# PATHWAY TO NET-ZERO

A NEW BENCHMARK FOR UNIVERSAL OWNERS

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#### **AUTHORS**

Trond Furnes, Senior Advisor Sustainable Finance, WWF-Norway Stefano Esposito, Senior Advisor Sustainable Finance, WWF-Norway Mats Boesen, Head of Sustainable Finance, WWF-Norway

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# CONTENTS

EXECUTIVE SUMMARY	4
Background	4
WWF's Recommendation to Norwegian Politicians	4
A NEW ERA BENCHMARK	6
A New Political and Financial Market Objective	6
The Advent of a New Benchmarking system	7
WWF's Proposal for a Sector Neutral Paris-aligned Benchmarking System	10
TECHNICAL CONSIDERATIONS	13
Cost and Expected Return	13
Pricing Climate Risk	15
The Role of The Universal Owner	
Construction, Disruption, and Adaption	17
Alternative Strategies	
Fiduciary Duties	
Advantages for Norway	
ENDNOTES	

# **EXECUTIVE SUMMARY**

#### BACKGROUND

This paper was prepared in response to a report published in August 2021 by a group of experts appointed by the Norwegian government to give its recommendation on how the Government Pension Fund Global (GPFG) could best manage climate risk.<sup>1</sup> The group of experts advised that the GPFG is given a new mandate "based on an overall long-term goal of zero emissions from the companies in which the fund has invested, in line with the Paris Agreement". It advised that active ownership should be the key strategy towards reaching this objective and advised against changing GPFG's benchmark. The group argued that Paris-aligned benchmark indexes are too poorly diversified and that transitioning to such an index would be too expensive. It added that there is no reason to believe that the market is not pricing climate risk in the first place. Norges Bank Investment Management, GPFG's fund manager, endorsed these conclusions. The Norwegian government subsequently prepared a report for the Parliament that was presented in April 2022.<sup>2</sup> In the report, the government aims to give the GPFG a net zero mandate, largely in line with the advice given by the group of experts. The government also reiterated its ambition to make the GPFG a world leader in responsible investment and the management of climate and nature risk.

A world leader in responsible investment and the management of climate and nature risk

#### WWF NORWAY'S POSITION

WWF Norway endorses the decision to give GPFG a Paris-aligned investment mandate. However, we disagree on the proposed strategy. With no change in the investment benchmark, the GPFG will not change the way it invests. Fund managers at GPFG will continue to be evaluated against a benchmark that is unconcerned with climate risk, and this will trickle down to the companies the GPFG is invested in. Company guidance is important, but it carries less weight when the GPFG will not invest more in carbon efficient businesses and less in companies with inferior transition plans.

The arguments put forth to justify a continuation of the current benchmark strategy, are weak. The claim that markets are already pricing climate risk, is refuted by the *Network for Greening the Financial System,* joined by most central banks. If the NGFS is right, a benchmark which invests more in carbon efficient companies and less in inefficient ones, should outperform a pure market capitalization based investment benchmark once the financial markets begin to factor carbon emissions into corporate valuations to a greater extent.

As to the second argument, that investable Paris-adjusted benchmarks do not exist, the fact of the matter is that such benchmarks have been developed, both in academia and in financial institutions, they just aren't commercially available yet. If the Norwegian parliament wishes to be taken seriously as owner of the "most responsible pension fund in the world", it must investigate whether an investment benchmark with better sustainability and financial return propositions exists. The GPFG may profit if it becomes an early mover in this regard. If it contributes towards the development of a new Paris-aligned benchmark standard, it may also help mitigate the climate crisis, which in turn will lift the financial return potential for the financial markets as a whole.

GPFG needs a new investment bechmark in order to become Paris-aligned

# PART 1 A NEW BENCHMKARK FOR A NEW ERA

## A NEW POLITICAL AND FINANCIAL MARKET OBJECTIVE

#### A New Era

Following the industrial revolution and two and a half centuries of exponential human population growth, the world economy has grown out of its planetary boundaries. This can be witnessed in a halving of species on earth in only half a century and in other out of control-imbalances, such as global warming. Global warming is a result of an increase in greenhouse gases in the earth's atmosphere that has followed at least partly from the exponential increase in human activity. The problem, however, may not rest so much in the level of activity as in the way it is being administered. Thus far, the greatest perpetrators of nature degradation have not been sufficiently incentivized to change their ways. Costs have mostly been paid by the victims of climate change. This is neither fair, nor effective in bringing about change. Now that the UN and national governments have decided to curb the global temperarure increase at 1.5 degrees above pre-industrial levels, this must be followed by a new financial framework that can effectively bring capital flows into alignment with our common goal.

