# Public consultation document:
# NZIF target setting and implementation guidance for externally managed funds

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# Introduction

This document sets out proposed methodology that could be considered when seeking to assess the alignment of externally managed funds, together with some accompanying target setting methodology and implementation guidance.[1]

The material this document contains is designed to serve only as a guide to investors in the management of their individual portfolios. It is not a prescriptive protocol, nor a standard, and it is not a reporting framework.

The document has been informed by bilateral and working group discussions with investors (that are allocators) and investment consultants across North America, Europe, Asia, and Oceania.

This document integrates views received where appropriate but is not intended to represent the views of all stakeholders, either individually or collectively. This document, produced under the aegis of the Paris Aligned Investment Initiative (PAII) is for discussion purposes only.

PAII is delivered by four investor networks (IIGCC, AIGCC, Ceres, and IGCC), supporting individual investors globally to implement the Net Zero Investment Framework 2.0 (NZIF 2.0) in their individual contexts. It was established in May 2019 as an investor-led forum, to support investors to align their individual portfolios and investment activities with the goals of the Paris Agreement and manage material climate-related financial risks and opportunities.

The PAII host the Paris-Aligned Asset Owners initiative, a global group of 57 asset owners, with over $3.3 trillion in assets. Consistent with their fiduciary obligations to clients and beneficiaries to mitigate financial risk and to maximize long-term value of assets, its signatories have made individual commitments to transition their investments to achieve net zero portfolio GHG emissions by 2050, or sooner, drawing on NZIF 2.0 to deliver these commitments.

The PAII follows five key principles to guide its work, and to assess methodologies and test conclusions.

- **Impact:** Primary objective is to maximise efforts to achieve emissions reductions in the real economy, through the unilateral and independent decisions of individual members to drive the process within the context of fiduciary duties owed to clients and beneficiaries.
- **Rigour:** Alignment based on sound evidence and data, and consistent with best available climate science.
- **Practicality:** Feasible for investors to implement, build on existing work, and be compatible with existing processes.
- **Accessibility:** Definitions, methodologies and strategies should be clear and easily applied.
- **Accountability:** The framework should allow clients and stakeholders to assess portfolio/fund alignment.

# The Net Zero Investment Framework (NZIF)

NZIF outlines the key components that an investor, when managing material climate-related financial risks and opportunities, can consider in the construction of a net zero strategy and transition plan with two key objectives:

- Transitioning investment portfolios in a way that is consistent with the mitigation goals of the Paris Agreement, focusing on real economy decarbonisation.
- Increasing investment in the range of climate solutions to enable the transition.

NZIF recognises that investors have a range of levers at their disposal to contribute to the transition, although many are indirect and not easily attributable to the specific actions of a single investor. These levers will have various levels of efficacy depending on the context. NZIF provides a suite of options for different types of investors, with different strategies, to manage climate risks in the economic interests of their clients and beneficiaries, as well as making financial flows consistent with the goals of the Paris Agreement.

NZIF is designed to guide investors to consider and to develop their own individual net zero strategies, targets, and transition plans (the latter is seen as equivalent to other terms such as 'Investor Climate Action Plans'). It is a guide, not a prescriptive protocol, nor a standard, and it is not a reporting framework. Investors should use it within the context of their own strategies, agendas, starting points, fiduciary duties, client mandates and regulatory considerations, from which and with which they make their own unilateral decisions regarding the ways and means with which they will set and reach their own net zero goals.

# Maximising practical contributions to real economy decarbonisation

NZIF guides investors in the management of their own individual portfolios. In doing so, it recommends investors use the levers at their disposal to support real economy emissions reductions to the maximum practical extent possible. It is only through the reduction of GHG emissions in the real economy that the systemic financial risks posed by climate change can be mitigated.

NZIF 2.0 currently focuses on 'asset alignment' as the premise through which investors can pursue real economy emission reductions, based on its multi-criteria maturity scale. However, this is difficult for investors using externally managed funds. This new methodology supports these 'allocators' to pursue real economy emission reductions through aligning externally managed funds, hopefully leading to asset alignment.

The various recommended action points across the framework support investors to address transition risk within their portfolios and take advantage of any potential opportunities posed by the net zero transition.

The term "practical contributions" is used to recognise that investors ultimately lack complete agency over the outcome they seek (real economy emission reductions). As per NZIF 2.0, it is recognised that action by other stakeholders (e.g. governments) is crucial for the global economy to reach net zero emissions and that short term progress towards reducing real-economy emissions could be inhibited, such as by:

- The requirement to appropriately manage differing legal obligations and differing legal and regulatory environments.
- Available, reasonable, and supportable information without undue cost or uncertainty.
- Internal skills, operational and investment capabilities, and resources.
- Available methodologies and scenarios.
- The absence of policies that create an enabling environment.

Users of this guidance must establish for themselves the maximum practical contributions that they can make on a case-by-case basis.

# Why this guide was developed

Feedback from investors using NZIF has indicated that some use NZIF 2.0 but not directly its asset class methodologies for alignment assessment and improvement. This can be due to resourcing constraints, a concern particularly affecting family offices and endowments. Additionally, it can be due to the heterogeneity and scarcity of asset-level alignment disclosures, a concern particularly affecting investors implementing fund-of-fund approaches. Furthermore, it can be due to existing methodologies not being specific to their position within the financial value chain.

Instead, some investors use NZIF 2.0's portfolio level methodologies to quantify their long-term ambitions and then expect their asset managers to support them to achieve those ambitions, using NZIF 2.0's asset class methodologies.

