Net Zero Asset Managers Initiative

As asset managers disclose their targets, commitments vary wildly. What's an investor to do?

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Executive Summary

The Net Zero Asset Managers Initiative, or 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 global warming to 1.5 degrees Celsius. To date, the initiative has 273 signatories, representing over USD 61 trillion in assets under management. Within 12 months of signing on to the initiative, asset managers are required to disclose the proportion of their AUM that will be managed in line with net zero and to announce emission reduction targets on the proportion of AUM that will be aligned to net zero in 2030[1].

On May 31, NZAMI released its second progress report disclosing these details and more for 43 signatories. In this paper, we discuss the wide range of net-zero commitments and compare the approaches taken by the three largest asset managers, namely BlackRock, Vanguard, and State Street. Additionally, we discuss the challenges that managers face when setting targets and lay out a few outstanding questions. This paper is a follow-up to Asset Managers and Net Zero Investing: The Road Ahead, published in November 2021.

Key Takeaways

- There are wide variations in levels of commitment across asset managers in terms of assets destined for net-zero alignment and interim emission reduction targets.
- Assets committed by the 43 managers in the May report range from 4% to 100%. Only nine managers committed 100% of their AUM, and 15 committed to less than 50%.
- The Big Three, namely BlackRock, Vanguard, and State Street, made contrasting AUM commitments of 77%, 4%, and 14%, respectively. Vanguard's 4% commitment consists entirely of subadvised assets, which means that the firm has effectively committed none of its in-house managed assets.
- The wide range of approaches to target setting renders it very difficult to make direct comparisons between asset managers, raising questions about the reliability of any of the commitments and decarbonization targets. Investors would benefit from standardized approaches.
- Less than a fifth of the firms set absolute emission reduction targets, which are harder to reach than carbon intensity targets. About a third did not set emission reduction targets but said they aim to invest a portion of their assets in issuers with science-based targets.

1 As part of the commitment, asset managers aligning with net zero must also prioritize real economy emissions reductions, consider material scope 3 emissions, increase investment in climate solutions, and create investment products in line with net zero. The signatories also agree to only use offsets that involve long-term carbon removal where there are no technologically and/or financially viable ways to eliminate emissions.

- Ten asset managers have no firmwide policy on coal and other fossil fuel investments. These include Invesco, Lazard, MFS, State Street, and Vanguard, among others.

A wide range of approaches, described in this paper, can produce what appears to be varying levels of commitment, leading to investor confusion. Nevertheless, despite the challenges, the results are encouraging. The Net Zero Asset Managers Initiative, created only 18 months ago, has already attracted some USD 61 trillion of assets under management. More than 80 of the 273 signatories have already announced interim targets. We hope to see a higher overall commitment from the next wave of managers who will publish their targets around the time of the United Nations Framework Convention on Climate Change's 27th Conference of the Parties, or COP27, in November. Ultimately, climate-focused investors will want to partner with the most committed managers.

What Is NZAMI?

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 the Paris Agreement goal to limit global warming to 1.5 degrees Celsius above preindustrial levels [2]. The initiative was launched in December 2020 as a sibling organization to the Net-Zero Asset Owners Alliance, with the aim of galvanizing the asset-management industry to provide products suitable for asset owners committing to net-zero goals. The initiative is convened by six investor networks: AIGCC (Asia), Ceres (North America), IGCC (Australasia), IIGCC (Europe), UN PRI (global), and CDP (global).

To date, NZAMI has 273 signatories, representing over USD 61 trillion in assets under management. In line with the best available science on the impacts of climate change, NZAMI signatories acknowledge that there is an urgent need to accelerate the transition toward global net-zero emissions and for asset managers to play their part to help deliver the goals of the Paris Agreement and ensure a just transition.

Within 12 months of signing on to the initiative, asset managers are required to disclose:

- The initial percentage of AUM that will be managed in line with net zero
- Their "fair-share" interim targets for AUM that will be managed in line with net zero, and target date
- The methodology used in target setting

Asset managers will have to report on their actions and update their targets regularly (at least every five years), with a view to ratcheting up the proportion of assets until 100% are included.

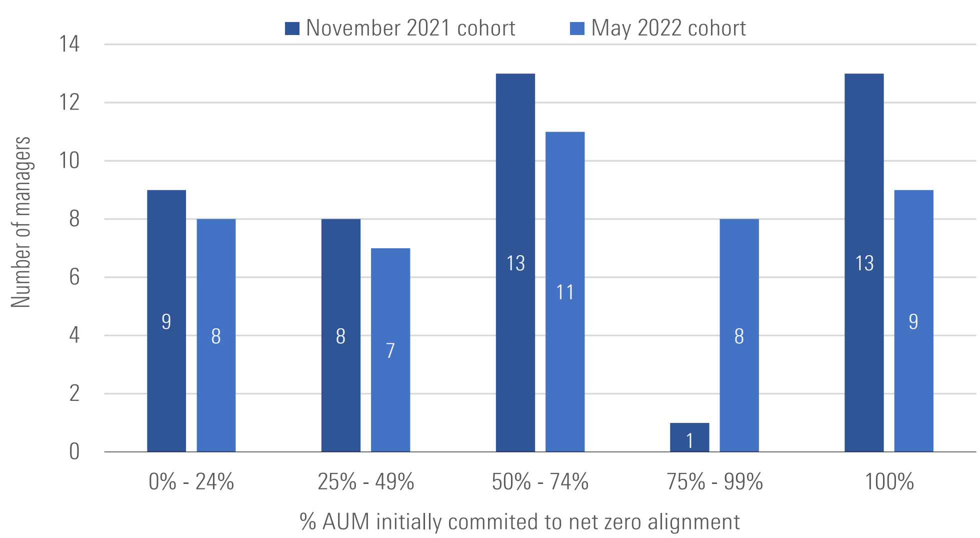
2 "Net zero" refers to the aims of reducing greenhouse gas emissions and fully offsetting the remaining emissions by activities that remove greenhouse gasses from the environment.

