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Active ownership:
A strategy to achieve net-zero goals

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Introduction

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For as long as anyone can remember, investors have typically used their influence to take a company's actions in a certain direction. Now there's a more ambitious version of that practice emerging, known as active ownership.

Active ownership is about pulling levers of influence that can build on each other to escalate an issue and effect real-world change. It's frequently seen among asset owners and other institutional investors intent on driving sustainable outcomes.

Sustainability has become a prominent shareholder issue in the wake of studies showing that climate change poses significant risks to global financial assets and economic growth. The Deloitte Economics Institute, for instance, reports that unchecked climate change could cost the global economy $178 trillion in net present value terms between 2021 and 2070.[1] Because of their long-term time horizons, institutional investors may be disproportionately exposed to "non-hedgeable" climate value at risk, prompting many to mitigate the risk via active ownership.

In this article, we'll explore the main levers of active ownership. Then we'll highlight different ways that active ownership can influence and accelerate the transition to a lower-carbon future.

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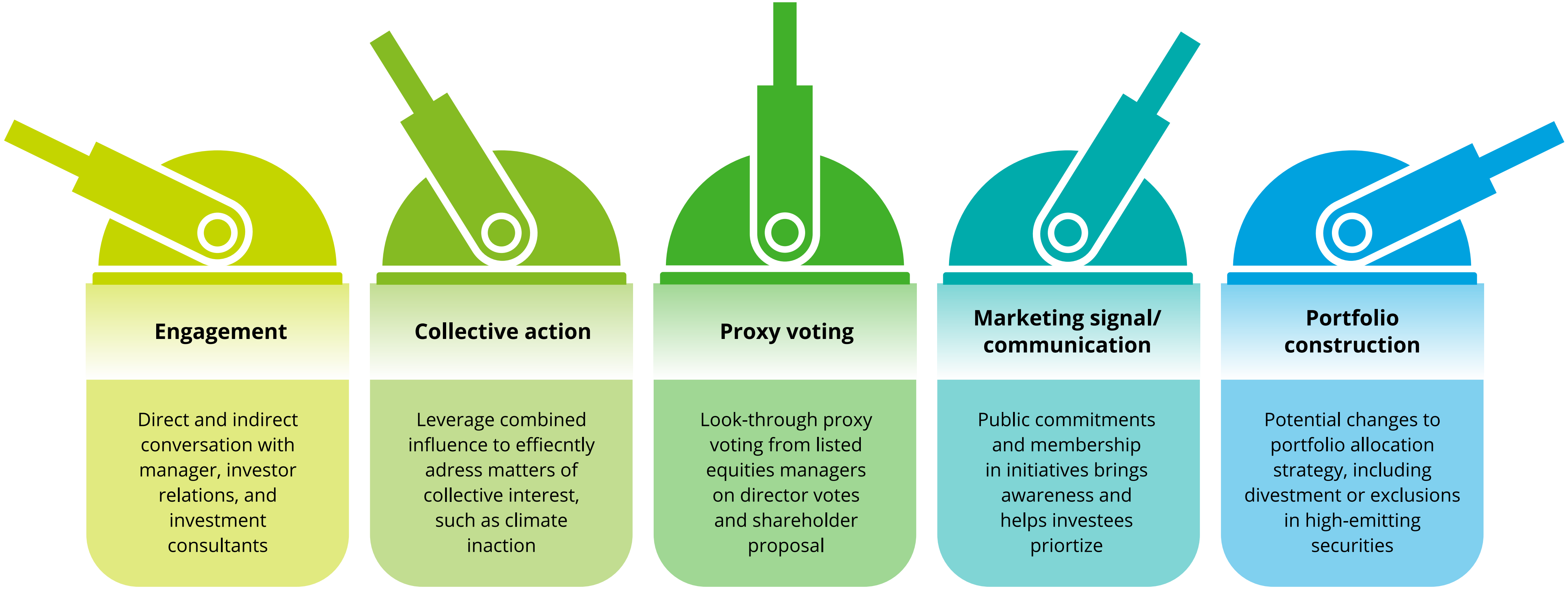
Levers of influence in an active ownership

Levers of influence in an active ownership

In an active ownership strategy, each lever has multiple tactics that investors can use to achieve specific milestones toward an ultimate goal (such as portfolio-level net-zero). Which levers and tactics to pull depends on the investment goals, asset classes, and timelines to achieve objectives.

