done – today – on the impact itself (degree warming realised), but for example,

on the company's output (its emissions) and outcomes (its emissions reductions vis-à-vis its targets).

Progress against these targets can be tracked against company disclosures, including company sustainability reports. Companies with Carbon Disclosure Project (CDP) disclosures that are TCFD aligned (*see Sources of data section below*) further facilitate the measurement process for investors.

Transparency on the success of any emissions-reduction plan is also a key input for investors' direct or collective engagement with a company. It can also inform proxy-voting decisions or ultimately, a potential divestment decision if the desired changes are not agreed by company management.

### SOURCES OF DATA

Following a thorough due-diligence review process, we have identified the following data providers as the best currently available in their respective areas of expertise.

#### Climate relevance: Associated emissions

S&P Trucost is a leader in carbon and environmental data and risk analysis. The company assesses risks relating to climate change, natural resource constraints and broader ESG factors. Companies and financial institutions use Trucost intelligence to understand their ESG exposure to these factors, inform resilience and identify transformative solutions for a more sustainable global economy.

#### Ambitious targets

A joint initiative among the Carbon Disclosure Project (CDP), World Resources Institute, the World Wildlife Foundation (WWF) and UN Global Compact, [Science-Based Targets Initiative \(SBTi\)](#), focuses specifically on ensuring that companies' forward-looking targets are aligned with the climate science. SBTi assembles teams of experts to provide companies with an independent assessment and validation of submitted targets, ensuring that approved targets are in alignment with the Paris Agreement.

### BOX 7

## CARBON EMISSIONS SCOPES 1, 2 AND 3

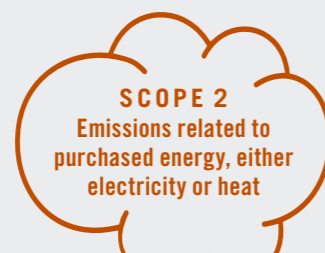
Many companies only report on Scopes 1 and 2 emissions. However, for many businesses, most emissions are indirect, or Scope 3.



Combustion of fuels stationary or in company vehicles, fugitive emissions or process emissions

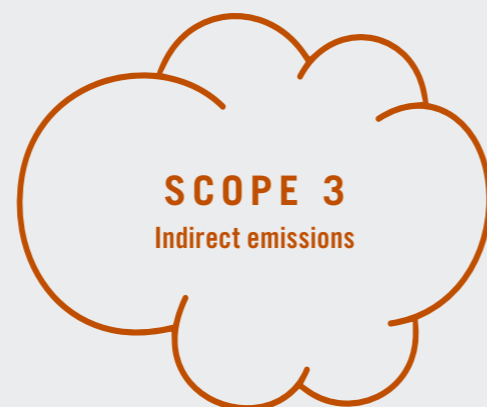
#### Examples:

Fossil-fuel heating of buildings, combustion of aviation fuel for airlines or in trucks for logistics companies, methane leaks for oil and gas companies, CO<sub>2</sub> emissions as part of chemical process in cement production



#### Examples:

Energy procurement from utilities, most prominently being addressed by tech companies like for their data centre usage



–upstream from suppliers and – downstream through distribution or use of product

#### Examples:

Upstream emissions can relate to agriculture and land use for food and beverage companies and the manufacture of textiles for clothes companies.

Downstream emissions come from the combustion or use of a company's end products, as in the oil and gas and automotive industries.

### IMPLEMENTATION

How to identify transition leaders through this screening process.

Data availability and integrity is critical for investors in determining which corporations are climate relevant and assessing their progress towards any climate targets. Whilst the data availability and reporting has improved over time, some challenges remain and the universe is rapidly evolving (*see box 8 – data*).