#### **Financial Sector Net-Zero Ambitions**

The financial sector is already adapting to the objectives of the Paris Agreement. An increasing number of financial institutions<sup>3</sup>, including the largest Norwegian institutions such as KLP, Storebrand and DNB, have committed to progressively align with a net-zero objective in line with the Paris Agreement's article 2.1c, which calls for "Making finance flows consistent with a pathway towards low greenhouse gas emissions". More than 65 institutional investors managing more than \$10 trillion have joined the <u>Net-Zero Asset Owner Alliance</u>. Many more diverse financial institutions have joined initiatives such as the <u>Net-Zero Banking Alliance</u>, <u>Net-Zero Insurance Alliance</u> and <u>Net Zero Asset Managers Initiative</u>. At this day and age, adopting a net-zero objective is a matter of course. For Norwegian politicians and GPFG, this does not represent a controversial political decision. One could even say it is not a political decision at all, but a financial one. Research from institutions such as <u>Mercer</u><sup>4</sup>, <u>Cambridge University</u><sup>5</sup>, <u>London School of Economics</u><sup>6</sup> highlights that a net-zero alignment should result in both a higher financial return and lower risk, over time.

"Net-zero should mean a higher financial return and lower risk, over time."

#### The Advent of a New Benchmarking system

#### **Current Approaches to a Paris-aligned Benchmark**

While most institutional investors are adopting a Paris-aligned investment objective, most lack a strategy to match.

Recently, major benchmark providers such as MSCI, S&P and FTSE have launched Paris aligned benchmark indexes for both fixed-income and equity portfolios. These indexes are constructed for the sole purpose of being Paris-aligned. Only companies that are directly aligned with a tool that is commonly associated with a pathway towards net zero are selected to be included in the benchmarks. Others are left out. For GPFG, investing along such a benchmark would entail selling up to 90% of the 9,000+ companies it is invested in<sup>7</sup>. This would result in an exposure to each of the remaining companies that would be far too big. According to GPFG, the average ownership in each of the companies it is currently invested in is approximately 1.3%<sup>8</sup>. With a climate benchmark like one of the benchmarks currently available from MSCI, S&P or FTSE, this ownership stake would increase to more than 10% for a significant part of the portfolio and even beyond 30-40% in some cases.<sup>9</sup> GPFG consequently considers existing climate indexes uninvestable, a position we support.

#### "Existing climate indexes can be uninvestable for large investors"

There is yet another problem with the existing climate benchmarks. If they were widely adopted among universal owners, this could result in a number of industries not getting the financing they need to transition to a net zero economy. That could not only jeopardize the green shift, it could also disrupt the markets that these industries are there to serve. If GPFG and other universal owners adopt benchmarks that are unconcerned with the demand and supply mechanisms of the market, people might not get the food and energy they need, and certainly not at the prices they expect. This might undermine political and social stability, a growing concern in the world already.

Not only are current climate benchmarks uninvestable for large asset owners and potentially disruptive, they are also largely unfair in how they assess emissions and assign company weights and inclusions. Historic carbon emissions are just about as relevant for a company's carbon-adjusted weight in a climate benchmark as historic earnings are for a company's market cap and weight in the existing market capitalization-weighted benchmark indexes. Forward-looking metrics such as carbon-accounting based methodologies, capacity-based methodologies (like PACTA), temperature-based methodologies, and methodologies that calculate the number of companies that meet a certain climate target, are all helpful tools in and of themselves, but they are not suited to be the basis for a carbon-adjusted benchmark index. There is also a difference between a target and commitment, but even the commitment says little about the real issue at hand, which is actual and expected carbon emissions. Further to this, identifying which companies have adopted a science-based climate target and a net zero transition plan, will only indicate which companies that should be included in the climate-adjusted benchmark and which should not. They cannot deal with how the companies should be weighted relative to each other based on actual emissions. Some climate benchmarks even focus entirely on emissions and disregard the market capitalization of companies altogether. They thus disregard companies' ability to make money, which of course is a primary objective for any pension scheme.

To conclude, current climate benchmarks can be used by companies and investors to assess whether a company's targets are in alignment with a certain Paris pathway, but they are not suited to be investment benchmarks, at least not for large portfolios.

#### **GPFG Specific Requirements**

That part of GPFG that is invested in stocks is invested globally according to a market capitalizationbased benchmark supplied by FTSE. This means that GPFG invests according to a shopping-list that is based solely on the market value of companies. The higher the market capitalization of a company, the more the GPFG will invest in it. No consideration is made with respect to how sustainable a company is relative to other companies in the same sector. Not on a strategic level at GPFG. If portfolio managers at GPFG wants to do something about this, they must do so at their own risk.