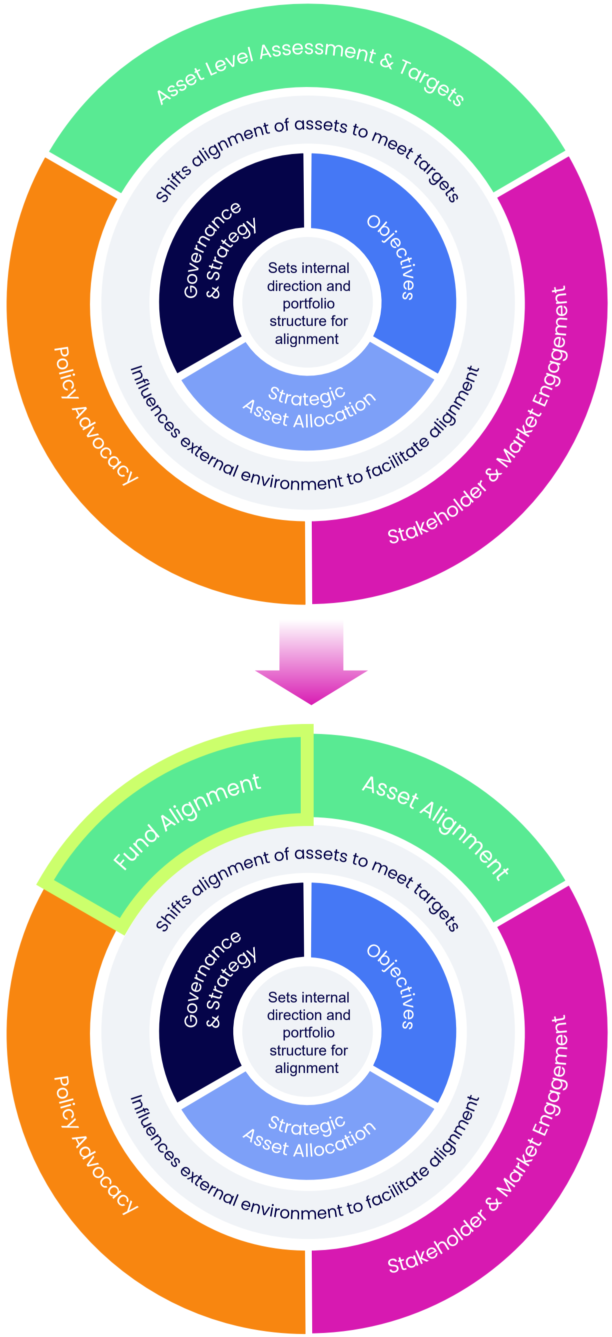
This guide has been developed in response to investor feedback and NZIFs principle to be an iterative 'living document' based on investor experience. It has been developed for investors who either fully or partially allocate to externally managed funds rather than manage funds internally. It provides complementary methodology to existing NZIF guidance, requires less resources to implement, and is specific to their position in the financial value chain. It has been developed based on a series of individual meetings with investors, investment consultants, and an IIGCC working group.

# How this guide fits with the existing NZIF structure

Within the 'Stakeholder and Market Engagement' section, a core recommended action point is provided that recommends allocators to *"engage external fund managers on the need to manage funds in alignment with net zero that is consistent with NZIF's alignment criteria"*. This guide supports implementation of this recommended action point.

This document adds an additional section to the NZIF structure entitled: "Fund Alignment". It is intended for investors who either fully or partially allocate to externally managed funds rather than manage funds internally. It is situated in the same area of the framework as the asset-level section. It is designed to complement this section, though for some allocators it could act as a substitute. For instance, where asset level assessment and improvement are not feasible or is not the most practical lever for the individual management of material climate-related financial risks and opportunities).

It contains alignment assessment and target setting methodology as well as high level implementation guidance to support its operationalisation. Its approach is intentionally high level to allow for flexible adoption by investors relative to their own context. It is designed as an integral extension to NZIF and therefore an extension to its guidance contained across the NZIF wheel.



| | |
|---|---|
| **Governance & Strategy** | Sets ambition towards global net zero emissions, and provide direction and basis for action. |
| **Objectives** | Defines anticipated progress in emissions reduction and increasing investment in climate solutions |
| **Strategic Asset Allocation** | Defines asset allocation to support an individual investor to achieve net zero alignment goals alongside risk/return objectives. |
| **Fund Alignment** | Encourages real economy emission reductions by aligning investments through fund selection and engagement. |
| **Asset Alignment** | Encourages real economy emission reductions by aligning investments through asset selection, management (of real assets), and engagement. |
| **Policy Advocacy** | Encourages policy environment to support decarbonisation and climate solutions, increasing ability to implement a net zero strategy. |
| **Stakeholder & Market Engagement** | Encourages the availability of data, mandates, and investment advice necessary to implement a net zero strategy. |

### Understanding alignment against a net zero pathway

This methodology continues NZIF's 'alignment' focus. This is a concept representing the extent to which an entity is positioned to benefit or not suffer consequences from the transition to a net zero economy.

Entities with targets to manage material climate-related financial risks and opportunities and suitable plans to achieve them are deemed better positioned to manage the transition. Within NZIF 2.0, this broadly represents the 'aligning to a net zero pathway' alignment category. Entities that also have an emissions performance for any given year which is at least consistent with what is required by a contextually relevant net zero pathway are also deemed better positioned. This broadly represents the alignment categories: 'aligned to a net zero pathway' and 'achieving net zero'.[2]

Within NZIF 2.0 the 'alignment' concept was used on financial assets and used as the basis of its net zero target setting methodology. This document proposes that the 'alignment' concept be extended to investment funds which contain financial assets.

It proposes that funds with targets (preferably alignment or climate solutions based) to manage material climate-related financial risks and opportunities and suitable plans and governance to achieve them are deemed better positioned to manage the transition (equating to NZIFs 'aligning to a net zero pathway' alignment category). Funds that are also performing satisfactorily against their targets are also deemed better positioned (equating to NZIFs 'aligned to a net zero pathway' and 'achieving net zero' alignment categories.[3]

Implementation strategies that maximise practical contributions to improving the alignment of externally managed funds over time are thus deemed an avenue for allocators to contribute towards real economy emission reductions. This guide provides support based on the specific location of allocators on the financial value chain which means they may not have discretionary powers over asset selection, management, and engagement.

