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Mercer COP27

Advancing the transition: Seeking to mitigate risk and drive adaptation beyond COP27

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Mercer is prepared to work with institutional investor clients to seek to achieve their specific investment objectives, within the relevant fiduciary and regulatory context in which they operate. This paper is geared toward institutional investors seeking to engage in climate transition investing.

With less than 30 years to achieve the net-zero target for carbon emissions by 2050, a goal enshrined by the Paris Agreement, the next, accelerated phase of the climate transition will present substantial investment risks and transformative investment opportunities globally.

Mitigation and adaptation

Climate transition planning and implementation aims to manage climate risk in portfolios - through a just transition using stewardship, integration, investment solutions and screening. It also helps to help identify transformational investments - allocations that may seek to deliver attractive risk-adjusted returns while addressing one or more long-term, global systemic risks.

In the context of the African continent – a central focus of COP27 – transformational investments may support solutions, stewardship and critical climate adaptations, from the delivery of renewable energy sources and improvements in energy efficiency, to the enhancement of an economy's infrastructure and resilience to the effects of global warming.

While risk management and mitigation remain dominant drivers behind transition plans, there is an opportunity for investors to advance the real-world impacts of climate adaptation in line with their vision and goals.[1]

Institutional investors are at different stages in their climate transition, but through the investment decisions they make, have the collective potential to protect against economic loss, mitigate[2] environmental damage and support climate adaptation[3], while pursuing attractive risk-adjusted returns.

In transitioning portfolios, investors want to understand their downside risks; identify opportunities to allocate to companies and assets moving towards sustainable, green revenues; align with the targets of the 2015 Paris Agreement, including limiting the rise in global average temperatures to 1.5°C and deliver broader environmental and social impacts aligned with their objectives. Working together, the investment community has a key role to play in enabling transition.

Recognizing that a 1.5°C scenario may have a financial impact on investors[4] and as a founding signatory to the United Nations-backed Principles for Responsible Investment in 2006, Mercer has committed to a target of net-zero absolute carbon emissions by 2050 for clients across multi-asset, multi-manager client portfolios (valued at ~$80Bn) in Australia and New Zealand and for all discretionary assets in Europe, Asia, Middle East and Africa. This is underpinned by a strategy to reduce portfolio-relative carbon emissions by at least 45% from 2019 baseline levels by 2030.

We help institutional investors interested in aligning their portfolios with net-zero outcomes by 2050 (or earlier), to develop and implement climate analysis and transition plans, according to their unique requirements, and goals.

[1] Mercer recognizes that such considerations may not be appropriate in all contexts depending on the nature of the investment portfolio and applicable fiduciary and regulatory requirements.

[2] As there is a direct relation between global average temperatures and the concentration of greenhouse gases in the atmosphere, the key to solving the climate change problem rests in decreasing the amount of emissions released into the atmosphere and in reducing the current concentration of carbon dioxide (CO_2) by enhancing sinks (e.g. increasing the area of forests). Further information available at: https://unfccc.int/topics/introduction-to-mitigation

[3] Climate adaptation refers to the adjustments in ecological, social, and economic systems in response to actual or expected climatic stimuli and their effects. It refers to changes in processes, practices, and structures to moderate potential damages or to benefit from opportunities associated with climate change. Further information available at: https://unfccc.int/topics/adaptation-and-resilience/the-big-picture/what-do-adaptation-to-climate-change-and-climate-resilience-mean

[4] Mercer Investment Beliefs - https://www.mercer.com/our-thinking/wealth/mercer-investments-beliefs.html https://www.mercer.com/our-thinking/wealth/zero-places-to-hide.html and Intergovernmental Panel on Climate Change site for latest reports - https://www.ipcc.ch/

Our position on transition

Climate change presents a systemic risk, challenging investors to consider both the potential financial impacts of the associated transition to a low-carbon economy and the physical impacts of different climate outcomes. Mercer is committed to investing for a 1.5-degree scenario because robust climate scenario analysis evidence that is in the best financial interests of our clients. We are seeing increasing demand for a rigorous and measurable approach to climate change investment as we support clients to meet their specific investment objectives of investing for a 1.5-degree scenario, and we are working with these clients to apply climate scenario analyses to evidence the financial merits of pursuing this objective.

