ClearBridge Investments

ClearBridge's New Targets for Net Zero

Key Takeaways

- As asset managers begin to set climate targets, they face the difficult question of how to measure portfolio performance against the goal of net-zero global emissions by 2050.
- Judging a portfolio's climate performance by assessing the "net-zero alignment" of each portfolio company is a new forward-looking approach better suited to the basic goal of investing — identifying future successful companies — than backward-looking portfolio carbon footprinting.
- Important company-specific nuances in aligning with a net-zero pathway mean there are benefits of measuring net-zero pathway alignment using multiple verification methods and of engaging with open and consistent dialogue.

The Case for Setting Portfolio Climate Targets

There is a strong case to be made for asset managers to assess the performance of their portfolios against the global goal of achieving net-zero emissions by 2050, and to go a step further by setting targets to ensure portfolio companies are pulling their weight when it comes to emissions reductions. More broadly, while governments worldwide ratchet up decarbonization commitments, the private sector must too play its part to help accelerate the world's transition to global net-zero emissions.

Having a formalized approach to assessing company net-zero alignment equips ClearBridge to navigate climate opportunities and risks. A low-carbon economy will offer new investment opportunities in the form of climate change mitigators and adaptors as well as improvers within high-emitting sectors; portfolios aligned with this economy would seem to have a natural advantage. By the same token, asset managers' fiduciary role requires them to act in the interests of clients in managing their long-term investments, and there is evidence that those interests will be best served by managers who adequately manage risks related to climate change, including physical risks, regulatory requirements and changing consumer preferences.

Active equity investors can also deliver value by supporting companies as they address climate change challenges. Engaging with portfolio companies on material ESG issues such as climate change and providing feedback on their strategy and performance helps improve an investor's understanding of their businesses and their potential for long-term success. When engagements with companies contribute to their improved performance on ESG issues, active investors achieve positive impact that leads to real-world outcomes. Engagement is an important part of active equity ownership for those managers committed to being responsible stewards of their clients' capital.

New Climate Performance Frameworks for Asset Managers

To this end, many asset managers are tackling the difficult question of how to measure portfolio climate performance against the goal of net-zero global emissions by 2050. For example, in joining the Net Zero Asset Managers initiative (NZAM) in 2021, ClearBridge made a formal commitment to bring 100% of our assets under management to net-zero emissions by 2050. Under our NZAM commitment, we needed to establish a way to measure ClearBridge's climate performance and set interim targets for 2030.

NZAM offers several approaches for measuring climate performance and setting targets. These include the Paris Aligned Investment Initiative's Net Zero Investment Framework (NZIF), the Science-Based Targets initiative (SBTi) Finance Framework, and the Net-Zero Asset Owner Alliance Target Setting Protocol (TSP). Each framework has slightly different requirements for how climate performance should be measured and which assets need to be included in the target. The NZAM commitment is designed to be methodology neutral and asset managers may choose the most appropriate target methodology — or a combination of them — for their business.

The Old Approach to Assessing Portfolio Climate Performance: Portfolio Carbon Intensity

Traditionally, portfolio carbon footprinting has been used to measure a portfolio's carbon intensity and as a proxy for climate performance and climate risk. However, this approach has a handful of challenges in capturing the full picture:

- It is backward looking: a high-emitting company may be on a path to decarbonizing its business, but a "point in time" emissions metric will not capture this.
- It does not include emissions from products or supply chains (Scope 3 emissions). The oil and gas as well as auto sectors have relatively low direct emissions, as most of the emissions are associated with the use of their products, combusting fossil fuels or driving cars.
- It does not consider regulatory factors or market dynamics. While the utilities sector has high emissions, for example, many utilities are regulated monopolies that face unique market forces that must be weighed when assessing risk.

Therefore, we view carbon intensity as a wholly inadequate measure of portfolio climate performance and climate risk.