NZAMI's Second Progress Report—A Wide Range of Commitments

On May 31, NZAMI released its second progress report disclosing the interim targets of 43 of its signatories. It follows the publication in November 2021 of the first progress report, which included the plans of NZAMI's 43 original members. The new set of targets brings the total AUM committed to be managed in line with achieving net zero to USD 16 trillion out of the USD 42 trillion total assets managed by all the firms that have set targets so far[3].

The second progress report highlights wide variations in initial commitments, ranging from 4% to 100% of AUM. Of the 43 asset managers included in the report, only nine committed 100% of their AUM to be managed in line with net zero and 15 committed to less than 50%. Two managers committed to less than 10%, namely Lazard Asset Management (9%) and Vanguard (4%).

Exhibit 1 Asset Managers Grouped by Proportion of AUM Initially Committed to Net-Zero Alignment



Source: NZAMI's first and second progress reports published in November 2021 and May 2022, respectively. Morningstar's calculations.

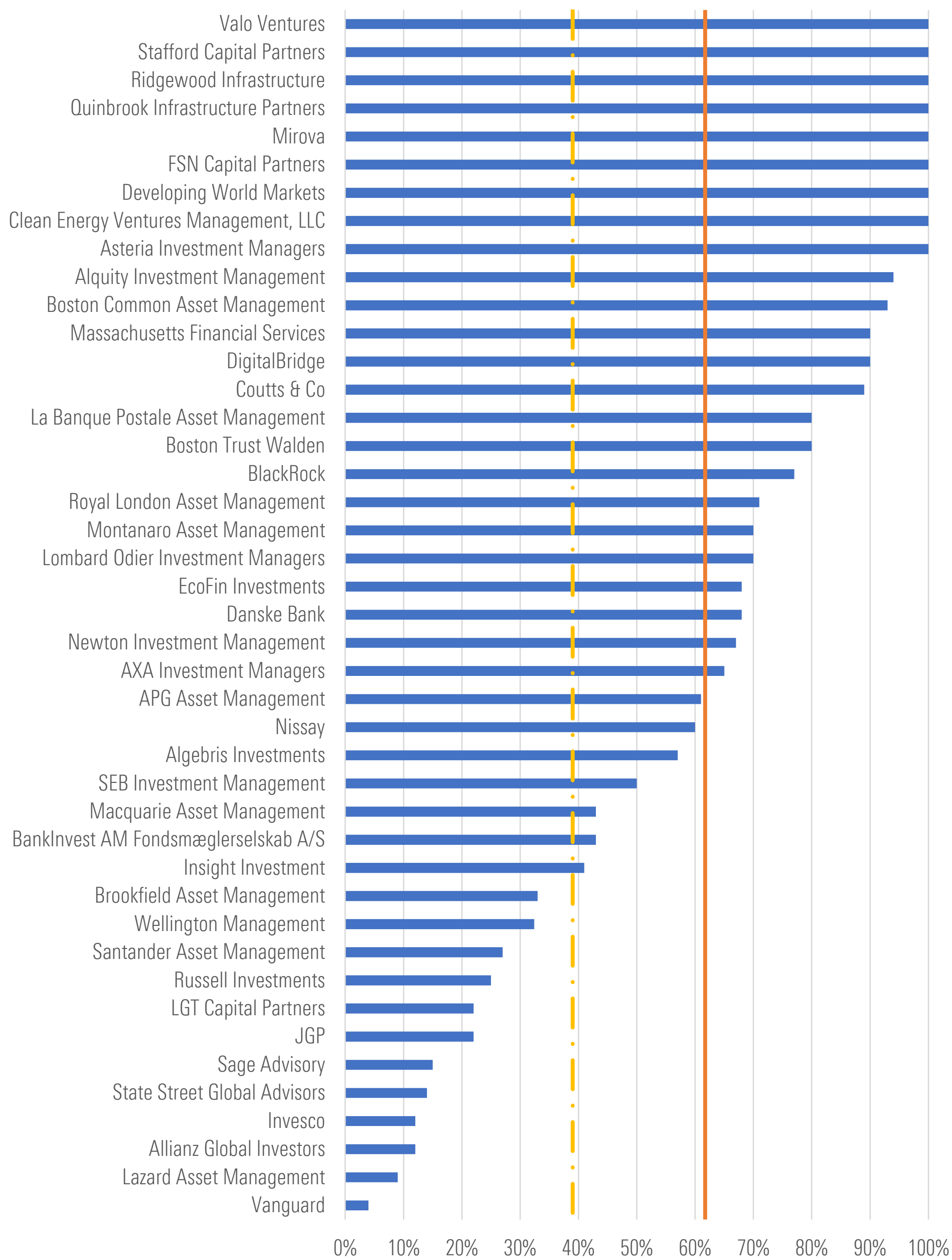
The wide variation in headline figures may come as a surprise to investors, but it is roughly in line with the range of AUM committed by the first cohort of managers (0.55%-100%). Out of the 44 managers that disclosed targets in November, more (13) committed 100% of their AUM, but also more (17) committed to less than 50%. Overall, the proportion of AUM committed by the May cohort is 4 percentage points higher (39% versus 35%) than that of the November cohort. One could have expected a more substantial improvement. We hope to see a higher overall commitment from the next wave of managers who will publish their targets around the time of COP27[4].

