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Market evolutions in sustainability

Best practice climate, nature and social solutions

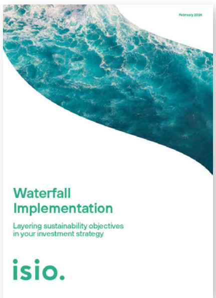
isio.

Paper Overview

The focus of this paper is to develop an understanding of best practice sustainability propositions, across the spheres of climate, nature and social investments. It is the final paper in a three-part series, which focused on:

1. **A cohesive approach to sustainability:** introduction to setting sustainability priorities;

2. **Waterfall implementation:** layering sustainability objectives in your investment strategy; and,



3. **Market sustainability evolution:** best practice climate, nature and social solutions.

We focus on the scale of the sustainability opportunity for investors, drawing on discussions with a series of managers, index providers and clients, to provide an understanding on the market's best practice sustainability solutions, redressing the challenges that remain in making such investments.

Summary

Background

Sustainable investment needs remain significant and to deliver global sustainability goals, we will need to scale up sustainable investments by over ~$10 trillion a year, by 2030 (although estimates vary). This is something the public purse will not be able to deliver alone, and investors will need to play a significant role in scaling up sustainability financing.

Mapping sustainability solutions

There is increasing diversity of sustainable themes that are growing traction with investors, and span the asset class universe, with a focus on:

Climate change – to transition to a low carbon economy, and adapt to a physically changing climate;

Nature & biodiversity – to improve the state of global biodiversity, including forestry, agriculture and wetlands, as well as oceans and freshwater systems;

Social issues – to contribute to the social Sustainable Development Goals (SDGs), concentrated under the theme of tackling inequality, including improving access to health, education and financial inclusion, for example.

But these themes do not live in isolation, and we are increasingly seeing sustainability solutions that draw in objectives across these thematic spheres. The holistic consideration of various sustainability themes is what we would consider best practice, and can be accomplished by both layering different sustainable investment opportunities across asset classes in the portfolio, as well as by integrating broad sustainability objectives within a single mandate. To elucidate on this point, we provide some case study examples of some best practice mandates, which we have been working with our clients and investment managers to develop, such as buy and maintain mandates, or Long-Term Asset Funds (LTAFs).

We also note that there remains some challenges to investing in the market's sustainability propositions. Barriers include sustainability barriers – such as the governance burden of extensive due diligence and verification required for sustainable projects – as well as investment barriers – such as the lack of scalability for many propositions. The key point, however, is that managers are developing innovative solutions to overcome these, such as introducing public co-financing, or optionality in which of a fund's underlying projects to invest in (and in so doing, controlling for the associated level of risk) – or in the case of sustainability barriers, hiring sustainability experts to handle the complexities of due diligence of sustainability projects and associated verification with external standards.

Whilst the sustainability industry continues to evolve, there is a significant sustainable investment opportunity for investors to engage with, today.

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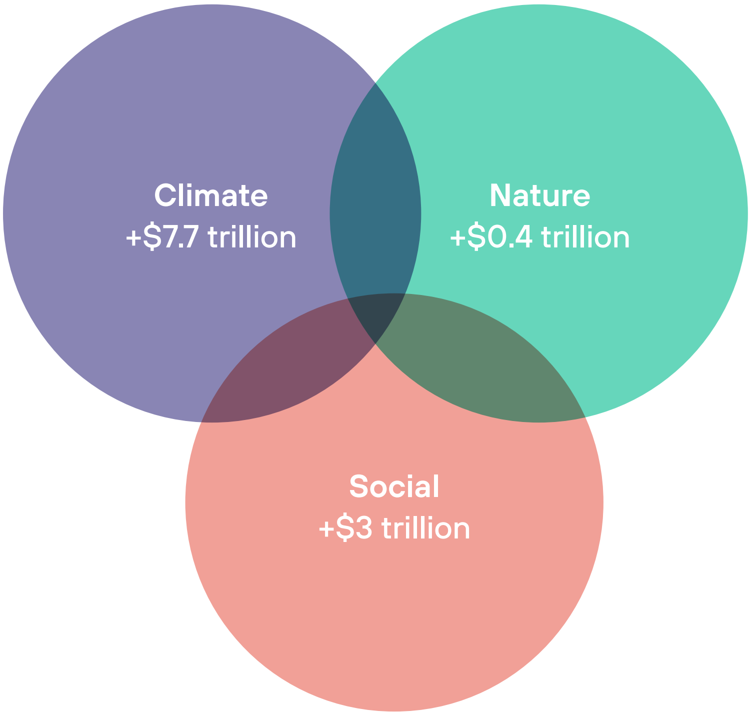
Background

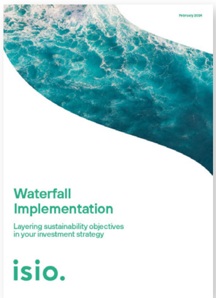
Additional annual financing needs, to 2030, although estimates vary significantly. These are all inter-related, for example climate solutions will include nature-based solutions; we cannot solve one area without the others.