Here, we explore the implementation and potential of the climate transition in portfolios.

We focus on the development of investment solutions and stewardship under climate transition programs - **Transition as the key response to climate risk** - and consider the crucial lessons to be learnt from investors pioneering climate-focused investment outcomes.

Then, we consider how investors can - **advance a 'just transition'** – in keeping with the African focus of COP27, we look ahead to the potential for transformational investments in Africa as part of transition plans. We examine the opportunity for impact frameworks as investors consider their role in supporting an orderly, just transition.

Investor net-zero commitments

An investor-based net-zero pledge typically involves committing a proportion of assets to the requirements outlined in, or broadly consistent with, industry-based initiatives such as the Net Zero Asset Owner Alliance (NZAOA) or the Net Zero Net Zero Asset Managers initiative (NZAM).

As an example, asset managers and investors who commit assets to NZAM "support the goal of net zero greenhouse gas ('GHG') emissions by 2050, in line with global efforts to limit warming to 1.5°C" and "commit to support investing aligned with net zero emissions by 2050 or sooner."

Transition is the key response to climate risk

Position for transition: the time to ACT is now

Mercer's Analytics for Climate Transition or ACT is a strategic, forward looking assessment of the risks and opportunities that arise from a transition to a low carbon economy in an investment portfolio. Companies are ranked along a spectrum spanning high carbon intensity assets with low capacity to transition, to green assets, providing the solutions, recognising that many companies are somewhere in between.

A 1.5°C scenario presents both transition risks (particularly for portfolios currently aligned to a higher, 3°C or 4°C+, warming scenario) and opportunities. Identifying and addressing these short- and long-term risk/return questions helps enable investors to allocate capital to the many mitigation and adaptation initiatives necessary to support an orderly – and just – transition.

For example, while a 1.5°C scenario limits the long-term exposure of assets to the risk of physical damage from climate change, it concentrates short-term risks in sectors disrupted by the transition. Within a 1.5°C scenario, emissions have already peaked, leaving high-carbon utilities and energy companies at risk of becoming stranded, with knock-on impacts on asset values.

Mercer’s Analytics for Climate Transition (ACT) helps asset owners identify latent risks and emergent opportunities in the transition ahead.

Establishing transition capacity

ACT supports climate transition strategies through top-down climate scenario analysis, forward-looking portfolio analytics and bottom-up assessment of holdings. This multi-dimensional view seeks to establish where emissions are currently being generated across the portfolio and, at a more granular level, companies' capacity to transition, mitigate and adapt.

From this starting point, ACT allows investors to develop transition plans that include a step-by-step process, enabling investors to rank companies and portfolios by their capacity to support annual emissions reductions (transition capacity), prioritize active ownership of companies, and allocate to transition solutions.

A multi-dimensional assessment draws on a range of data providers and metrics to assess portfolios across a spectrum from 'grey' to 'green' investments; given that many companies lie somewhere in the middle, their capacity for future transition needs to be fully assessed and determined.

Through this process, investors start to identify which portfolio companies and holdings are, for example, high carbon and low transition, or low – even zero – carbon and high transition.

Figure 1. Overview of the Analytics for Climate Transition (ACT)

Mercer's climate transition advice adopts a spectrum approach to transition risk and opportunity, and a step by step process to developing a climate transition plan to align your portfolio to a net zero outcome by 2050 (or sooner). Our advice is supported by our **Analytics for Climate Transition (ACT)** tool.

Manage 'Grey' Risks
High carbon intensity, low transition capacity

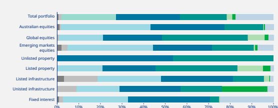
Steward the 'In-between'
Varying carbon intensity, and transition prospects

Target 'Green' Solutions
Low carbon intensity, high transition capacity

2020 2030 2050

1. Determine current baseline

2. Analyse portfolio possibilities



3. Set measureable goals

Determine a pathway suitable for your portfolio and set net zero targets with confidence

Milestone expectations are set out for each asset class through a phased approach

4. Implementation plan

Integration
- **Incorporate** scenario and transition analysis into strategy and portfolio construction decisions
- **Monitor** market pricing*

Active ownership
- **Engage** with companies, including via collaborative initiatives
- **Utilise** voting rights

