



Institute for Energy Economics
and Financial Analysis

Universal Ownership: Decarbonisation in a Hostile Engagement Environment

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Key Findings

Constrained by weak tools and outdated product development that focuses too narrowly on short-term returns, corporate engagement alone cannot achieve the wider decarbonisation of markets.

The recent weaponisation of antitrust and aggressive silencing tactics from investee companies underscores the need for universal owners to be more pragmatic.

Universal owners must urgently collaborate with sovereign stakeholders, push for the rapid adoption of carbon markets, make efforts to stymy climate lobbying, leverage relationships with banks and incorporate divestment into their stewardship toolset.

IEEFA diverges most from existing frameworks by recommending that universal owners consider making bolder allocations to “systemic funds” that specifically seek decarbonisation over short-term returns.



Executive Summary

Universal owners hold long-term investment horizons and such broad economic exposures that they effectively own a small but broadly representative slice of the global economy. It follows that they have a vested interest in the long-term health of global capital markets as a whole because their own returns are largely tied to overall market movements. Universal owners are unable to avoid risks that affect the entirety of the economic system to varying degrees, meaning they must seek to reduce “systemic risk” to protect beta (market) returns. This will often mean addressing the externalities caused by entities held within the universal owner’s own portfolio.

The most foreseeable and potentially damaging systemic risk is of course climate change. Even by making relatively conservative choices in its modelling, a recent study by EDHEC predicts global equity values to compress by about 40%, should we not enact more robust abatement policies and better direct capital to combat climate change. This compares to losses of just 5-10% if prompt and robust abatement action is taken along a two-degree, Paris-aligned pathway.¹ To minimise climate change as a systemic risk, active owners have almost exclusively relied on corporate engagement to drive decarbonisation at investee companies. Yet investors are increasingly questioning whether they can move the needle through discourse and voting. This is particularly true as it relates to engagement with the fossil fuel industry, which continues to disproportionately channel capex into exploration for new reserves, increase production targets and walk back emissions promises.

As the limitations of corporate engagement become more apparent, so too do the realities of the hostile conditions in which stewardship teams operate. The recent weaponisation of antitrust rhetoric in the U.S., coupled with aggressive silencing tactics from investee companies, underscores the need for universal owners to be more pragmatic in their approaches. Universal owners must supplement their active ownership strategies to encourage systemic decarbonisation. To this end, IEEFA proposes several key actions that universal owners should incorporate into their active ownership frameworks, if they are not doing so already:

- **Collaborate with sovereign stakeholders:** Help from governments and policymakers will be essential. These stakeholders are uniquely positioned to create the enabling environment for private sector transition. They also hold controlling interests in state-owned enterprises (and operate state-run industry), which today contribute more to global carbon emissions than investor-owned entities. Far from being bystanders, active owners must join sovereign engagement programmes, such as that piloted by the Principles for Responsible Investment, or otherwise seek to work closely with governments, policymakers and regulators to expedite wider decarbonisation.
- **Endorse carbon markets:** Universal owners must advocate for the adoption of stronger carbon pricing mechanisms and encourage their investee companies to do

¹ EDHEC. [How Does Climate Risk Affect Global Equity Valuations? A Novel Approach](#). July 2024.

the same. Schemes that internalise the costs of emissions have a strong history of promoting rapid behavioural change.

- **Expose and stymy climate lobbying:** Engagement with policymakers will be key. Investee companies must be prevented from undermining efforts in this space through their own climate lobbying agendas. Universal owners must in the first instance demand transparency with a view to immediately halting investee company activity that contradicts stated transition goals.
- **Leverage relationships with banks:** Banks remain pivotal in financing the transition to a low-carbon economy. In many cases, they continue to facilitate fossil fuel expansion, which is at odds with recommendations from the International Energy Agency. Universal owners should make assessments based on banks' wider financing activities and look to reduce or increase their use of ancillary bank services, as appropriate. If well-communicated, stewardship outcomes can also raise public awareness of banking practices, both good and bad.
- **Keep divestment options open:** Far from being solely an exercise in idiosyncratic risk reduction, divestment in secondary markets can bring systemic benefit and should be viewed as symbiotic to engagement. Divestment policies guided by "systemically adjusted" valuation methods (as outlined in previous IEEFA research² would allow for capital to be reallocated to more systemically beneficial investments that often hold similar risk/return profiles.

Finally, IEEFA would argue that action on systemic risk reduction is constrained by traditional product development that is outdated in its overly narrow focus on short-term return generation. This results in myopic interpretations of fiduciary duty even for impact products, which in turn limits how forcefully investors can engage with their investee companies and prevents capital allocation to the areas of the economy that need it the most. In perhaps the largest departure from existing universal ownership frameworks, IEEFA recommends the establishment of "systemic funds" to explicitly target decarbonisation above the need for maximised short-term return generation.

To be clear, investing in decarbonisation is not inherently concessionary, yet by setting fund performance objectives as above-market return (over periods as short as five years), potentially transformative decarbonisation opportunities are likely being systematically overlooked. Viewed only at the level of the fund, systemic funds may appear unappealing; viewed at the universal owner level, the case for such vehicles is clear. As portfolio values are dragged down by ever-more obvious physical damage, asset owners will increasingly seek solutions that might preserve long-term wealth. This makes systemic funds a potentially significant growth market. If carefully constructed—to avoid free-rider and liquidity problems—as a supplement to existing active ownership, systemic funds provide a robust solution to an opportunity set currently inadequate for universal owners.

² IEEFA. [Universal ownership: A call for practical implementation](#). 8 May 2024.

The Universal Owner Problem

The cost of environmental degradation on economic performance is increasingly obvious, manifest through event-driven and chronic physical risks to companies, both direct and indirect. Countless examples of acute infrastructure damage, supply chain disruption and power outages can, for example, be paired with trends of increased resource costs and rising insurance premiums. Against this backdrop, even through the lens of single materiality,³ it is typically the fiduciary duty of asset managers and owners to recognise and avoid such risks to their portfolios. This presents a significant problem for the universal owner, a concept popularised by Hawley and Williams.⁴ Universal owners hold such broad economic exposures and long-term investment horizons that they are unable to selectively allocate away from growing environmental risks. This means that for the universal owner, beta (market) returns *must* be protected, with the only means of hedging against systemic risk being to encourage change in the economy at large. Often this will mean addressing the externalities caused by entities held within the portfolio itself.

Idiosyncratic risk

Risk distinct to investing in a particular asset (such as company securities) or a group of assets with shared characteristics (such as an industry or country). Sometimes referred to as specific risk, it can be minimised through portfolio diversification.

Systemic risk

Risk that affects the entire global marketplace (to varying degrees) and must therefore be shouldered if investing in a broadly diversified portfolio. Examples include global macroeconomic factors, pandemics and climate change.

The scale of the universal owner problem is laid bare in recent IEEFA research⁵ that draws attention to the self-destructive nature of existing equity holdings and uses Norway's Government Pension Fund Global as a case study. Designed as a proof of concept and using the social cost of carbon as a simplified barometer of damage, the report illustrates how in 2023 alone the externalities of just five portfolio constituents imply a gross performance drag of around -0.36%, through the destruction of earnings that would otherwise ultimately be distributed to shareholders. The same research also discusses one part of the problem when it comes to solving externality-based wealth destruction: the failure of universal owners to effectively integrate theory into valuation models, stewardship and decision-making. In short, IEEFA proposes that universal owners adopt "systemically adjusted" models to better understand the true value proposition of an asset in the context of impacts on the wider portfolio. Integrating such analysis into investment processes would allow for better

³ Single materiality relates to how environmental and social factors can affect the operations and consequently value of a company, often referred to as the "outside-in" effect. Single materiality is not concerned with the impact that the same company itself may have on the environment and society (the "inside-out" effect). To consider both is referred to as double materiality.

⁴ James Hawley and Andrew Williams. *The Emergence of Universal Owners*. Challenge. Volume 43:4, pages 43-61. 2000.

⁵ IEEFA. *Universal ownership: A call for practical implementation*. 8 May 2024.

prioritisation of resources, correct for misalignment between the goals of investment teams and those of the universal owner as a whole, and help frame climate-based stewardship in quantitative, fiduciary terms—reducing reliance on more ambiguous guiding principles. However, an investment approach guided by systemically adjusted analysis also needs to be accompanied by a robust stewardship framework that targets systemic risk reduction. Simply put, such analysis might allow universal owners to better understand true asset value, but they must also effectively act on that information.

Universal Ownership Frameworks: Engagement Is King

Impact-based universal ownership frameworks that seek systemic decarbonisation already exist, including that put forward by Quigley,⁶ who advocates in the first instance for an approach split by asset class. In primary markets such as credit issuance, initial public offerings (IPOs) and private equity, universal owners should prioritise excluding company issuance that contributes substantially to systemic risks (while simultaneously failing/refusing to make transition efforts). On the other hand, “forceful stewardship” should be prioritised in secondary markets such as public equity. The latter refers to employing some of the pricklier tools available to asset owners when interacting with their investee companies and entails more than simple environmentally friendly proxy voting policies. For example, asset owners should actively look to remove/replace directors in light of environmental intransigence, support “vote no” campaigns and force executive remuneration packages to include environmental and social metrics.

Figure 1: Quigley’s Asset Class-Based Universal Ownership Approach (Simplified)

	Engagement (Forceful stewardship)	Divestment (Exclusion)
Primary markets (Credit issuance, IPOs, private equity, special purpose vehicles, etc.)		✓
Secondary markets (Bond trading, public equities, etc.)	✓	

Source: Quigley.⁷

Note: IEEFA visual simplification. Recommendations extend beyond an asset class approach, as illustrated above.

⁶ The Centre for the Study of Existential Risk. [Universal Ownership in Practice: A Practical Positive Investment Framework for Asset Owners](#). 22 July 2020.

⁷ Ibid.

This binary “engage equity, deny debt” approach is justified by Quigley on the grounds that capital expenditure is propped up by a company’s ongoing fundraising efforts, which by and large are carried out through primary markets. Should investors turn their back on credit issuance or refuse to participate in IPOs (or indeed pressure banks to reduce loan facilities and underwriting services), financing options become less abundant and more expensive. In theory, this reduces the ability for divested companies to expand carbon-intensive operations, by raising the cost of capital. Alternatively, companies can change their behaviour to prevent the lending squeeze. This is particularly true of smaller companies, less able to fall back on established profit streams as a source of funding. But it has also impacted the scale of projects even at industry heavyweights. One often-cited example is that of Adani, which in 2020 pared back plans for the world’s largest mining operation at the Carmichael site in Australia following activist pressure that triggered external financing constraints.

Given that secondary market activity doesn’t normally impact fundraising, Quigley’s framework does not regard divestment in this space to be a sufficiently potent tool for influencing investee company decision-making. What public equity *does* offer is a say in how the investee company is run, typically through direct access to management and voting at shareholder resolutions. In theory, the opportunity for engagement is far greater than in primary markets, and an approach split by asset class can therefore be symbiotic.

It is worth highlighting that subsequent discourse from Quigley⁸ has hinted at the potential for a more nuanced approach—one in which secondary market divestment, for example, plays a bigger role as part of a more holistic approach. Yet the train of thought favouring direct company engagement in secondary markets tends to echo across academia⁹ and industry initiatives alike. The United Nations Principles for Responsible Investment (PRI) remains lukewarm on divestment in secondary markets as part of its highly influential Active Ownership 2.0¹⁰ framework, another model for stewardship closely linked to universal ownership and systemic goals.¹¹ The PRI concedes that the threat of divestment may be necessary to ensure certain companies are receptive to engagement. But it points to mixed evidence on whether divestment itself leads companies to adopt more sustainable practices,¹² strongly favouring a collaborative engagement approach. Evidenced by weak firm-level exclusionary policies and the fact only a minority (18%) of managers¹³ even specify escalation steps for failed engagement, for now, corporate engagement remains king and is by far the most practised method for tackling systemic risk reduction.