ClearBridge's Approach: Net-Zero Pathway Alignment

When assessing frameworks for achieving its approach to net zero, ClearBridge looked for a forward-looking approach that dovetails with our investment process and the goal of identifying companies that will be successful in the future.

To achieve this, we have chosen to focus on assessing each portfolio company's emissions trajectory and determining if it is aligned with the pathway required to achieve global net-zero emissions by 2050. We call this **net-zero pathway alignment**. A key part of this assessment is whether or not a company has set science-based emissions reduction targets. Net-zero pathway alignment and science-based targets are two overlapping concepts at the heart of our approach.

Net-Zero Pathway Alignment

- A **net-zero pathway** represents the emissions reductions needed from a company to play its part in achieving global net-zero emissions by 2050. Different companies will have different required pathways based on their sector (e.g., the power sector is expected to reduce emissions faster than aviation).
- A company's **forecast emissions trajectory** can be compared to its **required net-zero pathway** to determine if the company's emissions reduction plans are in line with what is required.
- If a company's forecast emissions reduction trajectory keeps pace with the required pathway, then it can be considered **"aligned" with its net-zero pathway**. Two companies in the same sector may or may not have forecast emissions trajectories aligned with their required net-zero pathway (Exhibit 1). ClearBridge has committed to have 100% of its assets aligned to a net-zero pathway by 2040.

Science-Based Targets

If a company has set an emissions reduction target, this can be compared to its required net-zero pathway to understand if it is aligned. Net-zero aligned targets are often referred to as "science-based targets" or SBTs. The "science" in the name refers to **climate science**: emissions reduction targets are considered science-based if they are in line with what the latest climate science deems necessary to achieve net zero by 2050. Climate scientists have developed models that show different emissions reduction pathways, which can be used to understand the required emissions reduction pathways for specific sectors, and then applied to companies in that sector (Exhibit 1).

Science-Based Targets (SBTs) and the Science-Based Targets Initiative (SBTi)

It's also important to distinguish between the general concept of a science-based target, and the Science-Based Targets initiative — this can be confusing. Any company can set an emissions reduction target and claim it is science-based if it has done the analysis to back up such a claim. But if the company wants that claim to be independently verified, then it can look to an organization called the Science-Based Targets initiative (SBTi). SBTi has developed detailed methodologies and guidance for setting SBTs. SBTi reviews all targets set using its method to verify they meet the standard and give its seal of approval.

There are many specific requirements for setting targets using the SBTi framework; these are available at the organization's website. At a high level, if a company's target has been verified by SBTi, then we can be confident in its legitimacy.