Investment
- **Allocate** to low-carbon / sustainability solutions
- **Monitor** developments and prices*

Screening
- **Monitor** high-carbon exposures where low transition capacity

Disclosure consistent with the TCFD framework – including metrics and targets

*Decarbonisation at the Right Price (DARP): is a term used to describe this market aware approach to transition objectives

Source: Mercer, for illustrative purposes only

Setting and integrating transition targets

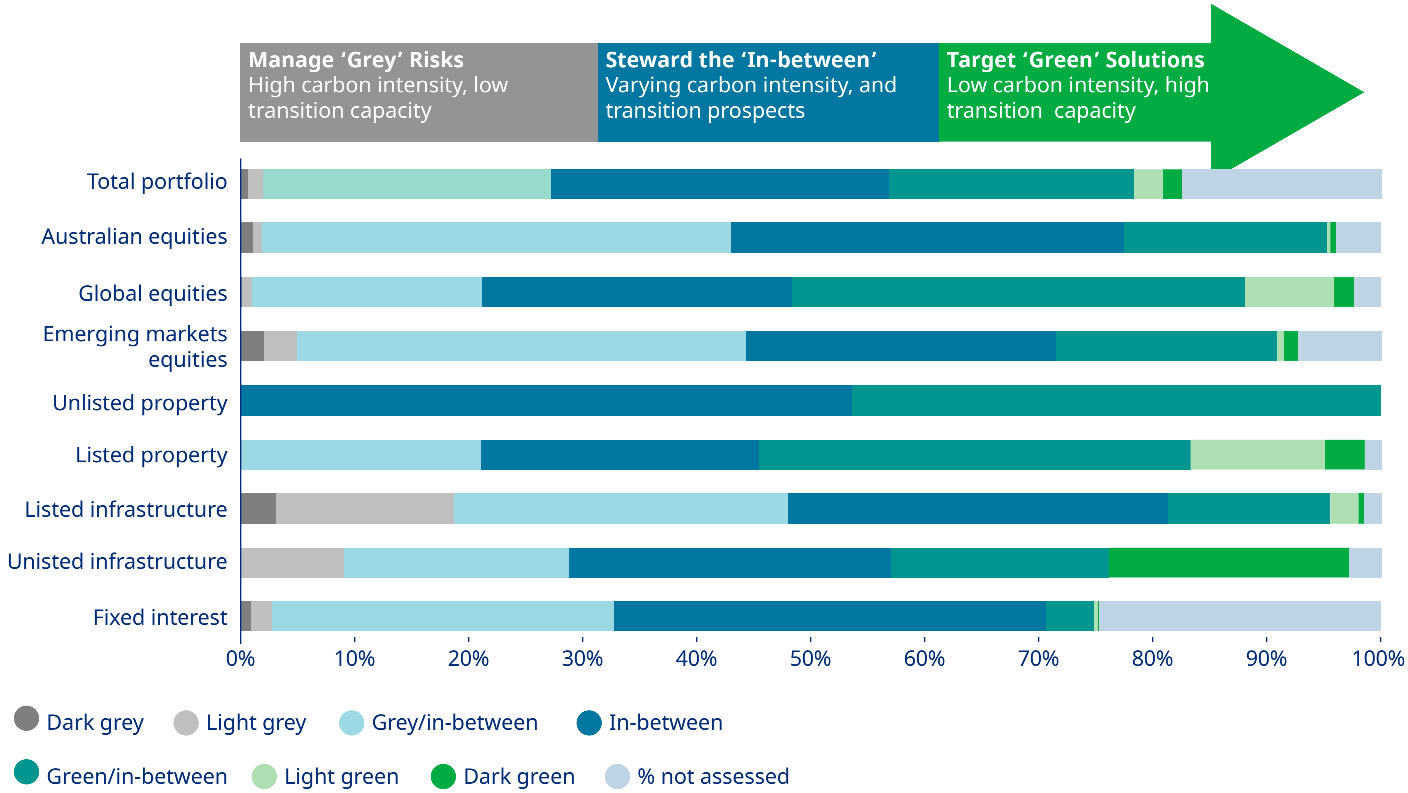
Given that carbon emissions may vary significantly in the short term, measurable targets that establish progress over time can guide investors in their approach to emissions reductions.

