Ninety One

Investing for a world of change

The rise of transition finance

Planetary Pulse

October 2022

This report reveals the findings from new primary research into transition finance.

It is based on a survey of 300 senior professionals at asset-owner institutions and advisors around the world, including pension funds, insurers, endowments, foundations, central banks, sovereign wealth funds, and consultants.

Will climate change cause irreparable harm?

Or will we get to net zero in time, averting the worst effects?

> To meet international, national and organisational climate targets, we need to decarbonise energy, replace myriad industrial processes with clean alternatives, improve energy efficiency and transform infrastructure.

There is much to do. CO_2 emissions are growing, and it is not clear how we will meet the proliferating climate targets or how a shift to a low-carbon world will affect many industries, systems, processes and workforces.

What we do know is that change will require enormous sums of capital, effectively directed. Making sure funds flow to all areas that need to transform or develop – in ways that are also profitable for businesses and investors – is going to be a key challenge in the fight against climate change.

Many 'green' strategies avoid the problem

The investment world has responded to this challenge in a number of ways. A predominant trend has been the rapid expansion of ESG-branded investment strategies, funds and services.

In 2022, global ESG assets are expected to rise to US$41 trillion, which is nearly twice the amount of 2016 (US$22.8 trillion). By 2025, ESG assets are forecast to pass US$50 trillion and to comprise one-third of total global assets under management.

Meanwhile, the exhausts and smokestacks of the world are setting their own records, releasing more CO2 in 2021 than in any other year in history, with the increased burning of coal the main factor behind the rise.

Why does it seem that the enormous movement of capital to ESG-branded assets has done little to slow the advance of human-driven global warming?

ESG-branded assets are designed to show small carbon footprints, but this sometimes means they are not addressing real-world decarbonisation.

> Portfolios are created that avoid the problem, instead of solving it — often, by simply limiting an investment universe to only the cleanest industries.

"It's good that investors can track the carbon intensity of portfolios, but this is often just portfolio, or paper, decarbonisation," says the head of sustainability at a European asset owner. "The fact is, you can easily change these numbers by simply shifting out of polluting sectors and companies, which does not help to reduce emissions in the real world."

There are similarly evasive strategies in other industries. For example, oil and gas majors have divested high-polluting business units, or contracted polluting processes to third parties, removing the emissions – on paper at least – from their responsibility, without reducing the real-world impact of the industry.

Funding real-world impact

Transition finance is a commercial investment approach that focuses on real-world impact.

The term describes investments that enable an investee's climate-change strategy and can involve:

1. Investing in some of the most challenging industries to decarbonise, such as steel, cement and chemicals, so that high emitters receive the capital and influence they need to transform their operations.

2. Investing in new innovations and projects that might not be profitable initially, such as green hydrogen and carbon capture and storage, but require stable funding to develop.

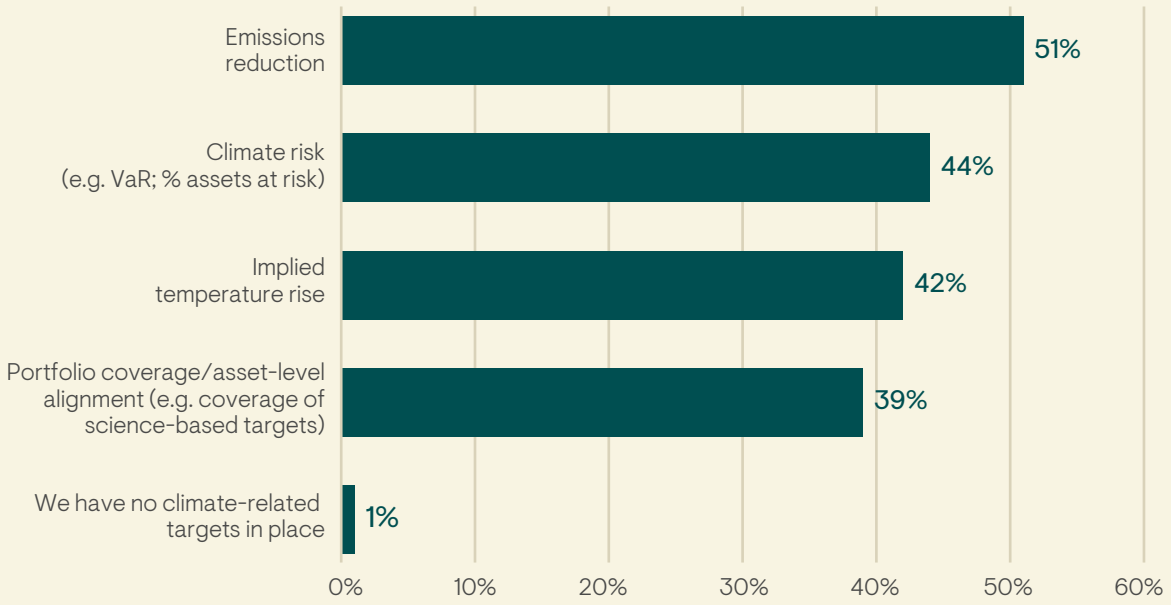
3. Funding vast infrastructure transformations, such as expanding and modernising electrical power grids and transmission systems.