⁸ Ellen Quigley. [Evidence-based climate impact: A financial product framework](#). *Energy Research & Social Science*. Volume 105. November 2023.

⁹ SSRN. [Divestment: Advantages and Disadvantages for the University of Cambridge](#). Appendix IV. 24 May 2021.

¹⁰ Principles for Responsible Investment. [Active Ownership 2.0](#).

¹¹ Principles for Responsible Investment and United Nations Environment Programme Finance Initiative. [Universal Ownership: Why environmental externalities matter to institutional investors](#), 2021.

¹² Principles for Responsible Investment. [Discussing divestment: Developing an approach when pursuing sustainability outcomes in listed equities](#). 4 April 2022.

¹³ ShareAction. [Power in Numbers? An assessment of CA100+ engagement on climate change](#). 19 May 2022.

Examining Engagement’s Mixed Track Record—Weak Tools, Weak Will?

Systemic risk reduction has been left predominantly to corporate engagement, but growing scepticism surrounds active owners’ ability to effect meaningful idiosyncratic behavioural change—let alone systemic change—through discourse and voting. Investable fossil fuel companies continue to expand production targets and walk back promises, while at a system level, active ownership’s best efforts at engagement have clearly not stymied spiralling global carbon emissions. Moreover, “successful” engagement outcomes are typically associated only with unambitious goals.¹⁴ IEEFA would agree that improved disclosure, the adoption of often questionable proprietary standards, or poorly defined medium- and long-term alignment targets (easily walked back following inaction) cannot realistically be deemed material given the size of transformation required. Indeed, many of these outcomes might actually be better understood as delay tactics from investee companies.

Among investors, the tide of sentiment has turned from an atmosphere of early optimism in the wake of COP26, to one of growing frustration. PGIM recently noted “a growing realisation – and genuine bewilderment – that engagement for positive sustainability outcomes is not living up to the expectations of its proponents”.¹⁵ The trillion-dollar manager concludes that successful, systemically beneficial engagement hinges almost entirely on whether an investor can propose win-win scenarios, underlining how difficult it is to achieve successful outcomes when environmental and social goals do not obviously align with a company’s immediate financial goals. Improved disclosure is easy to achieve as it typically falls in this win-win category; disclosure provides the market with potentially actionable information, costs the investee company relatively little and can even result in improved environmental, social and governance (ESG) ratings (simply by dint of improved transparency). Disclosure, however, doesn’t ask for behavioural change or directly serve to reduce systemic risk. Conversely, asking a company to implement costly Paris alignment is more likely to be win-lose, certainly in the immediate term. This becomes increasingly true when net-zero goals conflict directly with long-established core business models, such as is the case with the fossil fuel industry.

The fact it is hard to persuade high-carbon-emitting company management to implement costly Paris alignment will come as a surprise to no one, but PGIM’s recently broadcast frustration does confirm that when an investor is unable to alter behaviour through gentle persuasion, there is little it can do through current methods of stewardship to actually force change. This would seem to corroborate research¹⁶ that casts doubt on whether the existing tools available to universal owners are currently strong enough to affect climate outcomes. Other industry participants might disagree entirely. For example, UK asset manager Schroders recently published an assessment of its ability to achieve emissions reductions through engagement, finding that “committed engagement” on climate change saw a 31% reduction in Scope 1 and 2 emissions intensity, compared to a 7% reduction for an

¹⁴ Tom Gosling. [Universal Owners and Climate Change](#). 2 February 2024.

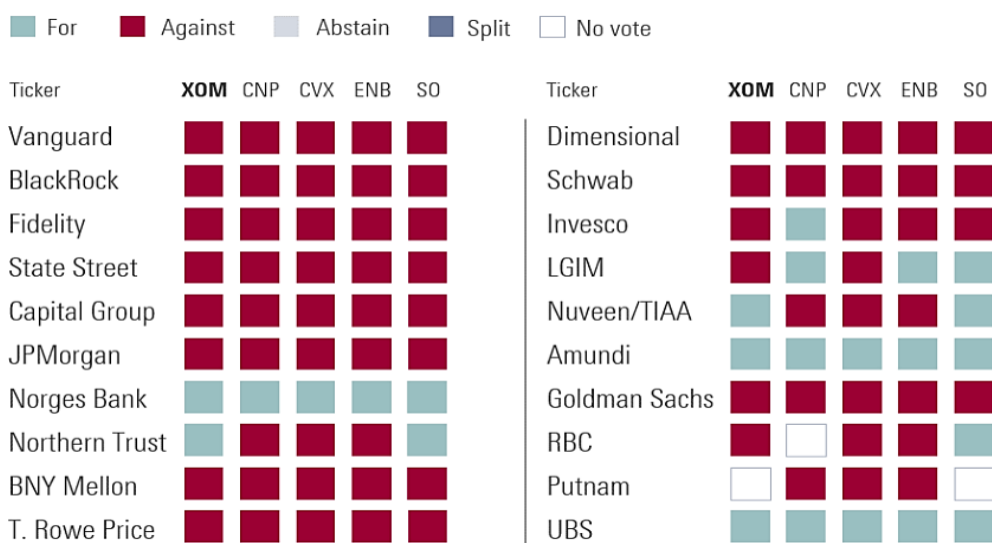
¹⁵ PGIM. [Great Expectations: Is engagement living up to its promise?](#) March 2024.

¹⁶ Tom Gosling. [Universal Owners and Climate Change](#). 2 February 2024.

unengaged peer group.¹⁷ Despite this, Schroders’ analysis stops short of confirming direct causal links, perhaps owing to other, unmeasured variables. For example, stewardship resource is likely to have been quite sensibly directed towards companies and sectors deemed receptive to engagement and therefore more likely to decarbonise. A breakdown of Schroders’ analysis is not available by sector, but such positive additionality is unlikely to extend to the fossil fuel sector, where behavioural change is most acutely required.

Not only is it difficult for investors to forcibly move the needle through engagement in obvious win-lose situations, but voting records confirm stewardship remains feeble at some of the world’s biggest carbon polluters. This is illustrated by investor demand for Scope 3 emissions targets. Although chronically underreported, Scope 3 emissions are an example of an “un-gameable”¹⁸ metric proposed by Quigley, in that they are absolute and not open to misinterpretation. Feasibly, targets to reduce Scope 3 emissions could lead to actual behavioural change and systemic risk reduction, should management be judged on their ability to achieve them. One might expect universal owners to be champing at the bit to see targets installed, yet Morningstar proxy voting analysis (as seen in Figure 2 below) says otherwise. Figure 2 visualises the voting practices of the top 20 shareholders of Exxon Mobil (XOM). Revealingly, only five owners voted in favour of putting Scope 3 emissions targets in place at the supermajor; only three—Norges Bank, Amundi and UBS—consistently demanded the same at similar resolutions put forward at other companies. You would be hard pressed to say this was indicative of the forceful stewardship recommended by Quigley.

Figure 2: Asset Managers’ 2023 Voting Records on Resolutions Requesting Scope 3 Emissions Targets



Source: Morningstar Direct, Morningstar proxy-voting database, asset manager disclosures. Data as of 29 January 2024.

¹⁷ Schroders. [How engaging on climate can achieve emissions reductions and enhance returns](#). 3 April 2024.

¹⁸ The Centre for the Study of Existential Risk. [Universal Ownership in Practice: A Practical Positive Investment Framework for Asset Owners](#). 22 July 2020.

Perhaps shedding light on reticence from major universal owners, Gosling¹⁹ concludes that strict decarbonisation targets, although likely to be most societally beneficial, are not likely to be financially maximising. This, he argues, creates fiduciary concerns for investors that lack a specific climate-based mandate from their clients, reflecting sentiment held by anti-ESG lobbying in the U.S. and which ultimately forms the basis of antitrust rhetoric. This situation is further complicated in the case of asset managers (as opposed to owners) that typically act as agents on behalf of thousands of clients. The majority of asset managers undoubtedly do fall under the universal owner banner, but their clients (the beneficial owners) may not. Consider a pooled fund participant that is invested entirely in one of BlackRock's global energy exchange-traded funds—it would be difficult to define them as a universal owner, given a selectively outsized exposure to the energy sector. If BlackRock was to then employ forceful engagement tactics to benefit its wider investments at the expense of energy sector profitability, consternation from our hypothetical participant is understandable. Would BlackRock be acting in that participant's best interests by pursuing potentially expensive net-zero commitments at fossil fuel companies? Arguably the answer is still yes, given the growing risks associated with failure to transition, but certainly such conflict puts asset managers in a tight spot.

Given that strict decarbonisation targets are not likely to be financially maximising and that tools available to bring about systemic change are weak, in the absence of an overriding environmental mandate Gosling finds that universal owners may be better served targeting modest systemic goals rather than immediate and full decarbonisation along a 1.5-degree pathway. This is something that may well be reflected in the voting patterns seen in Figure 2. Seeking more modest goals based on fiduciary duty is extremely contentious, however. The future path of climate damage is notoriously difficult to predict, and to scale back systemic stewardship ambitions in the name of short-term fiduciary duty risks ignoring potentially catastrophic tail risks²⁰ associated with failing to achieve a sub-1.5-degree (or even two-degree) target. Despite all this, we must concede that Gosling has a point under incumbent investment structures. Almost all investment vehicles, including most impact products, maintain relatively short-term (up to five-year) financial performance objectives. Given such myopic time frames, it is little wonder that reducing potentially devastating systemic risk is demoted in importance.

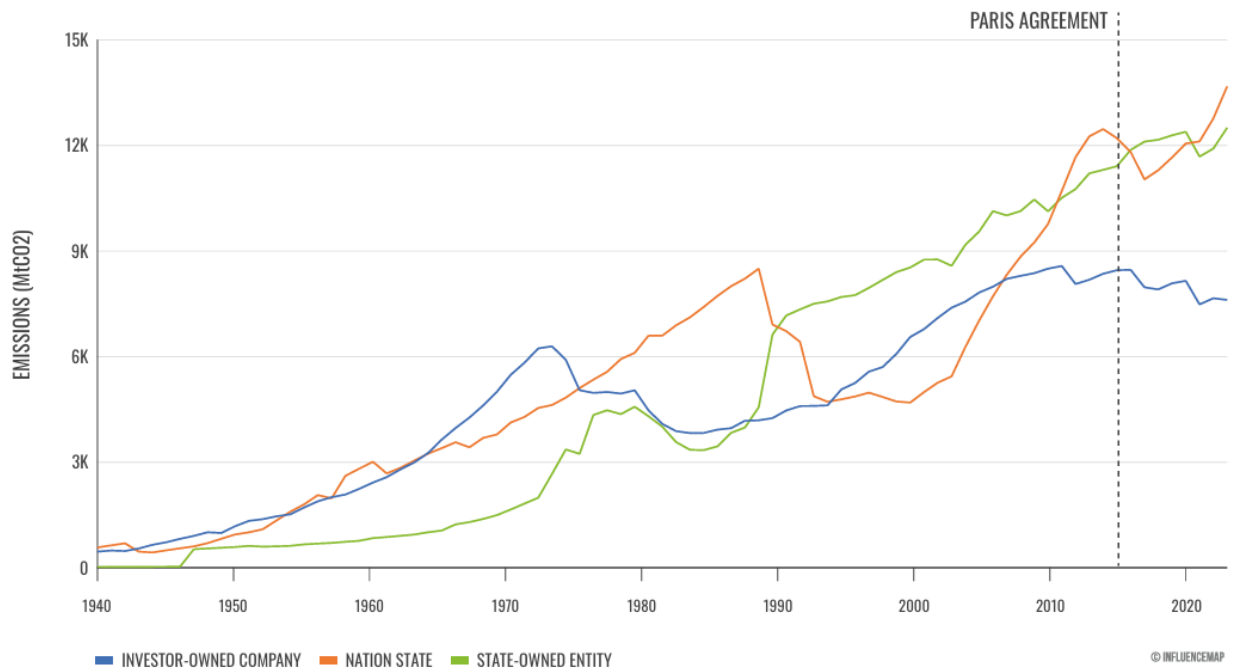
Engagement is likely constrained, therefore, by the fact that there is neither the will nor the way for it to succeed under limitations imposed by traditional performance horizons and incumbent product development. Recent negativity towards engagement seems warranted, particularly as it relates to engagement with the energy sector. Yet demanding behavioural change at fossil fuel companies, with core business models at odds with the transition, was always likely to have been the most difficult task. Given the fossil fuel industry accounts for the lion's share of carbon emissions (on a Scope 3 emissions basis), dialogue and voting practices under the status quo cannot alone be expected to get us to broader net-zero goals. Despite this, it would be a little dismissive to suggest that corporate engagement has not at least been influential. This is especially true when looking past fossil fuel companies and "hard-to-abate" industries, where short-term competitive positions rely on

¹⁹ Ibid.