**Alignment not financed emissions**

As per NZIF 2.0, it is believed that financed emissions should not have a significant role within portfolio optimisation, investment decision making, or be used as a target setting tool to reduce financed emissions through year-on-year reductions.

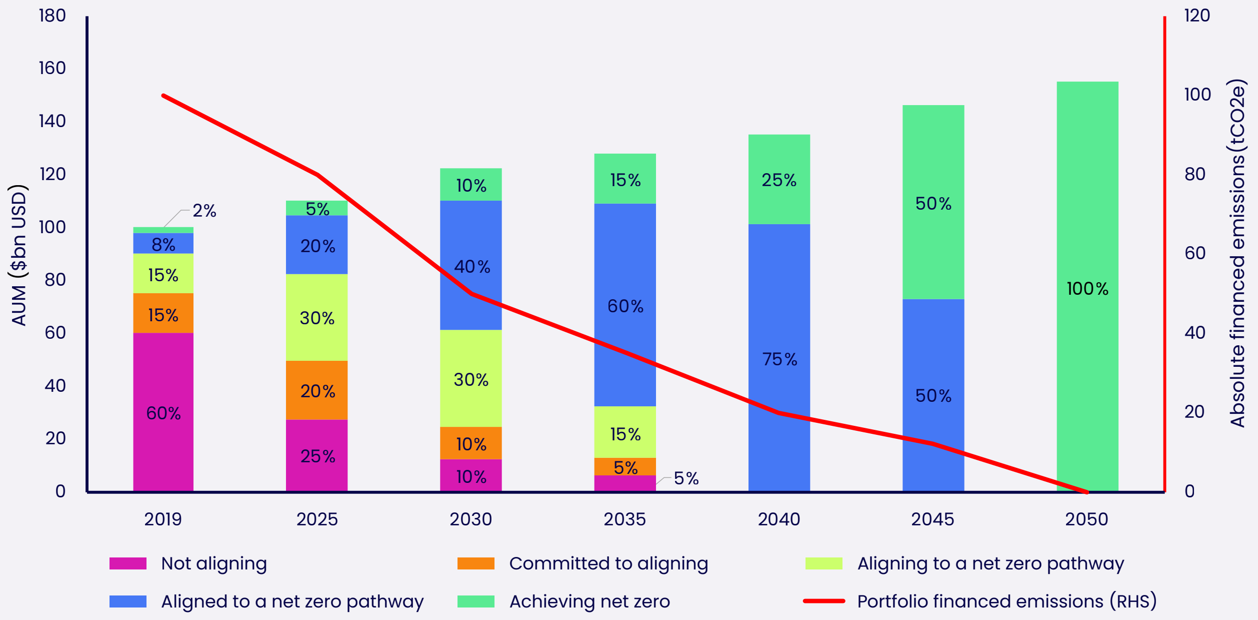
A portfolio decarbonised through actions that do not reduce real economy emissions may not reduce systemic financial risks posed by climate change. It is also not necessarily 'Paris Aligned' in so far as the Paris Agreement[4] calls for financial flows towards low carbon and resilient development, not for attributed financial portfolio emissions to mirror integrated assessment models for global decarbonisation.

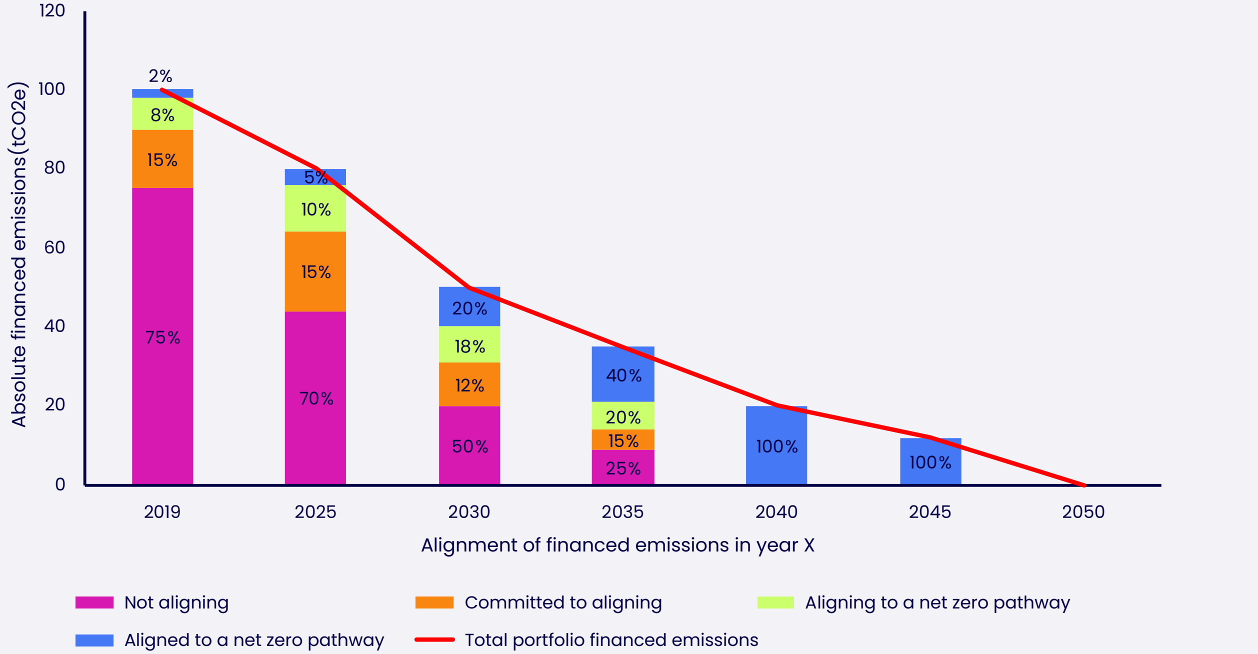
**Facilitating asset managers and owner information exchange**

It is recognised that both allocators and investment managers may benefit from consistency regarding expectations and information requirements which this guide can provide (see section 'Criteria underpinning fund alignment assessment'). This can help develop standardisation in the market and potentially reduce transaction costs.