4. Increasing exposure to emerging markets, where emissions continue to grow the fastest and the need for all forms of support is greatest.

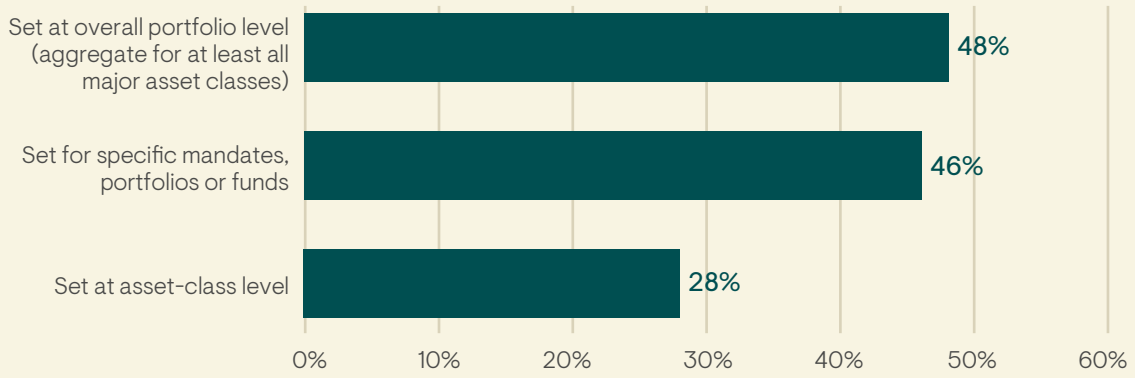
How asset owners set their targets

Among the asset owners that have climate-related targets, 48% set them at overall portfolio level, while 46% set targets for specific mandates, portfolios or funds. Only 28% set their targets at asset-class level.

Q1 Which type of climate-related targets or limits does your fund have in place?



Q2 What is the level or scope of your climate-related targets?



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Section 1

Early steps towards transition

In our survey of senior executives from asset owners around the world, 60% of respondents say that fighting climate change is one of their fund's strategic objectives. About half (51%) say their fund has emissions-reduction targets in place.

This is an encouraging picture at one level: it shows that the majority are doing **something** in response to climate-related risks and opportunities. But it is less positive when we look for real-world impact. Only about one in five (19%) say they use transition finance to any extent, and fewer still say that their fund invests in transition-finance assets in emerging markets (16%), the regions where emissions and populations are growing the fastest.

Emerging markets present an enormous challenge – and opportunity. But currently, asset owners with a climate agenda are more likely to be using other investment approaches. **Five of these stand out:**

Portfolio construction/ reweighting
to achieve overall climate-related target(s) **(used by 47%)**

Active engagement
directly influencing the decisions of invested companies **(47%)**

Adoption of climate-related themes
e.g. mandates focused on renewable energy and green bonds **(45%)**

Climate-related factor integration
including sustainable investing indicators in fundamental analysis **(45%)**

Positive screening
seeking exposure to investments with positive climate-related characteristics **(44%)**

Although about half (52%) of respondents believe that transition finance is a major commercial opportunity for asset owners, and 60% believe that transition finance will grow rapidly over the next three years, our research suggests that transition finance needs to grow much faster.

Despite more than half of the asset owners believing in the commercial opportunity, just 35% say that their organisation is likely to make transition-finance investments in the next 12 months, 20% say they are researching opportunities in transition finance, and only 8% are building their internal capabilities in transition finance.

