

Net Zero Investing: BMO Global Asset Management Approach

November 2021



In December 2020, BMO Global Asset Management committed to an ambition of reaching net zero emissions by 2050 or sooner across all assets under management, as a signatory to the Net Zero Asset Managers Initiative.

During 2021 we have been working on implementing this commitment by developing a methodology, and identifying an initial set of funds which will be managed using net zero investing principles. This paper sets out the approach we have taken, and some of the challenges and methodological choices we have made.

Our primary focus initially has been on equities, due largely to data availability, although the model we have built also can be applied to corporate bonds. Our emerging thinking on other asset classes is set out at the end of this paper, which focuses on the approach for listed equities and corporate bonds.

Principles underpinning our net zero approach

Early in the process we identified three principles to guide our approach to net zero, which have helped with some of the choices we have made along the way.



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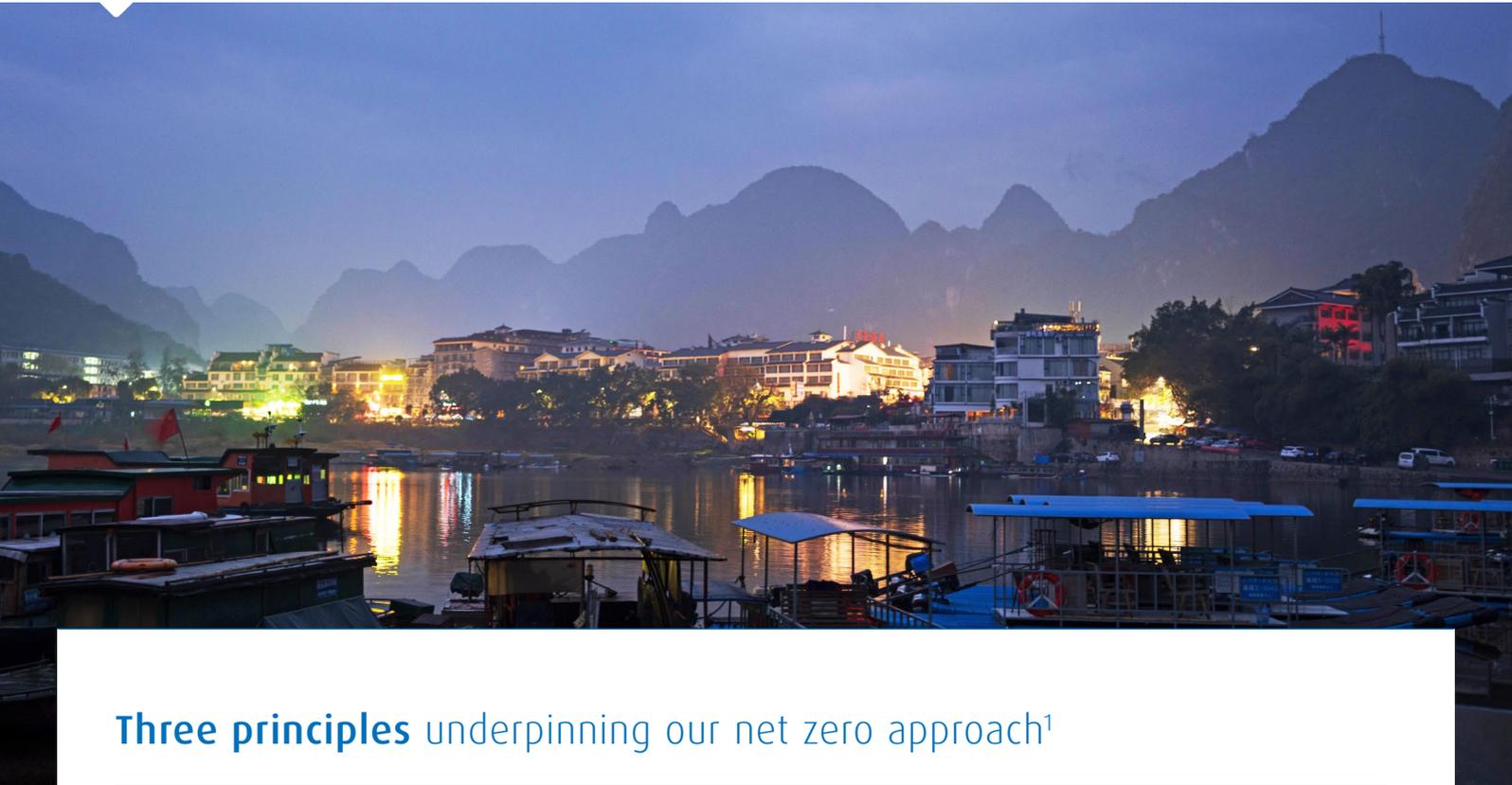
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Three principles underpinning our net zero approach¹