# How existing objectives and targets work together

NZIF recommends investors set portfolio-level objectives as well as asset-level net zero targets. The graphs below show how setting and achieving alignment targets can vary dependent on the metric chosen using a dummy portfolio. The top graph shows a growing portfolio that is assessing alignment based on AUM. The bottom graph shows the same portfolio but uses financed emissions to assess alignment.



## Portfolio-level objectives

At the portfolio level, the 'Portfolio Decarbonisation Reference Objective' and the 'Allocations to Climate Solutions Objective' support investors to manage material climate risk and opportunities by quantifying their long-term ambitions. Setting these objectives can help investors to:

- Establish and monitor changes in portfolio-level emissions and exposure to climate solutions.
- Express long-term ambitions to relevant stakeholders.
- Facilitate internal accountability efforts regarding the efficacy of net zero strategy.

They are not intended to be used for portfolio optimisation, investment decision making, or as a target setting tool to create year-on-year changes in financed emissions or exposure to climate solutions.

## Asset-level targets

It is at the asset-level that NZIF has target setting methodology which is specific to each asset class. Its foundation is NZIFs multi-criteria maturity scale. This is a consistent framework of criteria and categories providing a common conceptual basis between the alignment assessment of assets within a fund (relative to a net zero pathway) and approaches to improving the alignment of assets within a fund. The framework is consistently applied across identified approaches to realising targets (i.e. across asset selection, management, and engagement).

The 'Asset Alignment Target' and 'Engagement Threshold Target' can help investors to express their intention to contribute towards real economy emission reductions, either by: investing in more aligned assets (i.e. asset selection), managing them in a manner which increases their alignment (i.e. direct management of real assets), or supporting assets to improve their alignment through stewardship (i.e. asset engagement).

NZIF recognises that investors utilise a range of approaches and face a number of constraints, some of which they do not have full agency to address (see section ''). It recommends setting net zero targets but it is only a guide. Investors should determine their targets and performance expectations based on their individual strategies, circumstances, and definitions; and which assets and asset classes are in scope of these. NZIF recommends investors disclose their individual performance against targets to relevant stakeholders, explaining reasons for any divergence under an 'implement or explain' approach.

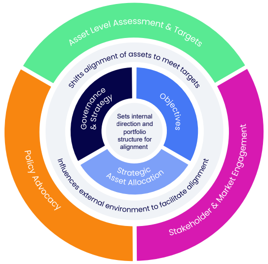
# How fund-level targets support existing NZIF structure

This document supplements NZIFs existing four objectives and target types. It intends to complement efforts by investors that – either fully or partially – allocate to externally managed funds rather than internally manage funds. In other words, it supports those lacking discretionary decision-making regarding asset selection and asset management; and to various extents asset engagement – as these are outsourced.

Its development seeks to solve for a specific problem. Asset-level alignment target setting methodology and implementation guidance is orientated to investors that have discretionary decision-making powers over asset selection, management, and engagement. Consequently, many allocators struggle to set net zero targets – whether they be asset owners or investment managers utilising a fund-of-fund approach. This issue is prevalent for allocators with limited resources to adopt asset-level alignment methodology into their own internal processes (e.g. endowments and family offices). It is also prevalent for investment managers with fund-of-fund strategies as this can often require vast amounts of alignment information for assets across many funds.

This guidance provides target setting methodology and implementation guidance which is generic across asset classes. As per the asset alignment guidance, its foundation is NZIFs multi-criteria maturity scale, providing a consistent framework of criteria and categories providing a common conceptual basis between the alignment assessment of funds and approaches to improving the alignment of funds (relative to an allocators' net zero objectives). The framework is consistently applied across approaches to realising targets (across fund selection and engagement).

Its 'Fund Alignment Target' and 'Fund Engagement Target' can help 'allocators' to express their intention to contribute towards real economy emission reductions by investing in more aligned funds (i.e. fund selection) or supporting funds to improve their alignment through stewardship (i.e. fund engagement). It could feasibly be used to complement efforts by investors with discretionary decision-making when directly managing funds. However, it is not intended nor recommended to substitute for the asset-level guidance outlined previously.




## Governance & Strategy

Establishes climate ambition through a portfolio-level net zero goal and establishes need to develop a transition plan, providing direction and basis for action.

### Portfolio Decarbonisation Reference Objective

Quantitative expression of portfolio net zero goal to invest in emissions reduction and/or desired progress over long-term

### Allocations to Climate Solutions Objective

Quantitative expression of portfolio net zero goal to invest in climate solutions and/or desired progress over long-term

### Strategic Asset Allocation

Supplement standard financial objectives with portfolio net zero objectives

## Net Zero Strategy

Strategy through which entity-level objectives are proposed to be achieved (either through the investment process and/or influencing the external environment to support real economy decarbonisation)

### Fund Alignment

Encourages real economy emission reductions by aligning investments through the selection and engagement of externally managed funds.

### Asset Alignment

Encourages real economy emission reductions by aligning investments through asset selection, management (of real assets), and engagement.

### Policy Advocacy

Encourages policy conditions to support decarbonisation and climate solutions, increasing ability to implement a net zero strategy.

### Stakeholder & Market Engagement

Encourages market service providers to provide data, tools and advice that underpin net zero strategies and industry-wide change.

# Fund alignment not investment manager alignment

This methodology supports investors to assess the extent to which their own capital is being managed in accordance with alignment criteria, via specific funds to which they have made allocations.

