

RI: Developing net-zero commitments and tools

Meeting Notes

2021.03.09

Speakers

WC – Wendy Cromwell, CFA – Director, Sustainable Investment @ Wellington

JD – Julia Delongchamp, CFA – Climate Transition Risk Analyst @ Wellington

Presentation



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Climate Transition Risk Analyst,
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- Wellington is proud to be a member of the Net Zero Investment Manager
- Global, 1.3 T in 60 countries across global equities, fixed income, commodities, alternatives, and privates
- One of the hallmarks is deep dive intensive research, which over the past several years we've focused on climate giving us a better intrinsic understanding of the need for a low carbon future

Agenda

Five key questions from asset owners

1. How did we get buy-in to make a net zero commitment? How do we define net zero?
2. Could net zero be at odds with risk/return objectives?
3. How much decarbonization will be organic from companies?
4. How will progress be measured?
5. What about the other net-zero goal, allocating to solutions?

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- We'll be running through some of the questions we've been hearing from asset owners
- Poll results for "Has your organization
 - 1/3 yes, 1/3 not yet, and 1/3 actively considering

How did we get buy-in to make a net zero commitment?**Grounding in climate science**

Builds upon partnership with Woodwell Climate Research Center to bridge the gap between climate science and finance to enhance investment decisions we make on behalf of clients

Financial materiality of climate change

Acknowledges that transition to a low-carbon economy is underway and unlikely to reverse

Having credible low carbon transition strategies is important to long-term security valuations

Opportunity for collaboration

Work with others to develop methodologies for additional asset classes and shape industry standards

Invites collaboration with our clients and prospects, who are increasingly making similar commitments for their portfolios

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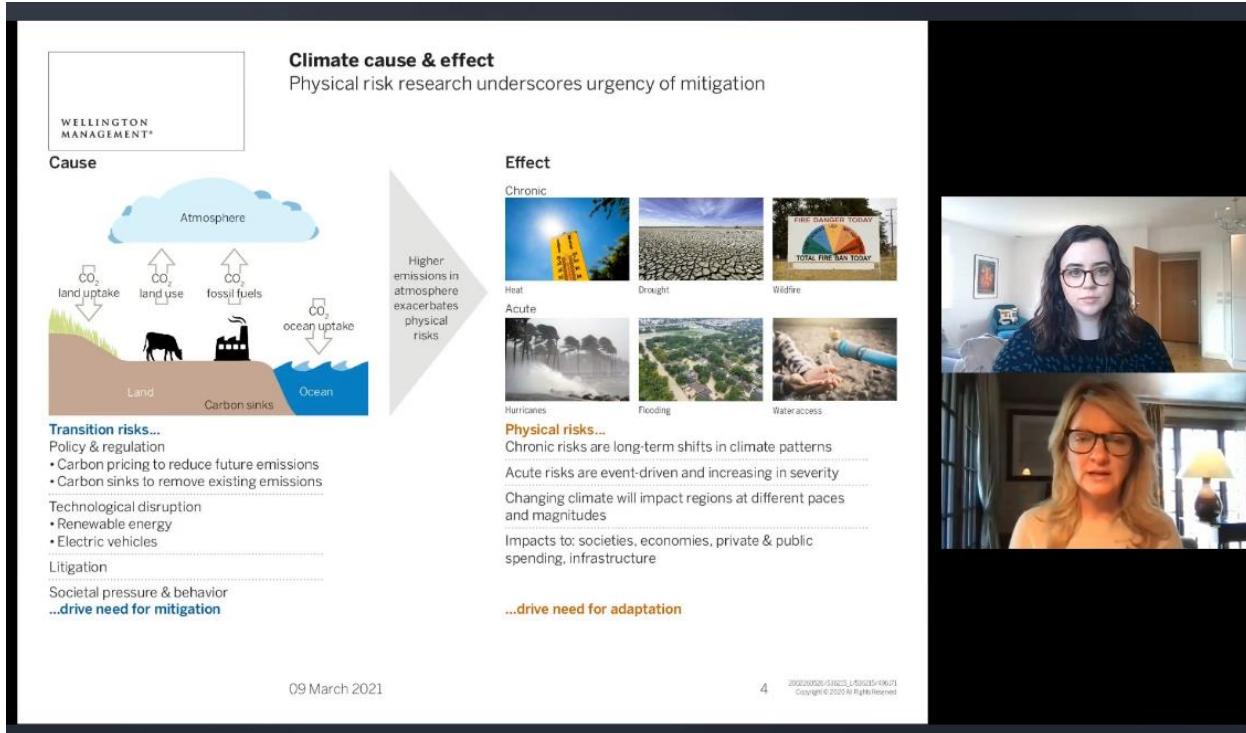
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- Collaborating with others
 - There are certain asset classes where there isn't a methodology for transition, rather than receive others research we wanted to get involved in it