Akin to setting any target, investors establish and report relative to a baseline starting date. The scope of the emissions captured is clearly defined – whether only CO2 emissions or also methane/other GHGs – prioritizing absolute emissions, rather than just carbon intensity.

Climate metrics are then integrated within portfolio asset allocation, asset class construction, and sector and company exposures, supporting the reporting of annual and rolling progress toward short- and long-term milestones.

Figure 2. Analytics for Climate Transition (ACT) Assessment by weight (%)

- **Mercer's Analytics for Climate Transition (ACT) tool categorizes underlying holdings across an asset portfolio.**
- **Draws on 15 different metrics**
  Backward looking portfolio alignment metrics
  Green revenues
  SDG alignment
- **Metric helps determine portfolio (and asset class) transition capacity:**
  Proportion of portfolio aligned with the transition to a low carbon economy and proportion that is exposed.



Source: Mercer, for illustrative purposes only

We have found progress can then be measured against climate transition benchmarks by setting a year-over-year carbon reduction target, with tolerance ranges to facilitate dynamic portfolio management, using a climate transition or Paris aligned index where possible.

There are two broad approaches:

1. **Focusing on a portfolio-level decarbonization pathway**

   Investors can aggregate emissions of portfolio holdings and commit to reductions over time. This approach often includes portfolio construction techniques like tilting or exclusion, but does not include a well-structured, climate-focused engagement and voting program. In our view, while tilting/exclusion may help investors meet portfolio decarbonization and net-zero commitments, it is unlikely to impact real-world carbon emissions. If transition capacity is not actively considered, short-term or systematic decarbonization objectives and pathways may limit investment opportunity and could lower a strategy's expected return.

2. **Focusing on forward-looking measures aimed at transition and net-zero commitments at a company level**

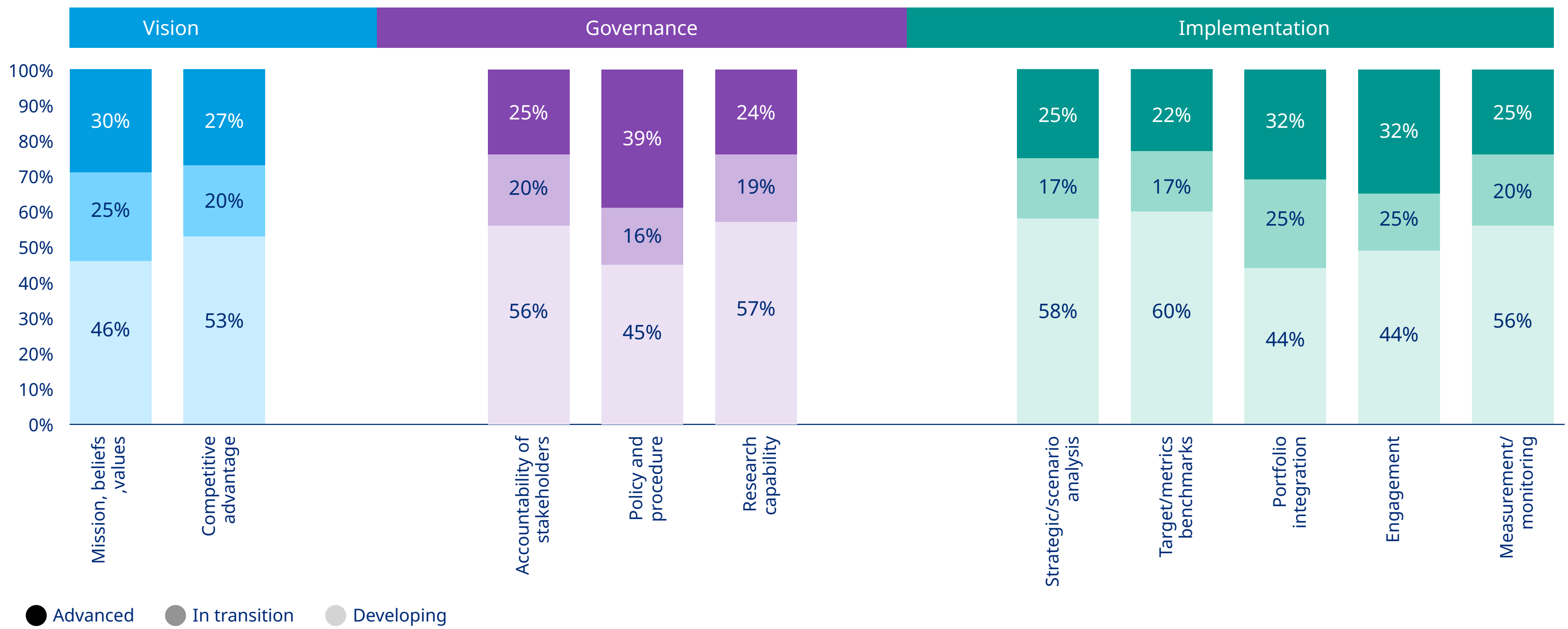
   This can be combined with a clear engagement, voting and measurement program. This is a more complex process and tracking progress and commitments is likely to include detailed internal and external (e.g. Science Based Target Initiative) data and analysis. Where engagement by asset managers is deemed to fail, escalation that considers the risk/return implications within the investment integration process would be expected. Engagement can encourage reductions in real-world carbon emissions.