1

Focus on real-world emissions reductions

We know that we can cut a portfolio's carbon intensity dramatically, just by selling companies in highly energy-intensive sectors like electric utilities and industrials, and replacing these with companies in lower-emissions industries. But such portfolio changes alone make little difference in the real world. Our ambition is to use the power of our engagement, working in collaboration with other investors, to influence companies to take action – and as their emissions fall, so too will the carbon content of our investment portfolios. However, engagement can't be open-ended. If companies fail to respond, and remain fundamentally misaligned with a low-carbon future, we will need to re-consider our investments in them.

2

Work in partnership with clients

As asset managers, our fundamental responsibility is to meet our clients' current and future investment needs. We believe that net-zero investing is supportive of the responsibility – but we also understand that many of our clients still have many questions about what this means, and we need to be mindful of the existing mandates we have with them. Our aim is to work in partnership with our clients, providing education on what the low-carbon transition means when applied to portfolios. In practice, this means we may be able to move some of our assets to a net zero-aligned pathway earlier than others – which is why we will set an interim AUM target, with the intention that this will ratchet up over time.

3

Transparency

The risks of 'net zero-washing' are real. Methodologies on net zero investing are still emerging, and disclosure by corporates is patchy, despite the progress made since the publication of the Task Force on Climate-related Financial Disclosures recommendations. However, the urgency of the issue is too great to wait until we have all the building blocks fully in place. In this context, it is important that we are straight with our clients and wider stakeholders about limitations in our approach, including gaps in data or methodology. We will seek to avoid 'black box' approaches, or simple metrics which could obscure a more complex reality.

¹ See 'The road to net zero', BMO GAM Viewpoint, March 2021





Our net zero approach is based on the Net Zero Investment Framework, developed by the Paris Aligned Investment Initiative.

Our approach

The basis for our approach for listed assets (equities and corporate bonds) is the Net Zero Investment Framework (NZIF), developed by the Paris Aligned Investment Initiative². We helped to develop the framework, and in 2021 co-chaired an Implementation Working Group. This group brought together asset owners and managers to discuss a range of issues arising as we put the Framework into practice.

In our own implementation, there were a number of issues where we had to make judgements and choices³. The purpose of this paper is to set out our methodology, including these choices, in the interests of transparency and of informing the investor debate.

Whilst we believe our methodology combines the best quality data sources we can identify, we believe that – as in other areas of ESG – data is only the starting point for deeper analysis. No data source is perfect or can fully reflect the complexities of climate change policies at an individual company. However, data models do enable portfolio analysis to be undertaken on a systematic basis, and provide a ‘heat map’ of where the biggest risks are likely to be – allowing us to prioritise our investment analysis and engagement resources. The data also allows us to report a range of metrics to our clients, in a way that is consistent with how other managers using the Framework are reporting.

² Paris Aligned Investment Initiative – Investing for a net zero future

³ See ‘Five challenges for net zero investing’, BMO GAM Viewpoint, August 2021



Company-level alignment assessment

Our focus on real-economy reductions led us to place a strong focus on the analysis of investee company alignment with a forward-looking net zero pathway, and the use of active stewardship to drive change at those companies not yet aligned.

Data and metrics

Our model for listed equities and corporate bonds covers over 7000 companies, and draws in data from a range of sources. Recognising that data may be imperfect, and also that new

company commitments will take time to show in the data, we also have the ability to override the model ratings where there is publicly available evidence of a company's policy.

Data sources for company alignment assessment

Climate Action 100+ Benchmark: We see this as the 'gold standard' of company net zero analysis, and use these indicators in preference to any other data source, where available. The Benchmark currently covers 159 of the world's largest-emitting companies.

Transition Pathway Initiative: TPI has a wider coverage than CA100+, with over 400 companies in high-emitting sectors. It has recently developed a 1.5 degree pathway, and will be issuing company assessments using this in the coming months.