A Flexible Approach to Verifying Net-Zero Pathway Alignment

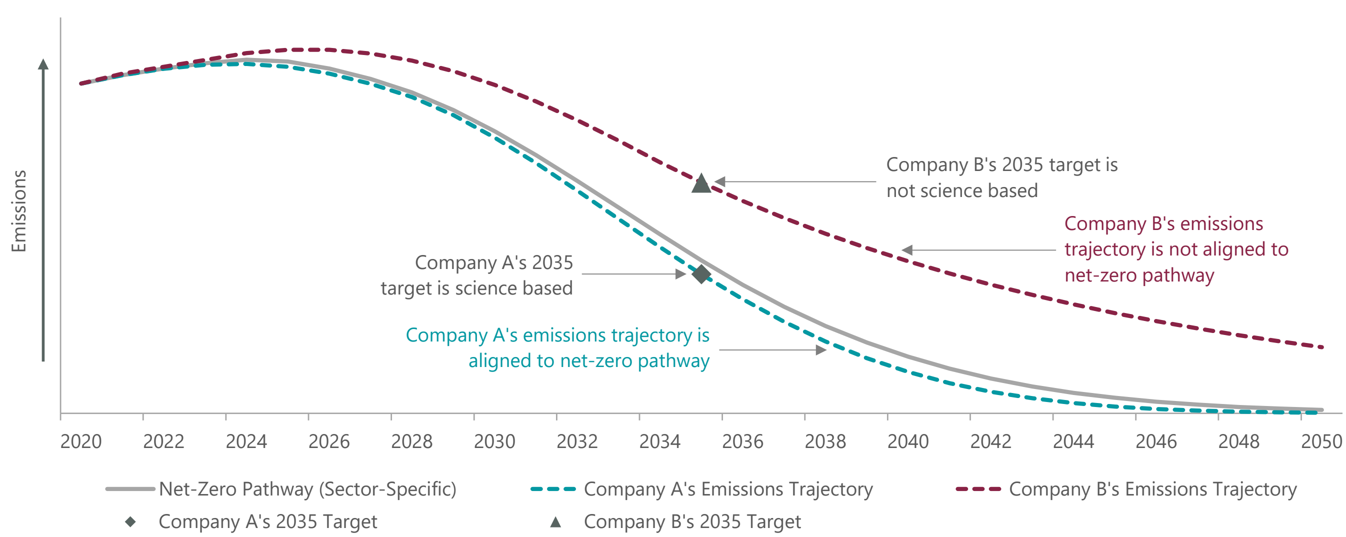
After conducting a thorough review of the SBTi's criteria for target verification and consulting with a range of portfolio companies, we have come to believe it is necessary to build some flexibility into a net-zero alignment approach. We have created this flexibility in our approach primarily to allow for additional verification methods of third-party SBTs (Exhibit 2).

Beyond the SBTi, internally approved verification methods include Climate Action 100+ (CA 100+), which covers a range of high-emitting sectors including oil and gas (which is currently excluded from SBTi), credible consultants and ClearBridge's own assessment for special cases, while keeping in mind SBTi criteria. We independently assess any company that claims its target is science-based but is not verified by a third party.

We also wish to allow for the inclusion of climate solution providers, or companies whose products result in emissions reductions. While there is still much discussion around the role of climate solution providers in measuring a portfolio's alignment, we feel it is important to include them to give credit to companies whose entire business model/product contributes to climate mitigation.

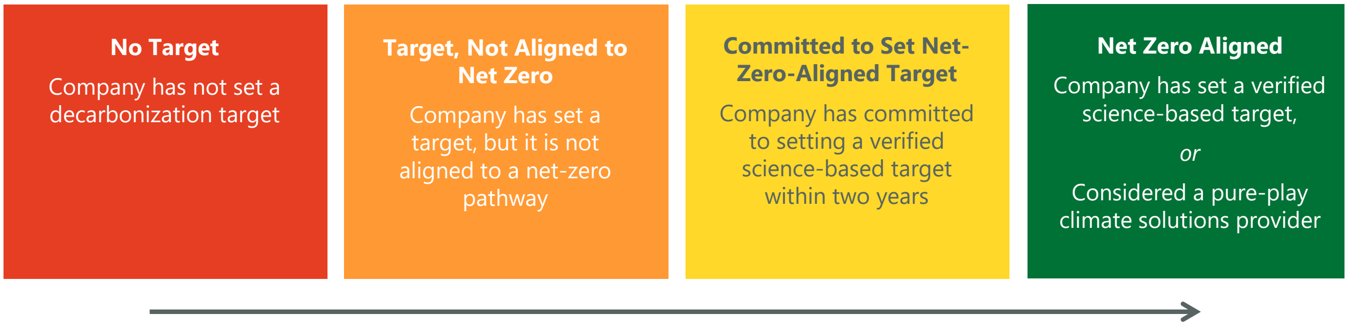
With the intent to encourage companies to become "Net Zero Aligned," we use this assessment framework to prioritize companies for our net-zero engagements through a decision tree (Exhibit 3). This approach helps us prioritize higher-weighted, high-emitting companies that either have not set a target or have set a target that is not aligned with a net-zero pathway.