Are asset owners investing in net zero?

We asked asset owners what proportion of their AUM is currently invested in portfolios with climate-related instructions or objectives.

In the diagram on the next page, we show the distribution of responses in orange, where the vast majority (nearly 90%) of asset owners indicate less than half of of their AUM includes climate-related instructions. Significantly, 46% have less than a quarter in these allocations.

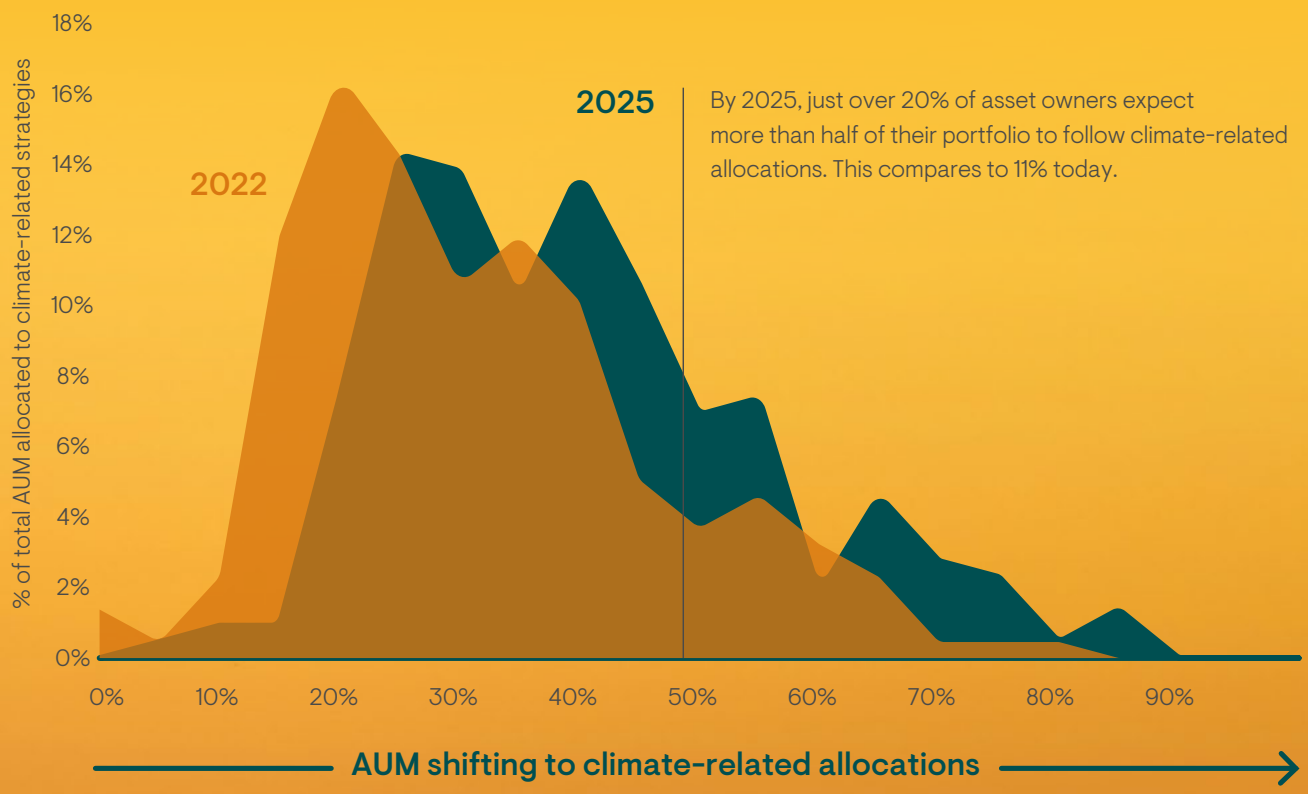
Just over 10% of asset owners said more than half of their AUM was invested in portfolios including climate-related instructions. This includes less than one percent with more than three quarters.

Then we asked respondents to look forward to 2025 and provide their expectations on how these investments might change.

By 2025, respondents anticipate a material increase in the level of AUM with climate-related instructions. The distribution of responses shown in the diagram in green, shifts to the right. Instead of 10% with more than half their AUM in these strategies, this could be more than 20% in 2025.