Sources: Climate Policy Initiative, United Nations Environment Programme, and Lagoarde-Segoe.

The period to 2030 will be critical in determining whether we achieve global sustainability ambitions. With the window rapidly closing, investments will need to scale up significantly, including to deliver the decarbonisation and climate adaptation goals of the Paris Agreement, the ambitions of the Global Biodiversity Framework, and wider social and environmental objectives under the Sustainable Development Goals (see left for estimated additional financing needs, to 2030). With the public purse unable to meet these needs, investors will play a substantial role in achieving these target flows.

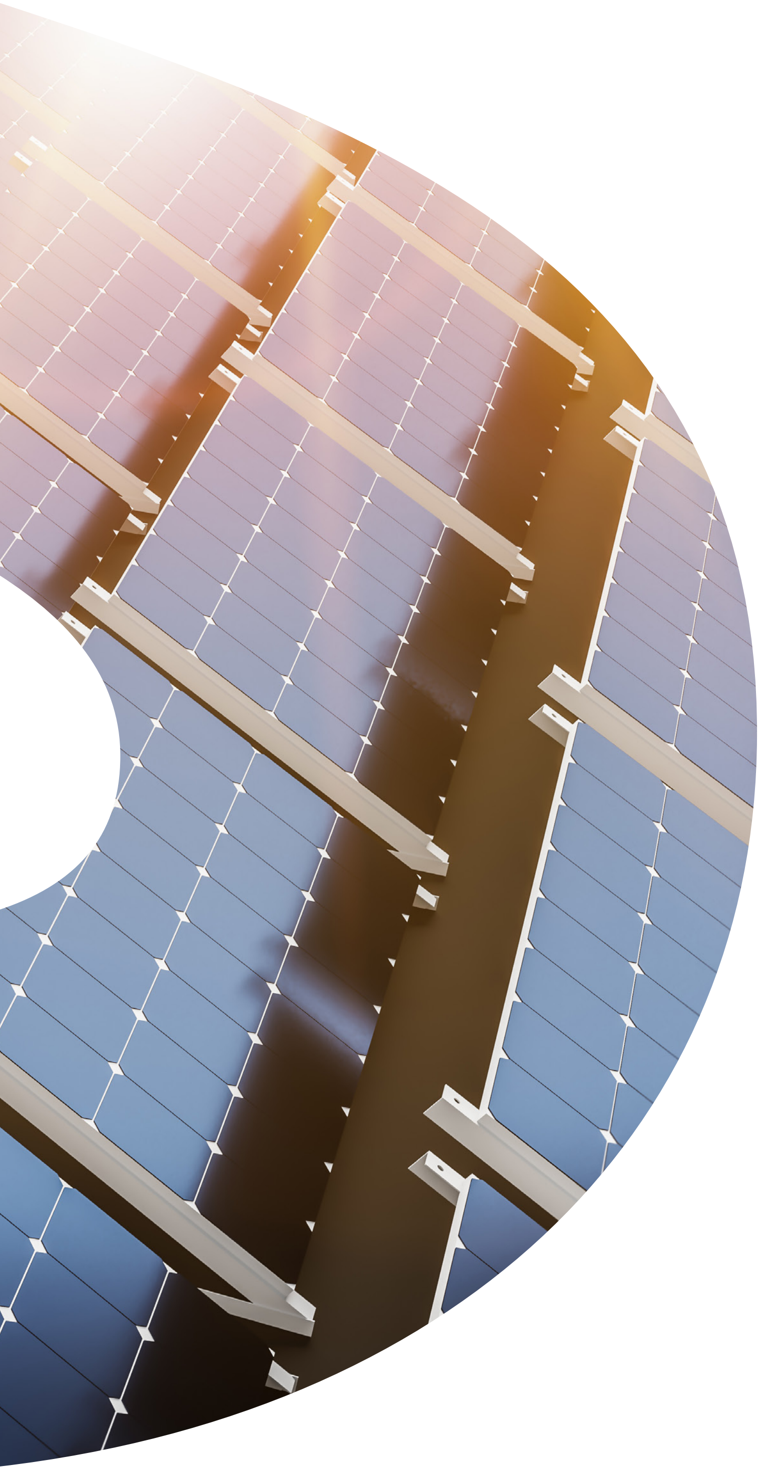
In this paper we focus on implementation opportunities, identifying sustainability solutions across the thematic spectrum. Across the portfolio, different asset classes and mandates can target different sustainability themes and solutions, but should consider the synergies and trade-offs of doing so (as we discuss in the previous paper in this series).



