



1.5 DEGREE TRANSITION CHALLENGE

Engagement update



Executive summary

In early 2020, Liontrust's Sustainable Investment team committed to our One and a Half Degree Transition Challenge. This has involved engaging with companies held across the Sustainable Future funds and challenging them to raise their ambitions to reduce absolute carbon emissions – and the following pages reveal our findings so far.

To keep the global average temperature rise below 1.5 degrees, the science is telling us that unprecedented decarbonisation is needed, halving emissions by 2030 and continuing at this pace to 2040 and 2050. This is a huge challenge and will require major changes across the economy.

From an investment perspective, the challenge of rapidly reducing emissions will drive innovation, which will accelerate the uptake of

ultra-low products and services. There is a competitive advantage to be gained by proactively managed businesses that will be rewarded economically in an increasingly carbon-constrained world.

To summarise our findings, around a quarter of the companies with which we engaged have absolute decarbonisation targets in place consistent with 1.5 degrees (others aligned with the Paris Agreement take this to a third), which obviously means, at present, two thirds do not. The situation is moving rapidly, however, and very few companies do not see this as a major focus for the years ahead.

Our engagement also revealed important issues across areas such as emissions disclosure, business risks and offsetting, and we will continue to engage with our companies on decarbonisation and monitor progress on these vital goals.



Over the last 30 years, we have seen significant progress in reducing the amount of Greenhouse gas emissions (GHG) for every unit of growth in the global economy, with the greatest progress in China where emissions per unit of GDP have more than halved.

For all the positive work in reducing GHG intensity, however, the concentration of carbon dioxide in our atmosphere has increased by more than 50% since 1760, with the decline in intensity dwarfed by how much the global economy continues to grow. The world has to understand that what really matters is total emissions; it is only by reducing these that we can stabilise the concentration of GHG in the atmosphere. This is what is driving increased temperatures and causing the rapid pace of climate change.

A goal to limit global average temperature rises, compared to industrial levels, to less than 2 degrees centigrade, and ideally less than 1.5, was internationally approved in the Paris Agreement, adopted at COP21 in Paris in December 2015 and implemented a year later. But the seminal Intergovernmental Panel on Climate Change (IPCC) report, published in October 2018, still shocked many with its stark conclusion: to meet that 1.5 degree target and stand any chance of keeping climate change manageable, we need to halve absolute emissions by 2030, and ideally sooner.

Work done by Carbon Tracker the same year estimated that even assuming all the global commitments on climate change are met, we should still expect to see global average temperatures rising

to around 3-4 degrees above pre-industrial levels. Meanwhile, the IPCC's latest report from earlier this year reiterated its earlier findings, reporting that the evidence of observed changes in extreme weather events (such as heatwaves, heavy precipitation, droughts and tropical cyclones) and the cause being linked to human activity has strengthened..

The sooner we cut emissions, the less negative impacts and costs there will be in trying to adapt to climate change; in short, this is an emergency.

Against this background, the Liontrust Sustainable Investment team launched our One and a half degree Transition Challenge in early 2020. In meetings with our Advisory Committee, we had discussed how the pace of change by companies in reducing carbon emissions was falling well short of the level demanded by science. Our challenge had its roots in the simple observation that small incremental annual decarbonisation targets of 1%-2% would take many decades – 50 and 25 years respectively – to halve emissions, when the science is telling us this needs to be achieved in less than 10.

The importance of this is not based on altruism alone. As investors, we believe companies with credible and ambitious strategies to decarbonise aggressively will gain a competitive advantage over their more reactive peers and will be more successful in a carbon constrained economy where demand for their lower carbon products and services will be strong.