- The partnership and commitment recognizes that most asset managers have a mix of AUM, some of which they have control over and some of which the client controls
- The commitment mandates working with the clients on decarbonization goals, and to help them execute so both groups can transition these trillions over time



- Here I wanted to remind everybody of the two major fields of risks – on the left you'll see transition risks and on the right you'll see physical risks
 - Transition risk really does drive the need for physical risk
 - On the right side we're seeing the effects of those emissions
 - I'm bringing these up in the context of a research collaboration we started with Woodwell Climate Research Center (the #1 climate thinktank) who we partnered with to bridge the gap between climate science and finance
 - Over the past 2+ years we've been engaging in a rigorous process which lays out a way for investors to consider these risks and make these commitments
 - As we understood where and when physical risks were going to happen and effect society, we became more intrinsically aware of the need to decarbonize society
 - We also concluded that the low carbon transition was on its way, and was only going to continue
 - And that companies that are going to thrive in this transition needed to plan for it

Why net zero? How do we define net zero?

Net Zero Asset Managers Initiative
Commitment language

Wellington commits to support the goal of net zero GHG emissions by 2050, inline with global efforts to limit warming to 1.5°C

- 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 AUM
- 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
- For these committed assets: set interim targets for 2030, consistent with a fair share of the 50% global reduction in CO2, identified as a requirement in the IPCC special report on global warming of 1.5°C
- Review our internal target at least every 5 years, with a view to ratcheting up the proportion of AUM covered until 100% of assets are included

To review the complete language of the commitment, please visit <https://www.netzeroassetmanagers.org/>

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- The three main commitments on the second question are outlined above
- On bullet 2
 - We'll be working on this and making the announcement in the leadup to COP26 in November
- There are two ratchets here – 1) the proportion of AUM that fall in the commitment and 2) towards the decarbonization over time, with a focus on the 2030 interim goal

Could net zero by 2050 be at odds with risk/return objectives?

Select implementation tools consistent with investment philosophy

Portfolio targets can be achieved through:

- Bottom-up: Portfolio holdings set targets, and portfolio decarbonizes as entities execute against targets
- Top-down: Portfolio tilts toward low-carbon entities and those actively decarbonizing, and away from entities that refuse to transition

Combination of tools at portfolio managers' disposal

1. Engagement
2. Divestment
3. Portfolio construction
4. Investments in solutions
5. Incremental use of carbon offsets

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- We believe this is not a concessionary commitment – it's principals based and there's flexibility in the commitment itself. It's credible by the groups that support it, and each client can look at their own business book
- We imagine each strategy will use a combination of the 5 tools outlined
- Our primary strategy at the outset will be engagement with companies to set science based targets, this is grounded in the research with Woodwell
- If we decarbonize by selling the emitters we're not insulating the portfolios by climate risk because we're not decarbonizing the economy and they'll come back and affect the companies in the form of climate risk
- Recognizing that engagement won't always be successful, we believe in having a transition strategy for long term value that involves selling those strategies
- Underweighting and overweighting companies based on their profile is the crux of the portfolio construction
- Carbon offsets really are meant to be incremental – we see the use case scenario being that a manager has been working with a company, seen progress, and they're almost there but not quite where they need to be for the portfolio in that case they can buy offsets to get them over that speedbump and allow them to continue their work

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Could net zero by 2050 be at odds with risk/return objectives?