Vision, governance, implementation

Through engagement with a community of leading institutional investors and managers, Mercer partnered with the World Economic Forum to develop a climate-investing benchmarking tool and framework, which seeks to highlight the practices and frameworks of pioneering climate investors that can be adopted by all institutional investors.

The benchmark assesses how institutional investors set their vision, governance and implementation across 80 investment-related activities, in 10 categories, to identify the key challenges impeding climate investing.

Figure 3. Aggregated results across vision, governance and implementation



Source: Pacesetters: Setting the Tempo of Advanced Climate Investing, 8
https://www3.weforum.org/docs/WEF_Setting_the_Tempo_of_Advanced_Climate_Investing_2022.pdf

Climate-investing benchmarking enables the asset owner community to pinpoint the activities that may deliver the most significant improvements to risk/return outcomes. While steps to advance the transition will evolve as standardization, climate data disclosures and measurement of adaptation improve, the adoption of a strategic framework can guide investors' approach.

Investors in the "advanced" stage according to the World Economic Forum (WEF) benchmark are able to work through these activities systematically – following their transition plan – using currently available data to measure outcomes. The adoption of a systematic process may help to unify and validate investment beliefs and intentions, which, in turn, can have a decisive impact on delivering outcomes.

Crucial lessons can be learnt from investors pioneering climate-focused investment outcomes through measurement, action and engagement.

Investors completing the benchmark identified the most pressing challenges impeding climate investing today as:

- **Defining and implementing a transition roadmap**
  Investors who have designed and implemented a transition roadmap can help to demonstrate the potential benefits of enhanced risk management and competitive advantage.
- **Measuring achievement and success**
  We believe than an effective means to evaluate achievements and guide future success comes from understanding the advanced climate practices of other investors.
- **Engaging investee companies actively and effectively**
  We believe that effective engagement programs follow a sequential process with triggers for escalation.
- **Defining climate reporting metrics by asset class and manager**
  We believe that climate metrics at the asset class and manager level form the building blocks of a portfolio-wide assessment, thereby guiding portfolio actions and tracking climate commitments.

The benchmark evidenced the nascent position of many investors in transitioning their portfolios.