Science-based Targets Initiative: SBTi provides an independent methodology and approvals process for

companies to set emissions targets in line with low-carbon pathways. Its 'Business Ambition for 1.5°C' pledge is designed for companies prepared to commit to the highest ambition level.

Carbon Disclosure Project: For more than two decades, CDP has run a global disclosure service, which now covers climate change, water and forests. Investor signatories can access a full download of all data provided in company disclosures.

MSCI ESG: Our main commercial ESG data provider is MSCI. Uses of this data in our net zero tool include company emissions data and the analysis of targets.



We rate companies in 8 categories (2 of which are only rated for Climate Action 100+ companies). These are based on the alignment criteria set out in the NZIF, but with some changes, as set out below. Our decisions on which indicators to cover have been based on a combination of the availability of data and the maturity of assessment methodologies.

NZIF	BMO	Metric	Description
●	1	1	Ambition Ambition to reach net zero emissions by 2050 or earlier
●	2	2	Targets – Interim targets set Short to medium term emissions targets set
●		3	Targets – Targets aligned Company targets are driving its emissions intensity consistent with a 1.5 degree industry trajectory (Additional BMO metric – not required by NZIF)
○	3		Emissions performance Current emissions intensity performance, relative to targets No reliable data yet identified
●	4	4	Disclosure Disclosure of Scope 1, 2 and material Scope 3 emissions
●	5	5	Strategy Strategy in place to achieve targets
○	6		Capex alignment Not rated, pending further developments in methodology
●	7	6	Policy engagement Lobbying policy is aligned to net zero emissions Assessed for CA100+ only
●	8	7	Governance Board oversight; link between climate change and executive pay
○	9		Just transition Not rated, pending further developments in methodology
●	10	8	Climate risk & accounts TCFD disclosure Assessed for CA100+ only

● BMO core indicators, assessed for all companies, ● Indicators assessed for CA100+ companies only, ○ Indicators not currently assessed

Assessing the ambition of companies’ emissions targets

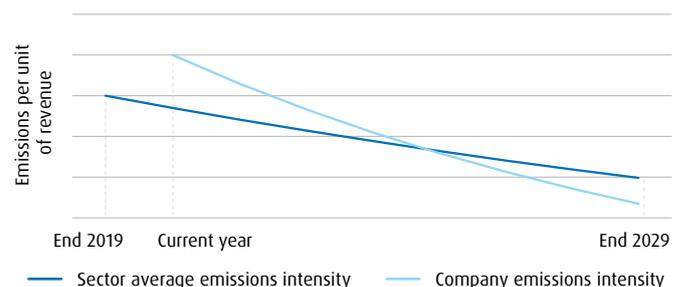
Category 3 – Targets Aligned considers whether companies’ medium-term targets are sufficiently ambitious, compared with a 1.5 degree trajectory. Making this judgement is at the core of assessing whether a company’s climate strategy is fully net zero aligned, and reflects emerging best practice, particularly the recent report to the TCFD from its Portfolio Alignment Team⁴.

There are significant challenges in making this calculation, as the degree of ambition is not always apparent from companies’ own targets and disclosures. Base years vary significantly, and targets can take different forms (for instance, absolute versus intensity targets), as well as covering different scopes of emissions.

Our assessment of the adequacy of companies’ Scope 1 and 2 targets uses data provided by MSCI ESG, who provide a standardised calculation of 2030 commitments. We compare these company commitments with a 1.5 degree consistent trajectory. This trajectory is calculated on a sector-specific basis where possible, recognising that emissions reductions are more technically challenging in some industries than others. We take sector emissions reductions rates from the International Energy Agency’s 1.5 degree report⁵. For those not specified in the report, we use a default rate. We can then construct a net zero aligned trajectory, based on current industry average emissions intensity, and compare this with the portfolio trajectory that considers

existing company reduction targets. If the company target is below the net zero trajectory by 2030, then we rate the target as ‘aligned’⁶.

Assessing company emissions targets



Source: BMO Global Asset Management

At this point in time, we have not included Scope 3 data in this analysis. We hope to build this in for sectors where Scope 3 is particularly material, as better quality data becomes available. That said, we have made key Scope 3 data available to the investment teams for monitoring purposes.

⁴ PAT_Measuring_Portfolio_Alignment_Technical_Considerations.pdf (tcfdhub.org)

⁵ Net Zero by 2050 – Analysis – IEA

⁶ In principle, alignment calculations should be based on cumulative emissions; however we have used point-in-time calculations (in line with, for instance, the Transition Pathway Initiative) for analytical simplicity.