Thematic investment solutions

Investors have historically adopted a strong focus on climate change, often referenced as a climate 'tunnel vision'. Despite this, the climate opportunity remains significantly untapped, with today delivering just 14% of the required annual investment by 2030 (Climate Policy Initiative). With a significant focus on decarbonisation dominating the climate change agenda, we are starting to see stronger attention on investment solutions addressing physical resiliency , or adaptation to shifting weather patterns and increasing natural disasters from climate change, which warrants equal attention.

Nature and climate change are inextricably linked, with the wellbeing of nature an enabler of boosting physical resiliency to climatic changes – whilst nature-based solutions are also central to the achievement of net zero ambitions. Major investor interest in nature-based



solutions is currently concentrated on forestry and timberland, as well as carbon credit exposure that can seek to hedge the portfolio against rising decarbonisation costs. In light of the accelerating rate of biodiversity loss, investors will however need to help engage with less developed areas, such as investments in agriculture to oceans, beyond a siloed focus on offsetting solutions (i.e. restoring trees as a means of taking emissions out of the atmosphere).

The climate and nature agendas are also increasingly adopting a social focus, from the just transition to a low carbon economy (protecting high carbon workers and communities), and the inclusion of local (including indigenous) communities in nature-based projects. But social concerns are rightly receiving attention in their own right, with the impacts of the Covid-19 pandemic and cost-of-living crisis close to home. Social factors however remain extremely broad, and a relatively nascent area for investor focus (versus e.g. climate). But we are seeing a significant increase in social impact investments, such as investments in social housing and social health and education infrastructure (Big Society Capital), in response.

Quantifying the opportunity set

It is not necessarily feasible to quantify the scale of the opportunity set across the whole range of sustainable investment solutions analysed. We however note that some of the (more established) areas have relatively reliable assessments on market opportunity, for example:

- From the asset class perspective, and although estimates vary, one figure regularly cited is that the issuance of green, social and sustainability-linked bonds has reached $1 trillion (World Economic Forum). Whilst estimates of sustainable Initial Public Offerings (IPOs) or the scale of private market sustainability financing becomes more difficult to quantity, we know, for example, that sustainability IPOs remains a niche area of the market (albeit many firms may seek to inflate their sustainability credentials ahead of IPOs).
- From the thematic perspective, some of the more developed areas of the market include investments in decarbonisation and offsetting (with growing investments in nature-based solutions to remove emissions from the atmosphere, in particular). With renewables and low carbon transport financing having reached an estimated $1.3 trillion (Climate Policy Initiative), and sustainable forestry and agriculture over $40 billion (United Nations Environment Programme). Whilst other nascent areas, such as ocean-based investing, remain difficult to quantify.

Next, we set out a mapping of sustainability solutions, for investors to consider in their portfolios.

Mapping sustainability solutions

We provide a high-level overview of some of the sustainability themes receiving increasing attention by investors. These are thematic areas we have been increasingly working on with our clients. (see below table). This is based on discussions with managers and index providers, over the past couple of years. We note the range of innovative sustainable investment solutions continues to grow and so the list below is far from exhaustive.

We also note that individual investment solutions that address climate, nature and social factors, collectively, remain relatively rare - albeit there is a growing market trend to employ this holistic thinking, which is extremely important to adequately reflect the complexity of the sustainability landscape.