Without major intervention, we should still expect to see global average temperatures rising to around 3-4 degrees above pre-industrial levels

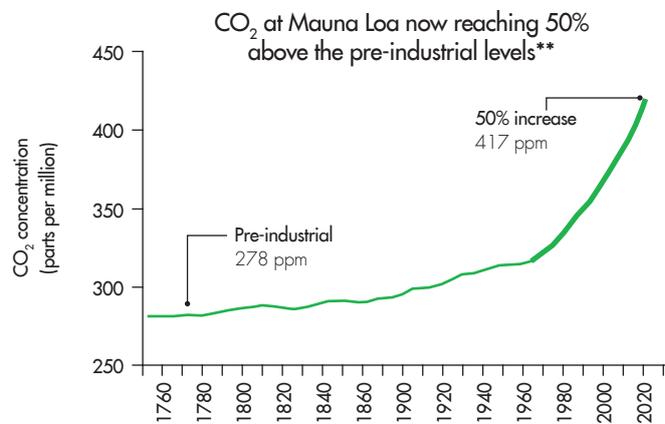
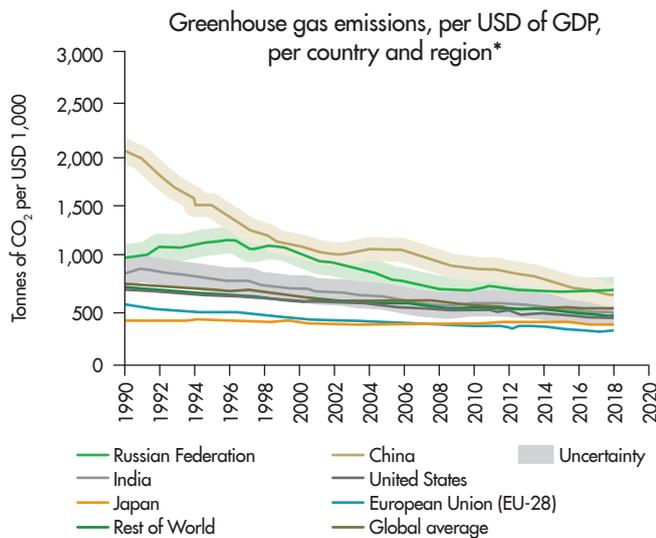


The pace of change by companies in reducing carbon emissions is falling well short of the level demanded by science



Decarbonisation targets of 1%-2% would take many decades to halve emissions, when the science is telling us this needs to be achieved in less than 10

Falling GHG intensity versus rapidly rising emissions and climate change



Source: *World Bank, IMF. Emissions do not include those from international transports or land-use change. **Ice core data from MacFarling Meure et al (2006), Mauna Loa data from the Scripps CO2 program, 2021 forecast from Met Office.

What, specifically, are we asking companies to do?

- Be more ambitious in emission reduction targets to make their pace of decarbonisation consistent with what science is telling us, requiring a halving this decade.
- Show front-loaded timely targets for this: for example, a 50% reduction in direct emissions by 2030 based on a suitable baseline and a 25% decrease by 2025.
- Understand the largest sources of indirect (Scope 3) emissions for their business and investigate what opportunities exist to reduce these aggressively.
- Something we are not asking is for companies to automatically divest from the more carbon-intensive parts of their business, especially if this is enabling people to reduce emissions by using their products. Instead, we want them to innovate and come up with creative ways to operate in step with an ultra-low carbon economy.

We initially planned to engage with all the companies held across the Sustainable Future funds but have not achieved this so far. This is largely due to Covid-19, as we suspended all engagement initiatives for two quarters in 2020 to concentrate on the impacts of the pandemic on the businesses held in our funds and their staff.



So far, we have contacted



71
companies

and met with



57
of these for detailed discussions
about decarbonisation targets

While this is

40%

by number (with 190 holdings across the funds), we have prioritised those responsible for the highest levels of direct emissions in our portfolios.

We found just



33
companies
(17% by number)

contributed



90%

of emissions
from the Funds

Of these,

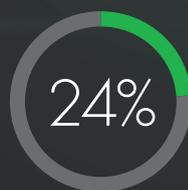


63%

are involved in the Science-Based Target Initiative (SBTi)

which is proving a helpful resource in setting decarbonisation strategies

with



24%
committed to
1.5 degrees
by 2030

and a further



9%
to 2 degrees. This means a third overall are Paris aligned to less than 2 degrees and have some manner of target in place to reduce absolute emissions.