The Norwegian authorities have already changed the GPFG's strategic exposure relative to the FTSE benchmark, primarily by overweighting Europe and underweighting the US (and by excluding upstream oil and gas in order for Norway to not be overly exposed to that sector). Overweighting Europe relative to the US was a political decision based on the idea that it is better to use GDP weights than market capitalization weights when deciding how much to invest in the two regions. This political decision had no backing in financial theory and has so far cost the GPFG close to \$1 trillion in lost financial return, with no apparent gain to compensate on either the economic, political or environmental dimensions.

While political overruling of the benchmark is not a new phenomenon at GPFG, it can be argued that giving GPFG a Paris-aligned investment objective is not political overruling; it is what "everybody" is doing, both politically and in the investment markets. It would be more political <u>not</u> to give GPFG an explicit climate objective – and a new benchmark to match. Not only is such a decision unpolitical; contrary to the decision to underweight the US, economists and financial experts rightly agree that curbing climate change will increase the long-term return expectations of the fund and the investment markets.

If Norwegian politicians choose not to change the fund's benchmark index, an eventual net-zero mandate for the fund will be weak. Let's look at an example to see how this works: If a company that decides to invest to improve its carbon efficiency experiences a short-term drop in profits and in market capitalization, the result will be that GPFG (and other market cap-based fund managers) will invest less in the company and more in its competitors. This is the exact opposite of what is needed to incentivize companies to improve their carbon efficiency. The way things are now, the GPFG says one thing and does another. It says that companies must set out on a course to reduce emissions in line with the climate goals, but if the companies listen and this costs them in terms of short-term profitability and a lower market cap, the GPFG will generally invest less in them and thus increase their cost of capital. With the benchmarking system we propose in this paper, this is not likely to happen.



Figure 1: Benchmark Concept (WWF, 2022)

If the Norwegian parliament chooses to maintain a market capitalization-based benchmark index for GPFG, this will strongly limit the efficacy of a Net-zero objective for the GPFG. To correct what is called the greatest market failure of all time we need major changes, not minor tweaks. We can only adjust that course strategically.

#### A Benchmarking Proposal from Bolton et al (2022)

In a paper named "Net-Zero Carbon Portfolio Alignment"<sup>10</sup>, economists Patrick Bolton, Marcin Kacperczyk and Frédéric Samama describe what an implementable net zero benchmarking system could look like. The proposal is based on the 1.5-degree global warming objective of COP26 and the corresponding carbon budget. The system essentially divides the overall carbon budget into annual budgets that are allocated to the companies represented in a typical benchmark index. The system then selects that mix of stocks that meets the climate budget with the lowest tracking error relative to the pure market cap-based benchmark. In other words, the carbon-adjusted benchmark becomes a portfolio that behaves most closely like the old benchmark in terms of performance, but within the framework of the climate budget.

Bolton et al. ran simulations on a European portfolio of \$1 trillion and found that it is possible to establish a carbon-adjusted portfolio that is within the climate budget and at the same time satisfy three critical criterions that need to be met for a new benchmarking system to be both investable and able to facilitate an orderly transition to net zero:

- 1. The tracking error is low, meaning the expected return of the portfolio is in line with that of the pure market capitalization-based indexes.
- 2. The turnover of the portfolio is less than 5%. This means that transaction costs, a considerable worry for many, would be low.
- 3. In Bolton et al.'s simulation, no sectors got eliminated, but sector weights got altered. Energy got hit the hardest, with its weighting nearly cut in half. This may or may not give the energy sector the investment funds needed for an effective transition to net zero to take place. Bolton et al.'s model does, on the other hand, allocate more of the capital to the companies with the lowest emissions and thus, arguably, the greatest transition capability.

Whereas Bolton et al. focus on present emissions in their corporate assessment, they do acknowledge that a similar system can be developed to also be based on forward-looking emissions. WWF supports the integration of forward-looking metrics as far as possible<sup>11</sup>.

WWF supports the integration of forward-looking metrics.

## WWF'S PROPOSAL FOR A SECTOR NEUTRAL PARIS-ALIGNED BENCHMARKING SYSTEM

When deciding on which Paris-aligned benchmarking system to choose, it is important to make sure the system is transparent. If the tracking error computations cause company weights to shift around a lot, the system is neither transparent nor transaction cost effective. The advantage with Bolton et al.'s 2022 model is that it makes a portfolio net zero and carbon budget-aligned with a low expected (ex ante) tracking error. The weakness of this model rests in the randomness of weights that follows from a tracking error-based system. Companies need a predictable business framework to make sound investment decisions. If the benchmark is not consistent in how it distributes weights, companies and industries cannot properly adapt to it. The benchmarking system would introduce new and unnecessary risk factors to a corporate sector that needs less risk.