3 The 83 asset managers consist of 43 that published targets in November and 40 additional ones in May. The second progress report includes three managers that revised their November targets.

4 https://cop27.eg/

The exhibit below ranks the 43 asset managers included in the May report by proportion of AUM committed to be managed in line with net zero. The red and orange lines represent the average commitment percentages, on a simple and asset-weighted basis, respectively.

Exhibit 2 Asset Managers Ranked by Proportion of AUM Initially Committed to Net-Zero Alignment



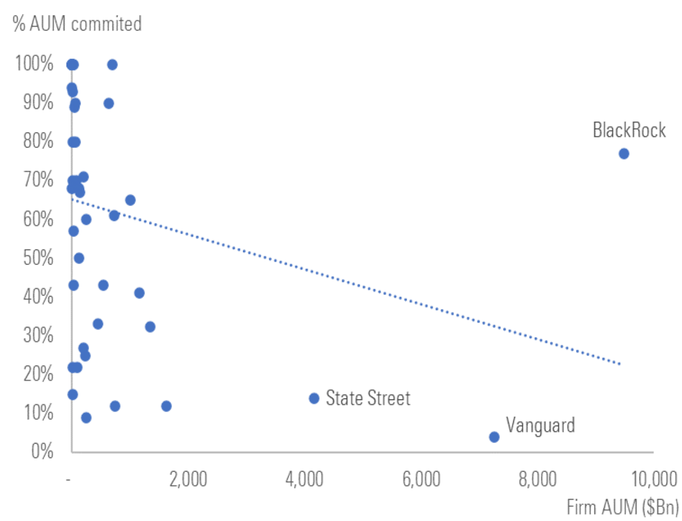
Source: NZAMI's second progress report published on 31 May 2022.

According to NZAMI, the diverging AUM commitments are mainly due to the diversity of the asset-management firms. Different managers face different constraints when setting targets depending on their business model, geographic footprint, and asset class mix. Nevertheless, they are all expected to commit 100% of their AUM in the next 28 years.

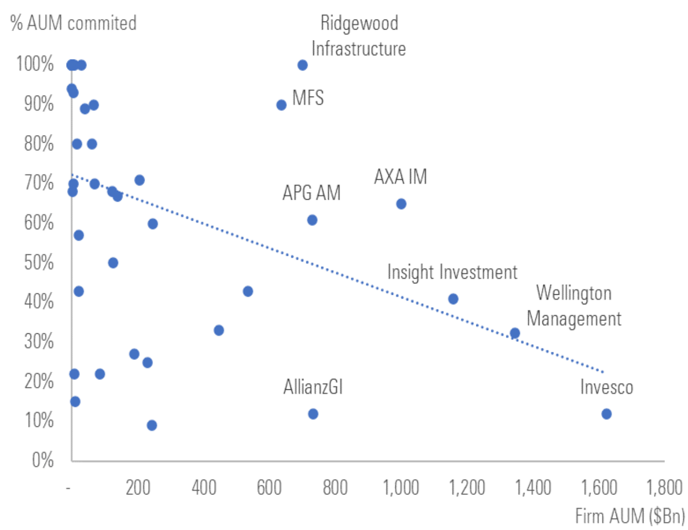
Below we show that there is a link between firm size and initial commitment level. In Exhibits 3 and 4, we plot the managers featured in the second progress report according to their total AUM (X axis) and their percentage of AUM initially committed to net-zero alignment (Y axis). Exhibit 3 on the left includes the Big Three, while Exhibit 4 on the right excludes them.

Exhibits 3 & 4 Proportion of AUM Initially Committed to Net-Zero Alignment Relative to Firm Size

Including BlackRock, Vanguard, State Street



Excluding BlackRock, Vanguard, State Street



Source: NZAMI's second progress report published on 31 May 2022. Firm AUM is calculated based on the firm's % AUM initially committed to net-zero alignment and the equivalent in AUM terms.