### BOX 8

## DATA PROVIDERS – KEY TO BEAR IN MIND

#### DATA COVERAGE AND AVAILABILITY

is rapidly evolving and data providers can change as that landscape develops

**SCOPE 3 EMISSIONS**, those found in companies' supply chains and the use of their end products, make up the bulk of many companies' emissions, yet are often not disclosed and require a number of assumptions if they are. This can lead to significant variation in Scope 3 estimates across different data providers.

#### FUTURE CONSIDERATIONS FOR OUR MODEL

could include capital expenditure and implied temperature rise metrics. We believe those data will be key part of future assessment, but not yet easily accessible or reliable enough. We are monitoring these areas particularly as they develop.

SBTi's *Net Zero Standard* addresses understandable concerns about greenwashing around corporate net-zero targets, particularly the over-reliance on carbon offsets. The *Standard* requires that companies decarbonise by 90–95% by 2050, leaving on 5–10% residual emissions to be addressed through carbon dioxide removal.

Companies submit near-term targets aligned with a 1.5°C scenario for Scopes 1 and 2 and well-below 2°C for Scope 3,<sup>17</sup> which SBTi then compares with the transition pathways set out by the Intergovernmental Panel on Climate Change (IPCC) to certify that they are science-based. In general, companies submit targets along an *absolute contraction approach*, which requires them to set interim absolute emissions reduction targets.

SBTi also provides a *sectoral decarbonisation approach* for certain, hard-to-abate sectors, like aviation, cement, steel, transport, etc, although some of these are still under development. This focuses more on a relative measure of emissions intensity reduction over the short term, or the reduction of emissions per unit of output. These pathways leverage the work undertaken by the International Energy Agency under its technology roadmaps.

Although the number of companies submitting targets to SBTi is growing rapidly, the absolute number remains relatively small. At the time of writing, around 2,100 companies have made commitments, just under half of which have had their targets confirmed by SBTi as being science based and consistent with temperature limits.