For instance, it concerns itself with the stewardship plan that a specific fund uses as part of efforts to manage material climate risks and opportunities. However, it does not concern itself with entity level approaches to stewardship if these do not apply to the specific fund to which an investor has allocated towards. In summary, how other investors capital is managed is not its concern.

It is recognised that to varying degrees the way in which funds are managed can be determined or influenced by entity wide structures, processes, policies, and practices. It is also recognised that these can be a concern for allocators, in particular systems-level components of net zero strategy such as policy advocacy as well as stakeholder and market engagement. A prominent example is the "Asset owner statement on climate stewardship".[5]

## Existing NZIF 2.0 guidance for investment manager alignment

NZIF 2.0 already has recommended action points which can be used in support of understanding entity level alignment via 'Policy Advocacy' and 'Stakeholder and Market Engagement'. Additionally, it recommends that allocators engage with investment managers on the need for net zero aligned policy advocacy and wider industry stewardship. These recommended action points are listed below as a reminder of examples of expectations allocators can have of investment managers:

**Policy Advocacy**

- Align direct and indirect policy advocacy efforts towards what is relevant for achieving global net zero emissions by 2050 or sooner.
- Participate in policy advocacy (directly or collectively) to international, national and sub-national policymakers to promote the implementation of climate and wider economic policies and regulations that support net zero objectives.
- Disclose internal climate policy positions and that of industry associations, participation in any advocacy or lobbying activities and submissions, and an assessment of the alignment of industry associations in alignment with the Global Standard on Responsible Climate Lobbying.
- Create procedures for robust internal oversight of policy advocacy efforts, including monitoring, review, and transparency through disclosure.

- Disclose within a transition plan the interdependencies between net zero targets and the wider policy environment.
- Engage with portfolio companies on their lobbying practices and industry associations, promoting the need for alignment with the Paris Agreement.

**Stakeholder and Market Engagement**

- Participate in advocacy to market service providers (directly or collectively through industry networks) for the tools, data, and advice required to achieve net zero goals.
- Undertake stewardship with market actors to ensure that their assessments, data and products are based on alignment criteria, robust methodologies, and are consistent with net zero goals.
- Undertake stewardship with industry peers to share expertise, experience, and address common challenges in support of the achievement of net zero objectives.
- Engage external fund managers on the need to manage funds in alignment with net zero that is consistent with NZIF's alignment criteria.
- Engage with existing and potential clients to encourage the uptake of net zero investment strategies and products, provide research and analysis to support climate risk assessment and net zero investing.
- Promote disclosure of corporate transition plans across industries, such as in accordance with IIGCC's sector neutral transition plan guidance and net zero standards covering high impact material sectors.
- Participate in regulator-industry initiatives to develop voluntary and mandatory standards of transition plans and other disclosures, such as Paris-aligned accounts.
- Participate in investor industry network associations to advance knowledge around benchmarking portfolios with the Paris Agreement goals.
- Engage with existing and potential asset managers to encourage managers to provide strategies and products to achieve asset owners' net zero investment goals.
- Engage private data vendors to pursue assessments that are consistent with alignment criteria within the latest detailed guidance on indicators from the Climate Action 100+ Net Zero Company Benchmark.
- Engage private data vendors to pursue data on scope 3 emissions that details which categories are used within assessments and their accuracy disclosed.
- Undertake participation in activities of the investor networks to facilitate knowledge creation relating to net zero investment.
- Communicate expectations relating to alignment criteria across asset classes (e.g. pre-issuance of bonds).
- Engage with index providers to provide benchmarks better aligned with net zero.
- Engage with providers of bond indices that may inadvertently require investors to purchase new bonds irrespective of climate impacts.
- Encourage through signalling, early-stage investing, or other methods for compatible firms to make it to the IPO stage.
- Encourage credit rating agencies, sell-side analysts, and fund managers to incorporate climate-related risk factors into financial analysis.
- Advocate for the development of contextually specific sector transition pathways which can be used to assess the alignment of investments.

# Fund level alignment methodology

## Core action points

NZIF recommends the following actions for allocators using the framework to consider:

- Set the scope for applying this methodology across externally managed funds for alignment action.
- Assess and disclose the baseline alignment of externally managed funds in scope, using the specified criteria.
- Set and disclose targets to improve alignment of externally managed funds (see section "Implementation guidelines" for full details):
- Develop a strategy and implement approaches to improve alignment of externally managed funds over time.[6]

## Advanced action points

NZIF recommends the following advanced actions. These may initially be difficult when beginning to set and implement net zero targets (when attention is likely to be placed on implementing core action points), but would likely prove beneficial over the long term:

- Disclose the science-based scenario(s) or pathway(s) used to guide target setting and assess the alignment of externally managed funds, including how scenarios meet key parameters, and critical assumptions used.
- Disclose why any AUM are not in scope of fund level targets, including the process, progress, and timeline for inclusion.
- Regularly assess and disclose alignment of funds, including those not in scope on a best effort basis.
- Disclose indicators used to assess and track alignment of funds, and the extent to which these are consistent with NZIF's target setting methodology.
- Disclose fund selection approaches implemented to facilitate allocation to products aligned with net zero objectives.
- Disclose fund engagement actions undertaken in relation to the engagement threshold target, and key outcomes achieved.
- Incorporate engagement on climate risks and opportunities into Investment Management Agreement (IMA) where feasible and appropriate.
- Clearly state the investment objective of the fund and how it is aligned with the climate objective.
- Outline the alignment of climate engagement policy with the climate objective and investment process of the fund.
- Ensure that the active ownership approach (proxy voting, corporate engagement, and shareowner campaigns) is independent of the portfolio construction process, active or indexed, but tailored to the nature of the funds. E.g., prioritisation and escalation mechanisms, and aligning fund climate criteria with engagement approach.
- Provide transparency around the allocation of resources related to stewardship and engagement activities on a fund basis.
- Publish a detailed policy on securities lending with regards to voting for securities on loan and voting rights protection. This could include details on whether securities can be recalled in accordance with local laws and exercised in line with the climate engagement policy of the fund.

