

Levers of change

Capital allocation and Model Portfolio



Asset owners have control over two key levers to determine the outcomes of their net zero investment strategy and facilitate the low carbon transition across all sectors and industries. These two levers are capital allocation and stewardship. This article will focus on the first lever of capital allocation. Look out for the final article in this series which will focus on the role of stewardship in further supporting a net zero investment strategy.

Taking advantage of investment opportunities

The efficient allocation of capital to key assets that support the low carbon transition is a crucial feature of an effective and robust net zero investment strategy. Capital can be allocated to accelerate change and solve challenges associated with the low carbon transition, as well as take advantage of opportunities such as climate solutions across the investment universe. Given how pressing the climate emergency is, decarbonisation in practice will not happen as rapidly as required to reverse the adverse impacts on the planet.

As a result, we'll see increasing needs across climate adaptation solutions – those that help society adapt to the effects rather than focussing on reducing emissions - offering both investment opportunity and positive impact.

Capital allocation includes a wide range of considerations from asset class allocation, manager selection and mandate-specific selections. For some specific investment opportunities, there are certain asset classes that provide access to these investment opportunities and is something to consider when exploring different investment opportunities across the climate solutions space. Mandate-specific decisions for an asset owner's net zero investment strategy can include ESG tilts towards companies who align with net zero objectives or equally, exclusions from certain types of companies who are not aligned or compliant with net zero ambitions can also be applied to mandate decisions.

When thinking about capital allocation and the types of assets that can accelerate the transition, we can think of these in two broad groups:



Emissions reducers

Investment opportunities centred around emissions reductions. Asset owners can increase allocations to more efficient companies within sectors.



Emissions removers

Investment opportunities centred around emissions removals. Asset owners can increase allocations to assets that remove or avoid emissions in a measurable and robust way.

Using capital allocations to build a strategy

Being able to prioritise your actions is key. As is being clear on where your role in the transition sits based on your Fund's objectives, funding position, stakeholder views and Pool opportunities.

To help frame approach we might want to look at the trade-off between 'ease' of investment and the relative 'importance' of different assets in the transition.

- When assessing the 'ease' of investment we consider factors like the time involved in building out a mandate and the range of suitable options available today in the market. For example, investing in natural capital assets may take time for a committee to get comfortable with and understand the nuances of different offerings in the market today. Timescales to then deploy assets into the investment would also be a key consideration.
- When assessing the 'importance' of investment we balance both the carbon emissions reduction potential as well as the asset's ability to influence real world change. The assets that move the dial (and we mentioned these in our first article of this series) are energy transition assets like renewable infrastructure and other enablers, and natural capital, like timberland – a 'remover'.

Model Portfolios – mapping out your path to net zero

Model portfolios can provide an illustration of how strategy and mandate changes could put your net zero journey on a better path. For a robust net zero investment strategy, it's still crucial that the approach displayed by a model portfolio is used as a guide and point of reference to help prioritise actions and drive positive investment decision-making for the future over the long-term, rather than simply providing a static well-rounded investable portfolio for today. Model portfolios are a particularly useful tool for asset owners when considering pre-2050 net zero target dates, as it can highlight the extent to which a current investment strategy needs to be adapted and the feasibility of this.

A model portfolio can help show how mandate changes through capital allocation decisions towards climate solutions over time support a portfolio's journey to net zero and emissions reductions. By allocating to climate solutions, an asset owner can take progressive steps to accelerate the journey towards net zero.

CASE STUDY

Our client asked for sample portfolios for a 2030 net zero target, as a theoretical exercise to establish the trade-offs that would be needed if that was to be the Fund's target.

We started by assessing the emissions journey for their current investment strategy. Then created a 2030 net zero portfolio, retaining as many asset classes as possible and considering within those asset classes what would be required. For example, in listed equities, what would the portfolio have to look like to be reasonably sure to achieve a position that was close to zero emissions by 2030?

Using qualitative and quantitative analysis we looked at concentration risks, likely impacts on risk and return,

and the level of portfolio change that would be needed to give any reasonable chance of a 2030 target date.

The exercise was extremely useful in helping all stakeholders understand the implications of different net zero target dates and we extended the analysis to look at other pre 2050 dates.

It also provided a clear direction on the priority order of actions to take to begin building a net zero strategy targeting a pre-2050 net zero date. One of the first actions was to consider natural capital solutions as an important component of their net zero plan.

Conclusion

Capital allocation is a key lever for change that asset owners can use to support net zero ambitions and the low carbon transition. It's important to be aware of the different investable opportunities available and how capital allocation decision will impact your own net zero strategy as well as the real-world situation. If you'd like to understand more about investment opportunities across the climate solutions space, model portfolios and how we can help please get in touch.

Important information

This communication has been compiled by Hymans Robertson LLP® (HR) as a general information summary and is based on its understanding of events as at the date of publication, which may be subject to change. It is not to be relied upon for investment or financial decisions and is not a substitute for professional advice (including for legal, investment or tax advice) on specific circumstances. HR accepts no liability for errors or omissions or reliance on any statement or opinion. Where we have relied upon data provided by third parties, reasonable care has been taken to assess its accuracy however we provide no guarantee and accept no liability in respect of any errors made by any third party.

General Investment Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes but is not limited to equities, government or corporate bonds, derivatives and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of investments. As a result, an investor may not get back the full amount of the original investment. Past performance is not necessarily a guide to future performance.

London | Birmingham | Glasgow | Edinburgh

T 020 7082 6000 | www.hymans.co.uk

Hymans Robertson LLP is a limited liability partnership registered in England and Wales with registered number OC310282.

A list of members of Hymans Robertson LLP is available for inspection at One London Wall, London EC2Y 5EA, the firm's registered office.

Authorised and regulated by the Financial Conduct Authority and licensed by the Institute and Faculty of Actuaries for a range of investment business activities. Hymans Robertson is a registered trademark of Hymans Robertson LLP.

A member of Abelica Global