Exhibits 3 & 4 show somewhat of an inverse relationship between firm size and percentage of AUM initially committed. Smaller asset managers and those specializing in sustainable investment were able to commit a higher proportion of net-zero-aligned AUM than larger and more diversified managers. This is the case for Mirova, Stafford Capital Partners, and Boston Common Asset Management[5], which committed 100%, 100%, and 93% of their assets, respectively. By contrast, Vanguard, Invesco, and State Street, three of the world's largest managers, committed 4%, 12%, and 14% of their total AUM, respectively. One notable exception in the group of large managers is BlackRock, which committed 77% of its AUM.

5 Mirova's AUM is USD 30 billion, Stafford Capital Partners' AUM is USD 8 billion, and Boston Common Asset Management has AUM of USD 6 billion.

Besides firms' diversity, the wide range of firms' initial commitment to net-zero alignment can also be attributed to the different scopes and target-setting approaches NZAMI allows asset managers to adopt, making comparisons between them more difficult.

One key methodological variable relates to the inclusion of sovereign assets and segregated mandates in the initial scope. Some managers took a conservative approach by excluding sovereign assets because of a lack of widely accepted methodology for net-zero targets. Some also excluded mandates that would first require clients' approval. As a result, many managers limited their initial commitment to portfolios already managed in line with net zero and asset classes for which established decarbonization methodologies exist, while pledging to expand their scope over time as better data and methodologies emerge.

Others, however, took a more forward-looking and confident approach by including assets they expect to be managed in line with net zero in the future, including sovereign debt and mandates as they expect both governments and clients to act on their own net-zero commitments.

The contrasting commitments are most evident when examining the initial net-zero plans of the three largest investment managers, namely BlackRock, Vanguard, and State Street Global Advisors.

Focus on the Big Three: BlackRock, Vanguard, and State Street

The exhibit below shows the details of the initial net-zero commitments made by BlackRock, Vanguard, and State Street Global Advisors, who together oversee investments worth about USD 21 trillion of assets.

Exhibits 5 Comparing the Initial Net-Zero Commitments of the World's Three Largest Asset Managers

Manager	Total firm AUM (USD trillion)	% of AUM committed to be managed in line with net zero	AUM to be managed in line with net zero (USD trillion)	Proportion of AUM committed	Baseline year	Quantified target(s) to be achieved by 2030	Baseline year performance for the target metric(s)	Target setting methodology
BlackRock	9.5	77%	7.3	The vast majority of listed corporate securities (listed equities and debt with ACWI IMI issuers) and treasuries, and was chosen based on currently available data and methodologies	2021	At least 75% of AUM will be invested in issuers with science-based targets or equivalent	Currently 25% of AUM with respect to corporate and sovereign issuers is invested in issuers with science-based targets or equivalent	For corporates: Science Based Target initiative for Financial Institutions; For sovereigns: Germanwatch Climate Change Performance Index referenced by NZIF, Climate Action Tracker
Vanguard	7.3	4%	0.29	Assets of nine actively managed funds subadvised by Wellington Management, including ESG products with net-zero commitments and funds without explicit ESG mandates that nonetheless align to net-zero objectives because of their existing philosophy and process	2019	Each strategy is expected to reach at least 50% of market value in companies with targets consistent with a net-zero glidepath.	Each fund will have a different baseline performance relative to its benchmark.	Science Based Target initiative for Financial Institutions
State Street	4.2	14%	0.58	Equity and corporate bond portfolios from clients who have adopted net-zero targets or similar climate commitments or are expected to do so, including index portfolios that have a climate component currently, or are expected to adopt a climate objective	2019	50% reduction in scope 1 and 2 carbon emissions intensity	Currently in the process of calculating baseline performance for its targets	Paris Aligned Investment Initiative Net Zero Investment Framework

Source: NZAMI's second progress report published on 31 May 2022.

Despite their similar sizes and business models (each one has trillions of assets in exchange-traded funds and index funds), BlackRock, Vanguard, and State Street have adopted very different approaches to target setting.

Vanguard's USD 290 billion committed to be net-zero-aligned by 2030 (representing 4% of its total AUM) are assets invested in actively managed environmental-, social-, and governance-focused products that already have net-zero commitments and in other actively managed funds that do not have explicit ESG mandates but align to net-zero objectives because of their existing philosophy and process.

It is worth noting that these committed assets consist of only nine funds subadvised by Wellington Management Co., which are already included in Wellington's in-scope AUM. This means that not only these assets are counted twice, but also Vanguard has effectively committed 0% of its in-house managed assets.

Vanguard excluded[6] index funds from its in-scope AUM, while acknowledging that over USD 1 trillion (20%) of its index equity assets are invested in companies that have committed to net-zero targets, according to MSCI data. An additional USD 2.8 trillion (56%) are invested in companies that have some other form of emission-reduction targets. In total, close to 76% of Vanguard's index equity assets are invested in companies with publicly stated emission-reduction goals.

In its Task Force on Climate-Related Financial Disclosures, or TCFD, report, Vanguard explained that NZAMI didn't have a methodology that allows for the alignment of portions of products, and the firm separately added:

> *"In light of our rigorous approach, there would need to be one or more credible actions taken before we would consider including index fund assets within our commitment, including:*
> *- an evolved NZAM methodology allowing for the alignment of a subset of assets within an index fund to be committed to net zero;*
> *- substantial changes to the methodology of the underlying indexes that fund provider's products track;*
> *- or if portfolio companies held in a given index fund substantially increase the adoption of net zero targets."*

Of the three, we believe the most likely action that will lead Vanguard to substantially increase its AUM commitment in the near future is the first one. We can indeed expect NZAMI to evolve its guidance with respect to alignment of portions of products.