This type of shift is evident throughout with only a handful of respondents expecting to have less than a quarter of their assets with climate-related instructions.

Expectations in 2025 show a meaningful shift in the proportion of AUM allocated to climate-related strategies.



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Section 2

Beating the barriers

Why are asset owners not more invested in transition finance?

There are several reasons. One of the most important is that it requires them to make a shift in their approach or culture. In our survey, for example, more than half of asset owners (55%) say their fund is not focused on any goal beyond the risk and return performance of their assets.

Portfolio managers at these asset owners are not driven by top-down sustainability principles. They could, of course, invest in transition finance, if they believe it would improve the risk-return profile of the fund, but they are less likely to be seeking such investments.

There is also the idea that climate-related investing leads to lower returns, which 40% of asset owners in our survey believe.

"Most investment professionals have grown up in an era where the framing of sustainability has typically been concessionary," says Alison Loat, managing director, sustainable investing and innovation at OPTrust, a CA$25 billion Canadian pension plan. "There has been a huge mindset shift, because it is no longer always true, yet the framing still exists for many."

Loat says that shifting towards transition finance involves asking different questions, gathering new data, challenging our assumptions and instilling new approaches into diligence, assessment and stewardship.

Committed for the long term

For funds that have positive climate outcomes as an explicit objective, there is another challenge: short-termism.

> In 2022, the soaring cost of energy reminded the world of the risks of a disorderly transition. Some of the highest-emitting companies in the world made enormous profits, and their investors shared in the returns.

Climate-focused funds are unlikely to have owned many of these companies, and would have missed out on the ensuing dividends windfall.

"Having a bias towards positive climate outcomes means you have to tolerate some periods of shorter-term underperformance," says Daniel Spencer, portfolio manager at Brunel Pension Partnership, a £35 billion UK local government pension scheme. "There's no corrective action we take, because our climate outcomes are a permanent feature of our funds. But we expect that in the longer term we are positioned to benefit from the transition towards a lower-carbon environment, and that we are doing the right thing from a fiduciary standpoint."

Nurturing institution-grade opportunities

For transition finance to grow faster, asset owners and investors need a greater pool of viable opportunities. In our survey, the most commonly cited barrier to transition finance is simply a lack of companies with credible and feasible transition plans — this was cited by 60% of respondents.

Established institutional investors are not used to micro-managing a fund or a company to improve their investment potential. "We can't be investing in moon shots — as a pension plan, that's not our purpose," says Loat. "Everybody is trying to work through how to get more climate opportunities to an institutional level. There is an aspiration to invest more in transition finance, and we have to ensure funds and companies that we invest in have the governance procedures in place to adhere to what we require as an institutional investor."

Another top barrier, which is cited by 55%, is the difficulty asset owners face in measuring and quantifying an organisation's progress in its climate strategy or related projects. This is something that should steadily improve as disclosure and data regulations change and transition finance matures, but it is complex and challenging for today's asset owners.

> "We track various KPIs, such as emissions intensity, science-based targets, ESG ratings, and so on," says one sustainability leader at a European asset owner, "But we can only manage those KPIs that are reliable and can be tracked reliably. We don't like estimation models when it comes to emissions, for instance. We need more progress in this area — we need good quality data, especially data directly from high-emitting companies."

How do we increase transition finance?

"I think I would probably start with the policy framework. So what do I actually need in the real economy? What are the specific outcomes we want? Then we need some certainty. One of the common questions is, 'What is the plan for this sector?' One of the examples we keep going back to — and which we want more of — is the announcements that have been made around the internal combustion engine and the shift to electric vehicles. That has set some clear timelines that policymakers, regulators, car manufacturers and investors can all get behind, because we know there are set deadlines within different markets for different parts of this, and a very clear transition plan for the shift to electric vehicles. We need similar types of long-term, well-thought-through strategies for each of our sectors."

