

Portfolio alignment metrics

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It is clear that the corporate and financial worlds are pivoting towards the lower carbon future that is essential to reduce the worst effects of climate change. But how can we measure progress? While there is a good understanding of the concept of greenhouse gas (GHG) emissions¹, portfolio alignment is a newer concept for many. In this document we explain what portfolio alignment metrics are, their importance in the transition to net zero² emissions, and their relevance to asset owners. For example, the Department for Work and Pensions will require UK pension schemes falling under the TCFD reporting requirements to use a portfolio alignment metric from 1 October 2022³.

What are portfolio alignment metrics?

Portfolio alignment metrics measure how aligned a portfolio is with a transition to a world targeting a particular climate outcome, such as limiting temperature rises to well below 2°C, preferably to 1.5°C, as per the Paris Agreement. Assessments using these metrics consider companies' and governments' greenhouse gas (GHG) emissions reduction plans and likelihood of meeting them, rather than current, or the latest reported, GHG emissions.

The IPCC (Intergovernmental Panel on Climate Change) has estimated that achieving global net zero by 2050⁴ is what is needed to limit temperature rises to 1.5°C.

There are three broad types of alignment metric, which are assessed at an individual issuer level and can then be aggregated across an entire portfolio.

Binary targets: Percentage of a portfolio that has declared net zero-aligned or Paris Agreement-aligned targets (or is already net zero-aligned or Paris Agreement-aligned)

Benchmark divergence⁵: Comparison of projected emissions of a portfolio against those of an emissions projection benchmark under a particular climate scenario

Implied temperature rise (ITR): Translation of an assessment of benchmark divergence into a °C temperature score

¹ Greenhouse gas (GHG) emissions usually refers to emissions from seven gases that cause global warming by trapping heat in the planet's atmosphere. Emissions data is usually expressed as CO₂ equivalent emissions. ² Net zero refers to a situation in which total GHG emissions released into the atmosphere are equal to those removed. ³ [Climate and investment reporting: setting expectations and empowering savers - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/news/mandatory-climate-reporting-for-pension-schemes) ⁴ The net zero by 2050 requirement relates to CO₂ emissions caused by human activities only (ie anthropogenic CO₂ emissions). ⁵ Also known as "benchmark performance".

An illustration of the three types of portfolio alignment metric

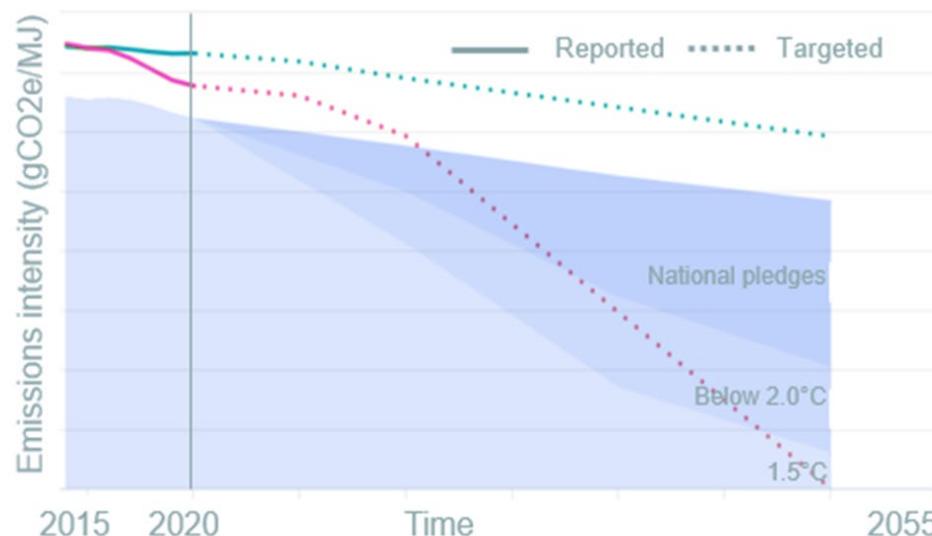
The **chart to the right** shows the reported emissions intensity to 2020 of two anonymised companies in the oil and gas sector (**solid lines**) and the projected emissions intensity beyond 2020 if the companies meet their emissions reduction targets (**dotted lines**). The **blue shading** shows the emissions intensity of the oil and gas sector under the Transition Pathway Initiative's three benchmark scenarios.

In 2020, the blue company has only slightly higher emissions intensity than the pink company, but they are projected to diverge significantly from 2030 onwards.

The **box below the chart** compares the two companies using examples of the three types of portfolio alignment metric:

- The pink company has a net zero **target**, but the blue company does not.
- The pink company's projected emissions intensity is below the 1.5°C pathway in 2050, so it is considered aligned with the 1.5°C **benchmark** scenario, whereas the blue company's projected emissions intensity is higher than all three pathways in 2050 so it is classified as not aligned.
- The implied **temperature** rise for the pink company is much lower than that for the blue company.

Emissions and portfolio alignment metrics for two oil and gas companies⁶



Binary target	Benchmark divergence	ITR
✓	1.5°C	1.2°C
×	Not aligned	3.3°C

⁶ Chart from [Oil & Gas - Transition Pathway Initiative](#). The table has been added by LCP, using illustrative binary target and ITR information.