Sustainability solutions mapping

Sustainability Mapping	Climate Change		Nature & Biodiversity	Social Issues
	Low carbon transition	Physical changes	Forestry & timberland	Social SDGs, housing & infrastructure
Passive financial assets	**Paris-Aligned indices,** tilting to increase decarbonisation and gain (small) exposure to green revenues. Some integrate biodiversity optimisation. **Carbon hedging,** with exchange-traded funds that provide exposure to carbon credits generated from reducing emissions, providing portfolio hedging against rising carbon prices.	**Indexes with physical risk optimisation**, which is a relatively nascent area. The aim is to use granular physical risks data to reduce exposure to key physical risks (e.g. wildfires, floods).	**Biodiversity optimised indexes**, which tilt towards companies demonstrating biodiversity best practice (e.g. optimising based on mean species abundance, or zero deforestation) . Select **indices integrate forestry and timberland companies**, providing indirect exposure to e.g. timber, or offsetting credits.	**Social indexes e.g.** social bond index funds, with use-of-proceeds earmarked to e.g. healthcare or education. These can be integrated with broader sustainability bond index funds (e.g. integrating sustainability and green bonds also)..
Active financial assets	Concentrating investments on **companies providing solutions** to the **transition to a low carbon economy** (e.g. electric vehicles, or energy efficiency demand side responses). Including **green and sustainable bond** issuance.	**Physical resiliency funds,** mapping physical risks and opportunities onto company or government prospects. This approach can intersect with social (e.g. access to water) and nature concerns (e.g. agricultural sustainability).	Thematic solutions for companies tackling **sustainable agriculture** (e.g. sustainable crops) or **restoring oceans** (e.g. disruption of plastic use). Targeting equity stakes, or green/blue bond issuance (with ringfenced proceeds). Some **DGFs** or **LTAFs** can include exposure to forestry/ timber or sustainable agriculture.	Investments concentrated in **companies with a focus on social innovation** (in e.g. health, education, or financial inclusion).
Real assets	**Low carbon infrastructure funds**, focused on gains from declining technology costs (e.g. low carbon energy and transport, energy efficiency, grids and carbon capture). A building block approach can layer in other opportunities, such as nature-based solutions and social infrastructure.	Investments in **adaptation infrastructure** (e.g. sea walls to protect against sea level rise, or river barriers to protect areas from flooding). This remains a relatively small area of the market. (There is overlap with nature-based solutions e.g. mangroves.)	**Reforestation (or afforestation) strategies,** which can help support net zero targets. These generate offsetting credits. Investers can consider integrating a small impact sleeve focused on broader (riskier) agriculture and oceans solutions, or wider aims (e.g. creation of carbon credits, local jobs).	Broad **social infrastructure funds** focus on e.g. social housing, schools and hospitals. Assets can integrate green clauses on decarbonisation and energy efficiency, whilst environmental assessments for developments/retrofits help to manage biodiversity-related impacts.

Portfolio construction

Ultimately, the above table can be seen as a shopping list, from which investors begin their sustainable investment decision-making process. Or otherwise, a starting point for sustainable investment selections, based on their sustainability priorities. From that point onwards, the focus should be on understanding the synergies and trade-offs with other sustainability (environmental and social) opportunities. This could work in practice by ensuring:

- **Across the sustainable investment strategy**, the investor can target multiple sustainability opportunities aligned with their priorities. For example, targeting different themes according to asset class, such as a sustainable investment strategy that integrates forestry (in real assets), renewables (in private debt) and social bonds with revenues earmarked for e.g. health and education (via corporate bond mandates); and/or,
- **Within individual sustainability mandates**, the investor can integrate various sustainability concerns by layering multiple objectives atop one another. For example, including different sleeves within a private market or Long-Term Asset Fund mandate (with separate sleeves targeting e.g. social housing, reforestation and/or low carbon energy and transport solutions, respectively). Or otherwise, introducing nature and social key performance indicators (KPIs) within a climate aligned mandate (e.g. ensuring decarbonisation targets within an equity mandate also focuses on ensuring underlying investee companies have zero exposure to deforestation).

This requires some initial due diligence by asset owners (with support from their investment consultants), as well as ongoing engagements with investment managers, to continue to push the status quo, and promote the consideration of different sustainability themes holistically. This would enable us to collectively push the market beyond the current, relatively siloed and thematically concentrated approach to sustainability solutions.

Next, we set out some case study examples, of layering various sustainability considerations into individual mandates. We relate this back to the Waterfall Implementation Framework, which we set out in our previous paper .

Case study examples

Case study – Investment Grade Credit

There has been an increased appetite, by clients captured by Taskforce on Climate-related Financial Disclosures (TCFD) requirements, for impactful climate mandates, including buy and maintain mandates targeting investment grade credit (IGC). We have, as part of this, been working with clients and investment managers to integrate broader sustainability considerations beyond climate.

Whilst the focus of these mandates has been on ensuring science-based and ambitious decarbonisation pathways, there has also been a wider focus on considering e.g. resiliency to physical risks from climate change (via modelling efforts), as well as e.g. broader sustainability integration through "impact" investment sleeves (providing exposure to use-of-proceeds bonds earmarked for social/environmental projects including and beyond climate).