Figure 1: Levers of influence in an active ownership



1 | Engagement

Active ownership engagement involves proactive individual discussions with relevant investment stakeholders to help drive specific outcomes. These can be oral or written. They include direct requests to take one or more actions such as disclosing a greenhouse gas emissions inventory, setting targets, or disclosing a transition plan. In addition, active owner engagement provides corporates the opportunity to address potential issues, foster transparency and accountability, and earn trust with investors.[2]

Traditionally, many investors considered engagement to be the sole purview of fundamental listed equity managers. An investment team—or the environmental, social, and governance (ESG) group in an investment management firm—would set up conversations with public equity boards of directors, management, or investor relations professionals at companies where they hold a significant stake. Sometimes, these conversations were around annual general meetings (AGMs) and the investor's related votes on board directors, executive compensation, and shareholder proposals. Other times, they were in reaction to a negative event or controversy affecting a company. Recently engagement activities have expanded to other asset classes as well.

Engagement might look different for investors without direct ownership control, but a well-targeted strategy can still be effective in driving sustainability outcomes. For some asset owners, fund of funds, or other investors who outsource their investment activities to external managers, engagement can either involve discussions with investment consultants or fund managers, or direct engagement with underlying security representatives. This can be challenging as these managers may have fewer direct relationships to leverage. But it's becoming more common for companies to engage with the direct owners of their securities (especially those with significant holdings) and understand their diverse perspectives.

Typically, an active owner's engagement strategy will include sustainability goals in the near, medium, and long term, with escalating requests that can drive performance toward objectives. The requests should align with firm or portfolio-level milestones and other relevant goals. Examples include enhanced reporting or transparency, specific sustainability actions, goal setting, and oversight and accountability related to sustainability and decarbonization programs.

1 | Engagement

Institutional investors who have set their own net-zero goals often seek:

- Disclosure of Scope 1, 2, and 3 GHG emissions (to gain better insight into their own emissions from investments).[3]
- Target setting (for decarbonization in the near term or net-zero in the longer term).
- Certification of goals through a third party (such as the Science Based Targets initiative).
- Disclosure of a climate transition plan (outlining the pathway the company intends to follow to decarbonize).

Often these engagements are most effective when expectations and timelines are clear, specific, and consistent. That makes it important for an investor to have a comprehensive, long-term strategy for engagement.

Some investors also engage with policymakers to encourage regulation and legislation aimed at mitigating these systemic risks and driving decarbonization.

2 | Collective action

Active owners generally have a bigger megaphone when they come together to achieve a goal or influence change. This often involves joining organizations that have campaigns to influence a company or industry to change its policies, leadership, or strategic direction.

One form of collective action is collaborative engagement, which is like direct engagement except it represents the view of many investors. Collaborative engagement may be particularly useful for investors with smaller stakes or limited resources for direct engagement. But even larger shareholders may want to pool their assets under management, or AUM, to drive progress on common sustainability goals.

Collective action may include:

- Joining sustainability-focused industry or trade associations (like Ceres and the UN Principles for Responsible Investing).
- Participating in working groups.
- Signing open letters to companies, regulators, or policymakers.

A popular climate-focused initiative for collaborative engagement is Climate Action 100+ (CA100+), which allows signatories to scale up engagement by pooling their collective AUM toward achievement of 10 specific requests for certain high-emitting companies. This is one way for investors to efficiently tackle emissions "hotspots" in their portfolios.

3 | Proxy voting

Through proxy voting, listed equity shareholders exercise their rights to elect board members, approve executive compensation plans, and make decisions on significant corporate matters. Active owners may use their voting power to support or oppose management proposals and board nominations that don't align with their sustainability goals. Additionally, active ownership strategies may use proxy voting as an escalation mechanism to help achieve sustainability outcomes.

The most common way of influencing companies through the proxy vote is by voting for shareholder proposals related to sustainability goals. Investors frequently support ESG-related shareholder proposals, especially those tied to climate or other specific risks that they've identified in their holdings.