Advantages of alignment metrics over emissions metrics

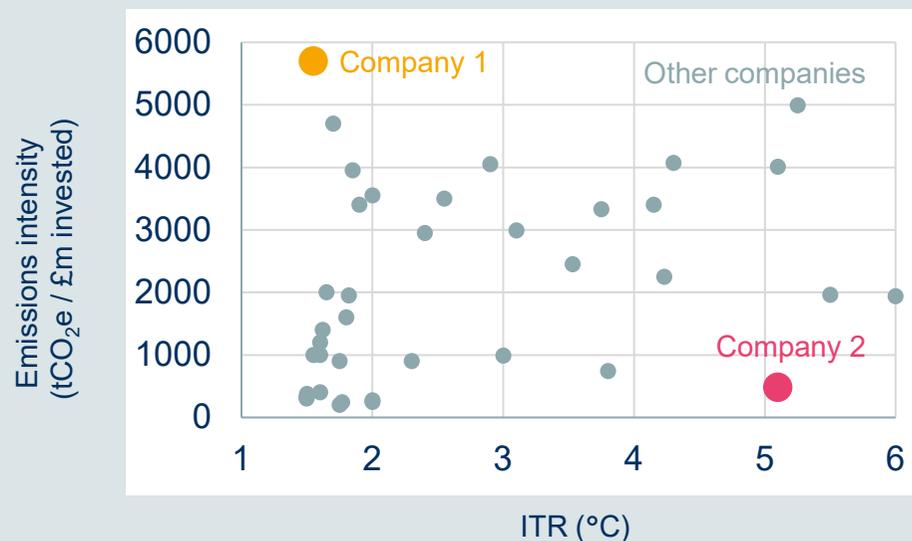
Alignment metrics are **forward-looking measures** that take into account a company's future plans for reducing its emissions. This contrasts with reported emissions metrics which are based on past emissions. Considering alignment metrics can provide a **clearer picture of a portfolio's climate risk**.

Commonly used emissions metrics include **total greenhouse gas emissions, carbon footprint** (normalising total emissions based on company value) and **weighted average carbon intensity** or WACI (normalising total emissions based on revenue). These can be easily manipulated or "carbon washed" at a portfolio level, eg by selling high emitters with no real world impact, or potentially even a negative real world impact as the holding may be sold to investors that do not use their influence to encourage better climate change practices.

The benefits of alignment metrics are that they:

- Are **easier to interpret** with a closer link to future real world impact, which is also useful for managers' engagement with companies;
- May be **easier to compare and to aggregate** across a portfolio of different asset classes if measured consistently; and
- Are likely to be **less volatile** than emissions-based metrics, where a small number of emitters and an overweight allocation to high emitting sectors can skew the outcome.

Example illustrating the benefits of alignment metrics



Using emissions data alone, a **high-emitting company with an excellent strategic transition plan** would look less favourable than a **low emitter that is not considering climate change in its strategy**.

Alignment and pathways to net zero

To help investors assess alignment, there are a number of independent organisations providing freely-available science-based alignment output, which incorporates the latest climate science and thinking about sector-level pathways to net zero, for example:

- [Science-Based Targets initiative \(SBTi\)](#)
- [Transition Pathway Initiative](#)
- [Climate Action 100+](#)

Implementing portfolio alignment metrics: now and in the future

More development is needed

- Binary target approaches are the simplest and most robust type of alignment metric. However, **as time goes on** and more companies have net zero- or Paris-aligned targets, **it will become increasingly important to measure progress against targets**. Clearly, a company simply stating a target, without sufficient plans to meet it or poor execution of its plans, is not likely to achieve the real world impact required.
- Benchmark divergence and ITR metrics measure this progress, but are at a relatively early stage of development. They are complex to calculate and heavily dependent on the methodology and assumptions used – for example there are nine key methodological judgements to calculate an ITR⁷. Therefore **metrics calculated by different providers** are typically not comparable at the moment and so **should not be aggregated**.
- Benchmark divergence and ITR metrics are expected to become more robust as methodologies improve and an industry consensus approach emerges. Binary targets may also evolve to encompass an assessment of whether a company is on track to meet its target.

LCP's Climate Dashboard

Our Climate Dashboard helps you understand your portfolios' climate exposures. It shows various climate-related metrics, including a portfolio alignment metric. You can use it to compare your portfolios' climate exposures against peers or benchmarks, or review the progression over time. This could be done as part of manager selection exercises or as part of ongoing manager monitoring.



LCP's view

Our current preferred portfolio alignment metric for investor monitoring purposes is the **weight of companies in a portfolio with science-based emission reduction targets**, a binary target.

- **Science-based targets (SBTs)** provide a clearly-defined pathway to reduce emissions, aiming to prevent the worst impacts of climate change.
- There are various organisations that can help companies set SBTs by providing technical assistance and expert resources, assessing and verifying them, for example **SBTi** (a partnership of non-profit organisations).
- We encourage investors to **collect and monitor this data** for their investments.

ITR metrics at a company level may be a useful input to managers' investment processes, but should be used alongside their expert judgement and detailed knowledge of the companies, given the uncertainties and limitations of this approach.

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