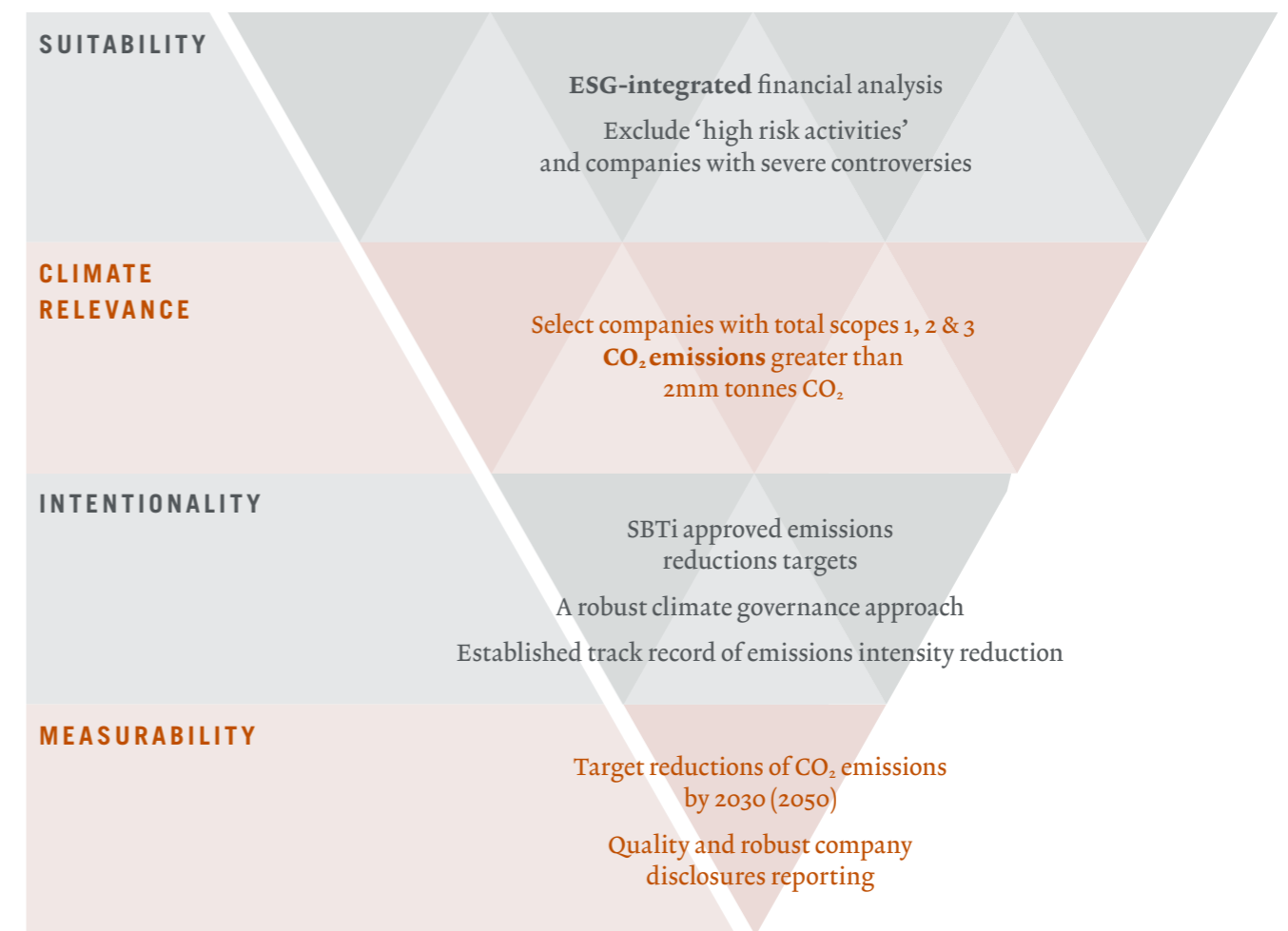
### Climate governance

Carbon Disclosure Project (CDP) is an independent non-profit charity that has built a voluntary mechanism for disclosure on climate-related issues, among others. The CDP produces a climate questionnaire for companies to complete. It takes a holistic approach, examining companies' climate action across governance, data quality, climate risk integration, targets and other areas. The respondents represent a large and growing universe of companies. In 2020, 9,500 companies responded on climate change, covering over 50% of global market capitalisation and a 14% increase on the year before.

CDP is broadly recognised as the gold-standard of environmental reporting, having the richest and most comprehensive dataset on corporate and city action. It is a leader specialised in climate-related data. Over 590 investors representing over USD110 trillion in combined assets have requested that companies disclose through CDP on climate change, water security and forests. Over 9,600 companies globally have reported through CDP.

CDP data helps companies and investors to make informed decisions. By measuring and understanding their environmental impact, companies can take steps to address and limit their contribution and risk exposure to climate change. Because of the granularity of CDP data, a company's carbon footprint and its forward-looking plans to reduce it can be more reasonably assessed.

Figure 5—DECISION FUNNEL – NET-ZERO TRANSITION LEADERS



<sup>17</sup>Source: [Science Based Targets](#), [SBTi Corporate Net-zero Standard](#), 2021

## INVESTMENT FUNDS INVESTING IN NET-ZERO TRANSITION LEADERS

For reviewing fund managers investing in *net-zero transition leaders*, we have identified a series of best practices.

### BEST PRACTICES

#### CLIMATE RELEVANCE – FUND OBJECTIVE

To demonstrate climate relevance, we would expect the investment fund to have climate-change mitigation as its main investment objective. More explicitly, to target a transition to net-zero greenhouse gas emissions by 2050 at the overall portfolio level, aligned with the Paris Agreement’s long-term warming target of 1.5°C.

We would therefore monitor the exposure to high-climate impact sectors<sup>18</sup> for those companies transitioning to net-zero greenhouse gas emissions.