Another avenue of influence that some investors pursue is votes against directors at companies that are deemed insufficient in their oversight of climate action. Some investors direct opposition at directors who have explicit oversight responsibilities of climate risk in their committee charters or are listed as a sustainability expert in proxy statements. Others take a broader approach.

Executive compensation is an additional avenue of influence. Many investors expect mitigation of climate risks, or achievement of sustainability-related goals, to be built into executives' compensation plans. So they're increasingly voting against executive compensation plans that aren't in line with these expectations or lack what they believe is sufficient accountability.

Additionally, some active owners looking to scale up their strategy may file their own shareholder proposals for consideration at AGMs, or nominate board directors aligned with their sustainability goals.

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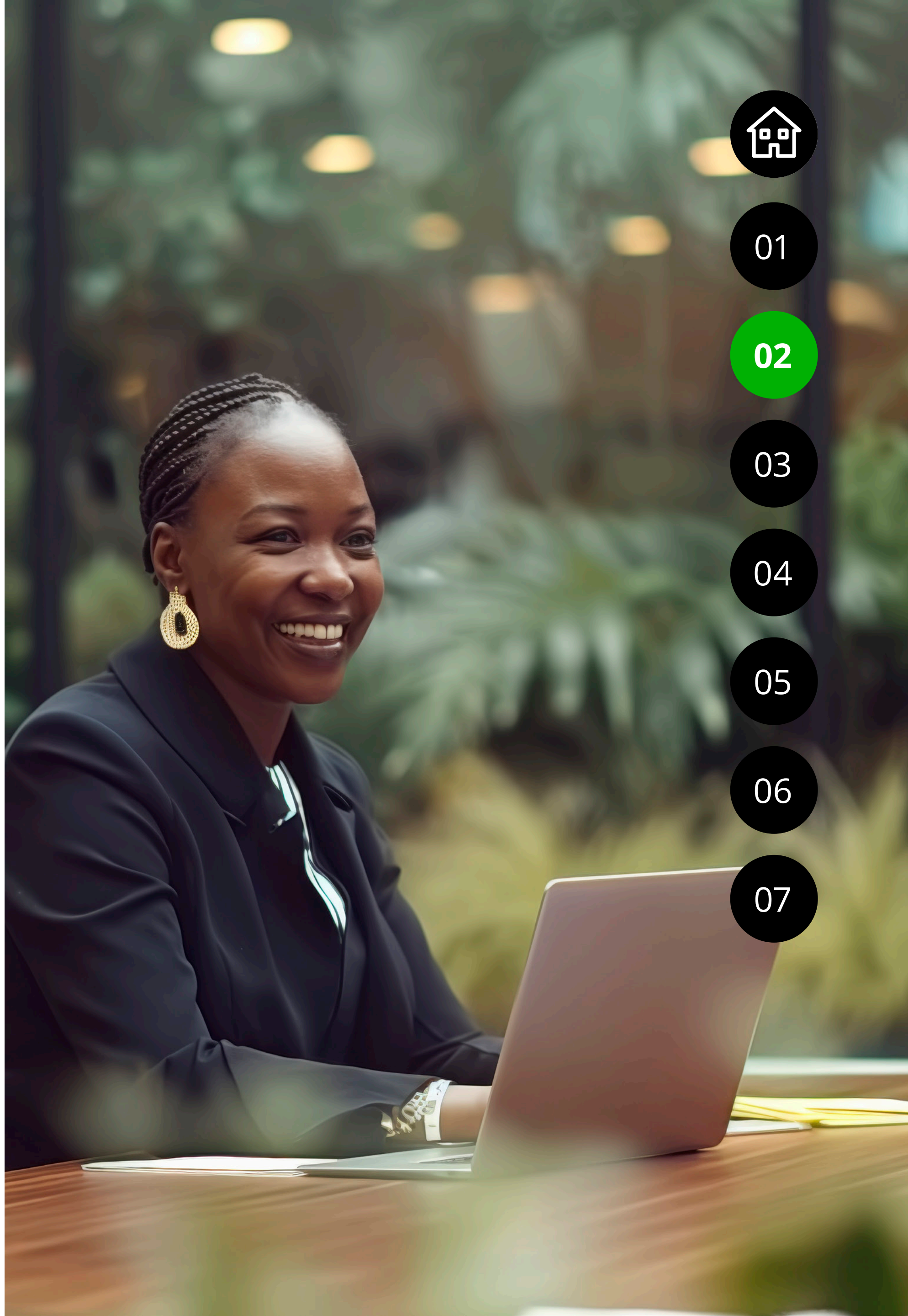
4 | Market signals/communication

One often overlooked lever of influence that institutional investors have is simply the power of public communication. Through disclosure and public statements, investors can convey their expectations to portfolio companies and investees. Companies often evaluate this possibility when developing their own sustainability strategy.