Consistent with non-concessionary approach to sustainable investing

Nature of goal incorporates forward-looking view

- Commitment and credibility of strategy are more important than current state
- The greater the success of engagement, the less portfolio construction must be utilized

Expected impact on long-term company performance

- Capture green premium and avoid brown discount from capital providers
- Better equipped to meet regulatory standards, much of which is already in force
- "Net zero club": Become more competitive, getting ahead of behavioral tipping points from customers and suppliers



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- I want to hit on the idea of a green premium and a brown discount from capital providers
- We have confidence that there is a financial materiality construct – as physical risks become more prevalent and acute we'll see more financial impact on the companies that aren't addressing this transformation
- The other thing we expect to see and are already seeing is the emergence of a net zero club – companies who have made commitments working with others

With respect to net zero alignment and risk/return objectives, I/my organization believes these are:

- Consistent
- Consistent in the long run but potentially inconsistent in the short run
- Inconsistent, but will deprioritize risk/return when at odds
- Inconsistent, and will prioritize risk/return when at odds

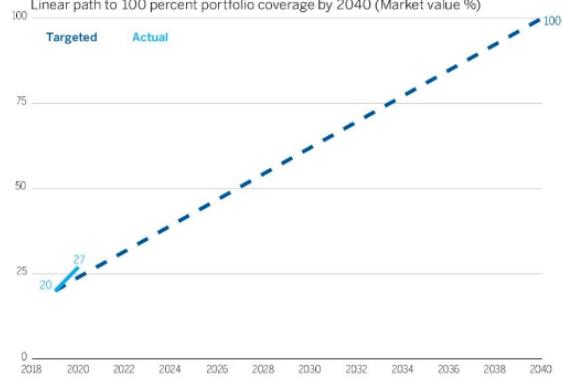
SUBMIT

DO IT LATER

- Poll Results
 - B is the most common answer with 50-60%, followed by consistent at 30% - so most participants believe we have long term alignment with risk/return and climate objectives



How much decarbonization will be organic from companies?
Set a bottom-up target
Engage to increase proportion over time



For illustrative purposes only. Methodology consistent with SBT Portfolio Coverage Approach from Financial Sector Science-Based Targets Guidance by the Science Based Targets initiative (SBTi).



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- We've been getting this question about how much natural decarbonization we can expect, more than 1200 companies have science based targets or are committed to setting them
- To measure portfolio alignment using a bottom-up message, we measure this via
- _____
- While the linear target you're seeing on the chart is meant to emulate real progress, we recognize that actual progress may be lumper than that linear trajectory
- But the _____



How much decarbonization will be organic from companies?
Engagement toward a broad net-zero aligned universe

TCFD | TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

Non-prescriptive disclosure framework put forth by the Financial Stability Board (FSB) to integrate climate risk into strategic planning and enterprise risk management

Focus on financial materiality of climate change to businesses, rather than businesses' contribution



Collaboration between asset owners & Grantham Research Institute on Climate Change and the Environment to assess companies' preparedness for the transition to a low carbon economy

CDP | DISCLOSURE INSIGHT ACTION

Formerly known as the Carbon Disclosure Project

Nonprofit global disclosure system for companies & municipalities to disclose qualitative + quantitative climate information (aligned with TCFD)

Investor members (WMC) sign on to disclosure requests

Scoring based on the quality of climate-related disclosure



Targets 161 companies with highest absolute carbon emissions with 5-year engagement plan, asking for 1) board oversight, 2) enhanced disclosure, and 3) Paris-aligned decarbonisation target.

Wellington participating in 4 US-domiciled companies in the energy, utilities, and materials sectors



European-based investor group supporting and helping define the public policies, investment practices and corporate behaviours that address the long-term risks and opportunities associated with climate change

Coordinates Climate Action 100+ engagements and constituent organization of the Investor Agenda

Secretariat for Net Zero Asset Managers Initiative



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- We have equity, ESG, and _
- In addition to that ongoing private engagement there are an number of organizations that facilitate collaborative engagement
- TCFD
 - has become the recognized standard, so we encourage our companies to adopt that framework
- Climate Action 100
 - The three



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Divestment
Portfolio decarbonization, not real-world decarbonization
Forward-looking consideration is key

Selective escalation
Exclude companies not receptive to numerous attempts at constructive engagement

Emissions contribution
Exclude least carbon-efficient companies within each sector or largest contributors to benchmark footprint

Revenue exposure to carbon-intensive business activities
Exclude companies with greater than 30% revenue from thermal coal or other fossil fuels