Faith Ward, Chief Responsible Investment Officer, Brunel Pension Partnership

The barrier outlook

	Rated a 'major barrier' today	Expected to worsen	Expected to improve
Insufficient companies with credible, realistic and feasible transition plans	27%	24%	17%
Difficulty measuring or quantifying company progress in climate strategy/projects	26%	24%	24%
Internal resistance to changing traditional strategies	25%	29%	20%
Expected returns are too low	25%	26%	18%
Beneficiaries demanding low-carbon only, not transition finance	24%	29%	15%
Lack of beneficiary demand for climate-related investments	21%	17%	14%
Transition finance does not easily integrate with our allocation approach	20%	9%	8%
Lack of transparency into investee activities	18%	19%	21%
Lack of clarity on the definitions or criteria for transition finance assets	16%	18%	18%
Insufficient track record for transition finance assets	15%	22%	19%
Lack of consultant advice on how to invest in transition finance assets	15%	11%	21%
Reputational risk	15%	18%	20%
Lack of suitable asset-management products	15%	19%	26%

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Section 3

The emerging net-zero world

Emerging market transition finance will be critical to successful climate action. It has been estimated that there is a US$94.8 trillion gap – an amount higher than global GDP – between existing commitments and the investment required for emerging markets to make a transition to net zero by 2060. (This model requires the developed world to reach net zero by 2050, and to then be net negative, allowing overall global warming to remain in line with a 1.5°C rise over pre-industrial levels).

This massive investment is needed to transform energy production, infrastructure, efficiency, transport, and several of the world's highest-emitting industries. Take steel production, for example. After energy, the steel industry is the biggest emitter of greenhouse gasses. Developing steel without emissions — so-called green steel — is among the biggest challenges in the battle to meet the Paris Agreement targets.

Parts of the steel industry are investing in full-scale pilot projects to explore the technicalities of producing green steel using new methods. Most of these are in developed economies, however, with some of the most advanced examples in Sweden and Australia. These two nations produce just 0.2% and 0.3% of the world's steel output, while China alone produces 53% of the world's steel, and the top 10 emerging market producers account for about 73%. On top of that, China currently generates twice as much CO2 per tonne of steel as Europe.

> Greening the Chinese steel industry requires committed investment and engagement, which may take time to pay off but could provide strong returns as green steel becomes more mainstream.

Steel is just one industry, of course, but the energy industry and several other high-emitting industries are similar with respect to emerging markets.

"We know that the amount of money being deployed for transition finance and emerging markets is about 10% to 20% of what it needs to be if we're going to achieve the Paris Agreement targets," says Faith Ward, chief responsible investment officer at Brunel Pension Partnership.

Only 16% of asset owners in our survey are invested in emerging market transition finance, but those asset owners appear to have high conviction about the strategy.

> Expanding transition finance in emerging markets is a moderate or high priority for 86% of those that have adopted the approach — higher than for any other climate-related practice.

Even among all respondents, 61% believe that emerging market transition finance will grow rapidly over the next three years.

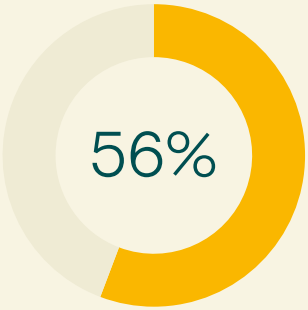
More than half of our survey respondents (53%) say their fund is concerned about the risk-return profiles available in the universe of emerging market transition-finance assets. Ward believes that to grow transition finance in emerging markets, asset owners need to consider their investment objectives more broadly and over longer timeframes — recognising, as she puts it, "that if we don't transition in emerging markets, then there isn't going to be a transition at all". Ward concedes that this may entail less transparency and more risk at times: "It requires courage, to some extent, but we can show that there is a huge opportunity in emerging markets."

Pulling the biggest levers

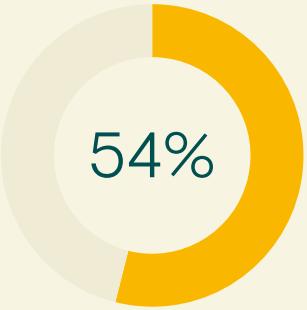
Asset owners that take a divestment approach to net-zero targets are letting go of some of the most powerful levers in the fight against climate change. "The main task for the real economy is to focus on high emitters, because they can make the biggest impact on the climate," says a senior executive from a public asset owner.

Asset owners can use their capital and influence to help major polluters to enable transitions to low-carbon alternatives and move closer to the Paris Agreement targets — a path that can often overlap with the path to long-term growth and responsible risk management.