For those funds with dual investment objective of decarbonization and climate solutions, we would also monitor the alignment with the EU Taxonomy Climate Change Mitigation objective.<sup>19</sup>

### BOX 9

## PICTET ESG DUE DILIGENCE AND SCORING FOR INVESTMENT FUNDS

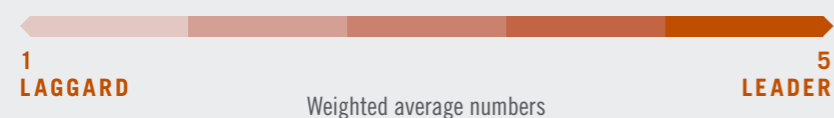
Over the last years we have applied a comprehensive ESG due diligence questionnaire to assess fund managers. The questionnaire includes both firm- and fund-level questions. The completed questionnaires are assessed and scored on four pillars (Management Firm commitment to ESG, Investment Process, Active Ownership, Monitoring

and Reporting). Each fund is ranked with a score from 1 (ESG Laggard) to 5 (ESG Leader). This structured and robust approach offers us a strong foundation to integrate further criteria around climate based on the identified best practices and as managers increasingly transition their strategies.

### THE ESG DDQ: 4 PILLARS OF ANALYSIS

MGMT FIRM COMMITMENT TO ESG	INVESTMENT PROCESS	ACTIVE OWNERSHIP	MONITORING & REPORTING
Signatory to recognised standards ESG principles and guidelines Products and resources allocated	Principles underlying the research Criteria defining investment universe Explicit list of exclusions	Proxy voting policy Engagement with issuer Products and resources allocated	Regular RI progress reports Monitoring of ESG parameters Communication

### OUTPUT: FUND ESG SCORE



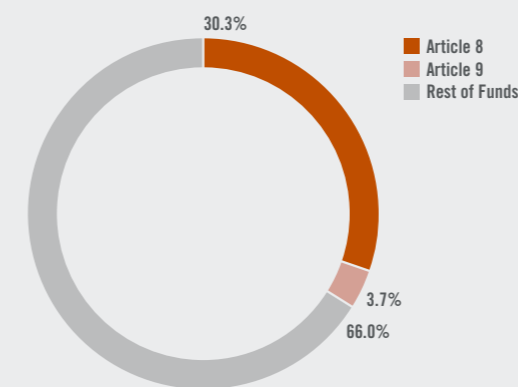
These ESG ratings are qualitative and while not systematically linked to the SFDR, they shall be used in conjunction with the external manager’s own SFDR classification

<sup>18</sup>Sources: COMMISSION DELEGATED REGULATION (EU) 2020/1818 as regards minimum standards for EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks Annex I to Regulation (EC) No 1893/2006 Establishing the statistical classification of economic activities NACE Revision 2

<sup>19</sup>for green bonds, this would apply to their use of proceeds

### BOX 10

## THE EU SUSTAINABLE FINANCE DISCLOSURE REGULATION (SFDR)



Source: Morningstar Direct. Data as of 10 July 2021. Based on SFDR data collected from prospectuses on 81.6% of funds available for sale in the EU excluding money market funds, funds of funds, and feeder funds.

The EU SFDR was created to standardise requirements for environmental and social claims in the aim of stopping greenwashing. Since March 2021, asset managers are required to provide information about their investments’ environmental, social, and governance risks as well as impact on society and the planet and to classify funds that are distributed in the EU as Article 6, 8 or 9.

**Article 6** – Non-ESG focused financial products

**Article 8** – Financial products that promote environmental or social characteristics

**Article 9** – Financial products that have sustainable investments as their objective

### SUITABILITY AND DO NO SIGNIFICANT HARM

– Our own proprietary ESG due-diligence questionnaire and scoring methodology provides the base of our assessment. It allows an objective analysis of all funds through the same lens and identifies those whose principles and methodologies are aligned with our long-term expectations (see box 9 – fund selection ESG due diligence process).