- Report on the outcome of stewardship activities through voting and engagement, including the approach to prioritisation, and escalation if companies are not responding to engagement.

## Alignment categories

This fund-level methodology adopts the five categories of alignment used within NZIFs asset-level guidance. It was deemed appropriate and beneficial to use the existing multi-criteria maturity scale for consistency and coherence. Allocators can use the maturity scale to evaluate where funds are on their progressive journey towards alignment with a net zero pathway and by extension, provide a forward-looking nuanced understanding of portfolio alignment (when investments are aggregated). The five categories are:

| Alignment category | Alignment description |
|---|---|
| **Achieving net zero** | Typically, refers to funds which meet all relevant criteria and/or have an emissions performance at net zero which can be expected to continue. |
| **Aligned to a net zero pathway** | Refers to funds which additionally have proven to have made sufficient progress against achieving their targets. This category broadly signifies that transition risk is being managed at a fund level. |
| **Aligning to a net zero pathway** | Refers to funds which additionally have targets (signalling their intent to progress against managing material climate-related financial risks and opportunities) as well as investment policies, processes, and/or stewardship plans that detail how they are going to contribute towards managing those risks and opportunities. |
| **Committed to aligning** | Refers to funds that recognise material climate-related financial risks and opportunities and have governance structures to hold relevant individuals to account to manage these over the long term. |
| **Not aligning** | Refers to funds that recognise climate risk as material to the management of the fund but do not have any intentions, accountability, plans or targets related to its management. |

*Funds that can demonstrate to clients that climate-related financial risks and opportunities are not material to the investments of the fund do not need to be assessed against the methodology.*

## Criteria underpinning fund alignment assessment

To determine the alignment of externally managed funds, NZIF proposes a set of 6 backward, current, and forward-looking criteria. These should be fulfilled for the specific fund being assessed:

| Criteria and description for externally managed funds | Rationale for clients with climate goals | Underlying concept |
| --- | --- | --- |
| **Ambition**: The fund has the intention to manage any identified material climate-related financial risks and opportunities. | Material risks and opportunities should be managed appropriately and communicated via fund objectives | Materiality |
| **Governance:** The fund has structures, policies, and processes relating to the management of material climate-related financial risks and opportunities. | If risks are material, then governance should seek to ensure relevant accountability for its management. | Accountability |
| **Targets:** The fund has near term targets for improving its climate performance, preferably in terms of asset alignment and/or climate solutions.[7] | Management of material risks and opportunities should be articulated and communicated via intentions. | Intentionality |
| **Decarbonisation plan:** The fund has a pre-defined set of actions that contribute to managing material climate-related financial risks and opportunities. | Intentions should be supported by a plan to demonstrate how they are to be achieved. | Contribution |
| **Disclosure:** The fund is measuring and disclosing progress and actions taken to manage material climate-related financial risks and opportunities. | Progress is not knowable unless it is being measured and disclosed (along with actions undertaken). | Transparency |
| **Climate performance:** The fund is on track to achieve its specific targets or emissions performance of the fund surpasses a relevant performance benchmark. | Managing material financial risks and opportunities requires achieving sufficient progress against targets. | Achievement |

The criteria laid out above provide a high-level framework for the alignment assessment of funds. Indicators for each criterion are intentionally unspecified to allow allocators the flexibility to determine what indicators and data sources suit their individual circumstances. However, NZIF 2.0 can provide guidance, particularly for disclosure, decarbonisation plan, and targets. The criteria and subsequent assessment should cover scope 1, 2 and material scope 3 emissions which should be disclosed to allocators.

Information to determine whether alignment criteria have been fulfilled should be found within the formal documentation of funds, when possible, rather than through informal channels for the sake of transparency and accountability. Allocators should disclose to relevant stakeholders, as and when appropriate, the indicators and data sources used to determine the fulfilment of alignment criteria.

## Considerations when selecting indicators

Within this methodology, as with all NZIF guidance, the selection of indicators is at user discretion. Additionally, the use of indicators to assess fulfilment of criteria will depend on the user's perspective. For instance, ascertaining the sufficiency of efforts by externally managed funds regarding targets depends heavily on what climate goals the allocator has as it is these goals which serve as the analytical reference point. To facilitate understanding and implementation some guidance on the selection of indicators has been provided below for each criterion.

### Ambition

Ambition is the base criterion of this proposed methodology on the reasoning that material climate-related financial risks and opportunities should be recognised and managed. Within this criterion, investors should be careful to choose indicators that assess whether those risks and opportunities are disclosed to clients for the specific investments in the fund and confirmation that these will be managed for the client (including how any trade-offs with other material concerns will be managed).

### Governance

Governance is also a base criterion of this proposed methodology on the reasoning that the management of material climate-related financial risks and opportunities requires governance. Within this criterion, investors should be careful to choose indicators that assess whether the following topics are being addressed:

- Governance structures, policies, and processes are appropriate and commensurate with the intentions and contributions the fund will make towards managing material climate-related financial risks and opportunities.
- Delegation of fund management to third parties is made explicit and is covered by due diligence structures, policies, and processes. Fund management could refer to investment activities outsourced, or the provision of asset-level data and information used, or any independent assessment of the fund regarding its management of material climate-related financial risks and opportunities.
- Evaluation of governance and resourcing to implement plans to achieve the funds targets on an on-going basis, including whether individuals responsible for achieving fund targets are appropriately skilled.