Meanwhile, State Street adopted a similar approach to Vanguard, although, in addition, it counted assets from clients who may be reasonably expected to adopt climate commitments as well as index portfolios that may be reasonably expected to adopt a climate objective.

These conservative approaches contrast with that of BlackRock, which included in its pledge all those investee companies that have adopted net-zero targets or similar climate commitments, as well as those it anticipates will make such commitments in the future. As such, instead of focusing on individual portfolio mandates and client types, BlackRock focused on the alignment of underlying companies to net-zero pathways. This approach assumes that more companies will adopt net-zero targets and the portfolios themselves will decarbonize as a natural consequence of the companies' real-world decarbonization.

BlackRock went one step further by including sovereign assets within its commitment despite the lack of clear industry methodology to assess net-zero alignment in that asset class[7]. This decision reflects

6 https://corporate.vanguard.com/content/dam/corp/articles/pdf/TCFD-Report-ISTCFD-052022.pdf

7 For sovereigns, BlackRock is leveraging the Germanwatch Climate Change Performance Index, CCPI, referenced by the NZIF, as well as Climate Action Tracker, or CAT, a well-cited rating method that evaluates a broad spectrum of government targets and actions to reduce greenhouse gas emissions in line with the Paris Agreement temperature limit. To define alignment thresholds, BlackRock is considering the countries in the top two tiers of these frameworks as net-zero-aligned or having set the equivalent of science-based targets. This is subject to change as further sovereign alignment methods are developed. BlackRock also defines sovereign green bond exposure as net-zero-aligned.

BlackRock's expectation that governments will follow through on their own commitments to ensure the objectives of the Paris Agreement are met. BlackRock wrote[8]:

> *"Our clients' portfolios – which reflect the global economy – cannot reach net zero without sustained and consistent government policy, accelerated technological breakthroughs, and substantial adaptation in corporate business models. These portfolios will reflect the regulatory and legislative choices governments make to balance the need for reliable and affordable energy, and orderly decarbonization."*

As a result, BlackRock anticipates that by 2030, 77% of its corporate and sovereign assets will be invested in issuers with science-based targets or the equivalent[9], compared with 25% today.

However, this means that, unlike State Street, which pledged to halve carbon emissions intensity in its in-scope assets, BlackRock didn't commit to any quantified emission-reduction targets, whether expressed in terms of carbon intensity or carbon footprint[10]. Instead, BlackRock's 2030 target is expressed as a percentage (77%) of AUM invested in issuers with science-based targets or the equivalent.

Like several other NZAMI signatories, BlackRock has taken the SBTi Portfolio Coverage Approach, which is an engagement-oriented approach focused on portfolio companies' actions to measure and reduce emissions. Under this methodology, financial institutions commit to having a portion of their investees set their own SBTi-approved science-based targets such that the financial institution is on a linear path to 100% portfolio coverage by 2040. BlackRock, however, does not intend to base its methodology and alignment tracking solely on the SBT initiative. It left open the door to consider issuers aligned if they follow another science-based framework, particularly for sectors for which methods are not available from SBTi.

According to NZAMI, the benefit of the portfolio coverage approach is that it focuses on getting companies themselves onto a decarbonization pathway that achieves real world reductions, as opposed to decarbonizing portfolios by divesting from heavy emitters. The downside, however, is that it can be more difficult to determine the portfolio emissions impact (compared with a portfolio emissions reduction approach).

Additional evidence that the choice of methodological approaches is the biggest source of divergence between managers can be found in the case of AXA Investment Managers. In May, AXA increased the scope of its commitment to 65% of its total AUM, from only 15% in November, after switching to a top-down asset-class approach from a portfolio-to-portfolio approach. AXA's pledge now includes 100% of

8 2030 Net Zero Statement | BlackRock

9 tcfd-report-2021-blkinc.pdf (blackrock.com)

10 Carbon intensity: The portfolio's exposure to carbon-intensive companies (expressed in tons CO2e/EUR revenue). Emissions are allocated to an investor based on companies' portfolio weights.

Carbon footprint: Total emissions for a portfolio, normalized by the market value of the portfolio (expressed in tons CO2e/EUR invested). Emissions are allocated to an investor based on their share of a company's total capital (EVIC: enterprise value including cash).

corporate equity and bonds, government bonds, listed real assets, and the real estate assets managed on behalf of AXA Group. For all of these assets, AXA has been able to define clear net-zero pathways in line with the Intergovernmental Panel on Climate Change, or IPCC, 1.5°C pathways report.

Strategies and Metrics

Another methodological difference across managers' plans relates to the metrics they use to set targets and track progress toward achieving net-zero goals. Depending on the net-zero strategies adopted, managers have a choice of metrics as outlined below by the Science Based Targets initiative.