Exhibit 1: Net-Zero Pathway Alignment and Science-Based Targets



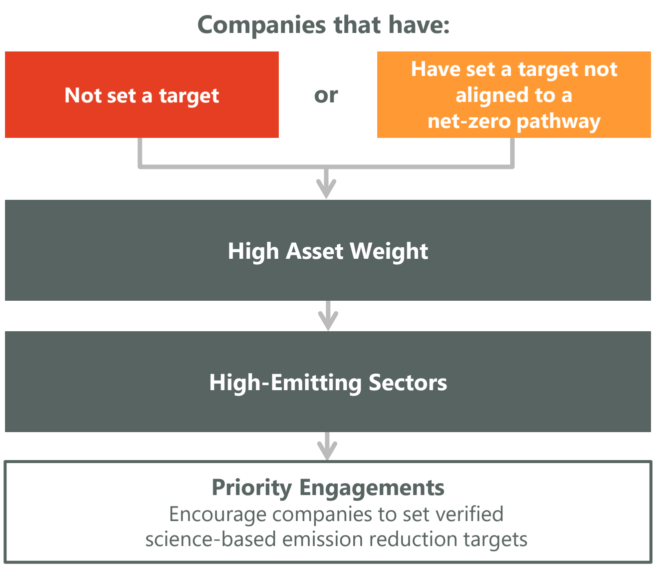
Source: ClearBridge Investments.

Exhibit 2: ClearBridge Assessment for Net-Zero Alignment of Portfolio Companies



Source: ClearBridge Investments.

Exhibit 3: Decision Tree for Proprietary Engagements



Source: ClearBridge Investments.

Using our Net-Zero Approach to Structure Engagements

The engagements highlighted below demonstrate company-specific nuances in aligning with a net-zero pathway as well as the benefits of allowing for multiple methods for verifying an SBT. They also show the importance of open and consistent dialogue.

Multinational Shipping/Receiving and Supply Chain Management Company

ClearBridge has actively engaged with a multinational shipping/receiving and supply chain management company which has set aggressive carbon reduction targets. We have discussed how due to heavy reliance on future technologies such as sustainable aviation, the company recognizes it cannot credibly set a companywide SBT at this time. We categorize the company as having a "Target, Not Aligned to Net Zero." However, it is working to align all other parts of the business with a net-zero pathway. Efforts include investments in electric vertical takeoff and landing aircraft and full electrification of its ground fleet, with a 2025 goal of 40% alternative fuel for ground vehicles, up from 24% today.

U.S. Integrated Electrical Utility

ClearBridge has actively engaged with a U.S. utility on its decarbonization efforts. A meeting in 2022 was specifically dedicated to the company's "Real Zero" strategy to eliminate carbon emission from its operations. The company has formally announced targets for Scope 1 and 2 emissions reductions in its operations and purchased power without using offsets. The plan has five-year milestone targets, e.g., a 70% reduction in emissions by 2025. We discussed specific assumptions underlying the plan, such as a coal plant retirement in 2024, a pilot combined cycle gas turbine plant able to blend green hydrogen with natural gas as fuel, and underpenetrated solar expansion as a main driver to reduce emissions at the company's regulated utility. The company also engages with CA 100+ and supports SBTi targets. While it is not eligible for SBTi verification due to its ownership of insignificant natural gas assets, its Real Zero target was verified by an industry climate consultant as a viable pathway to meet net-zero goals. Its 2025 target was verified by CA 100+. We were therefore comfortable considering this company to be currently "Net Zero Aligned." We will continue to engage with the company to monitor progress on its emission reduction targets.

Actively Investing in Tomorrow's Climate Leaders

Net-zero pathway alignment is a new method of judging portfolio climate performance and target setting that is in some respects superior to portfolio carbon footprinting. ClearBridge's approach to net-zero pathway alignment focuses on engaging companies to set science-based targets and uses a rigorous yet flexible framework for verifying them. As active investors seeking to both lower global emissions and identify future successful companies, we believe this approach is the best way for us to meet our commitment as a signatory to NZAM to bring 100% of our assets under management to net-zero emissions by 2050.

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