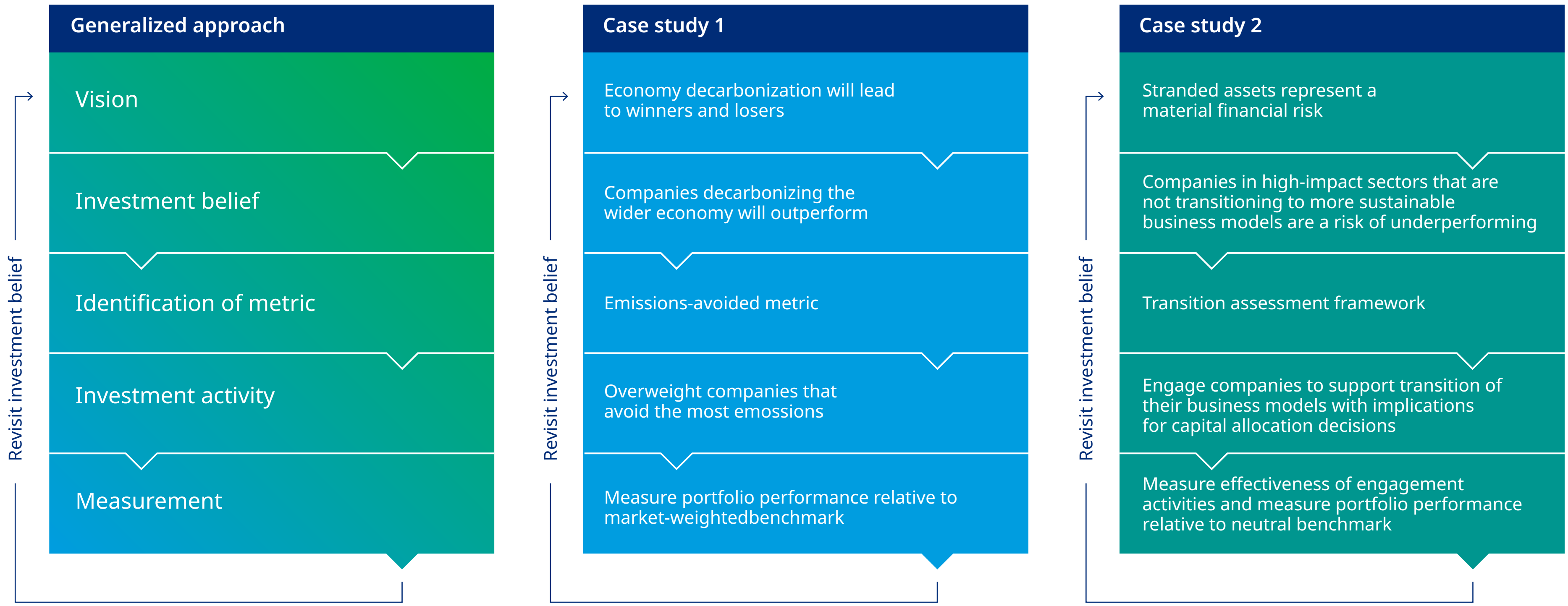
Across six of the 10 categories of activity assessed, more than 50% of investors surveyed were in the "developing" stage, meaning that the majority were just getting started or had yet to set their vision, establish governance models and implement their transition.

Figure 4. How to measure and validate investment beliefs

By establishing a clear framework, transition plans can deliver a systematic approach to managing risk and advancing transition.

Case study 1: GIC Private Limited developed a feedback loop based on the premise that decarbonization of the economy will lead to winners and losers and that companies actively decarbonizing will outperform. The establishment of this baseline belief led to the development of an 'emissions avoided' metric, which was then implemented through a strategic overweight of companies avoiding the most emissions.[5]

Case study 2: The New York State Common Retirement Fund implemented a transition assessment framework across its portfolio, built on the foundational belief that stranded assets present a material financial risk. This framework was then integrated into the fund's engagement program with companies, which then informed capital allocation decisions, restrictions and divestment. The effectiveness of engagement activities could be assessed by measuring portfolio performance relative to a neutral benchmark.[5]



Source: Pacesetters: Setting the Tempo of Advanced Climate Investing, page 15

[5] Source: World Economic Forum and Mercer; "Pacesetters: Setting the Tempo of Advanced Climate Investing" - case studies adapted from GIC Private Limited and New York State Common Retirement Fund

Advancing a just transition: Potential Investment solutions for mitigation and adaptation

[6] United Nations Department of Economic and Social Affairs, Population Division. "World Population Prospects 2019," available at https://population.un.org/wpp/Graphs/DemographicProfiles/Line/903

[7] Mercer and the Inter-American Development Bank, Crossing a Bridge to Sustainable Infrastructure, 2017, available at: https://www.un.org/pga/71/wp-content/uploads/sites/40/2017/06/IADB-and-Mercer-Crossing-the-Bridge-to-Sustainable-Infrastructure-Investing-Exploring-Ways-to-Make-it-Across.pdf