Exhibits 5 Observed Metrics Used in Net-Zero Strategies

Net-Zero Strategy	Claims	Metric Types
1. Portfolio Emissions	Net-zero claims are based on measuring and tracking emissions associated with financing activities i.e. reducing financed emissions along relevant sector pathways and financing emission removals to achieve net-zero portfolios	• Absolute Portfolio Emissions (tCO_2e) • Portfolio-Wide Intensity, e.g., Weighted Average Carbon Intensity (tCO2e/revenue) • Sector-Based Physical Intensity (e.g., tCO2e/MWh)
2. Portfolio Alignment	Net-zero claims are based on assessing the relative level of net-zero alignment of their financing activities i.e. reaching a state where all portfolio companies achieve net-zero	• Binary Target Measurement • Implied Temperature Rise • Capacity-Based Metrics
3. Portfolio Contribution	Net-zero claims are based on shifting financing toward technologies needed for the real economy to reach net-zero emissions i.e. reaching a state where all financing contributes towards achieving a net-zero economy	• Internal Carbon Price • Green Metrics (e.g., Taxonomy or Revenue Share)

Source: SBTi. https://sciencebasedtargets.org/resources/files/SBTi-Finance-Net-Zero-Foundations-paper.pdf

These metrics are being used in isolation and in combination. However, according to the SBTi, not all metrics can be used to credibly track progress. This is either due to uncertainty in how they can be consistently quantified or due to the lack of a clear link with how science-based ambition is defined.

Out of the 43 managers included in the May report, the most adopted metric was carbon intensity[11]. More than 14, including State Street, Wellington Management, and Macquarie AM, reported their interim targets mainly using carbon intensity. Fewer than 10 managers used absolute portfolio emissions[12] targets, which are much harder to achieve than carbon intensity. Examples include APG Asset Management, SEB Investment Management, and Royal London AM. Meanwhile, implied temperature rise was adopted as the sole metric by Lombard Odier Investment Managers.

11 The portfolio's exposure to carbon-intensive companies (expressed in tons CO2e/EUR revenue). Emissions are allocated to an investor based on companies' portfolio weights.

12 The absolute greenhouse gas emissions associated with a portfolio (expressed in tons of CO2e). Emissions are allocated to an investor based on their share of a company's total capital.

The use of different metrics adds to the challenge of making comparison between managers.

Fossil Fuel Policies

The proportion of AUM committed to be managed in line with net zero and the accompanying targets are not the only factors that vary widely from manager to manager. There is also variation in managers' stance on coal and other fossil fuels.

The network partners[13] of NZAMI expect signatories to adopt a robust and science-based policy in relation to fossil fuel phaseout. Both the Paris Aligned Investment Initiative Net Zero Investment Framework and the Science Based Targets initiative recommend that investors immediately cease all financial or other support to companies that are building new coal infrastructure or investing in new or additional thermal coal expansion, mining, production, utilization, retrofitting, or acquiring of coal assets.

Despite these expectations, we have identified 10 asset managers in the May report without firmwide policies on coal and other fossil fuel investments. These include Invesco, Lazard, MFS, State Street Global Advisors, and Vanguard. These and other managers do, however, have coal and fossil fuel exclusion policies for certain funds. In many cases, these funds represent a small portion of their total assets.

Challenges Faced by Asset Managers

In this section, we discuss in more detail some of the challenges that NZAMI signatories currently face in setting targets and fulfilling their commitments. These include:

- the nascent stage of methodologies and data availability
- managers' dependence on clients' commitments
- the need to prioritize the achievement of real-economy emissions reductions
- the increased variation in the ESG regulatory and policy environments
- the current energy crisis following the Russian invasion of Ukraine

Nascent Stage of Methodologies and Data Availability

As previously mentioned, one of the reasons for the wide range of manager commitments is the lack of a common approach to target setting. The commitment made by NZAMI signatories is designed to be "methodology neutral" such that asset managers may choose the most appropriate target methodology[14] for their business. As a result, asset managers have taken different approaches to determine a) the perimeter of their commitment and b) the emissions reduction targets for that perimeter.

13 The six network partners are AIGCC (Asia), Ceres (North America), IGCC (Australasia), IIGCC (Europe), CDP (Global), and UN PRI (Global).

14 The network partners, through the Investor Agenda, recognize and endorse three target-setting approaches: Paris Aligned Investment Initiative's Net Zero Investment Framework, or NZIF, Science Based Targets initiative for Financial Institutions, or SBTi, and Net Zero Asset Owner Alliance Target Setting Protocol, or TSP. To ensure targets are robust and science-based, asset managers should choose one or a combination of the above methodologies. If asset managers wish to use an alternative methodology, they should explain the rationale in their disclosure and reporting, including how their alternative methodology is in line with best available science on achieving the 1.5 degrees Celsius goal of the Paris Agreement.