– We expect funds that target social and/or environmental objectives to be classified as *Article 9* under the EU’s Sustainable Finance Disclosure Regulation (see box 10). These are the so-called ‘dark green’ funds that have ‘sustainable investments’ or ‘reduction in carbon emissions’ as their objective.

– Finally, the investment fund itself could also screen for do no significant harm and exclude companies with adverse impacts on the environment and society (e.g. as required by [EU Climate Benchmarks regulation](#)).

### INTENTIONALITY

When it comes to demonstrating intentionality, there are several best practices that funds can follow:

– At the company level, a fund manager could be signatory to the Net-Zero Asset Manager Initiative (NZAMI) (see box 11 on page 30 – Net Zero Asset Managers Initiative)

– At the portfolio level, managers should set interim decarbonisation targets. For example:

- 50% global emissions reductions by 2030 (NZAMI)
- 7% annual year-on-year reduction (EU Climate Benchmarks regulation)
- sector-specific decarbonisation targets

– Fund managers could apply both *carrot and stick* approaches by

1) recognising and rewarding companies with robust transition plans as per the *net-zero transition leaders* framework<sup>20</sup>.

2) actively engaging with companies with insufficient transition plans, for example encouraging adoption of best practices rather than divestment, which should be a last resort. Divestment from high emitters risks driving their activities out of the view of regulated capital markets and public ownership.

<sup>20</sup>In absence of the previously identified data sources SBTi and CDP, Transition Pathway Initiative (TPI) assessment or a recognised alternative could be used.

**MEASURABILITY**

At the portfolio level, there are several tools available for robust measurement, including forward-looking metrics that measure alignment with the Paris Agreement, actual portfolio greenhouse-gas emissions or intensity and alignment with the EU taxonomy’s Climate Change objective. We would expect fund managers to invest in *net-zero transition leaders* to use those tools and provide transparency.

According to the final report from [Portfolio Alignment Team](#), the tools available today to asset managers for measuring portfolio alignment to the Paris Agreement at the portfolio level are:

**BINARY MEASUREMENT**

The simplest of the three tools, binary measurement looks at whether a portfolio’s constituents have made Paris aligned, net-zero commitments that are consistent with the climate science and existing industry frameworks. The percentage of a given portfolio’s constituents with such commitments is then provided as an overall portfolio calculation.

**BENCHMARK DIVERGENCE MODEL**

A more complex approach, benchmark divergence modelling measures present-day performance and forward-looking forecasts of a portfolio constituents’ emissions against a reference pathway drawn from a climate scenario. The EU Climate Benchmarks regulation

require portfolios to decarbonise at an average rate of 7% per year, in alignment with the global 1.5°C IPCC scenario. Complex benchmark-divergence models may use forward-looking climate scenarios to disaggregate the global carbon budget down to region- and sector-level benchmarks, thereby enabling portfolio managers to measure alignment with a Paris compliant future in a way that accounts for different decarbonisation rates across sectors and regions.

**IMPLIED TEMPERATURE RISE (ITR)**

ITR, or degree warming models, are the newest type of portfolio alignment tool, meaning there remains

a significant lack of understanding around what ITR models are and how they work. ITR models are identical in design to the more established benchmark divergence approaches, but rather extend model output one level further by translating each portfolio constituent’s benchmark alignment (or lack thereof) into a single temperature score. For example, a score of 2.5°C assigned to a given company indicates that it is exceeding its share of the global carbon budget (its benchmark) and that if all emitters exceeded their emissions shares by the same proportion, the world would end up with ~2.5°C of warming by the end of the century.