Alignment ratings for companies

Based on the data across these 8 categories, we give companies an overall alignment rating. This is based on how many of the above expectations the company meets, with higher standards set for companies in the most emissions-intensive industries:

- **Aligned:** Company meets expectations highly in all relevant categories
- **Aligning:** Company meets core expectations around disclosure, setting targets and strategy
- **Committed:** Company has not yet met these expectations, but has committed to set a science-based target
- **Not aligned:** Company does not meet expectations, and has not committed to set a science-based target

Two categories of companies are not given a rating: companies in the lowest-impact sectors from a climate perspective, and in the finance sector. We see climate change as a critical issue for financial institutions, but the metrics used to judge the adequacy of performance are very different to those for industrial sectors with high direct emissions. The impact of financial institutions comes primarily through their lending and investment policies, and methodologies to judge whether these are 'net zero aligned' are still relatively new, with data on Scope 3 financed emissions very limited. This is an area we will seek to address as our methodology evolves, using some alternative metrics; in the meantime, as described below, we have a particular focus on financial institutions through our engagement.

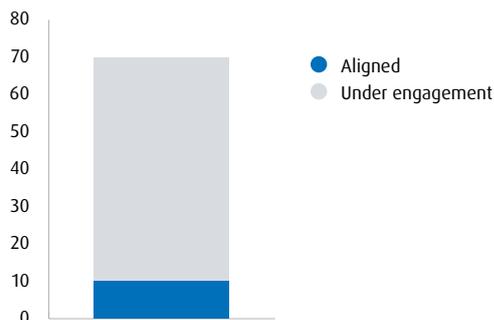
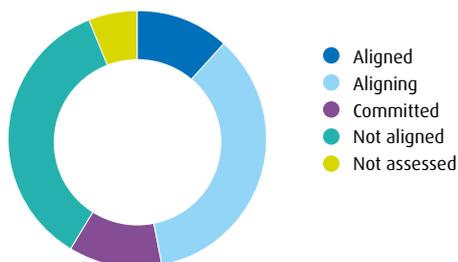
Portfolio analysis and target setting

Having established company alignment status, we can analyse how this aggregates to portfolio level, and what actions we will take to improve performance over time.

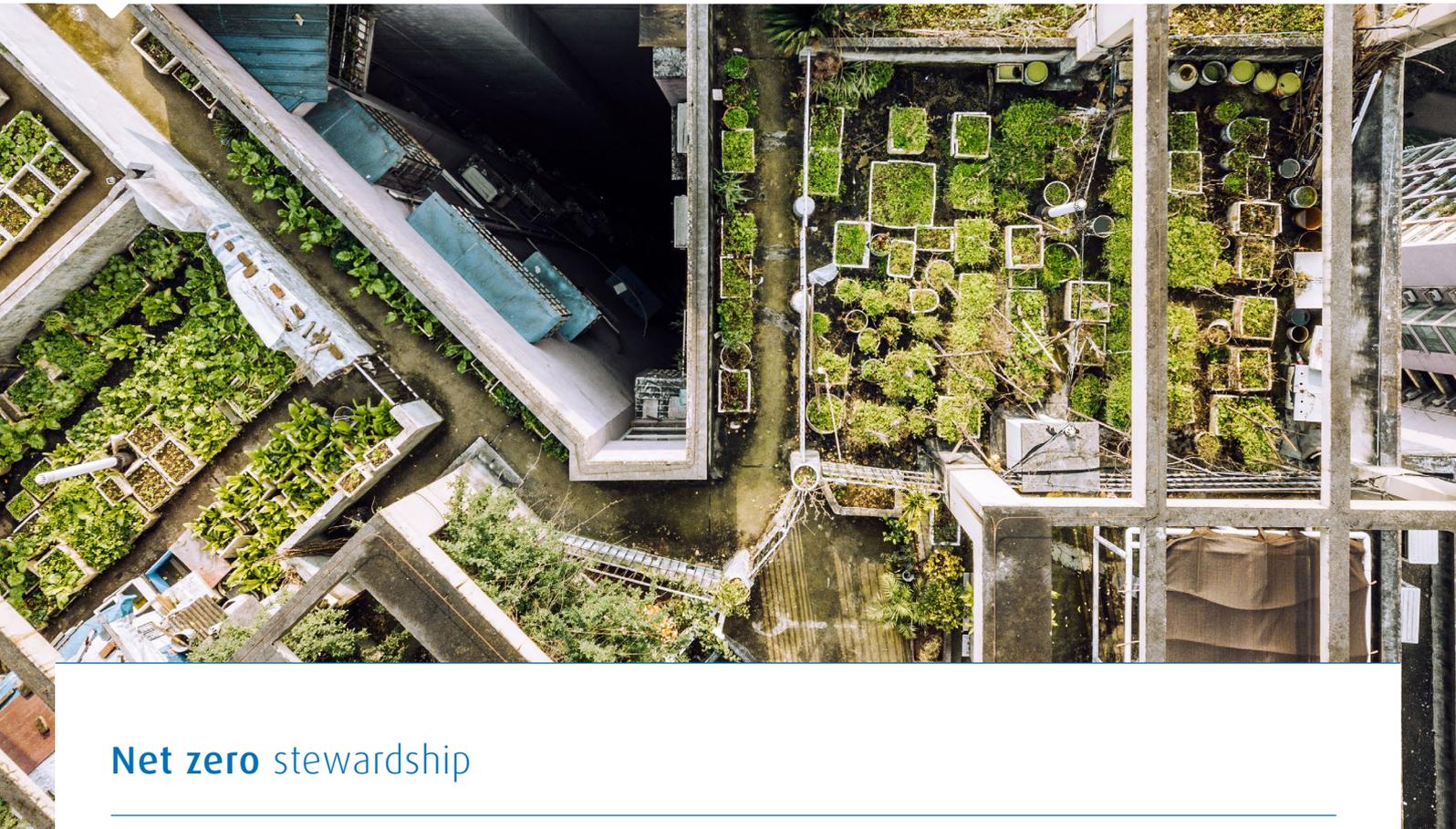
The pie chart shows a representative breakdown of companies in each alignment rating, calculated as a percentage of