²⁰ "Tail risk" in this instance refers to currently unexpected (low-probability) climate change scenarios occurring, with severe financial consequences.

the proliferation of carbon-intensive activity. Measuring the specific additionality of engagement (that is, real-world decarbonisation outcomes) is an entirely separate discussion, but the recently updated Carbon Majors database does give some reason for hope in this regard, despite making for otherwise gloomy reading. The blue line in Figure 3 shows emissions from investor-owned sources have plateaued, perhaps even declined over the past decade. This trajectory appears too shallow to achieve net zero by 2050 but contrasts starkly with the emissions of state-owned enterprises and nation-states, which continue to track upwards, seemingly inexorably. These latter emissions remain by and large out of reach of normal shareholder activism given only small ownership stakes are possible (if at all). Obviously, this investor-owned pattern cannot be entirely attributed to corporate engagement as the prevailing stewardship approach, but if it forms part of this qualified success story, it would be counterproductive to simply give up on it. In line with PGIM’s recent thinking, engagement has likely been influential, without being entirely transformational.

Figure 3: Emissions by Entity Type (1940-2022)



Source: Carbon Majors. *The Carbon Majors Database: Launch Report*. April 2024.

A “New”, More Hostile Engagement Environment

As the limitations of corporate engagement become apparent, so too do the realities of the hostile conditions in which stewardship teams operate. The political **weaponisation of antitrust** considerations and **aggressive silencing tactics** from investee companies are relatively new developments, but to label these emergent obstacles as part of a new paradigm would probably be generous. More likely, we are simply bearing witness to the visible endgame for a model of stubborn environmental intransigence that has been with us all along—particularly at oil and gas supermajors that are unwilling, or perhaps unable, to transition to low-carbon solutions. Below, we touch on issues having a further constraining effect on engagement. Overcoming, or at least sidestepping, these challenges could be key to unlocking universal ownership solutions, particularly as it relates to employing more forceful methods in secondary markets like public equities.

Antitrust Concerns, Weaponised

Antitrust legislation commonly shields consumers from predatory business practices that might result in inflated prices or a lack of choice. As part of a phenomenon largely restricted to the U.S., political stakeholders have accused collaborative shareholder engagement initiatives of collusive behaviour, which, they theorise, will ultimately lead to more expensive financial products and/or a failure to prioritise the stated financial goals on behalf of the consumers of their products. Many observers including the U.S. Sustainable Investment Forum point out that such claims rest on tenuous legal ground for several reasons, not least because: “[First,] it would be difficult to demonstrate that the commitments made by signatories rise to the level of an agreement, and second, even if the commitments could be considered an agreement, such an agreement is unlikely to produce anticompetitive effects.”²¹ The PRI has also addressed this antitrust challenge head on, arguing that collaborative engagements are designed and facilitated “in a way that we believe enables investors to maintain compliance with rules and regulations in key markets, including anti-trust and securities laws in the U.S.”²² To date, not one antitrust case has been brought against asset managers.

Regardless, the extent of antitrust’s destabilising influence can be seen at a beleaguered Climate Action 100+ (CA100+), the investor-led initiative backed by the PRI, founded to “ensure the world’s largest corporate greenhouse gas emitters take necessary action on climate change”.²³ CA100+ got off to a strong start in 2019, and membership boomed under an introductory phase. Initial successes such as persuading Shell to make carbon reduction pledges in 2020 added to optimism. Possibly noting such successes, the seed of antitrust protest took root in right-leaning U.S. political circles, coming fully into bloom as CA100+ entered its second phase (designed to improve and expand the ways in which investors could participate, while further enhancing the investor engagement model). Most of the very largest asset managers suddenly got cold feet and have since retracted their

²¹ U.S. Sustainable Investment Forum. [US SIF and Sphere release new legal analysis that counters claims of anti-trust violations](#). 22 May 2024.

²² Reuters. [Climate investor group seeks to shore up support after US exits](#). 22 February 2024.

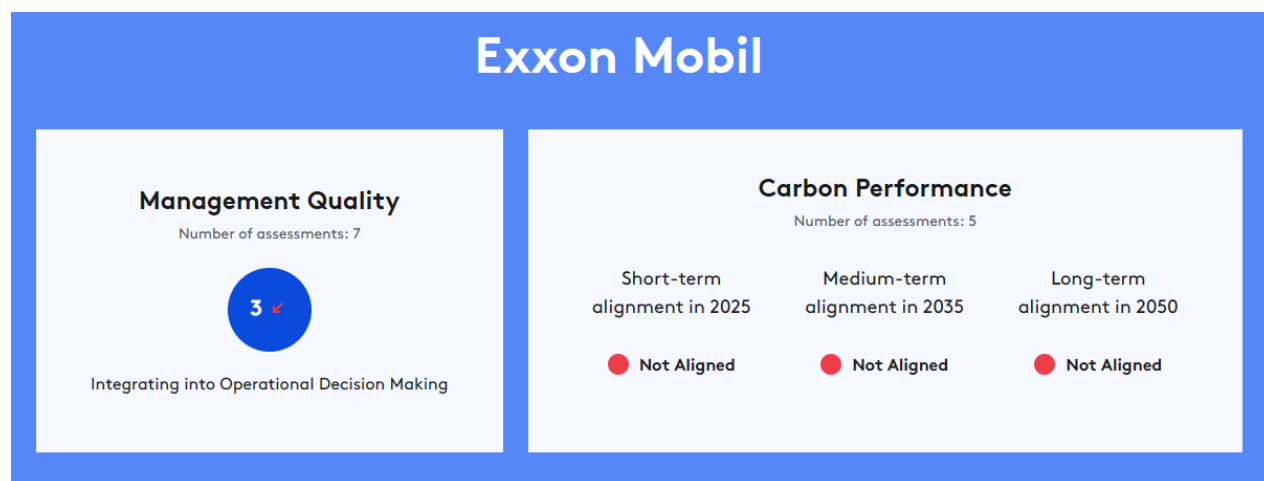
²³ [Climate Action 100+](#).

membership. Given the evacuation has been led by U.S. managers, we can surmise that recent backpedalling is more a function of business risks associated with taking a perceived political stance, rather than a genuine belief that antitrust accusations have legs. However, antitrust has provided managers with a solid excuse for retreat as the political climate has deteriorated. Proponents of anti-ESG agendas, it would appear, have found an effective weapon in antitrust rhetoric.

Aggressive Anti-activist Litigation

Antitrust concerns are not the only proverbial fly in the ointment. A striking precedent has been set in the case of Exxon Mobil versus Arjuna Capital, one that might already have fundamentally changed the dynamics of engagement in secondary markets. IEEFA’s recent analysis²⁴ pegged Exxon as the developed world’s largest carbon polluter on a Scope 3 basis. Despite this, the supermajor does not convincingly incorporate climate change risks or opportunities into its corporate strategy, nor does it produce credible transition plans over the short, medium or long term. Unlike many of its peers, Exxon refuses to publish information on Scope 3 emissions or lobbying activities.

Figure 4: Exxon Mobil’s Poor Transition Credentials



Source: Transition Pathway Initiative. Note: Latest assessment carried out in June 2023.

Naturally, one might expect investors to be interested in acquiring some of this information given the materiality to investment decision-making. Arjuna Capital certainly thought so, co-filing a resolution with activist group Follow This, asking the company to report on how it planned to adapt its business model to align with a decarbonising economy. Couched in terms of transition risk, the resolution called for the supermajor to set more aggressive emissions-cutting targets.²⁵ The problem for Arjuna was that this resolution was the latest in a string of substantively similar proposals. Although not an uncommon occurrence, having previously fended off questions about the appropriateness of its

²⁴ IEEFA. [Universal ownership: A call for practical implementation](#). 8 May 2024.

²⁵ Reuters. [Exxon pursues lawsuit despite activist investor climb-down](#). 3 February 2024.

business model, Exxon fired back—not with a complaint to the U.S. Securities and Exchange Commission about proposal belligerence, but with a lawsuit.



Direct company engagement may increasingly become untenable for some investors for fear of legal repercussion.

Despite successfully cowing Arjuna into a retraction, Exxon alarmingly persisted with litigation. It insisted that the lawsuit related not so much to any one resolution but represented a response to broader “concerns about the shareholder proposal process and the need for clarity and fairness in evaluating such proposals”.²⁶ Exxon’s litigation was ultimately dismissed but only after Arjuna agreed to restrain from filing any further resolutions related to greenhouse gas emissions. Such silencing tactics signify a total breakdown in typical engagement processes and have set a worrying precedent. Indeed, direct company engagement may increasingly become untenable for some investors for fear of legal repercussion.

What Can Universal Owners Do About it?

Under increasingly (or at least, more obviously) hostile engagement conditions, pragmatism is required. IEEFA certainly does not propose that corporate engagement is suddenly redundant. Indeed, outside of engagement with fossil fuel companies, win-win engagement scenarios are easier cases to argue, but the fact remains that investors face an uphill battle, particularly in this sector. Faced with growing obstacles, universal owners must acknowledge the limitations of an overreliance on discourse and voting and look to supplement their systemic decarbonisation strategies. What IEEFA recommends is ultimately an adaptation of existing frameworks, which benefits from a clearer understanding of a more challenging engagement environment than perhaps previously anticipated. Combined with better integration of systemically adjusted analysis,²⁷ the recommendations described below provide a platform for universal owners, including asset managers, to meaningfully reduce the climate-related externalities that damage shareholder wealth.

Support Sovereign Engagement Programmes

Despite climate change presenting significant risks to government budgets and the competitive positions of national economies, the sovereign debt market has not been subject to the same levels of systematic ESG scrutiny when compared to other asset types. Many investors directly engage with governmental authorities to better understand fiscal and monetary policies, yet assessments of progress towards decarbonisation are mostly overlooked during this process. This is despite these assessments being similarly essential to bond pricing and understanding the long-term health of

²⁶ Exxon Mobil. [2024 Shareholder proposal lawsuit – Our responsibility to fight back](#). 29 February 2024.

²⁷ IEEFA. [Universal ownership: A call for practical implementation](#). 8 May 2024.

sovereign investments. Engagement programmes, such as that in pilot at the PRI,²⁸ bring investors together to change this and to reap the wider benefits of closer ties between governments and financial institutions when tackling climate externalities.



Certain sources of carbon emissions aren't directly accessible through capital markets, meaning universal owners must engage with sovereign owners if they truly hope to reduce systemic risk.

Such programmes are critically important to universal owners because governments are uniquely positioned to effect change within their respective economies. Not only can they provide an enabling environment for the private sector, but they directly hold controlling interests in state-owned enterprises and state-run industry. Indeed, although much of the discourse on existing active ownership is thought of in terms of how to approach investor-owned entities—as the Carbon Majors database makes clear in Figure 3—the largest carbon polluters are in fact now state-owned or -controlled. The world's single largest polluting investor-owned entity (Exxon) doesn't even break into the top 10 emitters list, based on data for 2016-2022.²⁹ Quite simply, certain sources of carbon emissions aren't directly accessible through capital markets, meaning universal owners must engage with sovereign owners if they truly hope to reduce systemic risk.