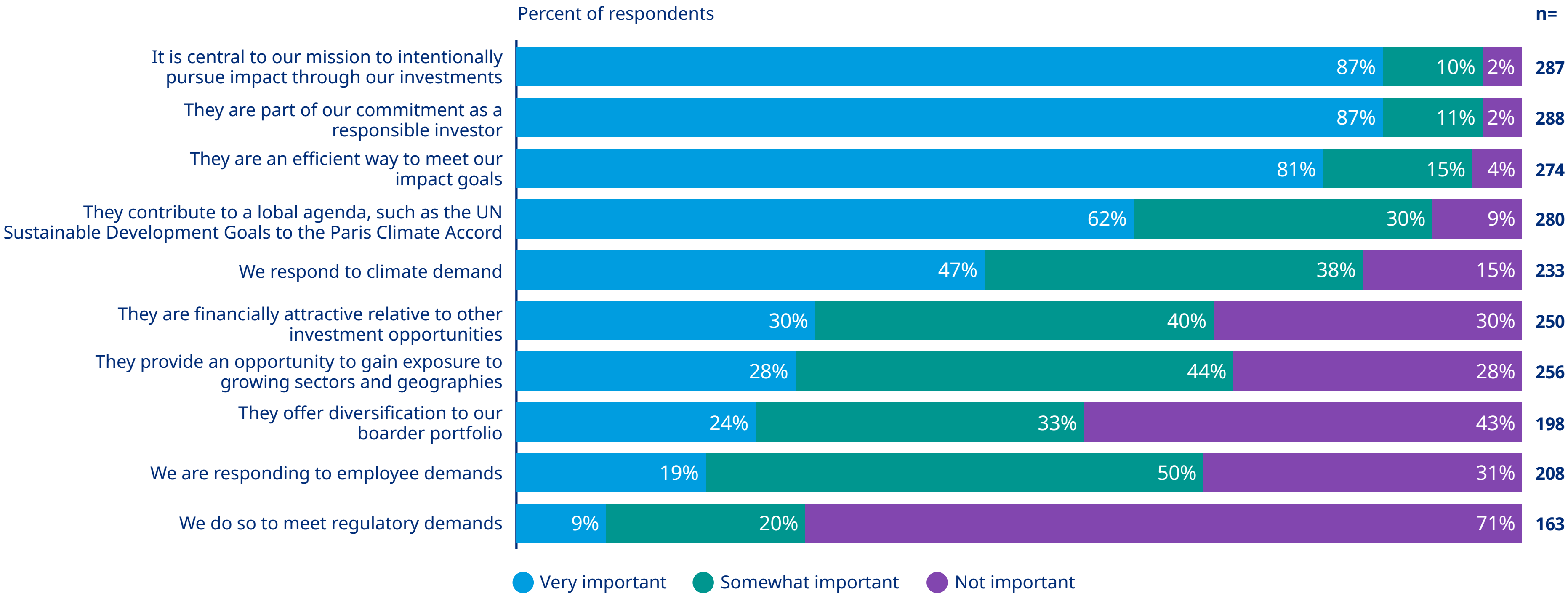
Investor demand can potentially catalyze the development of climate solutions in areas such as sustainable infrastructure across the globe, in turn supporting the deepening of capital markets in emerging economies. Comparison of the number of strategies available to investors across developed and versus emerging markets evidences the scale of the opportunity for the development of solutions within the emerging markets universe of 741 in comparison to developed markets universe of 2,476[8]

Within markets, increased collaboration and coordination between stakeholder groups – managers, governments and multilateral development banks – can help drive the development of key steps in the infrastructure financing cycle. More coordinated project planning and enhanced due diligence processes, for example, can support investors' consideration of the sustainability characteristics and impact opportunities of prospective investments.[9]

Impact outcomes can only become a more substantive part of investors' transition plans through the more widespread adoption of standardized impact frameworks. UN Sustainable Development Goal (SDG) assessment, for example, can provide a mechanism through which investors begin to assess the real-world impacts of investment solutions.

Figure 5. Motivations for making impact investments

Number of respondents shown beside each bar, some respondents chose "not sure/not applicable" and are not included.



Source: GIIN. 2020 Annual Impact Investor Survey, 68.