On an ongoing basis, engagement with issuers ensures mandates can meet set sustainability objectives, with possible escalation to selectively disinvest where poor performers are unresponsive to engagement. As well as reporting against relevant metrics, to ensure sustainability targets are met.

1. Sustainability priorities
Climate change

2. Asset class priorities
Public markets (IGC)

3. Sustainability objectives
Primary objective: to align with the Paris Agreement on a 1.5°C scenario

Secondary target: e.g. science-based decarbonisation targets

Synergies: e.g. green and social impact bond exposure

4. Monitoring and reporting outcomes
Stewardship and KPI reporting.

Case study – Long-Term Asset Fund (LTAF)

Master Trusts seeking to access impact opportunities in private markets have welcomed the launch of Long-Term Asset Funds (LTAFs). These offer open-ended fund structures, more appropriate for Defined Contribution (DC) members, with associated high liquidity requirements.

Partnering with a Master Trust client and a chosen manager, a building-block approach was adopted to gain exposure to opportunities across the thematic spectrum. The mandate's construction ensured a set proportion of investments tackled decarbonisation (clean energy solutions), physical climate resiliency (climate insurance products), and natural capital (sustainable forestry), as well as social vulnerabilities (social housing).

Ongoing monitoring and active ownership are central tenets to delivering the sustainability aims. This is particularly important for LTAFs given the inertia of underlying exposures (requiring extensive detailed due diligence to ensure the credibility of companies' and assets' sustainability aims in the long-term).

1. Sustainability priorities

Climate change, biodiversity and social equality

2. Asset class priorities

Private markets / infrastructure / natural capital

3. Sustainability objectives

Primary: to align with the Paris Agreement, Global Biodiversity Framework and SDGs (select social goals)

Allocation: target sub-allocations to different sustainability themes

Synergies: e.g. role of sustainable forestry in net zero

4. Monitoring and reporting outcomes

Stewardship and KPI reporting

Overcoming barriers to scale

There remain challenges to investors being able to access some sustainability offerings. But at the same time, **managers have been developing some innovative responses to address these barriers.** We touch on some of the key barriers below, whilst noting this is far from an extensive list.

In terms of **sustainability challenges,** the governance burden of undertaking due diligence on a diverse set of sustainability projects was often cited as a barrier. Many managers have been making strategic hires of sustainability experts to conduct due diligence on the economic return potential of projects, on behalf of clients. With these experts also ensuring a focus on obtaining external verification to ensure compliance with industry standards. In talking to index providers there was also a focus on the possible concentration that can arise from layering multiple sustainability aims within a single index, or otherwise, exclusively seeking out best practice in a single thematic area, which can significantly narrow down the universe, calling into question the "passive" labelling of such solutions.

From the perspective of **investment challenges,** many innovative sustainability solutions lack a track record, or lack scalability. One possible avenue to enabling growth in fund sizes is with building block approaches such as layering climate, nature and social sleeves into a single fund (whilst also promoting sector diversification). This includes through new fund structures such as LTAFs. Another key area of discussion was risks arising from private market investments, including long lock-up periods, J-curve returns, and asset class idiosyncratic risks (e.g. wildfires in forestry). Managers have been responding to some of these investment risks through various avenues – including through public co-financing (or leveraging public-private partnerships to ensure offtake risk is taken on by the public sector).

The individual sustainable investment solution sought will necessarily depend on the type of asset class and mandate exposure being sought out by the individual investor. The encouraging development, however, is that managers are actively seeking out responses to overcome the challenges. These innovative steps to evolve the market will be key from a scaling perspective, to be able to make sustainability **solutions more accessible for a broader set of investors.** This has included some emphasis to reduce the premium on fees for sustainability solutions, particularly where we believe sustainability due diligence and stewardship activities should be a central part of investment managers' ongoing investment approach.

Next steps

In this paper, we have provided examples of sustainability mandates for investors to consider for their portfolios. In the wider series, we have set out the urgent need for investor action towards a sustainable and inclusive future, and an example framework for investors to consider the implementation of their own sustainability strategy, in practice.

Within the rapidly expanding sustainable investment market, it is important to understand your sustainability priorities and set out your forward-looking journey. Investors will have an important role to play in contributing to global sustainability goals moving forward

Please contact your Isio consultant or the Sustainable Investment team (contact information overleaf) if you are interested in discussing this important topic further.

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This series of implementation papers benefitted from discussions with managers, index providers and clients.