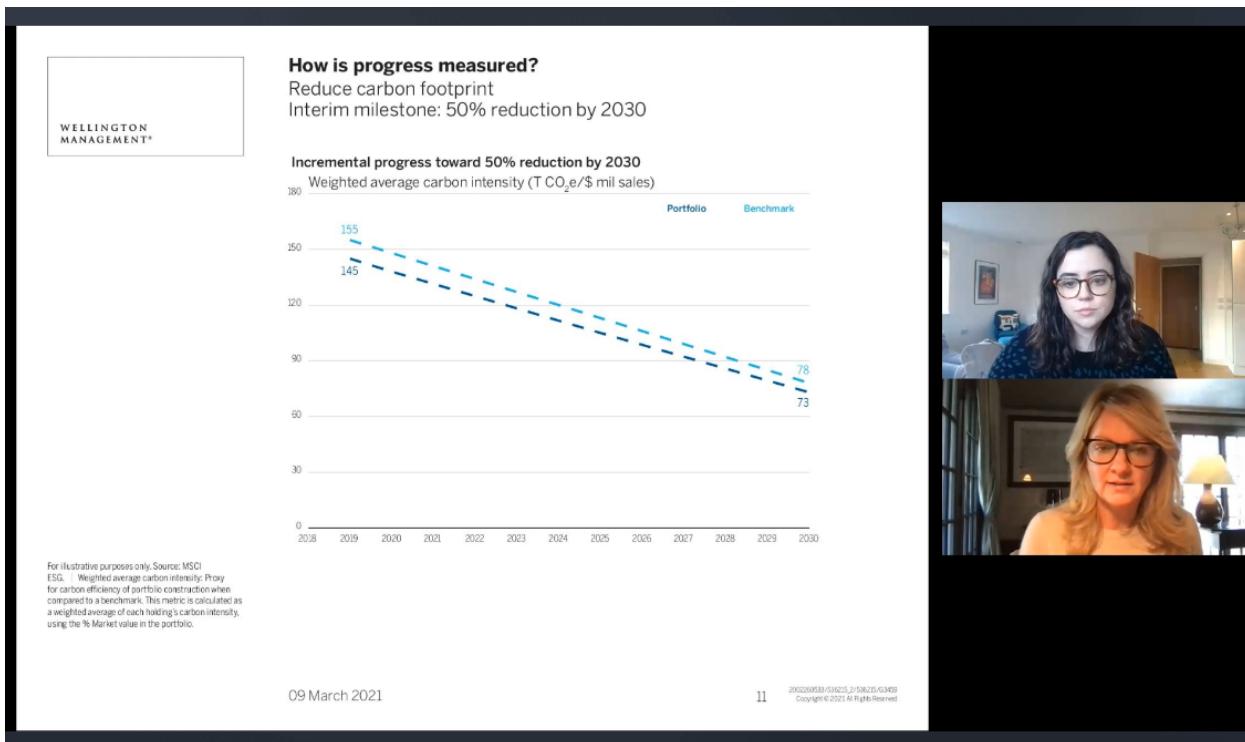
Threshold percentage could be lowered over time

Sector classification
Exclude all Oil & Gas companies



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- We often think about divestment as the flip side of engagement, we know that some companies will be unable to successfully transition
- We primarily see divestment as an escalation tool where over time as we make progress to 2030 interim targets where companies are refusing to participate or are unable to keep up with their peers we'll use divestment as an escalation tool
- Audience Q: Why the emphasis on committing to targets as opposed to action?
 - The commitment to a science-based target is a commitment to action



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- We have clients who have both divestment and engagement as key parts of their strategy
- Those who lean towards divestment their rationale is that the cost of capital for those companies will go up so that'll force change
- On the engagement side the thought is if nobody is working with these companies to make these plans we're not going to have real reduction in society only in our portfolio
- There's also the question of how we're going to hold ourselves accountable, for the assets we commit to manage in line with 2050 we commit to a 2030 50% reduction identified in the IPCC report, so additional benchmarking details are being discussed among NZAM members
- Its agreed that 2019 is going to be the benchmark year for assessing progress

How is progress measured?