### Disclosure

Disclosure is fundamental to this proposed methodology on the reasoning that understanding progress towards managing material climate-related financial risks and opportunities requires that 'progress' and 'actions' are measured and disclosed

Within this criterion, it is imperative that investors ensure that the indicators they adopt enable them to understand ongoing fund performance against its target type, preferably on at least an annual basis. The indicators disclosed by investment managers should be pre-identified and consistent with the methodologies outlined within NZIF 2.0 where possible and relevant.

One of the wider benefits this methodology is hoping to achieve is to narrow and/or focus attention on a reduced set of information requested by asset owners and provided by asset managers. Ideally, this would be fund level based on the alignment criteria outlined in this methodology and the asset alignment information which NZIF 2.0 provides on an asset class basis.[8]

It is noted that allocators will likely need further disclosures for enhanced due diligence processes. For instance, data associated with proxy voting, engagement milestones, or escalation tracking. They may also require disclosures on any negative outcomes associated with achieving targets (e.g. shifting of investment away from emerging and developing markets or any negative consequences for workers and communities).

### Decarbonisation plan

The decarbonisation plan criterion will inevitably be key for many investors. Within this methodology it captures the contribution that a fund intends to make regarding real economy emission reductions. Ultimately, few assets in the economy will already have an emissions profile consistent with the end state of a net zero pathway, especially when embodied emissions and historical emissions are considered. Within this criterion, investors should be careful to choose indicators that enable them to ascertain whether the decarbonisation plan is:

- Realistic and transparent with the limitations faced, such as dependencies on policy changes.
- Linked to desired outcomes– preferably within a 'theory of change'.
- Adequately resourced and supported by relevant engagement platforms.
- Be relevant to the investment strategy adopted.
- Contains an escalation plan describing the steps to be taken if initial efforts do not sufficiently lead to desired outcomes.
- Support real economy emission reductions (i.e. supporting financing of reduced emissions and not simply reducing financed emissions).

Finally, approaches to be used by investment managers should be pre-identified and consistent with the methodologies outlined within NZIF 2.0 where possible and relevant.

### Targets

Targets used by externally managed funds will be an inevitable focus criterion of this proposed methodology and for allocators, on the reasoning that they represent and articulate intentions to manage material climate-related financial risks and opportunities.

To a significant extent, an allocators ability to achieve their climate goals will depend on the targets to manage material climate-related financial risks and opportunities that are used by its externally managed funds (i.e. if the externally managed funds used by an allocator have no targets to improve their climate performance, then this will significantly diminish the ability of the allocator to achieve their own climate goals).

Within this criterion, investors should be careful to choose indicators that assess whether the target(s) used by the externally managed fund:

- Clearly articulate the desired outcomes being sought, ideally as part of a wider 'theory of change'.
- Express the desired outcome quantitatively and be time bound.
- Where possible be consistent with the methodologies outlined in NZIF 2.0 on an asset class basis.
- Capture the coverage of the target over the capital of the fund.

It is noted that intentions can be achieved via a range of approaches, such as investing in activities which:

- Already meet all of the NZIF criterion or already meet a 2050 emissions performance standard.[9]
- Gradually improve against NZIFs asset-level alignment multi-criteria maturity scale over time.
- Provide climate solutions.

Finally, net zero targets to be used by investment managers should be pre-identified and consistent with the methodologies outlined within NZIF 2.0 where possible and relevant.

### Climate performance

Climate performance is the outcome criterion of this proposed methodology on the reasoning that achieving better climate performance leads to better management of material climate-related financial risks and opportunities.

This methodology recognises that climate performance cannot necessarily be ensured by the investment manager. Achieving real economy emission reductions requires an enabling environment which the investor alone cannot provide.

Within this criterion, indicators should be chosen which ascertain whether the fund is achieving its targets. Consequently, the target type and desired outcome should determine indicator choice (e.g. improving alignment, reducing emissions, or providing climate solutions). Additionally, indicators may seek to assess coverage improvements (i.e. improvements to the proportion of the fund covered by targets over time).

Finally, as per NZIF's implementation guidance, assessment of targets can be done on a benchmark relative or self-decarbonisation approach, and via a cumulative or point-in-time based approach.

# Implementation guidelines

## Alignment target

- Fund alignment target: Maximise practical contributions towards increasing the %AUM in externally managed funds that are at least 'aligning' over a predefined period of time such as 5 years.
- Engagement threshold target: A minimum threshold of %AUM from externally managed funds assessed as either achieving net zero or aligned to a net zero pathway or are subject to engagement.

### Minimum expectations within target setting methodology

The target setting methodology intentionally refers to 'aligning' as the minimum expectation, rather than 'aligned' or 'achieving net zero'. This represents an expectation that external fund managers strive to have accountability, targets, and plans to manage material climate-related financial risks and opportunities. Climate performance is not required though investors are encouraged to maximise practical contributions to real economy decarbonisation.

### Climate-informing investment decision-making

This guidance supports allocators to set targets and make practical contributions towards achieving them.[10] This is within the broader aim of understanding, measuring, and communicating progress towards contributing to real economy emission reductions and managing material climate-related financial risks and opportunities.

### Achieving targets is not a requirement

Investors should adopt an implement or explain approach (to relevant stakeholders) regarding the extent to which they are sufficiently progressing against their own targets. Achieving the fund alignment and fund engagement targets is not a requirement of this methodology. The lack of a minimum performance expectation explicitly recognises that investors will have different starting points, progress may take time and is unlikely to be linear.

## Scope

- The guidance contained here is intended to be usable across asset classes, facilitating aggregation. Investors can determine the extent to which they apply it in support of the management of their individual portfolios, both immediately and over time.

### Segregated mandates versus pooled funds

This guide is agnostic as to whether allocators use segregated mandates or allocate towards funds with multiple clients (pooled vehicles). It notes that fund structure and the extent to which material climate-related financial risks and opportunities are being managed will strongly influence the speed of progression that allocators can expect regarding progression against the alignment criteria outlined in this guide.