total portfolio emissions. We will set targets to increase the proportion of companies in the Aligned or Aligning category over time, and will make active use of stewardship to improve the alignment of companies, aiming to have at least 70% of portfolio emissions either Aligned or under engagement for the funds committed to using this net zero framework.

Example of net zero alignment analysis, as a percentage of portfolio emissions



Source: BMO Global Asset Management



Net zero stewardship

Stewardship lies at the heart of our approach to net zero. We already have a comprehensive global engagement programme, through which we have engaged with over 300 companies so far in 2021. Our objectives are aligned to those of the Climate Action 100+ benchmark, in addition to which we have sector-specific expectations, drawing on the work from organisations such as the IIGCC which has developed approaches covering a number of key high-impact sectors.

One important focus area for us has been financial institutions, given their systemic importance in mobilising capital for the transition⁷. We have also focused on the links between climate change and broader environmental issues, particularly biodiversity and water.

Climate change is systematically incorporated into our voting policies and implementation⁸. We use data from CDP and the Transition Pathway Initiative to identify potential laggard companies in high impact sectors, and will vote against management resolutions (such as election of directors or approval of accounts) if a company does not meet our minimum expectations. In 2021 so far, we identified 71 such companies, and in a majority of these cases voted against a management resolution.

Through impactful and targeted stewardship, we hope to influence change at the companies we invest in, and as a consequence achieve improvements in the alignment status of companies over time.

What if engagement fails?

We will engage with specific objectives, and a timeframe for action. Where we do not see progress, we will consider using escalation strategies. These include building collaborations with other investors; the use of proxy voting; attending company Annual General Meetings; and filing shareholder resolutions. Ultimately, if we have given engagement time to work and used any appropriate escalation, yet a company still fails to meet our minimum expectations, we will divest it from portfolios applying a net zero approach.

⁷ See 'Banks and climate risk management', BMO GAM Viewpoint, May 2021

⁸ See 'Climate voting 2020', BMO GAM Viewpoint, January 2021



Portfolio-level emissions target setting

As well as the asset level analysis, we also aim to achieve portfolio-level emissions reductions consistent with a 1.5 degree aligned trajectory. We see portfolio level aggregate emissions data as an accountability tool, to monitor how well our investment and stewardship activities are working in achieving actual reductions in emissions.