Investors with a net-zero goal may wish to disclose this goal, their interim targets, and how they expect portfolio companies to adapt. They also may wish to disclose the escalation plans they have related to their net-zero strategy, so that investees can understand what the implications may be if they fail to make meaningful progress on net-zero goals.

Investors can also join and publicize their involvement in climate focused nonprofit organizations, such as the Science Based Targets initiative or CA100+, to convey their support for the goals of these groups.



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5 | Portfolio construction

For investors considering how to develop a net-zero strategy, portfolio construction changes often come to mind first. But this isn't always necessary in the near to medium term, and often it's not the first lever to pull in a comprehensive portfolio decarbonization strategy. Neither is it always a feasible option, depending on the investment strategy. Even so, active owners may choose to use this lever as part of an escalation plan or to avoid new investments in high-emitting securities.

Exclusion policies are one of the most common ways to implement a portfolio construction change. This happens pre-investment and essentially restricts the investor from investing in any new securities aligned with certain predefined criteria. Historically, exclusion policies were more focused on "sin stocks." But for investors with net-zero strategies, they may exclude (for example) investment in high-emitting industries such as fossil fuel or thermal coal producers.

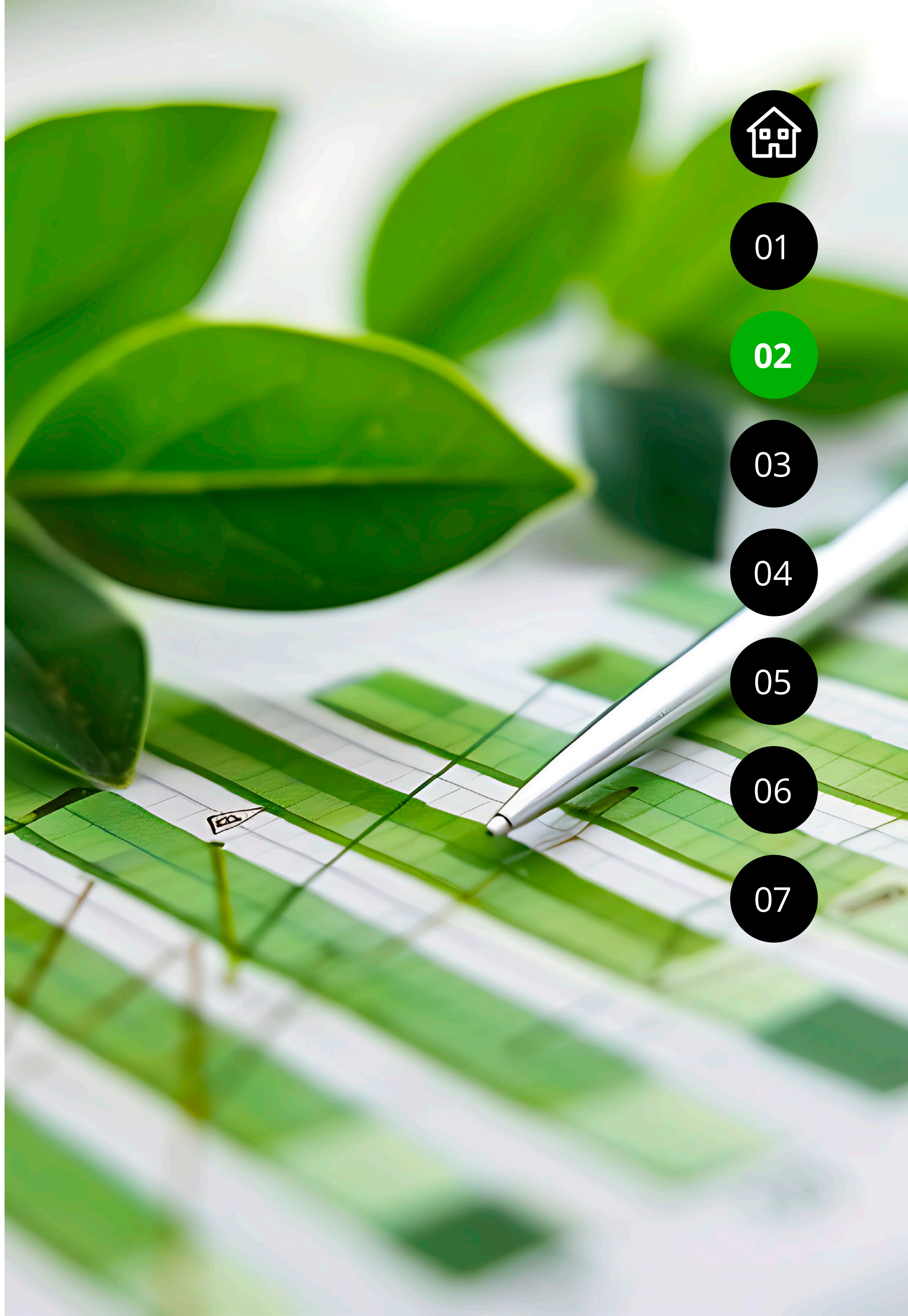
Rebalancing a portfolio away from high-emitting industries can help to mitigate climate risk and reduce a portfolio's emissions toward net-zero. Investors often identify portfolio hotspots for emissions before developing their net-zero strategies so they can tackle emissions reductions more efficiently.