Access to capital markets remains critical to government borrowing, meaning universal owners, as significant holders of sovereign debt, may hold substantial leverage over government decision-making. This is especially true during times of financial stress, persistent inflation and elevated interest rates. Clearly, however, to pull the rug from under some of the largest sovereign polluters through the suspension of debt buying would likely be counterproductive as national stakeholders become less, not more, able to enact decarbonisation goals. Similarly, pushing for an overly aggressive transition policy as part of engagement could have unintended adverse “second-order” impacts, including:

- Unreliable or unaffordable energy supply
- Significant inflationary pressure
- Rising unemployment
- Retaliatory industrial policy from other nations
- Geopolitical shifts and disrupted trade patterns

Norges Bank Investment Management, which manages Norway's sovereign wealth fund, recently voiced concerns related to financial market overreach into industrial policy.³⁰ It argued that the

²⁸ Principles for Responsible Investment. [Collaborative Sovereign Engagement on Climate Change](#). 28 June 2024.

²⁹ Carbon Majors. [The Carbon Majors Database: Launch Report](#). April 2024.

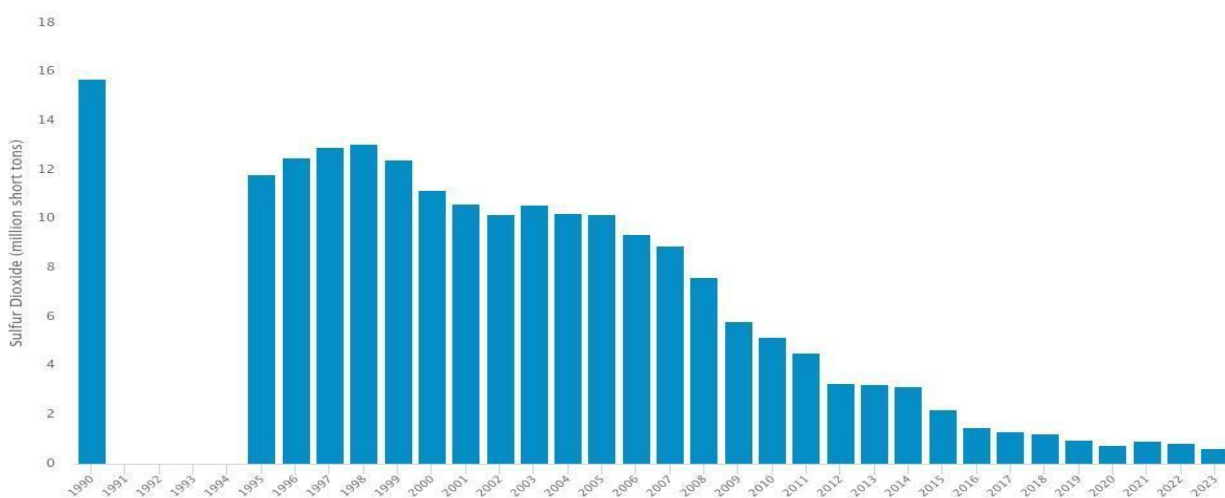
³⁰ Norges Bank Investment Management. [PRI Strategy Consultation “Responding to a Changing World”](#). 14 May 2024.

expertise required to understand second-order impacts (such as those listed above) is lacking at most asset owners/managers. Deteriorating economic outlooks or social cohesion might in turn result in falling political and popular support for net-zero goals. It is for this reason that universal owners must be willing to collaborate closely with sovereign policymakers—not only to help design policies but to support them by facilitating the investment structures and capital flows that will ultimately allow sovereigns to enact decarbonisation plans. Dialogue between financial market participants and governmental entities will allow for a cohesive strategy including blended finance agreements. As the PRI has identified in its sovereign engagement programme, a collaborative approach is mutually beneficial and should be supported by universal owners wherever possible. Even where universal owners are restrained from joining collaborative initiatives by the threat of antitrust, efforts should be made separately to seek out opportunities for open dialogue in this space.

Push for the Rapid Adoption of Carbon Markets

Advocating for more aggressive carbon pricing may fall under the domain of sovereign and policy engagement, but it is worth singling out given its significance and that universal owners should encourage investee companies to do the same. Despite relative inaction on global warming, governments have proven themselves capable of swiftly effecting environmental change. Amendments to the U.S. Clean Air Act in 1990, for example, effectively halted acid rain, urban smog, toxic air pollution and ozone layer depletion within two decades in the country—having received bipartisan political support. IEEFA would highlight the role that carbon markets can play and draw direct parallels between current CO₂-based emissions trading schemes and the sulphur dioxide cap-and-trade system established under the U.S. Acid Rain Program. Examples like the Acid Rain Program prove that by legislating for externalised costs to be internalised, the goals of universal owners and companies can quickly align.

Figure 5: U.S. Annual Sulphur Dioxide Emissions



Source: [U.S. Environmental Protection Agency](#).

Note: Data unavailable for 1991-1994.

Recent IEEFA research suggests that the redistribution of externalised costs back to carbon emitters will in all likelihood increase significantly over the coming decades, but engagement with policymakers to ensure that this process happens as quickly as possible will be critical.³¹ IEEFA estimates the receipts from carbon pricing globally amount to just 1% of the present and future economic cost of environmental damage caused by those emissions.³² This means that across jurisdictions there is quite some way to go before the cost of carbon becomes a meaningful transitional tool.

Encapsulating the profound impact that carbon markets are expected to have on company behaviour, Exxon's CEO discussed during an investor call how the supermajor's low-carbon business has the potential to generate hundreds of billions of dollars, enough even to eclipse current revenues based on its existing oil- and gas-dominated business (US\$345 billion³³). The president of Exxon's Low Carbon Business Solutions unit further confirmed that just how quickly the company transitions to such a business model rests on regulatory and policy support for carbon pricing specifically.³⁴

Demand Transparency on Climate Lobbying

Engagement with sovereigns, policymakers and regulators will be crucial over the coming years. It is vital that universal owners ensure investee companies do not undermine those efforts through their own climate lobbying practices. Lobbying has proven to be a highly potent weapon in the arsenal of carbon-intensive industry, stretching back decades.³⁵ Through lobbying, oil and gas majors—along with manufacturing and utilities companies—have played a significant role in promoting climate denial, doubt and delay.³⁶ In terms of measurable activity in this space, US-based trade associations opposing climate policies spent US\$3.4 billion on political activities between 2008-2018.³⁷ Direct lobbying, grants and political contributions made up US\$1.4 billion of that (with the lion's share spent on advertising and promotion), dwarfing similar spends from climate-supporting groups by a ratio of 27:1.³⁸ This measurable activity is just the tip of the iceberg given the prevalence of backchanneling and the fact that additional, untraceable expenditure is likely to be multiples higher. Targets are also no longer simply political; reports of an escalation in lobbying at the U.S. Securities and Exchange Commission began to surface in 2021.³⁹ These efforts started bearing fruit this year through watered-down corporate climate risk rules and Scope 3 emissions being removed entirely from financial disclosure requirements.⁴⁰ The negative externalities associated with lobbying efforts are clear, even if they are difficult to precisely quantify.

³¹ IEEFA. [Carbon pricing: Governments increasingly make polluters pay for climate change](#). 30 May 2024.

³² Ibid.

³³ Exxon Mobil. [ExxonMobil announces 2023 results](#). 2 February 2024.

³⁴ Reuters. [Exxon says its decarbonization business could outgrow oil, in multi-trillion market](#). 4 April 2023.

³⁵ Benjamin Franta. [Early oil industry disinformation on global warming](#). *Environmental Politics*. Volume 30:4. 5 January 2021.

³⁶ Emily L Williams et al. [The American electric utility industry's role in promoting climate denial, doubt, and delay](#). *Environmental Research Letters*. Volume 17:4. 1 September 2022.

³⁷ Robert Brulle and Christian Downie. [Following the money: trade associations, political activity and climate change](#). *Climatic Change*. Volume 175:11. 2022.

³⁸ Ibid.

³⁹ Financial Times. [Fossil fuel groups step up lobbying of SEC to dilute climate reporting rules](#). 2 August 2021.

⁴⁰ Reuters. [Exclusive: US regulator drops some emissions disclosure requirements from draft climate rules](#). 23 February 2024.

Work is still required to improve company reporting on environmental and social issues, particularly in terms of nature-related disclosures. But the situation has improved significantly over the past few years. Thanks in no small part to improvements in regulatory environments and reporting standards, universal owners increasingly have the information needed to assess whether a company is on the right track to meet Paris alignment goals. Despite this, transparency on lobbying activity remains elusive. If universal owners are struggling to move the needle at investee companies on obvious win-lose engagements, perhaps the next most realistic target for engagement is to insist on climate lobbying transparency, with a view to reducing it. Although obviously not a clear win-win scenario, providing transparency on lobbying activity does not, for example, ask fossil fuel companies to enact changes to core business models that might be idiosyncratically damaging. With improved transparency, investors should at the very least be able to argue for a halt to lobbying that clearly contradicts public transition promises.

Leverage Relationships With Banks

Corporate loan facilities, project financing and the provision of underwriting from banks continue to play a major role in the expansionary activity of fossil fuel companies, particularly those unable to fund projects entirely from existing revenue streams. In such instances, it may be possible for universal owners to impact the cost of capital by leveraging their relationships with banks, both in their capacity as significant shareholders and as clients.

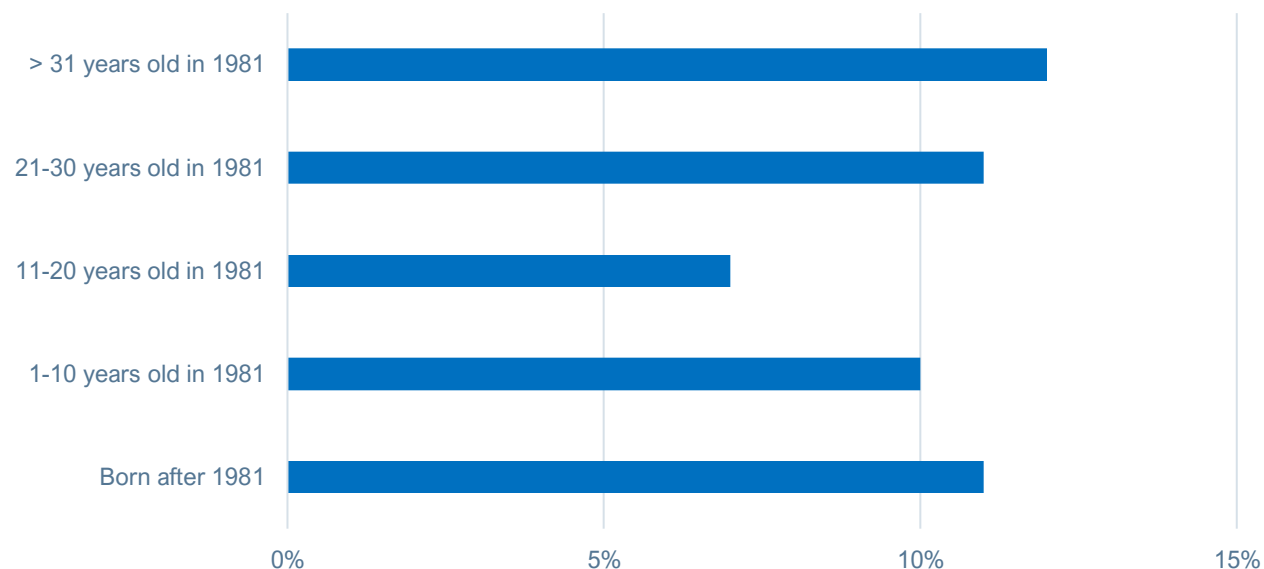
Barclays was recently confirmed by Rainforest Action Network⁴¹ to be Europe's largest fossil fuel financier. It has been a perpetual laggard when applying environmental restrictions to lending policies. Earlier this year, however, following protracted investor engagement and high-profile activist pressure, the British lender announced it will cease direct financing for new oil and gas projects and no longer lend to companies planning to expand fossil fuel production.⁴² Barclays' acquiescence is arguably a function of growing credit risks associated with lending to the fossil fuel industry,⁴³ but the bank will also have been acutely aware of growing negative publicity. Investment banks often operate profitable consumer-facing retail arms, where image remains critical.