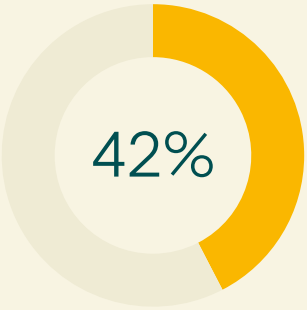
It is also important that asset owners, investors, regulators and governments understand that there are some companies and sectors that have two sides. This point was made by a sustainability leader at a European asset owner, citing the examples of transportation, energy and utilities, "which on the one hand have the older business activities that are linked to fossil fuels, but on the other hand are growing a new business that fits into the clean energy world of the future."



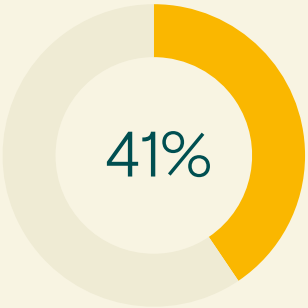
Our fund is committed to active engagement with high emitters **to support decarbonisation**



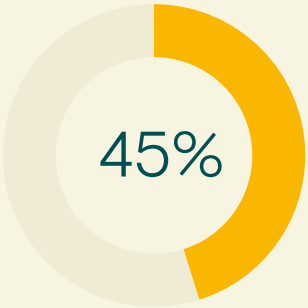
Our fund is seeking to invest in high emitters **with innovative or ambitious decarbonisation plans**



Our fund is seeking to invest in high emitters **with measurable, science -based decarbonisation plans**



Our fund is seeking to invest in high emitters **in emerging markets with measurable, science-based decarbonisation plans**



Our fund is seeking to invest in high emitters **in emerging markets**

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Section 4

Improving guidance for asset owners

About half (51%) of asset owners rely on consultants for advice about climate-related investments, so consultants can play an important role in supporting the growth of transition finance.

For their part, 58% of the consultants in our survey believe that transition finance will be needed for their clients to achieve their climate-related objectives, and 58% are seeking to encourage clients to consider transition-finance investments.

> Fewer are encouraging consideration of transition-finance investments in emerging markets (52%).

"It's a different set of skills and knowledge and experience you need for emerging markets, which I would say is sometimes missing with investment consultants," says a senior leader at a European asset owner. "This creates a barrier for us and makes it appear — incorrectly — as if we intentionally neglect some regions in favour of developed markets where we have more confidence in the advice we can access."

More than a third (35%) of the consultants we surveyed say that their clients do not consider transition finance to be an important climate-related investment approach. And 30% say that their clients do not have an adequate understanding of transition-finance investing — rising to 36% for emerging markets.

Asset owners need more from consultants

Meanwhile, a third of asset owners (34%) say that consultants do not consider transition finance to be an important climate-related investment theme. The same proportion say that consultants do not have an adequate understanding of transition-finance investing — rising to 37% for emerging markets.

Some 47% of asset owners say that their fund is seeking additional consultant relationships to provide deep expertise in transition finance investments, and 53% are seeking deep expertise on transition-finance investments in emerging markets.