Setting a reference pathway

In terms of understanding the required global emissions reductions, our starting point was the IPCC report, Global Warming of 1.5°C. This report concluded that in model pathways with no or limited overshoot of the 1.5°C limit, global CO₂ emissions need to decline by about 45% from 2010 levels by 2030⁹. Since 2010, however, global emissions have risen from 47.3 GtCO₂e to 52.4 GtCO₂e by 2019. Therefore the required global effort is around a 50% cut in emissions from a 2019 baseline by 2030.

The task then is to translate this global trajectory into a pathway for individual portfolios. There are some key decision points here:

- Which emissions metric to use
- Baseline year and target year
- Whether to account for a portfolio's start point by using a benchmark-relative approach, or to use a self-decarbonisation approach
- If using a benchmark, which one to select

Emissions metric: In line with best practice from the Platform for Carbon Accounting Financials, the metric we will focus on for the emissions trajectory is financed emissions intensity, expressed as CO₂e/\$mn invested.

Financed emissions intensity =

$$\frac{\sum_c^n \left(\frac{\text{current value investment}_c}{\text{issuer's enterprise value}_c} * \text{issuer's Scope 1 and Scope 2 GHG emissions}_c \right)}{\text{current portfolio value (in millions)}}$$

The main advantage of this metric is that it is an ownership-based metric, allowing measurement of an investor's share of emissions proportional to its exposure to the investee's total value.

One downside is that the denominator for calculating the intensity measure, \$ million invested, is subject to both market movements and inflation, meaning that emissions

intensity is likely to change purely due to these factors even if nothing changes in the real world. To counter this, we also continue to monitor absolute emissions, and will seek to apply a normalisation approach to the intensity figure once methodologies are available. We will also continue to measure and monitor weighted-average carbon intensity (WACI) as a metric to help understand climate risk.

⁹ IPCC, 'Special Report: Global Warming of 1.5°C', 2018



Baseline and target year: Where possible we will use a baseline year of end-2019. The target year is end-2029. In 2025 we will assess progress against targets as part of a methodology review.

Benchmark-relative versus self-decarbonisation: There are two types of approach to setting emissions pathways – benchmark-relative, which means comparing a fund’s emissions to those of a net zero-aligned representative benchmark; and self-decarbonisation, which means cutting a fund’s own emissions by a given percentage, set in line with a net zero pathway.

We selected a benchmark-relative approach, on the basis that this allows us to make an allowance for the starting point for each fund – meaning that funds that are highly carbon-intensive to start need to cut emissions by more than those which are already well below their benchmark. This is consistent with the way we approach target-setting with companies, where we ask for greater ambition from companies which are above their own sector average.

Choice of benchmark: There are various options for what benchmark to compare fund emissions performance with. Options include:

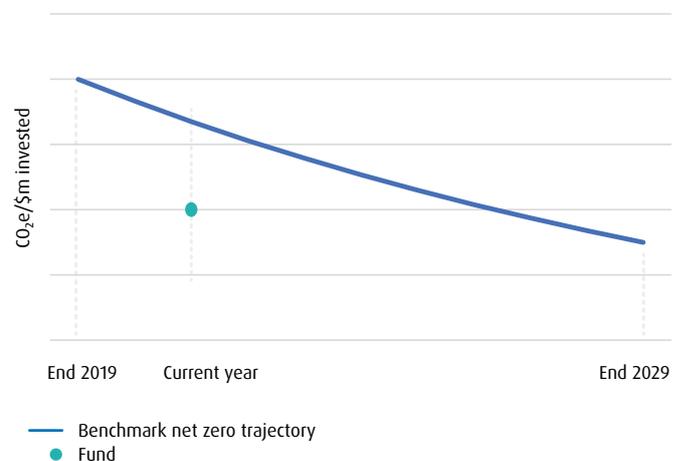
- A benchmark which reflects the whole global economy (such as MSCI World);
- Each fund’s own market benchmark;
- An artificial benchmark, constructed to reflect the sectoral and/or regional exposure of each individual fund; or
- A climate benchmark, such as the EU Paris-Aligned Benchmark.

There are advantages and disadvantages to each option. In theory, constructing a benchmark with identical sector

allocations to a fund, but using sector-average emissions, would give the most representative starting point for a future emissions pathway. In our internal model, we have calculated a benchmark in this way. However, it is analytically complex both to construct and to communicate, potentially undermining the principle of transparency.

We have chosen instead to use each fund’s own market benchmark to construct a future emissions reference pathway. This has the advantage of consistency with the way we analyse and report financial results. Market benchmarks are also chosen to reflect the investment universe of the fund, and so are reflective of regional or country restrictions and differences in average emissions.