For a significant proportion of companies, we appear to be pushing on an open door but have to acknowledge our engagement has focused on a proactive sub-set of the economy where businesses are typically better than the market average on carbon abatement. In contrast, there remain a small number of hard-to-abate industries –

primarily heavy industries such as the steel, cement, and aluminium sectors that employ extremely high-temperature processes – which have not yet been able to come up with absolute reduction targets in line with the science.

Key findings

- **Around a quarter of the companies with which we have engaged have absolute decarbonisation targets consistent with one and a half degrees and a further 9% have committed to 2 degrees, which means a third are aligned with the Paris Agreement.** The remaining two-thirds do not, at present, have absolute reduction targets in line with 1.5 degrees. This is moving quickly, however, with many demonstrating positive momentum on decarbonisation. Very few companies we spoke to do not see this as relevant to their business.
- **Disclosure is inconsistent.** It has been challenging to analyse exactly what targets are in place on a company-by-company basis beyond a simple 'net zero' by a suitably distant date in the future when most decision-makers in the business will have long retired. A further hurdle has been to identify and meet appropriate people for discussions on strategy to decarbonise and the opportunities and challenges presented by this. Communication on climate change, especially decarbonisation targets, can be tough to decipher. Initially, there appeared to be a competition between the more proactive companies about how soon they would become carbon neutral. Aiming to achieve this by 2050, 2040 or even 2035 appeared to be a way of showing leadership, which it does, albeit only partially. These statements on their own tell us little; how companies plan to achieve carbon neutral is key.



- **Risks of higher-carbon products being displaced by lower-carbon alternatives are rising.** Where there are lower-carbon alternatives to a particular product or service, the potential for disruption and replacement is high and the risks to that investment could be material. We draw a contrast between companies like **Welsh Water or Waste Connections**, with significant emissions from performing their critical role treating water and waste, and those selling fossil fuels, which is increasingly substitutable by a lower-carbon alternative (as petrol and diesel are displaced by electric vehicles). We see the risk as lower for the former and are therefore invested in some of those businesses but none of the latter.



- **Fast-growing companies face a challenge.** The biggest challenge in achieving absolute emission reductions is in fast-growing companies, where carbon intensity targets have to be significantly higher than how much the business is growing for there to be any fall in absolute emissions. For example, if a business is growing 5% a year and the target to reduce carbon intensity (per unit of sales) is 2%, absolute emissions are still rising by 3% annually. **Helios Towers**, for example, is a business rolling out mobile communication towers, especially in underserved emerging markets. This is very positive and can help deliver lower-carbon services to these customers. While the growth rate of the business is expected to be high, there are ways to increase resource efficiency by having more than one mobile carrier using its network infrastructure, which can reduce emissions by around 40%. There are opportunities to use renewables to power some of these towers but this is not possible for all of Helios's assets all of the time. The company remains proactive in trying to solve this challenge.
- **Third-party models are inconsistent.** Measuring which global average temperature rise a portfolio is aligned to using different third-party models gives a broad range of results due to the different methodologies and assumptions. Many, in our view, do not give enough credit for the products and services needed to reduce emissions and simply look at the rate of decarbonisation within a company over the next decade. We interpret the results of these models with caution and do not currently disclose a single number for temperature alignment for our portfolios.
- **Offsets are not currently part of the solution.** We want companies to concentrate on reducing absolute emissions before offsetting emissions at any large scale. Offsetting can be a distraction and there are not enough legitimate carbon offsets available at present. Some notable exceptions are businesses within the EU Emissions Trading Scheme, which have to comply with carbon emission limits, or where there are few viable alternatives and the level of emissions is relatively small (such as indirect emissions from business travel flights).