The court of public opinion can present a genuine business risk, as Barclays discovered in the early 1980s. Before ending institutional investment support for the South African apartheid regime, public recognition of Barclays' business activity saw prospective customers look elsewhere. Students in particular turned to competitors, a pattern still evident in Barclays' customer demographics even decades later—a lasting scar left by well-publicised activism. The conditions underlying Barclays' recent announcement are yet to truly manifest, but certainly such occurrences might indicate that targeting banks for more forceful and well-publicised stewardship may prove more fruitful than directly targeting significant carbon emitters.

⁴¹ Rainforest Action Network. [Banking on Climate Chaos 2024](#).

⁴² BBC News. [Barclays to end direct financing of new oil and gas fields](#). 9 February 2024.

⁴³ IEEFA. [A matter of opinion: Credit rating agencies evolve on climate change, fossil fuel risk](#). 14 March 2024.

Figure 6: Barclays UK Savings Account Penetration in 2015 (By Age in 1981)

Source: Statista, IEEFA, based on a 2015 survey of retail consumers that asked which products (if any) individuals held from Barclays. Data shown for savings products only.

As significant shareholders of major global banks, universal owners have the platform to raise awareness through their engagement, but they also typically also act as important consumers of banks' services. This means they are well-placed to leverage their positions as institutional clients. Asset managers, for example, often employ banks for fund administration and accounting, trading services, collateral management and custody, including the provision of local regulatory oversight. Universal owners should make assessments based on banks' wider financing activities and look to reduce or increase their use of ancillary bank services, as appropriate. Further publicising the reasons behind operational decisions like changing bank relationships can only serve to amplify effectiveness.

Keep Divestment Options Open

IEEFA has made the case on multiple occasions for the divestment of fossil fuels in secondary markets on the grounds of idiosyncratic financial prudence.⁴⁴ The historical performance of fossil fuel players is now entirely reflective of an industry in decline, which—aside from periods of occasional geopolitical instability—has been a near-constant disappointment to investors for well over a decade. As companies continue to demonstrate intransigence in the face of ever-growing transition risks, the outlook for the industry remains bleak. This is a compelling argument, yet it is not to suggest that blanket divestment is the only option available to universal owners that might further seek systemic decarbonisation to benefit their wider portfolio. Nor does it mean that corporate engagement should not be attempted. Despite often being pitched as a binary choice, engagement and divestment

⁴⁴ IEEFA, [The Financial Case for Fossil Fuel Divestment](#).

should be viewed as entirely symbiotic,⁴⁵ with divestment a natural escalation strategy. The International Association of Insurance Supervisors, for example, views divestment as a meaningful and even necessary complement to engagement strategies:

“In order to be effective, an engagement strategy with the investee company may include exercising voting rights as a shareholder, sending letters to or attending meetings with the management of investee companies, setting up documented and time-bound engagement in actions or shareholder dialogue with specific sustainability objectives, planning escalation measures in case those objectives are not achieved, **including reductions of investments or exclusion decisions.**”⁴⁶

Opponents of divestment may even find the financial case for doing so appealing, yet argue that the resulting loss of influence at investee companies is counterproductive to achieving systemic decarbonisation goals. This argument only holds up if investors can evidence meaningful behavioural change as a result of engagement—a situation that appears rarely true of engagement with fossil fuel producers, which in most cases continue to disproportionately direct capex towards further exploration and expand production targets. Where engagement over time has failed, for universal owners to continue committing resource to this process becomes meaningless at best, costly at the very least and potentially destructive if it gives the impression of remedial action being taken when it is not. In such situations, and to **avoid “engagement washing”**, divestment should remain on the stewardship table.

Far from being solely an exercise in idiosyncratic risk reduction, divestment in secondary markets brings with it potentially considerable systemic benefits, not least because the knowledge that it will be routinely enacted **serves as a deterrent** to companies that might otherwise ignore engagement efforts. It is worth understanding why this deterrent exists, despite the fact that small divestments in secondary markets are often assessed by academia as having little impact on borrowing costs, implying that it cannot influence executives’ decision-making.⁴⁷



Far from being solely an exercise in idiosyncratic risk reduction, divestment in secondary markets brings with it potentially considerable systemic benefits.

Firstly, divestment even by small actors can influence the actions of a much broader universe of investors.^{48,49} By delegitimising certain business activities, larger investors may reconsider their investments, **shifting market norms at large**. Discourse of divestment also tends to

⁴⁵ IEEFA. [Engagement and Divestment: Shareholders Transcend a False Binary](#). September 2024.

⁴⁶ The International Association of Insurance Supervisors. [Application Paper on the Supervision of Climate-related Risks in the Insurance Sector](#). May 2021.

⁴⁷ Jonathan Berk and Jules H. van Binsbergen. [The Impact of Impact Investing](#). Law & Economics Center at George Mason University Scalia Law School Research Paper Series. No. 22-008. 23 August 2021.

⁴⁸ Marti et al. [The Impact of Sustainable Investing: A Multidisciplinary Review](#). Journal of Management Studies. Volume 61:5. 2 June 2023.

⁴⁹ Ceres. [The Role of Investors in Supporting Better Corporate ESG Performance](#). February 2019.

underappreciate the fact that supply-demand tipping points exist, beyond which prices might become meaningfully pressurised over the longer term. It may simply take a **critical mass** of divestment by investors (around 10-20% of the market) to initiate the “bursting of the carbon bubble”,⁵⁰ while the point at which a company starts to “pay more serious attention to the expectations of their shareholders would likely precede any tipping point for the price of their securities”.⁵¹ Further study has observed correlations between divestment decisions and reduction in carbon emissions at divested firms.⁵² If we are to understand that this latter point is not because the cost of capital is impacted, this perhaps points to the **share price incentivisation of management**. This is to say that executives’ remuneration (paid typically as deferred company shares) is naturally tied to the price performance of a company, providing personal motivation for management to reverse selling activity and associated negative news flows that could hamper price performance.⁵³

If divestment is managed correctly and accompanying messaging delivered constructively, it sends a **clear signal to policymakers** that corporate engagement on its own is not a panacea. It simultaneously **free up capital for reallocation** to more progressive peers, sustainability-linked bonds, green bonds, renewable energy solutions and infrastructure. These assets often hold similar financial risk/return profiles but serve to reduce externalities. A good divestment policy should not simply be designed to encourage change at companies harming wider portfolio value. It should also redistribute funds into systemically beneficial investments.

Routinely exercised, divestment can:

- Act as **deterrent** to companies that may otherwise grow complacent, ensuring they remain receptive to engagement.
- Send a clear **signal to policymakers** and regulators where intervention is required.
- Help to delegitimise certain business activities and **shift market norms at large**.
- Provide a **counter to engagement washing** concerns.
- **Free up capital for reallocation** to positive externality-generating assets such as renewable energy, sustainability-linked bonds and green bonds, often with similar risk/ return profiles.
- Contribute to reaching a **critical mass of divestment** so that the supply-demand tipping point is crossed and the share or bond price is affected.

⁵⁰ Birte Ewers et al. [Divestment may burst the carbon bubble if investors' beliefs tip to anticipating strong future climate policy](#). February 2019.

⁵¹ ShareAction. [Undermining transition, risking capital: RISE Guidance Paper #3](#). June 2024.

⁵² Martin Rohleder, Marco Wilkens and Jonas Zink. [The effects of mutual fund decarbonization on stock prices and carbon emissions](#). Journal of Banking & Finance. Volume 134. 2022.

⁵³ Nickolay Gantchev, Mariassunta Giannetti and Rachel Li. [Does Money Talk? Divestitures and Corporate Environmental and Social Policies](#). Review of Finance. Volume 26:6. November 2022.

- Threaten remuneration and thus **incentivise executives** to alter company behaviour.
- Potentially impact the **cost of capital** for some companies, particularly through primary market exclusions and in the case of smaller market participants.
- Improve ex-ante portfolio risk/return profiles. The compelling **financial case** for removing industries facing extreme transitional headwinds grows stronger yearly.

IEEFA's proposal for universal owners to keep divestment on the table in secondary markets diverges from recommendations made by the likes of Quigley and the PRI; it aligns more closely with ShareAction's recent Responsible Investment Standards and Expectations (RISE) framework.⁵⁴ Both of the former approaches are well-reasoned and logical but are founded on the assumption that discourse and voting practice will be strong enough to bring about meaningful behavioural change alone. Particularly as it relates to the fossil fuel industry, this seems increasingly dubious.

But what should divestment look like? Blanket divestment is of course an option that works for universal owners that adopt strong social or environmental stances, agree the compelling financial case for divestment applies to an entire industry that is unable/unwilling to transition, lack the capacity to carry out granular company assessments or otherwise believe they can achieve more by allocating resources elsewhere. However, the typical universal owner is not simply chasing environmental outcomes at any cost. Universal owners should instead weigh the costs that result from enabling carbon-intensive activity against the expected returns from making that investment—much like how the social cost of carbon is used in public cost-benefit analysis—to inform allocation decisions. This is the basis of a systemically adjusted approach, which values assets in the context of wider portfolio effects. For more information on this process, see IEEFA's previous research on the topic.⁵⁵

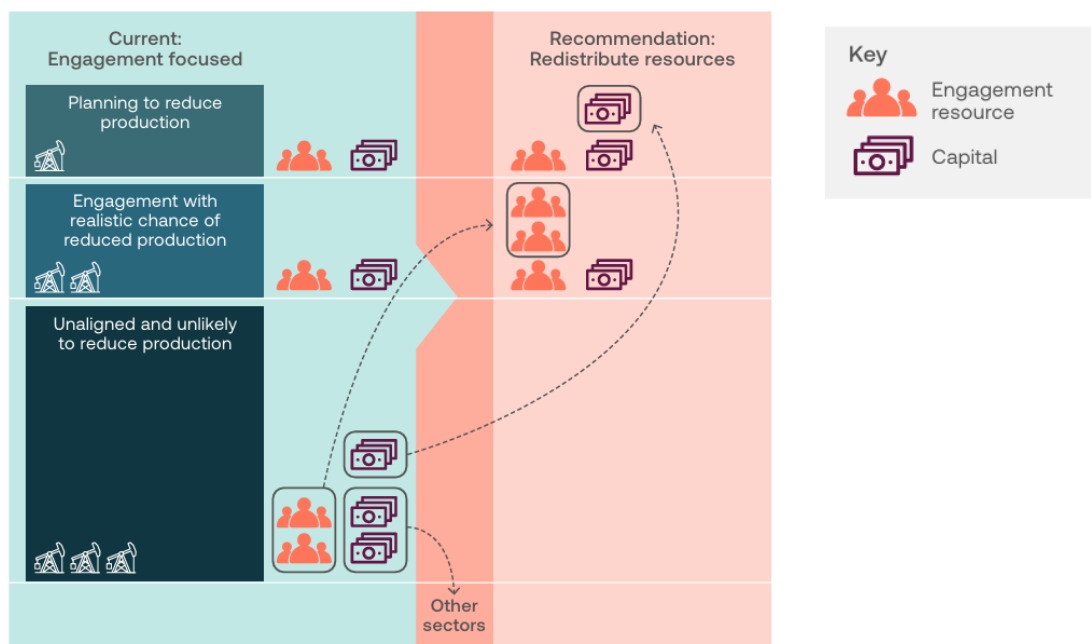
That research also sets out a method for identifying companies that require “enhanced stewardship”.⁵⁶ This is to say, companies that exhibit expected upside to fair value at the asset level but whose upside is outweighed by the negative impact of that company's activity on the remainder of an investor's holdings. In the first instance, companies in this valuation band should be engaged with to ascertain whether there is a chance for behavioural change. Where this has been attempted and it is clear that it will not be possible to reduce externalities through engagement, capital should be reallocated in a fashion similar to that put forward by ShareAction's RISE framework.⁵⁷ RISE advocates for both engagement resource *and* capital to be selectively redistributed away from such companies.