#### Industries need a stable business framework

Bolton et al.'s model overweighs the financial sector at the expense of industries that are in greater need of investment capital if they are going to be able to successfully transition to net zero. Some industries carry, by their very nature, a larger carbon footprint than others. They are there to serve a market and they do not operate in direct competition with companies in other industries. It would not necessarily speed up the transition to net zero if we withdraw investment funds from these industries and invest them in, e.g., banking. The benchmark portfolio might look cleaner that way, but the industries might actually be in a worse state, net zero-wise.

## "Dirty" industries are there to serve a market and they need transition funding

A new benchmarking system must reflect both market capitalization and emissions. However, in the same way the market capitalization of a company is based on expected future earnings, the emission adjustment of a company's benchmark weight should also be based on expected future numbers. When improvements in future carbon efficiency are discounted and reflected in current benchmark weights, this will lower a company's cost of capital and thus make climate-friendly investments more profitable for the company. Consequently, more emissions-reducing investments will be made, speeding up the transitioning process towards net zero.

#### Discounting future emissions makes climate investments more profitable

In order to facilitate the transitioning process and not disrupt the underlying goods and services markets, we believe the new benchmarking system should be sector neutral to the extent possible. We believe this would set about a more efficient race towards net zero. So do Andersson, Bolton and Samona 2016 in the paper *Hedging Climate Risk*.<sup>12</sup> How much it will take in terms of added tracking error to keep sector weights market capitalization based is something that must be investigated further. In Working Paper 985 on building benchmarks with decreasing carbon footprints, Jondeau, Mojon, and da Silva at BIS (Bank for International Settlements) finds a sector neutral approach to be the most favorable alternative.<sup>13</sup>

However, a larger tracking error vis a vis pure market capitalization-based benchmark may not be such a bad thing if financial markets fare better with less global warming. If that is the case – and there are strong arguments it is (ref Costs and Expected Return, next) –, it may be irrelevant to measure tracking error relative to a benchmarking system that represents an inferior financial return proposition. Deciding on which climate-adjusted benchmarking system is better, then, should perhaps be based on higher-level criterions, such as consistency, fairness, transparency, automation, and low market disruption, rather than on the "black box" computations of a tracking error-based system.

A net zero benchmark should be sector neutral

In the model we propose, a company that is 20% less carbon efficient than the industry average will get its benchmark weight cut by 20%. If the company's weight in the pure market-cap index was 2.5%, its weight in the new benchmark will be 2%. Companies in the same sector with above average carbon efficiency would get their weights increased in the same way. Thus, for the industry as a whole, the weight will be neutral relative to a pure market cap-based benchmark, irrespective of the industry's carbon footprint. For companies, a higher benchmark weight means a lower cost of capital and improved transitioning ability and profitability. This is transparent, desirable, and, arguably, also fair. The result of the system we propose would be a continuous race towards net zero that would involve all companies and all industries equally.

#### A higher benchmark weight means a lower cost of capital for the company concerned

Most companies already produce the data required to make the benchmarking system we propose. Some of the least carbon efficient companies do not report their greenhouse gas emissions, but that is a matter the US SEC (Securities and Exchange Commission) has set out to change. Institutional investors and other regulatory bodies are likely to contribute to this also, in the near future. All major companies should be able to report emissions and produce future emissions pathways. Before a company undertakes an investment to reduce emissions, it naturally estimates the impact the investment will have on future emissions. These estimates play a crucial part in deciding whether an investment should be undertaken or not. In the case of large investments, this information is important for investors that will end up funding them. Companies already spend a lot of time making detailed forecasts on a wide variety of topics. A typical budget spans four years into the future and must now include emissions. However, the emission pathway should extend further into the future than that. There is no corporate return on investment assessment that does not extend at least 8-10 years into the future. There is therefore no reason why the emission pathway should not extend 8-10 years into the future either. This time-frame is an important aspect for a new benchmarking system, if we are going to be able to curb global warming at 1.5, or even 2 degrees C.

In this new age of taxonomy and transparency, reported pathways that are out of alignment with actual emission numbers and corporate investment plans, are likely to be quickly uncovered by investors, outside observers, or inside whistle blowers. This will expose companies that may try to abuse the system to the risk of being penalized by regulatory bodies and in the benchmarking system.

#### The longer the emission pathway, the faster the transitioning process.



# **TECHNICAL CONSIDERATIONS**

#### **COST AND EXPECTED RETURN**

Major research institutions, such as Cambridge University and London School of Economics, are concerned that global warming has an adverse effect on financial return.<sup>14</sup> Cambridge estimates that changes in market sentiment induced by awareness of climate risk alone could result in financial losses of up to 45% for a diversified equity portfolio. About half of this loss is believed to be "hedgeable", while the other half can only be mitigated through coordinated efforts among financial market participants and legislators. We believe a benchmarking system like the one we recommend, can hedge parts of the losses due to climate change for a single user. If the benchmarking system is also adopted as a new benchmarking standard in the financial markets, it may actually mitigate all of the financial losses expected by Cambridge University. In additions to the concerns raised by Cambridge University, there is also a growing consensus that long term economic growth (and therein profits growth and financial returns) will be impaired if climate risk is not successfully reigned in.