There are various options for reweighting a portfolio to reduce emissions. For example, an investor may set a carbon budget on absolute emissions, set a target of targets (a minimum percentage of securities with credible net-zero targets), or target a specific portfolio temperature alignment (such as 1.5° Celsius). Which approach to take depends on the strategy, asset classes, and investment objectives.

5 | Portfolio construction

For investment managers launching new products and investment solutions or redeveloping existing products, there's a rising number of net-zero-aligned indices to benchmark against. These benchmarks could facilitate a net-zero strategy while limiting tracking error. The European Union's Regulation (EU) 2019/2089,[4] known as the Low Carbon Benchmarks Regulation, put forth minimum standards on climate transition and Paris-aligned benchmarks to enhance transparency and comparability, promoting the development of credible net-zero indices. Commonly used net-zero indices include the S&P Paris-Aligned & Climate Transition Indices, the MSCI Climate Paris Aligned Benchmark Select Indexes, FTSE TPI Climate Transition Index Series, and the STOXX Paris-Aligned Benchmark Indices.

Finally, an investor may choose to divest completely from certain high-emitting sectors, investments, or industries to reduce emissions exposure. Many investors elect to divest as a measure of last resort, after repeated engagement failed to drive net-zero alignment. The reason for this is twofold. First, an investor's influence ends when they divest, as they lose their voice and vote. They're no longer able to use the other levers of influence to change investee behavior once divestment has been made. Second, on a more systemwide level, if divestment of a security is widespread, the high-emitting company may be driven out of regulated capital markets where transparency and responsible behavior is favored. That's why many consider divestment a less effective tactic than others.



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Decarbonization within companies

Decarbonization within companies

Decarbonization, the process of reducing carbon dioxide and other greenhouse gas emissions, is an important component of achieving net-zero goals. Active ownership can influence and accelerate companies' decarbonization strategies in several ways.

Advocating for emission reduction targets and strategies
Active owners can engage with companies to set specific, measurable emission reduction targets—including net-zero targets—and develop transition plans. These transition plans can cover areas such as energy efficiency, renewable energy sources, cleaner technologies, and a measure of accountability to goals.

Supporting renewable energy transition
Many active owners advocate for the adoption of solar, wind, and other low-carbon energy sources, or a pivot to these energy sources from utility providers, as well as energy storage technologies.

Engaging with high-emitting industries
Many companies in high-emitting industries like energy, transportation, and heavy manufacturing are investing substantially in research and development (R&D) to create solutions for the low-carbon transition. Engagement can drive both alignment with net-zero goals and future-proofing of investee businesses by encouraging proactive pivots into climate solutions.