Consider carbon offsets as a true-up tool

Carbon offsets are investments in projects designed to reduce future emissions

Acknowledges that there will be residual emissions along the way to 2050

- Limitations in some sectors and regions – no technologically and/or financially viable alternatives to eliminate emissions

Not intended as a primary tool, but rather as a true-up mechanism

- Continue holding companies on the right track but have not yet achieved significant reductions



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- It's worth noting each strategy will be assessed independently
- The NZAM has allowed for the purchase of credible incremental offsets, but only for those who have made significant progress
- We could have a strategy whose primary tool is engagement which in 2029 is exceeding its requirement on that primary measurement tool but because of the nature of the footprinting they only see 40% instead of 50%, we'll use that incremental 10% to purchase offsets while using _____

What about the secondary net-zero goal, allocating to solutions?

Invest in climate mitigation
Measurement hurdle

Difficult to combine the dual goals of net-zero by 2050, decarbonization and investing in solutions

- Current measurement does not account for "net" emissions
- Scope 3 and 'avoided' emissions are also required

Standard, credible methodology needed to account for 'avoided' emissions in portfolio metrics
• IIGCC implementation working groups, among others, working on this

In the interim, allocate to companies providing mitigation solutions

- Conceptually high 'avoided' emissions through low-carbon, carbon-removal technologies
- Highly efficient operational emissions (scope 1+2) compared to peers



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- There are two goals in net zero – to debaronbiase and to invest in low carbon solutions
- However it's currently difficult to marry that into a single metric, we're not thinking about net carbon exposure in traditional metrics we're mostly looking at ____
- So avoiding emissions in scope 3 ____
- The market hasn't developed metholdoies for measuring this
- The concern around netting is that fossil fuels will continue to be owned and operated, this should be addressed in a more nuaned way and this where the IIGCC ____

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What about the secondary net-zero goal, allocating to solutions?
Investments in climate mitigation
EU Taxonomy: Framework for eligible investment opportunities

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- Putting the hurdle of combining those two goals into one metric aside, there are good tools available
- The EU taxonomy is aiming to help identify solutions – it's a classification system intending to provide universal definitions and sets a high bar for capitalizing the transition towards a sustainable economy – we believe public and private capital will be aligned b _____
- The taxonomy also raises e _____

Audience Q&A

- Do you consider scope 3 emission in your NZ calculations?
 - JD Great questions, this was one of the internal hurdles in the specific of the commitment because the intention is to cover all three scopes
 - Emissions disclosures on scope 3 are really in the infancy, but we think about a 30 year horizon we're making the assumption that enhanced measurement tools and data will occur
 - We're currently using scope 3 for research purposes but not for target setting _____
 - These data sets are still quite new and can't capture company nuances, we don't want to be myopic _____
- WC – One of the things I think is going to unlock potential is investing in technology
- Do you see national governments as a limitor to progress, particularly when looking at sovereign bonds held? What about other asset classes?
 - JD – we know that all of our assets aren't in corporates so this was another hurdle, and it's been acknowledged in the NZAM statement that there's more to develop and sovereign is in those categories
 - We have initial guidance from the Paris Aligned Investment Initiative but more will be developed and it's part of the main workstream for the implementation working group
 - It's an area where we wanted to be part of the initiative to allow us to work in setting the standard rather than complying with standards we didn't have inputs into

- I don't think we need to have the plan finalised now – we know that the first step is to start with engagement and improve disclosure
 - That can begin even with these imperfections and question marks
 - WC – one of the tactical things we did that allowed us to make the commitment internally was to create a massive spreadsheet of all of our funds and their potential paths and where they stand today and where they might go, a hypothetical of 2030 and 2050 including science based targets, portfolio construction, divestment, etc.
- Who is purchasing the offsets – Wellington or the investors?
- How can offsets be considered consistent with fiduciary duty?
 - Offsets are only going to be used very incrementally to help actual investors who are very close to a particular target because they're working with a company and don't want to give up on the company just yet
 - In that case Wellington would purchase the offsets
 - We don't expect them to _____
- Ben _____ also the IIGCC doesn't permit them to
 - Just as a reminder the IIGCC is the secretariat for the as is CDP,
- Are you finding that US Universities and Endowments are more receptive than before?
 - WC – yes, _____
 - We often saw them divesting from thermal coal which is a start (which they were able to make because it was a small market cap and it wasn't a big commitment)
 - But we're also seeing divestment from fossil fuel

Next Steps

- WC – we started working on this in late summer and made the commitment in December, so in AM terms that's warp speed
- Internally our process involves lots of focus groups with managers and investment leaders, which helped us frame the decision and dive deeper into the _____
- Acknowledging that weakness up front.
- A
- A
-