**BOX 11**

**NET ZERO ASSET MANAGERS INITIATIVE**

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

Specifically, signatories commit to:

- Work in partnership with asset owner clients on decarbonisation goals, consistent with an ambition to reach net zero emissions by 2050 or sooner across all assets under management
- Set an interim target for the proportion of assets to be managed in line with the attainment of net zero emissions by 2050 or sooner
- Review our interim target at least every five years, with a view to ratcheting up the proportion of AUM covered until 100% of assets are included

In relation to b) above, in order to fulfil these commitments, signatories further commit to:

- Set interim targets for 2030, consistent with a fair share of the 50% global reduction in CO<sub>2</sub> identified as a requirement in the IPCC special report on global warming of 1.5°C

- Take account of portfolio Scope 1 & 2 emissions and, to the extent possible, material portfolio Scope 3 emissions
- Prioritise the achievement of real economy emissions reductions within the sectors and companies in which they invest
- If using offsets, invest in long-term carbon removal, where there are no technologically and/or financially viable alternatives to eliminate emissions
- As required, create investment products aligned with net-zero emissions by 2050 and facilitate increased investment in climate solutions

As regarding accountability, signatories agree to publish annual TCFD disclosures, including a climate action plan and submit them to the Investor Agenda via its partner organisations for review to ensure the approach applied is

- based on a robust methodology,
- consistent with the UN Race to Zero criteria, and
- action is being taken in line with the commitments made here

Figure 6— BEST PRACTICE FRAMEWORK FOR TRANSITION LEADERS AND CLIMATE SOLUTIONS FUNDS





## CONCLUSIONS

The agreement reached under the Glasgow Climate Pact has underscored the urgency and global commitment to addressing climate change. It has also reaffirmed that as asset owners, it is our responsibility to do all within our power to push our shared trajectory onto a 1.5°C pathway.

Our continued prosperity and, in some cases, our very survival depends upon not only our immediate action, but more importantly on our capacity to rise to the challenge. The climate emergency humanity faces today comes with it the opportunity of our lifetimes – the opportunity to create an economy and society that works with our planet’s ecosystem services, not against them, and to capture the resulting natural, social and financial capital in so doing.

## A WORD ABOUT PICTET’S CLIMATE COMMITMENTS:

We believe that as part of the asset manager/owner community, our investment activities have an impact on climate change outcomes.

We therefore have a responsibility to understand how to foster positive impact and mitigate negative impact.

A natural part of this journey has been joining the Net Zero Asset Managers Initiative and the complementary SBTi Business Ambition for 1.5°C ensuring we set science based and verified 2030 targets in the course of 2022.

Transparency will be key to solving the climate challenge. Material environmental and social disclosures help us make better capital allocation decisions, and ultimately contribute to the transition. This is also why we have endorsed the Task Force for Climate Related Financial Disclosures (TCFD). We will progressively incorporate material-TCFD aligned disclosures in our annual reporting.

As a signatory of both the UN Principles for Responsible Investment and the UN Principles for Responsible Banking, we will continue to drive change within the financial services community and strengthen our policy work around the topic of climate.

Locally we support the Swiss CEO4Climate initiative, which calls on the Swiss government to take more meaningful legislative action in support of achieving the Paris Agreement goals. Beyond our borders, we have signed the Global Investor Statement on the Climate Crisis, which is the strongest ever call by global investors for governments to raise their climate ambitions and implement meaningful policies to support investment in solutions to the climate crisis.

Given the scale of the challenge, we believe the investment community can be more effective if its members work together to achieve common goals. As a result, we have actively supported the Institutional Investor Group on Climate Change since 2013, and are part of Climate Action 100+, an investor-led initiative to ensure the world’s largest corporate greenhouse gas emitters take necessary action on climate change. We are also a member of the Farm Animal Investment Risk & Return (FAIRR) Initiative, which engages with companies active in livestock production as they are also large contributors to greenhouse gas emissions. And finally, we support and are working with the Centre for Education and Research in Environmental Strategies (Ceres) to prepare collaborative engagement on the critical topic of water. In the context of the climate challenge, water is a critical element of adaptation in the face of impending climate change.

To learn more about Pictet’s actions to tackle climate change, please visit [here](#).

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