Enhancing disclosure and reporting
Just requesting investor-grade climate disclosures is a signal to management and the board that the topic is of financial interest and therefore worth managing. The data itself then allows investors and other stakeholders to assess a company's emissions profile, evaluate progress over time and against peers, and hold the company accountable for meeting any decarbonization commitments.

04

Driving portfolio and systemwide decarbonization

Driving portfolio and systemwide decarbonization

A government creates change through regulatory measures. Businesses invest in R&D for technological advancements. Consumers are demanding more sustainable products and services. Now, with active ownership, investors likewise can have significant influence and an important role to play in achieving meaningful decarbonization impact in the real economy.

By engaging with their investee companies on matters of climate risks and impacts, opportunities, transparency, and accountability, investors likely don't just mitigate potential risks to the long-term financial stability of their investments. They also send signals that can ripple throughout the capital markets. However, the most effective and efficient net-zero active ownership activities are often grounded in a comprehensive strategy, leveraging the appropriate levers of influence in line with an investors' style and investment objectives.

A glossary of active ownership concepts and terms

Active ownership
The United Nations Principles for Responsible Investment (PRI) defines active ownership as "the use of the rights and position of ownership to influence the activities or behavior of investee companies."[5]

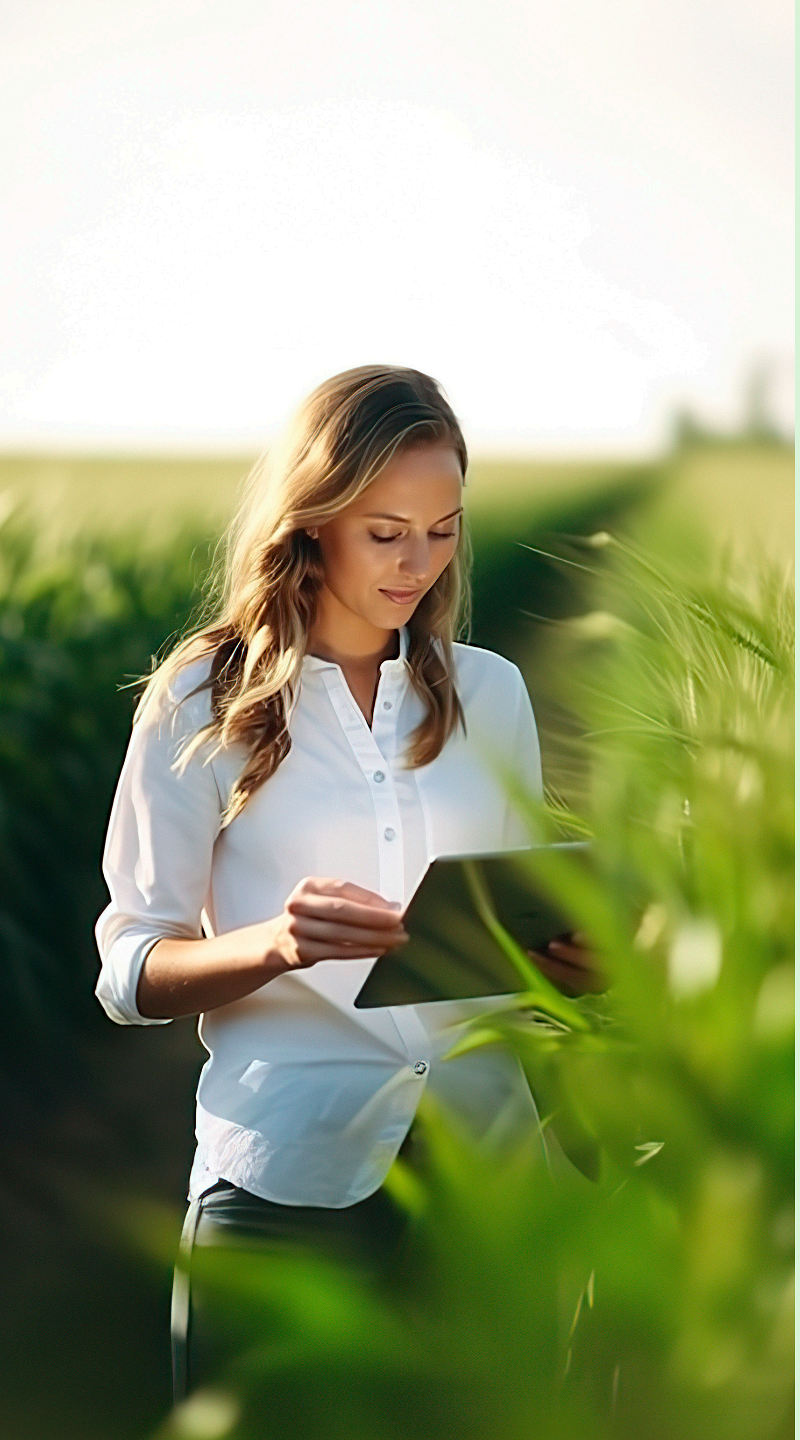
Investment stewardship
The PRI defines investment stewardship as "the use of influence by institutional investors to maximize overall long-term value including the value of common economic, social and environmental assets, on which returns and clients' and beneficiaries' interests depend."[6]