Investors may find segregated mandates provide more influence and communication over the investment process; as the investment management agreement can be tailored to the allocator's own beliefs, approaches, and climate objectives. However, it is also recognised that segregated mandates may be unsuitable for smaller allocators which need to rely upon multi-client funds and the support of investment consultants.

## Criteria underpinning alignment assessment

| Criteria | Committed to aligning | Aligning | Aligned | Achieving net zero |
|---|---|---|---|---|
| Fund has emissions intensity required for 2050 and whose approach will maintain this performance. | | | | ✔ |
| **Climate performance:** The fund is on track to achieve targets for the fund or emissions performance of the fund surpasses a relevant performance benchmark. | | | ✔ | ✔ |
| **Disclosure:** The fund is measuring and disclosing progress and actions taken to managing material climate-related financial risks and opportunities. | | ✔ | ✔ | ✔ |
| **Decarbonisation plan:** The fund has a pre-defined set of actions that contribute to managing material climate-related financial risks and opportunities. | | ✔ | ✔ | ✔ |
| **Targets:** The fund has near term targets for improving its climate performance, preferably in terms of asset alignment and/or climate solutions.[11] | | ✔ | ✔ | ✔ |
| **Governance:** The fund has structures, policies, and processes relating to the management of material climate-related financial risks and opportunities. | ✔ | ✔ | ✔ | ✔ |
| **Ambition:** The fund has the intention to manage any identified material climate-related financial risks and opportunities. | ✔ | ✔ | ✔ | ✔ |

# Approaches to align portfolios and achieve targets

The following approaches are examples that allocators may wish to consider when undertaking efforts to achieve fund-level targets. They are presented agnostically regarding their efficacy and relevance, which will depend on the context an individual investor operates within.

## Fund selection

- Assess externally managed funds for the extent to which they are managing material climate risk.
- Consider allocation to funds which are credibly managing material climate risk.
- Invest in specialist products/funds (alignment/use of proceeds/climate solutions focused), that are consistent with regulatory labels when available.
- Balance the need for action with an understanding of the limits to investor action and anticipate differences in net zero uptake across relevant and specific markets and/or geographies in which investments are held.

## Fund engagement

- Engage with senior leaders of externally managed funds to make clear your commitment to net zero, and how consideration of net zero will impact your investment decisions going forward.
- Engage with senior leaders of externally managed funds to advocate that they are managed in line with net zero according to NZIF criteria and methodologies.
- Engage on the disclosure of fund-level baseline scope 1 and 2 emissions, with material scope 3 emissions disclosed separately.
- Advocate for the disclosure of metrics, targets and methodologies used to assess and track alignment of assets according to each asset class, and the extent to which these are consistent with NZIF.
- Request disclosure of performance against net zero targets over time, and any updates or adjustments to alignment criteria, on at least an annual basis.
- Request disclosure of reasons for any assets uncommitted under fund level targets, including the process, progress, and timeline for inclusion.
- Request disclosure of actions relating to asset selection, direct management of real assets, and/or engagement, stewardship that have been undertaken to achieve net zero targets, and any key outcomes achieved.
- Request disclosure of utilisation of screening or exclusions, the rationale, and the extent to which this has been the means to achieve targets.
- Engage on the science-based scenario(s) or pathway(s) used by managers to guide their asset-level target setting and assess the alignment of underlying holdings, including how scenarios meet key parameters, and critical assumptions used.

## Endnotes

1 A fund could refer to a collection of investments covered by a single International Securities Identification Number, a managed discretionary account, or a separate managed account/segregated mandate.

2 Within the NZIF alignment methodology it is generally accepted that investors can loosen the requirement for assets to have targets and plans to manage material climate-related financial risks and opportunities if emissions performance is at least consistent with what is required by a contextually relevant net zero pathway (for that year). Targets and plans are deemed to be factors increasing the likelihood and ability of assets to have satisfactory emissions performance (i.e. the desired outcome) especially over the long-term, and so still have significant relevance to understanding alignment.

3 It is anticipated that investors may again loosen the requirement for funds to have targets and plans to manage material climate-related financial risks and opportunities if climate performance is considered to be satisfactory. Targets, plans, and governance are deemed to be factors increasing the likelihood and ability of funds to have satisfactory climate performance (i.e. the desired outcome) especially over the long-term, and so still have significant relevance to understanding alignment.

4 Under 2.1(c), see https://unfccc.int/sites/default/files/english_paris_agreement.pdf

5 See https://thepeoplespension.co.uk/pension/basics/investments/responsible-investment/asset-owner-statement-on-climate-stewardship/

6 Users should develop a strategy that suits their own priorities and circumstances. For instance, they could prioritise externally managed funds over which they feel they have sufficient influence or they could prioritise those which are the biggest size.

7 As per NZIF guidance, targets should be set using its alignment and climate solutions methodology. However, but it could also be a pure emissions reduction target such as those used in 'Paris-aligned' and 'Climate transition' benchmarks.

8 During a piloting of this methodology, it was noted that alignment data of underlying holdings can complement alignment information relating to the management of the externally managed fund.

9 Such as would be the case with renewable energy investment funds which would be classified under NZIF as 'achieving net zero'. This is due them satisfying three factors A) they are disclosing their emissions, B) emissions performance is already at least equal to what is required by its sector/regional pathway for the year 2050, and C) their operational model will maintain this performance. This does not negate the utility of other criteria. For instance, science-based targets and decarbonisation plans are important for the ongoing maintenance of facilities or the importance of issues such as embodied emissions. However, currently it is considered that the lack of these should not inadvertently demote the categorisation of investments.

10 This guidance is directly orientated to allocators. They are not designed to be used by investment managers although they could be depending on the context.

11 As per NZIF guidance, targets should be set using its alignment and climate solutions methodology. However, but it could also be a pure emissions reduction target such as those used in 'Paris-aligned' and 'Climate transition' benchmarks.

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