⁵⁴ ShareAction. [Undermining transition, risking capital: RISE Guidance Paper #3](#). June 2024.

⁵⁵ IEEFA. [Universal ownership: A call for practical implementation](#). 8 May 2024. (See page 14).

⁵⁶ Ibid. See page 14.

⁵⁷ ShareAction. [Undermining transition, risking capital: RISE Guidance Paper #3](#). June 2024.

Figure 7: Capital and Engagement Resource Reallocation Model from ShareAction’s RISE


Source: ShareAction.⁵⁸

By applying systemic valuation adjustments, therefore, a selective divestment, or “tilting”, approach might result based on a trade-off between the expected idiosyncratic upside, severity of externality, credibility of a company’s transition plan and its receptiveness to engagement. It is worth noting that for now at least, selective and blanket divestment approaches might ultimately result in broadly similar outcomes. For example, Danske Bank AM’s divestment policy, announced earlier this year, will cut its investable universe of oil and gas companies by around 90%. Similarly, Dutch pension fund PFZW’s case-by-case approach has resulted in only seven fossil fuel companies being retained in portfolios, on the basis that they are “convincingly committed to switching from fossil fuel to low carbon energy sources”.⁵⁹

Systemic Funds—a US\$5 Trillion Growth Market?

Part of the problem for asset owners looking to tackle systemic risk through their investments is that their opportunity set is lacking. In the active space, products that might promote systemic decarbonisation continue to be held back by short-term performance objectives, while the proliferation of negatively screened passive offerings means this is perhaps an area more immediately suited to the reduction of idiosyncratic risk. IEEFA would argue that there is space in the market for a new breed of impact product, one which clearly prioritises systemic risk reduction *ahead of* short-term performance. Such vehicles for now are few and far between, or at least remain

⁵⁸ Ibid.

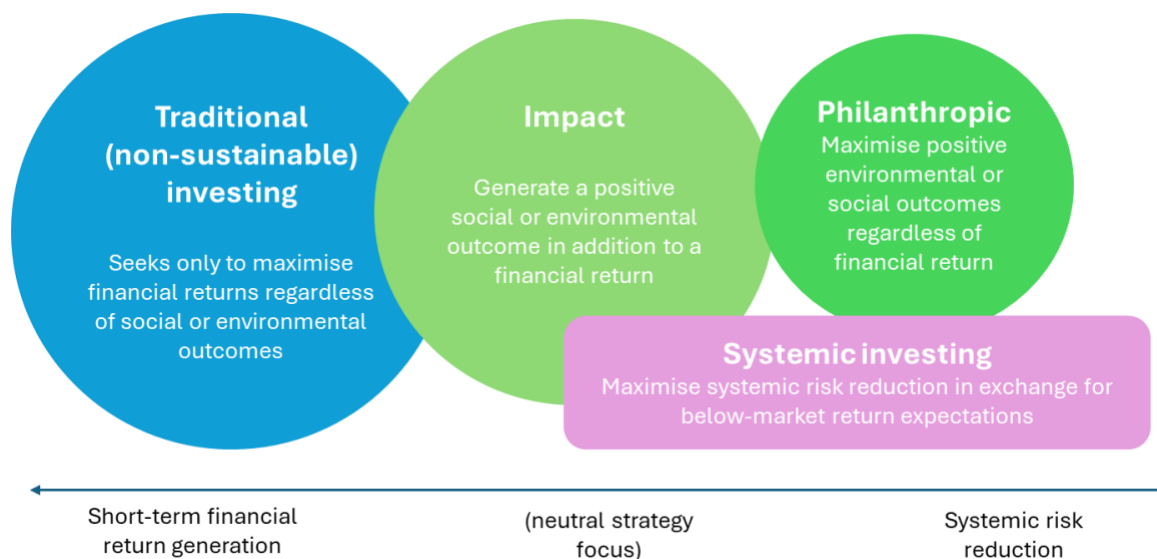
⁵⁹ PFZW. [Only seven listed oil and gas companies retained in PFZW investment portfolio](#). February 2024.

difficult to discern from less systemically minded counterparts. As we will touch on, this is likely to be a function of both outdated product development and a hitherto lack of clarity as to whether sustainable investing can satisfy legal definitions of fiduciary duty. The latter at least appears to be catching up with modern understanding of the valuation risks posed by climate change. As portfolio values are dragged down by ever-more obvious physical damage, asset owners will increasingly look for solutions that might preserve long-term wealth. This makes systemic funds a potentially significant growth market. Carved from the traditional impact segment, IEEFA contends that systemic funds present a considerable business opportunity for asset managers to exploit.

Systemic Investing—a More Purposeful Form of Impact

Systemic investing can be considered a currently niche subset of impact. Whereas impact funds quite broadly seek financial returns *alongside* positive social or environmental outcomes, systemic funds should more narrowly adopt at- or below-market short-term financial return expectations to pursue more aggressive systemic risk reduction. Lower near-term return expectations aside, systemic investing is arguably more self-serving as a philosophy than impact investing. This is because the positive social or environmental outcomes are a means to an end, as opposed to the ultimate goal. Systemic funds should not aim to simply generate societal benefit but to reduce negative externalities that damage investor wealth. Naturally, these goals will be well-aligned, but a systemic approach should focus on outcomes that are likely to be most financially material, as opposed to societally beneficial. Because of this inherent selfishness, systemic investing should not be confused with philanthropy, even if taken to its furthest concessionary reaches (such as return generation removed as an objective entirely).

Figure 8: Investment Strategies on a Financial Return vs. Systemic Benefit Scale



Source: IEEFA.

Why a New Category is Needed

Either through outdated product development or simply due to inherent limitations, existing impact offerings are broadly ill-suited to the genuinely forceful reduction of systemic risk. Below we touch on some of the factors that underscore why new products are required and why it is that so far neither existing active nor passive approaches have resulted in vehicles properly equipped to counter significant tail risks posed to wider investment portfolios.

Active Investing’s Performance Blinkers

Given one is a subset of the other, differences between IEEFA’s proposed systemic investing and impact investing are nuanced, yet they are meaningful. To perhaps best illustrate this, the vast majority of existing active impact products still interpret the financial half of their mandate as maximising risk-adjusted returns, just with the caveat that investments must additionally pass a minimum social or environmental bar. This remains most obvious where alpha (excess return versus a benchmark) appears as an investment objective.

Figure 9: Example Impact Fund Investment Objectives

Baillie Gifford Positive Change Fund - Class 1
 Accumulation Shares - ISIN GB00BYVGKV59
 This Fund is a sub-fund of Baillie Gifford Investment Funds ICVC. Baillie Gifford & Co Limited is the Authorised Corporate Director of the Fund.

Objectives and investment policy
Objective
 • The Fund aims to outperform (after deduction of costs) the MSCI ACWI Index, as stated in sterling, by at least 2% per annum over rolling five-year periods.
 • The Fund also aims to contribute to a more sustainable and inclusive world through investing in companies whose products and/or services contribute to impact themes addressing critical social and/or environmental challenges, measured over at least a five-year period.

M&G Climate Solutions Fund
 a sub-fund of M&G Investment Funds (10)
 Sterling Class A – Accumulation shares ISIN no. GB00B03QK194
 Managed by M&G Securities Limited

Objective and investment policy
Objective:
 The fund aims to:
 • provide a combination of capital growth and income to deliver a return net of the Ongoing Charges Figure that is higher than the MSCI World Index over any five-year period; and
 • invest in companies that aim to deliver solutions to the challenge of climate change.

Aviva Investors Climate Transition Global Equity Fund, Class 2, Accumulation Shares
 Investors Investment Funds ICVC (ISIN: GB00BLNQ1978). The Fund is managed by Aviva Investors.

OBJECTIVES AND INVESTMENT POLICY
Objective: The Fund aims to grow your investment and provide an average annual net return greater than the MSCI® All Country World Index (the "Index") over a 5 year rolling period by investing in shares of global companies responding to climate change by orientating their business models to be resilient in a warmer climate and a lower carbon economy; or providing solutions to mitigate climate change or help communities adapt to the adverse impacts of climate change.

abrdn SICAV II – Global Impact Equity A Acc EUR
 A Acc EUR
 ISIN: LU2534880344 SEDOL: BP69PS8 Valoren: 122238870
Fund objective
 The Fund aims to provide long term growth by investing in companies listed globally that aim to create positive measurable environmental and/ or social impacts.
 The Fund aims to outperform MSCI AC World Index (USD) benchmark before charges.

Source: [Baillie Gifford](#), [M&G](#), [Aviva](#), [Abrdn](#).

These relatively short-term performance objectives are a holdover from standard active product development, where they have matured for good reason—asset owners have demanded them to

prevent giving their investment managers too much rope for fiduciary underachievement. The investment management industry has responded in kind by offering products with investment processes built to outperform over these time horizons. Put simply, asset managers are heavily incentivised to focus on idiosyncratic return generation over the course of a handful of years because that is what they are ultimately judged on, relegating the importance of addressing longer-term systemic issues like carbon emissions.

The problem, particularly as it relates to impact products, is that this process ultimately constrains any potential systemic benefit. In terms of climate change, it is quite likely that the greatest decarbonisation opportunities are less attractive on a risk-adjusted, five-year forward-looking basis. They may be early-stage technologies requiring capital to develop, or perhaps success is contingent on governments providing the enabling environment. Equally, they may involve encouraging carbon-intensive companies to make business decisions that are idiosyncratically damaging in the short term. To be clear, investing in climate solutions is by no means inherently concessionary, and impact product managers can reasonably expect to outperform wider benchmarks. But by setting the performance bar as above-market return over periods as short as five years, significant and potentially transformative decarbonisation opportunities are likely being systematically overlooked.

This blinkered approach to product development understandably proliferated while looming systemic risks were poorly recognised. But it appears increasingly anachronistic now that asset owners better understand the dangers of ignoring environmental issues. Studies such as EDHEC's assessment of climate impacts on equity valuations spell out the likely damage to long-term wealth accumulation.⁶⁰ Even by making relatively conservative choices in its modelling, EDHEC expects global equity values will compress by 40% versus a no climate damages baseline, assuming we fail to effectively enact more robust abatement policies and better direct capital flows into climate change mitigation and adaptation. By starting from a base of below-market, but acceptable return expectations, a systemic investment process can more aggressively allocate and/or engage to achieve maximum reductions to systemic risk. Presupposing that the most impactful investments are those less likely to generate a short-term return is perhaps overly pessimistic, but such an investment strategy can clearly go further than traditional impact investing because it needs not cherry-pick only the most profitable opportunities.