There are also cost considerations to take into account. There are transaction costs related to rebalancing the portfolio. These may seem insignificant in the grand scheme of things, but they are mentioned by the group of experts as a concern and are a factor that must be treated with the same degree of transparency as everything else related to the likely transitioning to a new benchmarking standard. Transaction costs come in two forms when a portfolio is rebalanced: as brokerage fees, as bid/ask spreads in the market (liquidity), and through the potential of moving the market in your disfavor as you are buying or selling to adapt to the new benchmark. Given the sheer size of GPFG's portfolio, transaction costs would negatively affect portfolio return in the rebalancing period. To compensate for this, there is, as already mentioned, the potential for an early mover to benefit as more players adopt the new benchmarking system and rebalance their portfolios in favor of more carbon efficient companies.

Cost of capital is another factor that has been mentioned. When an analyst discounts a company's expected future earnings, or a company calculates the expected return on an investment, it uses a cost of capital factor of X%. In the benchmarking system we propose, this X factor plays an important role in determining changes in company weights. The lower the cost of capital, the greater the impact of an emission-reducing investment on a company's weight in the new benchmark. Cost of capital is also an important aspect when governments consider emission-mitigating investment projects. Today, economists believe a discount rate of about 2% is what it takes to make investments to limit global warming to 1.5-2 degrees profitable, on the aggregate.<sup>15</sup> According to the same survey, Germany, England and the Netherlands are using this rate, while the US is reported to be considering the same. With the global warming target now set at 1.5-degrees, the discount rate will need to be lower, perhaps as low as 1%. A discount rate of 1% or 2% is also what we would advise for the new benchmarking system. This will make more emission-mitigating investments profitable, which will counteract the higher interest rates companies must pay in the financial markets when investing.

Another cost factor is called opportunity costs. Opportunity costs are what we give up, in this case by *not* transitioning to an emissions-adjusted benchmarking system. Presently, GPFG's portfolio, along with its *FTSE Global all cap*-based benchmark, is mirroring a world on track towards a global warming far in excess of 1.5 degrees.<sup>16</sup> Some argue that more climate risk translates to a higher financial return, but they seem to confuse climate risk with tech stock volatility and tech stocks' historic outperformance of the financial markets. Climate risk is an altogether different animal, and there appears to be a growing consensus that every decimal point of global warming is going to come at a cost.

#### The benchmarking system favors the most innovative companies in each sector of the market.



## **PRICING CLIMATE RISK**

The group of experts that advised the Norwegian government not to change GPFG's benchmark, did so for two primary reasons. Firstly, because there were no investable (sufficiently diversified) Paris-aligned benchmarks in existence at the time when its recommendations were presented, and secondly, because the group opined that there is no reason to believe the financial market is not pricing climate risk in the first place. At WWF, we fully agree that investable climate adjusted benchmarks were not commercially available at the time when the report was released. This, however, is a work in process that Norway and its GPFG should have a keen interest to participate in.

As to the pricing of climate risk, there are three aspects that should be considered. First, there is the issue of who is paying for the excessive emissions and their consequences. It is a fact that the cost of excessive emissions is not paid so much by the companies spewing them as by the people, companies and countries that stand to lose the most as a result of the emissions. If externalities related to excessive carbon emissions were fairly distributed, perpetrators of these excesses would pay a higher price for emitting them. This would incentivize them to invest more in order to emit less.

Secondly, there is the more general pricing of climate risk in the financial markets. Here, IPCC (Intergovernmental Panel on Climate Change) stated in its Working Group III report presented on April 4<sup>th</sup>, 2022, and citing numerous academic studies, that investors have only accounted for climate risk to a limited extent.<sup>17</sup> The *Network for Greening the Financial System (NGFS)*, joined by most central banks, underlines that *"there is a strong risk that climate-related financial risks are not fully reflected in asset valuations"*<sup>18</sup>.

Against this, the group of experts and Norges Bank state that there is no reason to believe the markets are not pricing climate risk. This is a bold statement. After the last major financial market crash in 2008/09, more than two thirds of UK chartered financial analysts concluded that investors behave irrationally and that markets, on a general basis, do not price risk properly.<sup>19</sup> The group of experts acknowledges that the climate crisis is the greatest market failure of all time, yet it still wants to leave the resolution of the crisis to the financial market.