Example of a fund’s emissions performance versus its own market benchmark



Source: BMO Global Asset Management



The diagram on the previous page shows how these choices shape the emissions pathway. We will seek to keep fund-level emissions within the net zero aligned trajectory, which declines by 50% from end-2019 to end-2029. Whilst the target is some years away, we will monitor and report progress on an ongoing basis.

A key part of monitoring will be to understand not only what changes in emissions intensity have happened, but what the reasons for these are. Some changes in intensity may be due to market movements or inflation (as discussed above); some to sector reallocation or company selection; and some to emissions reductions by our investee companies. In line with the principle of achieving real-world emissions, we will seek to achieve reductions where possible through the decarbonisation of the companies we choose to invest in.

Finally, there may be circumstances where a fund exceeds the pathway, but we believe this is justified from a climate change point of view. In particular, this may occur if a fund manager chooses to invest in some high-emissions companies which we are confident have a strong net zero alignment strategy, but where emissions remain high during a transition period. If this happens, we will be transparent about the reasons why we have taken this decision.

Investments in solution providers

Net zero methodologies have put a heavy emphasis on the decarbonisation of portfolios. However, as investors we also need to focus on our role in shifting in capital allocations toward climate solutions. The scale of capital needed is enormous – for energy systems alone, the International Energy Agency recently estimated¹⁰ that to reach net zero

emissions by 2050, annual clean energy investment worldwide will need to more than triple by 2030 to around \$4 trillion. Investments will also be needed in adaptation to the changing climate, and to secure emissions cuts in areas including deforestation and land use.

The EU Taxonomy has provided a methodology for classifying climate solutions, with work underway in other parts of the world, such as in Canada and the UK, to develop similar approaches.

For the funds committed to using the net zero framework, we will monitor and report on the proportion of portfolios aligned to the Taxonomy. More widely across our portfolios, we also seek opportunities to invest in solutions, such as significant investments in the green bonds market.

Tackling net zero across other asset classes

BMO Global Asset Management's net zero commitment covers all asset classes. However, net zero methodologies are more developed in some asset classes than others.

Work underway or planned in other asset classes by BMO GAM includes:

- **Property:** Our property asset management arm, BMO Real Estate Partners (BMO REP), set out the details of its net zero commitment in October 2021. The approach is consistent with the UK Better Buildings Partnership's Net Zero Carbon Pathway Framework and will apply across its real estate operations in Europe. It will set short-, medium- and long-term delivery targets, with the goal of becoming third party certified as carbon neutral by 2032 and culminate in achieving net zero carbon status by 2050¹¹.

¹⁰ [Net Zero by 2050 – Analysis – IEA](#)

¹¹ [bmo-rep-net-zero-carbon-pathway-gbp.pdf \(bmogam.com\)](#)

- **Sovereign debt:** This will be a future area of focus. We are awaiting the outcome of the ASCOR (Assessing Sovereign Climate-related Opportunities and Risks) Project, which is looking at alignment metrics at a country level, and will draw on this in developing a methodology. In the meantime we have been reviewing other metrics from sources such as GermanWatch and Climate Action Tracker.
- **Private equity:** We have been involved in the IIGCC's Private Equity working group on net zero implementation, to contribute towards a consistent industry-wide approach. In the meantime we have also included questions on net zero alignment in our regular annual ESG survey with our GPs, asking whether they have a net zero approach. In our latest survey, 17% of the GPs we surveyed have a goal to become net zero, with a further 14% developing this.

Net zero – what next?

Net zero investing has developed extremely rapidly over the past two years, from being almost a new concept two years ago, to covering around half the global asset management industry now¹².

Industry standards and methodologies are continuing to evolve, as our understanding of what meaningful net zero investing is grows. At the same time, data is rapidly improving, with mandatory climate reporting being introduced in a rising number of jurisdictions. In terms of net zero alignment data, one important recent announcement is the planned expansion of the coverage of the Transition Pathway Initiative from around 400 companies now to over 10,000.

We will continue to keep track of these changes, and our own approach will need to be nimble to adapt as the net zero landscape evolves. In line with our commitment on transparency, we will seek to share both the opportunities and the challenges that this new era in investing is bringing, and our success in achieving the real-world outcomes we are striving for.

¹² \$43 trillion committed under the Net Zero Asset Managers Initiative, at the time of writing

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