Passive Investing's Negativity Problem

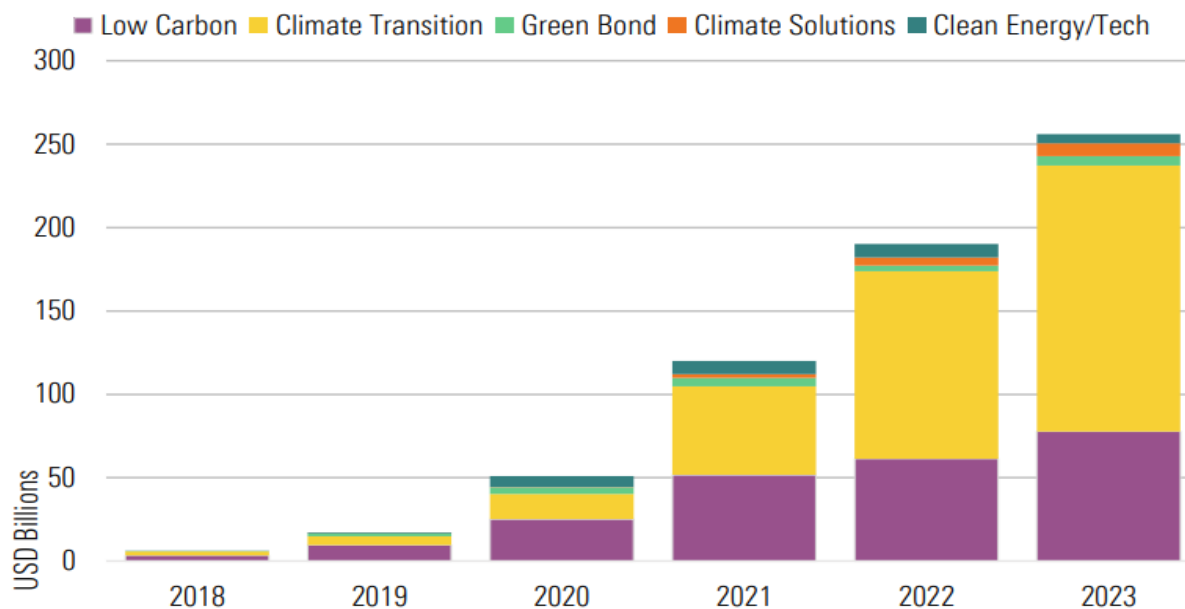
Inherent limitations in passive investing as an approach constrain its ability to combat systemic risk. To understand why, we need only look at how the marketplace has developed. Today, European investors dominate ownership, with the region accounting for the overwhelming majority of assets under management in Morningstar's "climate-fund" universe.⁶¹ Within Europe, the last few years have seen explosive growth in "climate-transition" products. No longer deemed too illiquid or risky compared to their standard counterparts, equity indices with reduced fossil fuel exposure "have

⁶⁰ EDHEC. [How Does Climate Risk Affect Global Equity Valuations? A Novel Approach](#). July 2024.

⁶¹ Morningstar. [Investing in Times of Climate Change: 2023 in Review](#). April 2024.

proliferated, passed major funds' prudence tests, and been adopted without significant transaction costs".⁶² As seen in the growth of both yellow and purple bars in Figure 10 below, the passive climate-fund market is now dominated by products tracking Paris-aligned and climate transition benchmarks or that otherwise negatively screen standard indices based on carbon emissions.

Figure 10: Assets in European Passive Climate Funds



Source: *Morningstar*. April 2024.

Exclusionary screening has understandably risen to prominence because the drivers of environmental damage are broadly quantifiable through emissions. European Union regulation has further legitimised these approaches through the standardisation of index construction. This means that carving out the worst climate offenders from a standard benchmark is at least somewhat objective, even if some industry commentators remind us that there is in fact “no such thing as passive Paris alignment”.⁶³ Conversely, making assessments of the enablers of decarbonisation remains quite subjective and, therefore, largely the domain of active investing. This is not to say that positively screened ESG indices don't exist but that patently active decisions must be made during their construction. Passive climate solutions, even when simply tracking a climate index, might be better understood as active investment products following quantitative processes that have been decided by index providers.

Although negatively screened standard indices have become the dominant force, first and foremost they present an opportunity for investors to reduce idiosyncratic risk. This is to say that by tracking such indices, an asset owner reduces exposure to an increasingly speculative market segment facing grim prospects in a low-carbon economy. For reasons detailed previously (see Keep

⁶² IEEFA. *Passive investing in a warming world*. February 2024.

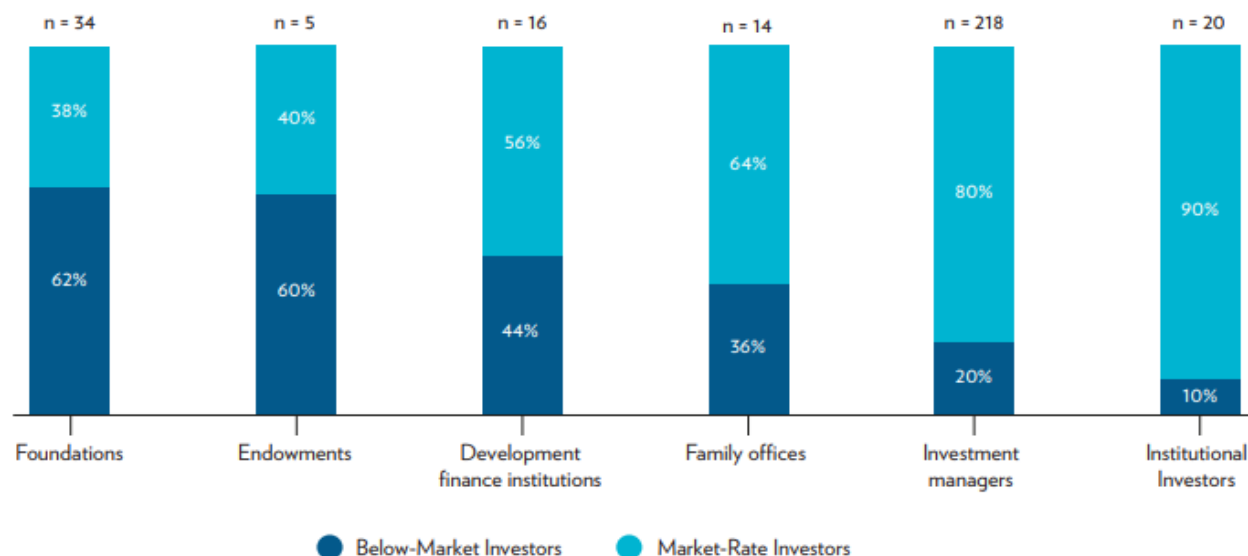
⁶³ Storebrand. *Climate Change Benchmarks: The Passive Pretenders*. 14 March 2023.

Divestment Options Open section), decarbonising passive investment portfolios can ultimately bring long-term systemic benefit. IEEFA would strongly encourage passive asset owners to adopt low-carbon indices. With that said, driving systemic benefit through this approach is likely to be a slow, steady march that perhaps snowballs as carbon-intensive industry is increasingly de-legitimised. It is unlikely to stimulate the immediate and transformative market shifts that some investors will feel are urgently required. Reducing exposure to carbon-intensive industry does not, for example, specifically channel capital into the development of climate solutions or demand more forceful corporate engagement. Some will take the view that a more purposeful approach is required, therefore, to combat climate-related tail risks with greater urgency.

Systemic Funds Already Exist... Or Do They?

According to a Global Impact Investing Network (GIIN) survey from June 2023,⁶⁴ there do exist impact investors targeting below-market rates, and in doing so, they *may* already qualify as systemic investors. Taking the GIIN survey at its word, it would follow that systemic products exist, even if this practice is yet to significantly penetrate the asset-heavy end of the market. Although a small sample size, the survey suggests only 10% of institutional investors adopt below-market return expectations for their impact investments. Actively participating GIIN members are also likely to hold disproportionately positive views on impact’s ability to satisfy fiduciary duty, meaning this figure would speculatively be lower were a wider audience surveyed.

Figure 11: Target Financial Returns of Impact Investments by Organisation Type



Source: *Global Impact Investing Network*.

What is more, prospectuses are rarely, if ever, explicit about concessionary return expectations. Alpha as an objective clearly signals that above-market returns are expected, but objectives are

⁶⁴ EDHEC. *How Does Climate Risk Affect Global Equity Valuations? A Novel Approach*. July 2024.

often fuzzier. For example, where an impact fund’s financial objective is to generate “a return on your investment”,⁶⁵ it becomes difficult to discern, even after reading process descriptions, whether this might imply lower risk-adjusted short-term financial expectations. This vagueness may be a result of managers trading carefully around legal fiduciary duty pitfalls (see next section). Tellingly though, where the financial objectives *are* ambiguous, they normally mirror those of “non-impact” counterparts offered by the same manager. This suggests that in the vast majority of cases, return expectations of impact funds do not materially differ from those of standard investment vehicles.

Figure 12: Spot the Difference? Impact vs. Non-impact Fund Objectives

Impact product	Non-impact product
<p>Pictet - Global Environmental Opportunities</p> <p>OBJECTIVES AND INVESTMENT POLICY</p> <p>Objective To increase the value of your investment while seeking to achieve a positive environmental and/or social impact.</p> <p>Reference Index MSCI AC World (EUR), an index that does not take into account environmental, social and governance (ESG) factors. Used for risk monitoring, performance objective and performance measurement.</p>	<p>Pictet - Emerging Markets</p> <p>OBJECTIVES AND INVESTMENT POLICY</p> <p>Objective To increase the value of your investment.</p> <p>Reference Index MSCI EM (USD), an index that does not take into account environmental, social and governance (ESG) factors. Used for portfolio composition, risk monitoring, performance objective and performance measurement.</p>

Source: [Pictet Asset Management](#).

Fiduciary Duty and Systemic Investing

That the likes of pension funds and insurance companies have thus far been slow to adopt below-market-rate returns as part of impact strategies is not entirely surprising. These investors operate within the constraints of legally binding fiduciary duty, meaning they are obliged to prioritise risk-adjusted returns on behalf of their beneficiaries. The question they’ve been mulling is whether prioritising social and environmental outcomes would contravene this core tenet of their role. Even if there is a clear consensus that averting climate change will significantly improve long-term economic prospects, there is no data to unequivocally quantify this. Trust must be placed in complex integrated assessment models which are subjective by nature and open to debate and challenge. With ambiguity, should such considerations be integrated into investments if there is the chance they could reduce the investment opportunity set or cause short-term financial pain? Would pension funds open themselves up to litigation by doing so? In an open letter to the UK parliament’s work and pensions committee, UK-based pensions and financial services consultant LCP spelled out historical apprehension on the part of pension funds owing to this ongoing uncertainty.⁶⁶

Indeed, such uncertainty might have been a barrier to systemic investing, which quite pointedly starts from a position of concessionary short- to medium-term returns. Increasingly, however, legal discourse clarifying the relationship between fiduciary duty and sustainable investing is tipping the

⁶⁵ BlackRock. [BGF Climate Action Equity Fund](#). August 2024.

⁶⁶ LPC. [Fiduciary duty and climate change: Input to the Work and Pensions Committee’s evidence session on 21 February 2024](#). 9 February 2024.

scales. The Freshfield report “A legal framework for impact” started the ball rolling in 2021. It found that across all jurisdictions surveyed “an asset owner would, if one or more sustainability factors posed a material risk to meeting its investment objective over the timeframe that is relevant to it, be legally obliged to consider what steps it can take to mitigate the risk”.⁶⁷ In February 2024, the Financial Markets Law Committee (FMLC) independently endorsed Freshfield’s view of instrumental investing for sustainable impact. The FMLC clarified that so long as due process is followed and climate change is considered through a financial lens, there is no reason environmental considerations would not be taken in the context of an asset owner’s portfolio “as a whole”.⁶⁸

The FMLC’s recent intervention has solidified stakeholder positions and cemented the acceptance of sustainability as a fiduciary necessity, at least in the UK (and perhaps to an extent in Europe, where legal and regulatory requirements of fiduciaries remain for the most part aligned). IEEFA would, however, further support calls for such sentiment to be made explicit through amendments to legal definitions of fiduciary duty. These recent clarifications imply that if a fiduciary expects environmental or social outcomes to negatively impact financial goals, not only is it its duty to seek solutions but that, crucially, committing a portion of assets to below-market-return investments to achieve these solutions is permissible. Assuming a balance is struck at the universal owner level and due process is followed, there is no reason that short-term concessionary return products such as systemic funds could not form part of a broader strategy. Whether legal counsel outside Europe will ultimately come to the same conclusion is another matter. The U.S. will be of particular interest given its outsized importance to equity ownership, often fragmented regulatory environment and the politicisation of ESG—divergence might be expected.