If the NGFS and IPCC are right, the question is when the cost of excess emissions will begin to be factored into the pricing of stocks and bonds to a greater extent than it is today. We believe this will happen as global capital flows become Paris aligned over the next several years, i.e., when pension funds and other institutional investors adjust their investment benchmarks accordingly. When that happens, companies with inferior transition plans are likely to underperform the market and investors who are early movers into Paris-aligned investment benchmarks may be in a position to capitalize.

"We see no evidence that the market is adequately pricing climate and nature risks."

## THE ROLE OF THE UNIVERSAL OWNER

There are essentially two types of investors in the financial markets:

- 1. Pension funds and other large institutional investors the so-called universal owners.
- 2. Active and focused investors, typically entrepreneurs, hedge funds and private equity funds

It is up the universal owners to establish a business framework in the form of a benchmarking system that can make the corporate world effectively Paris-aligned. It will then be up to the businesses and the active owners to find the solutions.

Pension funds, life insurance companies, and most mutual funds are passive investors. Since the advent of exchange traded funds (ETFs, the so-called index-funds) 20 years ago, the pricing of risk in the marketplace has been increasingly left to active owners. Pension funds have shifted more of their investments toward low-cost ETFs and, to some extent, counterbalanced the absence of active risk-taking with a dose of hedge fund/private equity exposure. Thus, more owner power has been transferred from long-term oriented pension funds to more short-term and opportunistic investors.

If the corporate world is going to transition to net zero within the framework of a 1.5°C global warming, it is up to the universal investors to investigate and develop the tools that can get us there. The role of the active owners will be to find the practical solutions. This is the logical distribution of roles given the distinct differences between the two investor-types when it comes to perspective, time horizon, and incentives. It would be meaningless for the universal owners to leave its overall climate ambitions to investors who neither see the complete picture as to how climate risk can be nest mitigated, nor have the same time horizon or incentives as those of the universal owners. Active owners compete against other companies in their field of same business given the prevailing business conditions. It is up to the universal owner to decide what those conditions should be.

Pension funds control about half of the world capital markets,<sup>20</sup> with mutual funds potentially adding to this universal owner power. The active owners are the big force in the day-to-day world of business, with the top three investors controlling more than 50% of the stock in half of the world's listed companies.<sup>21</sup> The active owners know that GPFG and other universal owners will remain invested in them as long as they maintain a purely market capitalization-based investment benchmark (shopping list). They know that the fund managers' hands are tied and that the only real threat is if a universal owner chooses to strategically disinvest from all the companies in their industry, which will not materially alter any company's competitive position.

#### It is up to the universal owners to develop a Paris-aligned financial framework.

The net-zero movement is based on a belief in the capacity of universal owners to influence companies to transition to a net-zero pathway. There is, however, a mismatch between what the universal owners say and what they do. As the gap between the real economy and the stated emissions targets widen, universal owners will be forced to walk their talk and divest from an increasing number of companies and industries, companies and sectors that are in need of investment funds to transition to net zero. This is the real risk that has been raised by the Net-Zero Asset Owners Alliance<sup>22</sup>. If the universal owners will not walk their talk, neither will the active owners.

### CONSTRUCTION, DISRUPTION, AND ADAPTION

The benchmarking system we propose can only be as good as the numbers it is based upon. It is timely and very welcome, therefore, that the US SEC on March 21<sup>st</sup> 2022 announced that companies will be required to publish audited greenhouse gas emissions (scope 1 and 2, initially, scope 3 is likely to follow) in much the same way they are required to disclose audited financials.<sup>23</sup> With credible reporting and control mechanisms in place, creating a credible benchmarking system will be a fairly simple undertaking. Who makes the new benchmarking system is of less importance. It could be done by the GPFG in collaboration with partners from academia, benchmark providers, financial institutions, and investor alliances (such as NZAOA).

When the GPFG was established, observers hoped it would mark the beginning of a financial cluster developing in Oslo. If the Norwegian government is serious about its ambition to make the GPFG a world leader in responsible investing, it needs to lead the transitioning to a new benchmarking standard as well. Certainly, no other pension fund has the size and reach that GPFG has. But, again, the creation of a new benchmarking standard should not happen in a vacuum at the Norwegian Ministry of Finance and the GPFG; it must be a collaborative effort involving the best research institutions in the world.

We believe it is important that a new benchmarking system is not disruptive. However, there may be one exception to this overall concern, related to the fund management industry itself. Today, hundreds of thousands of analysts go to work every day to analyze corporate earnings on behalf of universal owners. This is not cost effective. US public pension funds underperform their benchmarks by 0.99% a year according to a recent study.<sup>24</sup> Endowments fare even worse. Hedge funds and private equity funds do not come to the rescue either; they have stopped outperforming the markets and are resembling diversified large cap- and small cap (value) funds in terms of performance, respectively. Pension funds are generally paying too much for outsourcing fund management services that could have been indexed at a cost as low as 0.01%. GPFG has, with its low-cost approach to fund management, been able to outperform the markets according to its own reporting. However, the excess return has not been statistically significant and may be due to the methods by which the performance is measured, a presentation arranged by GPFG on March 21<sup>st</sup> 2022, revealed. In short, it may be in the pension saving public's interest to reconsider the current investment practice and focus more explicitly on long-term targets in the form of a more just and sensible benchmarking system. If some of the costs of transitioning to the new benchmarking system is not paid for by the financial industry through lower costs, this may be listed among the opportunity costs discussed in a previous section.