Climate risks and opportunities
The International Sustainability Standards Board's (ISSB) International Financial Reporting Standards (IFRS) S2 sustainability standard defines climate-related risks as "the potential negative effects of climate change on an entity. These risks are categorized as climate-related physical risks and climate-related transition risks. Climate-related opportunities refers to the potential positive effects arising from climate change for an entity. Efforts to mitigate and adapt to climate change can produce climate-related opportunities for an entity."[7]

Climate-related physical risks
IFRS S2 defines physical climate risks as "risks resulting from climate change that are event-driven (acute physical risk) or driven by longer-term shifts in climatic patterns (chronic physical risk). Acute physical risks arise from weather-related events such as storms, floods, drought or heatwaves, which are increasing in severity and frequency. Chronic physical risks arise from longer-term shifts in climatic patterns including changes in precipitation and temperature which could lead to sea level rise, reduced water availability, biodiversity loss and changes in soil productivity."[8]

Climate-related transition risks
IFRS S2 defines transition climate risks as "risks that arise from efforts to transition to a lower-carbon economy. Transition risks include policy, legal, technological, market and reputational risks. These risks could carry financial implications for an entity, such as increased operating costs or asset impairment due to new or amended climate-related regulations. The entity's financial performance could also be affected by shifting consumer demands and the development and deployment of new technology."[9]

Asset owners
Asset owners are public and private pension funds, foundations and endowments, insurers and reinsurers, and sovereign wealth funds. They're commonly known as institutional investors because of the amount of capital they have and the sophistication of assets in which they invest.



A glossary of active ownership concepts and terms

Escalation strategy
An escalation strategy aims to achieve a desired outcome at an investee company by increasing pressure on the company's management over time using various active ownership techniques. Escalation strategies sometimes start with increasing the frequency of outreach to the investor relations team before moving on to file shareholder proposals and conduct proxy battles. Ultimately, they can lead to divestment.

Portfolio hotspots
Portfolio hotspots are segments of an investment portfolio (think assets or asset classes) with above-average exposure to a predetermined type and amount of risk. For example, a portfolio's real estate investment trusts with buildings located in New York City or Miami may have a higher-than-average exposure to flood risks during hurricane season.

Non-hedgeable risk
According to the American Academy of Actuaries, a hedgeable risk can be mitigated by investing in an asset that behaves in an opposite manner within a given set of circumstances, or a risk that can be transferred to a third party such as an insurance company. A risk (financial or non-financial) is non-hedgeable when no such mitigation exists.[10]

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Endnotes

1 Pradeep Philip, Claire Ibrahim, and Cedric Hodges, *The turning point: A global summary*, Deloitte, 2022.

2 Michael Bondar et al., "How can the enterprise earn investor trust through sustainability disclosures?," Deloitte, March 12, 2024.

3 For more information, see Category 15 of the Greenhouse Gas Protocol's *Technical Guidance for Calculating Scope 3 Emissions*.

4 Official Journal of the European Union, "Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks," December 9, 2019.

5 Principles for Responsible Investment, "Introduction to active ownership in listed equity," February 27, 2018.

6 Ibid.

7 International Financial Reporting Standards Foundation, "IFRS Sustainability Standards Navigator," accessed April 2024.

8 Ibid.

9 Ibid.

10 American Academy of Actuaries homepage, accessed April 2024.