How to Build Systemic Products—Two Initial Approaches

Following robust debate at IEEFA Europe’s Sustainable Finance Day at London Climate Action Week 2024, the case for two potentially complementary approaches to building active systemic funds has emerged: one more traditional approach, targeting decarbonisation through aggressive impact investments, and another that seeks decarbonisation through unconstrained, forceful engagement of emissions laggards. Details of these approaches are outlined below.

“The Gosling Fund”: A Contrarian Insurance Policy

In his recent paper, subsequent discourse and debate at IEEFA’s London Climate Action Week event, Tom Gosling^{69,70} posits that there is a case to be had for asset owners to make small allocations that protect against potentially catastrophic tail risks, at the cost of lower near-term return expectations. He suggests that allocations of up to 5% of total assets under management might be a reasonable level of investment in such products. Even 5% of assets, if widely adopted by asset

⁶⁷ Freshfield Bruckhaus Deringer. [A legal framework for impact](#). July 2021.

⁶⁸ Financial Markets Law Committee. [Pension Fund Trustees and Fiduciary Duties - Decision-making in the context of Sustainability and the subject of Climate Change](#). 6 February 2024.

⁶⁹ Tom Gosling. [Universal Owners and Climate Change](#). 2 February 2024.

⁷⁰ Tom Gosling. [A fiduciary argument for impact investing?](#) 14 June 2024.

owners, would represent roughly a US\$5 trillion market. Gosling himself describes the thinking as early-stage, but IEEFA strongly agrees that universal owners must consider investing in systemically minded funds as a risk reduction strategy.

Gosling proposes that such products should be constructed by carefully selecting investments with certain characteristics (edited and abridged below):⁷¹

- Investments should have the prospect of delivering an acceptable return to limit aggregate underperformance and the potential loss resulting from such allocations. This would presumably therefore mean such products use “benchmark -X%” as a minimum performance objective or an absolute return objective denoted as concessionary.
- Investments should focus on the biggest and most scalable problems such that the potential marginal climate benefit is maximised for the marginal impact investment. Gosling concludes that investment might therefore be concentrated where breakthroughs are required to create scalable technologies and where the potential climate gains are great.
- Impact investments should provide a hedge to other parts of the portfolio, in particular climate scenarios. For example, an asset owner remaining invested in oil and gas companies faces downside risk in scenarios where the policy transition is much more rapid than expected, yet these are the exact conditions where investments in innovative solutions to high-carbon industrial processes become viable, and impact investments might deliver the highest returns.

The concept is attractive because it removes the free-rider problem. The characterisation that such investments provide a hedge is important because it positions systemically focused investments as contrarian (or at the very least, uncorrelated), which ultimately offers an opportunity for diversification. By accepting lower expected short-term returns as a base case, an asset owner can expect to receive considerable payoffs if, for example, technological breakthroughs are made, policymakers shift more quickly than expected towards aggressive decarbonisation or carbon markets rapidly grow. At the very least, investments in decarbonisation present a long-term structural growth story. One added benefit to this approach is that by channelling capital into these areas, the likelihood of achieving such breakthroughs is increased.

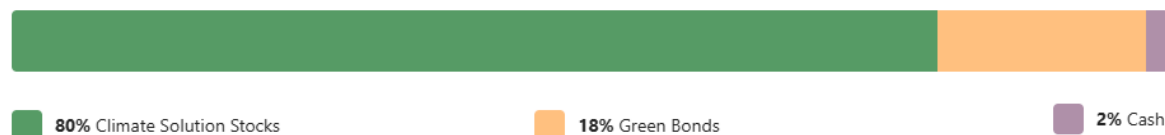
Without seeking to fully critique a fledgling concept, IEEFA has preliminary recommendations to expand the potential opportunity set. The type of investments suggested are often the not-separately-investable parts of larger carbon-intensive businesses (such as Exxon’s Low Carbon Business Solutions unit) or private assets. This means that the opportunity set is likely to be relatively small and/or illiquid, which might ultimately lead to capacity issues. Although not an immediate issue, should a significant proportion of asset owners allocate 5% of assets in such a manner, concerns may become more apparent. Perhaps exacerbating this issue, IEEFA would also suggest that for investments to be most systemically beneficial, they should be selected carefully and avoid “solutions” that ultimately delay the phase-out of fossil fuels. IEEFA has, for example, been a longstanding critic of carbon capture and storage, owing to its demonstrable track record of failure

⁷¹ Ibid.

and propensity to distract attention and capital away from cheaper, proven decarbonisation technologies. Prioritising technological breakthroughs in areas such as energy storage, manufacturing processes, power generation efficiency and electrification of industrial processes remain critical. But IEEFA would argue that systemic funds of this nature might adopt a mix of acceptable return green bonds as well as assets that aim to drive technological breakthroughs. Expanding selection criteria in this way might alleviate capacity constraints and provide minimum baseline returns for investors, while still providing some of the contrarian upside. Products of this nature would potentially allow for green bond yields at very attractive rates to issuers, strongly encouraging market participants to decarbonise.

Investment vehicles that follow something along the lines of this model are young but available. Carbon Collective's Climate Only portfolio, for example, appears to loosely match these suggestions. To be accurate, the fledgling exchange-traded fund (ETF) does not invest in private assets, nor does it claim to make short- to medium-term performance concessions. It does, however, invest in a diverse pool of publicly traded companies offering climate solutions rather than cherry-picking the most profitable. The strategy also fills the portfolio with green bonds, providing a base level of return alongside potential contrarian upside.

Figure 13: Carbon Collective's Climate Only ETF Asset Allocation



Source: [Carbon Collective](#).

“The O’Brien Fund”: Intensive, Unencumbered Engagement

Australasian Centre for Corporate Responsibility executive director Brynn O’Brien offers an alternative approach to systemic funds, based on the influential advocacy group’s existing engagement model. Rather than investing in potential enablers of decarbonisation, her strategy negatively screens for companies that are expected to contribute significantly to systemic carbon emissions. Rather than excluding these assets to protect from idiosyncratic transition risk, an O’Brien fund would purposefully invest, with the intention of decarbonising their operations and supply chains through intensive engagement as an asset owner. Long-term performance objectives (10 or more years) may still be required to prevent free-rider issues from holding back some investors, but a strategy unencumbered by short-term performance objectives would have a far stronger mandate to press for rapid decarbonisation. In terms of the characteristics of potential investment targets, these would likely be publicly listed companies with large carbon emission profiles, have the propensity to decarbonise and be judged as receptive to engagement.

The advent of split voting in most jurisdictions opens the door for asset managers to create O'Brien funds and to engage more forcefully on behalf of smaller portions of their investment base. But for this approach to achieve results, a significant position in major carbon polluters would likely need to be built. Size in this instance *probably* matters—the systemic fund needs to be a significant owner holding a sizeable share of voting rights. O'Brien argues that being a significant institutional owner provides a platform for the fund not only to persuade company management to enact its decarbonisation proposals but also gives gravitas to discussions with other, less systemically minded investors. Such decarbonisation proposals would certainly position a company favourably over the long term but may be immediately less beneficial to tactical, short-term owners. This means that PGIM's win-win decarbonisation scenarios must still be skilfully and carefully crafted.

Lending itself to investment in large-cap companies on strong financial footing, an O'Brien fund is unlikely to suffer from some of the liquidity issues that may befall a Gosling fund. Quite the opposite perhaps, some will argue that transformational change at companies will remain difficult until systemic fund ownership reaches a critical level, the point at which it becomes difficult for company management to simply ignore. Sceptics might also point to the fact that some investors do already push for systemic goals without success and question whether it is possible to build sufficient positions in industry heavyweights like Exxon, for example, where even the 10th-largest investor might require an investment of at least US\$5 billion. By way of consolation, IEEFA might reiterate that some studies suggest changes in corporate performance tend to be driven by a small number of leaders, often without significant ownership stakes.⁷² Regardless, an investor will clearly engage more forcefully if its mandate is based on decarbonisation, as opposed to maximising short-term capital returns. Even if question marks might remain as to the way, at least the will is there for corporate engagement to succeed.

Another consideration for such an approach is where the off-ramp is set. Assuming an unencumbered engagement approach is successful, should the fund immediately divest in order to select and decarbonise another target? To do so might be sensible in terms of its primary goal of decarbonisation but may be to the detriment of long-term value accumulation. Much will depend on how markets react to successful decarbonisation outcomes, but the competitive benefits of achieving decarbonisation may not be immediately apparent in a company's financials. This means that to sell may be to give up long-term return potential. Such a fund might ultimately have to accept quite significantly discounted financial goals, if it is to truly leverage its assets for maximum systemic benefit. To do so will genuinely test legal definitions of fiduciary duty across jurisdictions, but proponents can be emboldened by recent legal discourse, including the FMLC's recent entry on fiduciary duty in the context of climate change.⁷³

⁷² Ceccarelli et al. [Which institutional investors drive corporate sustainability?](#) January 2022.

⁷³ Financial Markets Law Committee. [Pension Fund Trustees and Fiduciary Duties - Decision-making in the context of Sustainability and the subject of Climate Change](#). 6 February 2024.

A Combined Approach

Given the potential strengths and weaknesses of the two approaches, perhaps the most practical route to creating a systemic vehicle might be to combine the two. Not only might an O'Brien sleeve help overcome liquidity issues faced by its counterpart, but a Gosling fund could ease some of the free-rider concerns that might hold investors back from an engagement-only approach. Combining the two would certainly allow for competing theories of change to find representation in product offerings, leading to a more diverse opportunity set for asset owners.

A Product-Based Approach That Can Co-exist With More Holistic Strategies

Given a dearth of investment opportunities that genuinely seek to maximise systemic risk reduction, IEEFA proposes that asset owners now urgently need access to investment products that definitively place systemic targets such as decarbonisation metrics *ahead* of idiosyncratic short-term financial returns. However, the act of committing small allocations to systemically oriented products (a product-based approach) may not be preferred by all. It would arguably be better for universal owners to take a strong house view on systemic risk and apply that view systematically across their entire investment portfolio, instead of allocating a small proportion to products designed for that purpose. This is an equally valid approach, but IEEFA would argue that pragmatism may be required to redress the intrinsic de-prioritisation of systemic risk.

The importance of a complementary, product-based approach is perhaps best illustrated by the reality of market forces. Asset managers have shown that they prefer not to apply more forceful stewardship holistically, for fear of alienating sections of a potential client base. The weaponisation of antitrust has shown just how quickly asset managers are willing to walk away from taking stronger positions when business risk grows. This means that through their engagements, managers tend towards a holistic, baby-steps approach, rather than more aggressively pushing for decarbonisation—something that might actually be in most clients' (and their own) best long-term interests. Because most investment managers adopt this cautious business-oriented approach, market ordering (asset owners placing money with managers based on their stewardship practices) is probably wishful thinking. A product-based approach, on the other hand, would set managers free, allowing them to allocate and engage as they like on behalf of clients that have decided to be invested in such products. Facilitated by the growth of split voting,⁷⁴ systemic funds would allow for a degree of market ordering behind products. This would provide managers the mandate to steward in line with the goals of the fund, without taking on significant additional business risk.

⁷⁴ In this instance, "split voting" refers to managers being able to split their vote based on the objectives of individual strategies, rather than necessarily "passing through" that right to beneficial owners.

Assuming a product-based approach is not treated as an opportunity for universal owners to wash hands of good practice elsewhere, IEEFA sees no reason that a product-level strategy for reducing systemic risk cannot co-exist and even complement more holistic, firm-level approaches.

About IEEFA

The Institute for Energy Economics and Financial Analysis (IEEFA) examines issues related to energy markets, trends and policies. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy. www.ieefa.org

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