As to the adoption of a new benchmarking system, this could be done in stages as the system develops. GPFG could be given a larger risk budget on a temporary basis to run a limited portfolio that can lead the evolution of the new benchmarking system. This will serve as a good learning ground. In this same process, GPFG should be instructed to report on transaction costs explicitly for this portfolio, as it will be of public interest to learn about it. When the new benchmarking system is fully developed and fully adopted at GPFG, the current 125 bps risk mandate should be reinstituted. That should suffice for GPFG to chase for incremental financial return relative to the new benchmark, if this is still of public interest. Even if we give GPFG the benefit of the doubt and accept the fund's claim that it has enhanced the benchmark return by 0.2% p.a., that means 97% of GPFG's performance still stems from a benchmark that is environmentally unsustainable and, arguably, financially inferior going forward. Norway's primary interest, therefore, should be to first enhance the benchmark itself.

### **ALTERNATIVE STRATEGIES**

We have introduced Bolton et al.'s model and our own ideas for how a new benchmarking system could be developed. We are convinced that once the investment community looks into these models and the larger rationale for them, the universal owners will close the door to the pure market capitalization-based benchmark indexes.

Disinvestment – the exclusion of sectors and in some cases, single companies – is another strategy that is used by some investors. Disinvestment may be effective in mitigating emissions, but it fails to consider the bigger picture, not only from a market disruption and transition financing point of view, but also because we do not know who will enter the market to pick up the slack as the disinvested brown sectors face financial problems.

When it comes to the benchmarking system we propose, it is also possible to picture more advanced versions of it. At this early state, however, we believe it is important that improvements do not come at the cost of automation. The market is not likely to accept the overruling of corporate data until and unless such adjustments are somehow done by the market itself, or by some larger entity supported and overseen by institutional investors. Another way to change the model could be to adjust company weights by a factor that is disproportional to the differences in carbon efficiency. This, too, is likely to be too complex a task. Again, it will require analytical intervention and subjectivity into the model, and again it would stir up unnecessary controversy when what is needed is a more united universal owner. Of course, in a future evolution of the benchmarking system, it is possible to picture pension funds pooling their resources in a CERN-like entity that can work to internalize more than climate related externalities into the investment and business frameworks. However, we need to take one step at the time, and we believe the first step should be focused on simplicity, transparency and automation.

When the benchmarking alternatives we have described become recognized in the market, major financial players may develop their own versions of it in order to attract investment capital. Again, there will be a competitive race, this time towards the best Paris- and net zero-aligned benchmarking standard. This will all be in GPFG's best interests. The Norwegian government and GPFG should be content to set this work in motion and contribute towards the best possible evolution of the financial system. That entails the eventual expanding of the system to also include nature and biodiversity risk.

### **FIDUCIARY DUTIES**

All money managers are bound by fiduciary duties and the prudent man principle. What these duties and this principle essentially mean, is that board members and administrators of a pension fund must work to maximize the return of the portfolio to put the pension fund in the best possible position to pay future pensions. The GPFG is not entirely exempt from this, even if it is less regulated than public pension funds, who in turn are less stringently regulated than private pension schemes.

Fiduciary duties have developed slowly since they originated 200 years ago to protect survivors and children. Back then, women and workers had no voting rights and pension funds did not exist. Today, workers have both voting rights and a pension fund. Not only that, collectively they are the universal owners of listed companies. We believe it is important that workers become more aware of this, and how their ownership power can be put to better use. Currently, corporate incentives are not sufficiently compatible with the climate objectives and other goals such as safeguarding and improving social/labor

standards and protecting and restoring the environment. This means that fiduciary duties must be reevaluated to see to what extent they serve their intended purpose.

What is common for all pension plans and across all jurisdictions, is a fixation on financial return. In some jurisdictions, it may be difficult to obtain a general approval for a new benchmarking standard without hard empirical evidence as to the financial return attributions of the new system. Again, public pension funds have more leeway, as we saw with the Dutch pension giant ABP, who in late 2021 announced it would disinvest from pure-play oil and gas companies.<sup>25</sup> With no investable climate benchmark alternatives, divestment became for ABP the only alternative to the equally dysfunctional market capitalization-based benchmark indexes. This underscores the urgency in bringing about an investable alternative to existing climate benchmarks.