The lack of globally accepted methodologies to set targets in asset classes such as sovereign debt, derivatives, cash, private equity, real estate, and structured products, among others, means that many managers refrained from including these assets in their initial net-zero commitments. For example:

> *Lombard Odier Investment Managers (70% of AUM committed to net zero): "The 70% target represents 100% of the AUM and asset classes where we presently have access to the methodologies, metrics and data needed to assess alignment. Increased coverage of carbon data and carbon metrics is the key priority, and most significant constraint we still face today. We are actively seeking to expand coverage of alignment metrics to infrastructure, hedge funds, and other alternatives, which would allow us to expand the coverage of our target. The assessment of alignment of sovereign debt issuance is a key near-term priority."*

A few managers, however, decided to include sovereign investments in their initial scope. For example:

> *Coutts & Co (89% of AUM committed to net zero): "Asset classes in scope are determined based on the availability of data and net zero methodologies at the time of target setting. Our decarbonisation target includes equities and corporate fixed income held directly within active and passive third-party funds. Our portfolio alignment targets also include sovereign bonds. Cash is currently excluded due to methodological limitations."*

Choosing the right approach to target setting is complicated by data quality issues and lack of data, especially on scope 3 emissions. Moreover, most widely available climate metrics are backward-looking, and historical emissions are not a good indication of a company's transition readiness. Meanwhile, available carbon reduction pathways for companies remain insufficiently robust, given the inexact science applied to sectoral emission-reduction projections.

According to NZAMI, a number of efforts are in train, supported by the network partners and individual managers, to address these gaps in methodologies and data, which will allow a broader range of asset classes to be included in the future. This, in turn, will allow signatories to quickly ratchet the proportion of AUM committed to net zero and enhance comparability for investors between managers.

Dependence on Clients' Commitments

An additional challenge for asset managers in setting net-zero targets is their dependence on clients' ambitions. Some clients may not be willing to make the necessary investment shift. A majority of managers in the May report excluded from their initial scope assets over which they do not have discretionary investment control (for example, segregated mandates), but they plan to engage with clients to seek their approval to include these assets in the future. For example:

> *Santander Asset Management (27% of AUM committed to net zero): "Private client mandates are out of scope initially, subject to client consent. We are proactively engaging with our asset owner clients providing expertise and analytics on net zero investing and encouraging them to adopt net zero criteria in their mandates, with the aim to increase the proportion of clients' mandates to be managed in line with net zero goals."*

However, a few managers' commitments do cover mandates. For example:

> *LGT Capital Partners (22% of AUM committed to net zero): "We included listed corporate investment instruments of our managed funds and customised mandates in asset classes such as listed equities and fixed income as well as liquid alternative strategies."*

By signing to NZAMI, managers have committed to working in partnership with clients on decarbonization goals. They have also committed to develop investment strategies in line with net zero and increase investment in climate solutions.

> *BankInvest Asset Management (43% of AUM committed to net zero): "Targets for the allocation to climate solutions are work in progress and expectedly dependent on the evolution of the EU Taxonomy as the new classification system for investments in climate solutions."*

Prioritizing Real-Economy Emissions Reductions

Another significant challenge for asset managers aligning with net zero relates to prioritizing the achievement of real-economy emissions reductions within the sectors and companies in which they invest. Portfolio decarbonization does not necessarily lead to real-economy emissions reductions. Managers often comment that divesting fossil fuel assets will not ensure that they are decommissioned.

Engagement and active ownership are therefore key strategies to establishing a link between portfolio targets and tackling emissions in the real economy. To drive real-world impact, NZAMI encourages asset managers to engage with companies to embark on a decarbonization pathway. In the May report, several managers noted that they felt confident about using engagement as a strategy for effecting change. For example:

> *MFS (90% of AUM committed to net zero): "We believe a portfolio coverage target using an engagement-based approach allows us to maximize the proportion of in-scope AUM on the path to achieving net zero, while being aligned with our overall investment philosophy and our fiduciary responsibilities to our clients. We believe this approach reflects the aspiration and ambition of the NZAM initiative to achieve real world emissions reduction in our portfolios."*

The Increased Variation in ESG Regulatory and Policy Environments

In its latest report, NZAMI notes that the increased politicization of ESG issues and the growing variation in the regulatory landscape globally are making the target-setting process more challenging. This affects managers' ability to shift assets toward net-zero alignment and can impact the level of client demand for such a shift. The initiative reports a number of cases where, due to policy changes or engagement with clients, asset managers have been able to commit a significantly higher proportion of assets than would have been possible even a few months ago. But equally, there are some who are operating in less supportive regulatory environments and are working to overcome some of the current constraints. Organizations operating globally must balance a range of jurisdictional requirements when setting targets and implementing their net-zero commitments.

One constraint that global managers must deal with is the different definitions of fiduciary duty between the United States and Europe. The U.S. has a narrow interpretation of fiduciary duty, which requires that investment managers focus on maximizing financial returns for the client. This contrasts with the European view that fiduciary responsibility encompasses a broader range of issues, including the impact of companies on the environment and society at large (concept of double materiality).

> *Vanguard (4% of AUM committed to net zero):* "*We remain clear that our duty to maximize returns for the investors in our products is our central objective. We believe any successful transition supporting net zero aligned investing will require the action of governments and policymakers.*"

When it launched, NZAMI was very clear that asset managers' net-zero plans would be made under the assumption that governments would follow through on their commitments to meet the objectives of the Paris Agreement, including by increasing the ambition of their nationally determined contributions[15]. To facilitate this goal, managers are encouraged to engage with governments through policy advocacy.