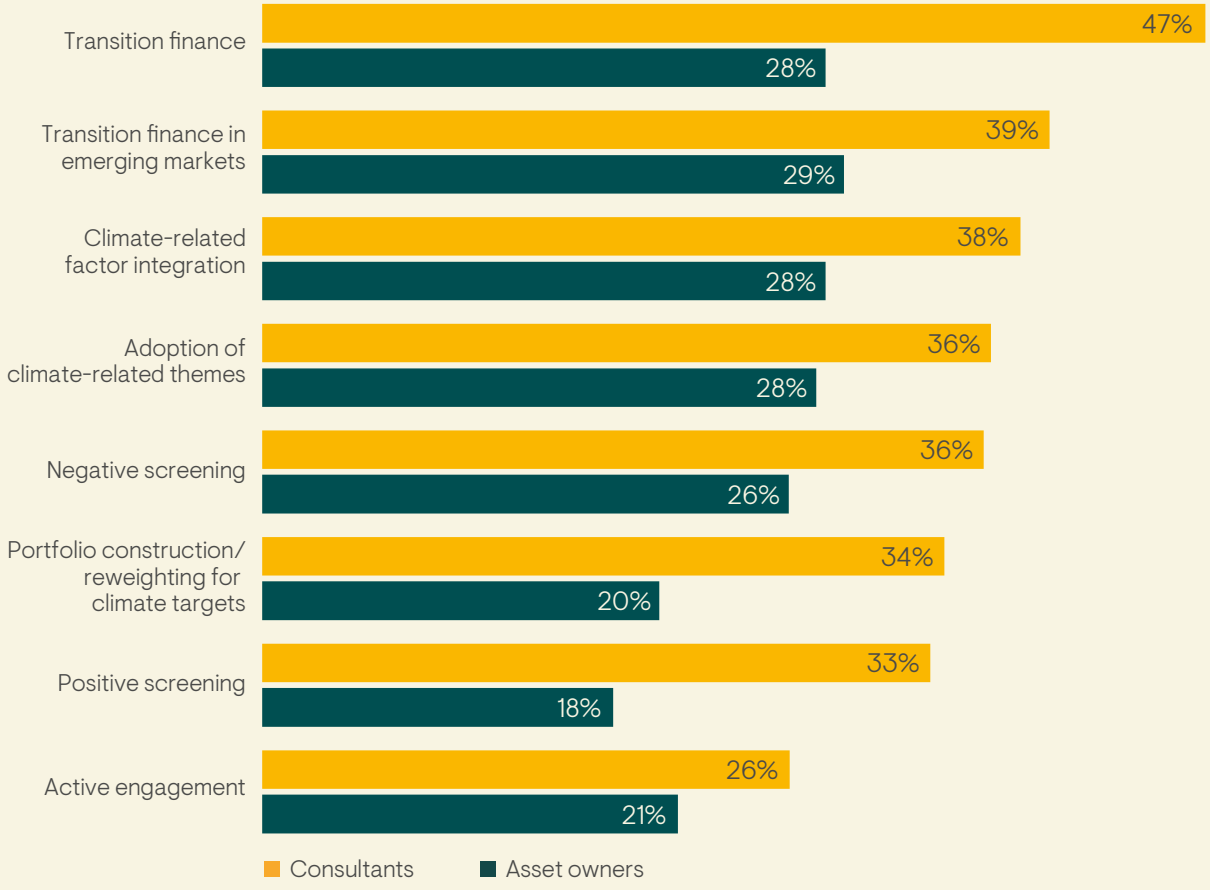
Advice on transition finance

Our survey shows that 70% of consultants say they have the skills and experience needed to advise on transition finance, while 55% say the same about transition finance in emerging markets.

Asset owners make it clear they are looking for more specific expertise from consultants — particularly in transition finance.

Rating the quality of advice between consultants and asset owners

(proportions reflect those rating advice given/received as 'very strong')



Note that consultants were only asked to rate types of advice that they said they provided.

Some asset owners do not use consultants. OPTrust is one example of this approach. "We do all that analysis in house," says Alison Loat, the Canadian pension plan's managing director, sustainable investing and innovation. "We have a lot more control. For example, we are able to make use of customised due diligence to understand how climate considerations are manifesting specifically in each of our asset classes."

Conclusion: The climate won't wait

More than half of asset owners (56%) believe that without greater investment in transition-finance assets, the world will not be able to meet the Paris Agreement climate-change goals.

That greater investment will require action at lots of different levels. "We need the policy positions, and we need regulations that underpin those," says Brunel Pension Partnership's Faith Ward. "There is an opening for blended finance and more collaboration between development banks and investors. Everybody needs to come together, recognising that there will be different solutions in different markets as well."

Within asset owners, asset managers and consultants, a culture shift that is already under way will need to accelerate. "I think most people with 'sustainability' in their title spend as much, if not more, time on culture change as they do on technical work," says OPTrust's Alison Loat. "The technical work is not the hardest part. It has plenty of complexity, but organisational change demands that we collaborate with every single part of the organisation, changing many processes and workflows. A lot of this relies on building trust and always ensuring good communication. It all takes a lot of time and is incredibly rewarding work."

Unlike some of the major transitions of the past, time is of the essence in the fight against climate change. There was no deadline on the industrial revolution, or the rise of electricity, or the information age. The pace of these shifts could largely be set by market forces, and in each case there were periods where progress slowed to a crawl before suddenly racing forward.

> Climate change is different. There is a deadline and an urgency — a need for sustained, increasing effort with no pauses.

And asset owners are in a unique position. They have the capital and influence to help the world transform before change becomes irreversibly harmful. By allocating finance to transition, they can help mitigate climate change while profitably participating in the world's adaptation to net zero.

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