#### **ADVANTAGES FOR NORWAY**

The benchmarking systems we describe can fulfill the Norwegian government's aim and obligation to make the GPFG the most responsible pension fund in the world. It would likely silence the critics from Glasgow. It will also likely silence anyone else who cannot contribute a full perspective to the climate crisis and its potential mitigation. By putting a carbon-adjusted benchmarking system on the agenda, the Norwegian government will not only lift the public discourse to a new level: the framework could also be used by the government when evaluating public investments as well as private applications that involve environmentally sensitive activities.

### The new benchmarking system would increase Norway's significance in the green transition.

A new benchmarking system may help illuminate the people's role as universal owners. This has political and economic dimensions, in addition to the financial dimension that comes with the shared owner responsibility. By putting the benchmarking system on the agenda and helping it develop, GPFG can pioneer a sustainable investment framework for the world that appropriately distinguishes the role of pension funds as universal owners from the role of active owners as creators of solutions.



# **ENDNOTES**

<sup>1</sup> https://www.regjeringen.no/contentassets/fb49a0e957324d7caadb625c6ec4490c/no/pdfs/r-0655-b-klimarisiko-ogoljefondet.pdf

- <sup>2</sup> https://www.regjeringen.no/no/dokumenter/meld.-st.-9-20212022/id2906344/?ch=1
- <sup>3</sup> "The Glasgow Financial Alliance for Net Zero" unites over 160 financial institutions committed to net zero
- <sup>4</sup> https://www.mercer.com/our-thinking/wealth/climate-change-the-sequel.html
- <sup>5</sup> https://www.cisl.cam.ac.uk/resources/sustainable-finance-publications/unhedgeable-risk
- <sup>6</sup> https://www.lse.ac.uk/granthaminstitute/publication/climate-value-at-risk-of-global-financial-assets/
- <sup>7</sup> The Parliament recently approved a change in the mandate of the Fund which will reduce the number of companies from 9000+ to approximately 6600, taking out many of the small cap.
- <sup>8</sup> https://www.nbim.no/en/the-fund/how-we-invest/equity-management/
- <sup>9</sup> https://www.nbim.no/en/publications/submissions-to-ministry/2021/climate-risk-in-the-government-pension-fund-global/
- <sup>10</sup> https://papers.ssrn.com/sol3/papers.cfm?abstract\_id=3922686
- <sup>11</sup> https://wwfeu.awsassets.panda.org/downloads/requirements for climate disclosure wwf briefing nov 2020 .pdf
- <sup>12</sup> faj.v72.<u>n3.4.pdf (columbia.edu)</u>, page 6
- 13 https://www.bis.org/publ/work985.pdf
- <sup>14</sup> https://www.worldbank.org/en/topic/climatechange/publication/turn-down-the-heat
- <sup>15</sup> <u>https://samf.ku.dk/nyheder/2021/klimaforskning-en-procent-der-goer-en-verden-til-forskel/</u>
  <sup>16</sup> <u>https://climateactiontracker.org/press/Glasgows-one-degree-2030-credibility-gap-net-zeros-lip-service-to-climate-</u> action/
- <sup>17</sup> https://report.ipcc.ch/ar6wg3/pdf/IPCC AR6 WGIII FinalDraft FullReport.pdf, chapter 15.2.1
- <sup>18</sup> NGFS (2019). A call for action: climate change as a source of financial risk. https://www.ngfs.net/en/firstcomprehensive-report-call-action
- <sup>19</sup> Gillian Tett, "Crisis of faith for high priests of rational markets", Financial Times, June 15, 2009
- <sup>20</sup> OECD Capital Market Series (link above), Owners of the world's listed companies, page 8 and on. An exact number for pension funds cannot be derived because 30% of corporate ownership pertains to owners that do not disclose ownership because it is either below the minimum disclosure threshold or because they are legally exempt from having to disclose. It is, however, generally assumed that pension funds control about 50% of the world capital markets.
- <sup>21</sup> https://www.oecd.org/corporate/Owners-of-the-Worlds-Listed-Companies
- <sup>22</sup> UN-NZAOA (2022). Target Setting Protocol, Second Edition. <u>https://www.unepfi.org/net-zero-alliance/</u>
- 23 https://www.sec.gov/news/press-release/2022-46
- <sup>24</sup> https://www.evidenceinvestor.com/public-pensions-98-certain-to-underperform-over-ten-years/
- <sup>25</sup> https://www.theguardian.com/environment/2021/oct/26/abp-pension-fund-to-stop-investing-in-fossil-fuels-amid-climatefears

# A FUTURE IN WHICH HUMANS LIVE IN HARMONY WITH NATURE



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