The Energy Crisis

Finally, in its May report, NZAMI highlighted the current energy crisis as a new factor contributing to the complexity of setting net-zero targets. Exacerbated by Russia's invasion of Ukraine, the energy crisis has increased short-term demand for fossil fuels, to which countries such as the U.S. and Germany have responded by increasing production of oil, gas, and coal. Over the short term, this means a slowing of the net-zero transition as governments shift their priorities to issues they consider more pressing.

> *Russell Investments (25% of AUM committed to net zero):* "*[We] will continue to assess our policy on coal and other fossil fuels over time, incorporating the latest climate science, considerations for a just transition, while acknowledging a practical need for energy security.*"

But over the long term, the energy crisis is likely to accelerate the net-zero transition, especially in Europe, where the drive for energy security should spur the development of clean energy.

15 The Paris Agreement requests each country to outline and communicate their post-2020 climate actions, known as their nationally determined contributions, or NDCs. https://unfccc.int/process-and-meetings/the-paris-agreement/nationally-determined-contributions-ndcs/nationally-determined-contributions-ndcs

Conclusion

The Net Zero Asset Managers Initiative was created only 18 months ago, and its achievements thus far are encouraging. The initiative has attracted close to 300 organizations, representing USD 61 trillion in AUM, and more than 80 members have already announced their interim targets. We applaud the signatories, who, by joining the initiative, have sent a clear signal to their clients and the market at large that they acknowledge their responsibility in the transition to a net-zero world. In addition, they have committed to transparency and accountability. Not all managers have made, or are willing to make, such a commitment. For example, as of this writing, large firms such as Capital Group, Fidelity Investments, Pimco, Goldman Sachs, and Morgan Stanley Investment Management aren't NZAMI members. Some of these firms contend that joining would compromise their fiduciary duty and that they prefer to make independent commitments.

While we welcome the commitment NZAMI members make by becoming signatories, we can't help but be critical about the wide range of initial commitments made by managers, both in terms of assets in scope for net-zero alignment and interim emission-reduction targets. It is true that some of the variation in commitments can be explained by the diversity of the firms represented, but that doesn't tell the whole story. As we saw from comparing the Big Three, managers of similar sizes and with similar business models can make contrasting commitments. Rather, we attribute the wide range of commitments to the different methodological approaches to asset coverage and target setting permitted by NZAMI. Unfortunately, this flexibility makes it very difficult to draw direct comparisons between managers, which hampers investors' understanding of the initiative itself. Investors stand to benefit from standardized approaches on these matters.

Investors may wonder what conclusion to draw from the latest NZAMI report. Are managers who commit higher percentages of assets more ambitious than those with lower numbers? Are some methodologies better than others? Many managers have attributed their relatively low AUM commitments to a lack of consensus on measuring net-zero alignment. Others, however, have found ways around this challenge and pledged higher percentages of AUM. One may therefore question whether the choice of methodology may itself reflect a manager's level of ambition and progress on its net-zero journey. Through our research, we have found that managers with more-advanced climate-related data and tools tend to set more-ambitious climate plans (be they in terms of asset coverage or emission targets). Nevertheless, as we have seen, other factors also come into play, including a manager's overall ESG philosophy and nationality (European managers operate in a more supportive regulatory environment than U.S. managers).

This leaves us with three questions:

1. **How quickly will remaining signatories commit 100% of their AUM to net-zero alignment?** NZAMI members are expected to review their targets at least every five years, but some have said they will do it more often, which we think would be more appropriate. Two managers—AXA Investment Managers and Wellington Management—have already reviewed and increased their scope in the last six months. A third manager, DigitalBridge, reviewed its own as well, but downward, following the recent acquisition of another asset manager for which net-zero

alignment has yet to be assessed. There may indeed be times when an AUM commitment has to be revised downward because of significant changes in the breakdown of the firm's AUM.

2. **Could a target-setting standard emerge in the near future?**
   While we expect NZAMI to recommend a common approach to AUM coverage in the near future, it is probably too early to tell if one target-setting methodology for asset managers will ever emerge as the market standard. What we have observed so far is that, out of the three methodologies endorsed by NZAMI, the Science Based Targets initiative for Financial Institutions has gained traction since the February finalization of its guidance[16]. From just eight in the November progress report, the number of firms that adopted this methodology increased to 14 in the May report (excluding those that used a combination of methodologies). This growth came at the expense of the Paris Aligned Investment Initiative's Net Zero Investment Framework, which saw its number of adopters decrease to 18 from 23 over the period. It will be interesting to see if this trend continues, starting with the next wave of disclosures, which should publish around the time of COP27.
3. **Who will win the race to net zero?**
   Ultimately, climate-focused investors will want to partner with the most committed asset managers—that is, well-resourced firms with the appropriate data, tools, and expertise to create the best net-zero-aligned investment strategies and demonstrate the impact they generate through engagement with issuers. The net-zero leaders will also be those firms that advance the development of methodologies and frameworks and help promote best practices and industry standards around net-zero portfolios.

All these questions and more are profoundly relevant for investors. Morningstar manager research analysts will closely observe and assess the managers' progress on their net-zero journey.

16 https://sciencebasedtargets.org/resources/files/Financial-Sector-Science-Based-Targets-Guidance.pdf

About Morningstar Manager Research

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