[8] Mercer GIMD database of asset managers as of 5th October 2022

[9] Mercer and the Inter-American Development Bank, Crossing a Bridge to Sustainable Infrastructure, 2017, available at: https://www.un.org/pga/71/wp-content/uploads/sites/40/2017/06/IADB-and-Mercer-Crossing-the-Bridge-to-Sustainable-Infrastructure-Investing-Exploring-Ways-to-Make-it-Across.pdf

While impact measurement and management practices have progressed considerably over the past four years – most notably in relation to the understanding of impact practices and reporting and the availability of guidance, tools and frameworks - these frameworks are rarely integrated into climate transition plans.

By way of comparison, the development of the EU Taxonomy and the task force on climate related financial disclosures "TCFD"[10] reporting requirements provided investors with a framework and a set of guidelines that we believe will, over time, integrate climate change and environmental information into mainstream reporting, with the net effect of mitigating harm to the environment.

The pursuit of impact through investment activity is already a priority for many investors. Yet impact frameworks are not yet being widely adopted as part of climate programs; it is not yet expected as standard that investors demonstrate positive impacts. The risk of overlooking the potential for broader, positive impacts delivered through investment solutions is that capital continues to flow into economies that are more advanced on the journey to net zero, rather than markets like Africa, which may present investors with transformational investment opportunities.

[10] Further information on the EU Taxonomy for sustainable activities available at: https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en. Further information in the Task Force on Climate-Related Disclosures available at: https://www.fsb-tcfd.org/about/

Conclusion

As the global investment community comes together at COP27, harnessing investment solutions and stewardship to navigate orderly climate transition is our collective priority.

Investors have a range of potential levers they can pull to address short – and long-term risk-return questions, while pursuing a net-zero portfolio. Transition plans provide an extensive range of tools for institutional investors to define and implement their climate vision, from helping to achieve real emissions reductions and assessing transition capacity, to investing in climate mitigation and adaptation across multiple approaches.

We believe there is an opportunity to advance climate adaptation through critical social and economic impacts. Investors have already taken important steps forward, yet impact investing remains almost a separate exercise undertaken by a small number of investors in limited parts of portfolios.

By developing a framework to measure the positive impacts delivered through climate programs, investors can seek to enhance their understanding of – and measure in a standardized way – how effective they are in advancing the SDG-linked social and economic benefits of climate investment solutions.

In order to better understand the current barriers to implementing transition plans and committing capital allocations to emerging markets, we have surveyed global asset managers to ascertain their current position. The second instalment of our Advancing the Transition series will explore the findings of our global asset manager survey, which will be released live at COP27 on 13 November. If you are attending the World Climate Summit in person, you can **register** for the presentation. Alternatively, we will be happy to share the report findings by email, please **contact us** to request them in advance.

For further information please visit https://www.mercer.com/what-we-do/wealth-and-investments/investing-sustainably.html

Learn more about sustainable investing at Mercer

Sustainability research

We were one of the first consultants to explore ESG factors and implement them into investment research, a pioneering position we are proud to continue to hold. Mercer's Global Manager Research Team is responsible for the more than 5,600 ESG-rated strategies on MercerInsight® that inform investment decisions across asset classes around the world.

Meet some of our sustainable investment advice professionals

Since 2004, our Sustainable Investment (SI) Advisory Team has been committed to helping clients achieve meaningful sustainable investment outcomes. Our team comprises more than 20 dedicated professionals, supported by a global network of champions.

Mercer's advice and solutions teams are happy to talk about our experience to date and what we anticipate coming next in the path toward sustainable investment.

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ESG investing refers to environmental, social and governance considerations that may have a material impact on financial performance and are therefore taken into account, alongside other economic and financial metrics, in assessing the risk and return potential of an investment. Thematic investing involves investing with a goal, at least in part, to achieve an impact on an environmental, social or governance issue alongside generating return and mitigating risk.

Under the Employee Retirement Income Security Act in the United States (ERISA), the decision to invest in ESG-themed options for ERISA plans, like all options, must be in the best financial interest of the plan and its participants. ESG thematic investing may be subject to greater scrutiny; for example, its inclusion in an ERISA plan may trigger a heightened level of review of various objective criteria across all investment options. Active ownership efforts should be considered in light of the cost versus benefit to the plan of engaging in such efforts. Clients are encouraged to consult with ERISA counsel regarding responsible investing.

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