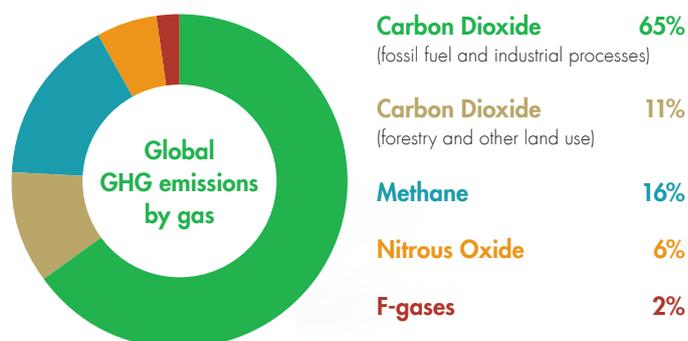
Direct and indirect emissions – Scope 1, 2 and 3

At present, we are concentrating on direct emissions from companies, so-called Scope 1 and Scope 2. These are linked to either assets the company owns or the energy it purchases, both of which it has most control over. This is clearly not the whole picture, however, and businesses also need to understand their indirect emissions (Scope 3). While this tends to be more challenging, most of the companies we have spoken to are aware of their largest indirect emissions and many have plans to reduce these.

While we are increasingly being asked about indirect emissions, it should be recognised that these are all effectively some other party's direct (Scope 1+2) emissions and the relevance is dependent on the industry as well as company specific.

Where a business consumes large quantities of materials, for example, it should be trying to source as much of those in recycled rather than virgin form. In designing products, companies should also be thinking about end-of-life and how to facilitate easy dismantling and reuse. For other

businesses, the most relevant indirect emissions might be from the energy their products consume in use and, for these, innovation and more efficient or alternative fuelled products are the best place to concentrate efforts to provide as low-carbon alternatives as economically possible.



Source: IPCC, 2014

Direct emissions		Indirect emissions
Scope 1	Scope 2	Scope 3
Measures carbon dioxide equivalents (not just CO ₂ , but also other Greenhouse gases) emitted by assets a company owns.	Measures carbon dioxide equivalents (again, including other GHG) emitted from the energy sources the business uses (purchased electricity, natural gas or other).	Measures carbon dioxide equivalents emitted indirectly as a result of this business (these are Scope 1 or 2 emissions from another party). There are 15 categories, as follows.
		Upstream Purchased good and services Capital goods Fuel and energy related activities (not included in Scope 1+2) Upstream transportation and distribution Upstream leased assets
		Business Waste generated from operations Business travel Employee commuting
		Downstream Downstream transportation and distribution Processing of sold products Use of sold products End of life treatment of sold products Downstream leased assets
		Other Franchises Investments

Source: Liontrust/GHG Protocol

We cannot get away from the fact that all actors in the economy, government, companies and individuals, need to halve their direct emissions and must not stand back waiting for others to take the lead.

It will be some time before we can understand whether indirect positive impacts (saving emissions from the products a company

sells for example) can offset Scope 1+2 and we are therefore encouraging businesses to concentrate on direct emissions first. In time, we will better understand where a company should direct its decarbonisation efforts in terms of indirect emissions, with each part of our economy different.

Next steps and what we want to see

Responding in a timely manner to the climate crisis is important but we have to bear in mind climate change also has a large social dimension. Our urgent response to climate change needs to go hand in hand with the social dimension (referred to as the Just Transition). We must remember not to solve only for the best climate change outcome but to ensure we also use this as an opportunity to reduce inequality, help alleviate fuel poverty and not lose sight of people. If people do not willingly move with the energy transition, it will fail.

This engagement for the One and a half degree Transition Challenge has been about waking companies up to the pace of change required and challenging them to set ambitious absolute decarbonisation targets that are front loaded and consistent with the science. What we need to see from here is these targets being reflected in falling emissions. To reiterate, these need to decline across the whole economy by around half every decade, equating to 5–7% every year and ideally even higher.

Arguably, asking companies to set an ambitious target to decarbonise is the easy bit. This needs to result in actual meaningful emission reductions and we will be monitoring companies' progress against targets. We believe companies that will be most successful in an ultra-low carbon economy are those that are proactive and use this as an opportunity to provide the economy with what it needs.

We will carry on engaging with the companies we own, and will report further progress in our 2021 Sustainable Future Annual review.

We called this initiative a challenge for a reason – it will not be easy to reduce emissions sufficiently within the remaining timeframe to avert the worst impacts of runaway climate change. But as proactive investors managing sustainable funds, we want to play our part by continuing to encourage a more rapid response to achieve this vital goal.

Key risks

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